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국제학석사학위논문

**The Paradox of Natural Resource Abundance:  
The Case of Mongolia**

천연자원 패러독스: 몽골의 사례

2015년 8월

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온드라

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The Case of Mongolia**

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**The Paradox of Natural Resource Abundance:**

**The Case of Mongolia**

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August 2015

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## **Abstract**

Mongolia is a vast, sparsely populated, mineral-rich nation located between Russian Federation and People's Republic of China. Today, Mongolia is one of the fastest growing economies in the world thanks to its resource abundance. Still the nation is struggling to translate its new found opportunities into long-term sustainable development, in common with other resource abundant developing countries. Thus the purpose of this research is to find out whether the natural resource boom taking place during 2002 to 2012 in Mongolia is an opportunity to escape from the resource curse or does it only strengthen the phenomenon. In the recent economic outlook, Mongolia appears to be successfully escaping the curse. However, in order to, investigate deep into correlation of natural resource abundance and the resource curse, this paper combined three models of rent-seeking: "Weak political institution and increased rent-seeking", "Failure in natural resource management and bad policy choices" and "Conflict over resource rents and institutional decline". Based on these models, this research empirically finds out that the resource boom during 2002-2012 encourages more predatory rent-seeking behaviors among political elites in Mongolia. This phenomenon occurs because the quality of Mongolia's institution is too weak to block rent-seeking behavior and encourages rent-seeking among policy makers which in return depletes the already weak institutions further, and thus, lend support to the resource curse discourse. So, degrading of Mongolia's institution quality and more increasing corruption in the wake of recent resource windfall, suggests that Mongolia, in the long term, may not be immune to the institutional resource

curse. As the resource boom gains momentum, Mongolia's most important challenge will be to reverse this trend and further reform the quality of its economic and political institutions.

***Key words:* resource curse, natural resource abundance, political institution, corruption, rent-seeking**

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# I. Introduction

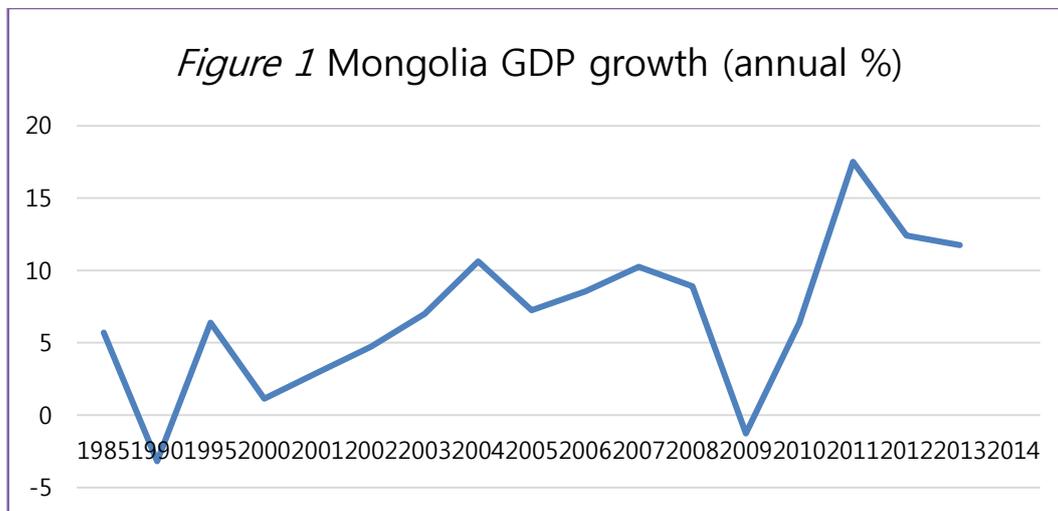
## 1. Background and Problem Description

Mongolia is a vast, sparsely populated, mineral-rich nation located as a sandwich country in the middle of Russian Federation and People's Republic of China. Formerly a Soviet satellite state, the country peacefully ended one-party Communist rule and launched democratic and free market reforms in 1990. Today, Mongolia is one of the fastest growing economies in the world, achieving 17.3, 12.4, 11.7 percent GDP growth in 2011, 2012, 2013, respectively.<sup>1</sup> The country is projected to be the second best performer in terms of economic growth in 2011 according to the Economist Intelligence Unit which calls the country's mineral resources as an 'exciting possibility' for Mongolia's 3 million people.<sup>2</sup>

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1 World Bank, 2014,  
<http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG/countries/MN?display=graph>

2 <http://www.economist.com/blogs/theworldin2014/2014/01/global-growth>



(Source: World Bank, Data Base 2015)

This “miraculous growth” has been possible because the country is endowed with rich mineral resources. Until recently, Mongolia had remained a relatively small, landlocked, low-income economy, per capita GDP of around US\$ 1,500 in 2009, and the total GDP of US\$ 4.2 billion in that year.<sup>3</sup> The resource boom made over the economy and transformed Mongolia from a low-income country to lower-middle-income country, with average per capita incomes increasing six-fold within a decade. Natural resource boom was driven by the coincidence of a drastic rebound in copper price and the discovery of the other major mineral deposits. Additionally, it overlapped with the rise of China which becomes a major

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<sup>3</sup> Mongolia Country Profile, World Bank

importer of mineral resources so that the neighboring nation creates a huge market for Mongolia's resources in near proximity.

Mongolia's development potential, is estimated to be enormous. It can be said that major mining development projects granted Mongolia a chance to build on the substantial achievements made since the country's dual transition to democracy and a market economy in 1990. By the time, major mining projects of copper (Oyu Tolgoi project)<sup>4</sup> and coal (Tavan Tolgoi project)<sup>5</sup> will reach their fullest operation capacity, it is expected that economic expansion will be grandly promising. More flattering news is that the profit generated by mining is expected to triple the national economy and become US\$25 billion by 2020 and drive the living standards of the 3 million people into the global middle class.<sup>6</sup>

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4 Oyu Tolgoi (OT) is the largest known unexploited copper deposit in the world, today with a mineral reserve of 1,393 Mt of ore grading 0.93 percent copper and 0.37 g/t of gold. OT is located in the South Gobi desert, approximately 80 km north of the border with China. Production is started in 2013 and expected to reach full capacity by 2021, supplying 450,000 tonnes of copper a year, close to 3 per cent of the world output. In October 2009 the government of Mongolia signed an investment agreement for the development of OT with Canada-based miner Ivanhoe Mines backed by Anglo Australian mining giant, Rio Tinto. Still there is an ongoing controversy over the OT financial undertaking between the government of Mongolia and investors.

5 Tavan Tolgoi (TT) is estimated to hold reserves of over 6 billion tonnes of coal. It is also in the South Gobi, approximately 240 km north of the border with China and 150 kms away from OT. The field has been in operation since 1967 but the volumes have remained relatively modest. To fully develop the deposit the government launched a tender for the right to operate the West Tsankhi block, expected to be completed by mid-2012. The East Tsankhi block is expected to be developed by Erdenes TT, a state-owned mining company. TT development envisages near-term investment of around 100 per cent of 2010 GDP, with coal production increasing substantially from 2013, subject to availability of transport to ship coal to customers.

6 Fisher B.S., Batdelger T., Gurney A., et al., (2011)

Therefore, it appears like Mongolia is one of the success cases which were able to turn natural resources into blessing while escaping the paradox of natural resource abundance. Historically, there are numerous cases showing that countries endowed with resource wealth are doomed to underperform over the long term, compared with resource poor economies with similar initial income levels and other characteristics (Auty 1993, 2001; Sachs and Warner, 1997, 1999, 2001). Auty (1993) termed this phenomenon a “resource curse” emphasizing the idea that natural resource in abundance could impede rather than foster economic growth. Even though it sounds paradoxical, the idea of a resource curse is hard to neglect. Angola, Congo, Nigeria, Venezuela, and the Middle East are notorious examples of countries that are endowed with natural resource abundance, but also plagued by low or negative GDP growth, widespread poverty, state failure, civil war, corruption, and political oppression.

Still, the existence of natural resource curse remains largely controversial as historical development routes followed by resource-rich economies are tremendously mixed. A resource abundance can contribute growth expansion, as demonstrated in the case of Europe (industrialization), the other economies (Australia, Canada and the United States), and tropical subsistence agricultural economies without manufacturing. Today, resource-rich countries like the United Arab Emirates, Kuwait, and Qatar are using revenues from their resource wealth to construct mega-cities out of desert land, thereby also generating considerable down- and side-stream economic activities and additional incomes. These countries have also received big-scale foreign investments, which not only uphold

economic development, but also advocate intergenerational equity. Therefore some point out that the resource curse is “elusive”<sup>7</sup> or “red herring”<sup>8</sup>.

Even though these mining development projects offer a promising growth opportunity for the Mongolian economy as a whole, at the same time, the mining windfall creates critical policy challenges as well. In common with some other natural resource-rich developing economies, Mongolia is struggling to translate its new found opportunities into long-term sustainable development outcomes.

The share of the mining sector in GDP boosted from 14 to 30 percent<sup>9</sup>, with the rising prices of commodities in the world market during the last 15 years. As Mongolia is becoming largely reliant on the export of raw minerals, price fluctuations of commodities in the world market bring up the destabilizing and shaking impacts on the economy. Foreign direct investment in the country plummeted by 49% in September 2013 compared to last year which already marked a 17% year-on-year decline<sup>10</sup>, and 2014 experienced FDI drop 71% year-on year, also the value of the currency, the tugrik, is down by 20% this year,

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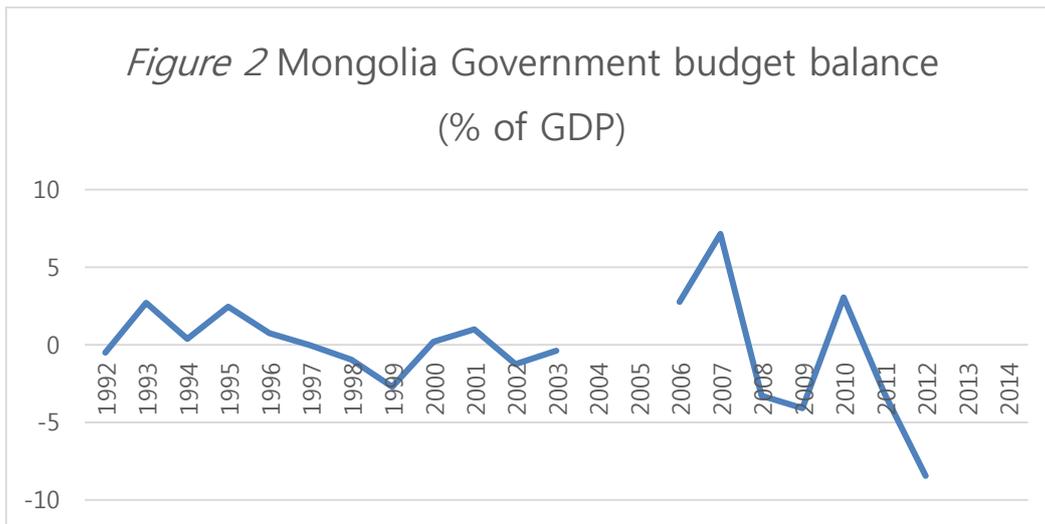
7 Lederman and Maloney, 2008

8 Brunshwigler, 2008

9 The Bank of Mongolia, 2015

10 World Bank Data Base,  
<http://data.worldbank.org/indicator/GC.BAL.CASH.GD.ZS/countries/MN?display=graph>

inflation has returned to double digits and the central bank's off-balance sheet expenditure is expanding through foreign reserves as foreign debts increase to 55% of GDP<sup>11</sup>.



