

**The Political Economy of Productivity:
The case of Venezuela**

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Abstract¹

For nearly four decades Venezuela has been under-performing other developing countries in terms of productivity trends and productivity growth. This study explores the idea that throughout this time period the productivity performance of the Venezuelan economy has been highly influenced by the outcome of a number of individual and collective decisions, which in turn are themselves endogenous to the actions and interactions of socioeconomic actors. In particular, the study establishes a clear connection among the policy making process, the bias of public policies and a process of reallocation resources, which affects overall labor productivity. From the general policy making process perspective, four distinctive sub-periods between 1974 and 2007 are identified. The study remarks that, in the case of Venezuela, the predominance of policies that favor the appreciation of the real exchange rate, business protection through generalized trade barriers, subsidies, tax exemptions, may explain the reallocation of resources from tradable to protected-non-tradable sectors, and consequently the threads to productivity growth.

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Introduction

At the end of the 1970s, Venezuelan economic growth experienced a stunning change in direction. Since the beginning of the century, the country had undergone a sustained economic expansion that took it from being one of the poorest countries in the region to being the second-richest, even before the first oil boom of 1974. At the end of the 1970s, that positive trend was turned around. Venezuelan non-oil per capita GDP declined at an annual rate of 0.9% during the period 1979-2002, for a total cumulative decline of 18.6% (Hausmann and Rodriguez, 2008). The evidence also suggests that Venezuela has been under-performing in terms of productivity trends and productivity growth. This productivity gap could explain why the country has shown very erratic economic growth in the last three decades, as well as why the country's growth performance has lagged behind the continent, despite being exposed to more or less the same external constraints as its peers over the same period.

Though the level of productivity and its growth rate depend on a complex and sometimes unidentified set of variables, there are good reasons to think that productivity is inherent to the actions and interactions of economic and political actors (see Murillo, Scartascini and Tomassi, 2008). Some dominant actors, for instance, use their political power to attain policies that provide them with rents, but have negative effects on productivity. Other political actors, though not dominant, are able to guide policies in a rather fragmented manner, and these policies introduce distortions with negative implications for productivity.

Both the aforementioned productivity performance and the possible link between policy-related factors and overall productivity give rise to a number of questions: Is it possible, for instance, to identify powerful political actors that influence the country's policymaking process, and policies that affect productivity? Is it possible to explain the variations in productivity in Venezuela over time as a result of the policymaking process? What kind of political arrangement determines the set of policies that harm productivity in Venezuela? How do public policies, and particularly fiscal, industrial and commercial policies (e.g. exchange rate policy and foreign competition barriers), affect productivity?

This study strives to respond to these questions, and investigates, for the period 1974-2007, what sort of political processes have led to outcomes in which overall global productivity has been negatively affected. It will thus tackle the following tasks: (i) The study will analyze in great detail the different forms or mechanisms through which relevant socioeconomic actors

(formal and informal) are organized, interact with the policymaking process (PMP hereafter), and affect overall productivity through certain public policies (ii) It will analyze relevant episodes and policy channels that help in understanding why the country is underperforming in terms of productivity.

It is argued that for most of the period, the PMP favors the adoption of pro-cyclical fiscal policies, prolonged real exchange rate appreciations, and local business protection, through generalized trade barriers, subsidies, tax exemptions, etc. That may explain the reallocation of resources from tradable to protected-non-tradable sectors, and the consequent risks to productivity growth. Furthermore, these factors, connected with a reduced and volatile oil rent during the 1980s, reduced the time horizons of the socioeconomic actors participating in the PMP. This helps explain why the political system failed to adjust, and the systematic disintegration of cooperation evoked negative consequences on productivity.

Productivity is the cornerstone of economic growth. Productivity affects the competitive position of a nation, determines a country's ability to compete in world markets, and is a primary source of the high standard of living enjoyed in some advanced economies relative to other developing countries. A number of recent studies that have attempted to explain the growth performance of the Venezuelan economy in terms of productivity or factors that somehow affect productivity dynamics.

For instance, Arreaza (2006) uses a growth accounting exercise introduced by Maloney and Rodriguez-Clare (2005) in order to test the relevance of a number of factors explaining the productivity gap between Venezuela and the U.S. The main purpose of her work is to "gauge whether the productivity gap between both countries is due to general (factor) accumulation problems, or if there are factors that particularly hinder the accumulation of knowledge capital and thus curtail innovation". She finds that the presence of several distortions (e.g. price controls, labor regulation, and distortionary taxation) seems to account for most of the productivity gap, and that factor accumulation problems are secondary. Restucia and Bello (2004) argue that "certain economic policies produce distortions in relative prices that reduce incentives to invest in the most productive sectors in the economy. Hausman (2001) shows evidence suggesting that the collapse in output per capita (1950-1999) can be associated with two main *empirical* facts: (i) Reverse capital deepening" (e.g. a decrease in the capital-labor ratio), and (ii) a reduction in total factor productivity. Both factors can result from the same underlying phenomenon if technology

is “embodied in machines”. Thus, a decrease in capital per worker would lead to a decline in productivity growth. Additionally, in an economy in which the government provides too little of a public good, such as infrastructure and other investment goods, or generates highly volatile policies that obstruct certain investments, productivity may be affected. Hausman and Rodriguez (2006) identify three primary causes of the Venezuelan growth collapse of the recent decades: (i) The sustained decrease in per capita oil rents, (ii) the absence of specialization in alternative exports and (iii) the decline in total factor productivity. Their argument states that countries that “occupy sparser regions of the product space” (that is, countries that attempt to produce export-goods that *are not* similar to those it already produces) can not take advantage of its specialized inputs, technical knowledge and institutional structure. This significantly impairs a country’s capacity to diversify its exports. Hausman and Rigobon (2002) develop a model that interprets the “natural resource curse” as resulting from the interaction between specialization in the non-tradable sector (negligible non-oil tradable sector) and financial market imperfections (high bankruptcy costs). The argument is divided in two parts. The first part presumes that initial full specialization leads to real exchange rate volatility in response to oil income shocks. The second part of the argument states that relative price volatility coupled with financial market imperfections causes the interest rate to increase and thus leads to private disinvestment.

None of these arguments contradict the main hypothesis of our work. We argue that productivity may be affected by variables related or sensitive to public policy bias and public policies may, in turn, be affected by the policymaking process.

Other explanations for the recent Venezuelan growth decline emphasize either the resource curse thesis or the debt overhang story. Rodriguez and Sachs (1999), for instance, set forth the idea that recent Venezuelan economic decline can be understood as the “convergence-from-above” path to a steady state characterized by the exhaustion of oil production. They use a Ramsey growth model with natural resources to show that the “miracle” phase of Venezuelan economic history (1920-1970) corresponds to an over-shooting of the steady state in which unsustainable –though optimal- levels of consumption and investment took place. The following “collapse” phase corresponds to the transition to a steady state characterized by negative growth rates. Central to their conclusion is the assumption that “exports of natural resources cannot expand at the same rate as other industries” because they “rely on exhaustible factors of production”. Manzano and Rigobon (2001) offer another interpretation of the resource curse that

dismisses the notion that the abundance of resources *per se* is to blame for the poor economic performance. They start by questioning the econometric evidence supporting the “natural resource curse”. In particular, they argue that growth regressions, where measures of resource abundance (e.g. primary exports) are statistically significant, suffer from the omitted variable bias and thus its coefficients are not consistently estimated. They support this idea by estimating a fixed effect model where the coefficient of resource abundance turns out to be insignificant. After trying several possible variables, they find a measure for credit constraints (which is positively correlated to natural resource abundance) that is statistically significant in fixed effects regressions. Their results point to a story of “debt overhang” as the explanation behind the “resource curse”. In the 70’s when commodity prices were high, natural resource-abundant countries used them as collateral for debt. When commodity prices fell in the 80’s, these countries experienced debt crises that prevented them from continued borrowing. Devaluation and other growth-hindering policies resulted in order for current accounts to be balanced.

This study proceeds with the analysis as follows. Section I presents a simple political economy story in which oil-rent model and productivity in Venezuela are inextricably linked. The section briefly analyzes the political economy of the PMP that permeates an oil-exporting nation such as Venezuela, and leads to an overall understanding of the political economy dynamics discussed in the rest of the study. Section II, presents a detailed account of the evolution of productivity and its overall relationship to policy-related variables, such as investment per worker. This section goes on to show the results of sectoral decomposition to illustrate the importance of resource allocation among sectors with differentiated labor productivity. Section III characterizes the PMP and actors for the four sub-periods identified between 1974 to 2007. Section IV describes the political process that led to the adoption of economic policy decisions impacting sectoral productivity, and in consequence global productivity. In particular, exchange, commercial-industrial and fiscal policies will be analyzed as a set of economic policy decisions that had negative impacts on productivity in certain periods. Finally, the study closes with comments and conclusions, and explores the implications of the analysis of the political economy of productivity, and suggests alternative avenues for analyzing the issues considered.

I. The political economy of the oil-rent model and productivity in Venezuela

Specialized literature often describes most of the governments of oil countries as ‘rentier states’ since they derive a large fraction of their income from external rents. Venezuela is an example of this model of development par excellence. The state has been the owner and administrator of oil rent, which in the last three decades has accounted for more than 80% of total exports (91% for the year 2007), 90% of total foreign assets income and 50% of total fiscal income. At the same time, oil has a clear political dimension. A large, concentrated rent source of national income can mould a country’s social and political institutions. Therefore, it is not possible to understand the evolution of productivity without accounting for the deep impact that oil has had on key areas of the economy, political institutions and society. Subsequently, this section briefly examines the political economy of the policy-making process within this oil-exporting nation. It demonstrates that oil has been the single most important factor shaping economic policy in the country. This section will impart a greater understanding of the dynamics of a rent-based economy, setting the stage for the political economy discussion in the rest of the study.

When oil is the key source of wealth for a state, this revenue alters the framework of decision-making. Oil creates a perverse incentive structure influencing the behavior of the actors in the policy-making process. Oil shapes preferences, perceptions, and attitudes. This explains why fiscal deficits, real exchange rate appreciations, indiscriminate use of subsidies, tax exemptions, and other disappointing economic policy outcomes are often present even during a boom. The exploitation of Venezuela’s oil constitutes the basis for its rentier state and, in general, a rent-seeking society. This is built on a principle of distributing rents where the state has maintained the citizens and not the citizens the state.

In particular, both private sector and government are in the capacity to extract rents and distribute them internally, using political criteria as a central mechanism of allocation. Politically powerful interest groups that are attached directly to the government resources, such as political elites and bureaucrats, as well as public and private sector unions have systematically tended to permeate the state. Therefore, oil revenues have fundamentally shaped Venezuelan politics for decades, creating a rentier state legitimized by patronage and entrenched constituencies, whose continued loyalty has been linked directly to state resources funded by oil rents.

