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MONGOLIA:

THE POLITICAL ECONOMY OF THE RESOURCE PARADOX

SYNTHESIS NOTE

The following note is a synthesis of six background notes prepared in 2008. The synthesis, prepared in fall of 2008 under the leadership of Genevieve Boyreau, was edited (and some economic information updated) by Christopher Finch in September 2009.

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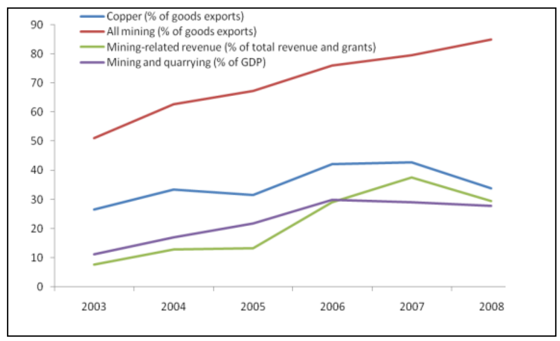
This scope of the report is selective and should be read concurrently with the recent Public Expenditure and Financial Management Review for Mongolia (2008).

Paper produced as part of a World Bank project on natural resource management.

Mongolia: The Political Economy of the resource paradox[1]

Mongolia's increasing dependence on mining revenues and the associated vulnerability to boom and bust economic cycles calls for special attention to governance in mining resource management: How does the country manage its mining resources and the related revenues so as to maximize the development impact? How does it avoid the so-called "resource curse" or deterioration of governance well known in mineral rich-countries with weak institutions?[2] What can it learn from the experiences of other mineral dependent countries that have succeeded in converting their mineral endowment into broadly shared growth, as well as from those that have not.

Figure 1: Mongolia is becoming increasingly mineral dependent



Rising global mineral prices from 2003 to mid-2008 brought changes that reverberated across Mongolia's small economy and young market and democratic institutions. The rising prices and the discovery of a world class copper/gold deposit triggered a mining exploration boom[3] in Mongolia. They also helped to bring a prolonged period of economic growth, and the expansion of foreign direct investment and foreign reserves. With higher prices and imposition of a windfall profits tax, government revenue from ongoing mining projects rose sharply. Political and public attention increasingly focused on Mongolia's large mineral endowment and mining regime. The boom contributed to major policy changes, some departing from global good practice, as policy makers and institutions with limited experience in managing large mining projects and revenues sought to grapple with rapid change.

The global economic downturn, and a sharp decline in copper prices in the fall of 2008, then rapidly brought the boom to a halt. Inflation rose sharply in 2007 and 2008, fueled in part by rising prices of imports but also by rapid increases in public spending and loose monetary policies. The US financial crisis and subsequent world economic slowdown then changed Mongolia's financial situation dramatically. The fall in copper prices from above $8,000 during the 2008 summer to $3,400 in January 2009 put the country under a much tighter financial constraint. With the fall in copper prices, Mongolia's fiscal balance turned negative in 2008, as did its current account, which swung from a 4.4 percent of GDP surplus in 2007 to a 9.6 percent deficit in 2008. The banking sector experienced a loss of confidence when the fourth largest bank

[1] The resource curse or paradox refers to the experience of resource rich countries with weakly developed institutions that have tended to do much less well in terms of growth and development outcomes than countries that are less well endowed with resources.

[2] When unbundling the resource paradox, three critical components of the mining value chain are identified as necessary conditions to maximize the development outcomes of mining: (i) securing revenues, (ii) spending wisely, and (iii) ensuring macro-stability.

[3] Between 2000 and 2005, mining exploration in Mongolia increased more than in any other country in the world, accounting for 4 percent of the global exploration budget.

collapsed, the public withdrew deposits in local currency and non-performing loans increased dramatically.

During the recent mining "boom" years, Mongolia started to exhibit some of the characteristics common to countries suffering from the "natural resource curse". Some sound policies were reversed, while other policy actions were taken without due regard for sustainability or Mongolia's continued competitiveness in attracting mining investment. Examples include: (i) major ad-hoc changes in the mining policy regime to introduce a windfall profits tax and significant state ownership stakes in strategic mining deposits, with important implications on mining sector competitiveness, (ii) appreciation of Mongolia's real effective exchange rate during the recent boom (22 percent from the end of 2005 to its peak in October 2008) was accompanied by a contraction in FDI into many non-mineral sectors, (iii) significant increases in public revenues were directed to large, mostly untargeted increases in the public investment program, in social transfers, and in civil service wages, leading to large increases in the non-mineral fiscal deficit, (iv) an amendment of the procurement law which favored direct contracting and a few local suppliers, (v) the universalization of previously targeted social assistance, (vi) the creation of a development fund with spending rules not discussed as part of the medium term budgeting exercise.

