



## ENTREPRENEURSHIP DEVELOPMENT FOUNDATION

The Project:  
**OIL REVENUES: CHALLENGES FOR AZERBAIJAN**  
**INFORMATION BULLETIN**  
№5, 2007

# Oil Revenues and Economic Freedom

Another round table discussion on the Project was held on 11 June 2007. The subject of the round table was the following: “**Oil Revenues and Economic Freedom**”. The representative of Center for Economic and Political Research Mr. Elkhan Mammadov and the president of the Entrepreneurship Development Foundation Mr. Sabit Bagirov made reports at the round table.

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The round table was attended by: Elkhan Mammadov (FAR Centre); Sabit Bagirov (The Entrepreneurship Development Foundation); Ali Masimli (member of parliament); Zaur Valiyev (Ministry of Economic Development); Tanriverdi Aliyev (Ministry of Economic Development); Namiq Azizov (Association of Azerbaijani Managers); Fuad Rasulov (Khazar University); Alimammad Nuriyev (Constitutional Fund); Alovzat

Bayramov (The Fund to Assist the Development of Entrepreneurship and Market Economy); Irada Eyvazova (Economic and Political Research Centre); Sevgim Rahmanov (Union of Merchants and Manufacturers); Zohrab Ismayilov (Centre to Assist the Free Economy); Aydın Nizamov (EITI NGO Coalition); Nigar Ibadgizi (APA Information Agency); İlham Hüseynli (Democratic Progress and Economical Cooperation); Hafiz Babalı (Turan Information Agency); Mirzaga Mammadov (“Sahar” Iran TV); Nicat Gafuroglu (Public TV); Anar Jabrayilli (ANS TV); Ulviyya Ismayilova (TREND Information Agency); Najiva Mirzayeva (BMM –observer); Latif Shamhal («Nedelya» Newspaper); Babek Jahandarov (“Paritet” newspaper); Kubra Aliyarli (“Ses” newspaper).



The classic definition of economic freedom is:

*Individuals have economic freedom when property they acquire without the use of force, fraud, or theft is protected from physical invasions by others and they are free to use, exchange, or give their property as long as their actions do not violate the identical rights of others. An index of economic freedom should measure the extent to which rightly acquired property is protected and individuals are engaged in voluntary transactions.*

James Gwartney and Robert Lawson et al.

*Economic Freedom of the World: 1996 Annual Report*

# Oil and Economic Freedom

*Elkhan Mammadov*

It has become customary to link the prospect of our economic development to increasing volumes of oil extraction. What is more, in discussions we definitely refer to the fact that the volume of extraction should grow and oil prices should not fall. This process is even planned for years ahead. What is more, there is even some “peak” of extraction after which we will all be rich enough. In this article, we will try to show that there are stronger factors of economic growth than the oil factor. Strange as it may seem, the factors we are going to talk about do not require resources. They are a fruit of the social deal between the government and society.

## **Economic freedom – ideal or reality**

Society is continuing discussions on the need to expand economic freedoms. There are numerous examples that demonstrate the positive effect of growth in the economic situation on people’s welfare in emergency situations. Many of us probably remember the bread crisis of the winter of 1993-94. Then the problem of the bread shortage was solved very easily. The government gave entrepreneurs full freedom to import flour from abroad. All vehicles carrying flour were given the green light. These vehicles did not need customs clearance, while the police escorted them to their destination (now it sounds implausible) and very soon, demand for bread was totally met. What is more, bread prices remained the same.

The governments of many countries keep to the policy of expanding economic freedoms. However, this policy needs “lighthouses” (objective criteria) that could be used as orienting points to successfully move towards the expansion of economic freedoms. Both methods are based on the calculation of the index of economic freedom. These systems have been drawn up by the Heritage Foundation and the Fraser Institute. Since both methods are

similar in principle, we will dwell on the method of evaluating economic freedoms drawn up by the Fraser Institute. The founder of this method is the Nobel prize-winner in economics, Milton Friedman, one of the outstanding economists of the 20<sup>th</sup> century.

The index of economic freedom measures the **quantity** of economic freedom in the country. It is difficult to imagine the quantitative criterion of economic freedom. Nevertheless, the index is highly objective. In compliance with the method of calculating the index, the main components of economic freedom are: 1) the possibility of a personal choice; 2) freedom of deals; 3) free competition; 4) protection of personality and property.