(Source: World Bank, 2015)

Recently, Government budget balance has been running persistent deficit despite a high economic growth<sup>12</sup>. Although Mongolia's economic growth has helped to reduce poverty by more than 11 percent in recent years 38.7% in 2010 and 27.4% in 2012<sup>13</sup>, it is obvious

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11 Info Mine, 2013, <http://www.mining.com/mongolia-gears-up-for-the-fight-of-its-mining-life-70319/>

12 Mongolia Government budget balance as percent of GDP: The average value for Mongolia during that period was -0.23 percent with a minimum of -8.44 percent in 2012 and a maximum of 7.14 percent in 2007.

13 The Asian Foundation, 2014, "Poverty, Inequality, and the Negative Effects of Mongolia's Economic Downturn"

that some are benefiting more than others from Mongolia's mineral wealth. There is a perception among many people of rising inequality in terms of income distribution, but also in terms of access to opportunities such as a good education, a good job, or just to get decent healthcare. The trend towards higher inequality is clearly an issue in Mongolia, which historically had relatively moderate inequality levels<sup>14</sup>. Even a senior economist, D. Byambasuren predicted in 2013 that Mongolia's economy is going to be bankrupt by 2017, if Mongolian government keeps on implementing expansionary fiscal policies and neglecting foreign debt<sup>15</sup>.

## **2. Purpose of the Research and Research Question**

Exposed to all these divergent consequences of natural resource endowments, the purpose of this paper is to research whether natural resource boom taking a place during 2002 to 2012 in Mongolia is an opportunity to escape from the resource curse or does it just strengthen the phenomenon for the economy and the people. Even though it looks like Mongolia has achieved very rapid economic growth during the last decade by utilizing the

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<sup>14</sup> World Development Indicators (WDI), 2014, Gini coefficient of 32.84 in 2002, increasing to 36.52 per cent by 2008

<sup>15</sup> Economics, News.mn, 2013, <http://economy.news.mn/content/136118.shtml>

resource wealth while escaping from the resource curse, economic growth looks highly fragile and sensitive to fluctuations of international markets. Additional research questions are what factors determine the outcome of this resource boom in Mongolia, or more specifically, what factors in the natural resource sector and resource rent management contribute downgrading of economic growth or a natural resource curse and who or what are the main actors in this process. What should the government of Mongolia do to avoid a recent economic slow-down and convert natural resource endowment into resource blessing while avoiding the curse?

### **3. Significance of the Research**

Divergent development routes of countries with natural resources in abundance present an idea that the natural resource curse is neither inevitable nor universal. Whether endowment of natural resource-abundance is a blessing or a curse is determined by circumstances of a host country. Simply confirming that rich resource endowment is empirically connected to growth regression or retarded prosperity is of little practical value. Policy makers in developing countries like Mongolia and in the international development community would need to know the causality mechanism in order to deal with the aftermath generated by resource abundance in smart ways. Thus it would be neither useful nor credible to suggest governments to lock up their resource wealth. On the one hand, if the resource curse is just a statistical artifact and there is no existence of causal relationship between

resource abundance and growth failure, then leaving resources unexploited with the purpose of avoiding a growth slow-down will lead governments lose an invaluable opportunity and fail to use this opportunity to achieve promising outcomes. On the other hand, if the resource curse does persist, and for example functions through political institutions, then perceiving the causality mechanism may allow a country with mineral abundance, like Mongolia to improve its institutions and exploit its resource wealth smartly while avoiding the curse. As a country that possesses a vast variety and huge deposits of natural resources and that heavily reliant on the resources for its economic growth, Mongolia demonstrates many symptoms of the resource curse even though the recent resource boom enabled the country to achieve a high economic growth. By looking at Mongolia closely, this research can identify specific causal mechanism through which resource boom impacts on the natural resource curse and knowledge can offer potential resolutions to fight back the factors behind the curse. Understanding the causal mechanism of resource endowments on economic downturn and learning how to convert potential curse factors into blessing factors is a life or death issue for Mongolian economy and the people at the moment. Hopefully this research can contribute to some insights about the causality and the potential solutions to the economic downturn or the natural resource curse in Mongolia.

The remainder of this paper is structured as follows: Section II details the existing literatures on the paradox of natural resource abundance and relationship between natural resource windfall and rent-seeking behavior. While Section III is about the research framework in which methodology and then analytical framework will be elaborated and

Section IV presents the empirical studies about Mongolia, which suggest several routes through which political rent-seeking make a country prone to resource curse. Finally Section VI concludes.

## **II. Literature Review**

### **1. Market based explanations on the natural resource abundance**

Let's see what the existing literature presents what happens when a nation is endowed with natural resource wealth or resource boom. The most well-known explanation about the aftermath contributed by the resource abundance is the Dutch disease phenomenon<sup>16</sup>. Dutch disease theory claims that high exports of natural resource generate an appreciation in a country's real exchange rate, as a result, tradables such as manufactured domestic goods become less competitive in international markets and the manufacturing sector is contracted. This phenomenon takes place if export commodity prices increase quickly or exports rise perhaps because new natural resource are discovered, as was the case when natural gas was discovered in the Netherlands in the late 1950s. The decline in manufacturing then has ramifications that grind the growth process to a halt. Resource abundant countries tended to have small contributions from export growth in manufactures. Sachs and Warner (1997, 2001) show that resource abundant economies have not experienced strong and sustained export-led growth.

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16 Van Wijnbergen, 1984; Sachs and Warner, 1995, 1999, 2001; Matsuyama, 1992

The Dutch disease is one of conventional theories based on a ‘crowding out’ explanation, whereby resource wealth diverts economic activity in detrimental ways. In 2001, Gylfason says that natural resource boom is very likely lead a country to care more about its resource wealth, not human capital, that contributes its future wealth and as a result, to ignore educational investment.<sup>17</sup> Torvik in 2002, views that the resource curse occurs because a resource boom diverts entrepreneurial talent away from wealth creation which could modernize an economy, and toward seeking resource rent from the public sector<sup>18</sup>

Another well-known challenge generated by natural resource rents on the real economy is volatility, with high cycles of bust and boom. For instance, the high prices of natural resources in 1970s made resource abundant countries to borrow heavily, and the high fluctuation, especially drop of prices, in the 1980s caused huge debts in those countries<sup>19</sup>. Additionally, unless a country with resource abundance has a large enough non-resource-related tradable sector to start with, the uncertainty accompanied with high fluctuations of economic growth can reinforce a downward fluctuation. The smaller non-resource-based tradable sector, the less opportunities for workers to find new jobs when prices of natural resources drop down, consequently a price drop could lead the whole economy to decline.

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17 Birdsall, Pinckney, and Sabot (2001) also stress a link between resource abundance and low educational investments, but see the effect operating through a political channel.

18 Torvik’s (2002) model is actually based on a political economy argument. It is elaborated and extended in Mehlum, et al. (2006); this extension is discussed in detail later in this review

19 Manzano and Rigobon 2001

The interest rates will show the risks accompanied with this volatility, in the essence, if the level of volatility is great, the interest rates will be high, and, in turn, investments in non-resource based tradable sectors will be small. Those two impacts combine to lead the economy to specialize away from the non-resource-based tradable sector. In sequence, the less the economy perform in non-resource-based tradable sector, “the greater the volatility of relative prices, the higher the interest rate the sector faces, leading to decline even further, until it disappears”<sup>20</sup>. Volatility leads oil-exporting economies to specialize inefficiently in the production of non-tradables, drawing back their long-term growth when there is no corrective policy implemented by governments. Therefore, it has been claimed that República Bolivariana de Venezuela’s growth implosion in the early 1980s was contributed by high real interest rates facing the non-resource tradable sector, and of uncompetitive and volatile exchange rates, which caused the country to specialize almost exclusively in resource exploitation sector and non-tradables (Hausmann and Rigobon 2002).

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20 Hausmann and Rigbon 2002

## **2. Weaknesses of Market based explanations on the natural resource abundance**

Even though market-based theories provide some valuable explanations about negative outcomes generated by natural resource abundance, history shows that resource wealth does not directly or specifically lead to economic downturn or the natural resource curse. By Dutch disease definition, most countries that do not have a diversified agricultural and manufacturing base become mineral dependent. Historically, almost all countries began as mineral-dominant economies. For instance, the US, Canada, Norway, Sweden, the Netherlands, Australia and Malaysia were, in earlier stages of economic growth, more mineral-dominant, less diversified economies. Not only that, natural resources generally played a growth enhancing role in stimulating capital accumulation and growth throughout the now advanced countries in the period 1870-1914 (Findlay & Lundhal, 1999). Therefore, empirical ground for the natural resource curse is not bulletproof, meaning that having endowed with natural resource wealth does not necessarily lead to retarded economic growth but could trigger the prosperity even further. Still, the fact that natural resource abundance is not a necessary condition to thrive economically, cannot be overlooked as well. Countries endowed with no resource wealth still achieved to become some of the world's most prosperous nations are, Hong Kong, Japan, Singapore, South Korea, Switzerland and Taiwan.

Back to the Dutch disease theory, in fact, there are many scholars who cast doubt upon the theory. For instance, Bulte et al. (2005) claims that terms of trade effects generally are not significant in economic growth regressions and, overall, there is little empirical support for the Dutch disease model. Additionally, literature work by Leite and Weidmann (1999) are skeptical about the credibility of the Dutch disease theory and related explanations. Leite and Weidmann disaggregate the variables of natural resources into 4 components; fuels, ores, agriculture and food. Whereas, the variables for ores and fuels are not playing critical role in the growth degrading, the variable representing food export shares is significant and of the correct sign for the resource curse story. When the resource variable is broken up into its components, the resource curse appears to disappear. However this conclusion could be incomplete since Leite and Weidmann also display that resource abundance tends to trigger corruption, and that corruption cancels out economic growth in turn. Further, the natural resource curse may still hold for fuel and ores, but the impact could be indirect, through the level of corruption. Additionally, the Dutch disease model cannot explain why diamonds have generated a curse for Sierra Leone while a prosperity for Bostwana, or why oil has generated prosperity for Indonesia not for Venezuela. Neither can these market based explanations answer why resources concentrated impact growth differently from more dispersed natural resources. Such divergences in performance have encouraged scholars to conduct a large literature research on the natural resource curse through the lens of political and institutional explanations.

### **3. Political Institution based explanations on the natural resource abundance**

As market based explanations, as mentioned above, do not satisfy skepticism and respond questions about divergent economic performances across countries endowed with resource abundance, a rich literature has emerged in the past few decades that explores the resource curse thesis in various disciplines from the political economic perspective.

