

# Financing social protection through taxation of natural resources



International  
Labour  
Office

## Mongolia

*Mongolia is an example of a country that has recently started to take more advantage of its vast natural resources. Mongolia's development has been spurred by revenues from extractive industries. The Government has made significant efforts to ensure that the wealth created from its natural resources is shared among the wider population and that resources are directed to social protection programmes, such as the Universal Child Money programme.*

Natural resources in resource-rich countries can create a basis for development and support social and socio-economic spending, technological advancement, foreign direct investment and overall economic growth.

Experiences from developing countries, such as Bolivia, Brazil, Chile, Argentina, Colombia, Botswana, Zambia, Indonesia and Malaysia, as well as those of developed countries, including Australia, Canada, Norway, Sweden and the United States, show that natural resource extraction can have positive impacts on socio-economic outcomes.

**National social protection floors (SPFs) guarantee access to essential health care and basic income security for children, persons of working age and older persons.**

**185 countries have adopted the Social Protection Floors Recommendation, 2012 (No. 202), an approach to achieve universal social protection.**

**This note presents a successful country experience of expanding social protection.**



### Main lessons learned

- Natural resource-rich countries can boost their social protection system through the taxation of natural resources, thus increasing government revenues to support increased social protection expenditures.
- Directly linking government revenues generated from natural resources to funds allocated to social protection programmes helps to redistribute wealth created from natural resources to the wider population.
- Through the taxation of natural resources and the expansion of social protection spending, the Government managed to significantly reduce poverty rates.
- Efforts to increase transparency and operational efficiency at all levels of the Government further support the allocation of funds to social expenditures.
- The establishment of a stabilization fund would further help in balancing volatility in government revenues due to natural resource price fluctuations.

## 1. Risk of natural resource abundance

Even though some countries have fared well, the impact of natural resource abundance is not always clear and predictable. In some cases, abundant natural resources have been a curse rather than a blessing, resulting in large-scale corruption, strengthening of authoritarian rules and environmental damage. Exploitation of mineral resources in the Democratic Republic of the Congo and oil in Nigeria, Angola and Equatorial Guinea offers clear examples of misappropriation of extractive industry revenues. Lopsided growth due to the “Dutch disease” can further lead to the crowding out of other sectors and make the national economy less competitive due to currency appreciation, making exports more expensive and less competitive.

Successful cases offer lessons on what to avoid and emulate when a developing country’s economy is based heavily on natural resource extraction. Common elements observed in countries that have successfully developed with the help of natural resource extractive industries include: introducing elements of revenue redistribution; linking natural resource rents and taxes to social and socio-economic investments and development; strengthening tax authorities; increasing transparency; and improving governance structures.

## 2. Taxing natural resource extraction in Mongolia

The Mongolian economy has experienced positive economic growth, with an average growth rate of around 8.4 per cent between 2005 and 2015, making it one of the fastest growing economies in the world. In parallel, the poverty rate has been on a downward trend from 38.8 per cent in 2010 to 21.6 per cent in 2014.

Mongolia, especially in relation to its population of 2.9 million, is rich in natural resources. The country’s gold and copper reserves are among the largest in the world. The estimated value of total natural resource reserves that have been identified to date is US\$1.3 trillion. Mongolia’s natural resources include copper, gold, coal, molybdenum, iron ore, uranium, tin, tungsten, silver, zinc and fluorspar.

The Government of Mongolia applies royalty rates of 5 per cent on natural resource extraction. In addition, there is a 10 per cent corporate income tax on profits and surcharges in the form of progressive royalty rates and exploration and production licencing fees.

Over the past decade, natural resource extraction boomed. In 2010, the extractive sector accounted for 30 per cent of GDP, 32 per cent of government revenues and 81 per cent of exports, with an employment share of 5 per cent of the total workforce. Government revenues have increased significantly since the expansion of natural resource extraction operations.

There have been visible efforts to increase transparency and operational efficiency at all levels of the Government. Mongolia joined the Extractive Industries Transparency Initiative, received a full compliance status in 2010 and has reported its revenues on a regular basis.

## 3. Natural resource extraction revenues and social protection

Several initiatives have been launched in Mongolia during the last decade, aimed at linking revenues collected from the natural resource extraction industry to social protection programmes, thereby redistributing wealth created from natural resources to the wider population.

### Mongolian Development Fund (MDF)

In July 2006, the Government introduced universal child benefits. In parallel, windfall profits taxes were introduced to capture a higher share of mining profits. All revenues created from natural resource extraction (dividends and 70 per cent of royalties) entered the newly created Mongolian Development Fund (MDF). This was the Government’s first attempt to create a sovereign wealth fund. The fund had several functions: stabilize unplanned budget deficits; undertake investments aimed at increasing domestic economic capacity; support small and medium-sized enterprises; and support children and families through the universal child benefit scheme.

The MDF was the Government's first effort to legislate the link between government resource receipts and cash transfers. In January 2007, the MDF significantly increased the annual benefit amount of the Universal Child Money programme from 36,000 Mongolian Tughriks (MNT) (US\$30.76) to MNT136,000 to (\$116.19) per child.

### Human Development Fund (HDF)

In 2009, following the 2008 elections and after the initial turmoil caused by the financial crisis that significantly affected natural resource prices, the MDF was replaced by the Human Development Fund (HDF). The mandate of the Fund, similar to the previous one, was to create and grow sustainable resources for better income distribution among the population. The HDF had the same function as the MDF but on a much larger scale. The legislation did not limit benefits and included health insurance and pensions, housing payments, cash and medical and education service payments. A cash transfer amount was set at MNT120,000 (\$89.08) per person in 2010. The total cost of the schemes was three times as much as the Universal Child Money programme in 2009. The new schemes under the HDF were generous and came under pressure after income did not meet expenditures. The fund was temporarily replaced by a targeted poverty benefit programme.

Currently, the Government is considering the establishment of a sovereign wealth fund called the Future Heritage Fund. The fund is proposed to be operational as of 2018 and will replace the HDF. The idea is highly controversial and critics are questioning its benefits as it diverts funds away from social investments. The fund is expected to invest resources in international capital markets rather than on people and national development.

Alternatively, a stabilization fund could help mitigate the risk of market and price volatility and help the Government maintain a higher degree of liquidity during economic downturns and mineral price drops. As a result the Government is more likely to be in a position to balance social investments in the long run.

The Economic and Social Stabilization Fund of Chile is a good example of how to maintain liquidity and balance

public expenditures. The stabilization fund is a countercyclical tool that aims to smooth government expenditures, finance fiscal deficits in times of low growth and/or low copper prices and to pay down public debt when necessary. Funds can be withdrawn from the Economic and Social Stabilization Fund at any time in order to fill budget gaps in public expenditures and to pay down public debt.

A high degree of fiscal flexibility is maintained by investing in portfolios with a high level of liquidity and low credit risk and volatility. The fund is invested up to 30 per cent in money market instruments, 66.5 per cent in sovereign bonds and 3.5 per cent in inflation-indexed sovereign bonds. The Chilean Economic and Stabilisation fund represents a model for Latin America and could be applied in other countries that face similar market volatilities.

### 4. Conclusion

Mongolia presents a case where government revenues generated from the taxation of companies engaged in natural resource extraction have been directed to social protection programmes. The Government was successful in redistributing some of the wealth from extractive industries.

Taxing natural resource extraction is one of the many alternatives that countries have to expand fiscal space for social protection. Governments normally use a mix of taxes and social security contributions to fund social protection, combined with other options explained in the paper, Fiscal space for social protection: Options to expand social investments in 187 countries.



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