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Монголын Төсөл

A Path Forward for Mining in Mongolia

A Report by The World Growth Mongolia Centre for Policy Research

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EXECUTIVE SUMMARY

This report addresses the key policy issues that confront the Mongolian Government and the State Great Hural in deciding the nature of the taxation and regulatory regimes which are to apply to commercial mining in Mongolia.

During this process, it will be important for the Government and the State Great Hural to consider the roles that the public and private sectors are best suited to play in the exploitation of Mongolia's mineral wealth. Only the public sector can establish the legislative framework that supports and enforces a system of transparent, secure and transferable property rights in mineral exploration, mining and processing. With that in place, the private sector is ideally placed to organise the extraction of economically useful minerals and metals.

In doing so, however, the public sector needs to avoid imposing excessive taxation and regulation on the mining sector, such as it has done with the Windfall Profit Tax and the statutory requirement for the state to acquire a percentage of the equity in mineral deposits of strategic importance to Mongolia.

Simply stated, these policy initiatives strongly discourage investment in Mongolia—investment that would generate tax revenues and employment, thereby raising living standards across the country.

The Windfall Profit Tax means that the effective tax rate on mining profits from all Mongolian taxes is over 80 percent. This is more than twice the effective tax rate that is imposed by international "best practice" mining jurisdictions elsewhere, such as Chile and Botswana. As a consequence, Mongolia is distinctly unattractive to international mining investors. This has been confirmed by the annual Fraser Institute surveys of international mining executives.

Implementation of any equity requirement, even at a much lower level, would only increase the effective tax rate and further aggravate Mongolia's already unattractive investment climate. This is at a time when the outlook for mining investment is being adversely affected by the global credit crunch, rapidly deteriorating economic growth in the U.S., the E.U., Japan and China, falling world metal prices, and accelerating labour costs in Mongolia. For example, Rio Tinto has indicated publically that it will probably put new investment in Mongolia on hold.

The recent proposals to replace the statutory equity requirement with a 'Golden Share' or to increase the level to a majority public ownership amount to effective nationalisation. Either proposal would completely devastate investor confidence in new mineral exploration.

Replacing the statutory equity requirement with a Production Sharing Arrangement would be little better. Effectively, such arrangements are an additional royalty that is levied at a much higher and uneconomic rate but with few of the advantages of the traditional *ad valorem* mining royalty. They are very costly for both parties to administer, as the metal content of the concentrate produced at a copper mine tends to vary continuously and hence conflicts between the parties are inevitable. Moreover, the Government would have to be actively involved in marketing its share of the concentrate to convert it to cash but has little or no specialised knowledge or experience to draw upon when doing so.

Implementation of any equity requirement, even at a much lower level, would only increase the effective tax rate and further aggravate Mongolia's already unattractive investment climate.

Furthermore, retention of the equity requirement would place an enormous strain on the Mongolian budget to finance it at a time when it is stretched by demands for substantial infrastructure investment. Attempts to get around this constraint by compulsory acquisition or compulsory financing of mining licensees would do little to reassure the international investment community.

Furthermore, retention of the equity requirement would place an enormous strain on the Mongolian budget to finance it at a time when it is stretched by demands for substantial infrastructure investment.

Despite the serious risks for economic growth and the living standards of the Mongolian people, should the Government and the State Great Hural wish to retain a provision for acquiring a public equity in mineral deposits in the *Minerals Law*, it would be essential to minimize the negative implications of the measure. This would be best achieved by the following amendments to the *Minerals Law:*

- the public equity in any mineral licence must to be limited to a maximum of 34 percent of its full market value at the time of acquisition and preferably less than this level;
- for the purposes of public acquisition, the market value of a mineral licence has to be determined by an independent valuation process agreed to by the Government and the licence owner prior to it being conducted;
- the actual level of public equity to be acquired in an individual mineral licence is to be agreed between the Mongolian Government and the licence owner in the context of their concluding an Investment Agreement in respect of the development of the mineral licence; and
- the Government must finance the acquisition of any public equity in any mineral licence without any recourse to the licence owner or to the shareholders of the licence owner.