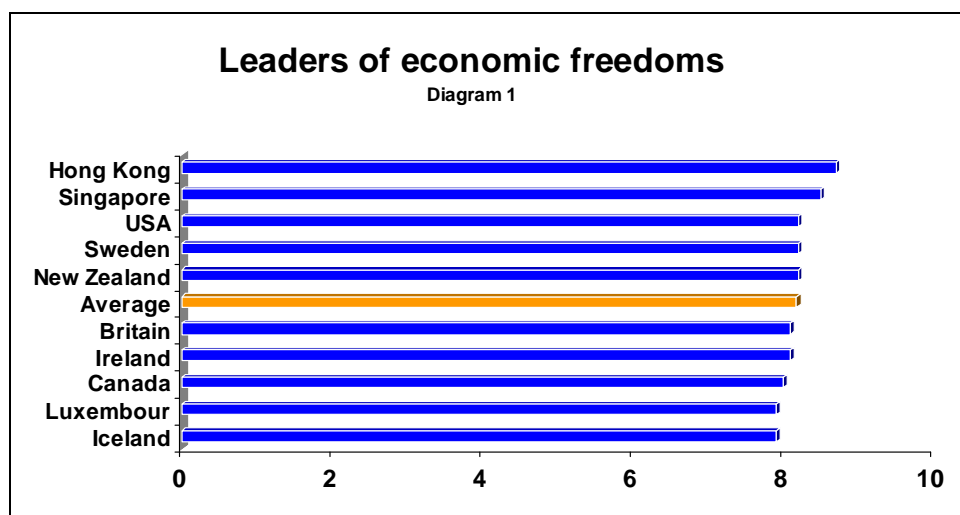
The index under review is based on the calculation of 38 components that reflect the state of economic freedoms in a state. The scale of measuring economic freedom is a 10-point scale (from zero to 10). The highest point that characterizes the highest level of economic freedoms is 10 points. Calculations on all components are averaged into sub-indices in five spheres:

- The size of the state sector in the economy;
- The legal state and immunity of the right to property;
- Money policy;
- Freedom of foreign trade;
- The degree of regulation (Credit policy, labor market, business)

The total index of economic freedom in a country is calculated at the end. This index is the average value of indices in these five spheres. The higher the index, the higher the level of economic freedom in a country.

The Index of Economic Freedom (IEF) is calculated in more than 130 countries the population of which comprises 93 per cent of the world population. It is quite logical to generalize the results from all countries and calculate the world IEF. Over the last 30 years, the world has seen a stable growth in economic freedoms. This global trend has affected almost all states. We can say that all the countries of the world have been improving their economic freedom indices to this or that extent. From 1975 to 2000, the world index of economic freedom increased by almost 30 per cent.

The leaders of economic freedoms are countries like Hong Kong, Singapore, the USA, Ireland, New Zealand, Canada, Iceland, Britain and others (See Picture 1).



Picture 1

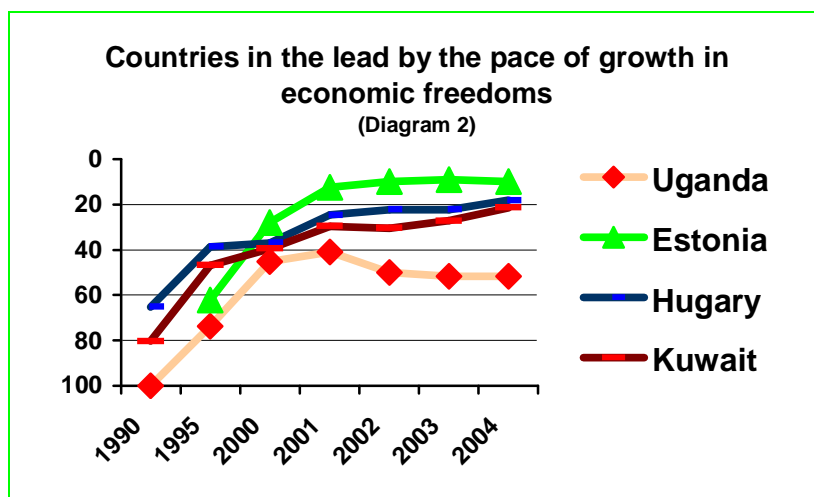
The first thing that we can notice with a naked eye is that the list of the first 10 leaders does not include the 10 countries that are in the lead for proven oil reserves (See Table 1). As a rule, the level of economic freedoms in these states is very low.

