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THE RESOURCE CURSE IN MONGOLIA:
MINERAL WEALTH, INSTITUTIONAL QUALITY, AND ECONOMIC PERFORMANCE

by

Nyamsuren Chultem
June 2014

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THE RESOURCE CURSE IN MONGOLIA: MINERAL WEALTH, INSTITUTIONAL QUALITY, AND ECONOMIC PERFORMANCE

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ABSTRACT

Mongolia is endowed with abundant natural resources from which it has generated a high level of economic growth over the past decade. Nevertheless, the country has already experienced some symptoms of the natural resource curse. This thesis argues that the quality of a country’s governance and institutions plays a crucial role in the management of resources, and therefore, it examines the political-economic environment of Mongolia’s resource sector. This study examines Mongolia’s performance on three steps of the natural resource management value chain: sector organization and the process of contract awards, the collection of taxes and royalties, and revenue distribution and public investment management. Furthermore, this thesis demonstrates that, while many resource-rich, developing countries experience civil war and conflict due to mismanagement of resources, Mongolia is not currently on this path. It concludes, however, that if the country does not effectively manage its resource sector, Mongolia’s young democracy may deteriorate.

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LIST OF ACRONYMS AND ABBREVIATIONS

EITI	Extractive Industries Transparency Initiative
FDI	Foreign Direct Investment
FSF	Fiscal Stability Fund
GDP	Gross Domestic Product
GIO	Gross Industrial Output
HDF	Human Development Fund
MDF	Mongolian Development Fund
MDP	Mongolian Democratic Party
MPRP	Mongolian People’s Revolutionary Party
WGI	Word Governance Indicators

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I. INTRODUCTION

Mongolia is endowed with abundant natural resources from which it has generated a high level of economic growth over the past decade. Nevertheless, the country has already experienced some symptoms of the natural resource curse. This thesis argues that the quality of a country's governance and institutions plays a crucial role in the management of resources, and, therefore, it examines the political-economic environment of Mongolia's resource sector. This study examines Mongolia's performance on three steps of the natural resource management value chain: sector organization and the process of contract awards; the collection of taxes and royalties; and revenue distribution and public investment management. Furthermore, this thesis demonstrates that, while many resource-rich, developing countries experience civil war and conflict due to mismanagement of resources, Mongolia is not currently on this path. It concludes, however, that if the country does not effectively manage its resource sector, Mongolia's young democracy may deteriorate.

A. MAJOR RESEARCH QUESTION

Literature on the economic growth from natural resources concludes that the endowment of resource wealth does not always have a positive influence on the political and economic development of a given country. Instead, many developing countries suffer from the "resource curse," which is a phenomenon that occurs when a resource-rich country is unable to manage resources appropriately for sustainable development, and its people experience low standards of living.[1] Although such countries experience some growth in their gross domestic product, other key development indicators, including especially the quality of governance, remain lower than they should be.[2] This thesis will examine the experience of mineral-rich Mongolia, and seek to answer the question, "Has Mongolia begun to experience the resource curse, and to which elements of the resource

[1] Jeffrey A. Frankel, *The Natural Resource Curse: A Survey* (Cambridge: National Bureau of Economic Research, 2010), 3.

[2] Naazneen H. Barma, Kai-Alexander Kaiser, Tuan Minh Le, and Lorena Vinuela, *Rents to Riches?, The Political Economy of Natural Resource-Led Developmen*t (Washington, DC: World Bank, 2011), 44.

curse is Mongolia most vulnerable?" In exploring the political economy of natural resource governance in Mongolia, this thesis will determine how and why resource-rich, developing countries experience economic and political struggles, as well as social suffering, while extracting and allocating rents from the resources.

B. IMPORTANCE

Mongolia had been a Socialist country strongly influenced by the Soviet Union until the 1990s. Since the collapse of the Soviet Union, Mongolia has been pursuing an independent policy that promotes democracy and an open market system. In relation, the political economy of the country changed tremendously, allowing for the presence of foreign investors that have wide experience and advanced technology in the extractive industry. The government, in consequence, has been facing new challenges. Crucially, the natural resource sector has become the most important part of Mongolia's economic development; in turn, the country has become very dependent on rents from that sector. There are more than 8000 deposits with more than 440 types of minerals, including gold, silver, copper and molybdenum, lead, steel iron, coal, fluorspar, salt, semi-precious stones and crystal.[3] According to World Bank data, more than 75 percent of total export was natural resources, and almost 40 percent of revenues were generated from minerals in 2008. Because of such dependence on minerals, Mongolia was confronted with governance and macroeconomic risks.[4] Literature on the resource curse affirms that whether a country becomes resource-dependent or not is conditioned by its government's ability and institutional capacity to make decisions and overcome challenges in sector management.[5] Therefore, it is important to analyze governance of the sector and institutional features of Mongolia in order to avoid this dependence.

In addition, the government lacks experience in collaborating with foreign extractive firms. In 1978, Mongolia accumulated some experience in the natural resource

[3] M.A.D., "The Mongolian Real State Report," http://mad-research.com/mongolia/macroeconomics-mongolia/mining-sector-mongolia/.

[4] World Bank, *Mongolia: Unbundling the Resource Paradox* (Washington, D.C: World Bank, 2009), 1.

[5] Barma, et al., *Rents to Riches?*, 9.

sector during the establishment of the joint mining venture, Erdenet, between the governments of Mongolia and the Soviet Union. However, today's environment demands advanced experience and knowledge, since competition for resources has increased globally, and actors in the field have become more mature and competitive. Therefore, it is a challenge for the Mongolian government to deal with experienced investors.

Scholars have observed that analyzing the sector governance and institutional quality through the steps of a "natural resource management value chain" (an analytical framework described in more detail in the next section), provides the opportunity to assess the political economy of extraction and allocation of rents.[6] Thus, this thesis will contribute to the existing knowledge of sector practitioners and researchers by characterizing the weaker dynamics in resource management and developing domestic policies that match the Mongolian context.

In a broader sense, the natural resource sector has a major impact not only on economic development but also on the national security of Mongolia. Countries are becoming more integrated economically and environmentally; in the meantime, non-traditional threats are emerging because of competition over natural resources, which further intensifies conflicts and pressures on democracy. Therefore, the main components of the re-adopted National Security Concept of Mongolia are linked to the natural resource sector, and this thesis will contribute to the discourse on the democratic and non-violent environment within the country.

C. PROBLEMS AND HYPOTHESES

The most common problems related to the resource curse are explained in association with corruption and "Dutch disease," specifically, rent seeking and the detrimental effects of volatility that Mongolia may already be experiencing. Corruption and rent seeking are interconnected behaviors that are prevalent in resource-rich, developing countries. Governments and political elites may provide more opportunities and advantages to their preferred allies or networks in terms of access to natural resources or favorable policy decisions, such as tariff protection. Rent seeking occurs in association

[6] Ibid., 9.

with an environment that has high tax revenue, lack of transparency, and corruption that in turn, distort efficiency and the allocation of resources. Furthermore, it weakens the state and its accountability. According to Transparency International, Mongolia has been affected by corruption; though, it is demonstrating some improvements in anti-corruption efforts, with its shift in the ranking of corrupt countries from 120 in 2011[7] to 94 in 2012.[8] The other fact is that in 2008, the Mongolian economy was badly affected by the global financial slowdown, which was a consequence of the United States' economic crises. The price of a ton of copper fell from $8,000 to $3,400, which turned Mongolia's monetary balance negatively from 4.4 percent of Gross Domestic Product (GDP) surplus into a deficit of 9.6.[9] These data suggest that the country is extremely dependent on natural resources. "Dutch disease" is another common dimension of the resource curse. It is "a process whereby new discoveries of favorable price changes in one sector of the economy cause distress in other sectors," according to Terry Karl.[10] The Mongolian mining sector's contribution to overall GDP has increased from 8 to 22 percent, while the agriculture sector that was once a main contributor to the economy has declined by the same percentage since 2001.[11] "Between 2001 and 2008, manufacturing in Mongolia fell from 30 to 20 percent of gross industrial output (GIO) while mining grew from 50 to 70 percent of GIO that is a classic sign of impending "Dutch disease."[12]

This thesis presents its arguments with the hypothesis that Mongolia has experienced some symptoms of the resource curse and has become resource-dependent due to the government's lack of capability in managing the sector. The relatively low

[7]Transparency International, "Transparency International, Corruption Perceptions Index 2011," http://www.transparency.org/cpi2011/results.

[8] Transparency International, "Transparency International, Corruption Perceptions Index 2012," http://www.transparency.org/cpi2012/results,%20accessed.

[9] *World Bank, Mongolia: Unbundling the Resource Paradox,* 3.

[10] Terry Lynn Karl, *The Paradox of Plenty: Oil Booms and Petro-States* (Berkeley: University of California Press, 1997), 5.

[11]World Bank, "Mongolia Economic Update 2013." http://www.worldbank.org/en/news/feature/2013/11/06/mongolia-economic-update-november-2013 (accessed June 9, 2014), 19–20.

[12] Jeffrey Reeves, "Development Planning in Mongolia: Failure and Potential," http://www.apcss.org/development-planning-in-mongolia-failure-and-potential/.

quality of institutions and governance in the mining sector is crucial, in turn, in making Mongolia more vulnerable to other resource curse dimensions, such as increased conflict and the potential for democratic backsliding. However, Mongolia can avoid or mitigate its experience of the various dimensions of the resource curse if the government improves its ability to manage the sector. To accomplish this, the government will need to examine and understand the steps of the natural resource management value chain, including: 1) sector organization and contract awards, 2) collection of taxes and royalties, and 3) revenue distribution and public investment management.

D. METHODS AND SOURCES

This thesis is an empirical case study that analyzes the Mongolian natural resource sector. It focuses on understanding the political economy of natural resource management through an application of the analytical framework of the value chain. It will take the governance and institutional quality of the Mongolian mining sector as an intervening variable, and the conflict and regime type will be the dependent variables of the study. The correlation between institutional quality and the resource curse is explained by analyses through the three previously mentioned steps of the natural resource management value chain. The thesis will also present a comparative analysis of practices in the Mongolian mining sector and assess them against good practice criteria for each step of the value chain. The thesis will draw from the experiences of other resource-rich countries that either avoided or suffered from the resource curse.

E. THESIS OUTLINE

This thesis is organized into five chapters. The introductory chapter includes the thesis overview, research question with a contextualized background, importance, problems and hypotheses, methodology, and layout of the thesis structure. Chapter II presents the literature review on the natural resource curse and its dynamics, including discussion of natural resources and the natural resource management value chain.

Chapter III focuses on the intervening variable of the thesis, which is the governance and institutional quality of the Mongolian mining sector. The analysis of how institutional quality and the resource curse are associated will be presented through the analytical framework of the value chain.

In Chapter IV, the discussion emphasizes that conflict and regime type, as dependent variables, are interrelated with institutional quality. The analyses in the chapters will be focused on the political economy dynamics around the natural resources and the importance of high-quality sector institutions. Chapter V concludes the thesis with findings and policy recommendations.

II. LITERATURE REVIEW

There are many literature reviews related to the natural resource curse. This thesis highlights some of the main findings of the literature by focusing on governance and institutional quality of the natural resource sector. Furthermore, it studies how the quality of governance and institutions impact potential conflict and regime types of a resource-rich, developing country.

A. GOVERNANCE AND INSTITUTIONAL QUALITY

In the 1980s, scholars recognized the idea of a resource curse, identified various factors and developed different theories. For example, in 1995 Sachs and Warner reported that economic dependence on natural resources and the slow growth of economy are linked.[13] Richard M. Auty affirmed that, based on the developmental level of natural resource-dependent countries since the 1960s, "not only may resource-rich countries fail to benefit from a favorable endowment; they may actually perform worse than less well-endowed countries."[14]

During the beginning of the twenty-first century, Naazneen H. Barma and her co-authors, in *Rents to Riches?*, argued that political economy dynamics could lead resource-dependent developing countries along the resource curse pathway. Moreover, not all states achieve development by adopting the policies and experiences of countries that converted their resource rents into wealth. In other words, a good policy for one country is not always efficient for another country; hence, countries need to have development-oriented policies that fit their specific context. Barma et al. explain further that weak governance and the institutional quality of the resource sector lay a foundation for the curse, and governments experience a more serious form of the curse if they ignore the warning signs.[15]

[13] Frankel, *The Natural Resource Curse: A Survey*, 11.

[14] Richard M. Auty, *Sustaining Development in the Mineral Economies: The Resource Curse Thesis* (London: Routledge, 1993), 1.

[15] Barma et al., *Rents to Riches?*, 5–9.

To avoid the curse and achieve sustainable development, “governments should be able to make credible inter-temporal commitments to both extractive companies and its citizens, and the political regime should be inclusive such that the government faces the incentives to use rents to provide public goods that enhance collective welfare.”[16]

B. NATURAL RESOURCE MANAGEMENT VALUE CHAIN STEPS

This thesis relies upon the definitions of the natural resource management value chain, clearly described in *Rents to Riches*?, which can be used for inclusive assessment of political economy dynamics and sector governance of the countries in order to determine the weak and strong characteristics that affect the resource curse. The thesis emphasizes three steps levels of the value chain that are not necessarily sequential: 1) sector organization and contract awards; 2) collection of taxes and royalties; and 3) revenue distribution and public investment management.[17]

Sector organization and contract awards, which are an upstream part of the value chain, cover core policies to regulate the relationship between government and private investors, including their legal framework, type of resource ownership, allocation of exploration, production, or extraction rights, and the capacity of sector agencies. Stability in the legal and regulatory environment allows “principles of simplicity, clarity, and predictability” in the sector.[18]

Collection of taxes and royalties, midstream in the value chain, includes policy and administration of the revenue from the sector. A “good enough” fiscal regime should be based on the links between transparency, credibility, and commitment of the actors, and profit-based taxes are the best mechanism to obtain revenue.[19] Policy stability is essential to the sector’s development. As Henning Bohn and Robert T. Deacon noted,

[16] Ibid., 58.

[17] Ibid., 5.

[18] Ibid., 78.