After the oil shocks of the 1970s and the huge income from ‘petro-dollars’, it was a fairly simple process to distribute oil income among different ‘rent-seekers’ in Venezuelan society. However, as oil rent faded and society became increasingly complex, the distribution process started to collapse either from a lack of resources, the failure to reach important parts of the population, or the evident incapacity of the political parties to deliver results. In particular, the decline of oil prices during the 1980s and the consequent drop in oil fiscal income were the primary causes of the rentier-state fiscal crisis. This decline in the oil fiscal income was sustained for more than two decades. In fact, it represented the demise of the oil-rent model of distribution which had been the basis of political stability for many years. Riots, attempted coups, electoral abstention, decay of the traditional political parties, and a general collapse of the political system have all been manifestations of the decay of the model. Therefore, it should be of no surprise that the decline of the old political and social model based on the ‘rent’ distributions through the state coincided with a general decline in fiscal income from oil during the 1980s and 1990s.

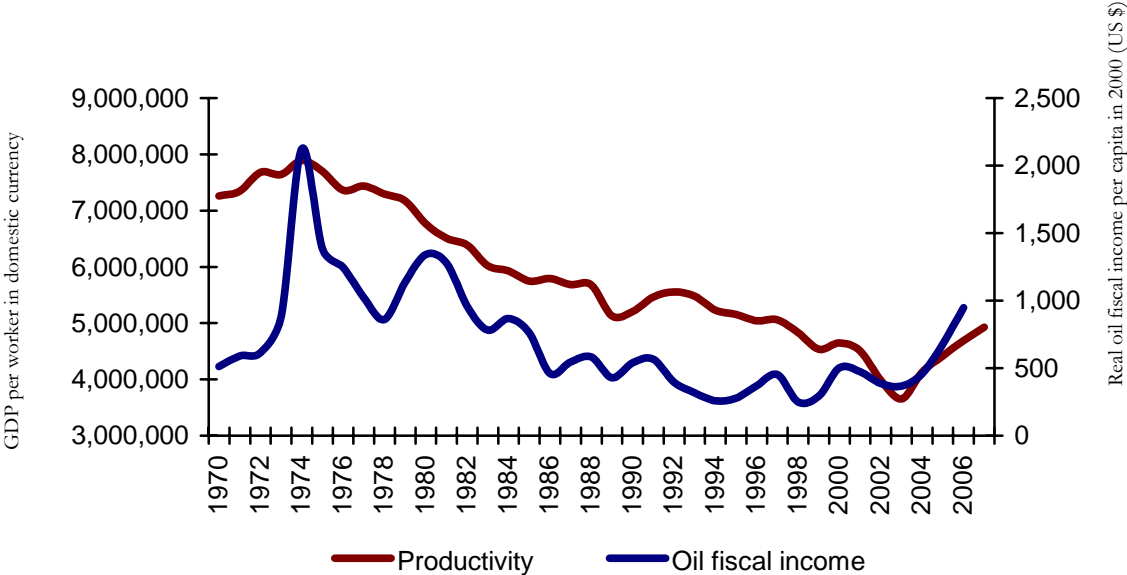
Similarly to the oil boom of 1974, during the period 2004 and 2007 oil rent has once again began to increase importantly. With this, the distribution process recommenced and the opportunities for rent seeking increased significantly. The actors and some mechanisms have changed, but the politically influential interest groups remain attached to government resources. These groups continue their efforts to systematically capture state resources during this period, reinventing the rentier state legitimized by patronage and entrenched constituencies whose continued loyalty has directly resulted from state resources funded by oil rents.

II. The productivity story

Venezuela, unlike other countries in Latin America, has suffered a severe decline and excess volatility in the levels of productivity during the last three decades. Indeed the trend in productivity levels has declined steadily since the early seventies though short and medium size cycles in productivity growth can also be reported. Figure 1 clearly shows that during the period that goes from 1974 to 2003, for instance, real GDP per worker decreased almost 50%. Small recoveries in productivity levels can only be found during the short period that goes from 1990-1992, (just after a strong realignment of the exchange rate and the implementation of structural reforms) and more recently during the last oil price boom.

Figure 1 also allows a comparison between the evolution of labor productivity (in levels) and the evolution of fiscal oil revenues (in per capita terms). Both follow a similar pattern and a clear downward trend since the 1970s. In fact, after the first oil shock (1973-1974), the average growth rate of labor productivity in Venezuela has been negative (-1.3%) and excluding recent cycle, the average rate of growth is negative (-2%) for the whole period 1970-2007. In other words, productivity levels in Venezuela have followed the decline and volatility of the oil income and in terms of growth rates the Venezuelan economy appears to be a case of productivity implosion.

Figure 1
GDP per worker and per capita oil fiscal revenues. 1970-2007

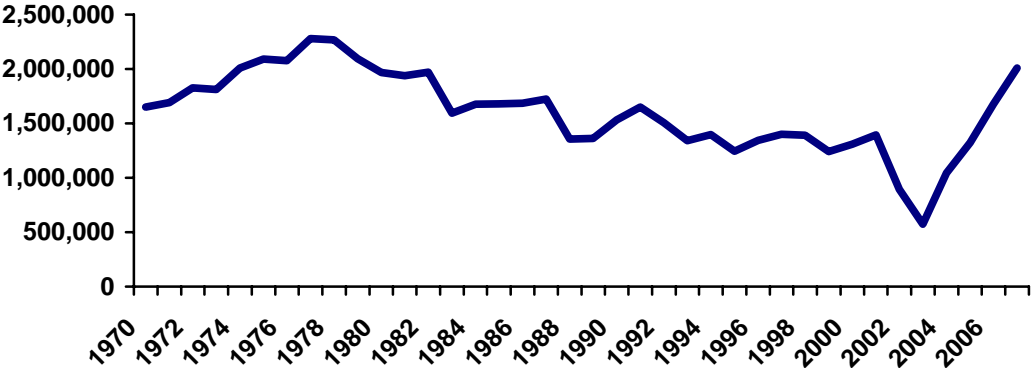


Source: Central Bank of Venezuela. National Statistics Office and own calculations

One very well known way through which an economy can improve labor productivity is by increasing the amount of capital it invests per worker. This phenomenon is called “capital deepening.” Capital deepening happens when businesses invest in more or better machinery, equipment, and structures, all of which make it possible for their employees to produce more. Thus, with more capital to work with or with new vintages of capital, workers’ productivity increase more and this could lead to higher productivity. Similar to other country experiences, in the case of Venezuela the decline of labor productivity seems to be highly correlated with the

contraction in the level of investment per worker a proxy for capital per worker (see figure 2). In turn, it may be the case that this reduction in investment is partly explained by a number of policy related factors, such as high macroeconomic volatility, distorted economic policies and incentives, low enforcement of properties rights, labor markets distortions, weak institutional environment, poor and volatile regulatory environment and insufficient human capital among others.

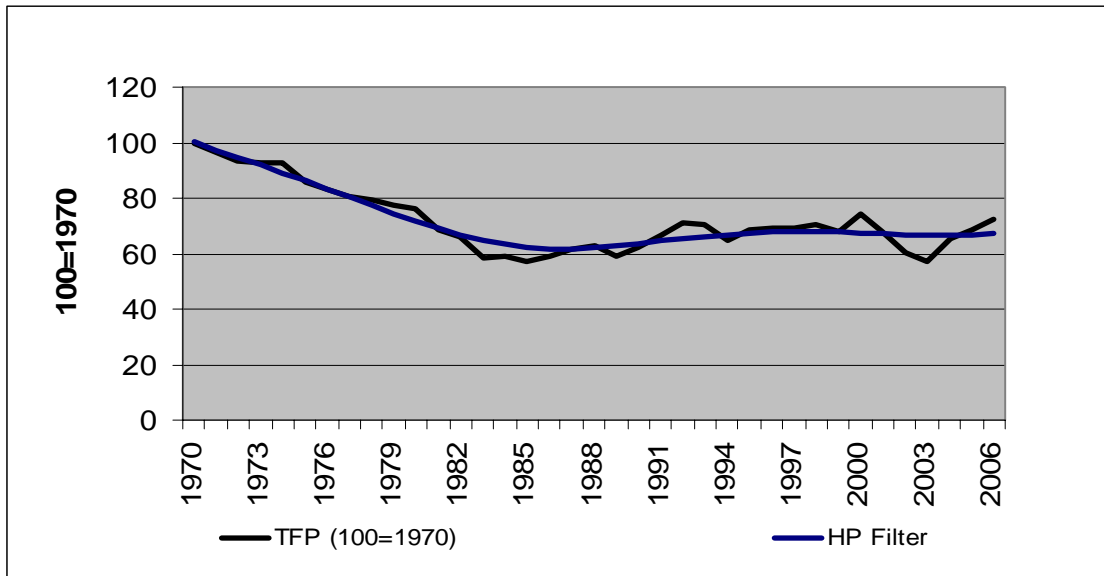
Figure 2
Investment per worker. 1970-2007



Source: Bureau of Labor Economics of USA. Central Bank of Venezuela and own calculations.

A second measure of productivity, called “total factor productivity” — or TFP, for short — is a broader measure. TFP takes into account the amount of capital employed in production in a more explicit way by measuring the productivity of the combination of labor and capital. For the estimation of the Venezuelan TFP, this work reproduces the same methodology used by Arreaza and Pedagua (2006). These authors used a non-parametric approach based on Solow (1957). Figure 3 shows the Venezuelan TFP and its long-term trend for the period 1970-2006 (1970=100). As the evidence suggests, TFP in Venezuelan experienced a period of steady fall from 1970 to 1983, and since 1984 it has shown stagnation. Notice that TFP rises during the same short periods in which labor productivity increases were reported. We refer here explicitly to the periods 1990-1992 and 2004-2007.

Figure 3
Total factor productivity (1970-2005)



Source: Own calculation based on data from the Venezuelan Central Bank

Despite the relative stability shown by the TFP trend between 1984 and 2005, the standard measure of TFP shows some degree of volatility afterwards. Looking at shorter periods of time, we can see a sharp and steady fall between 1970 and 1983, a period of stability from 1984 to 1989, and finally a more volatile period from 1990 to 2006.