These policies, in turn, exacerbated the impact of the global economic downturn on the country. Initial analysis suggests that compared with other major copper producers (Zambia, Chile), Mongolia suffered greater deterioration in its fiscal balance, inflation, reserves, and domestic credit in recent months, indicating a particularly weak policy environment.

These impacts highlighted the risks of Mongolia's rising mineral dependence and the need for prudent macroeconomic policies, and strengthened market and democratic institutions. However, they also accelerated momentum to implement policy reforms that could enable the country to better withstand future external shocks and to increase the development returns from mining revenues. Since early 2009, the Government has introduced an ambitious macroeconomic program and has taken strong actions on fiscal, monetary, and exchange rate policies to address the crisis since the beginning of 2009. Among other changes, the Government is drafting a new package of fiscal rules to limit discretion to spend future windfalls. Hence, the events of the last decade in Mongolia parallel the experience of many other mineral-dependent countries: during periods of high commodity prices and substantial resource flows, there will in general only be a muted interest in reforms, or worse, policy reversals occur, because of short-term pressure to spend with a relaxed budget constraint. Lower mineral prices, on the other hand, imply lower public resources which in turn require taking a much harder look at public expenditures, including public wages, social transfers and investment policies, and improving accountability of natural resource management.

1. Governance snapshot

On several dimensions, governance in Mongolia is better than in comparator countries – in particular with regard to political and civil freedoms and constraints on the executive. After the fall of the Soviet Union, Mongolia faced several transitions, including, moving from: plan to market, socialism to democracy, and from being part of an economic bloc to an independent entity. Like other transition economies this meant that Mongolia had to strengthen existing or build new institutions, especially in areas of managing and regulating a market economy, in promoting democracy with appropriate checks and balances, and opening itself to new trade and investment possibilities. These efforts have to a large extent been successful. Mongolia is today a democracy and enjoys economic liberalism, basic institutions for a market economy, political pluralism, and varying degrees of voice and accountability. Education and literacy levels are relatively high. As such, Mongolia has managed its transition to a democracy and market economy quite well.

Nonetheless, despite this good progress, Mongolia has been thrust into modernizing the institutions and governance capabilities needed to manage its mineral endowment almost overnight. The pace and breadth of changes occurring (e.g for dealing with rapidly expanding mining revenues and the potential for large increases in mining production) has meant that at times sensible and sound policy making has taken a back seat to fighting crises, addressing immediate needs, and learning by doing.[4] Mongolia thus stands at the doorstep of what resource rich countries the world over have struggled with for decades: preventing the harmful effects of its riches and realizing the potential of mineral resources to contribute to growth and poverty reduction. Harmful effects include not just economic ills like Dutch disease which are well known, but the potential for natural resources and the associated revenues to weaken incentives for policy reforms and governance of institutions, with consequences that can be much harder to reverse.

In addition to the boom-bust cycle, several other "symptoms" of governance shortcomings emerged during the 2004-08 period. suggest some of the risks that Mongolia faces in managing its mineral endowment. Existing policies and institutions will need to be strengthened to ensure that Mongolia can cope with these challenges in a way that is conducive to sustainable development and shared growth:

- **Mongolia's overall mining regime became characterized by increasing uncertainty and decreasing competitiveness.** Adoption of a Windfall Profits Tax and amendments to Mongolia's Mining Law in 2006 led to a significant loss of competitiveness. Uncertainty over the mining regime – including the state's share of mining revenues and in equity – contributed to delays in commissioning proposed projects.
- **The allocation of property and mining rights and rents lacks transparency and institutional restraints.** According to public opinion polls, the public perceives that corruption significantly affects both of these areas.
- **Mining windfalls were quickly converted into large increases in public investments, social transfers, and across-the-board civil service salary pay increases,** which led to a rapid expansion of the non-mineral deficit and questions over sustainability**.**

[4] Mongolia had a tradition in mining & geology during the Soviet period; but much of previous capacity was lost during transition and the period of low metal prices associated with little exploration.

- **There was mixed success in managing fiduciary risks.** Although Mongolia made significant strides in implementing an effective budget execution and monitoring system, amendments to a new procurement law enabled use of direct contracting for specific ministries.
- **Some indicators and surveys of businesses and public opinion (including WBI's Governance indicators) suggest that corruption has been worsening in recent years and is a major hindrance to development**. [However, a semi-annual survey of household level corruption (conducted by the Asia Foundation) indicates that the incidence of households paying bribes is declining, that public tolerance for corruption is decreasing, and that the degree to which corruption is seen to be a major problem is declining (although this last finding is largely attributed to the impact of the economic crisis.]