The Challenge Facing Mongolia

To facilitate Mongolia's transition from a centrally planned to a market economy, during the 1990s the State Great Hural passed a series of laws to establish the regulatory and taxation regimes within which commercial mining was to be conducted by the private sector in Mongolia. With few exceptions, state-owned mining companies in Mongolia and elsewhere have been less than successful in terms of their operational efficiency, risk exposure and public financial liability.[1]

As it turned out, the *1997 Minerals Law* [2] provided a very sound basis for the conduct of commercial mining in Mongolia and has been acknowledged as one of the most attractive policy regimes world-wide. For example, the World Bank has concluded that it incorporated those fundamental policy principles that are regarded as essential by governments and mining companies right around the world.[3]

The central achievement of the *1997 Minerals Law* was the creation of a system of transparent, secure and transferable property rights in mineral exploration, mining and processing. The soundness of the *1997 Minerals Law* was reflected in the boom in mineral exploration and mining development, which followed its passage by the State Great Hural. Since 2001, there has been a five-fold increase in both the number of exploration licences and the area under exploration. The Government has issued nearly 2,600 exploration licences covering a total of 40 million hectares — or 26 percent of Mongolia's land area.[4]

The exploration boom has lead to the development of a number of major mining projects. They include the Oyu Tolgoi and Tavan Tolgoi projects in the South Gobi region of Mongolia. Oyu Tolgoi, for example, has the potential to become the world's largest copper-gold mine producing 500,000 tons of copper and 330,000 ounces of gold a year for more than 35 years.[5]

By 2005 the mining sector was directly contributing some 18 percent of Mongolian gross domestic product (GDP), 66 percent of its industrial output, almost 76 percent of its export earnings, and 20 percent of its public revenue.[6] By 2007 the mining sector was generating nearly half of all revenue collected by the Mongolian Government.

As a consequence, the mining sector has expanded rapidly and is now Mongolia's largest industry sector. By 2005 the mining sector was directly contributing some 18 percent of Mongolian gross domestic product (GDP), 66 percent of its industrial output, almost 76 percent of its export earnings, and 20 percent of its public revenue.[6] By 2007 the mining sector was generating nearly half of all revenue collected by the Mongolian Government.

Although the public policy principles embodied in the *1997 Minerals Law* were sound, there was a clear need for further legislation to be developed and implemented to specify how a number of its principles were to be applied in practice. As a consequence, the Law foreshadowed that regulations would subsequently be implemented to:

- specify the corporate income tax treatment of certain mining finance and accounting issues; [7]
- establish reporting formats and reporting standards for mining licensees; and

[1] The World Bank, 2008, *Mongolia Quarterly*, The World Bank, Washington, DC, 28 January, p. 18

[2] *The Minerals Law of Mongolia*, Official Translation, 5 June 1997

[3] The World Bank, 2004, *Mongolian Mining Sector: Managing the Future*, The World Bank, Washington, DC

[4] The World Bank, 2007, *Mongolia: Sources of Growth*, Country Economic Memorandum, Report No. 39009MN, The World Bank, Washington, DC, 26 July

[5] Ivanhoe Mines Ltd, 2008, *Oyu Tolgoi Gold and Copper Project, Southern Mongolia,* accessed at www.ivanhoe-mines.com/s/OyuTolgoi.asp

[6] The World Bank 2007, p. xiii

[7] They are the amortization of exploration and development expenses; the depreciation of fixed assets and infrastructure; the carry-forward of tax losses; and the treatment of maintenance expenses. (Article 63, *The Minerals Law of Mongolia*, Official Translation, Ulaanbaatar, 30 October 2006)

The 2006 changes to the Mineral Law have been an unmitigated setback for the development of commercial mining in Mongolia. The fiscal and regulatory regimes are now highly unattractive to international mining investors, both in terms of the policy settings themselves as well as the sovereign risk for investors in the light of the politicisation of the debate over the policy settings.

- integrate the regulatory processes imposed by other Mongolian laws and levels of government.

Unfortunately, these regulations have mostly yet to be implemented. Instead, in 2006 the State Great Hural extensively amended and added to the *1997 Minerals Law*.[8] By doing so, it significantly undermined some of the fundamental public policy principles upon which the 1997 Law had been based.