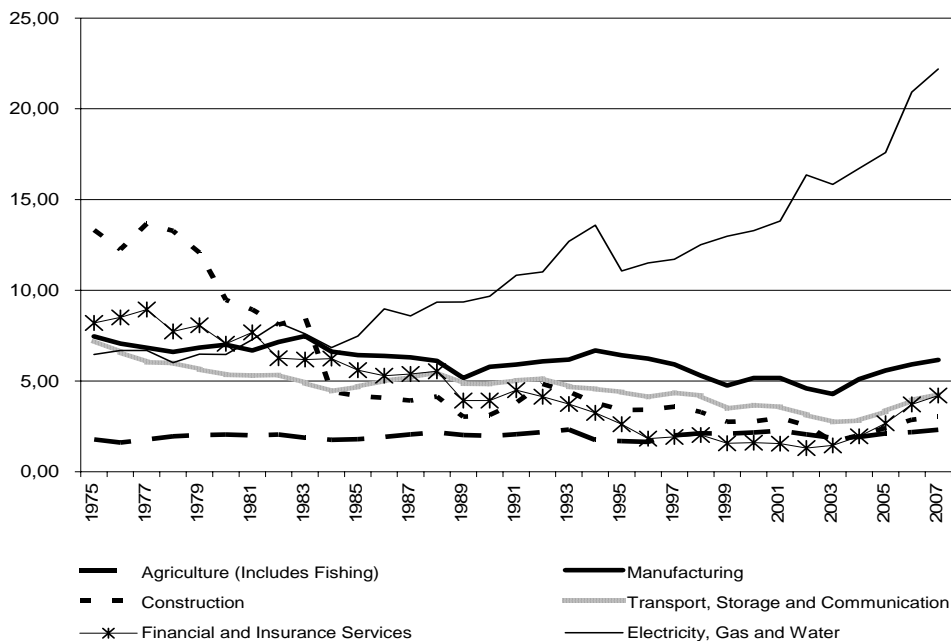
These slightly increase in the degree of volatility of productivity is consistent with the macroeconomic instability associated with relative price adjustments, in particular with real exchange rate adjustments. Suffice to say that from the early 1960s and up to 1983 the Venezuelan fixed exchange rate system provided a general anchor for stability but generated a strong real exchange rate appreciation. That year (in 1983), and after almost twenty year of exchange rate stability, the Bolivar was devaluated against the American dollar for about 30%. Between 1984 and 1988, the rate of devaluation remained below the cumulated rate of inflation and this was combined with a system of relatively high commercial barriers. The distortions were corrected once again in 1989. After 1989 the exchange rate and the whole set of commercial policies changed: commercial barriers were reduced and the nominal exchange rate was adjusted. The Bolivar rate remained undervaluated until 1993 and since 1994 and up to the early 2000 the Bolívar started to appreciate against the dollar. New devaluations follow after two

consecutive balance of payments crises in 2002 and 2003. All these waves of real exchange rate appreciations and realignments may have been associated with the increase volatility of the TPF.

Sectoral Changes in Labor Productivity

Though changes in labor productivity growth are, of course, the result of systemic forces or incentives that have an across the board effect, at a meso level, the sectoral performance or behavior of productivity may be an important determinant of global or overall productivity as well. A scrutiny of sectoral labor productivity may be important in our explanation of the labor productivity slowdown. The fact of the matter is that the policy making process, through some specific economic policies, may change political and economic incentives and the reallocation of resources among different sectors. Resource reallocation among sectors that show labor productivity differentials or heterogeneity in TFP productivity, affect global or overall productivity levels.

Figure 4
Sectoral productivity. 1975-2007
Millions of Bs. at 1997 prices



Source: Own calculation based of data from Venezuelan Central Bank

Figure 4 shows data reflecting the evolution of sectoral productivity in Venezuela. The time series shows the evolution of productivity per occupied worker, between the years 1975 and 2007. Given the difficulties in obtaining more disaggregated data, the series for six of the major sectors of the economy are presented (excluding oil and wholesale and retail business).

Though most sectors show declining trends in labor productivity until 2003, that trend is not clear in agriculture and it is absolutely the opposite in utility industries. In addition, it should be noticed, that the fall in labor productivity over the period has been more pronounced in some sectors than in others. For instance, labor productivity in agriculture remains more or less the same over the period. But the same as for agriculture can be said of labor productivity in non-tradable. Indeed, the picture for services and construction is slightly different. Construction shows the greatest productivity contraction in the group, by falling from about Bs. 13 million of 1997 in 1977 to around Bs. 3 million of 1997 in 2007. The largest on-year recorded fall occurred in 1984 (when it fell nearly Bs. 5 million of 1997 in a year). The sector that recorded the second highest period of contraction is financial and insurance services, which dropped from just over Bs. 8 million of 1997 in 1977 to about Bs. 2 million in 2002. But it is striking the fact that the productivity level in services has declined to almost one half of the productivity level in manufacturing.

Productivity slowdown and differential performance between economic sectors

It may prove very difficult to empirically explain the recent Venezuelan productivity growth slowdown. But an interesting hypothesis that may hold is that this stylized fact it is not only due to a general across-the-board decline in productivity growth, but also the result of a shift in sectoral employment shares and resource reallocation. In this sense, a standard view assumes that as an industrialization process develops, a surplus of labor in some (less productive) parts of the economy (such as agriculture) shifts towards higher productivity sectors (industry) and are beneficial for aggregate productivity growth. Even within manufacturing, shifts towards more productive branches should boost aggregate productivity. This may have happened in Venezuela during the industrialization process that took place during the 1950s and 1960s. On the other hand, a shift in sectoral employment shares from (high-productivity), for instance manufacturing, to (low-productivity) services sectors could mean that structural change, promoted by the

policymaking process, may have a negative impact on aggregate productivity growth. Services in general tend to be non-tradable in developing countries and may lose productivity at least for two reasons: they are not exposed to foreign competition, or there are local barriers that allow the survival of the less efficient firms.

Shift-share analysis provides a convenient mean to investigate how aggregate productivity growth is mechanically linked to differential growth of labor productivity and the reallocation of resources (labor) between industries. This methodology can show how much the various sectors have contributed to the overall productivity decline. To this end, the aggregate productivity growth rate is expressed as a weighted average of sectoral productivity growth rates—the weights being the share of sector i in aggregate employment. That is:

$$\left[\frac{\dot{Y}}{L}\right]^t - \left[\frac{\dot{Y}}{L}\right]^0 = \sum_{i=1}^n (\dot{P}_i^t - \dot{P}_i^0) S_i^0 + \sum_{i=1}^n \dot{P}_i^0 (S_i^t - S_i^0) + \sum_{i=1}^n (\dot{P}_i^t - \dot{P}_i^0) (S_i^t - S_i^0).$$

This expression is indeed a discrete-time first difference expansion of productivity growth decomposed into three components; where Y and L represent aggregate output and employment, Y_i and L_i represent output and employment by sector, P_i stands for sectoral labor productivity (Y_i/L_i) and S_i is the sectoral employment share (L_i/L).

The first term on the right-hand side of the above expression represents the intrasectoral productivity growth, i.e. it that part of the overall productivity change which is caused by productivity growth within the sectors. The second term is called the net shift effect (or static effect), and measures the effect of the change in sectoral employment shares on overall growth. The third term represents the joint effect of changes in employment shares and sectoral productivity and is called the interaction effect.

Thus, though part of the overall productivity change may be caused by productivity growth within the sectors, another part may be explained by labor reallocation among sectors. To explain productivity declines of the second type, we need to verify if employment shares declined exceptionally rapidly in sectors with relatively rapid productivity growth (i.e. agriculture and manufacturing) whereas the increases in productivity were much more moderate in those sectors with rising employment shares (i.e. services). Using the shift-share decomposition the findings can then provide support for the view that the slowdown of productivity growth in Venezuela may be due, in part, to sectoral asymmetries in the behavior of

labor productivity and reallocation of labor between industries. This in turn relates directly to public policies since a connection can be established between the bias of public policies (exchange rate, trade and industrial and fiscal policies) and the reallocation of resources and final sectoral productivity performance.

Table 1
Breakdown of total productivity change by components. 1975-2005
(As percentages)

Intra-sectoral Change	72.29%
Shift-Effect	4.53%
Interaction Term	23.18%
Total	100.00%

Source: Own calculation based of data from the Venezuelan Central Bank

Table 1 shows the results of the shift-share decomposition analysis for the Venezuelan case for the period 1975-2005. Of the 100% aggregate productivity change, 72.3% is explained by changes in intrasectoral productivity, 4.5% is explained by changes in sectoral employment shares and the remaining 23.2% is explained by joint effects (the interaction of first two coefficients of the equation).

Table 2
Breakdown of total productivity change by components. 1975-2005
(Bs. of 1997 per capita)

Intra-sectoral Change	-2,33
Shift-Effect	-0,15
Interaction Term	-0,75
Total	<u>-3,22721222</u>

Source: Own calculation based of data from the Venezuelan Central Bank

Though the results say that the aggregate productivity changes are mainly explained by productivity changes occurred within sectors, the changes due to structural effects (28%) can not

be neglected. The resource reallocation away from sectors with high productivity appears to be the norm. Moreover, as we can see from Table 2, the dynamic shift effect (interaction term) is negative which means that a shift in sectoral employment shares from high-productivity to low productivity sectors (such as services) has been happening. It should be remarked, that among the analyzed sectors, the biggest productivity changes occurred within non-tradable sectors such as: a) Construction, b) Wholesale, Retail Trade and Restaurants and Hotels, and c) Finance, Insurance, Real Estate and Business Services. We will argue later that to a certain degree it is possible to establish a connection between the policy making process, the bias of public policies (exchange rate, commercial, industrial and fiscal policies) and the reallocation of resources. In that respect the evidence for the reallocation of labor towards low productivity sectors should now find an explanation in public policies.

As a first approximation, it is possible to say that the predominance over the period of policies that favor the appreciation of the real exchange rate, local business protection through generalized trade barriers, subsidies, tax exemptions, etc. may explain the reallocation of resources from tradable to protected-non-tradable sectors and may be good candidates to explain consequently the harms to productivity growth.

III. Policy making process, actors and political foundations in Venezuela

This project will apply the same general framework developed in Monaldi, Gonzalez, Obuchi and Penfold (2005) and Puente, Daza, Ríos and Rodriguez (2007), regarding the policy making process and the institutional foundations in Venezuela. However, in this study an additional period is included (2004-2007), and greater detail will be placed on the way political institutions specifically affect economic policy results, particularly industrial, commercial and exchange rate policy decisions. In the period covered by this study (1974-2007), it is possible to identify different sub-periods with significantly different institutional foundations and policy making processes.

Venezuela's economic dependency on oil has impacted the institutional setting, policy making processes and economic policy outcomes, especially concerning the industrial and commercial sectors. Notwithstanding, changes in the economy and oil revenue conditions are not the only explanation for modifications in the different stages of the policy making process

throughout 1974 and 2007. Changes in the rules of the game and the performance of political institutions have also played a significant role in such variations.

