An Analysis of the New Budget Law of Mongolia of 2011

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Summary

The government of Mongolia developed and passed a new Budget Law on 23 December 2011 in order to improve the legal framework for budgeting, budget relations and fiscal management by integrating the Budget Law of 2002 and Public Sector Management and Finance Law.

The purpose of new Budget Law is to ensure fiscal stability, enhance the efficiency and predictability of resource allocation, and to increase citizens' participation in the budgeting process. The new Budget Law in its 11 chapters and 66 articles redefines the budgeting principles, scope, composition, classification of the budget, clarifies expenditure and revenue assignment, improves authorities and responsibilities of the bodies that participate in the budgeting process, and improves regulations on budget transparency and accountability.

The key new regulations introduced by the Budget Law concern the following areas:

- Public investment budgeting;
- Government debt management;
- Program budgeting;
- Public private partnership;
- Formula based transfer allocation; and
- Citizens' participation in budgeting.

The most important change introduced by new Budget Law is a reform of the intergovernmental fiscal relations system towards greater decentralization. The law clarifies expenditure assignments by clearly defining delegated functions and differentiating the functions among sub-national governments. It also introduces a formula based transfer allocation that will allow predictability and sustainability in the local budgeting process.

Contents

List of Abbreviations

BL	Budget Law
CIT	Corporate Income Tax
FY	Fiscal Year
GLDF	General Local Development Fund
LDF	Local Development Fund
MFF	Medium Term Fiscal Framework Statement
MoF	Ministry of Finance
NDIC	National Development and Innovation Committee
PIP	Public Investment Planning
PIT	Personal Income Tax
PPP	Public Private Partnership
PSMFL	Public Sector Management and Finance Law
SEG	Socio – Economic Guidelines
VAT	Value Added Tax

1 Background Information and Concept of the Law

In recent years the Mongolian economy has expanded rapidly due to the significant increase of the mining sector and related foreign trade. As a result the consolidated budget revenues have increased, and the social welfare spending and overall government expenditures are growing concurrently. In addition, the price increase of some metals in the world market has further positively affected the budget expansion of Mongolia.

The above mentioned economic framework conditions, and the dissatisfaction of citizens over the provision of local public goods have led the government to undertake a fiscal reform of the budget system towards greater decentralization.

1.1 Rationale for the New Budget Law

The Budget Law (BL) of 2002 set out the general regulations and defined the budget composition, classification and financing scope. However, the law was not complete and also was not up to date with international standards and methodologies. The Public Sector Management and Finance Law (PSMFL) of 2002 regulated the budgeting process and relations, but the bodies that participate in budget relations were dissatisfied with the law due to the unclear expenditure assignment, overly detailed regulations on organizational levels, and badly implemented performance contracting and missing aspects of fiscal management.

The medium term fiscal framework statement (MFF) and the social-economic guideline (SEG) for the next fiscal year (FY) are usually approved by Parliament in the spring session. The planning of the next FY budget proposal starts at the lowest jurisdictional level and is submitted to the next higher level organization, until ultimately submitted to the Ministry of Finance (MoF). The MoF reviews and screens the budget governors' budget proposals, then prepares the consolidated budget, defines the amount of intergovernmental transfers (from local to state and state to local), and submits the budget proposal to the Parliament.

The Parliament discusses and approves the budget proposal upon submission by the central government. After that the Capital City and Aimag Assemblies approve the budget proposal of their respective jurisdictions as approved by Parliament. A similar procedure takes place at the next lower level of government. Thus local governments have no influence in the budget planning and approving process in Mongolia.

Due to the vertical administration and budgeting process local governments have no possibility to make their own development and investment plans, hence budgeting is not consistent with local policy priorities, and local needs are not considered in the budget. For instance, public investment decisions are centralized by budgeting process and made by central government on an ad hoc basis. Therefore, the improvement of the legal environment for the budget relation system in general and local budgeting in specific is an unsolved issue in Mongolia.

In light of these limitations the government as well as its general commitment to improve legislation in Mongolia[1], the government decided to develop a new integrated law to regulate budget relations by combining the BL of 2002 and the PSMFL. The new BL was passed by Parliament on 23 December 2011. The new BL corrects the duplications and contradictions; rationalizes authorities and responsibilities of the officials that participate in the budgeting process; redefines budgeting principles, scope, composition, and classification of the budget; and introduces regulations on the following aspects:

- Investment planning, financing and monitoring;
- Debt management, internal audit system, borrowing and loan guarantee;
- Transparency in budgeting and accountability;
- Public private partnership;
- Citizens' participation in budgeting;
- Program budgeting;
- Formula based intergovernmental transfer.

