

**Property Rights, Institutions, and Economic Deregulation:
The Case of Chile, 1964-1998.**

(This paper was financed through a University of Chicago Committee for Latin American Studies 2001 Field Research Grant. It was presented as a public lecture at the Harris School of Public Policy at the University of Chicago, in May 2002)

1. Introduction: A house divided

There is little argument among the members of the economic profession that in order to function efficiently, market economies need proper allocation of property rights and the corresponding economic institutions to guarantee their protection and enforcement. It is universally argued that the unambiguous distribution of initial entitlements is the ultimate necessity for an optimal market process and a prerequisite for the viable political organization of societies. However, as far as the process of property rights allocation is concerned, opinions are usually grouped along distinct ideological lines. The legislative, or the pure Coasean view, holds that as long as an effective legal system is put in place early enough by the government, market economy should grow unrestrictedly and the respect for law should generate equal respect for the rules of the market game. The market view, on the other hand, argues that the development of the legal-regulatory system and of the economic

institutions is a gradual, incremental and evolutionary process and the proper allocation of property rights is a result from progress in both the legislative and economic philosophy. The proponents of this view point to the old Hobbesian conundrum – how to police everyone, when the majority stops respecting the law? – and use it to suggest that only a long tradition of market interchange and an infinitely repeated market game can sustain the respect for the institution of property rights.

Consequently, any research in this direction is forced to side with one of the competing arguments and look for the appropriate evidence that would prove the opposing view wrong. The important role of the US constitution, and especially of the sturdy legislative protection for the concept of private ownership, for the successful development of the American market institutions during the 19th century is often cited in support of the first view, whereas the slow economic development in the East European states which largely lacked a developed market economy prior to 1989 is used to support the second one. Of course, as in any respectable academic endeavor, every single case needs to be examined *sine ira et studio*, but it should be clear from the beginning that the conclusion will finally fall into one of these two categories, since this is one of the rare cases when a middle solution is not possible.

2. The Chilean case

The general picture of the Chilean economic and political development since the fall of Gen. Pinochet largely supports the market view of the allocation of property rights. Unlike Eastern Europe, during its transition from dictatorship to democracy Chile was facilitated by the existence of working market institutions, by an already established system of transactions and economic practices and by an undisputed arrangement of enforceable obligations. Whereas in Eastern Europe the biggest problem proved to be the fact that the state of its capital stock by far exceeded the development of the institutional environment, Chile did not have this kind of problem. The Chilean state was not faced with the necessity to create a system of property rights, along with the proper economic institutions, sufficient to support viable entitlements to the kinds of assets being transferred, while many countries in the former Soviet block produced chaotic results in their attempts to do so overnight. As a result, in many countries in Eastern Europe nostalgia for the “old times”, when there was order and clarity as to who held what position in society, is growing nowadays at the expense of respect for the principles of market economy. People constantly complain about the loss of moral values and about the rule of the wild forces, and enthusiasm for market reforms is believed to be at an all-time low, chiefly because societies proved to be unable to accomplish the transition as fast as it was expected. On the contrary, Chile by far doesn't have this kind of doubts whether it is on the right path. The Chilean economy is considered by many macroeconomic experts to be the star of Latin America and the country has had a steady economic growth for the last two decades, with the transition from one political

system to another proving to pose no major questions and create no major difficulties. Many peculiarities of the Chilean model can be evoked to explain this success, like the fact that Chile is a Catholic state, for instance - a reminiscence of the Hobbseian argument that a set of moral norms necessarily keeps people within the framework of a type of behavior conducive to the interest of society even in the absence of explicit threat of sanctions. The fact remains however that at the time the military regime collapsed and was replaced by a parliamentary democracy, the debate on the economic future of Chile was largely kept within the institutions already established, and among these the institution of property rights and generally free markets. As a result, the viable market economy managed to produce a working political democracy, in comparison with the slowness of the same process in Eastern Europe, where democracy lacked such a powerful ally. This research will therefore argue that, as the Chilean experience shows, economic development and the transition to democracy are much more successful, where property rights are assigned in the process of market evolution, than in these cases, when governments are forced to provide legislative basis for property entitlements in a rush.

3. "I believe in facts, not truths." The evidence.

