

Resource Revenue Management in Venezuela: A consumption-based poverty reduction strategy

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Abstract

The oil sector in Venezuela is the largest source of foreign currency, the biggest contributor to the fiscal sector and the leading economic activity. During the 1997-2006 bull market, rent from the oil sector was \$259.71 billion, according to our calculations, and the government take over this period was \$200.68 billion. This paper reviews the management of the rent. The main priority of the government has been reducing poverty. Although quite successful, this policy has been carried out mainly through an implicit “consumption based” strategy, and might not be sustainable.

Executive Summary

The oil sector is the dominant force in Venezuela. The sector represents 80 percent of exports and is the largest source of foreign currency. Depending on the oil price, the sector delivers 40 to 70 percent of the government's income, and it is the biggest contributor to the fiscal sector. The sector comprises more than 25 percent of all economic activity.

In this paper we review the management of Venezuela's oil income, or oil rent. First we explain the institutions set in place to manage the rent as a background to understanding how revenue is spent. The government is managing the windfall through discretionary mechanisms, created for this purpose. We discuss how the government has bent the rules of a stabilization fund, and opts for saving in much more discretionary funds. We also explain the off-budget mechanisms to bypass the revenue sharing arrangements with regional and local governments.

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Then we present our main observation that the priority of the government is to reduce poverty mainly through an implicit “consumption based” strategy. The government spends oil income through direct transfers into social programs called *misiones*. In addition, the government is increasing the state participation in the economy: it has drastically increased the state role in the oil sector and has nationalized or purchased electric utilities, banks, sugar mills, agricultural suppliers and other companies.

We review literature on the political economy of Venezuela to support the idea that the current “consumption” policy of poverty reduction is not sustainable. The current administration has two constituencies: the popular bases and the radical ideologists. President Hugo Chavez tries to balance the interests of both constituencies. Because there have been 12 electoral events since December 1998, public spending was boosted to win votes every round.

Finally, we examine reasons why this poverty reduction strategy might not be sustainable. These social programs usually lack conditionality and do not address structural problems. Thus, human capital has not substantially improved. Furthermore, economic growth has been relatively low as government policies discouraged private investment.

The paper is organized as follows. Section 1 reviews the importance of the oil sector in the country. Section 2 looks at the size of oil income (the oil rent) and the institutions that manage it. Section 3 presents how the revenue is spent and reviews recent literature about the political economy of rent management in Venezuela to support our arguments. Section 4 discusses the outcomes of this pattern. Section 5 presents the concluding remarks

1. Venezuela: a country highly dependent on oil

Venezuela has been a net oil exporter for close to 100 years, and oil reserves have continued to increase, especially in the last decade. The Venezuelan national oil company Petroleros de Venezuela (PDVSA) says the current proved oil reserves are 211 billion barrels compared with just 76.9 billion barrels in 1999.¹ In fact, OPEC's Annual Statistical Bulletin for 2010 puts Venezuela's proven crude oil reserves at 296.5 billion barrels, which makes Venezuela's reserves the largest in the world and 32 billion barrels higher than Saudi Arabia.