The new BL will enter fully into force from 1 January 2013 onwards. The articles related to budget adjustments for projects implemented over more than one fiscal year (art. 43.1.2 and 43.4) entered into force on 30 December 2011. The articles related to the preparation, submission and approval of the budget, MFF and the SEG, and pre-election economic and fiscal report entered into force on 1 February 2012.

1 *The government developed the "General guideline to develop and improve legislation of Mongolia up to 2012", which was approved by Parliament in 2009*

2 The Purpose, Structure and Scope of the Law

2.1 The Purpose of the Law

The immediate purpose of the law is to define the budgeting principles, budget system, composition, classification, authorities, responsibilities and accountabilities of the participants in the budget relations; and to regulate relations connected with budget preparation, approval, execution, accounting, reporting, and controlling.

2.2 The Structure of the Law

The law has 11 chapters and 66 articles, which can be summarized as follows:

- Chapter one of the law sets out the general provisions of the law relating to its purpose, scope and the definition of terms used in the law.
- Chapter two establishes the budgeting principles, sets out the fiscal year and outlines the budget calendar.
- Chapter three defines the authorities and responsibilities of the government institutions and officials in the budget process such as Parliament, Central Government, Cabinet members in charge of finance and budget, Ministry of Finance, National Development and Innovation Committee (NDIC), general budget governors, central budget governors, direct budget governors, budget entity, special funds, appointment and dismissal of budget chief accountant, and integrated budget accounting system.
- Chapter four outlines the budget structure that entails budget level, classification, budget revenue, expenditures, grants and its financing activities, and accounting standards.
- Chapter five sets out the budget preparation, submission and approval process including the requirements for budget proposal preparation, public investment program planning, investment budgeting, public private partnership, general budget governors' budget proposal, submission of the budget proposal to the Parliament, budget approval by Parliament, and supplementary budget.
- Chapter six sets out the regulations relating to budget execution and performance that consist of treasury operation, treasury single account, functions of the treasury, contract for delegated functions, performance contract, organization of budget execution,

adjustments on budget governors' budget, adjustment for activities implemented over more than one fiscal year, complementary activities, expenditure savings, budget motivation, and additional budget.

- Chapter seven contains provisions relating to government property and debt management including provisions concerning state property, incurring debt, issuing loans, government guarantee, and contingent liability.
- Chapter eight defines the regulation on budget reporting that consists of financial statement report and budget execution report. The chapter also regulates pre-election economic and fiscal reporting.
- Chapter nine establishes the local budget relations including fiscal relations between budget levels, local budget, local expenditure assignment, general local development fund, local development fund, delegated functions, incurring debt at the local level, participation in local budgeting, authorities of the Assemblies, authorities of the Capital City and Aimag governors, authorities of the District and Soum governors, preparation and approval of local budgets, as well as approval of the local budget.
- Chapter ten contains regulations relating to audit and inspection.
- Chapter eleven sets out the accountability of the officials that participate in the budgeting process and budget relations by stating the sanctions in case of violations of the Law.

2.3 The Scope of the Law

The law applies to budget entities and their officials, government and local special funds, fully and partly state and locally owned bodies that provide works and services related to the functions of the state on a contractual basis and which are obliged to collect revenues of the budget in accordance with legislation.

The regulations on program planning and performance agreements, and their execution and reporting stipulated in the law will not apply to the budget of authorities executing functions related to state security (art. 3.2). In addition, the article related to the transparency of the law will not apply to the entities dealing with state secrets (art 3.3).

3 The Key Changes of the Law Compared to the Previous BL and PSMFL

3.1 Introduction of Clearly Defined Budget Related Terminology

The legal terms related to budgeting were defined in an imprecise and inconsistent manner in the BL of 2002 and the PSMFL. For instance, the notions of budget governor, state and local budget were defined in both laws using different terminology, which created ambiguity in the budgeting process. Articles 4.1.1 to 4.1.50 of the new BL define 50 legal terms related to the budget and budget relations that provide the consistency and comprehensiveness of legal terms expected of a budget legislation corresponding to international standards.

3.2 Redefined Budgeting Principles

Under the PSMFL the principles of fiscal management for government, budgetary bodies and officials were output budgeting, medium term planning, stability in tax system, efficiency in fiscal management and medium term budget balance. The new BL defines the following five principles of budgeting with the aim to ensure (i) fiscal stability and transparency, (ii) comprehensiveness and accuracy of the budget, (iii) efficient financial and budget management, and (iv) accountability. It also regulates the implementation of the budgeting principles in article 6 of the law. Overall the budgeting principles and its applications are more clear and complete under the new law compared to the previous ones.