1. Public spendings.

Speaking about property rights and institutional reform, we should bear in mind that the state also has property rights, which should be exercised through appropriate institutions. Now, a chronic problem of Chilean economic policy had been the large and persistent budget deficits. The basic problem was, of course, the complete mess in the administration of public spending and the lack of an appropriate institutional arrangement that would guarantee control and monitoring of fiscal discipline. Indeed, there were no clear responsibilities in terms of spending and in practice no one knew exactly what was going on with public finances. As a result, in 1971-73 on average the budget deficit of the non-financial public sector was 23.4% of GDP, and it peaked in 1973 at 30% of GDP.

In 1975 the new organic law of the “financial administration of the state” was approved. According to this, only the executive branch is responsible for proposing the budget for the year (both estimates of revenues and spending) and Congress cannot increase spending. It only can approve the proposal of the Executive or, if it considers that public spending is too high, propose a reduction in it. All public debt issue must be approved by the Budget Office and has to be in line with the approved budget. There is some flexibility in the allocation of resources within the different areas of the state, but there is an absolute ceiling for public spending given by the budget. This new institutional framework established clear responsibilities in the administration of the budget and allowed the government to control spending.

2. Privatization and large private ownership.

The first (1974-83) round of privatization in Chile was aimed at returning the assets that had been expropriated to the previous owners. In particular, the law from 1928, according to which the government could nationalize any large private ownership, if a sufficient number of the workers expressed dissatisfaction with the management, was abolished. All big enterprises, which the Allende administration had confiscated on the basis of that law were returned to their former owners. This included mostly big farms, industries and banks. In this first phase state owned enterprises were reduced from 596 in 1974 to 48 in 1983. However, as the enterprises that remained in the state were bigger than those privatized, total value added was reduced only from 39% of GDP to 24% of GDP.

This is the most important phase of the Chilean privatization with respect to restoring property rights. The second and the third phases (1985-1990; 1990-presently) saw a privatization of public utilities plus privatization of infrastructure (through concessions) and water companies. By 1998 the share of public enterprises in GDP had fallen to 9%. Currently the most important state owned enterprises are CODELCO, a copper company, a state owned bank and the oil company. But the most important achievement of the Chilean privatization seems to be the legislative arrangement, accompanying it. Thanks to the clear administrative basis, all private businesses and owner in Chile nowadays have the full insurance, that no excess like the mass nationalization of 1970-1973 can be repeated.

3. Tax reform and tax collection

One of the most important economic institutions, guaranteeing the state property right on public spending, is the institution of taxation. Before 1973, tax rates were huge, and tax collection was poor. In combination with enormous public sector spending, this contributed to the monstrous levels of budget deficit, mentioned above. Recognizing the problem, and equipped with a “low-taxes-high collection” philosophy, Pinochet’s economic team executed two major tax reforms. In 1975 the value-added tax was introduced at a flat rate (currently 18%) and with very few exceptions (most importantly education and public transportation). Currently about 50% of tax revenues come from the value-added tax.

The second major tax reform came in 1984, reducing drastically the corporate income tax (currently at a flat rate of 16%) and integrating this tax with the personal income tax.

This means taxes paid at the corporate level are credit for personal income taxes.

With increased discipline of tax-collection, the low tax rates had important implications during the next two decades. It has been estimated that the reduction in the tax rate on retained profits contributed to the Chilean investment and growth boom. Also, the tax structure has had a positive and significant effect on saving. Finally, tax evasion in Chile, estimated at around 22% of potential tax revenues, is the lowest in Latin America and not very different from many developed countries.

4. Investment – foreign and domestic.

This macroeconomic tool is often used as an argument against Chile's economic reforms after 1975. To make a long story short, with the unclear system of property rights in Chile in the 1960s and early 1970s, with the high level of government regulation in the banking sector and with the general uncertainty at the market for investments, Chile's was a stagnant economy, not very different from most Latin American ones. Foreign, as well as domestic investors, were faced with an economic environment, in which private property was not protected and, as a consequence, every potentially successful investment was jeopardized from the beginning. In the mid 1970s the group of mostly Chicago-educated young people, who were in charge of the economy, implemented radical (by those days) free market economic reforms, and especially in the field of investments. Those people realized, that in the modern world it is essential to attract foreign capital through creating an environment, in which investors would feel safe. Therefore, the banking sector was completely privatized. The regulations, concerning the operation of the domestic and foreign banks, were eased to a minimum. (To show how ubiquitous the process of liberalization in that sector was, I will mention that in the beginning of the 1980s Chile even ended up with the first totally private Social Security System). As a result, in the following years the foreign capital perceived Chile as a very favorable place to invest, and the level of foreign investment rose by double