The political rules of the game that influenced the institutional framework in Venezuela varied throughout the period from 1974-2007. Political incentives and constraints that affected political actors influenced the policymaking process. The subsequent policy outcomes present varying trends, and in the last three decades, economic policies in Venezuela can be generally characterized as having very low quality. To establish an analytical framework that adjusts to the distinctiveness of the Venezuelan case, for the purpose of this study, the period 1974-2007 has been broken down into four sub-periods (1974-1988, 1989-1998, 1999-2003, 2004-2007), broadly characterized in table 3:

Table 3

The policy-making process. 1974-2007

1974-1988	1989-1998	1999-2003	2004-2007
<ul style="list-style-type: none"> • Institutionally cooperative PMP • Low number of key players - allowed policy consultation with very limited actors. <ul style="list-style-type: none"> • President • Leaders from the two main political parties (AD and Copei) • Leaders from peak unions (CTV and Fedecamaras) • Stable Actors (repeated play) • Powerful President - Constitutionally weak but informally powerful, important power in PMP, and strong partisan powers, control over high oil rents, rights to appoint cabinet members and regional governors. • Political Arrangement – Two-party cartel-type. • Party system - highly centralized, disciplined and non-fragmented. • Party Leaders – long tenures, with control over congressional nominations, and many were members of Congress. • High inter-party cooperation • Marginalized legislature – mainly controlled by the two main political parties. 	<ul style="list-style-type: none"> • Decline and breakdown of cooperation – political fragmentation. • Volatile PMP • Higher number of fragmented and polarized actors – new actors: newly elected regional authorities and new political parties with significant participation in Congress. • Higher transaction costs • Weaker President – loss of control over economic policy and governors, reduced influence in Congress, need for political coalition. Oil income decline. • Party system – decline in discipline, fragmentation. • Institutional instability • Stronger legislature power - despite fragmentation and polarization. 	<ul style="list-style-type: none"> • Weakening of cooperation – political fragmentation and instability, partisan policymaking • Increased confrontation -Political polarization, <i>Coup d'état</i> (2002), oil national strike (2003) • Higher transaction costs • Strong President – constitutionally and informally powerful with strong concentration of powers and important role in the policy process. • Weakening of institutions and accountability • Governance quality declined – increased cabinet turnover • Weakening of the legislature – given stronger role of the President and strong discipline within the government party members. 	<ul style="list-style-type: none"> • Even stronger President constitutionally and informally powerful with almost absolute control of powers and important role in the policy process. • Low number of key players Policy consultation with very limited actors. <ul style="list-style-type: none"> • President • Leaders PSUV • "Boliburguesia" • Militaries • Many changes in formal and informal powers • Weakening of institutions, transparency and accountability • Weakening of the legislature – stronger role of the President and strong discipline within the government party members.

These periods are described and analyzed separately, as well as jointly, in order to develop a better understanding of the dynamics involved in the policy making process.

First period (1974-1988)

The institutional framework during the first period (1974-1988) was embedded within the Pact of *Punto Fijo* and the 1961 Constitution (Monaldi et al., 2005). A constitutionally weak but informally powerful president guaranteed the main party leaders veto over major policy changes. The fundamental institutional structure which categorized this period includes: a high degree of inter-party cooperation, incentives for centralized, disciplined parties in the electoral system, presidential elections held concurrently with all legislative elections, a lack of regional elected officials, and a lack of legislative expertise in the decision-making process.

This period comprises the final fifteen years of democratic consolidation in Venezuela. Under the theoretical perspective of Spiller, Stein and Tommasi (2003), it can be typified as having an environment conducive to political cooperation, given the participation of few political actors, stable actors (repeated play) and low stakes of power. Stability was privileged over flexibility or efficiency, and the two-party cartel-like political arrangement that had evolved since 1958 between AD and Copei became a scheme that was exacerbated by the end of the period 1974-1988. Minority parties such as MAS were guaranteed access to small prerogatives to maintain them “inside” the system, but they did not play a major policymaking role. Corporatist arrangements were also formally integrated and used as vehicles to channel through interest group concerns. Thus, concurrent agreement included the umbrella organization of the labor unions (*Confederación de Trabajadores de Venezuela – CTV*) and business groups (*Fedecamaras*), as well as the Catholic Church and the military. Beside the corporatist agreements there were many occasions for personalized or group access and connections between business groups and policy makers. Those informal channels provided the means to patch any particular failure that the general corporatist agreement could have from an extremely consensual point of view.

From the key players, the only group explicitly excluded was the communist party (PCV). The two main parties (AD and Copei) generally controlled the leadership of Congress, and with a few exceptions, they also heavily influenced the leading corporatist groups. Party leaders were

quite powerful with strong roles: they enjoyed relatively long tenures; almost all of them were members of Congress following long legislative careers, had significant control over congressional nominations and decided how the party voted in Congress. Such corporatist arrangements permitted the president to conduct policy consultation with a reduced number of actors. The marginal role of legislature in the policymaking process was apparent through the predominance of policy agreements negotiated between the president, the national party leaders and the key corporatist groups. Given the disciplined party delegation in the legislature, these agreements, when required, were signed into law. It was common for Congress to delegate legislative authority to the president.

The favorable oil scenario during part of this period made the distribution of the oil revenues a key political element, also influencing the policy making process. The oil booms shaped political distortions. The abundance made the executive branch more powerful and the increased stake of power-triggered deviations from cooperative behavior heightened incentives for inefficient behavior and corruption.

The stability, coherence, and some of the capacities for building policy observed before 1970 started to decline during 1974-1988. Certain policy processes were unraveled and inefficiency in several areas became too evident. Notwithstanding, a number of key areas, such as the oil industry (PDVSA) and the central bank, still preserved relative good quality policymaking capacities.

From the policy making process perspective, the President had broad and significant powers. This, combined with a bipartisan political agreement within a corporativist arrangement, resulted in a limited number of actors interacting throughout the different stages. Initially presidential power was strongly exercised in the allocation of economic benefits in order to maintain political cooperation (congress re-elections and resources geared towards powerful interest groups), but eventually it became an unsustainable scheme.

Second period (1989-1998)

The second period, in contrast with the preceding period, was characterized by multiple actors (sub-national actors among many others), high electoral volatility and institutional instability.

During this period, democracy in Venezuela began to dissipate and cooperative agreements to decline. The previously prevailing political arrangement was fractured and led to greater political fragmentation, weaker presidential power and stronger congressional influence in policymaking. Transaction costs increased and economic policy outcomes significantly deteriorated.

Presidential power weakened and the introduction of regional elections in 1989 activated the formal federal system that had been historically dormant. The rise of federalism transformed party politics as it increased the number of electoral arenas and competition. The non-concurrency between regional and presidential elections and the possibility to re-elect governors and mayors gave new regional political actors the opportunity to gain independence vis-à-vis the national authorities. Despite modifications in the legislature system in 1993, from a pure proportional representation to a mixed-member system of personalized proportional representation, the system continued to be globally proportional. In 1993, incentives for political fragmentation grew and the decline in party discipline was becoming continually more evident. Institutional and political instability thus became the norm.

The presence of many fragmented and polarized actors changed the political scenario, and a volatile process evidenced the weakening of cooperation. With varying degrees of formal and informal powers, new key actors, such as the military, civil society groups, and regional authorities appeared on the political stage.

The substantial increase in transaction cost, reflected by the multiplication of relevant policy actors at the national and regional level, made it more difficult for political players to credibly commit to and reach policy agreements in more informal environments. Paradoxically, despite the increase in political players, the legislature played a more significant role during this period. Closer electoral connection of legislators to their constituents made legislators more specialized and less submissive to party leaders and the parties that nominated them. Independent legislative groups emerged as a result of the separation of some factions from consolidated political parties. Dependency of national political parties on party alliances increased during this period, and incumbent governors could shift “running-mates” more easily to assure re-election, increasing their independence from their original parties.

The decline in presidential powers was strongly influenced by the introduction of regional elections. Also, the political influence of presidents was reduced by the combination of declining

oil income and market-oriented reforms, which limited subsidies and reduced rent-seeking opportunities (Villasmil et al., 2004). In particular, a weaker presidential figure reduced the executive branch's influence in the legislative policy-making process. In 1998, with the intent of reducing the effect that a potential landslide-victory by Chavez might have on the legislature, Congress approved the separation (for the first time) of the legislative and presidential elections for that year. Notwithstanding, it generated the largest political fragmentation in the history of Venezuela.

Third period (1999-2003)

Hugo Chavez's revolution and the 1999 new Constitution characterized the third period, with a significant effect over the institutional and political landscape. This period is characterized by the presence of a constitutionally powerful president, greater concentration of power, increased stakes of power, weakened accountability, political instability, polarization, acceleration of political confrontation, partisan policymaking and weakened political cooperation. Despite greater polarization, power was consolidated within one political party. Many formal and informal powers changed during this period, and a decline of civilian control or relevance over the military became one of the most salient features after the election of Hugo Chávez.

A key feature of the Venezuelan political process since 1999 is the rejection of any political negotiation with minorities. The new political group in power sees public policy choices more as a by-product of centralized criteria than as the result of negotiations in relatively stable coalitions. This led to the dismantling of the traditional mechanisms of coordination and to the disqualification of unions and traditional parties.

This process began with the call for a national constituent assembly in which the presence of the traditional political actors was minimized and replaced by newcomers and some lawyers with expertise in constitutional design. The new dominant group was represented by an alliance between the military, independent "left-wing" leaders coming from smaller parties and representatives of the media.

At the same time, to avoid the rigidity of the customary bureaucracy where the traditional parties retained presence, a process of experimenting with parallel channels of budget

implementation began. This process started with the Plan Bolivar 2000, through which a significant proportion of the fiscal budget was channeled, and included the so-called "Misiones", which created a vertical bureaucratic structure (parallel to ministries) and other state bodies, without budgetary control by the parliament. With the creation of this parallel institution, the deliberation and negotiation of decisions are reduced and the traditional mechanisms for providing goods and services through the public sector were broken.

As explained in this study, in the first phase of the government of Hugo Chávez (1999-2003), the pattern of unstable equilibrium that characterized the country since the attempted "golpe de estado" of 1992 is maintained. This phase began a process of destruction and disregard for the legitimacy of the traditional political actors, which took place entirely after the military coup in April 2002 and the oil strike in December 2002-February 2003. These conspiracy events had two important effects: they allowed for the identification of sectors that openly opted to conspire to regain space for their interests, and they justified the destruction of the political arena, turning control over to the ruling coalition.