3.3 Improved Budget Calendar

In the PSMFL the calendar for the submission and approval of the local budget was defined only for the Capital City and Aimag level. Article 8 of the new BL defines a budget calendar for central and local governments down to the level of District and Soum (see figure 1). The law introduces annual budget ceilings for the general budget governors'[2] budget (art. 8.3). General budget governors will have to prepare their budget proposal within the approved annual budget ceilings (Art.31). As defined in the law the local budgets shall then be planned, approved and implemented without deficit (art 57.2).

2 *As defined in the law, the general budget governor is an official who is responsible for developing the budget proposal, allocating the adopted budget, controlling, executing and reporting the budget within his/her field of authority.*

Figure 1: Budget Calendar of Local Government as per the BL 2011

Submission	• Aimag and capital city governors submit the budget proposals of the respective level to the respective Assembly by the 25 November of each year. • A 58.1 of PSMFL: The governors submit budget proposal to the respective Assembly by 1 December.
Approval	• Aimag and the capital city Assembly discuss and approve the respective annual budget proposal by 5 December. • A 58.3 of PSMFL: The Assembly discusses and approve the budget proposal within 1 month upon submission.
Submission	• Soum and district governors submit budget proposals to the respective Assembly by 10 December.
Approval	• Soum and district Assembly discuss and approve the respective annual budget proposal by 20 December.
Submission to government	• Aimag and capital city Governors shall submit approved annual budgets of the respective level to the State Central Administrative Body Responsible for Finance and Budget by 31 December. • A 58.4 of PSMFL: The Aimag and capital city budget proposal submited to the State Central Administrative Body Responsible for Finance and Budget within one week upon approval.

3.4 Improved Budget Structure

The budget classification and composition was defined differently in previous budget laws. For instance, budget expenditure was defined and allocated by economic classification[3] in the BL of 2002; however the PSMFL stated the budget and its allocation by output classification[4]. Hence, the budget structure needed to be formulated identically. Moreover, in the previous legislation grant revenues from international and local organizations were not included and recorded in the budgets.

Chapter 4 of the new BL defines the budget level, classification, revenue and expenditure as well as grant revenues. According to its article 21, the consolidated budget of Mongolia is comprised of the state budget, local budgets, Social Insurance Funds' budget and Human Development Budget. As provided under article 22 of the law, the budget shall be planned, implemented, recorded and reported with the classification defined by the law, i.e. by budget level, by budget governors, by economic classification, by programs, by activities, and by financing sources. The law redefines the state and local budget revenue sources, as well as the types of grant revenues and types of expenditure to be financed by grant revenue. The law furthermore legalizes that grant revenues (international and domestic donations) become part of the budget. They should be presented as non-tax budget revenue source on the executed budget and on budget execution reports.

3 *Budget expenditure in practice classified as current and capital expenditure.*

4 *Budget expenditure classified by output or services provided.*

3.5 Introduction of Program Budgeting and Investment Planning Regulations

Two important changes introduced by the new law are program budgeting and public investment program (PIP) planning regulations. According to the PSMFL the budget proposal was prepared on the basis of defined outputs, and there were no regulations related to investment budgeting. Article 27 of the new BL defines that the budget will be prepared by programs and that the MoF should provide the instruction for the preparation of the program budget. The new law introduces comprehensive regulation on PIP (art. 28) and investment budgeting (art. 29). PIP should include development and infrastructure projects that support long term economic growth with total values higher than 30 billion Tugrugs, and article 28.3 defines the criteria for prioritizing investment projects. A feasibility study for investment projects with total values of more than 30 billion Tugrugs must be undertaken by NDIC, and the feasibility study for projects with total values of less than 30 billion Tugrugs has to be performed by the respective Ministries and submitted to the MoF.

3.6 PPP and Regulations on Adjustment

Public private partnerships (PPP) and adjustments among budgets are among the key issues that were legalized by the new BL. Article 30 of the law defines the different types and cases of PPP. The law also defines the specific cases when central and local governments can formulate and submit the supplementary budget (art. 34). Articles 42 and 43 of the Law set out the regulations for the budget adjustments between the budget governors' budget and the adjustments in case of the activities implemented over more than one fiscal year. The adjustment of the governors' budget must be made only by the supplementary budget. The budget can be adjusted between programs, between central budget governors' budgets, between central and direct budget governors' budgets, and between direct budget governors' budgets. The adjustment between recurrent and capital expenditure is prohibited by law.

3.7 Debt Management

Under the PSMFL local governments were not allowed to incur deficits and liabilities on their account. Articles 7 and 8 of the PSMFL (authorities of central government) stipulated that the central government was responsible for the issuing of bonds, loans and loan guarantees, as well as government debt management. Hence, there were no comprehensive regulations related to the entire government debt in the previous legislation. Chapter 7 of the new BL introduces regulations on government debt management including in relation to incurring debt, issuing of loans and guarantees, contingent liabilities and debt management. According to article 62 of the law, Aimag and Capital City governments can borrow from the central government, and the Capital city can incur debt up to 4 years as well as issue bonds.