digits per year. Subsequently, the economy grew 6.8% on average during 1976-1981. And it's important to notice that this was achieved in the middle of an economic crisis, which was a consequence of both the collapse of the previous economic system and a world economic slowdown (with a significant impact on Chile's terms of trade) as a consequence of the oil shocks.

Then, however, Chile suffered the worst recession since the great depression. GDP fell 16% in 1982-83 and unemployment climbed to 30% of the labor force. Two causes have been mentioned to explain this recession. First, the world economic recession of the early 1980s. The huge increase in international interest rates, induced by the very tight monetary policy in the United States, had a devastating effect over Chile and the rest of Latin America. Second, and more interesting for our discussion, there was not enough good banking supervision. The crisis hit banks, which went under. The banking crisis made things much worse. Not having a precise policy recipe to implement, the authorities watched passively a massive real exchange rate appreciation and huge current account deficits (in 1981 the current account deficit reached 14.5% of GDP) without taking any measure to correct them.

So, is investment liberalization a good or a bad thing? As explained later by Prof. Harberger, the unofficial "father" of the "Chicago boys", excessive optimism can be dangerous in the market of investments. Foreign investors, lured by the attractive conditions, overestimated the short-run growth potential of the Chilean economy and rushed to invest in it. This made the economy too dependent on investment, while the deregulation

of the banking sector made its operation prone to misuse. As a result, banks suffered from mismanagement and excessive investment in general. When the world crisis of 1981-1982 hit, foreign investors withdrew from the Chilean market, the bank sector collapsed and the economy contracted. The lesson for Eastern Europe – responsible liberalization of the banking sector, good conditions for foreign investment, but state regulation of the rules of the game.

5. Tariffs and trade

The last state economic institution, guaranteeing efficient trade, is the institution of tariffs. Before Pinochet's ascent to power, import tariffs were on average 105% with a high variance – some products had 0% while others 1000%. It isn't hard to imagine what devastating effect this had on trade and imports, with many basic goods practically extinct in the Chilean market in 1972-1973. In 1974 Chile initiated a revolutionary unilateral strategy of trade liberalization. The strategy consisted of reducing tariffs independently of what other countries did, so as to converge on a low and flat rate. By 1979 that rate was 10%. After the crisis of the 1980s there was some attempt at protectionism and tariffs increased marginally. However, starting in the mid-1980s the process of tariff reduction was resumed. Currently the average tariff is 5%.

The effect of trade liberalization has been a significant increase in exports, which went from US\$1 billion in 1970 to close to US\$18 billion currently, despite the fact that the prices of main export products (especially copper) have declined in real terms. The other major effect has been a diversification of exports. The share of copper in total exports declined from 76% in 1970 to 38% in 2001, while non-traditional exports have increased their share in total exports from 10% to 38%. With countries with which Chile has signed free trade agreements, tariffs are zero for many products. As a result, Chile practically has no problem with tariff-collection, and the income from tariffs has actually increased in real terms.

Fortunately, this lesson has been learned by some countries in Eastern and Central Europe – for example, Estonia presently has zero tariffs for most imported goods.

6. Central Bank independence

A recognized element of the system of economic institutions in a modern country is an independent central bank, with clearly defined responsibilities and property rights. In 1989 a new law giving independence to the Central Bank was adopted. According to this new act the board of the Central Bank consists of five members nominated by the president and approved by the senate. Each one has a 10-year term. Every two years there is a change in one of the board members. They are independent from the government (cannot be removed

from their position). The Ministry of Finance has the right to participate in the board meetings but does not have any voting power.

The record in terms of inflation of the Central Bank is impressive. After the big inflations of the early 1970s, inflation in Chile had been in the 20%-30% range. The new autonomous central bank decided to implement inflation targets starting in 1991. The purpose was to have a persistent and gradual decline in the inflation rate. In general targets have been met in every year since 1991, with minor exceptions, such as 2000 when inflation at 4.5% was somewhat above the 3.5% target. The reason for this difference was the increase in the price of oil.