The exact mechanism of the causality diverges across models. In the model developed by Lane and Tornell (1996, 1999), government's coercive power is used solely to transfer wealth from the private sector to powerful interests. In the period of a resource price boom or new discovery, a country could experience a more than proportional increase in such transfers, thereby slowing down growth. Also, Karl (1997) underlines that when wealth is concentrated in minerals and the resulting rents are directed to State coffers, government's decision-making framework and the locus of authority can be shifted. Control over mineral rents becomes a basis for political power and institutions evolve to perpetuate existing patterns of control. She also notes that the enhanced payoffs to rent seeking enticed individuals with entrepreneurial talent, who otherwise might have been the creators of wealth and future prosperity in the country, to direct their talents to rent seeking. As political elites channeled these newly created rents to their supporters, corruption increased and political power became more concentrated. Another class of models invokes the mechanism of diverted entrepreneurship. Similarly Torvik (2002) and Mehlum et al. (2006)

point out that a resource windfall becomes a curse by diverting entrepreneurial talent away from wealth-creating industrialization and toward rent-seeking.

Torvik (2002) emphasizes that resource abundance increases the payoffs from unproductive rent seeking behavior and thus lowers overall growth of the economy. Barbier (2003) also claims that resources rents are oftentimes dissipated through corruption, bureaucratic inefficiency and policies aimed at rent-seeking interest groups. Congletan in 2008 claims that natural resource wealth is a “curse” rather than a benefit to society when property rights are not defined or respected and the wealth becomes a rent seeking prize.

Additionally, Mehlum and Torvik claim that resource wealth is a curse only in the absence of institutional barriers to rent-seeking. The role of political institution is a key to all rent-seeking models mentioned above. Empirical example about Venezuela and Nigeria, is persistent with the term that rent-seeking by political elites is responsible for the resource curse phenomenon. The oil price boom of 1979- 81 led Venezuela to expand public spending on infrastructure and industrial policy, which mainly benefitted political elites; the increase was so dramatic that Venezuela experienced a current account deficit despite a large, favorable shift in its terms of trade (Lane and Tornell 1996, p. 216). In Nigeria, that is an oil abundant nation, income became highly concentrated during the oil price run-up between 1970 and the early 2000s. By 2000, the share of income earned by the richest 2% of the population equaled that of the poorest 55%; in 1970; the richest 2% obtained as much as the poorest 17% in 1970. The fraction of Nigerians who subsist on \$1 per day or less rose from 26% to 70% over the same period (van der Ploeg 2011, pp. 367-8). On the

contrary, political institutions that have been relatively effective in discouraging rent-seeking behavior could be responsible for the more favorable results in countries endowed with resource abundance, such as Norway, Chile, Malaysia, and Botswana.

Jeffrey Reeves (2011) claims that Mongolia is doomed to trap in a resource curse because of the weak sovereignty the country has. Sovereignty that measures a state's control over the domestic institutions, is an important factor to determine if a country has a good governance or not, according to J.Reeves. International legal sovereignty, Westphalian sovereignty, interdependence sovereignty, and domestic sovereignty was measured to determine that Mongolia has weak sovereignty so that the nation is not capable of governing the natural resources to lead the state towards affluence.

Theodore H. Moran in 2013, claims that Mongolia has been making progress in terms of managing the process of mineral resource development. Mongolia is an exemplary case study showing how huge inflow of foreign investments in the mining sector could encourage the nation's economic growth, according to Theodore. FDI in the mining sector began to take off substantially 2000, reaching \$437 million in 2006 and exceeding \$1 billion in 2010<sup>21</sup>. Nonetheless, Theodore has been too much optimistic on the impact of resource boom in Mongolia. It is true mining boom has offered enormous opportunities for Mongolia as a lower -middle developing country but at the same time, created critical

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<sup>21</sup> Theodore H. Moran, 2013

policy problems as well. In fact, foreign direct investment in Mongolia drastically dropped by 49% in 2013 compared to the previous year which already marked a 17% year-on-year drop, and plummeted by 71% year on year in 2014.

Sala-i-Martin and Subramanian (2003) claim that there are two empirical regularities which have resulted in search for causal links to take account of interactions with political institutions in the political economic perspective. Firstly, resource windfalls or natural resource abundance tend to result in resource curse phenomenon in countries with weak pre-boom institutions but not in countries with strong institutional framework initially<sup>22</sup>. Secondly, resources found in dense concentrations are likely to result in a curse, while other natural resources tend to be largely immune<sup>23</sup>. None of these two regularities agrees with market based explanations for resource curse phenomenon; and they are consistent with theories of how resource abundance and political institutional systems interact.

However, in case of Mongolia, most of the natural resources are concentrated densely, therefore, this paper will omit the second regularity and instead mainly focus on how the quality of political institutions and the rule of law impacts on social and economic context

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22 Sala-i-Martin and Subramanian (2003) were among the first to look for a political link in the connection between resource abundance and reduced economic growth. Adopting the Sachs-Warner cross-sectional empirical strategy, they found that, while resource abundance is linked to slow economic growth, the entire effect operates through an institutional channel, operationalized by a rule of law index. If the institutional effect is controlled for, resource abundance has no further direct effect on economic growth.

23 Leite and Weidmann (1999), Isham et al. (2003), and Boschini et al. (2005) all report this result

when a nation is endowed with resource windfall. More specifically, this research will pay more attention on how resource abundance result in potential factors such as misbehavior of policy makers or rent-seeking which tends to generate resource curse phenomenon. Still, lacuna and controversies remain regarding how exactly natural resources lead to rent-seeking or corruption and under what conditions such effects take place. This paper will try to fill this gap.

After elaborating about the thesis hypothesis and research methodology, the next section, will explain the main terms in detail, along with mechanism of rent-seeking that leads to slowing down of economic development or a natural resource curse. What factors in the natural resource sector and resource rent management encourage rent-seeking or corrupt behaviors and who are the main actors in the process will be discussed deeper in the coming section. And the latter part of the next section is going to theoretically explain the resource curse phenomenon on the grounds of rent-seeking behavior and clarify the relationship between resource abundance and rent-seeking.

### **III. Research Framework**

#### **1. Thesis Hypothesis**

In response to the research question - “ Is resource boom taking a place during 2002-2012 an opportunity to escape from the resource curse or does it just strengthen the phenomenon?” , this paper predicts that, natural resource boom in Mongolia during 2002 to 2012 might enforce natural resource curse because Mongolian decision makers and politicians are immersed with rife corruption. This is because in corrupt regimes with weak institutions, resource endowments allow governments and policy makers to extract greater surplus (bribes) by pursuing policies that are detrimental to economic growth.

#### **2. Research Methodology**

The methodology of this study is mainly based on analyzing outcomes after occurrence of mineral resource boom which took a place since 2002. This analysis is traced through, first of all, analyzing the periodical sources of information that are accessed through a wide range of the news servers of foreign as well as Mongolian domestic origin. These sources are valuable because they provide up-do-date current information on the situation, meanwhile the official websites of the Mongolian government and the ministries are much

slower in providing updated information or if the information they offered is rather fragmented. At the same time, a valuable part of information can be covered by other external and internal non-government organizations, CSOs and other actors who have an unbiased look at the situation. As well as, the data resources available through the World Bank, the Asian Fund and the other international organizations were used particularly to describe specifically what kinds of factors are playing key roles in determining whether the natural resource endowment is a blessing or a curse in Mongolian context.

Second of all, the archives on the official websites of the Ministry of Foreign Affairs, Ministry of Finance, the Mongolian Audit Chamber, the Bank of Mongolia, the Independent Authority against Corruption of Mongolia and the president's website were addressed in a search for the evaluation on the consequence of mineral boom occurred in 2000s in order to obtain a fair and not-manipulated picture of the situation.

Therefore, more effort was put into researching this area and finding a certain number of governmental assessment and evaluation issued by the president and the ministries in order to complete the missing parts in the evaluation on outcomes mineral resource abundance. These documents were obtained from the independent legal databases of governmental evaluation. This variety of documents enabled to have an unbiased perspective on the outcomes and processes of natural resource management in Mongolia.

Several attempts were made to contact the department in the charge of implementing the mineral law and issuing mining licenses, the Mineral Resources and Petroleum Authority of Mongolia and the Independent Authority against Corruption of Mongolia, an institution

to fight against political and public sector corruption through transparency and accountability. The first e-mail was sent to request on some details about whether there are assessment reports on the outcome or the processes of mineral resource management and natural resource exploitation. The follow-up emails for further clarification were left not replied (yet). Therefore, a great value in this research was put on documents and orders obtained through databases of Mongolia's government, legal support portals and databases of international organizations.

Through qualitative analysis with several empirical cases, this paper will conduct investigations on outcomes of natural resource boom occurred in 2000s and research whether this abundant resource endowment is an opportunity to escape the natural resource curse phenomenon or just strengthens the curse phenomenon in Mongolia.

In coming sections, this paper will evaluate the quality of Mongolian political institutions based on the reports and assessments made by international organizations, such as, the World Bank, the Transparency International, the Asian Fund. Next, this study places main focus on theoretical and empirical research that brings to bear the concept of rent-seeking behaviors to explain whether natural resource boom occurred in Mongolia during 2000s is an opportunity to escape the resource curse or does it just strengthen the phenomenon.

This research contributes to the existing discourse on the impacts of natural resource boom on rent-seeking behavior and corruption of politicians on by focusing on one single country, Mongolia.

### 3. Analytical Framework: Three Models of Rent-seeking

#### Definition of terms

**Natural Resource Curse** is a paradoxical situation in which countries with abundant non-renewable resources experience negative developmental outcomes, including stagnant economic performance, growth collapses, widespread corruption, ineffective governance and political violence etc. The term ‘resource curse’ was first introduced by Richard Auty (1993) to highlight the fact that natural resources might be more an economic curse rather than a blessing. Natural resources also tend to decrease human development and increase economic inequality and poverty<sup>24</sup>. Thus, natural resource rich countries are likely to grow slower, considering their resource wealth, and, in many cases, actually grow slower than resource-scarce countries.

**Rent-seeking** in economics and political economic theory, refers to an attempt to gain economic rent by manipulating the social or political environment to expand one’s share of existing wealth without creating new wealth. In other words, rent-seeking means a redistribution of an existing cake, rather than an expansion of the cake. Thus rent-seeking behavior is not only socially but also economically costly. The outcomes of rent-seeking behavior are decreased economic efficiency through poorly allocated resources, decreased

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<sup>24</sup> Bulte et al., 2005; Gylfason 2001a

wealth creation, lost government income, exacerbated income inequality, and potentially declined national capacity. Resource rents are dissipated in various ways, including spending on militias to protect beneficiaries from other rent seekers, wealth transfers to private overseas bank accounts, selective law enforcement, and illegal rent expropriation. Additionally, rent-seeking behavior could take the form of transferring government jobs with excessive salaries, bribes collected from providing public services or for neglecting violations of laws and regulations, or theft from public funds or resource extraction contracts and so on.

From now on, the present section will focus on models based on rent-seeking in natural resource abundant countries, the process whereby competing political interests expend economically valuable resources to obtain government favors and as a result the economic downturn or the curse occurs.