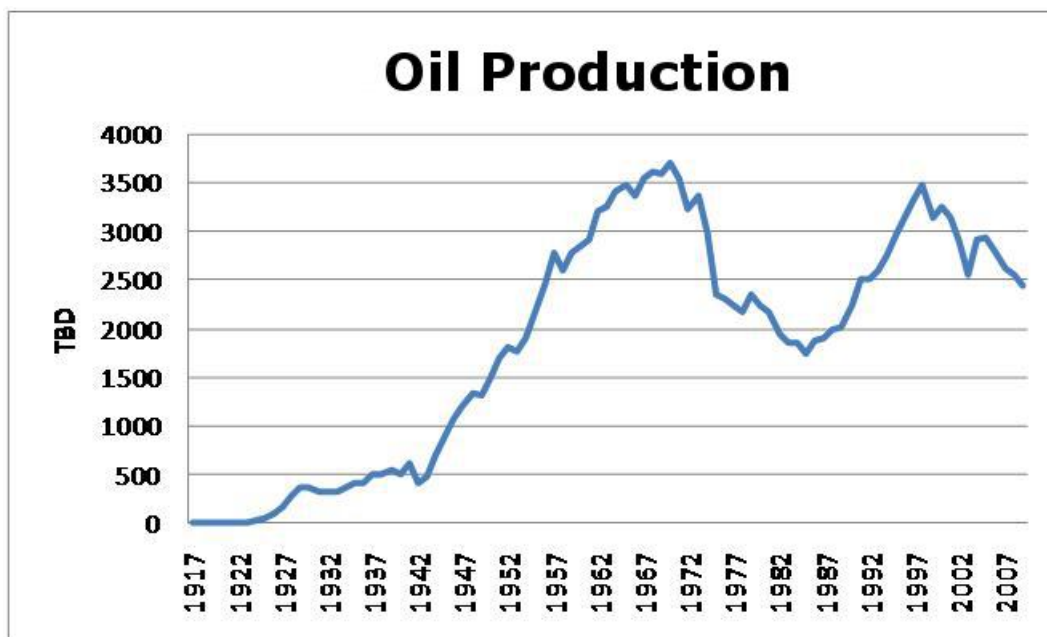
Venezuelan oil reserves could be roughly divided into two categories: conventional and extra-heavy oil. Assessments for conventional oil are around 41 billion barrels, with the balance coming from heavy oil, which has an average API of 8.6 degrees. This thick oil slurry is difficult to transport and refine, which raises the cost of production. Advances in refining technology allow heavy oil to be upgraded to so-called synthetic crude oil. In turn, this synthetic, lighter oil gets refined into consumer fuels such as gasoline and diesel.

¹ However according to international sources, British Petroleum (BP) Statistical Review of Oil Energy Venezuelan reserves are only 172 billion barrels. Nevertheless, even at this level, Venezuela will claim the third largest oil reserves in the world.

The abundance of oil has made the Venezuelan government highly dependent on oil revenues, and the addiction has introduced policy challenges. Given the boom-bust nature of oil markets, efficient management of this revenue has proven to be difficult -- not only in Venezuela, but in most oil-producing countries.

As a result, Venezuela and its oil industry have seen ups and downs. As shown in Figure 1, there have been different production cycles. As argued in Manzano (2010), most of these cycles are associated with investment cycles and are therefore linked to policy decisions. Periods of expansion occur when the government reduces its take and PDVSA, or any other producer, has resources to invest. The opposite happens when the government takes a bigger slice of the rent.

FIGURE 1

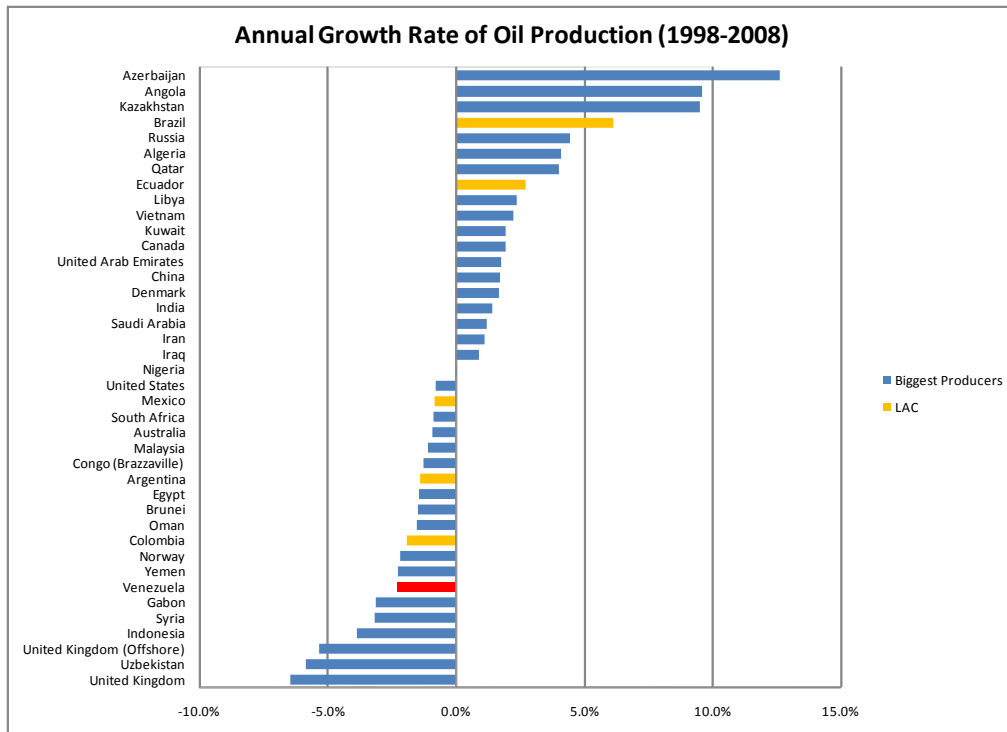


Source: MEM (various years)