3.8 Clarified Expenditure Assignment and Redefined Revenue Assignment

The PSMFL defined the core local functions (art. 51.2) and contracted outputs (art. 52.1.2) for the Aimag and Capital City level, but unclear expenditure assignments co-existed. Hence, the new Law addresses this shortcoming by clearly defining the functions delegated to the Aimag and Capital City level, and by differentiating the functions among local governments such as Capital city, Aimag, District and Soum level. As defined in the law, local functions are financed by the local budget and delegated functions are financed by conditional transfers. Article 23 of the new BL redefines the state and local revenue sources. However, the provisions do not make a major change in the revenue autonomy at local level (section 4 will provide more detailed explanation on the expenditure and revenue assignment).

3.9 Introduction of Formula Based Intergovernmental Transfer System

The PSMFL provided a very general regulation of the intergovernmental fiscal transfer system (art. 57). The new BL introduces a formula based allocation of revenue sharing, transfers from state to local governments, and it also categorizes the transfer types into financial support transfer, revenue sharing transfer, and conditional (or earmarked) transfer. The new law also provides the variables used for transfer allocations from the General Local Development Fund (GLDF) to local governments. The source of the Local Development Fund (LDF), and the activities that are prohibited to be financed by the LDF, are defined in article 60 of the new law (see text in box).

Funds from LDF prohibited to spend on:

- Programs & activities not articulated in the law
- Spending for political parties & NGO
- Celebrations other than national Naadam
- Activities not in common interest
- Issue loans, guarantees with financial consequences
- Expediture not approved and reflected community opinions

The GLDF will be constituted by 25 percent of domestic VAT, 5 percent of mineral royalty, international and national donations, and the basic budget surplus coming from the local level. The GLDF is a part of the state budget that should be allocated to each local jurisdiction by formula, and the transfers allocated from the GLDF will form the LDF as part of the local budget at each jurisdictional level.

3.10 Citizens' Participation in Budgeting

One of the most important changes introduced by the new BL is the provision of citizens' participation in the budgeting process. The law defines that the governors of the community (Bagh and Khoroo) should conduct open surveys on the investments, programs, projects and activities to be implemented by the LDF, then prioritize and select the projects and activities in the People's Assembly (art. 63). Finally, they should be reflected in the budget proposal of the respective jurisdiction and submitted to the upper level Assembly (Soum and District Assembly). The latter would then discuss and approve the budget proposal.

3.11 Accountability

Accountability issues are clearly defined in article 70 of the law where it states the penalties in case of violation. For instance, if the budget governor of the President's Office, or the budget governor of the organizations directly reporting to the Parliament, or the budget governor of the organizations under the direct supervision of the Prime Minister and Deputy Prime Minister as well as the budget governors of the Ministries violate the specific articles related to (1) budget sustainability, (2) comprehensiveness and accuracy of the budget, (3) effective budget management,(4) donations to other organizations, or (5) making budget adjustments between budgets, then it may serve as the basis to dismiss the concerned official from his/her position.

4 The Expenditure and Revenue Assignment of the New Budget Law

4.1 The Expenditure Assignment

Under the PSMFL the Aimag and Capital City governor had to supply state financed outputs through a contract (A 52.1.2), and supply the local public goods assigned to them (A 52.2). The Soum and District governor had to supply state financed outputs to the Aimag and Capital City governor by contract (A 53.1.2). The local public goods assigned to the sub-national level were financed by the sub-national budget, and contracted outputs were financed by the state budget. According to this legal provision, the expenditure assignments faced the problem of overlapping and dual subordinations at the sub-national level.

The new BL has addressed this issue by clearly defining the delegated functions (art. 61), and also differentiating between the functions of the Aimag and Capital City as well as Soum and District (art. 58). According to article 61, the functions delegated to the Aimag and Capital City level are as follows:

- Pre-school education services;
- General education services;
- Cultural services;
- Primary health care services;
- Land relations and cadastre services
- Child development and protection services; and
- Community sports.

The delegated functions will be financed by conditional or earmarked transfers from the state budget and the amount of transfers are defined on the basis of the contracts. Aimag, Capital City, Soum and District governors have to develop proposals of the monthly budget allocation schedule for each delegated function, and submit it with the local budget proposal to the respective Assembly. The Assembly then approves the amount of the earmarked transfer on the basis of the contracts defined in article 39 and the proposal for the monthly allocation schedule. The expenditure assignment of the Aimag, Capital City, Soum and District are illustrated in table 1.