### 3.1. Weak Political Institution and Increased Rent-seeking Behavior

Natural resources does not directly contribute to a curse, government failure is the problem, within institutions not defining and enforcing watchdog rent-seeking, nor protecting citizens from theft that is commonly carried out by agents of government. The resource curse phenomenon has been increasingly identified as a challenge of natural resource abundance, resulting in dysfunctional behavior in a weak institutional context. (Sala-i-Martin and Subramanian, 2003; Bulte et al., 2005; Mehlum et al., 2006; Robinson et al.,

2006; Collier and Goderis, 2007). The role of political institution is key to all rent-seeking explanations. Moreover whether a resource abundant country will be trapped into a curse or endowed with a blessing is determined by how effective political institutions are at hindering rent-seeking behavior. When institutional quality is low, skilled people choose to be rent-seekers such as, oil and mineral bureaucrats or lobbyists, rather than starting a business in another field (Mehlum 2006). In addition to weak institutional quality, generally commercial value of natural resource is high and this fact makes them a coveted target for rent-seeking behavior, plundering and misappropriation by political leaders.

Mehlum, *et al* (2006) also, incorporates a role for institutional quality by specifying that the payoff to rent-seeking depends both on the size of the resource rent and on the quality of a country's institutions. Given a level of resource rent, sufficiently high institutional quality will prevent a resource curse from occurring because rent-seeking never becomes sufficiently lucrative to attract entrepreneurs away from modern production. If institutional quality is low, however, the same resource rent will divert entrepreneurial talent and the resource curse will follow up. The institutional threshold required to escape the curse depends on the size of the resource rent, so a large enough resource boom could cause an otherwise well-functioning country to slip below the threshold and end up in a rent-seeking equilibrium.

A country's political institutions provide a set of constraints that may or may not be effective in preventing dissipation of resource rents. At the same time, some treatments of the resource curse postulate that a resource windfall can itself hamper the effectiveness of

these institutions. Especially, government regulations are strict over natural resources and governments own and control the acquisition of rights for mineral extraction in natural resource rich countries. When government structures are weak with poor policy regulations to guarantee transparency and accountability, mining and extractive activities were more exposed to corruption risks, involving public officials than other industries, since they require frequent contacts and interactions with government officials in terms of getting concessions, licenses and approvals for the exploration, development and exploitation of the mining deposit (Chene, M and Marshall, M).

### 3.2. Failure in Natural Resource Management and Bad Policy Choices

This explanation lays main attention on policy making mechanism. Auty (2001a,b) claims that countries with rich resource endowment are most likely to be dominated by factional and predatory oligarchic policies, as promoting narrow sectional interests. The resource curse occurs since countries with resource abundance tend to implement bad policies and those bad policies contribute to delay in transition to competitive industrialization and economic diversification. Consequently, the resource sector supports a burgeoning non-tradable sector made up of infant industries and an inflated but unproductive public sector. In this model, incumbent politicians appropriate all resource rents and might deviate allocation of resource revenues or resource labor to generate political support and retain office (Robinson et al. 2002). In essence, natural resource curse occurs because resource rents are easily appropriable by an established elite, triggering bribes and distorted policies.

In addition, with large inflows of money into government coffers, corruption and vote buying could thrive. The outcome of resource windfall will largely depend on the country's ability to establish strong legal and institutional frameworks that ensure fair and equitable distribution of resource rents to all citizens. Basically, rent seeking perspective suggests that countries that have bad institutions suffer a resource curse, whereas those with good institutions do not. Where corruption is widespread, e.g. at the start of oil extraction, the rent-seeking effect of resource revenues can be more malignant (Baland and Francois, 2000).

### 3.3. Conflict over Resource rents and Institutional Decline

According to historical accounts, competition among influential groups over resource windfalls may not just dissipate resource rent, but also intensified rent-seeking erodes a country's political institutions as well. Institutional erosion is a strong claim in Ross's (2001) research of the hardwood timber boom in Southeast Asia and in Karl's (1997) analysis of political events in oil producing states after the price shocks of the 1970s and 1980s. Hodler in 2006 brings out a formal model of competition among interest groups for a fixed rent in which the process of competition erodes institutions. Interest groups in Hodler's model (2006) compete for a resource rent. Each interest group has a fixed allocation of effort that it can put in between producing a private good and engaging in a rent-seeking behavior, which Hodler names 'fighting'. Effort put in fighting generates no output but does allow an interest group to obtain a rent. A larger rent naturally leads to

more fighting in equilibrium and greater waste. The mechanism for economic decline is therefore very straightforward. There is no shift away from investment to consumption or away from an efficient sector to an inefficient one; rather, productive inputs become engaged in an activity, fighting, that generates no output. In Hodler's specification the intense rent-seeking brought on by the windfall spills out and erodes property rights in the non-resource sector. This institutional erosion provokes a true resource curse—an actual decline in welfare resulting from a windfall.

It can be concluded from this section, that if institutions are initially weak in terms of placing barriers against the appropriation of rents from the public sector, then a resource windfall will lead to slow growth and may cause institutions to deteriorate even further. When institutions are strong at the start, however, a resource boom need not impair institutions and rather will enhance wealth.

*Figure 3* Vicious cycle of Rent-seeking models



Above graphic presents the relationship of three rent-seeking models which can explain the misbehavior of policy makers which lead to economic downgrade or the resource curse in natural resource rich countries. To wrap-up analytical framework again, when a country is endowed with resource windfall due to sudden resource price boom or resource discovery, the initially weak institutions or absence of barrier to hinder rent-seeking behavior triggers more predatory and rife rent-seeking behavior among policy makers and incumbent politicians. Occupied with self-interested rent-seeking behavior, policy makers are very likely to fail in managing the natural resource revenues beneficially for the nation as a whole and therefore implement bad policies to retain their offices as the resource rents are too high to disregard. As policy makers are desperate to remain in their positions with the purpose of gaining more from resource rents, they compete over the resource rents and this

competition in turn will erode the institutional quality as well. Therefore, this process creates a vicious cycle of rent-seeking which leads to the resource curse.

Next section will focus empirical studies based on rent-seeking models shown above. The first part of the next section will analyze the quality of Mongolian political institutions when and after the resource boom occurred and the latter part will pay attention on misbehavior or rent-seeking behavior of policy makers in natural resource management and in competition over resource rents, as a result economic inefficiency or economic downturn takes place.

## **IV. Empirical Studies**

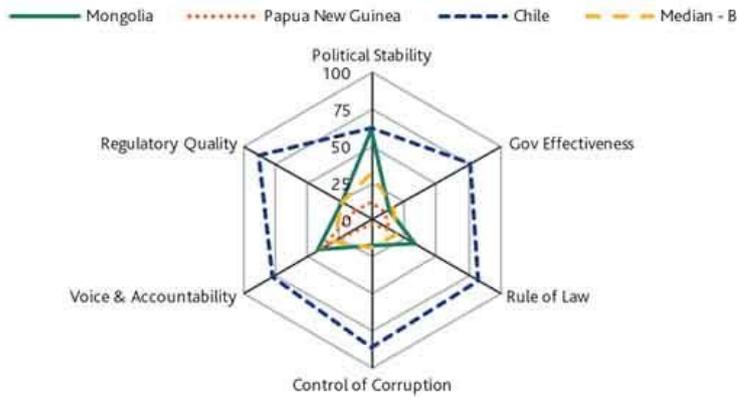
### **1. Quality of Mongolian Political Institution**

Past literature presents that the impact of resource abundance depends crucially on the initial quality of economic and political institutions (Mehlum, Moene and Torvik, 2006). In countries where institutions are insufficiently strong, they further deteriorate under the “pressure” of commodity rents, while countries with initially strong institutions, like Norway or Australia, are more likely to be able to develop frameworks for dealing with natural resource wealth, which both support growth and protect institutions. Resource abundant countries with weak institutions may thus get into an “institutional trap” characterized by a vicious cycle of weak institutions and non-existent incentives to improve them. Therefore, Mongolia’s ability to manage its mineral wealth in a sustainable and transparent manner largely depends on the quality of its economic and political institutions, the country’s broader governance context as well as the legal and institutional anti-corruption framework in place to ensure transparency and accountability.

Thus this section will further analyze the assessments conducted by international organizations on the quality of Mongolian political institutions and evaluate Mongolian governance.

*Figure 4* World Bank Governance Indicators

## World Bank Governance Indicators



Source: World Bank

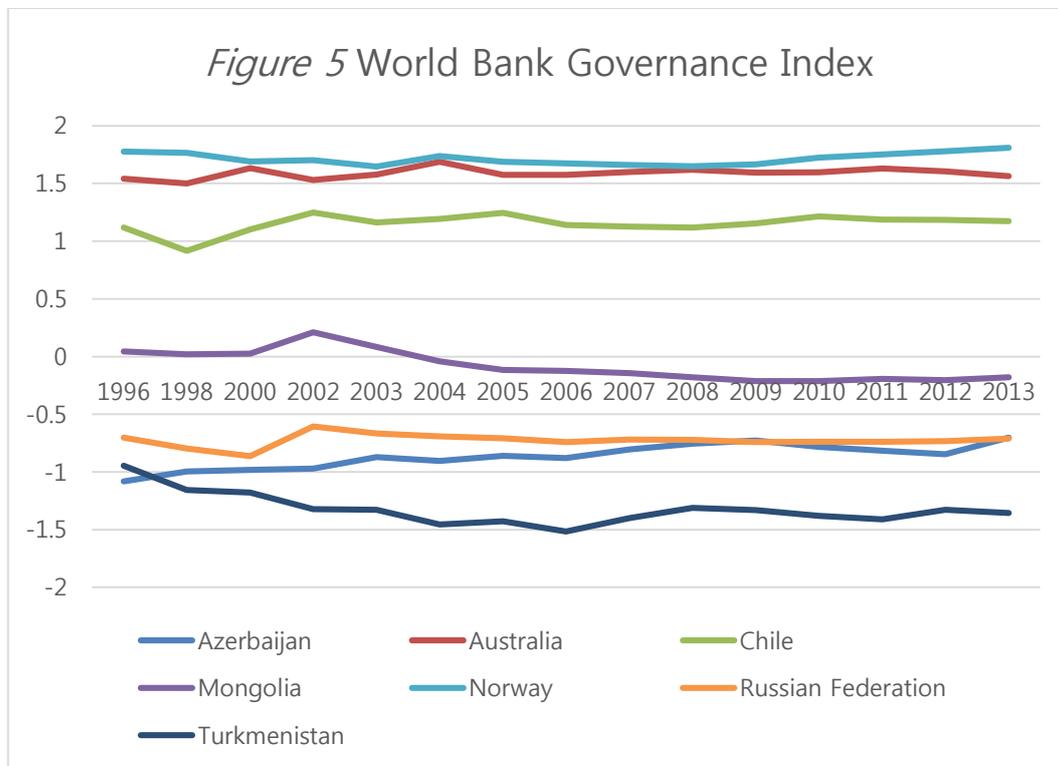
World Bank Governance Indicators points out that Mongolia is relatively better in terms of political stability compared to other median B rating countries. Nonetheless, Mongolia is in desperate need to improve Regulatory quality, Government Effectiveness, Voice and Accountability, Rule of Law and Control of Corruption. In fact, the World Bank's Worldwide Governance Indicators indicates relatively low and declining performance in control of corruption, with a score of 27 in 2011 on a 0 to 100 scale compared to 34, in 2006. Except for rule of law and regulatory quality which remained relatively stable compared to 2006, the country scores decreased on all other areas of governance assessed, especially with regards to government effectiveness (31,3 in 2011 compared to 40,5 in 2006)

and voice and accountability (49,3 in 2011 compared to 54,8 in 2006)<sup>25</sup>. This suggests that corruption challenges are becoming an increasingly serious problem in Mongolia, recently.