In recent years, oil reserves have risen 10 times their size of 30 years ago, but production levels have remained similar. The most recent peak of oil production in Venezuela was in 1998, according to the British Petroleum (BP) 2010 Statistical Report. After that year, the Venezuelan oil industry was unable to expand production levels.² As shown in Figure 2, since 1998, Venezuela has underperformed compared to other oil producers.

FIGURE 2

² It is very important to mention that after that year many disparities existed between the level of production claimed by PDVSA and by international sources. In 2009, PDVSA said its production was around 3.1 million barrels per day (bpd). The BP Statistical Report puts the production figure for Venezuela at only 2.6 million bpd.



Source: EIA (2010)

How much is the government earning from this output through taxes and fees? The Venezuelan fiscal regime is complicated and involves different taxes and royalties, which, furthermore, have seen major changes in the last ten years. Manzano and Monaldi (2010), discuss those changes. Currently, the system comprises the following:

- Income tax: 50 percent
- Royalties: The conventional crude oil rate is 30 percent. The rate applicable to extra-heavy oil could be under 30 percent, but it depends on different circumstances. The rate could be decreased if it can be proven that an oil field in the Orinoco Belt is not economically exploitable with a royalty of 30 percent. In the case of conventional and extra-heavy oil it can be reduced to a minimum of 20 percent. The government can raise the rate when it can be proven that a project is economically viable again. This payment is deductible from the income tax.
- Surface taxes: This annual tax -- 100 tax reference units per square kilometer -- covers acreage that is part of a company's lease but not being exploited.
- Extraction Tax: The tax equals one third of the value of liquid hydrocarbons extracted in the area, calculated with the same rule as the royalty. Special conditions exist that could lower this tax. In practice, this tax represents an additional royalty of 3.33 percent that PDVSA and Orinoco Belt projects have to pay.
- Own use tax: This tax is the equivalent of 10 percent of each cubic feet of fuels produced and used in the company's own operations, calculated as percentage of the consumer price.

- Export tax: This tax is equivalent to 0.1 percent of the value of hydrocarbons exported from any port in the nation. For the payment of this particular tax, the seller should inform the ministry about the volume, API degrees, sulfur composition and destiny of the shipment.
- Special Contribution over Extraordinary Prices on the International Market of Hydrocarbons Law: This is only paid when the Venezuelan crude basket's monthly average price is over \$70 (USD). Under such conditions an additional royalty of 50 percent on all above \$70 has to be paid. In case the price is over \$100, the additional revenue rate will be 60 percent. This additional royalty payment and the regular royalty payment are deductible from the income tax.

In the last decade fiscal income from oil accounted for 48 percent of total fiscal income, which makes the government vulnerable to oil market shocks. To become less vulnerable to the oil price, the Venezuelan government has been diversifying its revenues. In 2009, for example, when fiscal oil revenue decreased by 35 percent, total fiscal income fell by just 9 percent.