Table 1: Expenditure Assignment by BL of 2011

Functions of the Capital city	Functions of the Aimags	Functions of the Districts	Functions of the Soums
Capital city management; Urban planning, construction and establishing new infrastructure; Capital maintenance of construction and buildings owned by the capital city, establishing new property and making investments; Social care and welfare services; Implementing programs and measures to support employment and alleviate poverty; Development of small and medium-sized enterprises; Pasture management; Establishing water supply, sewerage and drainage systems; Housing and public utility services; Flood protection; Public transport services; Fight of infectious livestock and animal diseases, pest eradication and control; Disaster prevention; Environmental protection and rehabilitation; Establishing large scale roads, bridges and their lighting, traffic lights and other respective construction; Utility services for public areas, landscaping, public hygiene, street lighting, cleaning, and waste removal; Within the territory of the capital city operation and maintenance services of high voltage and electricity lines and substations and other activities to ensure normal functioning.	Aimag management; Urban planning, construction and establishing new infrastructure; Capital maintenance of locally owned construction and buildings, establishing new property and making investments; Social care and welfare services; Implementing programs and measures to support employment and alleviate poverty; Development of small and medium-sized enterprises; Replace livestock; Pasture management within the territory of the Aimag; Establishing livestock fodder reserve; Water supply, sewerage and drainage systems, housing and public utility services, and flood protection; Public transport services; Fighting infectious livestock and animal diseases, pest eradication and control, and disaster prevention and elimination; Environmental protection and rehabilitation; Establishing within the territory of the Aimag and inter-Soum road, bridge and their lighting, traffic lights and other respective construction; Utility services for public area, landscaping, public hygiene, street lighting, cleaning, and waste removal; Within the territory of the Aimag operation and maintenance services of high voltage and electricity lines and substations and other activities to ensure normal functioning.	District management; Social care and welfare services provided subsequent to the decision of district governors; Within the territory of districts, utility services for public areas, public hygiene, street lighting, cleaning and waste removal; Promotion of intensified raising of livestock; Protection of nature and the environment within the district territory; Recurrent maintenance of lighting of public areas within the district territory; District landscaping, and development and maintenance of sidewalks, recreational areas and children's playgrounds.	Soum management; Social care and welfare services provided subsequent to the decision of Soum governors; Within the territory of Soums, utility services for public areas, public hygiene, street lighting, cleaning and waste removal; Replace livestock; Pasture management within the territory of the Soum; Protection of nature and the environment within the Soum territory; Recurrent maintenance of lighting of public areas within the Soum territory; Soum landscaping, and development and maintenance of sidewalks, recreational areas and children's playgrounds.

Under the previous legislation, capital expenditure was an exclusive central government function. While capital maintenance was partly assigned to the Capital City and Aimag levels, no capital expenditures were assigned to the District and Soum levels. The new BL assigns capital expenditure to the Aimag and Capital City level, and capital maintenance is partly assigned to the District and Soum level.

4.2 The Revenue Assignment

The BL of 2002 defined the revenue sources for the central and sub-national government, as well as common taxes for revenue sharing. According to the BL of 2002 royalty on minerals, license fees for mining and exploration of mineral resources were common taxes shared among the central, provincial and local governments; value added tax (VAT), corporate income tax (CIT), excise taxes, import duties, gasoline tax, and air pollution fee were state taxes; wage tax, immobile property tax, city tax, land payment, vehicle tax were Aimag and Capital city taxes; and personal income taxes (PIT) other than 8.1.1 of the PIT law, gun tax, self employment tax, stamp duties, user fee for hunting, natural resources, herbs, timber, common minerals, water and springs were Soum and District taxes.

Table 2: Revenue Assignment According to the BL of 2011

Common taxes	State taxes	Aimag and Capital City taxes	Soum and District taxes
Royalty on minerals (95:5)	CIT	Capital city tax*	PIT other than 8.1.1 of the PIT law
Domestic VAT (75:25)	VAT of imported goods and services	Land payment	Gun tax
	Excise taxes	Immovable property tax	Stamp duties other than 11.2 of the stamp duty law
	Custom duties	Vehicle tax	User fee for hunting
	Gasoline tax	User fee for water on production	User fee for natural resources other than minerals
	License fees for mining and exploration of mineral resources	Wage tax (8.1.1 of PIT law)	User fee for herbs
	Ai pollution fee	Inheritance and gift tax*	User fee for timber
	Stamp duty (11.2 of the stamp duty law)	Stamp duties other than 11.2 of the stamp duty law	User fee fro common minerals
			User fee for drinking water and springs
			Self employment tax
			Dog tax*

Note: *these taxes are not yet legislated.