In addition, according to the measurement made by World Bank's Governance Index (WBI), when compared with the other resource abundant countries, Mongolia is perhaps near the border line. It has entered the resource boom with relatively strong institutions, scoring well above resource-rich countries in the former Soviet Union. By the same measure, however, its institutions remain much weaker than those of advanced resource-rich economies such as Norway and Australia, as well as those of Chile. While Mongolia enjoys a multi-party democracy, a free press and a vibrant network of non-governmental organizations, the WBI has been gradually declining since 2002. This has been due particularly to a deterioration of the corruption sub-index.

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<sup>25</sup> World Bank, Worldwide Governance Indicators,  
<http://databank.worldbank.org/data/views/reports/tableview.aspx>



(Source: World Bank Governance Indicators, 2014. An average of 6 components: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption. Higher values correspond to better institutions)

In accordance with the corruption index produced by Transparency International, Mongolia scored 4.3 on a 0 (highly corrupt) to 10 (highly clean) scale in 1999 and ranked at the same level as Poland, Uruguay and Jordan. In 2004 Mongolia scored 3 points, moving backward by 42 positions and ranking at the same level as Armenia, Madagascar, Iran and Romania. In 2006 and 2007, Mongolia scored 2.8 points ranking at 99th position, but in November 2008 it ranked 108th position. By 2011, Mongolia ranked 120 out of 183 countries, with a

score of 2.7 out of 10. According to the corruption index produced by Transparency International, Mongolia's scores have been decreasing significantly over the last decade confirming that corruption is becoming an increasingly serious problem in Mongolian public sector<sup>26</sup>.

*Table 1* Corruption Index of Mongolia (1999-2011)

year	score	rank & same level as
1999	4.3	43th & Poland, Uruguay and Jordan
2004	3	85 <sup>th</sup> & Armenia, Madagascar and Iran
2006 & 2007	2.8	99 <sup>th</sup> Mali, Mozambique and Ukraine
2008	3	102th, Lebanon, Rwanda and Tanzania
2010 & 2011	2.7	116 <sup>th</sup> & 120 <sup>th</sup> , Mozambique and Solomon Islands

(Source from Transparency International, 2014)

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<sup>26</sup> Transparency International, The Global Coalition against Corruption, <http://www.transparency.org/cpi2014/results>

Consistent with these findings, most governance indicators suggest widespread corruption permeating all levels of Mongolian society. 73 % of the Mongolian citizens interviewed within the framework of Transparency International's 2011 Global Corruption Barometer (GCB) share this view and consider that corruption has increased in the last three years preceding the survey, while 49 % report having paid a bribe in the twelve months preceding the survey.

According to the report prepared by the Asian Foundation, over 17 percent of large businesses (with transactions of more than 200 million Tugriks, or \$144,000) spent over 50 percent of their time overcoming non-productive obstacles, such as obtaining or renewing licenses, facing temporary prohibitions, and navigating an unstable regulatory environment . The 11 percent of businesses which overcame these obstacles have been able to accomplish this by using 25 percent of their company resources. Similarly, 16 percent of respondents revealed that they had observed instances of corruption in the last month, and nearly 50 percent reported they had personal knowledge of corrupt transactions in the past seven months. A total of 75 percent of businesses reported they “always” or “often” experienced corruption in public tenders and contracting<sup>27</sup>.

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27 Asia Foundation, 2013, <http://asiafoundation.org/in-asia/2013/02/13/debate-over-corruption-heats-up/>

Close to 40% of the firms interviewed within the framework of the 2009 World Bank/IFC enterprise survey reported being expected to make a gift to secure a government contract, with the value of the gift estimated around 3% of the contract value, while more than a third expect to give a gift to get a construction permit.

Additionally, Index of Economic Freedom 2015, reveals that corruption and rent-seeking is viewed as pervasive and widespread. Graft is endemic, and Mongolian weak institutions do not enforce anti-corruption measures effectively. The judiciary is independent but inefficient and vulnerable to political interference. Corruption persists among judges. Property and contractual rights are recognized, but enforcement is weak. The government lacks the capacity to enforce intellectual property rights laws<sup>28</sup>.

These downgrading assessments of the quality of Mongolian governance in recent years, suggests that Mongolia may not be immune to the institutional resource curse even though recent rapid economic growth shows that Mongolia has escaped the natural resource curse. As the resource boom gains momentum, Mongolia's most important challenge will be to reverse this trend and further improve the quality of its economic and political institutions.

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28 Index of Economic Freedom, 2015,

<http://www.heritage.org/index/visualize?countries=mongolia&type=9>

## **2. Evidence I: Mineral Resources & Petroleum Authority of Mongolia**

The regulatory framework is assessed to be weak in the areas of public participation, sanctions, informal mining (The World Bank, 2006, 2011). Public participation in the permitting procedure was not formalized as of 2006 and there was no obligatory public involvement in the scoping and discussions of environmental impact assessments. Efforts are currently being made to institutionalize public participation in many state institutions (Global Integrity, 2011). The institutional framework in Mongolia is also considered to be weak for enforcing mining regulations, especially those relating to procedures for local governments to issue land user permissions and contracts and to the enforcement of sanctions for license violations (The World Bank, 2006). In addition, according to external observers, civil servants employed in the various ministries and government agencies providing oversight to the mining industry receive low wages, which may provide incentives to indulge in corrupt and rent-seeking behaviors (Billiter Partners Ltd, 2012).

In Mongolia, the awarding of exploration and production rights is highly vulnerable to corruption, as companies have strong incentives to restrict competition and government officials may be tempted to get a share of deal (Marshall, I, 2002). In particular, the integrity of the process is undermined when governments are not making clear the grounds for why a particular company is given a contract and certain companies are granted special or preferential access to licenses. There are also cases where government agencies are awarding the licenses to companies whose beneficial owners remain undisclosed, and some

of these companies may be owned or controlled by government or their private sector proxies (Global Witness, 2012). In Mongolia, corruption is likely to occur both in concession auctioning processes as well as in contract awarding processes for the major construction and infrastructure projects associated with mining operations.

Additionally, given the high risks involved in mining activities, companies are be tempted to pay bribes, make political donations to the ruling parties or develop corrupt networks with local politicians to bend the rules and regulations applying to the sector in their favor (Global Witness, 2012). There have been examples of such interference of politicians and the following case will show unclear or suspicious relationship between a mining company and a Mongolian politician.

In Mongolia, the Mineral Resources and Petroleum Authority of Mongolia is responsible for implementing the mineral law, issuing mining licenses, archiving geological data and conducting surveys and research. In 2013, the former chairman of the Mineral Resources Authority (MRA) and the advisor of the Prime Minister was sentenced to 6.6 years in prison for a number of cases around misusing the official authority for private interests, the renewal of suspended four licenses for “SouthGobi Sands” LLC by violating the regulations, handing a number of in illegal mining licenses with no selection criteria, conveying them to private companies owned by his friends and relatives, and causing severely negative repercussion for the interest of government and the nation.

Mongolian court determined that the former chairman issued 120 illegal mining licenses, renewed five of the SouthGobi Sands LLC’s licenses and embezzled one of them for his

ownership when he was the chairman of the Mineral Resources Authority and an advisor to a former prime minister.

Specifically, the former chairman of MRA misused his authority by obtaining one mining license which has the registration number of 5261X, as a bribery in return for the permission of renewing SouthGobi Sands LLC's four suspended mining licenses. Those mining licenses had been suspended because the company failed to pay taxation for exploring and exploiting the mining areas. After the former chairman was found guilty for the illegal cooperation with SouthGobi Sands LLC, the Inspection Office checked for the financial accounting of the company to find out that SouthGobi Sands had evaded to pay 150 billion tugrik<sup>29</sup> worth taxation to the government of Mongolia.

Furthermore, the mining license, embezzled by the former chairman was the permission to exploit the mining site covering 72000 hectare with 42 million ton reserve of coal and was worth 2 billion US dollars in 2010 estimation. And the value of this site was increased by 30% in 2012 according to related mining experts. In addition to this case, the former chairman conveyed three licenses to a private company "Zelme" and "Vitafit group" owned by his friends.

There was public interest in knowing how the government distributes the mining licenses or how it manages the revenue from mining sector. However in countries like Mongolia,

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<sup>29</sup> 1US\$=1946 tugrik according to 11<sup>th</sup> of May, 2015 exchange rate,  
<http://www.xe.com/currencyconverter/convert/?Amount=1&From=USD&To=MNT>

endowed with natural abundance, the negotiation process of mining contracts is complicated, lengthy, and highly technical and frequently occurs behind closed doors due to confidentiality reasons often invoked in relation to such contracts (Chêne, M., 2007). The high technical complexity of such contracts also limits opportunities for public scrutiny and creates a bigger room for rent-seeking and corruption to take place. Additionally, the level of information available to citizens is largely limited and this lack of information is normal phenomenon in countries experiencing a sudden boom in the mining sector.

Given the fact that Mongolian institution is weak in enforcing the rule of law as well as, when there is absence of institutional barrier to rent-seeking, this case has shown that a sudden resource windfall rather has triggered more predatory rent-seeking behavior of Mongolian key policy makers and corruption or rent-seeking behavior make them fail in managing the resource rents properly. Therefore, increased rent-seeking and competition over resource rents by stakeholders during their term of office deplete the ability of the core institution to manage the resource wealth for the sake of the economy. This case presents that resource windfall in Mongolia strengthen the resource curse phenomenon and in the long run rent-seeking behavior will disturb economic growth which has been recently observed in the country.

### **3. Evidence II: Parliament of Mongolia**

This case is about, in the context of weak institutional framework, how political decision makers fail to manage resource boom to ensure the resource boom is a blessing and how this increasing rent-seeking disturbs the already weak institutions. Particularly, the case will show, as fiscal capacity started expanding with the resource boom emerging in Mongolia, how political competition wasted the resource revenue with the purpose of retaining office to find the political institutions less capable of dealing with economic downturns or external influences, such as, global crises or international market swings.

Even though Mongolia had established a democratic regime relatively successfully and peacefully in 1990s, still the remaining of the old, more closed and secretive system of single party rule have lingered during the early 2000s. Especially the policy making process persisted to be non-transparent and unaccountable. Specifically, State Secrets legislature largely constrained the public access to government information. There was an absence of legal rule for publicly revealing the draft laws or the government budget. The public was not able to scrutinize the voting record of members of the parliament. Mongolia's existing fiscal framework had not provisions for mandatory savings during mineral booms and for

abstaining pro-cyclical spending<sup>30</sup> or limitations on the levels of debt or annual deficits. This weakness and empty gap of the institutional framework gave a room for populist electoral campaign promises to be made on the bases of growing fiscal resources especially since these pressures went hand in hand with increasing political competition.