The key legislative changes involved the introduction of:

- a 68 percent Windfall Profit Tax on the production of gold and copper;[9]
- a provision for the Mongolian Government to acquire a substantial equity in the exploitation of all 'mineral deposits of strategic importance';[10] and
- a requirement that at least 10 percent of the equity in all 'mineral deposits of strategic importance' to be listed on the Mongolian Stock Exchange.[11]

Economically efficient mining is typically a highly capital intensive operation that is conducted on a large scale.

Where the Mongolian Government had contributed to the exploration expenditure on a 'mineral deposit of strategic importance', it can acquire up to 50 percent of the equity. Where it had not, it can acquire up to 34 percent. Legislative proposals that are currently before the Great Hural, however, would raise these to a *minimum* of 51 percent.

The 2006 changes to the Mineral Law have been an unmitigated setback for the development of commercial mining in Mongolia. The fiscal and regulatory regimes are now highly unattractive to international mining investors, both in terms of the policy settings themselves as well as the sovereign risk for investors in the light of the politicisation of the debate over the policy settings. Investor aversion will have only been substantially entrenched by the recent global financial crisis, the sharp declines in world metal prices, rising labour costs in Mongolia, and the increasingly unrealistic nature of the proposals that are being canvassed in the public debate over the Minerals Law.

In the case of gold mining, officially declared production of gold has declined, particularly by artisanal miners, in spite the fact that world gold prices have generally been higher over the past two years. The apparent decline in output is due to increased hoarding and the smuggling of gold to foreign countries.[12] In

8 *The Minerals Law of Mongolia*, Official Translation, Ulaanbaatar , 30 October 2006

9 *Law of Mongolia Windfall Profit Tax*, Ulaanbaatar , May 2006

10 See Articles 5.4 and 5.5 of the *2006 Minerals Law*. A mineral deposit is deemed to be of strategic importance to Mongolia where it '…*may* have a potential impact on national security, economic and social development of the country at the national and regional levels or that is producing or has a potential of producing more than five (5) percent of Gross Domestic Product in a given year.' (Article 4.1.11, *The Minerals Law of Mongolia*, Official Translation, 30 October 2006, the emphasis has been added)

11 See Article 5.6 of the *2006 Minerals Law*

12 Since the imposition of the Windfall Profit tax in 2006, seizures of illegally traded gold by the Mongolian government have risen significantly (see Government of Mongolia, 2008, *Law of Mongolia: On Making Amendment to the Minerals Law*, Draft Law submitted to the Speaker of the Parliament, Ulaanbaatar , 14 May).

both cases, small scale producers are seeking to evade payment of the substantial Windfall Profit Tax that was introduced in the middle of 2006.

The flaws in the Mongolian policy regime have been highlighted by recent surveys of mining company executives. Each year The Fraser Institute of Canada asks executives to rate the quality of the policy regimes in mining jurisdictions around the world in terms of their investment attractiveness. In 2007-08 Mongolia was ranked as the 8th worst jurisdiction out of the 68 surveyed.[13] More tellingly, its ranking had dropped 28 places compared to the 2005-06 survey, which was conducted just before the 2006 amendments to the *Minerals Law* came into effect.

The extent of the gap in investment attractiveness between Mongolia and international 'best practice' jurisdictions has been confirmed by independent empirical research. Professor James Otto — an international expert in mining taxation and regulation with extensive World Bank experience — has estimated that the effective tax rate is nearly 70 percent of the gross profit from a large-scale copper mining project, such as Oyu Tolgoi.[14] The IMF has calculated that the marginal effective tax rate is in excess of 80 percent for such a project.[15] Even the lower of these two estimates is around twice as much as is levied by the 'best practice' mining jurisdictions around the world.

Mongolia has very strong geological prospects, of which Oyu Tolgoi is only the best known of the more immediate prospects for commercial development. The exploitation of this considerable potential in a way that maximises the economic benefits for ordinary Mongolians will, however, require vast amounts of investment capital and highly specialized expertise.