As illustrated in table 2, the new BL redefines the revenue assignment for common taxes, and state and sub-national taxes. Under the new BL the royalty on minerals is shared by a ratio of 95:5, and domestic VAT by a ratio of 75:25 rates among the state and sub-national levels. Afterwards the revenue sharing transfers are distributed by formula to each jurisdictional level. There are some minor shifts in the revenue assignment under the new BL such as: license fee for mining, and exploration of mineral resources and stamp duty (11.2 of the stamp duty law) shifted to state level; user fee for water on production and stamp duties (other than 11.2 of the stamp duty law) shifted to the Aimag, Capital City, Soum and District level. The new BL created taxes such as capital city tax, dog tax, inheritance and gift tax for the sub-national budget, which needed a legal framework.

5 Intergovernmental Transfer System and Local Development Fund

Under the previous legislation fiscal transfers across levels of government were non-predictable, non-stable, negotiable and non-transparent. The legal regulation related to the transfer allocation among different government levels was captured in article 57.3 of the PSMFL and stated that the central government can provide a gap filling transfer to sub-national levels. For instance, the central government determined the amount of transfers to the Aimag and Capital City level. No direct central transfers to the Soum and District level were established by central government; it was the primary responsibility of the Aimag and Capital City to establish such transfers to the lower levels. Thus the amount of transfers to the sub-national governments was determined largely by political decisions on an ad hoc basis and disregarded local differences in terms of needs and fiscal capacities.

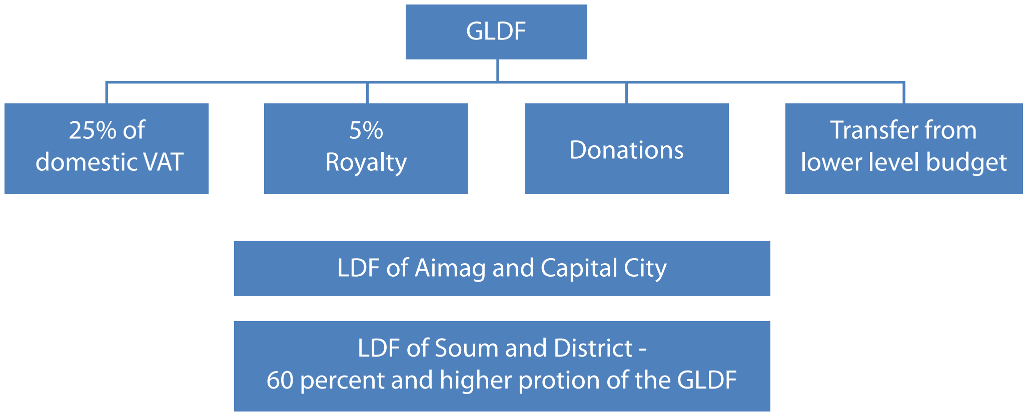
Another problematic issue encountered under the previous intergovernmental fiscal transfer system was the lack of incentives to mobilize revenues at the sub-national government level due to the previous practice of the intergovernmental fiscal arrangement. The MoF discretionarily determined the amount of transfers from the own revenues of the Aimag and Capital City to central government in each fiscal year. Similarly Aimag and Capital city determined the transfer amounts from the own revenues of the Soum and Districts to the Aimag and Capital City budgets. Hence, any increase in sub-national revenues was equalized by reductions in either tax sharing or transfers.

The new BL addresses the above mentioned issues related to the intergovernmental fiscal transfer system. Articles 56, 59 and 60 define the types of the transfers from central to sub-national government and vice versa, as well as the principles for the transfer allocation from central to local jurisdictions. There are three types of transfer to the lower level budget, namely (i) financial support or gap filling transfers, (ii) revenue sharing transfers and (iii) earmarked transfers to finance delegated functions. The transfer to the upper level budget has to be determined as a residual of the basic budget surplus minus the basic expenditure of the lower level government.

5.1 Local Development Fund

As defined in article 59, the general local development fund (GLDF) comprises four sources including 25 percent of domestic VAT, 5 percent of royalty on minerals, donations from national and international organizations, and transfers from lower level budgets. The approximate amount of the revenue sharing transfers, calculated using the 2011 budget execution data, would be $79.7 million.

Figure 2: Composition of General Local Development Fund



The GLDF is a part of the state budget, and at the minimum 60 percent or a higher portion of the GLDF must be allocated to the Soum and District local development fund (LDF) by considering the allocation criteria stated in the law such as the local development index, population, population density, remoteness, territorial size, and local tax incentive. The methodology for the transfer allocation has yet to be determined and approved by the central government. Article 59.4 states that when allocating the transfer from the GLDF to the LDF of jurisdictions where mining is carried out, the amount of per capita revenue sharing transfer of mineral royalty shall be increased up to 10 percent compared to the amount of the transfer to jurisdictions without mineral deposits.