[19] Ibid., 158.

when the laws and regulations are in constant change, skittish investors stay out of the sector.[20]

Returning to Barma's analyses, revenue distribution and public investment management, which are downstream on the chain, are heavily dependent on domestic taxation, since they tie state and citizenry through mutual demand. Terry Karl described the effect of tax generation on policy. The way the state generates taxes shapes its public policies. If government is not dependent on taxation from non-resource development sectors, its incentive for a development-oriented policy is lessened. If it is more dependent on taxation from these sectors, taxpayers have the ability to control and demand the quality and amount of the government's spending. Moreover, citizens will be able to limit inefficient, unplanned, non-development oriented expenditure.[21] A government that is unable to positively manage the previously mentioned steps of the value chain becomes resource dependent.

C. REGIME TYPE

Another strand of the resource curse literature debates the relationship between resource dependence and democracy, with some scholars arguing that resource wealth can support democracy, and others arguing that it weakens democracy. Michael Ross, "Does Oil Hinder Democracy" argued that mineral exports have an "antidemocratic effect," and economic dependence on resource rents is closely associated with authoritarian governments.[22] He explained three "causal mechanisms to the antidemocratic effect." First, the "rentier effect" enables governments of resource-rich countries to alleviate democratic pressures by setting taxation at very low rates; second, through the "repression effect" governments spend resource rents to build up internal security to protect them and suppress democratic movements; and third, under the

[20] Henning Bohn and T. Robert Deacon, "Ownership Risk, Investment, and the Use of Natural Resources," *The American Economic Review* 90, no. 3 (2000).

[21] Karl, *The Paradox of Plenty: Oil Booms and Petro-States*, 190.

[22] Frankel, *The Natural Resource Curse: A Survey*, 18.

"modernization effect," economic development does not create the social and cultural changes that bring about democratization.[23]

Without ignoring that democratic effects will be weaker in developing countries that are economically dependent on the rents, Thad Dunning discovered that oil rents can positively influence democracy.[24] He theorized that elites potentially can strengthen democracy at less cost when they have lower need for redistribution of non-resource rents.[25]

Frankel attempted to resolve this debate by disputing the common claim that economic growth and democracy are always correlated. He further stated that "some correlate of democracy—rule of law, political stability, openness to international trade, equality of economic endowments and opportunities will tend to be good for economic growth. But each of these variables can exist without democracy."[26]

Anca M. Cotet and Kevin K. Tsui offer a conditional theory of the relationship between natural resource wealth and democracy, positing that leaders of oil-rich countries are expected to act repressively in order to weaken their political contestants, and this repression creates nondemocratic regimes. However, this is conditional: if, after discovering mineral wealth, the regime is already democratic, then wealth does not damage democracy; however, if the regime starts out weak or non-democratic, then wealth hinders the transition to democracy.[27]

D. CONFLICT

The political economy literature on natural resources also includes the finding that domestic conflicts, be they violent or non-violent, adversely affect the relationship between natural resources and economic development. Elites and factions are more likely

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[23] Michael L. Ross, "Does Oil Hinder Democracy?" *World Politics* 53, no. 3 (April 2001), 327–36.

[24] Thad Dunning, *Crude Democracy: Natural Resource Wealth and Political Regimes* (New York: Cambridge University Press, 2009).

[25] Barma et al., *Rents to Riches?*, 46.

[26] Frankel, *The Natural Resource Curse: A Survey*, 18.

[27] Anca M. Cotet and Kevin K. Tsui, "Oil and Conflict: What Does the Cross-Country Evidence Really Show?" http://dx.doi.org/10.2139/ssrn.1347700, 24.

to battle over valuable resources instead of supporting labor and capital investment to the sector.[28] Michael Ross claims that the most common cause of conflict is unequal distribution of resource wealth, and if the conflict becomes more serious and violent, it deters investment in sectors other than minerals, such as agriculture and manufacturing, which could bring growth in equitable forms. He also claims that resource extraction causes low-level violence, though it is not always raised to larger civil war. Capital-intensive extraction has more probability to ignite separatist rebellion, for it brings less benefit to locals and more benefit to the government and investors. Conversely, labor-intensive extraction is less likely to provoke secession.[29]

Scholars, such as Paul Collier and Anke Hoeffler, Richard Snyder and Ravi Bhavnani, and Macartan Humphreys agree that political leaders of resource-dependent countries are finding it possible to fund weapons and war with rents from the resource sector.[30] However, Cotet and Tsui argue that resource rents can help prevent conflicts when authoritarian leaders in resource-rich countries strengthen their military in order to deter opponents,[31] or they can buy off potential challengers and avoid civil conflict.[32]

E. PREVENTING THE RESOURCE CURSE

Scholars recommend various methods to prevent or mitigate the resource curse. They agree that enacting transparent and accountable policy, in particular, through an unambiguous and nondiscretionary legal and regulatory framework for the sector is essential.[33] Furthermore, it is crucial to establish a natural resource fund, ensure diversification of the economy, and distribute revenues from natural resources directly to the population. Yet, as Erika Weinthal and Pauline Jones Luong argue, the potential

28 Frankel, *The Natural Resource Curse: A Survey,* 14.

29 Michael R. Ross,"Mineral, Wealth, Conflict and Equitable Development," in *Institutional Pathways to Equity: Addressing Inequality Traps,* ed. Anthony Bebbington, Anis A. Dani, Arjan de Haan, and Michael Walton (Washington, DC: World Bank, 2008), 212.

30 Barma et al., *Rents to Riches?,* 46.

31 Cotet and Tsui, "Oil and Conflict: What Does the Cross-Country Evidence Really Show?" 24.

32 Barma et al., *Rents to Riches,* 46.

33 Naazneen H. Barma, "Petroleum, Governance and Fragility: The Micro-Politics of Petroleum in Postconflict States," *in Beyond the Resource Curse* (Philadelphia: University of Pennsylvania Press, 2012), 336.

benefit of these methods is extremely dependent on the level of institutional capacity. The concern is that developing, resource-rich countries lack the necessary capacity, and they are not able to build qualified institutions in a short time; sometimes, therefore, a release of the state's direct control over the resource rents is desirable, along with privatization of the sector to domestic owners who are capable of demanding strong institutions.[34] Richard Pomfret, however, asserts that this domestic privatization approach can hold the demand for economic reform back and affect the stagnation of productivity.[35]

When leaders make decisions on natural resource processing, they base these decisions upon the "availability of alternative sources of export revenue" and "the level of political contestation"[36] according to Jones Luong and Weinthal. Yet, the leaders do not always keep both political and economic balance. In this context, political elites should take responsibility for the curse, because these deteriorating characteristics are caused by government's mismanagement and institutionally weak capacity,[37] which are more likely, in turn, to lead to potential conflicts as well as an increasingly authoritarian regime.

Considering these various methods to avoid the resource curse, the governments of resource-rich, and developing countries need to strengthen governance and institutional quality of the sector and develop specific policy for the country.

[34] Erika Weinthal and Pauline Jones Luong, "Combating the Resource Curse: Alternative Solution to Managing Mineral Wealth," *Perspectives on Politics* 4, no. 1 (2006), 46–47.

[35] Richard Pomfret, *Resource Management and Transition in Central Asia, Azerbaijan, and Mongolia* (Washington, DC: Peterson Institute for International Economics, 2011), 7.

[36] Pauline Jones Luong and Erika Weinthal, "Prelude to the Resource Curse: Explaining Oil and Gas Development Strategies in the Soviet Successor States and Beyond," *Comparative Political Studies* 34 (2001).

[37] Andrew Rosser, *The Political Economy of the Resource Curse: A Literature Survey*, Working Paper 268, Institute of Development Studies (UK: University of Sussex, April 2006), 15.

III. CORRELATION BETWEEN GOVERNANCE AND INSTITUTIONAL QUALITY AND THE RESOURCE CURSE

This chapter focuses on the governance and institutional quality of the Mongolian mining sector, which is the intervening variable of the thesis. Through the application of the natural resource management value chain framework, this chapter evaluates how Mongolia's governance and institutional quality and its resource curse are associated, with an emphasis on the following three steps:

1) sector organization and contract awards,
2) collection of taxes and royalties, and
3) revenue distribution and public investment management.

To determine potential weaknesses and strengths of governance and institutions that may stimulate the resource curse, this chapter begins with the definitions of governance and institutions in the context of the political economy. The World Bank defines governance as "the traditions and institutions by which authority in a country is exercised,"[38] and uses a conceptual tool called the "World Governance Indicators (WGI)" to assess governance and institutional framework. According to the WGI, governance includes: "(a) the process by which governments are selected, monitored, and replaced; (b) the capacity of the government to effectively formulate and implement sound policies; and (c) the respect of citizens and the state for the institutions that govern economic and social interactions among them."[39]

According to Douglass North, "institutions are the rules of the game in a society…, and they structure incentives in human exchange, whether political, social, or economic."[40] Barma and her co-authors explain institutions in the context of the natural resource sector as follows: "Laws and regulations on the natural resource sectors, operational and fiscal procedures for the transfer from resource-rich areas to resource

[38] Daniel Kaufmann, Aart Kraay, and Massimo Mastruzzi, *The Worldwide Governance Indicators: Methodology and Analytical Issues* (Washington, DC: Brookings Institution and World Bank, 2010).

[39] Ibid.

[40] Douglass North, *Institutions, Institutional Change and Economic Performance* (New York: Cambridge University Press, 1990), 3.

poor can be formal institutions. Informal institutions can be publicly accepted, but not legally adopted rules that structure the behaviors."[41]

In mineral-rich countries, the capacity of the natural resource sector can be a reflection of not only the sector's but also the state's overall governance and institutional quality. The current governance and institutions of Mongolia were founded in the political and social environment following the collapse of the Soviet Union. In 1990, Mongolia started its peaceful transformation from a heavily centralized and state-led political economy to a democratic and open-market regime. This change allowed enormous progress, facilitating political freedom, the first democratic election and a multi-party parliamentary system, and the first democratic constitution. However, the former regime had been in place for 70 years, so the state encountered numerous political and economic challenges. Experiencing successes and failures, the state has gradually established the current legal and institutional framework.

A. SECTOR ORGANIZATION AND CONTRACT AWARDS (UPSTREAM LEVEL OF THE VALUE CHAIN)

In this section, within sector organization and contract awards that are the upstream level of the natural resource management value chain, core policies to regulate the relationship between the actors of the sector are covered. The sector regulatory framework provides the government and investors with guidelines to deal with political, economic, and social challenges, and potential risks in the extractive industries.[42] In order to make an assessment of institutional quality through the sector organization and contract awards step, this thesis relies on four dimensions used in *Rents to Riches?*: a) "legal and regulatory framework of the sector; b) type of ownership; c) allocation of exploration and extraction rights; and d) capacity of the sector agencies."[43]

[41] Barma et al., *Rents to Riches?,* 9.

[42] Ibid., 77.

[43] Ibid.

1. Legal and Regulatory Environment

Typically, rules of law shape the effectiveness and efficiency of the governance of any sector. Due to the natural resource sector's potential impact on the country's economic, social, and environmental status, key decisions regarding sector management are often made at the constitutional level.[44] Mongolia's economic growth has become extremely dependent on the natural resource sector. For example, 22 percent of GDP, 61 percent of industrial value added, and 94 percent of export earnings come from the mining industry (Figure 1).[45] Therefore, the legal and regulatory environment of the Mongolian mining sector plays a significant role in whether or not the country suffers from the resource curse.

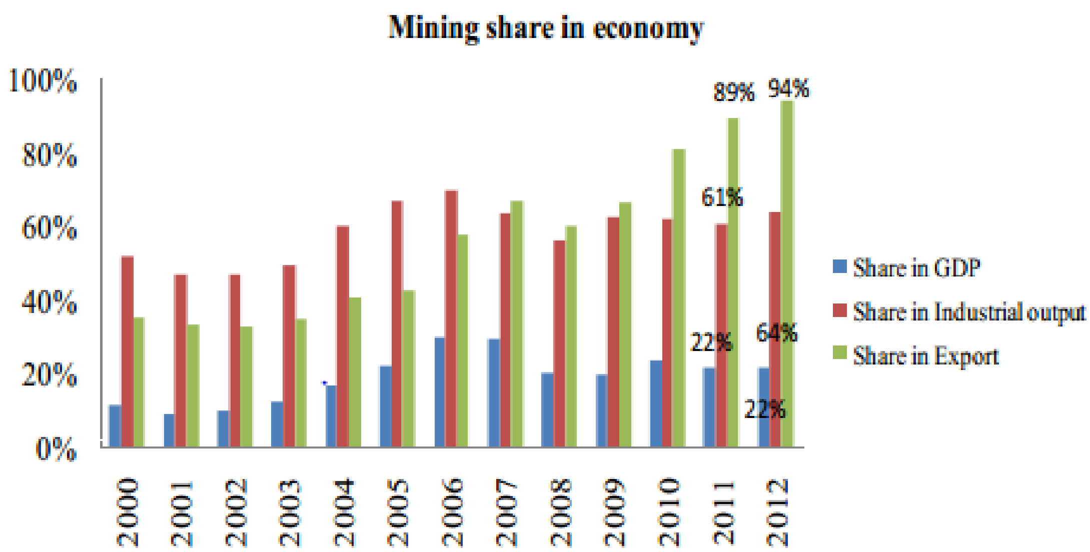

Figure 1. Mining Share of Mongolia's Economy (From National Statistical Office of Mongolia, 2013).

This section covers the key institutions, along with the primary laws, that impact the development of the mining sector while attempting to determine the best practices for governance and institutions. The best practices include clear and consistent legal and

[44] Nicolas Hayson and Sean Kane, "Negotiating Natural Resources for Peace: Ownership, Control and Wealth-Sharing," *Briefing Paper* (2009), 8.

[45] Otgochuluu Chuluuntseren, "Mongolia's Mineral Future and Development," Ministry of Mining of Mongolia, http://www.exportmongolia.mn/userfiles/Otgochuluu-UUYam.pdf, 6.

regulatory standards, which enable consistent expectations of the sector, along with a transparent and nondiscretionary framework to allocate exploration and extraction rights.[46] These characteristics facilitate steady development of the sector that is independent of the political influence by particular parties or fractions.