Congressional power in the policy making process declined. While the Presidential powers were strengthened and the Executive branch regained a stronger role in the economic policy making process, compared to the first period, the President exercised his power within a non competitive political context.

Governance and institutional quality declined, reflected by the reversal of several reforms implemented during previous administrations, an increase in cabinet turnover, and a deteriorated perception of many public institutions. An example of this is the loss of credibility experienced by the Supreme Court, which contrasts with cases of judicial independence displayed in previous years (such as President Perez's impeachment in 1992). A similar loss of credibility has been experienced by the Central Bank, PDVSA and the National Electoral Council (CNE).

Fourth period (2004-2007)

As already mentioned during the third period, important events occurred which changed the institutional playing field. This includes the coup d'état in April 2002 and a nationwide strike between December 2002 and February 2003. These two events had far-reaching economic and

political consequences, and in conjunction with the drastic increase in oil prices after 2004, generated changes in the policy-making process. These factors characterized the fourth period (2004-2007) and had significant effect over the institutional and political landscape including: an even stronger President than during the third period, constitutionally and informally powerful with almost absolute control of powers and important role in the policy-making process, weakening of institutions and high levels of polarization. Despite greater polarization, power was consolidated within one political party. A low number of key players implied policy consultations with participation of very limited actors: the president, close personal advisers, leaders of PSUV, “Boliburguesia” and military officials in key political and public sector positions. In this narrow circle, it appears that the decisive factor is to have access to the President. This result is a very “personalized” policy-making process in which the ability to influence the President depends on a number of particular factors: unconditional loyalty, ideological closeness and instrumental usefulness.

Additionally, the extremely favorable oil income scenario during this period made the distribution of the rents a key political element, also influencing the policy-making process. The huge oil boom shaped political distortions as the abundance made the Executive branch more powerful. Rents increased the stake of power-triggered deviations from a cooperative behavior, amplifying incentives for inefficient behavior, the lack of transparency and accountability with important consequences over the levels of corruption.

National Assembly’s legislative power in the policy making process declined almost entirely, while the Presidential powers were strengthened and the Executive branch strengthened its hold over the economic policy making process.

During the second, third and fourth periods (1989-2007), the progressive deterioration in the quality of economic policy features became evident given the increase in volatility, incoherence and retrogression of policy effectivity/competence. The success of reforms in specific areas, such as the opening of the oil sector and privatization, as well as the presence of capable technocratic teams, was shortly lived during these periods, given the political instability and the lack of state capacity.

IV. Actors and the policy making process

One of the main objectives of this research project is to analyze in great detail the way in which the interests of socioeconomic actors are organized as well as their interaction with the PMP. In the case of Venezuela, it is possible to trace significant changes in the dynamics of socioeconomic actors in response to the institutional transformations of the PMP. Likewise, these changes, along with economic factors can be linked to the types of interests involved. In particular, the project will look very carefully into business and labor (unions) interests and their interaction with the PMP. This will be done in the context of an oil economy facing significant positive and negative external shocks, as well as in the presence of a more or less consensual and conflict-prone political and decision making process. Our fundamental hypothesis concerning labor and business interests is that in an oil economy, these interest groups will attempt to extract rents at the expense of pursuing a policy agenda aimed at improving productivity. In this context, distributional policies are considered of greater priority than policy issues related to productivity.

By contrast, in moments of a decline in oil income, a productivity agenda gains prominence among government priorities, but business and labor interests resist these reforms. In regards to business, this stems from the fact that in an oil economy, the non-tradable sectors become stronger and more able to solve collective action problems through access to the PMP. Thus, while the non-tradable sectors will be more focused on capturing the rents created by the oil income, the tradable sectors, on the contrary, become weaker. If they are able to solve their collective action problems (given, for instance, a real appreciation of the exchange rate), then they will be induced to persuade the government in the PMP for market protections. By the time the oil income has declined, other potential tradable sectors that could export are latent groups, and do not have the political clout to defend the productivity agenda. The outcome will exhibit a political conflict between organized business interests and the productivity agenda. On the other hand, our hypothesis concerning labor is that unions will tend to resist any change, given their interest to defend gains in real wages. Though these gains might be artificially sustained as a result of the real appreciation of the exchange rate, the labor front will try to protect them even in the context of declining oil income. This outcome creates priorities for labor movement that do not support or match a productivity agenda rather it will favor one that is more narrowly focused on distributional issues indistinctly of oil cycle timing.

The Venezuelan case is particularly interesting since significant variations are evident in the way in which labor and business interests were interacting in the four different periods of the PMP. In the first PMP period (1974-1988), business and labor were institutionally joined through a corporatist arrangement that stemmed from the social spirit of the Punto Fijo pact. Under the consensual spirit of that pact, both the confederation of business associations (Fedecamaras) and the labor organization (CTV), negotiated with politicians and influenced policy through tripartite commissions. In fact, tripartite mechanisms were so well embedded into the system that most public institutions or public enterprises had formal representation of both interests in their boards. One of our main hypotheses for this period is that within Fedecamaras, the interests of non-tradable sectors were better represented than those of the tradable sectors (the latter could have potentially been favored by a more focused agenda on productivity). This in turn, favored a business behavior more centered on rent seeking.

During the second period of the PMP (1989-1998), which coincides with a steady decline in oil income, the tripartite mechanisms were substituted in order to promote a more open economy. In this period, the government attempted to create more autonomous regulatory agencies as well as independent public institutions, i.e., a more independent central bank, autonomous anti-dumping and competition commissions, and autonomous judiciary powers. However, many latent groups that could have potentially benefited from these sets of policies were not organized and existing business and labor interests blocked reforms. Additionally, given the weakening of political parties and the emergence of the legislative arena as an important space for policy making, it became even more difficult for these latent groups to defend policies oriented towards gains in productivity. One possible hypothesis is that business interests from the non-tradable and even from the organized and protected tradable sectors would align with labor interest to undermine reforms. Latent groups would appear but without the power to defend reforms.

Finally, during the third and fourth period of the PMP (1999-2007), largely characterized by high oil income, the radical transformation of the political landscape greatly undermined the capacity of existing labor and business interests to influence policy of any sort. The Punto Fijo consensual spirit was replaced by conflict and political polarization. As a dominant power, the government, attempted to consolidate a popular majority for a revolutionary project. Certainly, the government used oil rents to favor emerging business interests: for example, promoting new

business associations such as Empreven and Fedeindustria. This created a policy agenda on small and micro enterprises, given preferential access to rents to certain business groups and introduced regulatory measures aimed at increasing costs for larger firms, etc. In the case of labor, the same strategy was pursued against the CTV. The government used oil rents to align itself with the informal sector and also attempted to strengthen alternative labor organizations such as the Federación Bolivariana de Trabajadores, although with more difficulty. The outcome was a large coalition between Fedecamaras and CTV to destabilize the political regime. However, the high oil income, particularly after 2003, provided the government with the opportunity to overcome these political efforts and build a winning social coalition through large investments in social transfers. Nonetheless, these new emerging interests are also focused on a more distribution-based policy agenda, rather than one centered on productivity. In this sense, both business and labor interests remain intact as a result of the structural dynamics created by an oil-based economy.

New actors since 2003

Political parties

Since 2003 there have been substantial changes in the political actors that influence the policy making process in Venezuela. Indeed, public policy decisions become more concentrated at the highest levels of government. Traditional players such as AD, Copei, Fedecamaras, the CTV and the Church lost their influence, and with it their ability to determine economic policy and participate in the appropriation of the oil rents. Since 1993, the traditional parties AD and Copei had been gradually losing electoral support. The number of votes for these parties fell from an average of 88.3% in the elections between 1973 and 1988 to an average of 19.6% in the 1993, 1998 and 2006 elections. The breakdown of the traditional political parties left the door open to new political actors: Among others, the party of President Chavez (MVR and PSUV thereafter), other ruling coalition parties (such as PCV, PPT and Podemos) and the opposition parties, *Primero Justicia* and *Un Nuevo Tiempo* (UNT).

Business and Labor Unions: Fedecamaras and the CTV

Since 2003, there has been an important change in the level of representation of the traditional business and labor unions and in their ability to influence policy decisions. The participation of leaders from both unions (business and labor), directly or indirectly, in the conspiracies of 2002 (coup and oil strike) had the effect of ending these "franchises" as partners of the government. As a result, they lost the capacity to channel influence to their affiliates. Fedecamaras went from being a vehicle of influence and coordinating the dialogue between the government and the private sector to an association left out of the formal dialogue. The role that business and union leaders played in the conspiratorial events of 2002 and early 2003, undermined their capacity for political action and legitimacy.

Given the huge increase in "rents" in consequence of the oil boom, after 2003, many businessmen tried to find alternative ways to lobby for their interests. Some businessmen found better opportunities for accessing government contracts without showing any connection to Fedecamaras. This process created new mechanisms for the appropriation of rents: a) some business firms abandoned organized action and began to act individually; b) new alliances arose between businessmen willing to cooperate with food supply programs and provision of other goods and services, and groups of government officials with some autonomy to allocate resources for these purposes; c) as these alliances evolved, new economic groups began to emerge, for example, the so-called "Boliburguesía" (or people who have made fortunes from contracts with the government of President Chavez); and d) other entrepreneurs who perceived that the lobby could still allow some coordinated actions to capture rents.

Military

One of the players whose power and presence in the executive increased after the events of 2002 and 2003 is the military. Indeed, the increasing number of military personnel in the cabinet's ministerial posts after the military coup of 2002 was notorious. Due to his military background, President Chavez deliberately increased the role of the National Armed Forces and extended the number of military officials in civil posts, including ministers, vice-ministers, directors of independent public institutions, as well as upper and middle staff of the entire civil service sector.

A new Bolivarian “bourgeoisie” (Boliburguesía)

The opportunities that arose from the escalation of oil prices between 2003 and 2007 were exploited by relatively new individuals and economic groups, which succeeded in creating vast fortunes doing business with the government. This was how the so-called "Boliburguesía" came into existence. This interest group was made up of, among others: i) new bankers and businessmen from the financial sector that achieved large profits from issuing government bonds, ii) businessmen from the agriculture and sea transportation sector that supported the government in overcoming logistical problems created by the oil strike in late 2002 and early 2003 iii) businessmen who took advantage of the construction boom for large infrastructure projects (railways, and big infrastructure projects such as subways and etc.), and iv) business in the printing industry that took advantage of the significant government spending on advertising and propaganda, aimed at improving the positioning of government facing the electoral processes in this period.