Since 2000 the target became a permanent one (rather than a year to year one as it was previously), and corresponds to a range between 2% and 4%. Whether it will be met on a permanent basis, remains to be seen, but it is important that all countries in economic transition recognize the positive effect, which an independent central bank can produce on the economy.

7. Contract enforcement.

It is generally expected that in the process of allocation of property rights the demand for legal services is expected to rise. The theory says that if it doesn't, there could be two explanations: either that a market economy does not need a complex set of judicially

enforced rules on property rights and that a simple contractory mechanism will do, or that, in the best sense of the Coasean argument, parties are trying to reach mutually beneficial agreements outside the courtroom.

The case of Chile shows that a modern market economy needs strict legislative protection, as it is too complicated a system to rely on out-of-the-court agreements and compensations. Especially in the early phases of the Chilean economic reform, the demand for legal services increased dramatically, as new owners rushed to legalize their property and seek notary services, and as the economic boom led to a clash of interests, which had to be solved in court. It is understandable that when the state was busy providing the institutional arrangement for the economy, courts were busy to smooth edges on the borders of these arrangements. In other words, in a developed economy, in which high consulting and judiciary costs accompany the economic process, agents may be willing to minimize those costs through bypassing the courtroom. Thus we get the close-to-perfect Coasean scenario. In a developing economy, however, as the Chilean one was in the mid-1970s, the benefits from contract enforcement, achieved through a court decision, were far bigger than the cost that had to be paid in the process. Subsequently, as ample evidence shows, with the increase in the number of contracts, the number of cases, in which the exact consequences of those contracts were disputed, also rose. This proves the importance of a strict legislative arrangement in the transition economies that would guarantee independent and efficient contract enforcement in case a dispute arises or a contract is breached.

8. Shareholder rights to corporate property.

This is the most interesting case of property right protection in the modern economy. Unlike the right to a house or to a piece of land, shareholders' rights are absolutely intangible. There is no easy way that the shareholders can force the management of the corporation to respect their rights at the expense of the best possible business judgement. Although these relationships rest on legal contracts, the implications of profit division and resource allocation reach far beyond the pieces of paper, which we respectfully call "laws". Shareholders usually rely on the fact that corporate ownership is a repeated game and that the majority will keep its commitment to the minority, without any need for individual monitoring or a constant threat of legal sanctions. However, it is extremely important that shareholders feel secure about their investment so that they would invest more than if pure trust in the market process were their only insurance against mismanagement.

What is the situation in Chile? The tender offer/corporate governance law (Ley de OPA) was passed by both houses of Chile's Congress on November 8th, 2000. Among the law's main goals is improvement of the corporate governance practices and to increase the Chilean market's liquidity and depth. In general, the law does the following:

- It allows for equal treatment of minority shareholders; ADR holders have the same rights as ordinary shareholders. Share holders of 5% of the company can call for an

extraordinary shareholder's meeting in the case of affiliated party transactions or an infraction of the law or company bylaws.

- It regulates corporate control and tender offers: A tender offer must be made for the remaining shares of a company if the controlling shareholder reaches a 2/3 or more stake in the company. A pro rata tender offer must be made whenever there is a change in corporate control. The owner of 10% or more of a company must inform the market of its intentions to sell or divest the stake at least ten days before the transaction takes place.

- It provides legal protection of shareholders' rights: Any director or shareholder representing at least 5% of the company may file a class action lawsuit on behalf of the company.

- It allows for stock buybacks: Share buybacks are permitted (up to 5% of the maximum outstanding shares) with 2/3-shareholder approval.

- It gives the Superintendence of Banks the right to reject a bank merger based on concentration of market share. Such a rejection must be approved by the Central Bank.

As can be seen, the rights of the minority shareholders are strictly protected in this 2000 law, and the limits of shareholders responsibilities and rights are clearly stated. It is a small wonder then that Chile presently ranks first in Merrill Lynch 's country rankings of shareholders' rights.

