

WEALTH THROUGH OWNERSHIP: CREATING PROPERTY RIGHTS IN CHILEAN MINING

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In 1971, Chile's president Salvador Allende, a Marxist, got congressional approval for a constitutional reform that gave the state "absolute, exclusive, inalienable, and imprescriptible" ownership of all mines, with the declared aim of confiscating four large copper companies belonging to U.S. companies without paying proper compensation. Soon after, the government expropriated those companies and refused compensation arguing that the mines were state property. In this way, a centuries-long legal tradition—stating that miners had a secure stake in their claims—was changed overnight, violating property rights and paralyzing all private mining exploration and investment in a country potentially rich in undiscovered mineral deposits.

After the change of government in 1973, the situation remained unaltered, pending a new Constitution that would establish the institutions for democracy and reinstate the traditional property rights in the mining sector. However, to the surprise of many, an unexpected disagreement within the government (generals versus economists) led to the failure of the 1980 Constitution to establish clear mining rights.

The day after the Constitution was approved by referendum, the mining sector began to call for constitutional reform through what would have been an unusual "mining plebiscite," or by means of publishing a law interpreting the Constitution. At that moment Chile faced two important problems: (1) the uncertainty concerning property rights in the mining sector, and (2) a threat to the legitimacy of the new Constitution.

In trying to resolve that crisis, President Pinochet asked me to move from Secretary of Labor and Social Security to Secretary of Mining on

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December 29, 1980, soon after the approval on November 4, 1980, of the Social Security Reform. That reform created a universal pension system based on private retirement accounts (see Piñera 1996).

The challenge was to draft a constitutional law that would establish secure property rights in mining, obtain presidential and legislative approval for it, win the assent of the Constitutional Tribunal, and convince local and international entrepreneurs of its rationality, as well as to persuade the public that the national interest had been safeguarded. All of those goals had to be achieved without weakening the legitimacy of the Constitution.

Our team of classical liberal economists had fought hard for a new economic model based on free markets and private property, and for a return to a limited democracy inspired by the lessons of the American Founding Fathers. The 1980 Constitution was a key step toward the second goal since it represented not only the government's decision to return power to civil society, but also set the timing and conditions for the free election of Chile's political representatives.

The Gordian Knot

From the very beginning, I declined to become involved in the emotive discussions about the proposal to privatize Codelco, the huge state-owned company operating the former American deposits. At the time, Codelco produced 85 percent of Chile's copper output and generated a similar proportion of the country's export receipts. Of course, I could never have been in favor of the creation of Codelco or of a similar state enterprise, but once it did exist—with a near monopoly position in the mining and foreign exchange sector—and given the exceptional circumstances under which the government had come to office, to have tried to privatize it under a nonelected government would have set off a "holy war" that would have made it very difficult to make progress with the problem whose solution was the priority for Chile.

In real life, the optimal sequence of public policies is very important. It was preferable to open the way for private production of copper (and other minerals) to grow to the point where it predominated, thereby creating new wealth, and only then address the Codelco ownership issue. The urgent challenge was to devise legislation, within the constitutional constraints, that would encourage the discovery of new deposits and the expansion of existing ones.

The correct identification of a problem is the first decisive step toward solving it. The Gordian knot impeding the development of private mining was the question of a fair indemnity in the event of

expropriation of the mining concession. For a private investor this was a vital consideration given the history of confiscations in natural resource rich countries, and especially in Chile.

The “sword” I found was embedded in a concept of economic science. It was the present value of the net cash flows of an asset or company, a figure that in a competitive and transparent market is equivalent to the market price of the asset or company. In my opinion, it was entirely compatible with the overall philosophy of the Constitution, once a robust mining concession right had been defined.

The reasoning behind this criterion is simple. An asset—whether an industrial, farming, or mining company—has value to the extent that it can generate future profits (assuming for simplicity that these are the only cash flows). A multistory car park at the South Pole has almost no value, whatever it may have cost to build; whereas a shop on the best corner in central Santiago is worth far more than it cost to open. But these future profits cannot just be summed up because they will arise at different points in time; they need to be discounted to the present at the appropriate rate of interest and then added together.

In order to apply this formula in the case of the mining concession, the concession right had to incorporate the right to extract minerals now and in the future, and that is how we drew it up.¹ To make this an entirely coherent solution to the fair indemnity problem, and to secure the assent of the Constitutional Tribunal to the present value concept never previously included in legislation of a constitutional order, it was necessary to define two points with great exactness: (1) the nature of the concession right that would be established in the constitutional law, and (2) the terms on which the concession-holder would hold the concession right.

The Constitutional Mining Law

The mining concession, which we called the “full concession” and was incorporated in the Constitutional Mining Law, has all the legal attributes required to provide guarantees to the private investor as well as to safeguard the national interest. The law provides for the following:

¹An expropriation deprives the owner of the possibility of future use and of the ensuing cash flows. Thus, the loss occasioned to him by the expropriation is the same as the present value of the net cash flows that the mine is capable of generating.