Bureaucracy

In the 2003- 2007 period, bureaucracy became a key political actor and within itself different groups emerged to compete for bigger budgetary allocations. This competition partly explains some of the differences that arose inside the government and the appearance of “loyal dissidents” (critical sectors that remained under Chavez umbrella). Sometimes this competition showed itself by the rapid changes of ministers or executives entities of the government (e.g. Seniat), which at the same time generated shifting of civil servant groups and their replacement by allies of the new group in power.

Media

Another important actor is the media. In Venezuela, the media traditionally represented specific interests, and because of its nature it has enjoyed the power to shape public opinion. The media had the power and the influence to modify public perception of government stability whereby threats began to emerge. From the beginning, the relationship between the media and the government of Hugo Chavez has been conflictive. This heightened after 2003, because of the involvement of an important sector of the media in the conspiracies events of the years 2002 and

2003. The government, which has become one of the largest advertisers in the country, has used, in turn, the allocation of advertising as a mechanism of reward and punishment towards the political positions maintained by some media groups. The reorganizing of the country's political and economical actors has impacted the configuration of new groups, motivating the formation of alliances between some media and political-business groups.

V. Policy making process, actors and economic policy decisions

As a main argument, it is possible to say that the predominant policies over the period favor the appreciation of the real exchange rate, local business protection through generalized trade barriers, subsidies, tax exemptions, etc. This may explain the reallocation of resources from the tradable to protected, non-tradable sectors and consequently the harms to productivity growth. These factors, connected with decreased and volatile oil rent during the 1980s, reduced the time horizons of the socioeconomic actors participating in the PMP and help explain why the political system failed to adjust, as well as the systematic disintegration of cooperation with negative impacts on productivity. This section briefly presents three different economic policies that illustrate why the country is underperforming in terms of productivity.

Exchange rate policy

As was mentioned before, the exchange rate policy carried out by the Venezuelan government has been key in explaining productivity variations throughout the studied period. Since oil constitutes a large portion of the Venezuelan exports, the exchange rate policy has historically been strategic for the government. The exchange rate is important not just for monetary policy, but also as a fiscal and commercial instrument.

By the early seventies, Venezuelan export revenues significantly increased as a result of the growth in oil prices. Consequently, the exchange rate was revalued from 4,50 Bolivar per dollar in 1970 to 4,40 Bs/\$ in 1971 and to 4,30 Bs/\$ in 1973 (BCV, 1999). During the early years of this decade, the Venezuelan Central Bank (BCV) purchased dollars from the export industry at different rates: foreign currencies from private export of oil and iron were purchased by the BCV at 4,20 Bs/\$, while the exports of coffee, cocoa and public sector exports were exchanged at 4,285 Bs/\$. This disparity of exchange rates ("sistema de cambio diferencial") was eliminated in 1976.

The exchange rate for selling foreign currency to the public was fixed at 4,30 Bs/\$ from 1973 until February 18, 1983, in spite of the significant cumulated inflation for the period 1974-1982 (138%). This level of inflation clearly meant that the Venezuelan Bolivar was increasingly overvalued during this period as a result of the fixed exchange rate regime (Table 4).

Table 4

The policy-making process and economic policy decisions. 1974-2007

1974-1988	1989-1998	1999-2003	2004-2007
<ul style="list-style-type: none"> • Fixed exchange rate and free convertibility • Price and interest rate controls • Nationalization of the oil industry • Large investment in basic industries • High levels of debt issued to finance investment plans (1977) • Foreign exchange control (RECADI, Feb 1983) • Two exchange rates: US\$ 4,30 for essential goods and US\$ 6,00 for other products • High levels of debt issuing (1982) • Protectionist policies (tariffs, subsidies, tax exemptions, import restrictions) General price controls (1983) (Sistema de Precios Administrados) (CONACOPRESA) 	<ul style="list-style-type: none"> • Adjustment program (1989-1992) • Differential exchange rate regime eliminated • Maxidevaluation and Crawling peg • Foreign exchange control (OTAC, 1994) • Flexibilization of interest rates • Substitution indirect subsidies by direct subsidies • Adjustment in price controls and public services • Privatizations (VIASA) CANTV (1991) • Implementation VAT • Long term plan of expansion for the Oil Industry • Commercial reforms (FINEXPO, Tariff Reductions, etc) • Adjustment Program (1996) 	<ul style="list-style-type: none"> • Exchange bands • Floating exchange rate (2002) • Foreign exchange control (CADIVI, 2003) • Macroeconomic Stabilization Fund (1998, 1999) • Interest rates controls • Land (estate) laws (Ley de Tierras" • Continuity in economic policy in relation with the "IV Republic" 	<ul style="list-style-type: none"> • Foreign exchange control (CADIVI, 2004) • Price and interest rate controls and employee immobility • High and volatile regulation • Expropriations, Nacionalizations • Statization of utilities • Decreasing well qualify human capital • Highest levels of imports (food and other manufacturing products)

The exchange rate regime changed in early 1983, during the last year of government of President Luis Herrera Campíns. The weakness of the external accounts, due to the mix between increasing imports, foreign reserves outflows and the international debt crisis, forced the monetary authorities to devalue the Bolivar and establishing a regime of exchange control. During 1983, there were two exchange rates: the rate of 4.30 Bs/\$ and was used to import food-consumption related goods; another was set at 6.00 Bs/\$ for the remaining imports. In 1984, the Bolivar was again devalued (41%, on average) and the new exchange parity was set at 7.50 Bs/\$. A minority of goods were imported at 4.30Bs/\$ (see Table 4).

The exchange control regime continued throughout the years 1985, 1986, 1987 and 1988, with several exchange rates for different types of imports. For example, in 1986, the exchange operations of the oil and iron industries, as well as the imports of essential goods and services, were carried out at 7.50 Bs/\$, while all other exchange operations were carried out at 14.50 Bs/\$.

The second period of this analysis (1989-1998) initiates with the changes proposed by the second government of Carlos Andrés Pérez (referred to hereafter as CAP II). CAP II received the government from the previous president, Jaime Lusinchi, with a series of economic problems: an overvalued currency, a low level of foreign reserves, and under pressure from the International Monetary Fund to implement a set of stabilization policies (Portillo, 2004).

In March 1989, the exchange control was eliminated, and the role of the Venezuelan central bank was relegated to trade the foreign currencies originated throughout the oil activity. This policy change defined a single floating exchange rate, to be set by the supply and demand of foreign currencies. As stated by Naim (1993), the changes in the exchange rate policy implemented in 1989 resulted in the lowest volatility of the currency since the fixed exchange rate system collapsed in 1983. There was a lot of controversy as to whether the overvaluation of the Bolivar had been reduced during the years 1989-1992. Exporters argued that the exchange rate was overvalued, while some economists argued that it was undervalued and it would feed inflation (Naim, 1993). As this author states, the evidence suggests that the overvaluation was, reduced but not eliminated due to the fact that the real price of oil decreased more than the exchange rate.

By 1992, the government experienced strong pressures to abandon the new policy scheme (Naim, 1993). Two attempts of military coups that year left the government in a fragile position. The central bank began to intervene more actively in the exchange market, and in September 1992 the floating scheme changed to a scheme known as Crawling peg (successive mini-devaluations). This scheme was sustained until mid 1994: in June of that year, the local exchange market was closed and in July another exchange control regime was implemented (Portillo, 2004). This new exchange control regime continued until mid-1996, when it was eliminated and free convertibility was restored (see Table 4).

By July 1996, a new exchange regime, known as “exchange bands”, was implemented. It began with a short period of floatation and then started a scheme of limited floatation between a band of 7.5% around the central parity. The central parity was allowed to move or slide

depending on the monthly inflation goal (Portillo, 2004). This scheme survived the remaining years of this period (1996-1998) and beyond, up to early 2002. Between February 2002 and January 2003 there was a single floating exchange rate. However, this system was aborted as a result of political instability, and a new exchange rate control regime began. During the remaining years of the period studied, 2004-2007, the exchange rate control has been sustained, and the exchange rate has again experienced a high level of overvaluation.

Industrial and commercial policy

This section presents an overview of the regulatory and industrial policy in Venezuela between 1974 and 2007. One of the central assumptions of this research is that the regulatory and industrial policies developed by the Venezuelan governments have contributed to the fall in productivity in the 1980s and the subsequent stagnation.

During most of the period, Venezuelan industrial and commercial policies reveal a preference for measures such as setting maximum prices for goods and services, using indirect subsidies to reduce inflationary pressures, and protecting domestic producers against those from the rest of the world. Price controls minimize or eliminate the risk-adjusted economic benefits for firms while subsidies and protectionist policies allow inefficient local firms to survive. This, in turn, limits the likelihood of consolidation in the respective industries. Both effects reduce the willingness to invest in the country. This also adversely affects private investment because it increases the risk of producing in the country.

From a political economy point of view, two hypotheses explain the path of economic policy. The first hypothesis is that regulatory and industrial policies observed during the period, which negatively affect productivity, are designed to achieve two goals for political parties and dominant interest groups: a) "to buy" political stability and little social conflict, transferring part of the rent to voter groups (consumers and workers in the formal sector of the economy), and b) to transfer short-term rents to economic groups through specific subsidies and preferential policies. The second hypothesis is that the policy preference for short-term effect is the result of an increase in the "discount rate" of politicians and dominant interest groups, which has occurred since the mid-seventies.

Although the first period (1974-1988) was generally characterized by protectionist policies, it is appropriate to assess specific aspects of government policy during each sub-period.

During this time, there were three electoral periods: Carlos Andrés Pérez (1974-1979) Luis Herrera Campins (1979-1984) and Jaime Lusinchi (1984-1989).

The beginning of the Carlos Andrés Pérez government, in 1974, coincides with the first oil boom determined by the conflicts in the Middle East. Between 1950 and 1973, the average oil price was \$ 1.94 per barrel; with little variation around this level (the standard deviation was \$0.43). In the previous five years (1969-1973) the average price of crude was \$ 2.41 per barrel. However, in the period 1974-1979 the average price of crude rose to \$ 11.45 per barrel. Between 1973 and 1974, the increase in crude prices was 184%, and very high volatility has been seen since then.