The Parliament of Mongolia has adopted core laws on minerals, and it scrutinizes the operations of the government, which is the body in charge of regulating the sector's procedure. The key sector institutions are the Ministry of Mining and the Ministry of Finance. The former has a wide range of responsibilities in developing and implementing the laws and regulations related to minerals. It is also engaged in processes, such as decision making on critical issues related to the sector, allocation of mining licenses, and performance of surveys and research. The Ministry of Finance is responsible for the state and local budget planning and expenditure, as well as customs, taxation, and insurance policies.[47]

Mongolia has made some efforts to improve the legal and regulatory environment of the sector, resulting in both positive and negative consequences. A consistent and predictable legal and regulatory environment creates a favorable operational environment among the actors, such as policy makers, public servants, and investors. Furthermore, the rules and regulations based on the laws produce significant implications on how the actors will act at each step of the natural resource management value chain, from the exploration to distribution of the resources.[48] The Mongolian Parliament issued its first "Mineral Law" to regulate activities and relations between the mining and socio-economic environmental sectors in 1997. This law established a positive atmosphere among the actors and created an investor friendly business environment. It allowed the first-come, first-served opportunity for mineral licenses and kept stability for almost 10

[46] Barma, "Petroleum, Governance and Fragility: The Micro-Politics of Petroleum in Post Conflict States" (2012), 336.

[47] InfoMongolia, "Ministries of Mongolia," http://www.infomongolia.com/ct/ci/169/138/Ministries%20of%20Mongolia.

[48] Barma et al., *Rents to Riches?*, 85.

years. Therefore, it contributed to the attractiveness of the sector and constantly increased Foreign Direct Investments (FDI).[49]

Governments of resource-rich developing countries can be extremely susceptible to inconsistent legal acts, because irrational and frequent changes in laws and regulations may decrease the reliability of not only the regulatory environment of the sector, but also the state and governance. It may also weaken transparency of policies and result in ineffective law enforcement, which badly erodes the quality of institutions. Such regulatory gaps would be more complicated and harmful as they continue without improvement.[50]

The 1997 Mineral Law was revised in 2006 and amended in July 2009; however, experts affirm that the amendment created backsliding and an unfavorable operational environment for investors due to the increased tax and regulatory burden on them, as well as the overall uncertainty introduced by an unstable and unpredictable legal framework for the sector.[51] The amendment also included a new type of mineral resource called the "strategic deposit." Such a deposit is defined as one that can influence national security and economic development, for it has capacity of producing more than 5 percent of the country's total annual GDP.[52] Regardless of the intended improvement purpose, the changes resulted in a substantial decrease in investments and license activities.

The Law on Prohibition of Mineral Exploration and Mining Activities in River Basins, Water Reservoir Areas, and Forested Areas, commonly known as the Long Named Law, was enacted in 2009 in order to secure the ecology and environment from the damage caused by the mining activities.[53] The law, generally, was appreciated by the

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[49] Christian Packard and Odmaa Khurelbold, "The Changing Legal Environment for Mining in Mongolia," http://www.anallp.com/the-changing-legal-environment-for-mining-in-mongolia-2/.

[50] Barma et al., *Rents to Riches?*, 85.

[51] Robert Shapiro, "Economic Modernization in Mongolia: The Impact of Tax and Regulatory Policies on the Mining Sector," http://www.sonecon.com/docs/studies/Report_Mongolian_Mining-Shapiro-Jan2009.pdf, 3.

[52] PWC, "Doing Business Guide in Mongolia 2012–2013," http://www.pwc.com/en_MN/mn/publication/assets/dbg_2012.pdf, 13.

[53] N. Erdenesaikhan, *Mongolia National Report on Sustainable Development for the 18th Session of the Commission on SD* (Ulaanbaatar: Ministry of Nature, Environment and Tourism of Mongolia, February 2010), 15.

local populace, for its intention was to protect the environment. The government reviewed 1,782 mining licenses and revoked 254 alluvial gold mining licenses in response to the law.[54] However, this environmentally beneficial effort reduced the investors' reliance on the mining sector. In 2009, the government passed another new law to create a separate legal environment for uranium mining from the other types of mining. The Nuclear Regulatory Authority of Mongolia was established as an executive agency in charge of uranium-related procedures. Under the law, the new agency revoked existing licenses of uranium exploration and mining, and required the license holders to get their licenses re-registered. In November 2010, the agency stated that the revoked licenses would not be restored.[55] These changes in the legal environment represent the government's inability to equally satisfy the actors of the sector while it launches new laws and policies. According to the Fraser Institute's Annual Mining Survey for 2009–2010, Mongolia received only 19 scores out of 100 for the Mining Policy Potential Index, "the third-lowest score issued for any jurisdiction."[56]

In 2006, the Law on Windfall Profit Tax contributed to the decline of the previously attractive environment due to the increased tax, set at 68 percent, on copper and gold production,[57] and the law was abolished in January, 2011. [The 2006 amendments are further discussed later in this chapter.] This was evidence to prove the researchers' argument that the governments of many natural resource-rich countries tend to renege on previous agreements when the world price increases. Such a "dynamic inconsistency" problem happens under political pressures, and it discourages foreign companies and investors.[58]

Decisions associated with the extractive industry are made by the politicians at higher levels, for the industry brings huge amounts of income which has the ability to impact the entire country. However, excessive involvement of the politicians in the

[54] M.A.D., *The Mongolian Real State Report* (August 2013).

[55] Ibid.

[56] Ibid.

[57] Shapiro, "Economic Modernization in Mongolia" (2009), 3.

[58] Frankel, *The Natural Resource Curse: A Survey,* 26.

executive branch's operation damages the government's ability to pursue consistent and reliable policy in the sector. Since the early 1990s, Mongolia has experienced inconsistency among the political parties in power as well as among members of the government. The frequent change of the governments negatively affects long-term policies, because the new government in power always seeks to neglect and end the policies that were initiated by the previous government.[59] The government, furthermore, makes decisions in favor of its political gain, which erodes the quality of transparency and enforcement of laws; poor decisions yield corruption and unfair competition in the sector.

2. Type of Ownership

As Pauline Jones Luong and Erika Weinthal argue, decisions on the ownership type are very much dependent on the degree of access to alternative sources of export revenue and the level of political contestation.[60] Because of the collapse of the Soviet Union, oil-rich countries that had previously either been within the USSR emerged as significant players in the global energy sector, and they chose different policies of sector development regardless of their inherited similarities under the Soviets. Turkmenistan and Uzbekistan sustained full state ownership and banned direct international involvement, whereas Kazakhstan pursued a complete privatization policy and allowed foreign investors to buy the most of its oil and gas enterprises that previously were owned by the state.[61]

Mongolia, having an experience similar to those countries in the way of obtaining its freedom of choice for the mining sector, made its own decisions. It was legitimized by the Mineral Law of Mongolia stipulating that "mineral resources naturally found on and under the earth's surface in Mongolia are the properties of the State. Therefore, the state, as the owner, has the right to grant exploration and mining rights."[62] As a consequence of

[59] Reeves, "Development Planning in Mongolia: Failure and Potential" (2014).

[60] Luong and Weinthal, "Prelude to the Resource Curse: Explaining Oil and Gas Development Strategies in the Soviet Successor States and Beyond" (2001), 369.

[61] Ibid.

[62] Laws of Mongolia, "Minerals Law of Mongolia," http://amcham.mn/laws/minerals%20law.pdf.

transformation from the state-led economy to open market system, privatization of the state-owned mining companies started in Mongolia. By 2010, approximately 28 percent of all companies were engaged in the mining business, according to the Mongolian stock exchange.[63] Currently, over 200 foreign and joint-venture companies are engaged in mining activity in Mongolia.[64]

According to Luong and Weinthal, if the degree of alternative sources of export revenue is higher and the level of contestation is lower, the leaders are less constrained about choosing policy. Conversely, if there is a lower degree of alternative sources and higher degree of contestation, there is more constriction.[65] In the initial period of the regime change, Mongolia did not have a high level of contestation of different ethnicities or groups competing over ideology, wealth, territory, or political power. However, there is a tendency for the state to seek more involvement in the management of the natural resource sector when more wealth from natural resources is explored.

This part of the thesis examines the relative effects of state and private ownership on the sector. The Mongolian government established a state-owned mining company, "Erdenes MGL," in 2007, and it represents the state's interest in strategic and state-funded deposits. It also holds "special permission to explore and develop strategic and state funded deposits, make reserve evaluations, and manage the mineral assets owned by the state in order to own state stakes of strategic deposits."[66] Establishment of state-owned enterprises could guarantee long term, sustainable ownership policies, encourage capable conglomerates that efficiently coordinate the operations of the subsidiary," and prevent major policy changes that could negatively affect the sector.[67] Some economic

63 World Bank, "Mongolia Economic Update 2013," http://www.worldbank.org/en/news/feature/2013/11/06/mongolia-economic-update-november-2013.

64 Ibid.

65 Luong and Weinthal, "Prelude to the Resource Curse: Explaining Oil and Gas Development Strategies in the Soviet Successor States and Beyond," (2001): 375.

66 News.mn, "Government-Owned Shares of 'Erdenet' Transferred to 'Erdenes MGL,'" http://english.news.mn/content/166078.shtml.

67 Barma et al., *Rents to Riches?*, 90.

analysts and Mongolian politicians have stated that the significant growth of the GDP is a result of a successful state-led development plan for the mining industry.[68]

Mining sector experts tend to emphasize that private ownership is more efficient than state ownership.[69] Yet the Mongolian state has increased its involvement in the mining sector through the exploitation of strategically important deposits. According to the Mineral Law of Mongolia, "the state may have up to 50 percent participation interest, and 34 percent of investment shares depending on how much investment the state itself made in the exploitation stage."[70] The Oyu Tolgoi Mine, for example, determined the reserves, and the Mongolian state now owns a 34 percent stake. Some economists argue that the legal provision, which allows state involvement in the management of and revenue stream from strategic deposits, erodes private companies' capacity. The private companies function more efficiently if they have full responsibility over the operations. Many other countries have shared a similar experience that a high level of the state ownership weakens the sector by contributing to "high costs, over-employment, above market pay, and low productivity."[71]

Weinthal and Jones Luong argue that under state ownership, the government does not encourage strong institutions that could challenge the government impacting its fiscal autonomy and power to make decisions.[72] Therefore, they suggest that domestic private ownership would be better to increase the institutions' capacity. According to this logic, the state should not be worried about exploration and extraction processes under private ownership; in turn, this enables the state to concentrate more on its institutional

68 Reeves, "Resources, Sovereignty, and Governance: Can Mongolia Avoid the 'Resource Curse'?" (2011), 179.

69 Otgochuluu Chuluuntseren, "Mongolia's Mineral Future and Development," Ministry of Mining of Mongolia, http://www.exportmongolia.mn/userfiles/Otgochuluu-UUYam.pdf.

70 Shapiro, "Economic Modernization in Mongolia: The Impact of Tax and Regulatory Policies on the Mining Sector" (2009), 3.

71 Barma et al., *Rents to Riches?,* 90.

72 Weinthal and Jones Luong, "Combating the Resource Curse: Alternative Solution to Managing Mineral Wealth" (2006), 43.

establishment, which ultimately enables the government to extract profits not only from the extractive industry, but also from the other sources of income.[73]

In order to put a smooth managerial process of the sector in place, a boundary between the main actors should be clear. Under state ownership, the border between the state elites and assigned bureaucrats to run the companies is blurred, because they lack clearly acknowledged principals. On the contrary, private domestic ownership clarifies this border, for the state and private sectors have their own administrative and managerial rules.[74] Reduction in state ownership and increase in private ownership discourage the tie between political leaders and private investors.

3. Allocation of Exploration and Extraction Rights

The most common forms of allocation of rights are direct negotiation between the state and producers, and criteria-based licensing. The first form can reduce government rigidity while the second can develop transparency and efficiency.[75] In order to have a good governmental and institutional setting for awarding exploration and extraction rights, the policies on contracts and licenses should be transparent, not complicated, and nondiscretionary.[76]

The fundamental legal and regulatory framework for the procedures of granting exploration and extraction rights in the mining sector was set up by the Mining Law, which was enacted in 1997. According to the law, the mineral licenses were granted on a first-come first-served basis, a low taxation and royalty burden was imposed on investors, and more importantly, a stable and predictable legal environment was present. For almost ten years, the law provided a stable and predictable operational environment and boosted the growth of the mining sector until the 2006 amendment.[77] Consequently, new mining applications were suspended for nine months and created an inconsistent situation. Even

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73 Ibid.

74 Ibid., 44.

75 Barma et al., *Rents to Riches?*, 94.

76 Barma, “Petroleum, Governance and Fragility: The Micro-Politics of Petroleum in Post Conflict States” (2012), 336.

77 Barma et al., *Rents to Riches?*, 86.

though the government started accepting applications, the activities could not reach the level of the booming period prior to the amendment (see Figure 2).

Figure 2. Evolution of Mining Applications (green line) and Granted Licenses (orange line) in Mongolia, 1997–2008 (From Mineral Rights Cadaster, The World Bank Team, 2009).

According to the law, two types of licenses, exploration and mining, are granted to legal persons, taxpayers in Mongolia, and actors that operate under the laws of Mongolia. Yet, lacking detailed regulations and established requirements for the companies and individuals to obtain exploration and extraction licenses, until recently the sector allowed many unincorporated applicants to accumulate licenses for re-sale for much higher prices than they were initially bought. As more mineral resources were discovered, such license dealings were amplified and yielded enormous rent-seeking possibilities. By the August 2012, there were already 1,096 mining licenses and an additional 3,450 exploration licenses, according to Ministry of Mineral Resources and Energy.[78]

Moreover, anyone, even those without professional experience and knowledge of the sector could conduct mining activities,[79] which slowed down the progress in sector development and ultimately created enormous negative consequences on the environment

[78] Ernst & Young, "Mongolia Mining and Tax Guide 2012/13," http://www.ey.com/Publication/vwLUAssets/Mongolia_Mining_and_Tax_Guide_-_2012_2013/$FILE/Mongolia%20Mining%20and%20Tax%20Guide%20-%202012_2013.pdf, 12.

[79] Ibid.

and people's behavior. In order to correct the regulatory gap, the government decided to stop issuing new licenses in 2010,[80] and it has not yet started accepting applications for new licenses. The Mongolian Law on the Licensing for Business Activity was approved in 2002. According to the law, agreement with the governors of local administrations is needed for the applicants in order to meet a requirement to apply for the rights.[81] If the government and agency have a clear cadastral plan and registration, this interfering step in the licensing procedure could be eliminated. Clear and unbiased legal and regulatory environment facilitates the smooth operation at this step.