In summary, during the recent "boom" years, policy-making became increasingly driven by populist tendencies, with short-term goals – e.g., to maximize Mongolia's share of mining revenues or to increase the distribution of cash transfers – overtaking medium-term objectives to ensure macroeconomic stability, fiscal sustainability, economic diversification, or global competitiveness. This tendency was exacerbated by weak processes for policy analysis, coordination, consultation and transparency – to help ensure that policy-making is in the long-term public interest. In some cases, it was also encouraged by public demands – to share in rapidly escalating mining revenues and to ensure that mining resources not be captured by foreign interests – also reinforced these tendencies. Populist policy making also, at least in some cases, aligned with incentives for patronage politics.

At the same time, Mongolia is not a "worst case" example of natural resource management. Significant portions of mining revenues appear to be reaching large segments of the population, although perhaps not in the most developmentally conducive forms. Based on pressure from reform-oriented policy makers, demand side actors, and donors resulted in the adoption of an Anti-Corruption Law and the establishment of an Anti-Corruption Agency; which government is slowly equipping with sufficient resources and legal powers. Mongolia made important progress in implementing the Extractive Industries Transparency Initiative, and is now one of a handful of countries on track to be recognized as "EITI compliant" by the EITI Secretariat. Mongolia boasts an active media and civil society, and there is a fairly active policy debate.

2. What the Mongolia governance assessment/political economy analysis set out to achieve:

So what are the key governance elements central to transforming Mongolia's natural wealth into development outcomes? In the context of Mongolia's political economy and institutions, how can Bank activities better support strengthening governance along this "mining value chain"?

For the relatively few mineral-rich countries that have managed to achieve sustained growth -- such as Botswana and Chile– their good performance appears to be associated with the quality of economic management and the competence of institutions, mostly those relating to the management of mining revenues and the management of the mining sector itself.

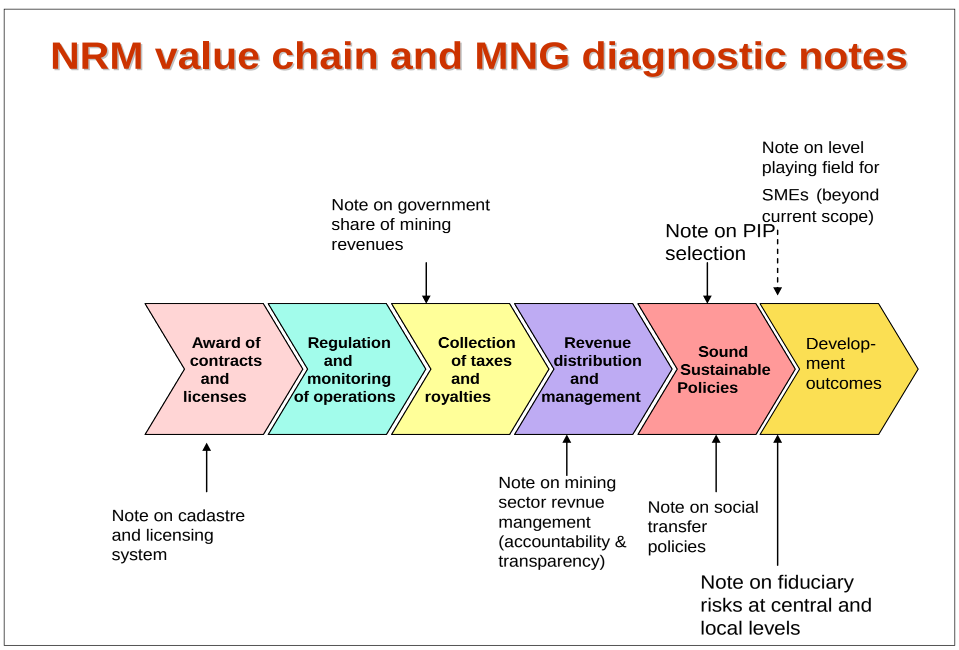
As such, where does Mongolia stand among other resource-rich countries? What areas of governance show greatest strength? What areas are potentially weak or unlikely to keep pace with these new demands? How might the World Bank's new country strategy and evolving program better assist the government and broader society in its efforts to strengthen these areas of governance?

To inform the World Bank's program and strategy, the governance assessment sought to: (i) identify what are the key governance ingredients (or governance obstacles to overcome) across the mining value chain which are central to transforming Mongolia's natural wealth into development outcomes, and (ii) propose pragmatic recommendations on how to strengthen governance – as an integral part of the World Bank Group's strategy and program, given Mongolia's political economy and institutional context.