This rise in oil prices represented a huge increase in the Venezuelan government's fiscal revenue. This high government income resulted in increased public spending as well as growth in demand that was not accompanied by similar growth in the supply of goods and services. This, in turn, generated strong inflationary pressures. The regulatory policy seems to have emerged in response to this inflationary threat as did their social and political consequences. The next section presents the more relevant regulatory measures during this period:

- March 1974: a presidential decree ordered prices of all goods and services to be frozen for 90 days. The goods and services needed for agricultural production were considered essential goods and subject to regulation. Also it was passed the Consumer Protection Law.
- June 1974: firms' rights to terminate employment were suspended for 180 days ("inamovilidad laboral"). Between 1974 and 2007, 18 decrees have been recorded establishing or renewing this limitation on the firms' right to terminate employment (Organización Jurisprudencia del Trabajo, 2007).
- 1974: a law was passed prohibiting unfair dismissal (Ley contra Despidos Injustificados), which increased the cost of terminating workers. At the same time, increases in salaries and wages of up to 25 percent were approved.
- 1976-1979: the policy of setting maximum price limits continued until 1979. In 1976, producers and importers of essential goods were forced to print the maximum allowed price for sale to final consumers on the packaging of products.
- 1976: a new type of regulation was added, which set minimum prices for a range of agricultural products, mainly oilseeds. This measure was taken in response to the shortages

caused by the imposition of maximum prices. This policy continued into 1977, when supply policies were implemented to encourage domestic production, and free importation of a set of goods considered "essential" was authorized.

- 1977: a decree was propagated as "buy Venezuelan," which stated that the government could not import goods when there was supply available of domestic origin (Lucas, 2006).
- 1977: Subsidies were introduced to solve the shortage originating from the imposition of maximum prices. The subsidies policy was aimed primarily at a governmental food production program known as the Corporación de Mercadeo Agrícola.

During this period, there were also industrial policy decisions directed to specific sectors. The case that best illustrates industrial policy is the Venezuelan vehicles assembly industry. The policy of protecting the auto industry resulted in an increase in local vehicle assemblers in the country. By 1975, there were 14 local assemblers and about 240 companies producing inputs for the local assembly of vehicles. As part of the national development policy, a goal was set: by 1980, 75% of the parts for vehicles assembled in the country should be national. In 1978, the importation of vehicles was banned (Lucas, 2006).

In 1978, Luis Herrera Campins won the election and went on to govern the country from 1979 to 1983. In response to shortages caused by the maximum price policy established by the previous government, in 1979 a policy of open competition was adopted and prices were allowed to be set by the interaction of supply and demand (Portillo, 2004). Herrera also eliminated a series of indirect subsidies, whose budgetary burden had become very large. In 1982, the government reduced subsidies on goods and services such as petrol, transport services and telephone and mail prices. While many price controls were eliminated, food price controls were preserved.

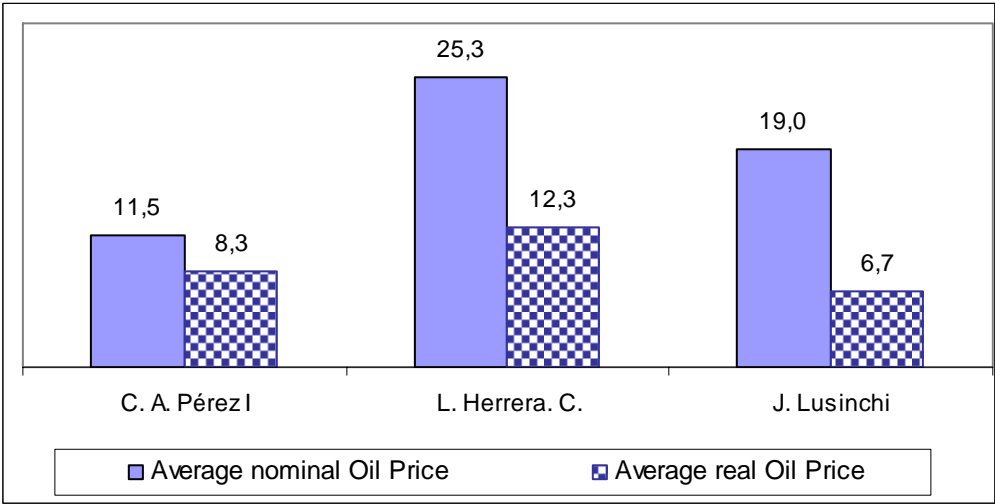
The policy preferences of Luis Herrera Campins' government could be sustained due to the high crude prices observed during his presidential period. As a matter of fact, the average oil price between 1979 and 1983 was \$25.3 dollars per barrel, a level 121% higher than the previous presidential period. As mentioned, the relative liberalization of the regulatory policy was combined with strong overvaluation of the local currency with the intention of evading the political cost of the price adjustments.

The increasing overvaluation of the currency, which allowed the government to preserve political stability while a liberal regulatory policy was set, came to an end in 1983. In 1983, the

local currency was devalued and an exchange control regime was implemented. The free pricing policy was suspended and the *Ministerio de Fomento* was again allowed to set maximum prices.

The third government of this period was the Jaime Lusinchi Administration. At the beginning of this new government (1983), there was a change in the way prices were regulated. The policy of “precios administrados (directly administrated pricing)” applied since April 1983 was changed to a new “corporative regime”. In this new scheme, prices would be set by a commission conformed by delegates of firms, unions and the government itself, which was named “Conacopresa” (an acronym for commission of costs, prices and salaries). Lusinchi’s government was a clear return to protectionism, short-run oriented regulatory policies, and a very “heterodox” monetary policy (Table 4).

Figure 5
Average Oil Price. 1974-1988 (dollars per barrel)



Source: OPEC

As shown by Figure 5, oil prices varied significantly between 1974 and 1988. One of our hypotheses is that the volatility of the oil price, and consequently of the oil fiscal income, reduced the time horizons of the socioeconomic actors participating in the PMP. This, in turn explains why the political system failed to adjust and there was a systematic disintegration of cooperation with negative consequences on productivity.

During the second period (1989-1998), there were three different Presidents in office: Carlos Andrés Pérez (1989-1992) Ramón J. Velazquez (1993-1994) and Rafael Caldera (1994-

1999). In particular, the second government of Perez began with an IMF macroeconomic adjustment program. The regulatory policies adopted by the previous government of President Lusinchi generated important economic distortions. Among them, there were the scarcity of goods and a sizeable decrease in the foreign reserves.

The political program of 1989 was based on competitiveness goals, the development of tradable sectors, free price-setting by firms, and correcting the overvaluation of the local currency. As in other Latin American countries, public enterprises were privatized and the government made efforts to change industrial and regulatory policies from direct ownership and high interventionism to free markets with light regulation. As an example, the Pérez administration eliminated non-tariff barriers on 94% of manufactured imports, eliminated the special permits for exports instituted by previous governments, and reduce the average tariffs from over 35% in 1988 to less than 12% in 1992 (Naim, 1993).

This new policy orientation changed the “traditional” methods of transferring rents: privileged industries varied from non-tradable to tradable ones; the correction of the currency appreciation reduced the exchange-rate based subsidies on imports; and the high inflation of 1989 (around 80%) negatively affected real wages. In exchange for all this, there was a promise of future improvement in competitiveness and real income. Under the hypothesis of the relatively high “discount rate”, as expected, these open market policies were not politically sustainable. During these presidential periods, there were two military coup attempts, and finally Pérez was impeached in 1993.

Rafael Caldera began his presidency in February 1994. The Caldera period was characterized by a weak president and the weakness of cooperation among the main political actors, high social demands, and a significant financial crisis. Facing this context, the government kept a relatively open commercial policy but reversed the market-based price policy. One of the first measures Caldera took was to re-establish the policy of setting maximum prices.

By January, 1994, the government had ordered the prices of a series of goods and services to be frozen, mainly medicines, electricity and products required to meet the daily needs of Venezuelans. Soon after the new president vowed, the prices of the most of the official CPI’s bundle of goods and services would be set by the *Ministerio de Fomento*. The price controls continued through 1995 until mid 1996, when the price policy changed, and controls were again abolished. The maximum-price policy had negative effects on the availability of goods,

generating high levels of scarcity of regulated items, and failing to slow down inflation of basic products. These events put pressure on the government in 1996 to implement a new set of policies characterized as market-oriented policy.

Hugo Chavez won the elections of 1998, and has ruled the country since that year. His first period began in 1999 and extended to 2006. Most of the commercial and regulatory policies inherited from the last part of Caldera continued up to early 2003. The political instability of the years 2001-2003 undermined the political consensus around the commercial and regulatory policies. As a result, the regulatory policy experienced a process of slowly change from a light-regulation approach to a more interventionist approach. The social demands fuelled by the polarization and confrontation period of 2002 and 2003 created the conditions for a new wave of strong regulation and interventionist policies (see Table 4).

During the last period (2004-2007), regulatory policy followed a highly interventionist approach. Since 2003, the prices of around 200 goods and services have been controlled by the government using a mix of maximum prices settings and laws that give the government the ability to control retailers' inventories. Other regulatory policies implemented since 2003 include interest rates controls and employee immobility.

In December 2006, Hugo Chávez won the elections for another presidential period (2007-2012), and the regulatory policy orientation continued down the same interventionist path. In the case of the exchange rate policy, an overvalued currency has been used as a price anchor and as mechanism of political control.

Fiscal policy and volatility

One of the main characteristic in the evolution of the Venezuelan economy, particularly since 1974, is the combination of public expenditure's volatility and pro-cyclicality (Garcia et al., 1997: 9; Puente et al., 2007: 6). Developments in Venezuela highlight the difficulties of making economic policy, and particular budgetary policy in an environment with highly volatile revenue flows, given the fact that fiscal revenues have depended heavily on oil prices and production. Over the years, there has been a strong deficit bias and pro-cyclicality in fiscal policy, driven largely by oil prices. Revenue shocks have thus typically been absorbed by adjustments to spending. As a result, government spending has been characterized by some short-term volatility. This is undesirable, both from a macroeconomic standpoint, since government spending may

have exacerbated the cycle, and in terms of the effectiveness of spending planning and control. Such instability has been very costly for Venezuela, given that its economy and budget adjust asymmetrically. On the upside, growth increases little; on the downside, output contracts. Rapid growth in public spending, which often follows oil price increases, reduces spending quality and introduces entitlements including recurrent costs commitments, which are often not sustainable in the long run. Productivity and efficiency often suffers from a high proportion of unfinished projects as well as from capital investments that cannot be effectively used because of shortages of recurrent resources (Eifert et al., 2002: 3).