If there is a lack of transparency and institutional restraints, allocation of rights becomes extremely susceptible to corruption.[82] Due to gaps in the regulatory environment, the sector produces poor quality contracts, and the government can make contracts on the basis of its own preference and benefit. In turn, the sector companies seek to negotiate with the government in order to maximize their company profits,[83] and such circumstances then damage transparency and increase corruption in the sector. According to the Transparency International and the World Bank's Governance Indicator, corruption in Mongolia had worsened between 2001 and 2006. The result of the firm-level survey conducted for 62 countries shows that Mongolia ranks 9 out of these 62 countries in terms of firms reporting corruption as a main obstacle to their growth.[84] The World Bank Policy Research Working Paper also presents that Mongolian transparency, accountability, and corruption in the public sector scored much lower than most other East Asian countries on the indicator of the Country Policy and Institutional Assessment.[85]

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80 Ibid.

81 Enrique Ortega Girones, Alexsandra Pugachevski, and Gotthard Walser, "Mineral Rights Cadaster," in *Extractive Industries for Development Series*, no. 4 (2009), 63.

82 Marie Chene, "Corruption in Natural Resource Management in Mongolia," http://www.transparency.org/files/content/corruptionqas/354_Corruption_in_natural_resources_management__Mongolia.pdf, 3.

83 Ibid.

84 Ibid., 32.

85 Elena Ianchovichina and Sudarshan Gooptu, *Growth Diagnostics for a Resource-Rich Transition Economy: The Case of Mongolia* (The World Bank, 2007), 32.

The government, however, has made some progress on modifying the weaker areas associated with the allocation of exploration and production rights. In order to improve the legal and regulatory environment, the government is reviewing processes to issue new licenses and contracts, and establishing some requirements to limit the transfer of existing licenses. Moreover, it has conducted an assessment defining and publicly announcing the areas where minerals are abundant as an effort to promote transparency.[86] Mongolia has participated in the Extractive Industries Transparency Initiative (EITI) since 2005 and was designated as EITI Compliant in 2010.

4. Capacity of the Sector Agencies

Capacity of the sector agencies is dependent on the state's ability to define its institutional mandates without overlaps, and to assure a collaborative environment.[87] A shortage of effective coordination among the agencies results in poor management and regulation of the sector,[88] which deepens the resource curse. Lacking a long-term, national level policy, the governments of resource-rich developing countries create a gap in the legal and operational environment of its agencies. The gap further generates overlap and contradiction among the responsibilities of various agencies, and increases misperception and inefficiency,[89] which ultimately spoil the overall capacity of governance.

Conditions to weaken natural resource sector capacity, like any other key state sectors, are caused by political and economic challenges. The political environment of Mongolia severely affects the quality of the sector. Decisions made at a high political level should be long term and unified for the benefit of the citizens. Nevertheless, it has been common that the political decisions are made in the interest of different political parties to defend the business which is their source of power (patronage).

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[86] World Bank, "Mongolia Economic Update 2013," 30.

[87] Barma, "Petroleum, Governance and Fragility: The Micro-Politics of Petroleum in Post Conflict States" (2012), 336.

[88] Barma et al., *Rents to Riches?*, 98.

[89] Reeves, "Development Planning in Mongolia: Failure and Potential" (2014).

A constitutional amendment in 2000 allowed Mongolian parliament members to hold multiple positions in government simultaneously. This decision has eroded the separation of power and the checks and balances between the Mongolian legislative and executive branches. Furthermore, it has diminished the public confidence in the state, and weakened the accountability for both the legislative and executive branches. The current government of Mongolia is formed with 19 ministers, 17 of whom are parliament members. The public has widely criticized the parliament for abandoning its major responsibility to adopt competent laws and lacking the power to scrutinize operations by the government. A further consequence is that government service has becom**e** a formation of interest groups that seek profit from the state, and allocate social wealth among individuals by appointing them to the main positions regardless of their experience and skill in the field. In other words, the government service which is pledged by the corrupted political and business factions has become an obstacle rather than a springboard for the development of the state and private sectors; moreover, it contributes to inequality and injustice in the society, which results in the government crisis or decline.[90]

Economically, as many other post-communist countries, Mongolia experienced "a blurred line between economic and political elites that often have widespread conflicts of interest. These conflicts of interest are compounded by ineffective governmental oversight bodies (U.S. Department of State, 2011)."[91] In 2005, between 50 to 70 percent of the parliament members already had businesses, and there were government ministers who had business interests in their directly mandated sectors."[92] Such interlinkages between the government and business have expanded as emerging conglomerates have built close ties with the government. According to the 2013 Resource Governance Index introduced by the Revenue Watch Institute (RWI), the quality of Mongolian governance in the mining sector achieved a "partial" score of 51 out of 100 score, and ranked 26 out of 58 countries. For the criteria of Reporting practices (a score of 39), Safeguard and

[90] Mijiddorj Batchimeg, "Бид Төөрчихсөн Хүмүүс Биш ээ," (We Are Not Lost People), http://politics.news.mn/content/157994.shtml#.UkzKT0W0XTY.twitter.

[91] Chene, "Corruption in Natural Resource Management in Mongolia" (2012), 8.

[92] Ibid., 7.

Quality Controls (49), and Enabling Environment (49), Mongolia received partial and failing scores.

These challenges stemming from the political and economic environment are followed by corruption that damages the quality and effectiveness of the sector agencies.[93] The World Governance Indicators measured by the World Bank present similar results as the RWI, assessing that the government effectiveness and controls of corruption are the most fragile areas of the Mongolian governance capacity. The latest discoveries of enormous mineral wealth brought a risk to the sector capacity, for "the nature of high-level corruption becomes more predatory with political elites attempting to take control over private companies and consolidating the public and private sectors."[94] This type of corruption undermines the likelihood of successful, long-lasting planning for the sector as the politicians advance their individual interests over those of society. While recent legislation aimed at limiting the conflict of interests between politicians and businessmen is seeking to break this cycle, the relations between the two groups still is a defining factor of Mongolia's political system since its transition to democracy.[95]

B. COLLECTION OF TAX AND ROYALTIES (MIDSTREAM LEVEL OF THE VALUE CHAIN)

At the midstream level of the natural resource value chain, "the relationship between the state and resource developers changes to one where, instead of a resource developer acting (at least in part) as an extractive agent for the state, the state takes on the role of collecting taxes from developers. The state, also, plays important monitoring and inspection roles."[96] There is a tendency for a linkage between the government and citizens to become weaker in resource-rich countries. In other words, when the state is able to collect "guaranteed"[97] revenue from the natural resources sector, a higher degree

[93] NRGI, "Resource Governance Index 2013: Mongolia," http://www.resourcegovernance.org/rgi/report.

[94] Chene, "Corruption in Natural Resource Management in Mongolia" (2012), 8.

[95] Ibid.

[96] Barma et al., *Rents to Riches?,* 42.

[97] Mick Moore, "Revenues, State Formation, and the Quality of Governance in Developing Countries," in *International Political Science Review* 25, no. 3 (2004).

of autonomy between the government and citizens is created due to that income. The main reason is that the government, relying on the other sources of revenue, does not impose effective taxes on its citizens. Since the citizens are not taxed by the state, they do not adequately consider the government's activities and scrutinize the state.[98] This section of the thesis will examine some of the political economic factors which determine the Mongolian tax regime of the natural resource sector, focusing on the legal background, transparency, and competency of the sector policies.

In order to meet the requirements for the newly adapted market economy system, which started right after the withdrawal of the former Soviet Union and its economic support, the democratically elected government of Mongolia updated the tax laws. The first General Law of Taxation, which provides the infrastructure for the overall tax regime, was introduced in 1993. It contains general provisions relating to tax and tax administration, including the rights and duties of both taxpayers and administrators. The other principal tax law that affects the tax payers and actors in the mining sector is the Mineral Law of Mongolia of 1997. It includes the provisions specific to the prospecting, exploration, and mining of minerals, and imposes royalties on mining license holders. The Corporate Income Tax Law and its provisions apply to all companies, and is calculated based on total annual profits or revenues made by companies, ranging from 10 to 25 percent, while the Value Added Tax Law is an indirect tax regime relevant to all companies, including miners.[99]

In 2006, during the most prosperous years of Mongolian mining, the Mineral Law was reviewed and major amendments were made for introducing equity participation to the government and increasing the government's share of mining revenues. Projected agreements of investment with major mines were repeatedly delayed due to the potential amendments in the legal environment.[100] Particularly controversial was the Windfall Profits Tax Law, which was passed separately in 2006 and abolished in 2011. According

[98] Macartan Humphreys, Jeffrey D. Sachs, and Joseph E. Stiglitz, "What is the Problem with Natural Resource Wealth?" http://www.columbia.edu/~mh2245/papers1/erc01.pdf, 11.

[99] Errnst & Young, *Mongolia Mining and Tax Guide 2012/13*, 12.

[100] *World Bank, Mongolia: Unbundling the Resource Paradox*, 7–10.

to the law, a 68 percent windfall tax was imposed on the profits from the sale of gold and copper[101]—at the time considered the highest royalty tax rate in the world. The tax increase was also interpreted as a burden shifted from smaller developers or individuals to large mining companies and resource developers. These amendments, which were made during the highly profitable period for the sector, increased uncertainty and decreased the competitiveness of the sector. In turn, this legislation damaged the attractiveness of Mongolian mining in the eyes of inverters. Before the amendment, in the Fraser Institute Mining Survey, Mongolia had achieved a score of 54 out of 100 on the Index of Policy Potential in 2005 for its overall policy attractiveness, while only 12 and 19 scores were achieved in 2006 and 2007 after the amendments.[102] It ranked 78 out of 93 counties with its very score low score of 19.5 in 2011–2012, and the low ranking has not improved until now, which demonstrates how easy it is to lose attractiveness, but difficult to regain it.[103]

Some resource-rich developing countries tend to rely on high levels of taxation and regulation, and it applies more to the businesses that involve foreign companies. This policy can be suitable on environmental grounds, yet it also can discourage output and foreign involvement as demonstrated by the experiences of the populist nationalism of Bolivia, Mexico, and Venezuela.[104] Since 75 percent of exports and 40 percent of revenues of Mongolia are formed by the mining industries,[105] which operate under the investment of domestic, foreign, and joint ventures, inconsistency in the legal and regulatory environment of taxation will be a big challenge to the government. In other words, tax policy should be favorable to both the state and investors.

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[101] Packard and Khurelbold, “The Changing Legal Environment for Mining in Mongolia,”

[102] *World Bank, Mongolia: Unbundling the Resource Paradox,* 10.

[103] Ibid.

[104] Frankel, *The Natural Resource Curse: A Survey,* 24.

[105] *World Bank, Mongolia: Unbundling the Resource Paradox,* 1.

With the intention to increase the government's revenue, the amendment to double the royalty rate was made in 2006. However, the doubled rate eliminated sector investors making the Mongolian extractive industry the highest mineral royalty regime, again.[106] Reduction of foreign direct investment will negatively impact Mongolian development, because the government lacks the managerial and financial capacity to operate the high-cost industry alone. It lacks well-functioning domestic capital markets and access to international capital markets. As evidence of the expensive operation of the sector, "60 percent of the total FDI, which is more than 30 times the percentage that goes towards manufacturing and 20 times more than towards construction," is devoted to the mining sector.[107]

Moreover, consequences stemming from the amendments show that the level of FDI, which is essential to sector operation, is very much susceptible to government decisions. In 2012, the Mongolian government received 3.8 billion U.S. dollars in FDI, yet it was 4.6 billion in the previous year. A major reason for the sharp decrease was the amendment of Foreign Investment Law of Mongolia (1993), which was approved in June 2012. Persistent debates before and after the change in the Strategic Entities Foreign Investment Law of Mongolia increased the cautiousness of foreign investors regarding the Mongolian investment environment. By November 2013, FDI slumped 50 percent due to a prolonged skirmish with the Rio Tinto Group, which is the largest investor in the Mongolian mining sector.[108]

Due to the decline in FDI and export of some minerals, the overall Mongolian economy confronts considerable external imbalances.[109] In short, overly optimistic changes that were made during the highly profitable period of the sector increased investor uncertainty and decreased the sector's competitiveness.

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[106] Shapiro, "Economic Modernization in Mongolia," 17.

[107] Reeves, "Resources, Sovereignty, and Governance," 171.

[108] Michael Kohn, "Mongolia Minerals Law Changes may Lead to Lifting of License Ban," http://www.bloomberg.com/news/2014-01-21/mongolia-minerals-law-changes-may-lead-to-lifting-of-license-ban.html.

[109] Asian Development Bank, "Report on Mongolia 2013," http://www.adb.org/countries/mongolia/economy.

The level of taxation is dependent on the smooth and profitable operation of the companies. Therefore, if there is an interruption in their operation, the revenue stream going to the government will be reduced. In short, in order to maximize its tax receipts, the government should encourage investments. After the Mongolian Parliament made amendments that were more resource developer friendly, including the repeal of the Windfall Profits Tax effective on January 2011, some positive results were observed. For example, the investment agreement of one of the biggest mining projects, “Oyu Tolgoi,” was finally signed in September 2009. A report issued by the Mongolian Extractive Industries Transparency Initiative in 2012 shows that the increase of mining and oil activity in recent years has resulted in significant improvement in tax revenue from extractive companies. The tax revenue increased 66 percent between 2010 and 2011, reflecting the rapid influx of investment into this sector.[110]

Taxes and revenues from selling the mineral resources are collected and divided by the state. According to the EITI Mongolia report, there are more than 100 government entities that accept payments from the mining companies in Mongolia, and the government lacks a centralized, systematic way to keep track of these taxes and revenues. Different ministries, agencies, provinces, and sub-provinces can collect the government receipts; consequently, substantial amounts of revenue can be left out of reports by the tax authority and therefore could be illegally spent and distributed. This also suggests that respected central and local authorities lack efficient coordination of rules and responsibilities to track and monitor taxes and revenues.[111]

Collection of revenue is process that is highly vulnerable to corruption, especially under an overly complex regulatory system and inadequate administration. According to the World Bank/IFC enterprise survey 2009 result, 20 percent of the firms interviewed expected to bribe tax officials in Mongolia during the course of their business transactions. Perhaps even more worrisome, revenue collection can become a bridge for businesses to establish close ties with government officials, which, in turn, increases the

[110] Errnst & Young, “Mongolia Mining and Tax Guide 2012/13,” 4.

[111] EITI, “Mongolia Seventh EITI Reconciliation Report - 2012,” http://eiti.org/files/Mongolia-2012-EITI-Report.pdf.

risk of utilizing the collected revenues for private or political benefit.[112] Having a comparatively small population, Mongolia is very vulnerable to this risk.