Economically efficient mining is typically a highly capital intensive operation that is conducted on a large scale. For example, the development of the Oyu Tolgoi deposit alone is estimated to require capital expenditure totalling US$7.3 billion over the life of the project.[16] Investment on such a scale is well beyond the capacity of Mongolians to finance from their own resources. Moreover, it ignores the high level of public investment in infrastructure that large-scale mining development normally requires, particularly in the remote areas of Mongolia such as the South Gobi region. The World Bank has estimated that the acquisition of 51 percent of the equity in both Oyu Tolgoi and Tavan Tolgoi together with the infrastructure required by the two projects could cost the Mongolian Government a total of US$4.4 billion, which is more than the country's GDP.[17]

[13] The Fraser Institute, 2008, *The Fraser Institute Annual Survey of Mining Companies 2007-08*, The Fraser Institute, Vancouver, BC

[14] Professor James Otto is an internationally renowned expert in mining taxation and regulation with extensive experience as a consultant to the World Bank. He instigated and published this research on his own account (see James Otto , 2007, 'Competitive Position of Mongolia's Mineral Sector Fiscal System: the Case of a Model Copper Mine', *mimeo*, January, accessed at http://21576430.domainhost.com/docs/Dr.%20James%20Otto%20—%20Mongolia%20Competitive%20Tax%20Report%20%202007.pdf)

[15] International Monetary Fund [IMF], 2008, *Mongolia: Selected Issues and Statistical Appendix*, IMF Country Report No. 08/201, IMF, Washington, DC, July, accessed at http://www.imf.org/external/pubs/ft/scr/2008/cr08201.pdf

[16] Ivanhoe Mines Ltd, 2007, *Reference Facts: Oyu Tolgoi Project*, 27 June, accessed at www.ivanhoe-mines.com/i/misc/OTFact.pdf

[17] Graeme Hancock, 2008, 'Mining Revenues: Great Expectations…What Reality?', *Open Society Forum Conference on Expectations vs Reality for Mining Sector Revenues*, Presentation by Dr Graeme Hancock, Senior Mining Specialist, The World Bank, Ulaanbaatar, 24 October, accessed at http://www.openforum.mn/pdf/public_meeting/Mining_revenues_expectations_and_realities.pdf

The Policy Solution

Mongolia does not possess either the financial capacity or the specialised manpower that are required for the development of a modern, internationally competitive mining sector. Accordingly, it has no choice but to seek the resources that it requires from the rest of the world.

To be successful in attracting these resources to Mongolia, however, the Mongolian Government has to completely revamp the regulatory and tax regimes that are applied to commercial mining there. The existing regimes are well below international 'best practice' and, as a consequence, the Mongolian mining sector is fundamentally uncompetitive in terms of its ability to attract the foreign investment that is essential to its development.

To be successful in attracting these resources to Mongolia, however, the Mongolian Government has to completely revamp the regulatory and tax regimes that are applied to commercial mining there.

Specifically the Mongolian Government should:

- return to the public policy principles set down in the *1997 Minerals Law*;
- fill in gaps in the *1997 Minerals Law* by developing regulations to:
  - clarify the treatment of mining operations by the corporate income tax regime;
  - specify the reporting obligations of mining licensees to government; and
  - streamline the regulatory processes affecting mining that are imposed by other laws or levels of government;
- repeal the Windfall Profits Tax Law;
- repeal the provision in the Minerals Law to allow the Government to acquire equity in all 'strategic' mineral deposits;
- rely on mining royalties and the corporate income tax to share the benefits of mineral development among Mongolians;
- establish a statutory Trust Fund to receive the nominated public revenues from all mining operations, to invest them as required, and to pay an annual dividend out of the net investment income direct to all Mongolian citizens;
- establish an independent body to administer the Trust Fund in accordance with explicit and transparent requirements set down by the State Great Hural, and to be accountable to it for the performance of the Fund.

These reforms have been designed with two public policy objectives firmly in mind.

The *first policy objective* is to reduce the considerable economic disadvantage that is currently imposed on the Mongolian mining sector by excessive tax and regulation. The most egregious impositions are the Windfall Profits Tax and the provision for the Government to acquire a substantial equity in any 'strategic' mineral deposits. The removal of these severe burdens will allow the mining sector to maximise its contribution to the growth of Mongolian GDP and living standards over the longer term. This must be the principal consideration in any reform process.

The Windfall Profit Tax is unprecedented among mining jurisdictions around the world. Taxing away more than 80 percent of the marginal profit on a mining project can only devastate international mining investment in Mongolia over the long term. Some existing projects may proceed because their exploration costs and some of their development have already been sunk but exploration activity will progressively decline, and with it the prospects of new developments being brought forward. Even with the repeal of the Windfall Profit Tax, the effective tax rate would remain in excess of international 'best practice'.