To do this, by unbundling governance at key points along the mining value chain, the team sought to identify a set of discrete problems, and propose entry points through which the World Bank and other stakeholders could support better informed policy making. Three critical components of the mining value chain were identified: (i) securing revenues, (ii) spending wisely, and (iii) ensuring macro-stability. Within these components, the_following areas were studied through a combination of stakeholder mapping, focus groups, key informant interviews, a cross-cutting public opinion survey, and background notes:

Securing revenues:
- (i) the government share of mining revenues;
- (ii) the cadastre and licensing system;
- (iii) the accountability of mining revenues;

Spending wisely
- (iv) the public investment program,
- (v) the child money program;
- (vi) fiduciary risks



At each point, the following questions were addressed: (i) what are the governance risks for not implementing policies that generate a "blessing"? (ii) What is the interplay between the demand and the supply side of governance? (iii) What are the possible entry points for influencing this interplay, including progressive coalitions which the Bank may be able to support? and (iv) how might the Bank adjust its programming to target realistic and feasible results.

The following section looks deeper into the mining value chain, from extraction to development outcomes, to examine governance constraints, with options for addressing these constraints in the Bank's strategy and program.

3. The political economy of natural resources

How do the cross-cutting governance problems identified above influence decision-making when it comes to mining resource management?

3.1. Governance challenges across the value chain – during a time of high global mineral prices:

The team examined the following links in the mining value chain, with an effort to understand key governance challenges, salient political economy drivers for or against reform, to identify "good enough" policy and institutional reforms, and rethink the results the Bank aims to support through its strategy and program.

- **Mongolia's overall mining regime: increasing uncertainty, decreasing competitiveness.** Against the backdrop of rising mineral prices and proposed stability agreements for large new mines, two policy decisions in mid-2006 significantly increased the government share of mining revenues and introduced the possibility for government equity participation. In May 2006, Parliament adopted a Windfall Profits Tax [5] and in July 2006, the Mining Law was amended. [6] Comparative analyses of Mongolia's fiscal regime for mining versus other major mineral producers indicated that Mongolia had become significantly less competitive[7]. Despite the adoption of the new laws, new amendments

Fraser Institute Mining Survey: Index of Policy potential (100 = most encouraging to investment)				
	2004/05	2005/06	2006/07	2007/08
Chile	73	87	64	82
Botswana	35	49	47	74
Zambia	38	23	31	50
China	49	41	28	33
Mongolia	**34**	**54**	**12**	**19**
Indonesia	12	22	23	14
Bolivia	20	25	9	7
Zimbabwe	8	2	3	3

[5] The Windfall Profits Tax applied a 68% tax to revenues from prices exceeding a base prices of $2600/ton for copper and $500/oz gold with a provision that the revenues collected under the fund would be deposited in a new development fund to finance social programs and infrastructure.

[6] The 2006 Mining Law included: a doubling of royalty rates on metals from 2.5% to 5%; an increase in mining licensing fees, shortening of license duration to discourage speculation and under-utilization of licenses, and a doubling of the maximum duration of investment contracts (up to 30 years), with provision for stability clauses on the tax regime and requirement that investments above $100 million be approved by parliament; establishment of the possibility for government equity participation up to 34% in strategic deposits and up to 50% in strategic deposits discovered with government support and a requirement that any holder of a mining lease for a strategic deposit to list 10% of the company's equity on the Mongolian Stock Exchange. The law also included a restriction that foreign workers make up no more than 10% of a mine's workforce, and provides for the sharing of royalty payments—10 percent to the soum or district budget, 20 percent to the aimag or city budget, and 70 percent to the state budget—and the allocation of 10-25 percent of license fees to aimag government for local economic development in an around the mines. Up to 30 percent of the royalty payment to the state budget will be distributed to finance the geology and mining sector.

[7] Mongolia's ratings on the Fraser Institute's policy potential index – a composite index measuring the overall policy attractiveness of 68 mining jurisdictions around the world – have fallen significantly, and

continued to be tabled, and proposed investment agreements for two new large mines were repeatedly postponed.