**Proven oil reserves in 2004**  
(Table 1)

No	Countries	Billions of barrels
1	Saudi Arabia	262.7
2	Iran	132.5
3	Kuwait	99.0
4	Iraq	115.0
5	UAE	97.8
6	Venezuela	77.2
7	Russian Federation	72.3
8	Kazakhstan	39.6
9	Libya	39.1
10	Nigeria	35.3

There is an interesting tendency: various nations are capable of equally perceiving economic freedoms regardless of their faith, race and other differences. Below are given tables of growth in economic freedoms in the leading countries. Having taken the path of expanding economic freedoms, the governments of these countries easily implemented this policy.

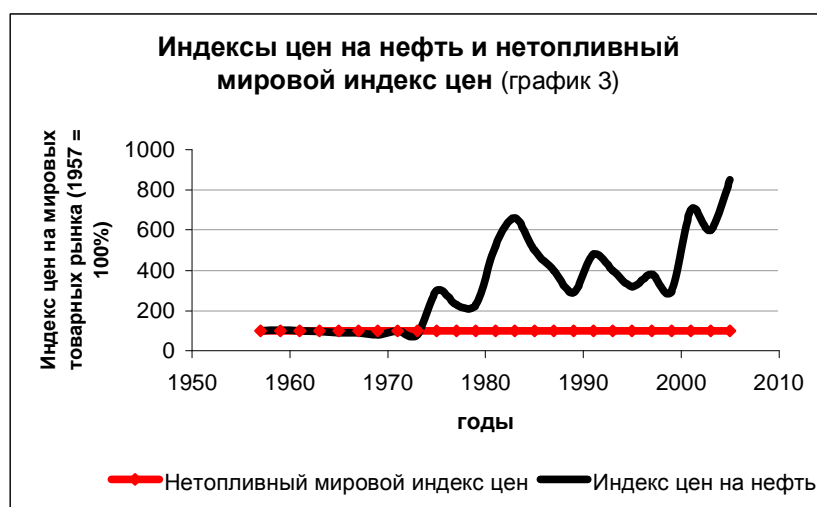
As can be seen from Picture 2, representatives of the African continent, Eastern Europe and the Middle East are in the lead by the pace of growth in economic freedoms. These are countries that are populated by various peoples of different religions.



Picture 2

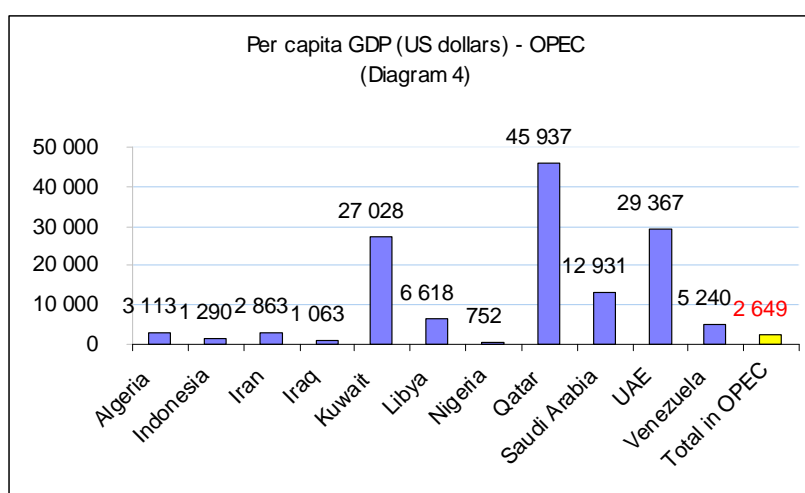
## What are the advantages of the countries that have a high level of economic freedoms?