Regulation is significantly less efficient in redistributing the economic benefits of mining among the population at large compared to broadly based taxes, such as the corporate income tax. It does not generate a revenue stream that can be applied for public use but it does add substantially to the mining sector's costs of production. Public equity in mineral developments is also signifi-

One needs to recall that the Windfall Profit Tax has already pushed the effective tax rate for mining in Mongolia to more than 80 percent. Any public equity requirement, no matter how small the percentage, which is imposed on top of the existing tax regime, will have a profound impact on investor perceptions.

cantly less efficient than broadly based taxes. There are a number of reasons for this.

First, the aggregate public revenue collected from the mining sector and the aggregate private investment would both be lower than would otherwise be the case. The end result in both cases would be reductions in the mining sector's contribution to GDP and the living standards of ordinary Mongolians.

One needs to recall that the Windfall Profit Tax has already pushed the effective tax rate for mining in Mongolia to more than 80 percent. *Any* public equity requirement, no matter how small the percentage, which is imposed on top of the existing tax regime, will have a profound impact on investor perceptions. Although reducing the pubic equity requirement to 34 percent may allow some of the mining projects currently in the development pipeline to proceed to fruition, it would still cut the investor's share of the profits to a mere 13 percent, devastating mineral exploration in Mongolia over the long-term.

Second, public equity in mining is a much riskier way for the public to share in the economic benefits of mining compared to broadly based taxes, such as the corporate income tax. In part, this reflects the fact that equity owners only have a residual claim on the profits generated by their investment, and that the accumulation of prudent provisions and reserves must take precedence over the distribution of dividends. As a consequence, there can be long delays in receiving dividends from a mining project, even after it becomes profitable in an accounting sense.

Third, public equity requires a substantial up-front financial investment on the part of the government in acquiring the equity in question. As we have seen, in the case of a single large-scale mining project such as Oyu Tolgoi, the upfront investment is measured in terms of billions of U.S. dollars. This would be a very poor use of the Mongolian Government's very scarce fiscal resources.

Although a government could compulsorily acquire the equity it desired, this would significantly increase the sovereign risk that is faced by mining investors and would devastate investor confidence. The same result would occur if there were any suggestion that the acquisition price paid by the Government did not compensate the licensee for the full value of the equity, including the takeover premium that accompanies majority ownership. Forcing mining licensees to lend the Government the funds for the public acquisition is no solution, as it raises essentially the same risks, as does any proposal for the Government to own a Golden Share or to share in the physical output of the mining development.

Replacing the statutory equity requirement with a Production Sharing Arrangement would be little better. Effectively, such arrangements are an additional royalty that is levied at a much higher and uneconomic rate but with few of the advantages of the traditional ad valorem mining royalty.

Finally, public equity increases the scope for the government to intervene in the day-to-day management of the mining project in question. Such interference is likely to be driven by political rather than commercial considerations and will increase the risk of the project underperforming over the long-term in terms of dividend distributions. This would be a financial cost to the public purse and would create a serious conflict of interest with the government's role as the regulator of

The global financial crisis has made it much harder for countries like Mongolia to attract investment. There is less capital available for investment and risk premiums have widened substantially, especially for large projects with long lives.

the mining industry in the public interest.

The Golden Share markedly accentuates this shortcoming as it generates negligible revenue in dividends, when they are eventually distributed. The concept is purely about control of the major decisions affecting the business in question. Investors have every reason to believe that governments have neither the knowledge nor the incentive to make these in the best interests of the business.

Replacing the statutory equity requirement with a Production Sharing Arrangement would be little better. Effectively, such arrangements are an additional royalty that is levied at a much higher and uneconomic rate but with few of the advantages of the traditional *ad valorem* mining royalty. They are very costly for both parties to administer, as the metal content of the concentrate produced at a copper mine tends to vary continuously and hence conflicts between the parties are inevitable. Moreover, the Government would have to be actively involved in marketing its share of the concentrate to convert it to cash but has little or no specialised knowledge or experience to draw upon when doing so.