- *Protection of the concession as a property right.* The registered owner can freely exploit, enjoy, and dispose of the concession as he thinks fit; he can sell or mortgage it, pledge it as collateral, or leave it to his heirs. Moreover, the concession right cannot be taken from him except by means of an expropriation.
- *Fair compensation for any act of expropriation.* The owner of the concession has to be fairly indemnified. Compensation must be paid in cash and must reflect the entire reduction in the owner's net worth, equivalent to the present value of the concession's future net cash flows.
- *Rational operation of a mine.* The concession-holder is not subject to an arbitrary "use it or lose it" clause, but may carry out the working of the mine in accordance with his own methods, processes, work tempo, and production plans, which will evolve in response to the demands of a complex and ever-changing international market. The management of the mine will not be subjected to controls and obligations imposed by the government of the day.
- *A concession right with an indefinite life.* There is no surrender date: retention of the concession is subject solely to the payment of an annual fee per hectare ("*la patente minera*"). The indefinite life was important in order to avoid the possible politicization of the process of renewing the concession term for a deposit under operation, and in order to eliminate incentives to "perverse" exploitation of a deposit in the years leading up to expiry of the original concession term.
- *Insulation from politics.* The full concession right is not a political creation. Its existence and termination are in the hands of the Judicial Branch, not the Legislative Branch or the Executive. The concession originates in a legal procedure whereby the judge recognizes the existence of the right conferred by the act of discovery.

On August 13, 1981, I submitted the draft Constitutional Mining Law together with a comprehensive explanatory report to the President. The report was published in December that year in my book, *Principles of the Basic Constitutional Law on Mining Concessions* (Piñera 1981).

The Legislative power (the "*Junta de Gobierno*") gave final approval to the Constitutional Mining Law on December 1, 1981. The following day, in my address at the opening of the El Indio mine high in the Andes, at the head of the valley where our great poetess and

Nobel Laureate Gabriela Mistral was born, I publicly announced the passage of this key law.

After the Constitutional Tribunal had subjected the entire law to the process of constitutional review, it was approved by all of its members on December 22, the unanimous approval being of crucial importance to the future permanence of the law. It was finally gazetted on January 21, 1982, in the *Diario Oficial* as Law No. 18.097. It should be emphasised that any change to a basic constitutional law requires a quorum of four-sevenths of the sitting deputies and senators (the quorum was formerly three-fifths under the 1980 Constitution, but was reduced in the 1989 constitutional reform agreed between the government and the opposition).

Although the Constitutional Mining Law took effect when a further ordinary law was gazetted, governing a number of procedural issues (known as the Mining Code), its economic consequences were immediate. Since all the characteristics of a concession—its nature, the rights and obligations it conferred, its duration—were set out in the Constitutional Mining Law, from an economic and business perspective the positive effects of the law began to show themselves in the form of increased exploration and production activity from the moment its approval was announced.

Thus, a decade of uncertainty in the 1970s over mining property rights was ended, and new horizons of investment, employment, and development were opened in a key sector of the Chilean economy.

Good Policy, Good Politics

Chile's reform of its mining law could help other countries by demonstrating that there is a way to make the nominal state ownership that is written into several constitutions compatible with a robust property right over a "full concession," and thereby to open new fields for the creation of wealth through the activity of private entrepreneurs.

The coherence of a government's or a statesman's economic and political vision is revealed by the answer supplied to the fundamental question: How is wealth created? Or to ask it another way, What is the key to riches?

The Constitutional Mining Law, by creating genuine property rights in the largest—and most politically sensitive—sector in the country, was the answer to that question and its approval sent a message to domestic and foreign investors from that moment that private property was fully guaranteed in Chile.

The process of radical opening and economic liberalization that

took place between 1973 and 1980 had demonstrated the commitment of Chile's new development strategy to free-market economic principles. Now the country would be able to see that full ownership of property was able to generate an unprecedented expansion in the mining sector and so to create great wealth.

The results speak for themselves. Chile's copper output has increased nearly 5-fold during the last 20 years, and there has been a 16-fold increase in private copper production. As a result, Chile is now by far the largest copper producer in the world, accounting for 35 percent of global output. In addition, Chile is the world's largest producer of natural nitrates, iodine, and lithium; the 2d largest producer of molybdenum; the 5th biggest supplier of silver; and the 13th largest producer of gold. Chilean entrepreneurs have made major investments in the mining sector, and that sector has attracted \$20 billion in foreign direct investment.

All these factors have combined to develop dormant riches, create new and productive employment, transfer valuable technology, generate new tax revenues, and stimulate investment in other parts of the production and service chain such as power, transportation, water, ports, highways, housing, and machinery.

Conclusion

It was demonstrated that the key to wealth, in the case of the mining sector, was the Constitutional Mining Law, operating within a free-market environment. The idea that property is sacred, so intensely reflected, despite the difficult starting point, in the Constitutional Mining Law, consolidated an intellectual framework supportive of the subsequent privatization of large state-owned companies, notably in the telecommunications and power sectors. In the 1990s, the concession system was extended into the infrastructure sector (highways, ports, and airports), which had traditionally been part of the so-called "public works" carried out by the state.

The Constitutional Mining Law simultaneously made a decisive contribution to the consolidation of a prosperous nation and of a democratic political system. It did this by contributing to the annual average economic growth rate of 7 percent for a period of almost 15 years, and by rendering unnecessary an alteration or a questionable interpretation of the 1980 Constitution.

I hope that this endeavor has demonstrated that true politics does not consist, as many claim, in the art of "the possible," but rather in

the art of “making possible what is necessary” for a nation to progress and to advance liberty.

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