From 2004 onward, Mongolian government rapidly accelerated spending as more resource windfall become available. The parliamentary election of 2004, was the first during which the prospect of a mining boom. Since 2002 and 2003, the prospect of mining sector boom appeared as copper prices began to increase on the one hand, and on the other hand the acceleration of China's economic rise which opens up a big market for Mongolia's resource exportation<sup>31</sup>. Additionally, the Oyu Tolgoi mining site was confirmed in 2001, and intensive exploration was to start by 2003. The alliance of a number of political parties, so-called, Motherland Democratic Coalition (MDC)-formerly called the Democratic Union (DU) proposed the launch of a new social benefit- "The Child Money Program (CMP)"<sup>32</sup> in terms of the alliance's electoral program. This proposal enabled the MDC to pull nearly

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<sup>30</sup> Alberto Alesina & Guido Tabellini, 2005, "Many countries, especially developing ones, follow procyclical fiscal policies, namely spending goes up (taxes go down) in booms and spending goes down (taxes go up) in recessions"

<sup>31</sup> The 2015 World Fact Book of the United States Central Intelligence Agency, "China receives more than 90% of Mongolia's exported raw mineral resources"

<sup>32</sup> The Child Money Program is the first ever proposal by electoral promise for the cash hand-outs for citizens in the case MDC wins the election and followed by a number of altered cash handout promises by politicians

even with the Mongolian People's Revolutionary Party (MPRP)<sup>33</sup>. The critical weakness of the CMP is that it targets every minor under 18 years-old meaning that the policy does not necessarily address to alleviate the poverty of Mongolia. The World Bank displays 'it is likely that between 36% and up to 62% of the target households not in poverty'<sup>34</sup> in the sense that targeting for the CMP should be improved by policy makers.

Increasing resource windfall and electoral calculations generated more spending pressures among the public. In particular, rapidly increasing mineral revenues stimulated the expectations of citizens in terms of economic benefits to be received. During this period, parliament obtained a critical role in decision making process and in policy formulation, implementing populist policy measures and overruling policy proposals. Specifically, parliamentarians had a growing influence over spending decision making. After the 2004 election is over, the government had implemented pro-cyclical policies persistently, expanding spending since more resource revenue was generated. Decision makers adopt these policies not to address a particular social requirement such as reforming infrastructure,

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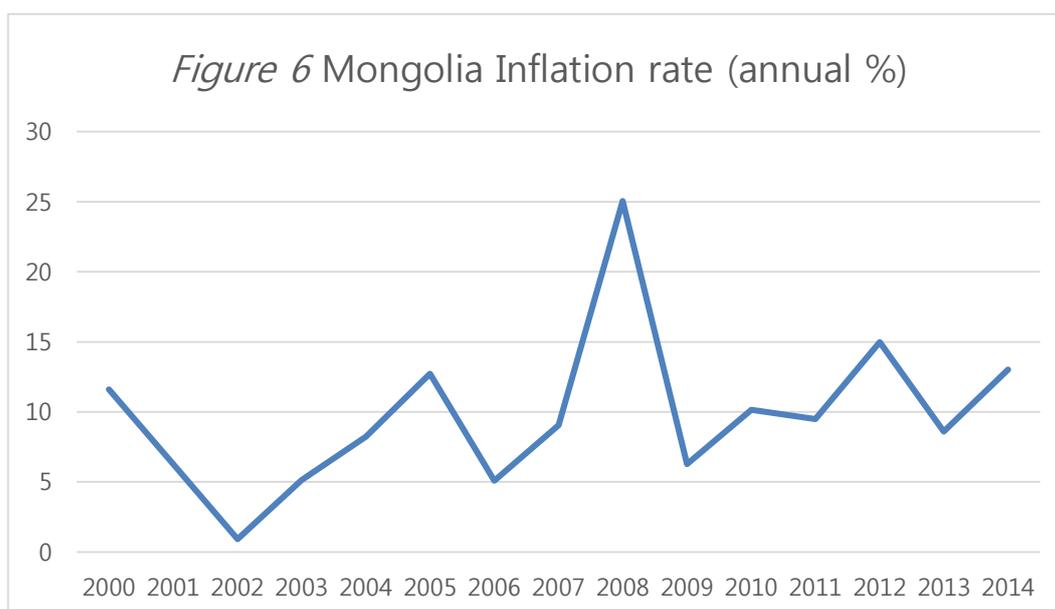
<sup>33</sup> The MPRP was the communist legacy party governing as the sole legal party from 1921 to 1990. The initial election in 1992 since the transition from Stalinist one-party-rule to the free market democratic regime was won by the MPRP. The 1996 election saw the first change in government. The Democratic Union (DU), an electoral bloc uniting a number of the parties formed since the early 1990s, won 47 percent of the popular vote. During this initial stint in government, the DU alliance pursued social and economic policies broadly aligned with the liberalization and austerity agenda of the Washington Consensus, including a major scaling back of the pension system. Predictably, the alliance lost the following elections in 2000, when the majority swung back to the MPRP, which gained a super-majority in parliament with 72 of 76 seats—based on winning 52 percent of the popular vote.

<sup>34</sup> Araujo, M Caridad, World Bank, 2006

schools, or hospitals but to buy public support. This is due to electoral promises made during elections, elected politicians had to spend most of the 'Human Development Fund' which is generated from mining revenue, as cash hand-outs to citizens. Mongolian citizens received 15 US dollars of cash through government allocated bank accounts monthly. Politicians justified this policy under the name of political methods to alleviate poverty and redistribution of recent national flowering prosperity. Nevertheless cash hand-outs to the population were a mere a method to secure electoral votes and in other words a total waste of valuable national fund which could be otherwise utilized for the sake of more foresighted social goals, such as investment in education or manufacturing sector.

Building on the 2004 experience, the two competing main political parties tried to outdo each other with electoral promises of new kind of cash handouts to citizens. This time the Mongolian Peoples' Revolutionary Party (MPRP) promised higher amount of cash handouts to citizens and won a majority of seats. While originally set up for investment and capital repairs as well as to reduce budget deficits and establish social welfare systems, the distribution plans have been again misused in the 2009 Presidential election campaign by the two main political parties to implement electoral promises in order to attract citizens' votes. In 2011, the Parliament stipulated that close to USD 600 million would be distributed for health insurance and students tuition fees, with about USD 15 per citizen for cash pay outs, representing almost 40 % of the state budget and 10 % of 2010 GDP (Isakova, A. and al, 2012).

Obviously cash handouts as government's spending expansion have increased the money supply which in return ignites already worsening inflation that only hurt poor groups in Mongolia. Inflation rate skyrocketed by 26% in 2008 and, inflation is rearing its head again in 2014, with double digit inflation expected by the end of the year.<sup>35</sup>



(Source: World Bank, Data Base 2015)

The World Bank and the IMF criticized these allocations as too expansionary and fuelling the country's high inflation rates and the distribution schemes remains at the heart of the political debate. Therefore the main challenges facing the country are to protect revenue

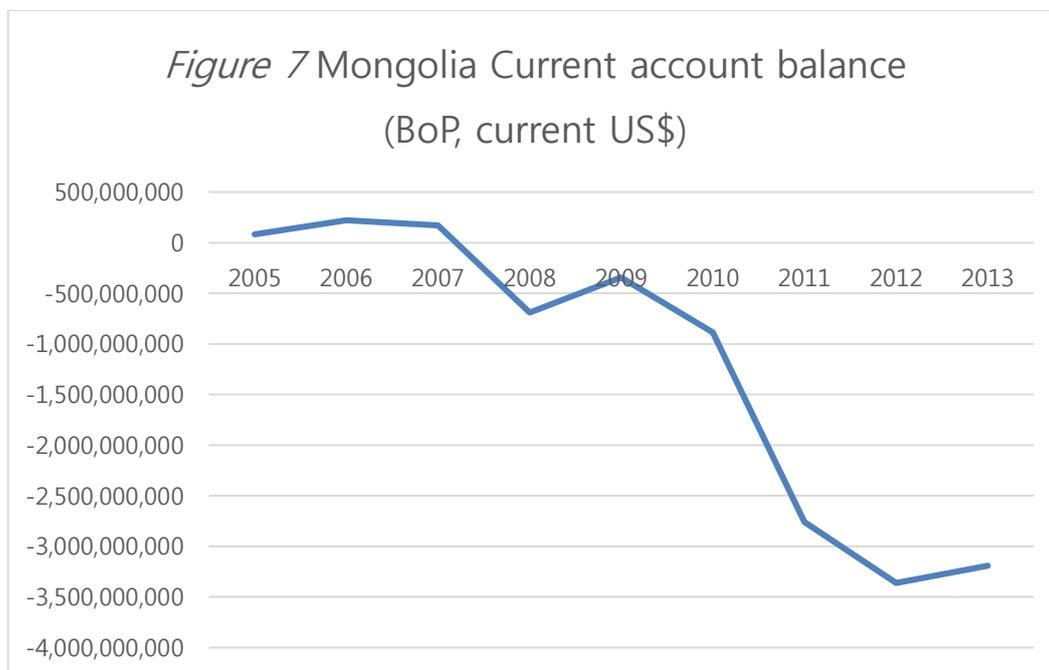
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<sup>35</sup> World Bank Data Base,  
<http://data.worldbank.org/indicator/FP.CPI.TOTL.ZG/countries/MN?display=graph>

flows from corruption on the part of the stakeholders having some degree of control over it as well as preventing politicians to prioritize short term issues over long term priorities (re-investment and mitigation) for political campaigning purposes (Brookings, 2012).

In addition to persistently increasing inflation, although Mongolia has been running a current account balance deficit since 2007, little concern among policy makers was focused to saving funds to assist smooth a potential downturn, and the fund from mining revenue was being wasted on the myopic political interests. Failure to manage the resource windfall and increased rent-seeking over the resource revenue impaired the capacity of Mongolian political institution to cope with possible economic downturns or external shocks, particularly the global crises.

Expansionary policies adopted by policy makers based on their electoral promises should be blamed for the continuing current account balance deficit since 2007. The global financial crisis struck Mongolia, as a result, Mongolia's real economy contracted to 1.3% growth in 2009 mainly due to a sudden and drastic drop in copper prices. If Mongolian policy makers have made smarter policy choices by saving funds to be used in case of economic downturns, Mongolian economy would not have been hurt to this extent.



(Source: World Bank Data base, 2015)

Not only international actors, but also domestic scholars<sup>36</sup> criticized the bad policy choices made during 2004 to 2012 in terms resource revenue of management. Chinese economic analysts<sup>37</sup> (Tsinhua Agency, January, 2015) and the former prime minister, Byambasuren revealed their alarming concerns that Mongolian economy is going to be bankrupt in 2017, if these ineffective policies and myopic electoral promises persist, at the same time, the

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36 Economics news.mn, 2013, <http://economy.news.mn/content/152997.shtml>

37 <http://mnb.mn/i/44600>

government is forced to pay foreign debt worth 4.954 billion US\$ in 2017 (CIA World Fact book, 2014)<sup>38</sup>.