The global financial crisis has made it much harder for countries like Mongolia to attract investment. There is less capital available for investment and risk premiums have widened substantially, especially for large projects with long lives. The crisis means that there is likely to be a strong 'flight to quality' by global mining investors, in terms of the quality of the policy regime where the investment is to be made. As we have already seen form the Fraser Institute rankings, Mongolia rates badly on this scale at the present time.

Moreover global economic growth is slowing markedly. The European Union and Japan are already in recession and the US is not far behind. World copper prices have halved in the past six months, copper stocks are rising, and labour costs in Mongolia are rising rapidly.[18] As the developed economies are the major markets for Chinese industrial exports and China is the major market for any expansion in Mongolian mineral exports, the business outlook for mining investment in Mongolia is now much less attractive than it was last year.

As a consequence, the large international mining houses are now reported as giving preference to investing in expanding their existing mines over riskier investments in new territory. Rio Tinto, for example, is reviewing all the proposed investment projects, which the company has in the pipeline, and expects that the review will lead to it putting its proposed investment in Oyu Tolgai on hold.[19]

The world has changed completely since the idea that the Government should own at least 51 percent of strategic mineral deposits was floated in Mongolia. The Government needs to recognise this fact and ensure that public policy allows the mining sector and the rest of the Mongolian economy to take the least painful path in adjusting to it.

Despite the serious risks for economic growth and the living standards of the Mongolian people, should the Government and the State Great Hural wish to retain a provision for acquiring a public equity in mineral deposits in the *Minerals Law*, it would be essential to minimize the negative implications of the measure. This would be best achieved by the following amendments to the *Minerals Law*:

- the public equity in any mineral licence must to be limited to a maximum of 34 percent of its full market value at the time of acquisition and preferably less than this level;
- for the purposes of public acquisition, the market value of a mineral licence has to be determined by

[18] Hancock 2008

[19] Rebecca Bream, 2008, 'Brutal reversal stuns mining groups', *The Financial Times*, 30 October, accessed at http://www.ft.com/cms/s/0/f03b2344-a6b9-11dd-95be-000077b07658.html

an independent valuation process agreed to by the Government and the licence owner prior to it being conducted;

- the actual level of public equity to be acquired in an individual mineral licence is to be agreed between the Mongolian Government and the licence owner in the context of their concluding an Investment Agreement in respect of the development of the mineral licence; and
- the Government must finance the acquisition of any public equity in any mineral licence without any recourse to the licence owner or to the shareholders of the licence owner.

Alaskan voters approved an amendment to their State's constitution to establish the APF. At least 25 percent of nominated mineral revenues paid to the State are deposited in the APF for investment in income-producing assets. The APF is independently administered by a statutory body, the Alaska Permanent Fund Corporation. Each year the Corporation distributes the net income of the APF to each and every Alaskan in the form of a dividend calculated on a rolling five-year basis. In 2008 the dividend was US$2,069 per person (about Tg 2.4 million per person at current exchange rates).

As a minimum, the proposed Trust Fund should receive all the royalties that are paid in respect of all new mineral developments, such as Oyu Tolgoi and Tavan Tolgoi. The coverage could be subsequently extended to pre-exiting mining operations, once an appropriate distribution formula had been determined for those royalties. As this option is likely to raise much more challenging policy issues — such as the practical difficulties of arranging retrospective compensation in the light of subsequent demographic, economic and social changes — it would be best left for consideration until after the proposed Fund and its associated administrative arrangements were well established.

Preservation of the financial capital would help to ensure that some of the value created by the mining of Mongolia's mineral resources was progressively reinvested for the benefit of future generations of Mongolians.

The *second policy objective* is concerned with the equitable distribution of the benefits of mineral development. This should include ensuring that those people who may be directly disadvantaged by mineral development are appropriately compensated for their loss. They include:

- landowners who bear some of the environmental costs associated with mineral development;
- artisanal miners displaced by commercial mining; and
- those employed in subsistence herding of livestock in rural areas who are adversely affected by mining operations.

The creation of an independently administered statutory Trust Fund would facilitate the more equitable distribution of the economic benefits of mineral development among the Mongolian people. It would also help to make the distribution process less susceptible to corruption, as well as more accountable and transparent to the Mongolian people.