Let's compare the 10 countries that are in the lead by economic freedoms and **import** oil with the countries that are the main oil **producers** in the world and are members of OPEC. Today OPEC supplies almost half of oil to the world market. These countries have a direct influence on world oil prices and an indirect influence on world prices for various natural resources. If we examine the dynamics of oil prices in comparison with the dynamics of prices for non-fuel goods (See Picture 3), oil prices have increased almost eightfold compared to 1957. This global trend began almost 30 years ago and predictions indicate that oil prices will keep going up. In essence, OPEC member countries have always had the opportunity to be very rich countries.



Picture 3

Unlike OPEC states, Ireland, Iceland and New Zealand have had no chance to make money on oil. These states chose an alternative path of development. Having made a significant breakthrough in the sphere of expanding economic freedoms in the last 30 years, they became one of the richest countries in the world. Per capita GDP in 2004 was as follows: More than 35,000 US dollars in Ireland, more than 30,000 US dollars in Iceland and more than 20,000 dollars in New Zealand. In OPEC member countries, the situation is not so simple. There is a significant divide between the poor and rich countries (See Picture 4). The biggest paradox is that average per capita GDP in OPEC countries is three times lower than the similar world indicator (8,142 US dollars). The divide between Ireland and OPEC is more than 13 times.



Picture 4

Our correlative analysis of the influence of oil prices and the state of affairs in the sphere of economic freedoms over the last 30 years showed that “the game of prices” for oil has no influence on the growth of economic freedoms in the world. Having taken the path of expanding economic freedoms in a consistent way, states are improving their indicators step by step, increasing their national health. It is interesting that there is a direct link between increasing oil extraction in the world and the growth in economic freedom. Our calculation showed that the coefficient of correlation between the volume of oil extraction and the world economic freedom index totaled +0.62. Both variables are playing the role of “bicycle pedals”. The growth in oil production stimulates the growth in economic freedoms in the world.

Let's summarize some results. The main argument that is put forward when it comes to political reforms – the people's mentality – does not play any role when it comes to expanding economic freedoms. The process of "learning" economic freedoms is very high in nations, and as we said above, different cultures, races and religions do not create problems for the development of economic freedoms.

It is not very consolatory for us that oil-producing countries usually have a very low level of economic freedoms. Unfortunately, people are not bathing in luxury in these countries. Perhaps, this is the price they have to pay for the world's interest only in stable oil supplies to the world market.

The fact that the growing level of oil extraction influences the growth in economic freedoms in the world gives us a sense of confidence that by supplying oil to world consumers, we help the peoples of the world to increase their economic freedoms.

(The following sources of information were used in the article: [www.freetheworld.org](http://www.freetheworld.org), [www.opec.org](http://www.opec.org), <http://www.bp.com/statisticalreview>, [www.iea.ru](http://www.iea.ru))



# Azerbaijan: Importance of economic freedom<sup>1</sup>

*Sabit Bagirov,  
Entrepreneurship Development Foundation*

Dear ladies and gentlemen!

The following issues will be discussed in today's presentation:

- Why is it important to increase economic freedom in Azerbaijan?
- The assessment of economic freedom in Azerbaijan by the Heritage Foundation<sup>2</sup>;
- What reforms does the increase in economic freedom require?

My colleague Elkhan who took the floor before me spoke about the example of a number of countries in his report, which clearly showed the importance of economic freedom. These examples proved that countries which secure economic freedom achieve better economic results. In countries where rights of ownership are properly protected and private business initiatives are better supported and protected, whether it is an oil-producing country or another, those initiatives bear fruit, the country makes progress and people's welfare improves.

The factor of economic freedom is of great importance to Azerbaijan. In my opinion, compared to a number of other oil-producing countries, it is even more important to secure economic freedoms in Azerbaijan. Why? The reason is that high-profile changes are expected in Azerbaijan's macroeconomic indicators in the next decade. Table 1 reflects expectations and challenges for two periods.

The expectations shown in this table are related to a drastic change in extraction from the Azeri-Chirag-Guneshli oil field in a short period of time.