C. REVENUE DISTRIBUTION AND MANAGEMENT (DOWNSTREAM LEVEL OF THE VALUE CHAIN)

At the downstream level of the natural resource value chain, revenue distribution and management, "the state-society relationship again comes into play, with the state as the agent charged with making sustainable, developmentally oriented savings, consumption, and investment decisions on behalf of society."[113] This section will focus on whether the Mongolian government manages distribution of revenues from the natural resource sector in an effective and transparent way for the benefit of all citizens. At the same time, it will focus on the Mongolian government's ability to balance between the current development needs and the need to accumulate the wealth that it will invest in its future generations.

"An effective public investment system is essential for avoiding the Dutch disease and for translating natural resources underground into productive assets above ground."[114] Many resource-rich countries encounter difficulties on how to put rents and royalties from natural resources into the useful assets that are able to substitute for the extracted nonrenewable natural capital, while effectively managing the expenditure and minimizing detrimental impacts of the resource revenues on other sectors.[115] To ease these challenges, "the countries must weigh decisions on intertemporal consumption versus saving, while considering politically charged, present-day demands as well."[116]

Due to its mining industry boom, the Mongolian economy has grown rapidly. Over the years, mining revenues have accounted for almost 30 to 40 percent of GDP. Today, the mining sector alone collects one-third of the government revenue (Figure 3,

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112 Chene, "Corruption in Natural Resource Management in Mongolia" (2012), 4–5.

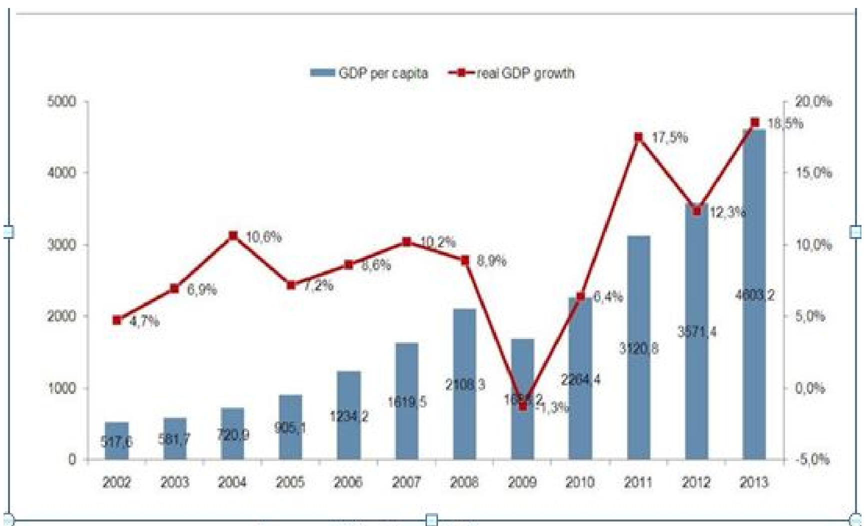
113 Barma et al., *Rents to Riches?*, 42.

114 Zahid Hasnain, *Incentive Compatible Reforms: The Political Economy of Public Investments in Mongolia* (The World Bank [2011]), 2.

115 Barma et al., *Rents to Riches?*, 65.

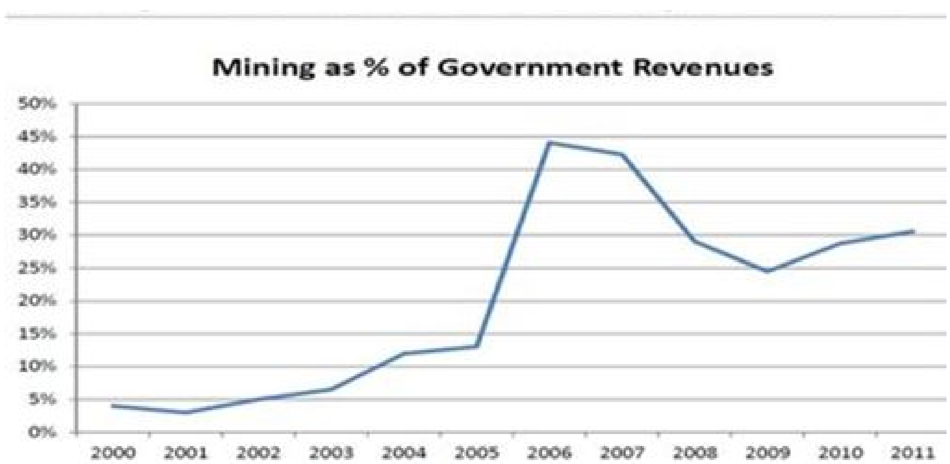
116 Ibid., 169.

Figure 4.) While benefiting from the huge revenue, the country has experienced symptoms of Dutch disease and has become heavily dependent on the mining sector. Therefore, the government must enable a good quality of public spending and saving in order to allow an exclusive opportunity to transform the development prospects in the country.



Source: Ministry of Finance

Figure 3. Economic Performance, 2002–2013 (From Ministry of Finance of Mongolia, 2014).



Source: Ministry of Finance

Figure 4. Mining Contributions to Mongolian Budget Revenues (From Ministry of Finance of Mongolia, 2014).

Public spending of mineral rents reached a peak from 2005 to 2008. Experts conclude that the excessive domestic spending of revenue surpassed the government's planning and implementation capacity[117] (Figure 5), and resulted in overheating of the economy. During past years, in order to accumulate wealth from the mining sector and to spend it for the developmental purpose, the Mongolian government established the Mongolian Development Fund (MDF), which was based on windfall tax revenue from gold and copper and budget surplus. The Ministry of Finance and the Central Bank managed the asset spending to distribute the child money program, which is a cash allowance to poor families with 0–18 years old children with the condition that the school-age childern should be enrolled at school. The other part of the asset was spent to cover the budget deficit, and build wheat and fuel reserves.[118]

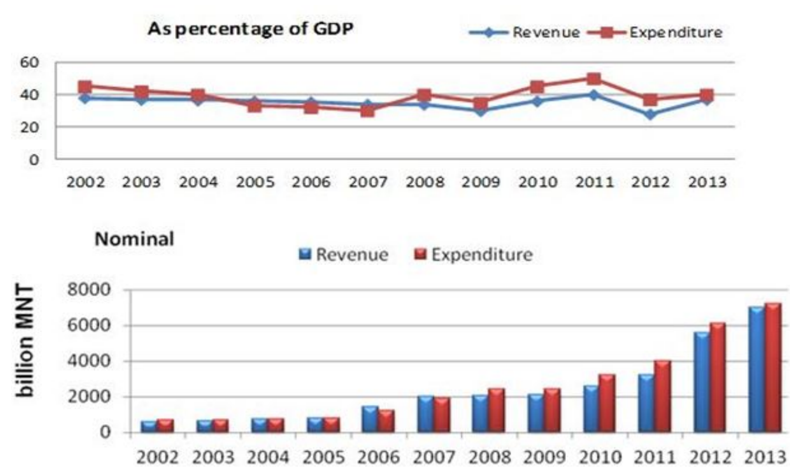


Figure 5. Budget Performance, 2002–2013 (From Ministry of Finance of Mongolia, 2014).

[117] *World Bank, Mongolia: Unbundling the Resource Paradox*, 11.

[118] Khuyagtsogt Ognon, "Sovereign Wealth Fund: Case of Mongolia, Ministry of Finance, Wealth Fund Division," https://www.google.com/?gws_rd=ssl#q=%E2%80%9CSovereign+Wealth+Fund%3A+Case+of+Mongolia%2C%E2%80%9D.

In 2009, the fund was replaced by the Human Development Fund (HDF), mainly subsidized by the royalty tax. The fund's distribution was in the form of cash allowances to citizens, as well as payments of tuition fees and other educational and health services.[119] The main goal of the funds was aimed at efficient use of revenue from mining; however, there were problems caused by political influence in the management of the funds. The majority of these funds were haphazardly spent as untargeted cash allowances (Figure 6) due to political promises the parties had made during the parliamentary elections.

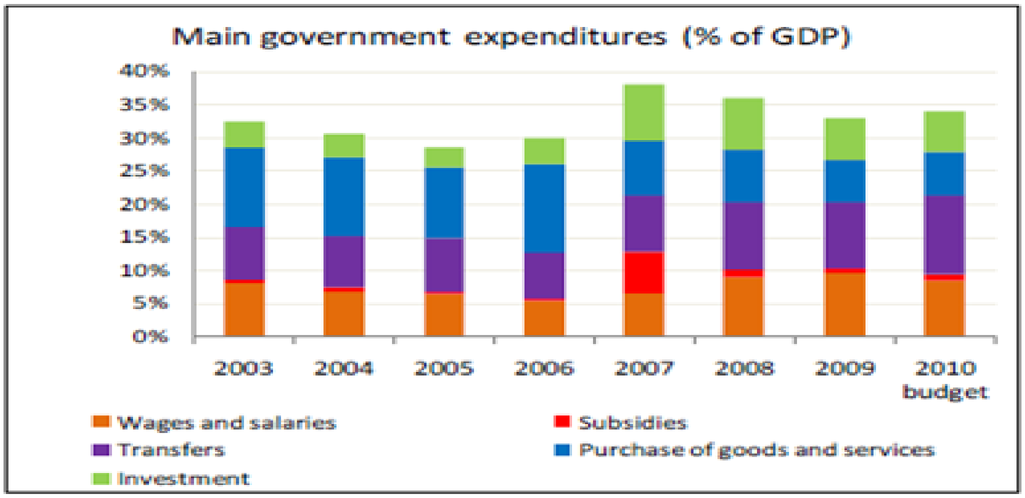


Figure 6. Main Expenditures of Government of Mongolia (From Ministry of Finance of Mongolia, 2011).

Being aware of the neccessity to eliminate negative consequences from ineffective expenditures in the previous years, in 2012, leaders of all political parties signed a memorundum agreeing not to compete with other parties by giving political promises, including a cash distribuiton to the citizens for the purpose of attracting constituents. In order to improve the legal framework of public invetsment management and fiscal responsibility, the parliament approved the Fiscal Stability Law in 2010. Combining the Budget Law of 2002 and the Public Sector Management and Finance Law, a new Integrated Budget Law of Mongolia was approved in 2011. The goal of the

119 Ibid.

law was to improve the legal framework of the budgeting system and better align it with state-prioritized projects under the Public Investment Program.

Moreover, the Fiscal Stability Fund (FSF) was set up and put certain limits on the power of parliament regarding budget approval. FSF, since its establishment, has accumulated 336 billion Tugrugs (equal to 300 million USD) in two consecutive fiscal years.[120] Establishment of the Treasury Fund was initiated, which should be financed by government revenue from the mining sector. The parliament has just discussed its first draft, and hopes to begin savings in 2016. At the initial stage of the expenditure, which starts in 2025, the government will spend up to 25 percent of the collected fund. At the second stage, starting 2050, the Mongolian younger generation will be able to use the main savings.[121] Taken together, this set of new developments marks a concerted effort to improve the downstream rent distribution practices of the Mongolian government, with a view to more sustainable and productive investment.

Effective spending and increased efficiency of revenue collection from the mining sector is shaped by “an integrity system that supports the transparent, sustainable, and participatory management of natural resources.”[122] Overall, in regard to budget transparency, the government of Mongolia has made some progress. It has created an e-budget portal and public access to budget documents through particular publications for giving comprehensive information on revenues and expenditures. Mongolia’s score on the Open Budget Index has dramatically increased from 18 in the 2006 survey to 60 in the 2010 survey, was although it dropped to 51 in 2012. Yet it is still considered above the worldwide average.[123] Despite the progress, the government still needs further improvement in this area, for the current legislature does not provide the public with the

[120] Ibid.

[121] Elena Fehrbach, “The Draft Bill on the Treasury Fund has been Introduced in Mongolia,” Mongolia Briefing, http://mongolia-briefing.com/news/2014/02/the-draft-bill-on-the-treasury-fund-has-been-introduced-in-mongolia.html.

[122] Chene, “Corruption in Natural Resource Management in Mongolia” (2012), 9.

[123] International Budget Partnership, “Open Budget Survey: Mongolia,” http://internationalbudget.org/wp-content/uploads/OBI2012-Report-English.pdf.

[123] Chene, “Corruption in Natural Resource Management in Mongolia” (2012), 9.

opportunity to participate in the process through different ways including, for example, an open budget discussion. The improvement is becoming more important than before, because the government's expenditure has been increasing rapidly; for example, the government spending of 2009 was almost doubled in 2011.[124] According to Chene, an increasing level of corruption across government sectors is becoming a main obstacle to the establishment of a system that ensures transparent and equitable wealth distribution to the citizens, while giving importance to sustainable growth rather than short-term political considerations.[125] The political environment has become one of the factors that encourage corruption, and the next chapter will further examine this phenomenon.

124 Ibid.

125 Ibid.

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IV. EFFECTS OF RESOURCE WEALTH ON DOMESTIC AND FOREIGN POLICIES

Mongolia grasped an opportunity to pursue its own independent, democratic, and liberal market policies after the dissolution of the Soviet Union in the 1990. Nevertheless, due to a lack of mature knowledge and experience in the democratic system, Mongolia, like the most post-Communist new democracies, has struggled to establish a democracy and an open market economic system. The challenge was compounded when huge amounts of natural resource deposits were discovered on its territory. This resource wealth challenges the state to maintain competent and transparent domestic and foreign policies.

This chapter focuses on the political dynamics around the natural resource sector, and assesses why resource-rich countries are likely to experience increased domestic instability and a weakened democracy. It also investigates why resource wealth plays a critical role in foreign and security policies. Two questions will be considered. First, how does the Mongolian political environment affect the management of the natural resource sector, which impacts domestic stability and regime type in the long run? Second, how can Mongolia manage its resource wealth in a way that promotes its autonomy and encourages a beneficial relationship with its neighbors, China and Russia?