The Alaska Permanent Fund (APF) provides a good example of the approach that is required.[20] In 1976

The proposed Trust Fund could also receive all or a specified proportion of the corporate tax revenues generated by mining operations. This option also raises a number of other policy issues — such as their fiscal and tax policy implications — which would be best left for subsequent resolution.

The revenues credited to the proposed Trust Fund should be invested in a suitably diversified portfolio of assets, such as common stocks, government and corporate bonds, and real estate. The more its funds are

[20] Alaska Permanent Fund Corporation, 2008, About the fund, accessed at http://www.apfc.org/home/Content/permFund/aboutPermFund.cfm).

invested in assets denominated in foreign currencies, the more the Trust Fund will contribute towards macroeconomic stability.

The investment objective should be to generate a sustainable investment income stream over the long term, from which dividends could be paid to individual Mongolians subject to the real value of the investments being preserved. Preservation of the financial capital would help to ensure that some of the value created by the mining of Mongolia's mineral resources was progressively reinvested for the benefit of future generations of Mongolians.

To ensure that the proposed Trust Fund achieves its policy goals, it would be essential for the day-to day conduct of its operations to be independent of both the Mongolian Government and the State Great Hural. For this reason, the Fund would need to be managed by an organization guaranteed operational independence by its enabling statute. The managing organisation should, of course, be required to account formally to the Mongolian public thorough the State Great Hural, for its performance against its statutory objectives each year.

The establishment of such a Trust Fund would contribute significantly to Mongolia's macroeconomic stability. By sterilising some or all of the public revenue stream from the mining sector, Mongolia would reduce the risk of it experiencing the extreme 'boom' and 'bust' economic cycles, which are often associated with economies that rely heavily on mineral exports.

During boom times mining exports can 'crowd out' non-mining exports due to the appreciation of the exchange rate. Moreover, the substantial windfalls in public revenue generated by booming mineral exports can encourage political corruption and erode fiscal discipline, leading to wasteful public spending.[21]

The World Bank has recommended virtually all of the proposed reforms to the Mongolian Government itself and has done so on numerous occasions over recent years.[22] The International Monetary Fund (IMF) has made similar recommendations to the Government.[23]

[21] Such phenomena are sometimes known as the 'Dutch Disease' or the 'resource curse'.

[22] Most recently The World Bank has recommend the creation of a fully fledged savings and stabilisation fund to receive all government revenues from mining (World Bank 2008). The IMF has made a similar recommendation (International Monetary Fund [IMF], 2008, Mongolia: Selected Issues and Statistical Appendix, IMF Country Report No. 07/39, IMF, Washington, DC, January, accessed at http://www.imf.org/external/pubs/ft/scr/2007/cr0739.pdf)

[23] IMF 2007

Equitably Distributing the Benefits for Mongolians

Mongolians have an understandable interest in wanting to ensure that economic development raises living standards across the board.

Although mining wages are relatively high in Mongolia, the number of Mongolians that are employed in the sector is relatively low. As a consequence, the direct contribution of mining to household incomes is relatively modest and is expected to remain so for the foreseeable future. This is simply a consequence of the capital-intensive nature of most mining production.

As the development of the Mongolian mining sector must rely heavily on capital and expertise from abroad, the majority of the economic benefits of doing so accrue to ordinary Mongolians thorough the taxes, fees, levies, and charges that the Mongolian Government collects from the sector and its regulation of the sector's activities.

There is, however, a distinct trade-off between the amount of the net economic benefit that can be compulsorily redistributed from the mining sector and the size of the overall net benefit that it can generate.

Beyond a certain point, the larger the share redistributed by taxation and regulation, the smaller the benefits the population at large will receive. Once taxation and regulation force the after-tax rate of return on Mongolian mining investments below the rate that can be earned elsewhere, the development of domestic mining will suffer and, with it, Mongolian living standards more generally.

In such an environment the mining sector would be unable to attract the substantial foreign investment that is essential both for its own development as well as for raising Mongolian living standards over the longer term. Moreover existing mining operations would be progressively wound back as their depreciated assets were not renewed, thereby eroding the *current* standard of living in Mongolia.

In principle, the combination of a mining royalty and the corporate income tax is the most economically efficient way for the wider Mongolian community to share in the net economic benefits from developing its vast mineral deposits.