- **Mining cadastre and licensing system: lacking detailed regulations and transparency in license allocation procedures**. Reform of the system has proceeded slowly, despite technical assistance from the World Bank. In addition to lacking a detailed regulatory framework, the system is operated manually, and includes multiple steps (up to 29 steps), many of which are subject to discretion and political interference. High-level personnel changes—the cadastre office was headed by four different individuals between 2006 and 2008—meant little continuity. The gaps in the system leave room for potential administrative corruption, conflict of interest, and state capture.[8] The 2006 World Bank Investment Climate Survey estimated unofficial payments required for exploration and mining licenses at about 40 percent of the official fees. These factors led to the perception, articulated by civil society groups as well as by government officials, that favoritism and patronage in license granting are common. For example, government officials are allowed to be shareholders in companies that are granted mining licenses. The lack of transparency contributes in turn to other governance obstacles, which include weak local consultation and inadequate dissemination of the mining register. Compounding this, civil society groups express the view that subnational officials often simply control the process themselves, ignoring the rules on public consultation and taking side payments from mining companies in return for issuing subnational approval.
- **The public investment program: rapid expansion, but limited systems to convert new resources into developmentally oriented investments.** The public investment program expanded rapidly from 2005 to 2008— especially in nominal terms (where it expanded nearly 9-fold), but also in real terms and as a share of GDP— challenging domestic capacity to prioritize and implement investments. However, PIP planning and execution systems were not prepared for the much higher volume of resources. The planning process retains substantial weaknesses: there is no institutionalized comprehensive overview of investment priorities, (ii) investment planning appears to be highly politicized and to lack systematic consideration of running and maintenance costs, (iii) processes for vetting projects are too weak, (iv) accountability mechanisms are weak. There is no firm legal requirement for (major) investment projects to be assessed through a feasibility study, cost-benefit analysis, or even a detailed costing plan before being included in the annual budget. As revenues rose, Parliament increasingly intervened to expand the PIP resources above those included in the executive budget proposal (for example, nearly doubling the executive's proposed PIP in 2007).
- **Social transfers: rapid expansion in untargeted transfers**. When introduced in January 2005, the Child Money Program constituted an important attempt to introduce for the first time a conditional and targeted cash transfer following good international practice. Initially, the program paid a small amount (3,000 T/month/child) to poorer families with three or more children, conditional on school attendance and several other behaviors. The CMP introduced the principle of beneficiaries being selected on the basis of need through an objective set of indicators, replacing the old system of subjective assessment of poverty by local authorities.

Mongolia's rank declined from 33rd highest out of 64 jurisdictions in 2005/6 to 61st out of 68 jurisdictions in 2007/8.

[8] *State capture* "refers to the actions of individuals, groups, or firms both in the public and private sectors *to influence the formation* of laws, regulations, decrees, and other government policies to their own advantage as a result of the illicit and non-transparent provision of private benefits to public officials." State capture, which includes patronage, is directed at extracting rents for a narrow range of individuals and groups through distortions in the legal and regulatory framework; it is most prevalent where economic power is highly concentrated, countervailing social interests are weak, and the formal channels of interest intermediation and political institutionalization are underdeveloped.

The Child Money Program and other social transfers were promised in political platforms of the 2004 elections. However, implementation of the CMP ran into many difficulties. Soon afterwards, amendments universalized the CMP to all families, increased the benefits and introduced other large allowances—all facilitated by large revenues from mining. The CMP was universalized to all families with children in July 2006, and benefits rose from 36,000 Tg per year to 136,000 Tg per year.[9]

- **Managing fiduciary risks: a mixed success.**[10] [11] On core budget execution systems, Mongolia has made significant strides and has an effective budget execution and monitoring system**.** And while the overall procurement framework is adequate, recently adopted provisions now allow the ministries of fuel and energy and transport to use direct contracting for high value contracts. This is a source of concern because direct contracting increases the ability of procurement entities to collude with suppliers, and also reduces competition and contestability. Another issue is that under Mongolia's relatively centralized budget planning and execution, service delivery units at the provincial level report vertically with very little reporting/oversight by provincial authorities. Finally, while MoF is able to control the funds spent but there is no means to verify if the service delivery units actually delivered the number of units of goods procured.

3.2. Unbundling the Resource Paradox in Mongolia

Five political economy factors were identified as critical in explaining governance problems in the mining value chain. Table 1 reports each of them, with their significance along the value chain, from securing revenues (licensing system and questions of ownership) to spending widely (investment spending, social transfers, and the fiduciary environment in which budget is executed).

Table 1: Governance factors and the resource paradox

	Rapid expansion of public revenues	Political uncertainty	Lack of accountability /transparency	Patronage networks/conflict of interest	Nationalism and Sovereignty	Populism
Securing revenues						
Licensing system	0	*	***	***	?	0
Government mining share	***	**	**	***	***	**
Spending wisely						
PIP	***	***	**	***	*	***
Cash Transfers	***	***	*	0	*	***
Fiduciary risks	**	**	**	***	0	0

The table provides an assessment of how significant the role of each governance driver is along the mining value chain.

[9] 3,000 T continue to be paid monthly plus 25,000 T paid quarterly.
[10] Fiduciary risks are the possible diversion or leakage of funds from the point of receipt to the point of execution.
[11] See also the Mongolia Public Expenditure and Financial Management Review (2008).

External factors

Rapidly rising mineral revenues, coupled with weaknesses in the fiscal framework, and public and political pressure to rapidly spend mining revenues.