A. REGIME TYPE AND POTENTIAL FOR CONFLICT

To understand the relationship between the resource wealth and regime type, which ultimately affects domestic stability, it is important to consider the definitions of democracy and authoritarianism. There is no consensus on a single definition of these regime types. According to common understanding, at a minimum, democracy should include: universal adult suffrage; periodic, free, and fair elections; multiple political parties; and alternative source of information.[126] Philippe Schmitter and Terry Lynn Karl define democracy as follows: “Modern political democracy is a system of governance in

[126] Larry Diamond and Leonardo Morlino, “The Quality of Democracy,” CDDRL, http://iis-db.stanford.edu/pubs/20729/Diamond-Morlino.QoD.intro%28book%29.drft1.pdf.

which rulers are held accountable for their actions in the public realm by citizens, acting indirectly through the competition and cooperation of their elected representatives."[127] An authoritarian regime, on the other hand, is characterized by a strict, top to bottom organizational and administrative structure. The regime is not open or accountable to the expression of public opinion. An authoritarian regime is defined as a system "…in which a leader or occasionally a small group exercises power within formally ill-defined limits but actually quite predictable ones."[128] Democracy and authoritarianism are thus in part distinguished by the degree of relationship between the state and its citizens, implying that the stronger the relationship is, the greater the opportunity for democracy and the less for authoritarianism.

This section of the chapter focuses on the impacts of Mongolian resource wealth and political environment on its domestic stability and degree of democracy. Under the current political economy situation with the resource curse symptoms, Mongolia is more susceptible to the deterioration of its young democracy; nevertheless, I believe there is no immediate cause for concern about the rise of domestic conflict and civil war.

Resource-rich developing countries are not predetermined by their resource wealth to be democratic or authoritarian; yet, as a general rule, these countries tend to experience a deterioration of democracy. Due to mismanagement of resource endowments and unequal distribution of wealth, many naturally resource-rich countries such as Algeria, the Democratic Republic of Congo, and Nigeria have, or have had, undemocratic regimes, and their people suffer from poverty, conflicts, and civil wars.[129] On the other hand, Botswana, Chile, and Malaysia developed policies that promoted democracy and reduced inequality among the people through the efficient use of their resource wealth.[130] The experiences of resource-rich countries demonstrate the following relationship between resource wealth and regime type: because of mismanagement of the

[127] Philippe C. Schmitter and Terry Lynn Karl, "What Democracy is … and is Not," *Journal of Democracy* 2, no. 3 (1991), 76.

[128] Juan J. Linz, *Totalitarian and Authoritarian Regimes* (Lynne Rienner Publishers, Inc, 2000), 159.

[129] Humphreys et al., "What is the Problem with Natural Resource Wealth?" 12.

[130] Ross, "Mineral, Wealth, Conflict and Equitable Development," 212.

natural resource sector, wealthy authoritarian regimes are not likely to pursue democratization, while newly developing democratic regimes are likely to weaken their immature democratic qualities.[131] More democratic and developed countries, by contrast, tend to pursue transparent and responsible governance of the sector, which is encouraged by sophisticated political institutions.[132] An examination of data on 141 countries between 1950 and 1990 demonstrates that if a country's dependence on the natural resource increases by as little as 1 percent, its government is likely to increase its authoritarian nature by almost 8 percent.[133]

Mongolia does not have a long history with democracy, but rather with authoritarian rule under a one-party political system, and it is located between the authoritarian regime of China and the authoritarian-based regime of Russia. The young democracy of Mongolia will be vulnerable to deterioration if the state lacks the governance and institutional capabilities to maintain its mineral wealth as an efficient source of development. Nevertheless, there are examples of authoritarian regimes achieving democracy through smooth transformation based on consistent and long-term policies. East Asian authoritarian regimes such as Taiwan, South Korea, Hong Kong, Singapore, and Malaysia serve as examples in this regard.

Mongolian democracy has become more susceptible to deterioration, due to the symptoms of the resource curse, which is "a multidimensional phenomenon"[134] that is associated with socio-economic and political performance. This section focuses on the political environment around the natural resources of Mongolia which may eventually weaken the country's democracy and heighten the possibility of domestic instability and even civil war. As discussed in the previous chapter, major decisions regarding the natural resource sector are made at the parliament level, and the parliament has the power

131 Humphreys et al., "What is the Problem with Natural Resource Wealth?" 12.

132 Reeves, "Resources, Sovereignty, and Governance: Can Mongolia Avoid the 'Resource curse'?" (2011), 171.

133 Rosser, *The Political Economy of the Resource Curse: A literature Survey* (2006), 10.

134 Ibid., 7.

to establish a positive political environment that enables democratic and sound policies to translate resource wealth into development and prevent the resource curse.

Mongolia had a one-party system based on the Soviet-style political and governmental institutions for 70 years, until the first multi-party parliamentary system was introduced in 1990. Since then, for the first 22 years, power alternated between only two major parties, the Mongolian People's Revolutionary Party (MPRP) and Mongolian Democratic Party (MDP). In 2011, the Mongolian parliament passed the current Law on Election of the Parliament, which enables a mixture of proportional and majority representation systems of voting, and stipulates that no less than 20 percent of the candidates must be women for each party and coalition.[135] The law's emphasis on a more diverse composition of parties and members has resulted in three political parties, one coalition, three independents, and nine female members being part of the current parliament.[136] Mongolia's percentage point for the Progress and Setbacks of Women in Lower or Single Houses of Parliament has increased by 9.6 points compared with the preceding legislature.[137] More opportunity for various representatives of society through the electoral system can positively affect the translation of natural resources into development, by way of increasing the public voice.

A close and accountable relationship between the state and its citizens is crucial for democracy to flourish; yet, this particular relationship is likely more isolated in resource-rich developing countries. Relying on the huge revenue flow from the resource sector, governments impose low taxes on citizens, which discourages them from demanding the government be held accountable for expenditure (as discussed in the previous chapter).[138] In addition, resource-rich governments increase their size as well as the number of agencies, increasing the degree of inefficient expenditure. In Mongolia,

[135] Quota Project, "Global Database of Quotas for Women," http://www.quotaproject.org/uid/countryview.cfm?country=147.

[136] InfoMongolia, "The Names of the 72 Candidates Received Seats in the Parliament of Mongolia," http://www.infomongolia.com/ct/ci/4481.

[137] Inter-Parliamentary Union, "Women in Parliament in 2012 the Year in Perspective," http://www.ipu.org/pdf/publications/WIP2012e.pdf.

opposition party members criticize the current government for the increase of inefficient expenditure of the state budget. They state that according to the Ministry of Finance, foreign investment has decreased by nearly 70 percent in 2012–2013; however, the budget expenditure for the public officials has increased due to establishment of five more ministries and 81 departments under those ministries, in comparison with the previous government structure. In other words, funds that could be used to build 150 schools, 225 kindergartens, and a 300-kilometer road have been spent instead on these additional salaries.[139] The more government agencies operate, the less opportunity exists for the establishment and involvement of independent and non-government institutions. Meaningful participation of non-government organizations and citizens must exist in a democratic society, and it should provide the government with checks and balances which ultimately consolidate democratic practice. On the other hand, the absence of such institutions and civil participation leads the government to lose efficient control over the country's social, political, and economic issues and results in higher vulnerability to the risk of conflict.

In Mongolia, environmental degradation is one issue on which public concern about the negative consequences from poorly managed mining operations has risen. In response, non-government organizations and civil movements to protect the country on this front have been established in the mining areas since 2000. Making up nearly 16 percent of the GDP, the Mongolian agricultural sector has become the second biggest contributor to Mongolia's economy, yet livestock alone supplies approximately 80 percent of the total agricultural output.[140] The booming extraction and exploration process of mining has directly threatened the livelihoods of locals, particularly herders. The Mongolian traditional way of herding in the vast countryside area without any limitation still exists, and "anyone may graze livestock on common land and everyone is

139 Montsame, "Demand for Less Expensive and Compact Government (Засгийн Газрыг Бага Зардал, Цомхон Бүтцээр Ажиллахыг Шаардав)," http://www.montsame.mn/index.php?option=com_k2&view=item&id=29149:2014-05-13-07-57-34&itemid=648.

140 World Bank, "Mongolia Economic Update 2013," 30.

free to graze as many animals as they wish."[141] Available sources of scarce water have already been exceedingly damaged by irresponsible mining activities, negatively affecting the rural Mongolian populace. According to the Land Office of the Ministry of Nature and Environment, mining operation in Mongolia covers a total of 47 thousand hectares of land, and 100,000 hectares have already been damaged due to mining activities.[142]

Pushing back against this environmental degradation, various international non-government organizations have contributed to the establishment of domestic civil movements to protect environment. For example, The Asia Foundation in Mongolia supported the Ongi River Movement, and it further helped to the establishment of the Mongolian Nature Protection Coalition, which includes 11 other domestic movements. As a result, the movement stopped 35 mining operations in the basin of the Ongi River enabling the flow of the river which had been drained for years.[143] In 2007, the leader of the coalition, Tsetsegee Munkhbayar, was awarded with the Goldman Environmental prize for peacefully and successfully organizing civil society. In 2013, however, Munkhbayar was arrested because of illegal gunfire near Parliament House during the protest led by him. The protestors' purpose was to stop the potential amendment to the Law on Prohibition of Mineral Exploration and Mining Activities in River Basins, Water Reservoir Areas, and Forested Areas (The Long-Named Law), which was adopted in 2009, for they believe that the change in the law will worsen the environmental degradation.[144]

This arrest of the most well-known protestor against Mongolian environmental degradation caused by the mining operations is considered as the most adverse skirmish on mining issues between the demonstrators and the government. Some civilians view the incident as a result of spreading corruption among the politicians and civil movements

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[141] N. Tumenbayar, "Herders' Property Rights vs. Mining in Mongolia," http://www.uvm.edu/~shali/Mining%20Mongolia%20paper.pdf .

[142] Ibid.

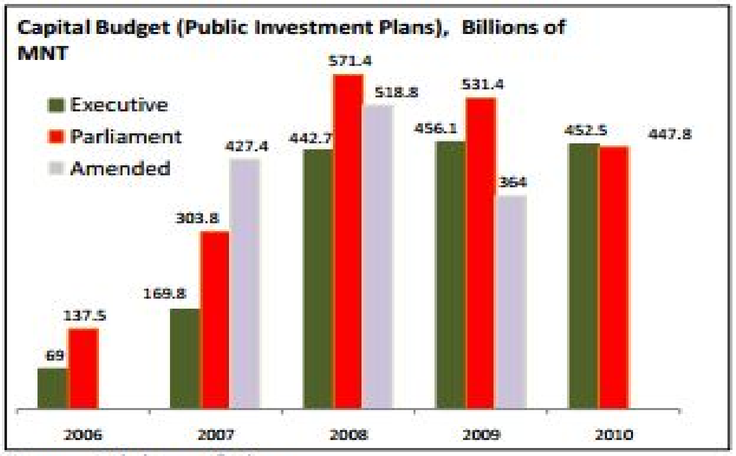
[143] M. Zoljargal, "Protest at the Government Palace Leads to Arrests and Evacuations," http://ubpost.mongolnews.mn/?p=6102.

[144] Ibid.

that are financially dependent on international non-government organizations, and criticize them for operating for profit only, instead of becoming a true voice of the locals and citizens. Others view the incident a result of the government's weakness in maintaining consistent and clear laws and regulations to efficiently coordinate interaction between the state and civilians. Moreover, they complain that the laws are not effectively enforced. For example, considering the fact that mining companies cannot operate without affecting the environment, the ministries in charge of their operation have to provide detailed environmental assessments that clarify the rehabilitation responsibilities of each side; in case of irresponsible action, the companies are charged equally. This procedure is the legal requirement; however, these laws are often not enforced in reality.

Moreover, ambiguity and weak enforcement in the regulatory environment enable politicians to implement policies for their own benefit, in turn, ultimately discouraging the quality of democracy through inequality, corruption, and rent seeking. Mongolian politicians are extremely interested in expenditure of the resource wealth, making the sector highly susceptible to their decisions. In turn, this typically prevents efficient, long-term-oriented policies and weakens the quality of the public investment. As commonly happens in resource-rich countries, the Mongolian government has a habit of over-spending revenue from the resource sector. In recent years, when the government submitted the capital budget (Figure 7), the parliament always increased the budget without acknowledging detailed economic analyses for the associated institutions.[145]

[145] Hasnain, *Incentive Compatible Reforms: The Political Economy of Public Investments in Mongolia* (2011), 2.



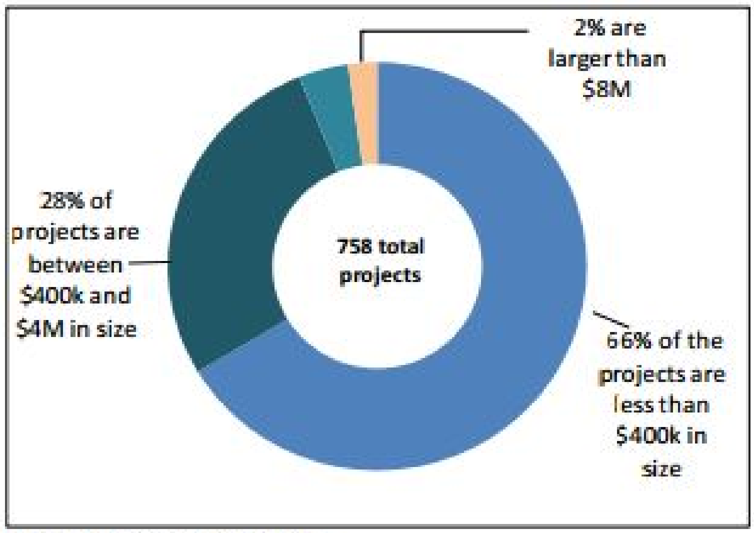
Source: Ministry of Finance

Figure 7. Capital Budget of Mongolia, 2006–2010.

The motivation of Mongolian politicians to become involved in the distribution of revenue is based on following conditions. The resource curse creates a situation in which many families live on insufficient income; therefore, physical investments based on their daily needs tend to be more appreciated by the public rather than long-term and state development aimed investments. Due to their visibility in public, investments are used by politicians as tools of publicizing themselves and, eventually, attracting votes.[146] In addition, each parliament member represents a particular geographical constituency according to the electoral system. In order to please their constituents and increase their chance to be re-elected, parliament members compete to allocate more budgets for their particular constituents. This results in numerous separate and small-scale projects which are not efficient for the country as a whole. Mongolia has a vast territory and sparse population, yet it lacks big projects from which the whole country benefits, such as development of infrastructure and domestic manufacturers (Figure 8). Furthermore, these power-seeking policies of the main political parties and individual politicians escalate corruption, which is itself a major obstacle to the consolidation of democracy. Generally, resource abundance makes political leaders especially vulnerable to corruption and rent-seeking behavior through the mutually beneficial relationship with businessmen. In other words, politicians protect private sector operations through a favorable regulatory

[146] Ibid.

environment and allocation of more investments, and in turn, businessmen give them a share of their profit.[147] According to the Policy Research Paper by the World Bank, there is a close relationship between the business communities and parliamentarians in Mongolia.[148]



Source: Ministry of Finance

Figure 8. Distribution of Investment Projects by Size, 2008.