Table 3: Calculation of Revenue Sharing Transfer to Sub-national Level

	Million Tugrug	Million $US dollar
GLDF, (royalty 5% + domestic VAT 25%)	110,421.8	79.7
LDF for Aimag and UB , (40% of GLDF)	44,168.7	31.9
LDF for Soum, District	66,253.1	47.8
LDF for UB	9,926.2	7.3
LDF for each Aimag on average	1,630.6	1.2
LDF for each District on average	1,654.4	1.2
LDF for each Soum on average	156.1	0.1

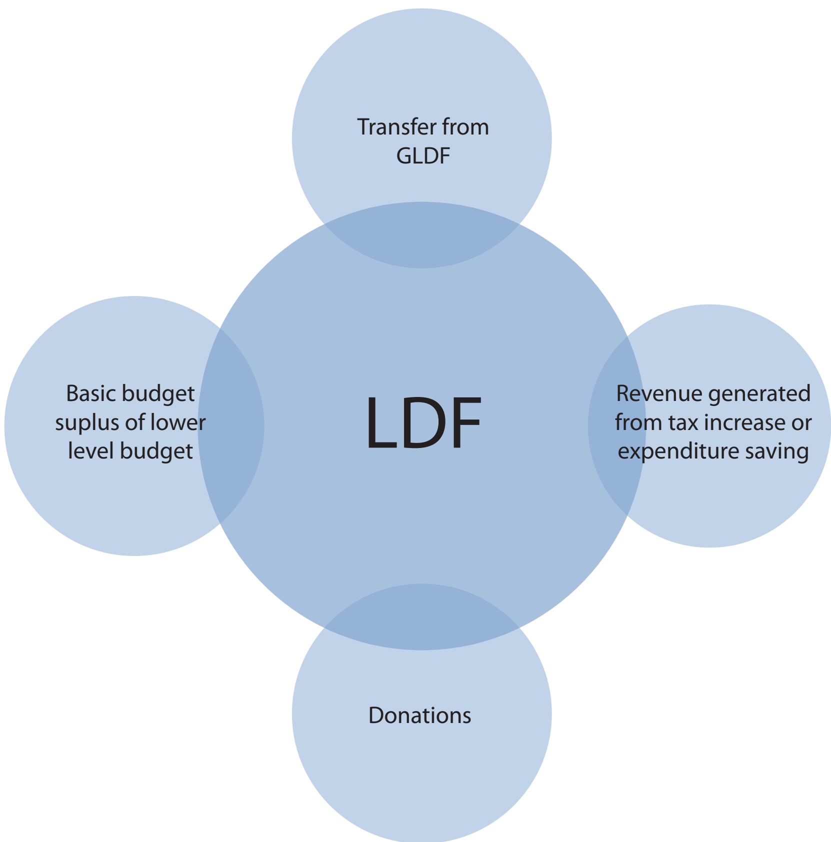
Source: Authors own calculation

The next step of the transfer allocation is to determine the transfer amount to Aimag, Capital City, Soum and District level by considering the criteria stated in Article 59.3 and that at least 60 percent of revenue sharing transfers must be allocated to the Soum and District levels. The allocation principle is not clearly defined in the law, hence the simulation in table 3 assumed that 40 percent of the GLDF would go to the Aimag and Capital city level and that 60 percent would go to the Soum and District level LDF which results in $31.9 million and $47.8 million respectively.

According to article 60 of the law, the LDF comprises four sources (see figure 3). However, the basic revenue source will be the revenue sharing transfer from the GLDF. Initially, the amount of the transfers to the Capital City, specific Aimags, Soums and Districts is to be determined on the basis of the above mentioned indicators. However, the law does not provide clear information on how to calculate the transfers. For instance, information on the weighting of each indicator is missing. The MoF's preliminary suggestion for the weighting of the indicators is as following:

- Local development index – 20%
- Population – 30%
- Population density, remoteness, and territorial size – 20%
- Local tax incentive – 30%

Figure 3: Composition of Local Development Fund



The results of the simulated transfer calculation for the Capital city, specific Aimags, Soums and Districts by using the above weights are illustrated in table 3. According to this estimation, UB city alone would get $7.3 million, which corresponds to 9.2 percent of the total GLDF. Considering that about 1.2 million or 50 percent of the population live in UB city, the allocation may not be adequate in terms of equity and efficiency in local service delivery. Other challenges with the new system include that 7 variables may be too many to consider, and that some indicators such as territorial size and tax incentive are double counted.

6 New Opportunities for Stakeholders

The BL of 2011 introduces new elements such as program budgeting, PIP, PPP, citizens' participation and formula based transfer allocation, that provide some fiscal autonomy for sub-national governments. These key changes will create new opportunities for stakeholders such as the central government, sub-national government, citizens, business entities, non-governmental organizations, and international organizations.