With the sudden inflow of resource windfall into government coffer, rent-seeking and vote buying did thrive in Mongolia as this case has shown. In the short run, from 2002 to 2012 Mongolia appears to be successful in escaping the natural resource curse with drastically increased real economy, in the long run, the country would be trapped in the natural resource curse because natural resource abundance has triggered more predatory rent-seeking and corruption among policy makers. The outcome of resource windfall does largely depend on the country's ability to establish strong legal and institutional frameworks that ensure fair and equitable distribution of resource rents to all citizens. Since, Mongolia has weak legal and institutional framework to prevent from rent-seeking behavior, policy makers carried out bad policy choices to satisfy their narrow political interests. As shown in this case, incumbent politicians become more desperate to retain offices by appropriating resource revenues to generate political support as resource revenues are too large to lose. Policy makers not only disregarded the health of the nation's economy but also, what is worse, dismantled the capability or quality of the government institution in terms of dealing with economic downturns. Consequently, the resource windfall enforces the natural resource curse in Mongolia, as shown in this case.

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38 [http://www.indexmundi.com/mongolia/debt\\_external.html](http://www.indexmundi.com/mongolia/debt_external.html)

#### **4. Does Culture encourage Rent-seeking behavior?**

In addition to political institutional factors, this paper looked shortly into the cultural essences which also might be playing essential role in triggering corruption and rent-seeking in Mongolia. In certain extent, cultural factors can explain rent-seeking behavior tolerated in the society because family and kinship ties among a small number of populations as well as the gift-offering tradition tend to blur the lines between benevolent traditional custom and malicious rent-seeking.

The term of “*ariin haalga*” or “back door” means a ubiquitous pattern of continuous barter, favors, suspicious favoring relationships, and IOUs which have dominated social and political inter-relationship for centuries, in which cash may or may not be exchanged in hands. Mongolians generally rely on “*ariin haalga*” by managing business through acquaintances, family member, or friends who would assist them to bypass the formal regulations, instead of processing through the complicated procedures of rules. These “back door” patterns usually contribute to cronyism, nepotism, and favoritism, and apply to both petty and grand corruption in Mongolia. Institutional decision making process concerning recruitment for management positions, procurement, electoral procedures, licenses for

mining exploitations are is progressed along networks of acquaintances, friends and families<sup>39</sup>.

Thus traditional Mongolian culture has drawn back the rule of law in the society due to its emphasis on obligation and reciprocity shared by close friends and relatives. The significance of culture in generating rent-seeking behavior is hard to neglect especially when reform efforts to be considered. Unfortunately, there are a very few signs of a decline in cultural tolerance to corruption, which is still very high in Mongolia. According to the survey conducted by the Asia Foundation in 2014, nearly 34 percent of respondents still agree that some levels of corruption should be acceptable. There are no fundamental shifts in attitudes since 2006 (decline by two percentage points in eight years). Similarly, nearly 23 percent of respondents would still pay if they are asked for a bribe (same figure in 2014), and only 13 percent will report (declined by 8 percentage points). The good news is if compared with data over time there are small improvements<sup>40</sup>. But there is a little doubt that the current levels of “acceptance to corruption” is very high, and must be tackled through well targeted education programs, public discussions, appropriate training to media, and re-evaluating the ethical contents of education curriculum.

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30 Casals and Associates, 2005

40 Asia Foundation, 2014, <http://asiafoundation.org/in-asia/2014/06/18/in-mongolia-perception-of-corruption-as-most-critical-problem-drops/>

Even though it is hard to neglect the role of culture in encouraging rent-seeking in Mongolian society, this paper still emphasizes that the quality of political institutions has the highest significance in determining the behavior of policy makers and politicians. As presented in “the vicious cycle of three rent-seeking models”, since Mongolia has relatively very weak institution which fails to enforce the rule of law and prevent from corrupt behavior of policy makers and politicians, decision makers are strongly encouraged to engage in rent-seeking activities. Consequently policy makers fail to make healthy policy choices as well as mismanage the resource windfall for the benefit of the nation as a whole. Additionally, competition over resource rents among the influential policy makers do not just dissipate resource revenues but also erode Mongolia’s already weakened political institution further.

All in all, the resource boom in Mongolia has strengthened substantial rent-seeking behavior of policy makers, such as incentives against sufficiently well management of natural resources, as well as the problem of developing the capabilities to deal with the very rapid economic growth. Therefore, it is plausible to conclude that the resource windfall during the 2002 to 2012 further enforces the natural resource curse in Mongolia.

## V. Conclusion

Mongolia is endowed with the resource abundance and has enjoyed the rapid economic development since 2002, and even the country was called by the Economist Intelligence Unit<sup>41</sup> as the second best performing economy in 2011<sup>42</sup>, due to the achievement of 17% GDP growth. Even though resource boom has offered Mongolia a huge opportunity to achieve the economic growth, at the same time, the mining rents threaten nation's long-term growth sustainability, a critical challenge shared with some other natural resource abundant developing countries. Throughout the history, some natural resource-rich countries have grown rapidly, achieving high standards of living, while others have experienced "the natural resource curse"- corruption, civil war and widespread poverty. The phenomenon so-called "natural resource curse" is that countries endowed with natural resource abundance struggle from low or negative economic growth, compared to states with same economic level and absence of natural resource. Natural resource curse is hypothesized to take place for many different reasons, including a decline in the competitiveness of the other economic sectors caused by appreciation of the real exchange rate as resource revenues enter into an economy, a phenomenon known as Dutch disease,

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41 The research and analysis division of the Economist Group, the sister company to The Economist newspaper, <http://www.eiu.com/home.aspx#about>

42 <http://www.economist.com/blogs/theworldin2014/2014/01/global-growth>,

fluctuation of revenues from the natural resource sector due to heavy reliance on this sector and exposure to global commodity market swings, government mismanagement of resources, or weak, ineffectual, unstable or corrupt institutions ( Sachs and Warner, 1997a, b, 2001; Auty 2001).

Therefore the research question of this paper is that “Is mineral boom during 2002-2012 an opportunity to escape from the resource curse or to strengthen the phenomenon in Mongolia?” And this paper places the main focus on the political economic explanation on how natural resource abundance affects the society and the economy.

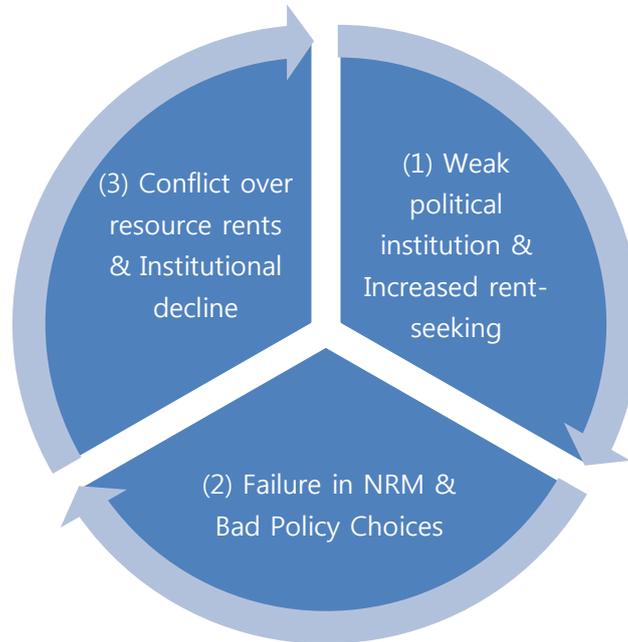
This study affirms that resource abundance in Mongolia offered both positive and negative outcomes for the economy and people. The real economy in fact has increased substantially thanks to natural resource wealth endowment since 2000 and it looks like Mongolia has successfully escaped from the natural resource curse. Nonetheless, in the long term, the prospective is much less promising than it looks because Mongolian government neither enforces the watchdog mechanism over rent-seeking nor protects people from the theft conducted by agents of governments. It is important to notice that natural resource curse phenomenon can be escaped with the right knowledge, institutions and policies. The links between natural resource abundance and overall standards of living are complicated. Specifically, natural resources provide a valuable flow of income to countries. If resource rents are invested in infrastructure and social programs that increase long-term growth and redistribute wealth appropriately, resource rents may increase standards of living. But if resource rents are captured by special interest groups, dissipated through corruption and

rent-seeking behaviors, then they may lower standards of living and increase income inequality. Whether resource rents can improve, rather than inhibit, economic development depends in large part on the quality of government institutions.

In the short run, even though during 2002-2012, Mongolia appears to be successful in fighting the natural resource curse with rapid economic growth, in the long run, the country would be trapped in the natural resource curse because natural resource abundance has triggered more predatory rent-seeking and corruption among policy makers. The resource curse phenomenon has been increasingly identified as a challenge of natural resource abundance, resulting in dysfunctional behavior in a weak institutional context. (Sala-i-Martin and Subramanian, 2003; Bulte et al., 2005; Mehlum et al., 2006; Robinson et al., 2006; Collier and Goderis, 2007). This is specifically relevant in the context in resource abundant developing countries where the institutions poorly developed to begin with. Therefore, resource abundant developing economies tend to reveal different results from developed economies like Holland, where institutional framework is better developed before natural resource is discovered.

Therefore this paper combined three rent-seeking models to display how resource wealth leads to the process where the misbehavior of policy makers contributes to economic downturn or the resource curse in the wake of weak political institution quality.

#### *Vicious Cycle of Rent-seeking Models*



Firstly, rent-seeking is profitable behavior when institution quality is low and value of rents is high, skilled people tend to become rent-seekers such as, mineral bureaucrats or lobbyists, rather than starting up a business in other fields. The result to be generated by natural resource abundance will mainly depend on the country's capacity to enforce strong legal and institutional frameworks which enable fair and equitable distribution of resource windfall to the people. Therefore when the political institution is weak or when there is no barrier to rent-seeking, natural resource rents generate rent-seeking behavior, which can be defined as the socially costly pursuit of rents. Strong institutions in the wake of natural resource discoveries are important actor to curb the associated negative growth effects of corruption. This is especially true in less advanced economies where natural resource discoveries have a much higher relative impact on the extent of corruption, and are

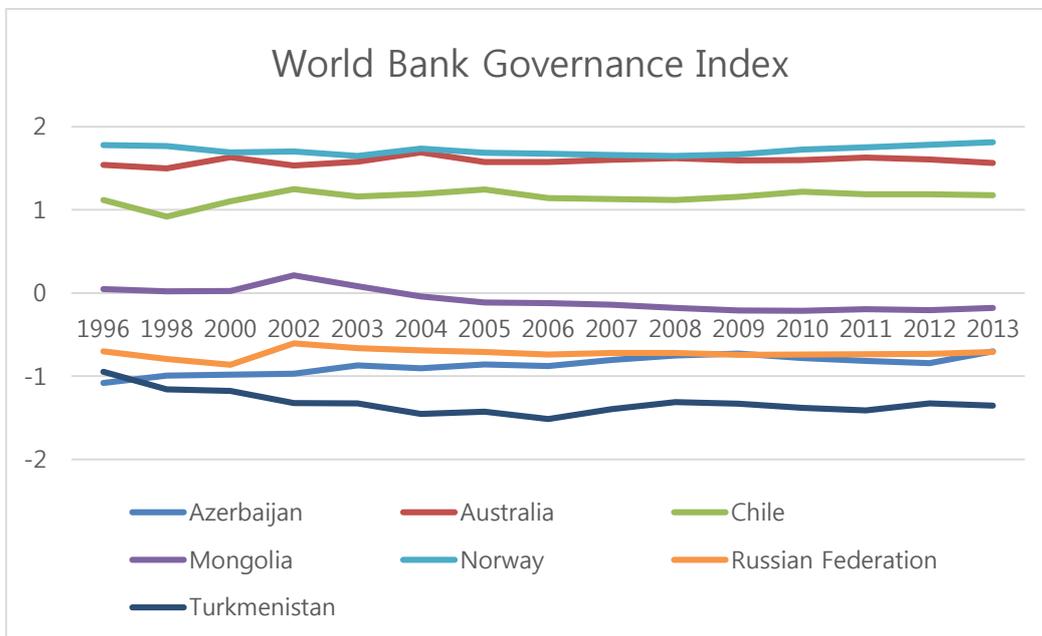
encountered with generally less strong and weak institutions (IMF 1999). This leads to the second model, “Failure in Natural resource management and bad policy choices”.