As you can see from the histogram on Picture 1, oil extraction will treble in 2006-2010. In the following seven or eight years, extraction will drop significantly. Thus, great

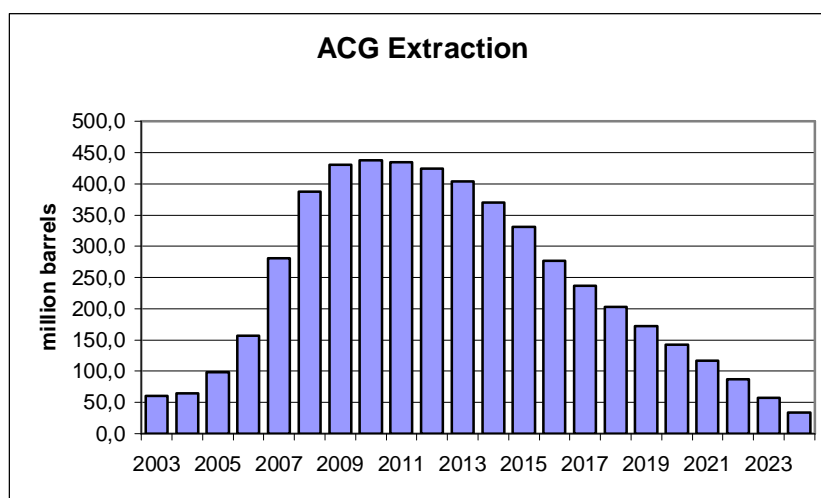
<sup>1</sup> This report was presented at the 11 June 2007 round table of the Entrepreneurship Development Foundation

<sup>2</sup> [www.fraserinstitute.ca](http://www.fraserinstitute.ca)

Table 1

Tendencies and risks, 2005-2010	Tendencies and risks, 2010-2020
<ol style="list-style-type: none"> <li>1. Rapid growth in oil extraction</li> <li>2. Rapid growth in GDP</li> <li>3. Rapid growth in budget revenues</li> <li>4. Rapid growth in budget spending</li> <li>5. Sharp fall in foreign investment</li> <li>6. Fall in the number of those engaged in the oil business</li> <li>7. The strengthening of the manat</li> <li>8. Fall in the competitiveness of the real sector</li> <li>9. Slackening of reforms</li> <li>10. Growth in state investments</li> <li>11. Growth in social spending</li> <li>12. Growth in inflation</li> </ol>	<ol style="list-style-type: none"> <li>1. Fall in oil extraction</li> <li>2. Fall in GDP</li> <li>3. Fall in state budget revenues</li> <li>4. Growth in the spending of SOFAR funds</li> <li>5. The shrinking of the role of the oil factor in the economy (owing to the fall in oil extraction) and as a result, an increase in the weight of the non-oil sector</li> </ol>

changes will happen in oil extraction in a short period of time and the high amplitude of these changes in a short period of time will create conditions for the expectations shown in Table 1 to come true to this or that extent. The difference between Azerbaijan and most of other oil-producing countries is that the period of great changes is very short.



Picture 1

Of course, it will depend on the government's policy in the next decade whether the expectations shown in Table 1 come true in full or partly. The fall in GDP and state budget revenues in 2010-2020 and the growth in the spending of SOFAR funds requires the development of the non-oil sector in a short period of time.

In order to create an economy that would serve as an alternative to the oil economy, it is necessary to expand private initiatives. A person who takes a business initiative must be sure that he will be able to rely on the supremacy of the law and state support. He must

believe that government agencies and individual officials will not allow any discrimination and that the business environment will be based on principles of fair competition. If this happens, we can expect that the number of those who will want to start their own business will increase.

By the end of the current decade, Azerbaijan is likely to face two paradoxes:

- Currency reserves of about 40 billion dollars and a great number of citizens displeased with their financial situation;
- The export of a great amount of energy and a shortage of energy in many parts of the country.

It could be possible to reduce the risks and consequences of both problems by means of promoting people's private initiatives.

Elkhan said in his report that there are two methods of assessing economic freedom today. These are the methods of the Fraser Institute and Heritage Foundation. The attitude to these methods in our country is not clear. Of course, some people may not like the indices of economic freedom calculated on the basis of these methods, however, we have to bear in mind that there is a respectful attitude to these methods in the world. Behind every method, there are prominent scientists. International financial institutions and organizations, investors and experts have an attentive approach to indicators of economic freedom in various countries on the basis of these methods, take account of these indicators in their work, research and policies and make relevant decisions.