6.1 Opportunities for Local Stakeholders

The implementation of the new BL will improve the fiscal autonomy of sub-national governments. It means that the local governments will have more resources to implement programs, project and activities. As a result, local public goods will be improved in terms of quantity and quality. The improvement of local fiscal autonomy, together with PPPs will create growth opportunities for local businesses and non-governmental organizations due to more public functions being contracted out.

The introduction of citizens' participation in the budgeting process is the most important move towards decentralization of the budget provided for under the new law. It will create opportunities to reflect citizens' preferences relating to local public goods in the budget and provide a possibility to control local politicians and administrative officials. Hence improvement in economic efficiency of public funds should be be achieved. However, local governments have to provide accurate information to citizens in order to generate effective participation. For instance, the existing formats and standards to publicize budget expenditure are non-transparent and unclear.

The introduction of the public investment planning regulation and the LDF will allow local governments to make their own development and investment plans to address local socio-economic issues, and investment budgeting will be consistent with local needs and policy priorities.

Therefore, successful implementation of the LDF, PPPs, public investment planning and citizens' participation will improve local service provision, enhance investment planning and efficiency of projects, as well as improve political and fiscal accountability that will create benefits for local governments, local citizens, local business entities and NGOs.

6.2 Opportunities for International Organizations

Various international organizations are supporting development goals and contribute towards poverty reduction in Mongolia. In order to achieve these goals, they are implementing a large number of programs, projects and activities that foster economic self reliance, improve environmental conditions, generate income and employment, and create better access to services.

As a result of the introduction of LDF by the new Budget Law local governments will have more financial resources at their disposal that will be allocated in a predictable and transparent way. This situation will improve local participation in and responsibility for the implementation of programs, projects and activities that are initiated and financed by international organizations. For instance, local governments can make financial contributions to projects that improve livelihoods of herders. Thus, the efficiency and effectiveness of the programs and projects implemented by international donor organizations will be improved. Hence, the implementation of the new Budget Law will benefit international organizations as well.

7 How to Make the New Budget Law Operational

The new Budget Law has introduced a number of changes in budgeting and budget relations. In order to implement these measures the government has to harmonize other related legislation with the new BL. The law changed the revenue assignment for the different jurisdictional levels, and introduced new taxes such as Capital City tax, dog tax, and inheritance and gift tax. Therefore, amendments have to be made to all related specific tax and user charge laws, such as the General Tax Code, Personal Income Tax Law, Property Tax Law, and Vehicle Tax Law etc.

In order to apply the new expenditure assignment, investment budgeting and PPPs, amendments have to be made to laws such as the Law on Territorial and Administrative Units, Concession Law, Social Security Law, Public Procurement Law, and other laws.

The development of specific regulations is needed for the transfer allocation from the GLDF to the LDF at each jurisdictional level that clearly indicates the variables for the formula and also their weighting for the calculation. Citizens' participation in the budgeting process is a very new activity that local government will also need to support. Therefore, a methodology or a handbook and training about the organization of citizens' participation in budgeting will be necessary, especially for the sub-national governments. The development of a methodology for and organization of capacity building training is also necessary for the successful implementation of program budgeting, especially at the local level.

Conclusion

Rapid economic growth and dissatisfaction over local public goods provision demanded fiscal reform in Mongolia. Hence, the government passed the new BL. The new BL improves and rationalizes regulations on the budget relations that were provided by BL of 2002 and the PSMFL. The law has made a first important step towards the decentralization process by introducing citizens' participation, formula based revenue sharing transfers, and by optimizing the intergovernmental fiscal relations system in Mongolia.

The problem of unclear expenditure assignments has been addressed by determining the delegated functions in article 61 and by differentiating the provision of local public goods by Capital City, Aimag, Soum and Districts in article 58. Capital expenditures are partly assigned to the sub-national level. Revenues are reassigned in article 23. However, the article does not provide major changes compared to the previous assignment, so local governments still have limited revenue sources and lack administrative sovereignty. The introduction of a formula based transfer allocation via the LDF, however, improves the revenue sovereignty of sub-national governments. The borrowing possibility of the Capital City has improved compared to the previous situation.

The law itself can provide a good platform for budget reform towards decentralization. However, amendments of the related laws, passing of some new laws and regulations are needed to achieve the full benefits of budget reform. It is recommended that the government urgently commence the following activities: a) make necessary amendments in related laws, b) develop the methodology for the transfer allocation, c) introduce a simple budget format for citizens' use and d) organize capacity building training especially on the organization of citizens' participation and program budgeting at the local level.

An Analysis of the New Budget Law of Mongolia of 2011

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