The second model focusing on policy making mechanism, shows that states endowed with rich natural resources are most likely to be controlled by factional and predatory policies which are implemented by policy makers to satisfy their political narrow interests. With huge inflows of money thanks to resource revenue into government fund, incumbent policy makers are very likely to become desperate to remain in office through, rent-seeking behaviors such as, buying political support and making bad policy choices.

Thirdly, competition among political groups over resource rents not only deplete resource revenue, but also erode further nation’s institution quality which is already weak. Rather than institution building, policy makers and politicians with their rent-seeking narrow political interests, are engaged in institutional destruction. These three rent-seeking models mentioned above create the vicious cycle of rent-seeking behavior that enforces the resource curse in countries with resource abundance. Also, it can be concluded that the relationship between rent-seeking and institutional quality is bi-directional. While weak institutions may encourage corrupt behavior or rent-seeking, increased rent-seeking may also erode the quality of political institutions.

Based on this vicious cycle of three rent-seeking models which lead a nation with resource wealth to the trap of the resource curse, this paper shows that the resource boom during the 2002-2012 enforces the natural resource curse phenomenon in Mongolia. To confirm this claim empirically, this paper analyzes the quality of political institutions and looked deep

into the mechanism of the resource sector in Mongolia. The quality of Mongolian political institution is low, based on the assessment about Mongolian governance conducted by international organizations, such as, the World Bank, Transparency International and Asian Fund. Specifically, the World Bank's Worldwide Governance Indicators show that Mongolia is in persistent downgrading trend in terms of governance and especially, Control of Corruption since the resource boom emerged in 2002.



(Source: World Bank Governance Indicators, 2014<sup>43</sup>)

<sup>43</sup> World Bank Governance Index shows an average of 6 components: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption. Higher values correspond to better institutions

According to the corruption index by Transparency International, the score of Mongolia has been decreasing consistently since late 1990s<sup>44</sup> and this fact is confirming that corruption is an increasingly critical threat in Mongolian governance.

Corruption Index of Mongolia (1999-2011)

year	score	Rank & same level as
1999	4.3	43th & Poland, Uruguay and Jordan
2004	3	85 <sup>th</sup> & Armenia, Madagascar and Iran
2006 & 2007	2.8	99 <sup>th</sup> Mali, Mozambique and Ukraine
2008	3	102 <sup>th</sup> , Lebanon, Rwanda and Tanzania
2010 & 2011	2.7	116 <sup>th</sup> & 120 <sup>th</sup> , Mozambique, and Solomon Islands

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<sup>44</sup> Transparency International, the global coalition against corruption, <http://www.transparency.org/cpi2014/results>

(Source from: Transparency International, 2014, score: 0-highly corrupt, 10 highly clean)

In addition, Index of Economic Freedom (2015) discloses that rent-seeking and corrupt behavior is pervasive and widespread in Mongolia's public sector. These degrading of Mongolia's institution quality and more increasing corruption in the wake of recent resource windfall, suggests that Mongolia, in the long term may not be immune to the institutional resource curse. As the resource boom gains momentum, Mongolia's most important challenge will be to reverse this trend and further reform the quality of its economic and political institutions. In order to escape the natural resource curse in the long run, Mongolia is in desperate need to reduce corruption. However in fact, the corruption has been continuously increasing since 2000.

Additionally, Mongolia still has vestiges of old, more closed and secretive system despite the relatively successful transition to a democratic regime from socialism in 1990s. The policy making process is nontransparent in critical areas of political institution. To be specific, Law on State Secrets substantially restrained public access to government regulated documents. There were no legal regulations for making information on draft laws or the budget to be public. Specifically, for the mining sector the lack of a detailed legal regulation framework in which the mineral law is drafted and implemented resulted in a high level of freedom of choices in the distribution of mining permissions.

Given the fact that Mongolia has relatively very weak political institution, this paper brings up empirical evidence in which Mongolian resource windfall contributes to increasing rent-

seeking behavior among decision makers and their competition over resource rents lead to further erosion of the institution.

The first case is about the former chairman of the Mineral Resource Authority and advisor to the former Prime minister who issued 120 illegal mining licenses arbitrarily, transferred licenses to private companies owned by his friends and relatives, and renewed suspended four licenses for the international company “SouthGobi Sands” LLC in return embezzled one of four licenses for his ownership as a bribery. When the government structures are weak with poor regulation framework to ensure transparency and accountability or there is no barrier in preventing dissipation of resource rents, Mongolia’s mining sector is more susceptible to rent-seeking activities and corruption shown in this case.

The next case is about policy making procedures in the wake of resource wealth endowment. With the huge inflow of revenue to the government fund, politicians got more desperate to appropriate resource rents and deviated allocation of resource revenues to generate political support or to retain office. Since 2004 elections, Mongolian politicians or the political parties tried to overbid each other by making too unrealistic electoral promises, such as cash handouts, to buy the public support. After the election, politicians had to spend the “Human and Development Fund” that is generated from resource windfall and originally set up for capital repair as well as reduce budget deficits and establish social welfare systems. Cash hand-outs not only did no good for poor citizens since the targeting was not for the poor class but for everyone, but also deteriorated already worsening inflation which only hurts the poor further.

The World Bank and the IMF criticized these allocations as too expansionary and exacerbating the country's high inflation rates and the distribution schemes remains at the heart of the political debate. In Mongolia, the main problems threatening the nation are to protect revenue flows from rent-seeking on the part of the stakeholders mismanaging resource rents as well as preventing politicians to prioritize short term issues over long term sustainable development (re-investment and volatility mitigation) for political campaigning purposes. Not only international observers like the Chinese economic analysts but also domestic economic scholars<sup>45</sup> revealed alarming news that Mongolian economy will be bankrupt by 2017 due to massive international debts, ineffective expansionary policies and widespread corrupt behavior.

Thus shown in the cases, it can be concluded that outcome of resource windfall will largely depend on the country's ability to establish strong legal and institutional frameworks that ensure fair and equitable distribution of resource rents to all citizens. All in all, the vicious cycle of rent seeking suggests that countries with weak institutions suffer a resource curse, whereas those with strong institutions do not. In case of Mongolia, the resource windfall during 2002-2012 enforces the natural resource curse occurs because in the wake of weak institutional quality, resource rents are easily appropriated by political elites who make bad policy decisions through triggering bribes and distorted policies, and waste the public fund

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<sup>45</sup> 17<sup>th</sup> Prime Minister of Mongolia during 1990-1992, economist, Byambasuren "Mongolian economy will be bankrupt by 2017 because of rife corruption, unprofitable contract agreement on Oyu-Tolgoi deposit, and huge international debts."

which could be used for more far-sighted decisions such as, minimizing the budget deficit or saving for foreign debts. Empirical evidences about Mongolia reveal that rent-seeking behaviors or corruption of political elites do make a resource rich country more prone to fall in the trap of resource curse. It is because the quality of the institution is too weak to block rent-seeking behavior and encourages rent-seeking among policy makers, as well as conflict over resource windfall in return depletes the already weak institutions farther, thus, lend support to the resource curse discourse.

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## Abstract in Korean

### 천연자원 패러독스: 몽골의 사례

#### 국문 초록

몽골은 중앙아시아 내륙 즉 러시아와 중국 사이에 위치하는 나라이다. 현재 몽골은 풍부한 천연자원으로 인하여 전 세계에서 빠른 속도로 성장하는 나라들 중 하나이다. 그러나 천연자원이 풍부한 다른 개발도상국들과 마찬가지로, 새롭게 발견된 기회를 장기적으로 지속 가능한 개발로 변형하는 데 있어서 어려움을 겪고 있다. 따라서 본 연구의 목적은 몽골에서 2002년에서 2012년까지의 10년 동안 일어난 천연자원의 붐이 천연자원의 저주에서 탈출할 수 있는 기회를 제공하고 있는지 혹은 천연자원 풍부함은 단지 저주의 현상을 강화시키고 있는지를 확인하는 데에 있다.

몽골의 최근 경제성장 전망을 보면, 성공적으로 천연자원 저주를 탈출한 것으로 나타난다. 그러나 몽골의 풍부한 천연자원 및 자원 저주의 상관관계를 살펴 깊게 조사하기 위하여 본 논문은 지대 추구(rent-seeking)의 세 가지 모델을 결합하여 몽골 사례에서 적용하였다. 지대 추구의 세 가지 모델은 첫째, 약한 국가 기관 및 증가된 지대 추구 행위, 둘째, 천연 자원 관리 실패 및 잘못된 정책 선택 셋째, 지대 추구 경쟁 및 국가 기관 품질 하락이다. 이와 같은 세가지 모델을 활용한 연구 결과는, 몽골에서 2002년에서 2012년

사이에 일어난 천연자원 붐이 몽골 상위 정치인들의 부패 행동을 더욱 유도함으로써 천연자원 저주가 더욱 자리를 잡고 있는 것으로 나타났다. 이러한 현상이 발생하게 된 주원인은 현재 몽골 정치기관이 지대 추구 행위를 차단하는 데 있어서 매우 약하기에 정책 수립자들을 비롯한 정치인들의 부정부패가 심해지고, 따라서 보편화된 부패 행위가 이미 약한 정치기관을 더욱 고갈시키기 때문이다. 이에 몽골의 정치기관 품질 저하 및 부정부패 행위 증가 현상은 천연자원의 붐이 앞으로 몽골에서의 제도적 자원저주를 더욱 악화시킬 것으로 보인다. 따라서 몽골 정부가 우선순위로 해결해야 할 과제는 위와 같은 추세를 역전시키는데 주의할 필요가 있으며, 천연자원 저주를 측면하지 않기로 경제적 정치적 제도를 개선할 필요가 요구되고 있다고 본다.

**주제어:** 천연자원 저주, 정치 및 경제 제도, 부정부패, 지대 추구 행위

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