Since my colleague spoke about the methodology of the Fraser Institute, I will focus on the second method and the index of economic freedom calculated on its basis.

The Heritage Foundation first started calculating the index of economic freedom in 1995, and the method of calculation it uses is arranged in a way that makes it possible to apply it even in the most different countries, for example, Hong Kong and North Korea.

According to the current method of the Heritage Foundation, the index of economic freedom (IEF) is the average indicator of 10 individual freedoms<sup>3</sup>. Each of these 10 individual freedoms (10IF) is an indicator that shows the liberal nature and openness of the

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<sup>3</sup> William W. Beach and Tim Kane  
[http://www.heritage.org/research/features/index/chapters/htm/index2007\\_chap3.cfm](http://www.heritage.org/research/features/index/chapters/htm/index2007_chap3.cfm)

economy of this or that country in certain directions. We should point out that the 10IF indicators are indicators suggested in the Heritage Foundation method in 2007. In previous years, there were 10 factors that were slightly different from the 10IF. The connection between them is shown in Table 2 below.

Table 2

10 Factors (Old Methodology)		10 Freedoms(New Methodology)
Regulation	1	Business Freedom
Trade Policy	2	Trade Freedom
Fiscal Burden	3	Fiscal Freedom
Government Intervention	4	Freedom from Government
Monetary Policy	5	Monetary Freedom
Wages and Prices	6	Labor Freedom
Foreign Investment	7	Investment Freedom
Banking and Finance	8	Financial Freedom
Property Rights	9	Property Rights
Informal Market	10	Freedom from Corruption

As we can see, the names of factors in the new methods are slightly different. However, this is not the only change as there are changes in the method of calculation as well.

Let's look at the essence of the 10 individual freedoms.

**“Business freedom”** is observance of the principle of brevity and simplicity in the process of setting up, operating and closing an enterprise. Difficult and excessive regulatory rules are the biggest obstacle to business freedom.

**“Trade freedom”** is indicator that assesses the lack of tariff and non-tariff obstacles in the export and import of goods and services.

**“Fiscal freedom”** is an indicator that assesses the tax burden on revenues. In the process of calculating this indicator, both the maximum taxes imposed on private individuals and corporations and the share of taxes in the gross domestic product are taken into account.

**“Freedom from the government”** is an indicator that takes account of all state expenses, transfers and the weight of state-owned enterprises. Ideally, the state must ensure only public welfare and observe the principle of minimum expenses at this moment.

**“Monetary freedom”** is an indicator that takes account of the stability of prices and the extent to which prices are regulated by the state. Both inflation and the regulation of prices by the state violate market economy principles. Stable prices without microeconomic intervention are a perfect condition for the market economy.

**“Labor freedom”** is an indicator that assesses the possibilities of businesses and workers establishing relations with each other without the state imposing any restrictions.

**“Freedom of investment”** is an indicator that assesses the freedom of the inflow of capital, especially foreign capital.

**“Financial freedom”** is an indicator that assesses the confidentiality of bank operations and their independence from the state. In a market economy, there is no room for ineffective state-owned banks and other financial structures like insurance and capital markets.

**“The right of ownership”** is an indicator which shows that the law and the state clearly guarantee the right to collect property.

**“Freedom from corruption”** is an indicator that is used to assess corruption in a business environment. This indicator is based on the assessment of the international organization Transparency International.

It does not seem expedient to examine the method of calculating these 10 individual freedoms here at this seminar, because on the one hand, it might take a lot of time, and on the other, the goal of our seminar today is to examine the importance of economic freedom and existing approaches to measuring it. The calculations of the listed indicators are not difficult and you can familiarize yourselves with this method on the website of the Heritage Foundation.

Along with this, I should point out that each of the 10 individual freedoms is assessed on a scale from zero to 100 per cent. At this moment, 100 per cent shows the maximum level of a relevant “freedom”. In previous years, the index was assessed on a scale from one to five. At this moment, one showed the highest degree of economic freedom.