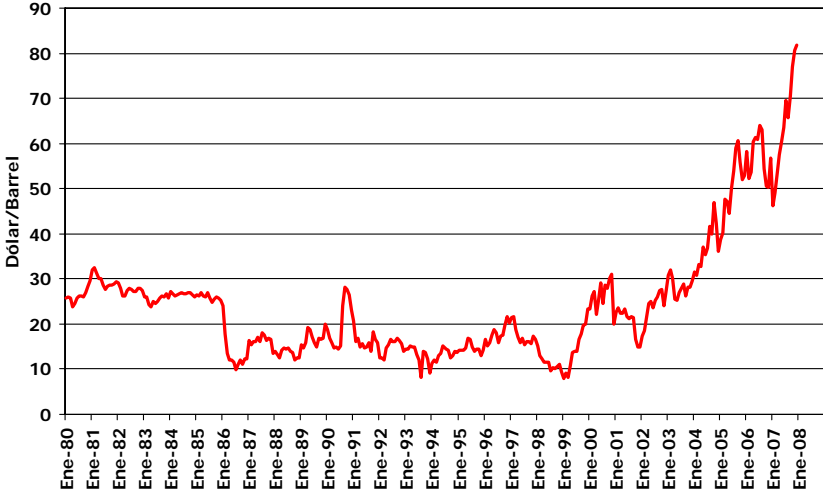
It is worth mentioning that oil prices have been highly volatile, usually twice as variable as other commodities (Dehn, 2001). Changes have also been poorly predicted, and it has been difficult to separate temporary fluctuations from general trends. For example, the 1974 and 1979 price increases were not foreseen either by Venezuelan or by international forecasts. By the early 1980s, high prices were widely blamed on scarcity, with projections of \$50 per barrel or even higher. Instead, the spike of the early 1980s was followed by the oil slump and a sharp decline in price. Despite such variability in the income brought about by the oil shocks, the majority of government fiscal income has consistently come from oil revenues. This explains an important part of the volatility of the fiscal policy, and in general of total economy, which has depended fundamentally on the behavior of a very unpredictable international oil market (figure 6.).

Moreover, as was stated in the first part of this document, the Venezuelan public sector is an important exporter in relation to the size of the economy. In the last three decades the oil export accounted for more than 80% of total exports, the state has produced more than 90% of all foreign assets in the economy, and more than 50% of the government fiscal income has consistently come from oil taxes and revenues. In consequence, a devaluation of the real exchange rate has improved both the country's fiscal balance and current account. For this reason the exchange rate has been also used with relative frequency to generate fiscal benefits since 1983² Consequently, external shocks and the use of the exchange rate as a mechanism of fiscal correction have created a notable volatility in public expenditure. Consequently, an overvalued exchange rate has entailed a subsidy to the private sector (by much the main importer in the economy), whereas devaluation has functioned as a tax transfers income from the private

² After the huge outflow of private capital had deprived the Venezuelan Central Bank of most of its liquid foreign exchange reserves, in February 1983 the government of Luis Herrera Campíns decided to put an end to 19 years of fixed exchange rates, to devalue the currency and to implement a regime of exchange controls.

to the public sector. For this reason exchange rate management in the Venezuelan case has been of the utmost importance, not only from the perspectives of competitiveness, productivity and long-term growth but also as a basis for a sound fiscal policy (Rodriguez, 1991: 242)

Figure 6
Venezuelan crude oil basket³. 1980-2007 (US\$/Barrel)



Source: Ministry of Energy and Mines.

As already mentioned, during the past three decades Venezuela has been subjected to various exogenous shocks which have rendered the pursuit of sound economic policy very difficult. Among them, the major global booms and recessions, by affecting the level of oil demand, have generated positive or negative shocks for exports. These uncontrollable external factors have had substantial effects on income levels and fiscal variables. They may improve or worsen the fiscal situation and, by doing so, may bring about fiscal policy responses. In Venezuela, as in other developing countries, the impact of external shocks on fiscal variables is

³ The Venezuelan Crude Oil “Basket” is a mix of light and heavy crude.

much more direct or automatic than in industrial countries. At the same time, the country's ability to neutralize these effects is much more limited.

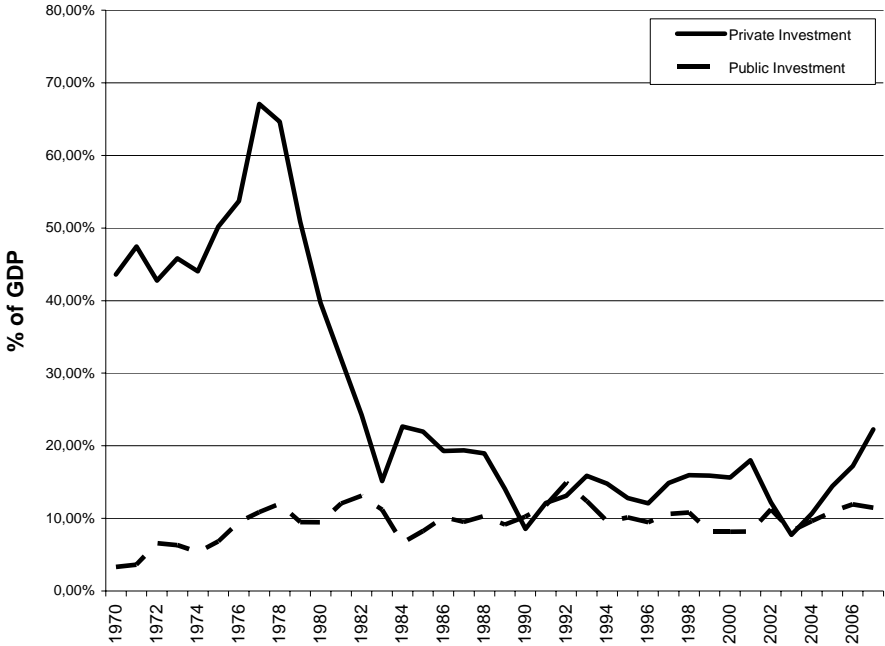
Another main feature of fiscal policy in recent period has been the reduction of spending in areas which are fundamental for macroeconomic growth and productivity. Public expenditures in Venezuela have rarely moved up or down as smoothly as they do in advanced industrial nations. This has been remarkably volatile with sudden leaps succeeded by gradual declines. This phenomenon basically reflects the high correlation of total public expenditure with oil fiscal income. During the early 1970s, public spending of the central government was around 22% of GDP. External debt was then relatively low, implying that this expenditure was basically primary spending (spending net of interest). As a result of the strong increment in oil export prices in 1974, total public spending increased to levels higher than 30% of GDP. However, this increase in public spending was concentrated fundamentally on transfers to finance the public wage bill, investment in public enterprises and subsidies compensating the losses of these enterprises, as well as different utilities (Garcia et al., 1997: 343, Naím, 1993: 38). Subsequently, as a consequence of a significant decrease in oil income and the increase of interest payments on the debt acquired between 1974 and 1983, public expenditure decreased gradually from the mid-1980s to 23% of the GDP in 1999. This level of public expenditure in real terms per year is similar to the level of the 1960s in Venezuela and is below the average for Latin American countries.

Moreover, governments tried to correct their fiscal imbalances in an unsustainable manner, such as the reduction of real wages in the public sector and the postponement of operating expenses, maintenance and public investment. The capital spending of the *Sector Público Restringido* (SPR) during the 1990s was on average 10% of GDP. There was a clear tendency of reduction, passing from a peak of 13% of GDP in 1993 to 7% six years later; in real terms. Despite the important increase during the period 2004-2007 the level of government investment in 2007 is approximately a third of that in the early 1970s (figure 9) In the case of road infrastructure, for instance, public resources available in 1998 (a year of severe budget adjustments) allowed the financing of less than half of the required road maintenance. Public investment was one of the adjustment variables of fiscal policy in the past years. The cuts and delays that have been implemented have almost certainly affected infrastructure programs essential to the country's development. This reduction has had negative effects on the life of the

inventories of goods and equipment which are essential to the population, seriously harming social equity and economic efficiency and productivity.

Figure 7

Private and public investment as percentage of GDP. 1970-2007



Source: Venezuelan Central Bank

It should be pointed out, however, that a slight turn in both the TFP and labor productivity is reported in the data for the period that goes from 2004 to 2007. The relative good performance and slight turn that registered during this recent and short period has very much to do with the renewal of the oil windfall combined with a PMP favored a particular macroeconomic policy arrangement. The oil windfall in an environment in which power was consolidated within a low number of key political players, let the room open to policies essentially directed to the consolidation of political power. An increasing level international reserves and net foreign assets allowed the government to keep the exchange rate fixed and to spend more money in the conservation and promotion of "patron-client" relationships. Though the decision to keep the exchange rate fixed postponed the potential political cost of an exchange rate adjustment, it also clearly harmed the tradable sector and favored the development of the non-tradable sector.

Moreover, expansionary fiscal policy started to reflect the increasing importance that interest groups (such as the “boliburguesia”) developed in the design and promotion of public projects and programs. Public investment increased during the period along with private investment in non-tradable (see figure 9). Productivity in non-tradable, specifically in services started to increase and through the reallocation of resources from tradable towards non-tradable may explain the recent increase in overall productivity.

Conclusions

As the evidence suggests, both measures of productivity in Venezuela, TFP and labor productivity, registered a period of steady decline that between 1970 to 1983, and since 1984 have shown stagnation, with a small recovery during the last four years. Though shift-share decomposition of labor productivity indicates that aggregate productivity changes are mainly explained by productivity changes occurring within sectors, the changes coming from structural changes (28%) can not be neglected. Resource reallocation away from sectors with high productivity appears to be the norm in the case of Venezuela. Moreover, the dynamic shift effect (interaction term) is negative, indicating that a shift occurred in sectoral employment shares from high-productivity to low-productivity sectors (such as services). It should be remarked that, among the analyzed sectors, the biggest productivity changes occurred within non-tradable sectors.

From the general policy making process perspective, four distinctive sub-periods between 1974 and 2007 were identified as having the following main characteristics:

First Period (1974-1988) - Strong Presidential power within a cooperative system strongly influenced by a corporative arrangement in a limited political competitive context.

Second Period (1989-1998) - Weakened Presidential power and stronger parliamentary forces within a non-cooperative system and a fragmented political context.

Third Period (1999-2003) - Constitutional and informally powerful President with no political competition, in an environment of weak cooperation and increased confrontation.

Fourth Period (2004-2007) – An even stronger President with no political competition, almost absolute control of discretionary decisions and important role the in policy making process, low number of key players and weakening of institutions, transparency and accountability.

As demonstrated in this study, a clear connection can be established between the policy making process, the bias of public policies and the reallocation of resources. In that respect, the evidence shows that public policy has been responsible for the reallocation of labor resources towards low-productivity sectors. In particular, over the period, the predominance of policies that favor the appreciation of the real exchange rate, local business protection through generalized trade barriers, subsidies, tax exemptions, etc. may explain the reallocation of resources from tradable to protected-non-tradable sectors, and consequently the risks to productivity growth. These factors connected with a declining and volatile oil rent during the 1980s tended to reduce the time horizons of the socioeconomic actors participating in the policy making process. This thus explains why the political system failed to adjust, and systematic disintegration of cooperation had negative consequences on productivity.

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