The rapid expansion of Mongolia's government revenues from 2004 until mid 2008 was a key driver of policies and governance across the mining value chain. High global prices, rising mineral revenues, combined with the prospect of future large mining developments, increased public expectations to see economic benefit from the mining sector. They also led policy makers to make changes in the mining regime, such as the windfall profits tax, that increased revenues to the state in the short term but that likely contributed to delays in new mining projects and potentially reduced Mongolia's competitiveness to mining investors. Rising prices for metals on international markets were also a key driver of policy changes to increase state equity participation in mining. Expanding revenues are also a major driver of public investments and the Child Money Program. The impacts of rising mining revenues were heightened by the country's fiscal framework, which lacked elements to smooth the effects of cyclical mining revenues on expenditures, and by the tax regime, which lacked provisions to increase state shares during times of high commodity prices. The presence of large fiscal resources also heightened competition between political parties to outdo each other with campaign promises for various social transfers. Politicians interviewed for the assessment cited strong public pressure to make social transfers; however, the public opinion survey conducted for the governance assessment found that the largest group of respondents said funds should be invested by the state to improve economic development, followed by those who said there should be increased social programs to give immediate relief to the population. By contrast, the sudden reversal of external conditions in 2008 has led to a renewed drive to fix shortcomings in the governance of mining revenue management.

Internal factors.

Political uncertainty and populism. A closely contested Parliamentary election in 2004, with each of the two major parties receiving a near-equal share of seats, led to a series of three fragile coalition governments from 2004 to 2008. With uncertain tenure and internal rifts, the coalition governments had difficulties in arriving at and implementing a coherent reform agenda. In this environment, the Parliament assumed a very direct role in policy formulation and decision-making, repeatedly adopting populist policy measures and over-ruling recommendations from the executive. Examples include Parliament's role in expanding social transfers (e.g., universalization of a child money program, introduction of money for newly-weds), introducing the windfall profits tax, expanding the public investment program beyond government proposals (nearly doubling it in 2007), and changing procurement rules. Parliament had little policy analysis capacity during the period, and has also lacked mechanisms for regular public consultation on draft legislation or for liaising with constituents. In addition, the succession of coalition governments contributed to a short time horizon for policy makers and rapid changes in policymaking.

The public investment program, which increasingly became an instrument to fulfill populist promises by parliamentarians, is a good example of how Parliament's role expanded. Similar to other countries, a politician's ability to deliver public investments to his/her constituency is a key factor determining electability, especially in rural districts. The allocation of investments is strongly influenced by a political-electoral logic. It is also strongly influenced by Mongolia's electoral system, in which rural voters are substantially over-represented (in the 2008 elections, 20 out of 76 seats were allocated to residents of the capital city Ulaanbaatar, although Ulaanbaatar residents account for over 40 percent of the population). Incentives and constraints to allocate interests in the long-term exist, but requirements for project vetting, the gate-keeping role of MOF, and constraints imposed by the formal budget process were insufficient to constrain political incentives – especially those related to the electoral system. Lack of rigorous systems to ensure that new investments match long-term development priorities, have undergone adequate feasibility study and cost-benefit analysis left parliamentarians in a position to be able to select and even introduce investment projects without strategic or upstream justifications. It was then possible to include large numbers of investment projects and to allocate projects across localities. It was also a key factor explaining the quick amendment of the procurement law to allow faster disbursement. The presence of coalition governments also complicated the ability of the Ministry of Finance, as a stakeholder or for the Cabinet as a group, to exercise a gate-keeping role. Finally, the decision to universalize the Child Money Program was clearly based on populist premises and was a promise of 2004 elections. The Mineral law amendments (past and future) were also linked to political promises to secure for Mongolia a fair share of mining revenues. Interestingly, however, the public opinion survey suggests that parliamentary decisions do not always track majority public sentiments.

Limited policy and institutional mechanisms to ensure accountability and transparency.

*The policy-making process remains non-transparent in important respects***.** The Law on State Secrets restricts public access to government documents. Draft laws scheduled for consideration by parliament are now mostly available to the public through the website of parliament and the 2007 draft budget was the first to be available for public discussion, but this is not yet institutionalized through legal rules. Parliamentary votes are difficult to access ex post, and hence the voting record of an MP is not readily monitorable.

Mongolia's relatively young institutions also often lack well-developed systems of vertical transparency and accountability. This includes mechanisms to transmit high-quality information to stakeholders, to consult with beneficiaries and stakeholders, and to enable stakeholders to seek recourse when laws or procedures are unclear or not followed.