Thus, working in a country where economic freedom is guaranteed means the following:

- You can set up a private company or another subject of entrepreneurship very easily and in a very short time;
- Tariffs on your trade with foreign companies are not so heavy;
- The taxes which you pay from your income are not so high;
- Your business does not encounter unfair rivalry from state-owned enterprises and the state cannot interfere in your business for no reason;
- You do not run your business in conditions of high inflation and regulation of prices by the state;
- You do not suffer from heavy state regulatory rules when your staff are employed and dismissed;
- Investments and investment flows related to your business are free;
- Your bank secret is protected;
- Your rights of ownership are totally protected by the state;
- You do not suffer from corruption in the authorities.

In this situation, business initiatives awaken in thousands of people.

According to the assessment of the Heritage Foundation, the assessments of the IEF in Azerbaijan in the last three years<sup>4</sup> are shown in the following table.

**Table 3**

	<b>2005</b>	<b>2006</b>	<b>2007</b>
Business Freedom	30	57.2	58.0
Trade Freedom	64.2	67.6	67.6
Fiscal Freedom	86.1	86.7	87.2
Freedom from Government	85.8	79.2	86.6
Monetary Freedom	80.4	75.5	76.8
Investment Freedom	30.0	30.0	30.0
Financial Freedom	30.0	30.0	30.0
Property Rights	30.0	30.0	30.0
Freedom from Corruption	18.0	19.0	22.0
Labor Freedom	70.5	64.4	65.4
<b>Index of Economic Freedom: Azerbaijan</b>	<b>52.5</b>	<b>54.0</b>	<b>55.4</b>

<sup>4</sup> Tim Kane, Kim R. Holmes, and Mary Anastasia O'Grady, 2007 Index of Economic Freedom (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007), at: [www.heritage.org/index](http://www.heritage.org/index).

## World Rankings

Before moving on to discuss the figures given in the table, I would like to point out that information used in these calculations (statistical and other) is based on information regarding the previous two years. For example, the figures for 2007 are based on information regarding 2004-2006.

As can be seen from the table, “business freedom” has increased in our country in the last two years. What is the reason for this? It is quite likely that this is due to amendments regarding the state registration of companies which were made to the law “On the state registration of legal entities” in mid-2005. According to those amendments, subjects of entrepreneurship should be registered within five days. The previous legal norms made it possible to delay this process for 110 days. In our opinion, the Heritage Foundation’s IEF regarding Azerbaijan might get slightly better in 2008, because according to the presidential decree, a “one-window” principle should be applied in the system of state registration. I should also point out that the issue of licenses also affects the “business freedom” indicator, and some regress that has been observed in this sphere in the last few years might reduce “business freedom”.

“Business freedom” in neighboring countries is as follows: Russia – 66.6 per cent; Turkey – 67.4 per cent; Iran – 54.9 per cent; Georgia – 78.9 per cent; Armenia – 84.5 per cent; Kazakhstan – 66.5 per cent; Turkmenistan – 30 per cent.

In some oil-producing countries, “business freedom” is as follows: Saudi Arabia – 52.9 per cent; Kuwait – 67.9 per cent; Bahrain – 80 per cent; Oman – 63.6 per cent; Qatar – 60 per cent; UAE – 49.2 per cent; Algeria – 73.7 per cent and Venezuela – 48.8 per cent.

Norway is a country that has the highest level of “business freedom”. “Business freedom” here is 97 per cent, which means that business is almost totally free in Norway.

Although “**trade freedom**” has undergone little change over the last three years, it is higher than the average. Along with that, there are still non-tariff obstacles. We can expect that Azerbaijan’s entry into the WTO in the future will significantly increase “trade freedom” in our country.

“Trade freedom” in neighboring countries is as follows: Russia – 62.6 per cent; Turkey – 76 per cent; Iran – 50.4 per cent; Georgia – 61.8 per cent; Armenia – 75.6 per cent; Kazakhstan – 64.2 per cent and Turkmenistan – 74.2 per cent.

In some oil-producing countries, “trade freedom” is as follows: Saudi Arabia – 65.4 per cent; Kuwait – 72.2 per cent; Bahrain – 69.6 per cent; Oman – 73.8 per cent; Qatar – 71.4 per cent; UAE – 70 per cent; Algeria – 56 per cent; Venezuela – 56.2 per cent.

Hong Kong and Singapore have the highest level of “trade freedom”. In both countries, “trade freedom” is 80 per cent.