Even though, there are some challenges to democracy as discussed previously, Mongolia is not likely to experience domestic conflict and civil war. First, Mongolia does not face geographical, ethnic, or religious tensions, which are all factors that have been found to heighten the risk of conflict in resource-rich countries. Ethnically, Mongolia is homogeneous, with a majority group of Khalkh Mongols who make up 86 percent of the total population. Even though 29 ethnic groups exist, they are not particularly distinct today. The biggest minority is Muslim Kazakh people who live in Bayan-Olgii province, the western part of Mongolia occupying about 5 percent of the total population.[149] The minority group enjoys its freedom to use its own language, religion, and administrative

147 Rosser, The Political Economy of the Resource Curse: A Literature Survey (2006), 15.

148 Zahid Hasnain, *Incentive Compatible Reforms: The Political Economy of Public Investments in Mongolia* (2011), 2.

149 E-Mongol, "Population and Demography of Mongolia," http://www.e-mongol.com/mongolia_population.htm.

unit. The group always has representation in the parliament, and their ethnic and social issues are not politicized. Overall, there is not much ethnic, lingual, or cultural distinction among the ethnic groups of Mongolia, and they are culturally and linguistically much assimilated into the majority group of the Khalkh.

Second, in the case of Mongolian, there is no severe struggle for power among elites that could lead to conflict. In developing, resource-rich countries, the power of political leaders is stronger if they have better control over the resource management. Authoritarian governments tend to establish large militaries in order to repress potential demands and uprisings by the populace, and they use the military to prevent democratic pressures.[150] Even though there is little serious conflict, governments that are susceptible to the conflict spend huge amounts of resource revenue to strengthen their militaries. In other words, this repressive method blurs core democratic accountability and dampens the extent to which leaders consider public opinion in decision-making processes.[151] In the Mongolian case, the politicians' competition for power is linked with the businessmen instead of military or enforcement organizations.

B. BALANCING MONGOLIA'S INTERESTS WITH THOSE OF THE INTERNATIONAL COMMUNITY

Apart from the political economy policies, Mongolian natural resource wealth impacts its foreign and security policies, especially regarding neighboring states, China and Russia. Mongolia has been an independent state since its declaration of independence from Manchu rule in 1911. Nevertheless, its socio-economic and political policies have been dependent on two major powers—China and Russia. Due to today's increased global demand for energy, Mongolia's enormous source of untapped natural resources has attracted the interest of both regional and non-regional countries, particularly the two neighbors and other developed countries such as the United States, Canada, Japan, and Korea. This section of the chapter focuses on the impact of Mongolia's natural resource wealth on its foreign and security policies. Mongolia's natural resource management

[150] Ross, "Does Oil Hinder Democracy?" *World Politics* 53, no. 3 (April 2001), 335.

[151] Ibid.

policies towards foreign countries cannot be independent from China and Russia, as is currently the case; therefore, Mongolia faces a challenge of sustaining good balanced policies to satisfy its two neighbors as well as other Western countries in order to maintain its autonomy.

China and Russia are particularly interested in Mongolia's resource wealth, because they have easy access to these resources due to socio-economic integration with Mongolia, as well as geographic proximity and infrastructure connections. Until the 1990s, the world consumption of energy and mineral resources was much less than today. Mongolians had no need to tap a wide range of subsoil minerals until the Soviets left Mongolian territory. Yet, Russia's involvement in the sector goes back decades. Most of the work to identify and classify the main subsoil mineral deposits such as copper, gold, and coal was performed by Russian-led geological teams during the Soviet period. In 1973, Russia made investments to open Erdenetiin Ovoo (Hill of Minerals), which is the fourth largest copper and molybdenum mine in the world today. This joint venture has been extracting minerals for over 40 years, with the ownership share split 51/49, respectively, between the Mongolian and Russian governments.[152] Major coal mining in Baganuur, Aduunchuluu, and Shariin Gol were established by Soviet investment. Currently, 265 joint ventures are operating in Mongolian mining fields, with a total of US$20 million investment.[153] With its huge deposits of natural resources, Russia aims to play a global game in the energy sector, as President Putin has stated, "a role of the country in international energy markets determines, in many ways, its geopolitical influence."[154]

China's involvement in the Mongolian mining sector, on the other hand, started much later than Russia's participation. However, China has already become the leading trade partner of Mongolia. In 2005, China allocated 53 percent of its total investment in

[152] Sergey Radchenko, "Sino-Russian Competition in Mongolia," http://www.theasanforum.org/sino-russian-competition-in-mongolia/.

[153] Sergei Blagov, "Mongolia Drift Away from Russia to China, " *China Brief* 10, no. 5 (2014).

[154] Alicia Campi, "The New Great Game in Northeast Asia: Potential Impact of Energy Mineral Development in Mongolia on China, Russia, Japan, and Korea, " *Asia-Pacific Policy Papers Series*, 2013, 1.

Mongolia to mining areas, particularly coal. Since then, China has constantly increased its investment and involvement in Mongolian mining, and now it accounts for 89 percent of all Mongolian mineral exports.[155] Mongolian coal exports to China make up 43 percent of China's coal imports, which are only 8 percent of its total coal needs.[156] According to the International Energy Agency, China leads the most energy-consuming countries in the world, and it has exceeded the United States' status as the biggest global energy user. The agency also asserts that the consumption of Chinese energy will increase by 75 percent in the coming two decades.[157] China constantly seeks to exercise its influence over the Mongolian economy and trade practices, in such a way as to increase Mongolian dependency on it. There is no reason to believe that China will diminish its interest in keeping its status as the dominant actor in the Mongolian mining sector. The fact of the globally increasing appetite for minerals and China's and Russia's interest in cheaper resources will keep Mongolia in a position of playing an active role in terms of regional stability and security policies.

As a landlocked and developing country, Mongolia's interest is to assure a balanced and friendly relationship with its neighbors. This strategy is legitimized through the National Security Concept of Mongolia, which states: "Good neighbor friendly relations and wide-ranging cooperation with the Russian Federation and the People's Republic of China shall be developed. More specifically, national interests and the history of bilateral relationships shall be taken into account while regional peace and stability as well as a general balance of relations with neighbors shall be sought."[158]

A bilateral relationship between Mongolia and Russia flourished during the Socialist period. The main infrastructure, power stations, and factories were established

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155 Clement Huaweilangand Dai and David Tyler Gibson, "Minegolia Part I: China and Mongolia's Mining Boom, " The Wilson Center, http://www.scribd.com/doc/152430266/Minegolia-Part-I-China-and-Mongolia-s-Mining-Boom.

156 Ibid.

157 Jeffrey Hays, "Coal Exports To China," *Facts and Details*, (2010).

158 National Security Council of Mongolia, "National Security Concept of Mongolia, Chapter One, General Provisions 3.1.1.4," http://www.nsc.gov.mn/sites/default/files/images/National%20Security%20Concept%20of%20Mongolia%20EN.pdf.

under Soviet projects, and they still contribute to the Mongolian economy that was heavily dependent on large sums of Soviet assistance. When the dissolution of the Soviet Union took place, Mongolia pursued an open market economy, and its relationship with its two neighbors stagnated. Even though more than two decades have passed since then, Mongolian dependency on Russia still exists in some areas. For example, Mongolia has explored some oil and gas resources, and according to the estimation of American experts, there is at least 4 to 6 billion barrels of recoverable oil in Mongolia.[159] Nevertheless, the country has not built a local refinery, and it imports 95 percent of its petroleum products from Russia. Mongolia also lacks a capacity to cover its territory with electricity, due to the scarcely settled population in the countryside and their way of living in a traditional nomadic style. The Western provinces still import energy from Russia.

The Mongolian generation, who lived and were educated in the Soviet Union during the Socialist period, is currently less predominant, yet their nostalgia for Socialism remains. The population that grew up during the period of "brotherly friendship" between Mongolia and Russia are now at the age of actively participating in social and political life. Therefore, the stagnated cooperation between Russia and Mongolia is easy to rejuvenate since the ordinary people of Mongolia no longer distrust Russia as they do China. Mongolian and Russian leaders have expressed their interest in stimulating bilateral ties, which have been expanded in recent years. Russia has increased its investment to Mongolia in the fields of socio-economic and defense issues.

By contrast, the Mongolian people have been extremely sensitive to Chinese policies towards Mongolia, for they have a historical and deep-rooted distrust towards the Chinese state and ordinary people. Mongolians believe that they are the oldest ethnic nation that is not linked with China, whereas the Chinese consider Mongolians as a former part of the Middle Kingdom. Distrust towards each other still exists; for example, official complaints from the Chinese people who reside in Mongolia are commonly heard, expressing disappointment about unequal and intimidating treatment by the

[159] Wolf Petroleum, "Oil in Mongolia," http://www.wolfpetroleum.net/mongolia/oil-in-mongolia.

Mongolians.[160] At the political level, Mongolian and Chinese leaders emphasize the importance of trust and understanding toward each other,[161] commending the fact that the two countries have no political, legal, or historical problems. China and Russia have been sensitive to, and carefully watchful of, the Mongolian government's decisions associated with its natural resource management, especially coal and copper mining. If interests in resource management policy were to diverge between Mongolia and its large neighbors, still-dependent Mongolia would find itself in a much more challenging situation than China and Russia.

To balance its interests with the international community and to maintain appropriate closeness to its neighbors, Mongolia needs to extend a "third neighbor" policy in all development sectors. This policy is legitimized by the statement in the National Security Concept of Mongolia: "Pursuant to a 'third neighbor' strategy, bilateral and multilateral cooperation with highly-developed democracies in political, economic, cultural, and humanitarian affairs shall be undertaken."[162] With a population of only 700,000, Mongolia admitted the need of a security umbrella in the 1920s. It took the support of Russia similar to the way other East Asian states were protected under the security umbrella by the United States. In turn, during the Cold War period, Russia benefited from having Mongolia, along with its wide territory, as a buffer zone for its security. Mongolia's current third neighbor policy "… does not seek to obtain a security umbrella or pledge of mutual defense obligations unless its existence is threatened militarily,"[163] but it is driven by Mongolia's survival challenge of being a geographically landlocked country between the two powerful states.

Pursuing the third neighbor policy to strengthen its relationship with regional and Western countries, Mongolia will strengthen its security, consolidate democracy, and

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[160] Mijiddorj Batchimeg, "Future Challenges for the PRC and Mongolia: A Mongolian Perspective," *China Brief* 5, no. 10 (2005).

[161] Ibid.

[162] National Security Council of Mongolia, "National Security Concept of Mongolia, Chapter One, General Provisions 3.1.1.5."

[163] Jargalsaikhan Mendee, "*Mongolia's Quest for Third Neighbours: Why the European Union?*" *EUCAM Policy Brief* 25 (2012).

build a stable economy. Territorially, Mongolia has established a strong degree of sovereignty, not having any disputes on territorial and border issues with either China or Russia; nevertheless, it still has a risk to its sovereignty in terms of its independence. As discussed in previous chapters, one of the serious problems that weaken governance and institutional quality is corruption. Mongolia's border length with China is 4,709.7 km and with Russia 3,543 km, out of the total length of 8,252.7 km.[164] The potential of a security threat from the South is higher for Mongolians because of corruption enabled by the underdeveloped infrastructure and lack of development in the isolated rural areas.[165] There are nine border crossings between Mongolia and China, though only one is utilized at full capacity, while eight border crossings remain vulnerable to smuggling and illegal crossings. To legally cross these eight, and conduct business, customers need to drive several days to come to the office that issues visas. The faster and easier way is to corrupt customs officials, with both traveler and customs staff earning some benefit.[166]

Mongolia's "third neighbor" policy on its foreign relations was initially constituted in cooperation with the United States, Japan, and Korea, along with the United Nations, international organizations, and various regional institutions. Countries establish a good relationship through common interests from which both sides benefit. Located between two authoritarian-based countries, Mongolia has pursued a democratic way of development. This choice, politically, attracted the attention of the democratic states such as the United States and the Western countries to Mongolia. Economically, Mongolian natural resource abundance has brought it under the consideration of many other developed countries that are in need of resources. In other words, Mongolia has an opportunity to utilize its available sources to increase its integration with regional as well as global politics and socio-economic networks. However, in terms of building a stable economy, Mongolia should expand its development opportunity with third neighbors beyond the natural resource sector, diversify economic relations, and invest in sectors

[164] Global Security, "Mongolia - Border Troops / Border Forces," http://www.globalsecurity.org/military/world/mongolia/border-troops.htm.

[165] Jeffrey Reeves, "Resources, Sovereignty, and Governance: Can Mongolia Avoid the 'Resource Curse'?" (2011), 176.

[166] Ibid.

other than mining. For example, agriculture, livestock, and farming were the main sectors that generated revenue before the mining industry blossomed in Mongolia in the late 1990s; and they were the main contributors to exports and the national GDP.