For example, the high degree of discretion in mining license allocation is made possible by limited accountability and opaqueness of the process. Perceptions that existing systems cannot reliably collect and track mining revenues and expenditures, and suspicions of corruption around natural resource deals where Mongolia received a smaller share of revenues, have contributed to calls for the state to take greater shares. The lack of a regulatory framework to properly implement the good practice provisions included in the Mineral law can be seen as a response allowing a certain degree of discretion in the licensing system. Similarly, the amendment to the procurement law limiting foreign competition and allowing direct contracting can also be interpreted as a means to limit accountability and increase discretion in decision-making.

Patronage networks and unregulated conflict of interest

According to key informants, patronage links are strong and embedded in political parties, regional networks, and business conglomerates. Politics and economic opportunities are closely linked, and the links are said to have become stronger during the recent series of coalition governments. Opportunities for conflicts of interest in the public sector are substantial and are not legally regulated. There are strong traditions of personalized interactions and mutual and family obligations. For instance, there is no regulation of conflict of interest in mining licensing, leaving room for patronage. State-owned assets in the mining sector have provided key sources of political patronage in the past, and hence are seen at least by some in the elite as models that have worked effectively to serve political and personal interests. This is said to be one factor contributing to the growing number of stakeholders during the boom period who advocated for Mongolia to take 51 percent in new strategic mining projects – a policy change that could create new sources of patronage along with responding to populist demands and concerns over sovereignty. The patronage logic applies to projects from which specific companies – including companies in which MPs themselves may hold business interests – would benefit. The amendments of the procurement law limiting foreign competition and allowing direct contracting have also left room for patronage.

Concerns over sovereignty and national interests

With rising prices and expanded presence of foreign companies, sovereignty and foreign policy interests were widely held up as a key justification for proposed policy changes to increase state participation in the mining sector and to raise taxes on mining companies and foreign investors. Some policy makers and civic movements say that Mongolia's national interest will not be served if strategic deposits are not controlled and managed by the state. The Erdenet mine, in which the Government controls a 51% share, is widely held up as a positive example of mining development that contributed to government revenues and local development because of Mongolia's controlling interest (since 1991). By contrast, more recent natural resource developments were cited as examples of the risk that national interests may be compromised if Mongolia does not hold a controlling interest in new mining projects. In the absence of a 51% or greater state interest, given a relatively weak legal environment, there is also the concern that there is little to prevent a company from selling its share to a company that may have lower standards for transparency, environmental management, or corporate responsibility.

Limited awareness of the costs and benefits of policy options related to managing a mineral-based economy, *of the related experience of other resource rich countries, and limited mechanisms to systematically gather high quality information on these policies, and to distill and inject such information into economic and mining policy debate was also a key factor in policy making.* A public opinion survey revealed that public interest in how the government manages mining resources is strong, but that the level of information is low and is perceived to be difficult to access and non-transparent. Public interest is strong both in upstream issues such as mining licensing and the share of state ownership in mining, and downstream issues such as how revenues are spent both at the central and service delivery level. There is also a lack of high-quality, appropriately presented information on the costs and benefits of mining policy options, and the experience of other countries in undertaking similar policy reforms. There are also weak mechanisms in place for opinion leaders to systematically gauge public opinion on specific issues, with the possibility of disconnects between perceived and actual policy preferences. For example, survey questions regarding the most important use of mining revenues, survey respondents indicated the strongest preferences for building rural infrastructure (the focus of the public investment program), followed by long term social programs in health and education (a lower budget priority), followed by increase salaries of state employees (a top budget priority) and increase pensions and allowances (a top budget priority). Yet the level of information is low, and the sector is perceived as corrupted. Access to information is perceived as difficult.

4. Implications for Bank engagement:

[*Note*: The following section was written before the finalization of Bank's new Interim Strategy Note (ISN) for Mongolia, decision to provide development policy credits (DPCs), and receipt of Mongolia's Governance Partnership Facility (GPF) grant. Many of the following ideas below have since been incorporated into the strategy and instruments.]

Given the governance drivers at play, what is the best strategy for the Bank engagement in Mongolia to help overcome governance problems in mining?

The Bank engagement will focus on building its capacity to flexibly respond to changing macroeconomic circumstances and priorities, on broadening engagement with and between parliamentarians and politicians and civil society, encourage more transparent policy analysis and debate while continuing building on core public sector reforms to strengthen institutional accountability. The Bank can also, in a limited way, help to strengthen monitoring by civil society at key points in the value chain, by strengthening capacity of Mongolian civil society organization to use a number of social accountability tools.

Strengthen policy analysis, with stronger dissemination to get message across. Facilitate an informed and transparent public policy debate, highlighting policy tradeoffs.