As we can see from Table 2, **“fiscal freedom”** is at a high level in Azerbaijan. This also means that tax conditions in Azerbaijan are more favorable than in a number of other countries.

**“Freedom from the government”** is at a high level in Azerbaijan. What is the reason for this? “Freedom from government” takes account of two components:

The correlation of state spending to GDP, per cent;

The share of state enterprises in state revenues, per cent;

Another specific feature while calculating “freedom from the government” is that the weight of the first component is two thirds and the second one third.

As we know, Azerbaijan’s GDP is growing at a high pace and the amount of state spending in GDP is falling. This ensures a high level of “freedom from the government”. As for the second component, we can point out that the share of state enterprises in state revenues is shrinking because of the oil factor. However, the two thirds and one third factors that I mentioned double the influence of the first component.

We can expect that our indicator of “freedom from the government” will worsen as the influence of the oil factor decreases after 2010.

In neighboring Georgia, “freedom from the government” is 91.3 per cent and in Armenia – 91.6 per cent.

**“Monetary freedom”** is no so bad in Azerbaijan. This is explained by the fact that the indicator has been calculated on the basis of the 8.3-per-cent level of inflation in 2003-2005. The sharp increase in inflation in 2007 gives us grounds to expect that the “monetary freedom” indicator will worsen in the next report.



As we can see from Table 2, “freedom of investment” is at a low level in our country. This sounds strange because for the amount of foreign investment, our country is one of the leading countries in the post-Soviet area. What is this assessment based on? There are two types of business environment in Azerbaijan. One is the environment in the sphere of oil and gas, and the other is the environment in the non-oil sector. The environment in the oil sphere is more favorable and risk-free for investments. As we know, oil contracts are endorsed by the parliament and even become a law. The situation in the non-oil sector is very different. The indicator “freedom of investments” is calculated on the basis of the methodology of the Heritage Foundation regardless of the investment conditions. These conditions are as follows in Azerbaijan: there is still no new law on foreign investments, investors suffer from officials’ arbitrariness and corruption, there is too much control over international financial transactions, the attitude to local and foreign investors is not the same and so on.

In neighboring Georgia and Armenia, this indicator is 60 per cent.

**“Financial freedom”** in our country is at a low level according to the Heritage Foundation’s estimation. The reason is that the banking system is still weak, two state-owned banks control 60 per cent of transactions in this sector, the activities of foreign banks are being restricted, financial stock-exchanges are weak, the activities of insurance companies are regulated by the state to a great extent, etc.

This indicator is 70 per cent in neighboring Georgia and Armenia and 60 per cent in Kazakhstan.

**“The right of ownership”** indicator is also at a low level. The reason is that there are gaps and shortcomings in the law, the current rules are too heavy, corruption is high in this sphere, those who are close to the political government have business advantages, courts depend on the executive authorities and so on.

**“Freedom from corruption”** is an indicator that is at the lowest level. If we note that the ratings of the organization Transparency International were taken into account while calculating this indicator, everything will become clear to us. On the basis of information coming into our foundation, corruption in the business sphere has increased in the last few years.

Though “**freedom of labor**” is higher than 50 per cent, there are too many problems here.

“Freedom of labor” in Georgia is 99.9 per cent. In Armenia, it is 80.9 per cent. Kazakhstan is also well ahead of us – 80.5 per cent.

What should be done to increase economic freedom? In my opinion, discussing Azerbaijan’s indicators, we answered this question in some way.

In order to assess the environment in the country, specialists of the Heritage Foundation suggested the following classification<sup>5</sup>:

According to this classification, the environment in our country is approaching the “average free” level.

Thank you for your attention.

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<sup>5</sup> <http://www.heritage.org/research/features/index/downloads/Index2007.pdf>

# WEALTH THROUGH OWNERSHIP: CREATING PROPERTY RIGHTS IN CHILEAN MINING<sup>1</sup>

*José Piñera*

*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 paralysing 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

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.

<sup>1</sup> *Cato Journal*, Vol. 24, No. 3 (Fall 2004). Copyright © Cato Institute. All rights reserved.

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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.<sup>2</sup> 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:

- 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

<sup>2</sup> An 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.

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 13<sup>th</sup> 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 CATO JOURNAL the art of “making possible what is necessary” for a nation to progress and to advance liberty.

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