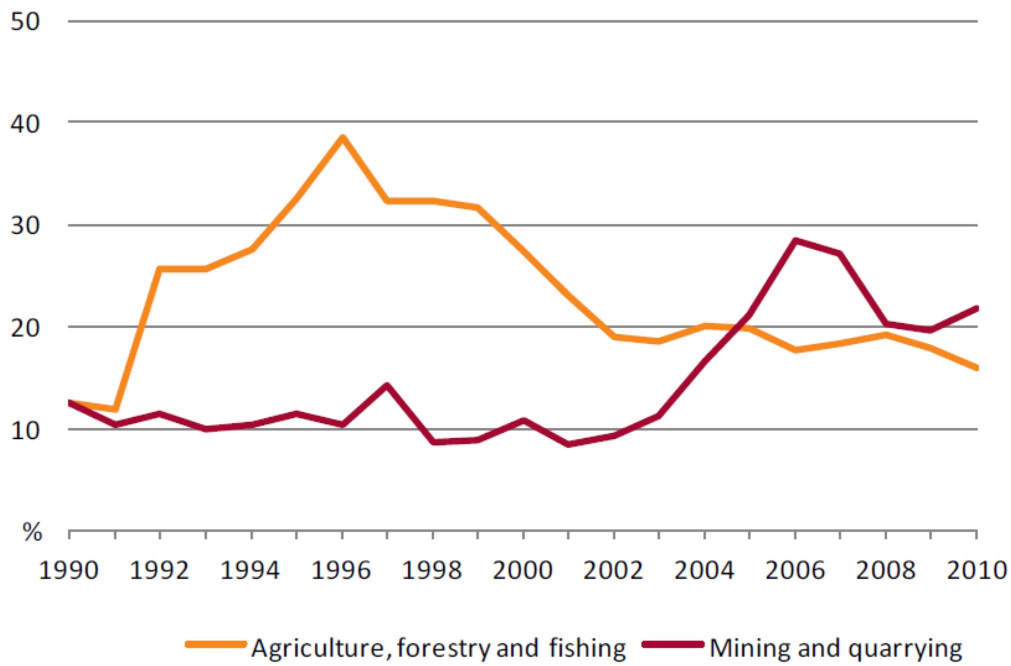

Figure 9. Contribution to GDP by Industry (2014).[167]

International relationships and the sovereignty of developing countries are shaped by the national interests of the world's powerful states. If Mongolia cannot assure global recognition of its government, it will be vulnerable to the implicit desires of China and Russia to keep the legitimacy and identity of Mongolia reliant on them. Therefore, even though Mongolia is an internationally accepted independent member state of the United Nations, it needs to maintain its third neighbor policy. The policy, however, brings a challenge to the Mongolian government in dealing with China and Russia—it obviously increases their displeasure with Mongolia, for it seeks developed and powerful partners other than those two.

[167] Bill Binks, Andrew Haylen, Sally Grimes, and Lyndal Thompson, *Potential Agricultural Cooperation between Mongolia and Australia* (Australia: Australian Bureau of Agricultural and Resource Economics and Sciences, March 16, 2014).

Mongolia's integration within the international community has increased through the third neighbor policy. For example, Mongolia's active participation in United Nations peacekeeping missions and NATO-led coalitional operations has contributed to the enhancement of its military capacity and its worldwide recognition. A bilateral peacekeeping exercise, "Khaan Quest," between the United States and Mongolia was initiated in 2003. Since then, Mongolia has annually hosted the event, aiming to make it a regional event. The number of participating countries has constantly increased, and in 2013, 1,000 officers from 14 nations, including the United States, Australia, Canada, France, Germany, Japan, India, Indonesia, Nepal, South Korea, Tajikistan, the United Kingdom, and Vietnam, participated in the exercise.[168] The displeasure of the two neighbors, Russia and China, was expressed, and they did not send their participants. In 2014, China is sending its contingent to participate in the "Khaan Quest" exercise for the first time, acknowledging Mongolia's effort to strengthen regional peacekeeping capability. Moreover, bilateral exercises between China and Mongolia, and Russia and Mongolia, have regularly been held. However, the close relationship between the United States and Mongolia, particularly in the military field will be limited due to its neighbors' discontent. For example, there are incidents in which China did not allow the United States to fly military transport planes to Mongolia via Chinese air territory. Mongolia's achievement in attracting the interest of the international community is made not only by its own sole effort. The United States, as a major global power and the closest "third neighbor" of Mongolia, has enormously supported Mongolia's involvement in global events. As a result, the immediate regional economics of the natural resource sector notwithstanding, the role of Mongolia in balancing power in the North East Asian region has continually increased.[169]

[168] InfoMongolia, "Khaan Quest 2013 to Start on August 3," http://www.infomongolia.com/ct/ci/6361.

[169] Jeffrey Reeves, "Resources, Sovereignty, and Governance: Can Mongolia Avoid the 'Resource Curse'?" *Asian Journal of Political Science* (2011), 171.

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V. CONCLUSION: VALUE CHAIN ANALYSIS OF MONGOLIAN RESOURCE SECTOR GOVERNANCE

Mongolia is endowed with abundant natural resources, including 8,000 deposits, and more than 440 types of minerals.[170] During the Socialist period, Mongolia had limited access to the global market. It extracted only a small portion of its sub-soil resource wealth with the participation of the Soviet Union. However, once the Soviet Union collapsed in 1990, Mongolia pursued its own independent policy that promoted democracy and an open market system. This policy allowed for massive foreign investment in Mongolia, especially in the mining industry. As a result, Mongolia is now one of the fastest growing economies in the world, with an ever-increasing GDP.

Nevertheless, Mongolia has experienced challenges both in managing its new democracy and its abundant natural resources. Mongolia has already experienced some symptoms of the resource curse, which is a common phenomenon in resource-rich developing countries. When a government collects huge revenue from its natural resource sector, it often ignores more traditionally important sectors to the economy, such as agriculture, livestock, and farming. An even more detrimental consequence is that the Mongolian economy has become extremely dependent on the mining sector, and as a result, corruption, rent-seeking, poverty, and inequality have become more prevalent in the country. Resource wealth is not the cause of the curse. Whether a resource-rich, developing country is able to translate its wealth into prosperity and prevent the resource curse depends on the government’s ability to efficiently manage its resources.

A. SECTOR ORGANIZATION AND CONTRACT AWARDS

The Mongolian experience in legal and regulatory environment of its mining sector demonstrates that the state lacks the ability to keep a consistent, transparent, and predictable regulatory environment. When the parliament amends or adopts laws, it tends to downplay the opinions of professionals and researchers or the debate among the public

170 M.A.D., *The Mongolian Real State Report*.

and sector-participators. Therefore, there is the risk of enforcing the laws weakly, adopting the rules based on temporary benefits, and reneging on previous agreements.

The Mongolian parliament adopted the Mineral Law in 1997 to regulate the activities and relations between the mining and socio-economic, environmental sectors. This core law improved the legal and regulatory environment of the Mongolian natural resource sector and established a positive atmosphere among its players. It especially created a favorable and investor-friendly environment by not applying high taxation and royalty burdens on them. The parliament did not amend the Mineral Law for a decade, and this consistency rapidly increased foreign investment in Mongolia, because investors were able to predict their future mining operations. Since 2006, the Mongolian parliament has adopted several significant laws related to the mining sector, but these laws have caused some controversy. An amendment to the 1997 Mineral Law created unfavorable conditions for investors. It increased taxes, banned foreign investors from directly owning mining licenses, and put a limit on the size of the exploration area. The short-lived Law on Windfall Profit Tax, in effect from 2006 through 2011, decreased the attractiveness of Mongolian mining. The enactment of the Law on Prohibition of Mineral Exploration and Mining activities in River Basins, Water Reservoir Areas, and Forested Areas improved environmental protection; yet, the government revoked 254 mining licenses that had already been allocated before the law.

In the ownership of the mining sector, excessive involvement of the Mongolian state is observed. State ownership erodes the capacity of the private mining companies that are unlikely to have the same rights and support from the state as the state-owned companies have. The absence of equality adversely impacts the responsibilities of the companies. In other words, the state limits its ability to demand the same responsibilities for both state and private companies. State involvement strengthened a strong tie between the political leaders and the business elites in the mining sector; consequently, corruption has flourished. Moreover, the state creates high costs and low productivity; for example, it is likely to have over-employment with higher salaries than the market average. The Mineral Law of Mongolia stipulated that the sub-soil minerals are the state property. State possession in the mining area may contribute to guaranteed long-term, sustainable ownership policies and encourage capable conglomerates that efficiently coordinate the operations of the subsidiary. The Mongolian government established a state-owned Erdenes MGL mining company in 2007. The company holds exclusive rights over the significant deposits that are strategically important to the state security and economy, because each deposit has the capacity to produce more than 5 percent of the overall GDP. The operations and ownership of the company are very wide, and it holds a 50–100 percent share of the major Mongolian mining companies.

The procedure to allocate exploration and extraction rights is highly susceptible to corruption, and vulnerability has escalated in the gaps in the Mongolian mining sector's regulatory environment. The most common forms of allocation of rights are direct negotiation between the state and producers and criteria-based licensing. The sector lacks the detailed regulations and precise requirements for the companies and individuals on how to obtain exploration and extraction licenses. This gap increases the number of small and unincorporated applicants that obtain the licenses and resell them at higher prices, or it neglects responsible mining activities that are conducted by experienced and professional members. The sector produces poor quality contracts. When the government makes contracts, it looks for benefit rather than potential long-term consequences, while the sector companies seek to negotiate with the government to maximize their company rewards. This circumstance has eroded transparency and increased corruption in the sector. The government, however, is aware of the weaknesses and has made some progress in modifying the flaws. It is reviewing the process to issue new licenses and contracts, clarifying the requirements for transferring the existing licenses. Mongolian participation in the EITI since 2005, and its designation as compliant in 2010, has been an effort to promote the transparency in the sector.

Capacity of the sector agencies is very much dependent on the political environment of Mongolia, and the quality of the sector has significantly worsened. A constitutional amendment in 2000 allowed Mongolian parliament members to hold simultaneous positions in the government. This amendment has distorted the separation of power, and the checks-and-balances between the Mongolian legislative and executive branches. The government service, which is influenced by the corrupt political and business factions, has become an obstacle rather than leverage to the development of the state and private sectors. Moreover, the political fragmentation caused a lack of long-term, national-level policy, and it further generated contradiction in the legal and operational environment of the sector agencies; for example, it created inconsistency and misperception, and overlaps among their responsibilities. Such a political and economic situation allowed corruption that damages the quality and effectiveness of the sector institutions, which ultimately spoils the overall capacity of the governance.

B. COLLECTION OF TAXES AND ROYALTIES

The government lacks a balanced tax policy that is favorable to both state and investors. The collection of tax and revenue has become vulnerable to corruption, because its regulatory system is overly complex, and administration is inadequate. Central and local authorities in the taxation area lack efficient coordination of rules, and they do not sufficiently monitor tax and revenue. The taxation system of the mining sector was very attractive until changes were made in the regulatory environment. The parliament approved the Law on Windfall Profit Tax in 2006 when the price of some commodities, including gold and copper was high in the global market. The law legitimized that the government imposes a 68 percent profit tax on companies if the market prices for gold and copper exceed a particular amount that is determined by the government. Policymakers abolished the law due to of the resulting decline in investor interest in the mining sector. An amendment to double the royalty rate accelerated the investment outflow, and the Mongolian extractive industry remained one of the highest mineral royalty regimes among resource-rich countries.[171] Even so, the mining sector still has not been able to attract as many investors as it had before the amendment was made. It demonstrates how easy it is for the sector to lose attractiveness, and how difficult to regain it.

[171] Shapiro, "Economic Modernization in Mongolia" (2009), 17.

C. REVENUE DISTRIBUTION AND MANAGEMENT

The political environment of Mongolia has negatively affected the distribution of revenue, for it encourages corruption and use of the revenue for political purposes. A number of funds were established from the revenue with the purpose of supporting sustainable growth; nevertheless, the majority of these funds was uneconomically spent as untargeted cash allowances because of the political promises that the parties had made during the parliamentary elections. Due to these promises, the government has damaged the overall economic situation. It was a good step that leaders of all political parties signed a memorandum in which they agreed not to compete with other parties by giving political promises, including a cash distribuiton to the citizens with the purpose of attracting constituents. At this step, an increasing level of corruption across government sectors is becoming the main obstacle to the establishment of a system that ensures transparent and fair wealth distribution to the citizens, and long-term, consistent growth.

D. EFFECTS OF RESOURCE WEALTH ON DOMESTIC AND FOREIGN POLICIES

The richness of natural resources can affect the regime type and domestic stability. Mongolia does not have a long history of democracy, but rather with authoritarian rule under a one-party political system. Under the current situation with resource curse symptoms, the young democratic regime of Mongolia is vulnerable to deterioration. If the state strengthens its governance and institutional capabilities to maintain its mineral wealth as an efficient source of development, the democracy will also be consolidated.

One of the main factors to promote democracy is a close relationship between the state and its citizens; however, the relationship is likely put in question in the resource-rich, developing countries. For Mongolian, there is a positive tendency to support this relationship. Civil movements and non-government organizations are able to conduct their activities and put some control on mining activities. Its political environment allows the representation of citizens to the parliament, and there are a number of members of parliament and political parties who support the civil initiatives and responsible mining activities.

There have been a number of civil protests against the state policies in the natural resource sector. These protests have mainly concentrated on the sector's harmful impact on the environment. The movements complain about the government's weakness in maintaining consistent and clear laws and regulations, as well as insufficient enforcement of those laws. Politicians contribute to the decline of democracy, because they create social inequality, particularly through their involvement in the distribution process of revenue from the mining sector. Moreover, they do not adequately represent the constituencies who democratically elected them, but represent themselves to the public using the mining profits as their political tool. Given the inequality among the public and politicians, and short-sighted policy aimed at their own benefit, Mongolian democracy faces the possibility of deteriorating.

Even though there are some challenges to democracy as we have just discussed, Mongolia is not likely to experience domestic conflict and civil war. First, Mongolia does not have escalating geographic, ethnic, and religious tensions. Second, in the Mongolian case, there is no severe struggle for the power among the elites that would lead to conflict. Mongolian politicians' competition for power is linked with the businessmen instead of military or enforcement organizations.

E. BALANCING MONGOLIA'S INTERESTS WITH THOSE OF THE INTERNATIONAL COMMUNITY

The abundance of the natural resources has brought a new context to Mongolian international relations, especially with its two neighbors China and Russia. Due to today's increased global demand for energy, Mongolia's enormous source of unopened natural resources has attracted the interest of both regional and non-regional countries, particularly its two neighbors and other developed countries. However, Mongolia faces a challenge of sustaining healthy and balanced policies to satisfy its two neighbors as well as other Western countries. for Mongolia's natural resource-management policies toward foreign countries cannot be independent from China and Russia.

Mongolia needs to continue the third neighbor policy that is legitimized by its National Security Concept to balance its interests with the international community and maintain appropriate closeness to the neighbors. This policy, however, should not be limited only to the natural resource sector, but should cover other sectors that Mongolia could use to expand its relationship and mitigate its dependency on one sector. International relationships and sovereignty of developing countries are shaped by the national interests of the powerful states in the world. Mongolia's third neighbor policy increases the world recognition of the state, strengthens the legitimacy and identity of Mongolia, and ultimately makes Mongolia an important player in the regional stability and security policies.

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