Facilitating an informed public policy debate will (i) improve transparency and act on public perceptions that the level of information available is low; (ii) respond to political divisions by broadening the debate and bringing all stakeholders to the table; (iii) strengthen accountability and help move away from patronage networks. This can be achieved by:

- Hosting regular policy forums to discuss mining sector, economic performance, and national development where candid views can be exchanged and the Bank view presented. To have traction, information needs to reach not only Mongolian policy makers, but also other key stakeholders, journalists, and the broader public. Using multiple channels would ensure the broadest coverage, with emphasis on television and radio as the preferred sources of information among the public.
- Strengthening capacity for policy analysis, on strengthening research and analytical capacities. Building the capacity of Mongolian organizations –independent Mongolia think-tanks and GOM/Parliament research and analytical capability -- to conduct and disseminate such analysis will be especially important.
- Supporting Government outreach efforts to lawmakers, key stakeholders, and the general public on proposed policy reforms to strengthen management of the mining sector, mining revenues, and related economic reforms.
- Increasing emphasis on cross-country learning between practitioners. Experience in Mongolia has shown that policy makers are often most receptive to learning from other countries and practitioners. Linking Mongolian policy makers and practitioners with countries that are successfully managing mineral resources, revenues, and related economic issues

Engage effectively with parliament and political parties and strengthen parliament's capacity.

Given the prominence of Parliament in decision-making in Mongolia and the key role of political parties, it would make sense for the Bank to engage more systematically with these stakeholders. Since many policy decisions are made in Parliament, the Bank might consider entry points for introducing expert advice into the policy dialogue in the parliamentary arena. In particular, the Bank is working to work on The Mongolia country team may consider partnering with the World Bank Institute to deliver a parliamentary capacity-building program that is focused on dissemination of international good practice in the mining sector to enhance decision-making in this critical area. The Bank could also partner with the Parliament in strengthening oversight of the Budget and the Development Fund Management while entering into partnerships to strengthen role of civil society on external oversight.

Strengthen social accountability by supporting community driven initiatives in monitoring mining and public resources management.

Another potential opportunity for the Bank is to increase its engagement with civil society with the objective of improving transparency and governance in the mining sector. This includes monitoring the licensing process, with partnership with civil society to monitor the allocation of licenses, particularly at the stages in which subnational governments are involved.

Another partnership would be for improving monitoring arrangements of service delivery units. The Bank can work with other development partners and civil society on developing a good monitoring framework that would inculcate horizontal monitoring of performance of service delivery units. Similarly, as stated earlier, with regards to the Child Money Program the Bank team could encourage government and potentially also non-government actors to establish systems to monitor the impact of the CMP and other social transfers.

Propose pragmatic policy options which fit policymakers' concern or vision, as opposed to first best optimal practices

A number of reforms were reversed from what was considered best international practice. This was the case for the Mineral law, the procurement law, the SSMP, and the conditional cash transfer scheme of the Child Money program. In all of these examples, the signal that came from policymakers was that structural conditions had changed and that, as a result, the legal context should adapt to allow the country to take maximum advantage of the new situation. This explains well the willingness to redefine the revenue sharing arrangements between the private sector and the Government (Mining law), with the Mongolian people (the universalization and scaling up of the Child Money Program), and the willingness to be able to procure more rapidly (procurement law amendment).

In addition, a number of reversed reforms were having in practice *implementation issues or teething problems*: The mineral law was best practice, but the provisions related in particular to the licensing and cadastre regime were not implemented, because of a lack of regulatory framework. The implementation of the Child Money program CCT had many issues, with large targeting leakages, and was as a result perceived as unfair, while monitoring the program was weak. The procurement law, which represented a significant improvement, had many implementation difficulties from the beginning, leading to delays in the investment plan execution.

A challenge for the Bank is to be able to formulate good reform solutions which fit the country implementation capacity and flexible enough to respond to changing country dynamics. Areas were the Bank could refine its support to fit better Mongolia's realities include (i) *Mining ownership*, by taking into account concerns that by entering into an investment agreement the Government will lose the ability to influence or veto decisions that negatively impact national security; (ii) the *Public Investment Program*, with focusing the discussion primarily on the principles of 'development oriented' investments and what this would imply across sectors and issues – without favoring one institutional model for pursuing the overall goal.; (iii) *Procurement*, by taking into account the policymaker's concern that public procurement of public investment projects must allow to disburse fast enough, by focusing on improving procurement efficiency.

Sustain assistance to build strong PFM institutions building on successful past assistance

The Bank is already significantly involved in supporting good governance in the public sector in general and in mining in particular. Further assistance should be built on these existing initiatives. The Bank benefits from an excellent record in public financial management reform, with in particular the implementation of the Government Financial Management and Information System, which has contributed to a great extent in eliminating leakages from the budget. Building on these good successes, assistance to strengthen horizontal accountability and effectiveness of the use of public monies at the service delivery level should be the next focus.