9. Creditors' rights and the institution of collateral.

The provision of an institutional network is especially important when the question comes to protecting creditors' rights. In many countries in transition, bankruptcies do not occur very often mostly because they are considered an expensive and politically dangerous way to solve market problems. No modern economy can function, however, if the rights of the creditors in cases of financial insolvency are not guaranteed by law, and the state is usually expected to intervene on the side of the creditors.

Advocates of creditor rights oriented institutional arrangements claim that if the right to repossess collateral in case of debtor default is not strictly protected, the use of collateral will lose its important role in solving the information asymmetries that can lead to credit rationing and underinvestment. The use of collateral in debt contracts has been deeply analyzed from a theoretical perspective. Collateral helps reduce several types of problems that arise when informational asymmetries between banks and entrepreneurs are present – for example, asymmetries in valuation of projects, uncertainty about the quality of projects and the riskiness of borrowers, and problems related to the cost of monitoring or supervising borrowers' behavior.

A glimpse at the situation with how the rights of creditors are protected in the Latin American countries shows that Chile's law is one of the strictest. In many other countries there is a restriction on the type of assets that can be used as collateral. Those include family

assets, assets with property limitations, non-commercial assets, fixed assets of financial sector firms, etc. None of them is excluded under the Chilean law from being used as collateral. Thus, in Chile in general there is little trouble for firms accessing financial markets, and there are rarely problems, leading to partial or complete credit rationing. Since collateral is easily pledged, lenders feel more confident and charge a lower interest rate than what they would have if the uncertain project itself were the only guarantee. This is an extremely important lesson for transition countries – especially the ones in Eastern Europe – where the capital stock is unequally dispersed and many emerging businesses have to rely on credit to finance their start.

10. Small private property.

The most important implication of an advanced system of formal property rights is the ability of “dead” property to be fairly easily converted into “live” capital and thus provide domestic economies with fuel for growth and further development. The institution of mortgage lending, for instance, allows the house to transcend the mere form of a private shelter and live a parallel life as an important generator of income. For that reason it is very important that housing, along with other immediate private properties (land, etc.) is legal, since this is the only way to receive a mortgage lending from a bank. Furthermore, as we already saw, contractors feel obliged to stick to the clauses of the contract only if they are

bound by the imminent danger of losing property. Thus the proper arrangement of property rights in a legal system creates the ultimate paradigm, within which individual transactions turn into extended market game. Under these circumstances personal incentives to seek profit and legal arrangements mutually sustain each other and boost the economic development, unlike countries, where a large share of the housing is extralegal and private property remains locked in the physical world of immobile objects.

Much was done during the several economic administrations after 1973 to provide a legislative basis, which would legalize all private property and would enable it to be used as capital in private entrepreneurship. The main features of the policies pursued in this direction include creating easy mechanisms for legalization of property (in the legislative package from 1974), simplifying the previously complicated system of giving away licenses and notary acts, in short – an administrative reform that would facilitate the process and reduce the opportunities for corruption in a sector, plagued by bribery in most of the developing world. Evidence, quoted by the Lima-based Institute for Liberty and Democracy shows that presently Chile is the champion in property legalization on a continent, where this process takes on average many months and often years.

Conclusion

The rapid liberalization of the Chilean state during the military rule of Gen. Pinochet, accomplished in several stages by two main economic teams (that of Sergio De Castro and that of Hernan Buchi) contributed to a large extent to Chile's entering the 1990s with a quite coherent system of property rights. The state of the economic institutions and the well-developed goods, bonds and labor markets in the wake of the fall of Pinochet was such as to ensure a smooth and respectable transition to democracy. The ambition of this paper is not as much to maintain that it is a working economy that ensures a stable democracy – although this is probably the main lesson for the East-European countries in transition. It rather to outline the necessary steps that can lead an economy in crisis to stability and prosperity, no matter what the political order is. Those necessary steps for instituting a clear system of property rights and the economic institutions, necessary to defend them are (but are not limited to): strict rules for public spending; easy legalization of private property; protected large private ownership; efficient tax collection; efficient tariffs policy; protection of foreign investments; independent central bank; contract enforcement; protection of shareholders' and creditors' rights. Any economic reform that tries to bypass those simple rules, risks to slow down, alienate the public and create what is called in newly democratic states as "fatigue with democracy".