The proposed reforms focus on reducing and streamlining the economic burden imposed on the mining sector by the tax and regulatory regimes in Mongolia to the point where the jurisdiction is strongly competitive with the other major mining jurisdictions. Subject to that constraint, they then seek to improve the distribution of the public revenues from mining in Mongolia to the benefit for ordinary Mongolians, as well as the transparency and accountability of the distribution process.

The recent and prospective changes to the Minerals Law together with the political hiatus associated with the latter have already caused a three-year delay in international investors committing to major mining projects in Mongolia, such as Oyu Tolgoi and Tavan Tolgoi. World Growth has estimated that a further policy-induced delay of three years for prospective mining investment could see Mongolia foregoing in excess of US$7.2 billion in prospective GDP.[24] The loss is equivalent to a lump sum of Tg 8.3 trillion (at present exchange rates) and represents about Tg 640,000 for each and every Mongolian citizen.

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Given the global financial crisis and the recent slowdown in a major export market for Mongolian mineral products,[25] these estimates underline the urgency of fundamental tax and regulatory reform and the rapidly rising opportunity cost to Mongolia of any further

[24] This is the Net Present Value of the annual loss in GDP over the subsequent 30 years. All values are expressed in real (2008) prices.

[25] During the September Quarter of 2008, the growth of industrial production in China slowed to 2.2 percent on annualised basis, which is China's slowest rate of growth for any quarter since 1999 (Hancock 2008).

delay in implementing such reform. Public support for such reform is therefore critical and it depends, in large part, upon public confidence in the fairness of the distribution of the economic benefits of mineral development. This is particularly true when the development is financed from outside Mongolia and the benefits, which it generates, have to be shared with the foreign entrepreneurs and investors who were critical to its success.

The current mechanisms for distributing the benefits of mining rely heavily on the governing institutions, which are generally considered to be highly unsatisfactory, both within Mongolia and elsewhere. Corruption is perceived as being significant, widespread, and growing, with allegations of corruption involving cabinet-level officials.[26] This is consistent with the evidence collected by Transparency International, a global anti-corruption NGO, which ranked Mongolia in 102nd place (out of 180 countries) on its Corruption Perceptions Index for 2008, which was worse than its result for 2006.[27] It is institutional failures such as these that lie behind much of the public unease about large scale mineral development in Mongolia.

The proposed Trust Fund has the potential to improve substantially on the economic efficiency and equity of the benefit distribution process by:

- making direct transfers to the intended beneficiaries;
- paying the benefits in cash rather than as standardised public services would significantly increase their value from the perspective of the beneficiaries;
- taxing the cash benefits in the hands of the beneficiaries would improve the transparency and accountability of the delivery of public services;
- significantly minimizing the scope for misappropriation and/or misdirection of benefits by public officials;
- highlighting the extent of the economic benefits that mining generates for the Mongolian people;
- improving the transparency of and accountability for the delivery of public services and the taxation that is imposed on Mongolians to fund them; and
- investing mining revenues in assets denominated in foreign currencies, as it would assist in the macroeconomic stabilisation of the Mongolian economy.

[26] Heritage Foundation, 2008, 'Mongolia', *2008 Index of Economic Freedom Website*, The Heritage Foundation & Dow Jones Inc, Washington DC, accessed at http://www.heritage.org/research/features/index/country.cfm?id=Mongolia

[27] Transparency International, 2008, *Transparency International 2008 Corruption Perceptions Index*, Berlin, accessed at http://www.transparency.org/policy_research/surveys_indices/cpi

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About World Growth Mongolia

World Growth Mongolia is a non-profit, non-governmental organization established to promote sound policies to address Mongolia's economic challenges. At World Growth Mongolia, we embrace and celebrate the new age of globalization and the power of free trade to eradicate poverty, improve living conditions, and create new jobs and opportunities for the People of Mongolia. We strongly believe in the need to promote our five core principles: Economic Freedom; Good Governance; Rule and Stability of Law; Property Rights; and Environmental Interdependence. For more information on World Growth Mongolia, visit **www.worldgrowth.mn.**

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Дэлхийн Өсөлт
Монголын Төсөл

Third Floor Admon Building
Amaryn Street-2
Sukhbaatar District
Ulaanbaatar, Mongolia
(976) - 11 - 330902

www.worldgrowth.mn