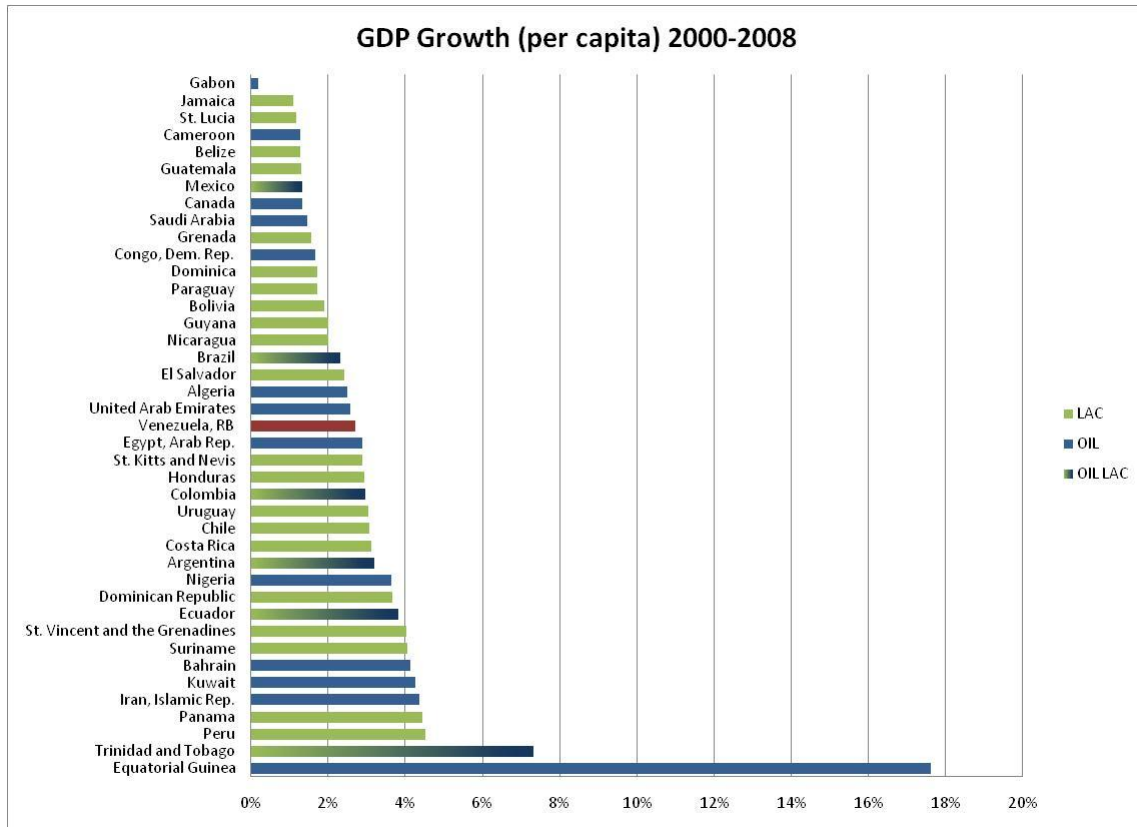
Venezuelan oil-related goods and services are the main component of the country's exports. Since 1997, oil export values have been more than 60 percent of total exports, and increasing steadily to 92 percent in 2009.

It is no surprise that the country's Gross Domestic Product (GDP) relies heavily on oil, and accounts for 15 to 25 percent of the economy.³ Numerous linkages exist between the oil and non-oil sectors, both through fiscal channels and demand for goods and services by the oil sector.

Venezuela's recent performance in terms of economic growth has not been bad compared to the rest of South American countries. As shown in Figure 3, between 2000 and 2008, the Venezuelan annual real per capita GDP growth rate was slightly higher than the South American average -- 2.7 percent versus 2.4 percent. However, the one discouraging characteristic is the volatility of this growth rate. Colombia and Ecuador experienced similar average growth over this period but less volatility and no negative growth rate. Venezuela's growth rates were as low as minus 9 percent and as high as plus 18 percent.

FIGURE 3

³ The debate on how to measure oil's contribution to GDP and how it should be included in national accounts has a long tradition (See Batista, 1989). The share of the oil sector changes every time the base year is changed in the National Accounts. The Central Bank, which is in charge of the National Accounts, has not given guidance on how to deal with this characteristic of the Venezuelan economy.



Source: World Bank (2010)

Furthermore, it is important to note that the Venezuelan economy did not experience high growth in 2008. The rate was just 4.8 percent, which is counter-intuitive given the peaking oil price that year. The average per capita GDP growth in Venezuela between 2000 and 2008 was slower than the average for oil producing countries (3.7 percent) and for Latin American oil producers (3.4 percent).

2. The oil windfall and the institutions that manage it

So how much money is the oil industry generating? Who is in charge managing its allocation? The money from the oil industry is here referred to as oil rent. Rent is the sales price of oil or gas minus the cost of production, which is the cost of taking oil or gas out of the ground and bringing it to market.

A sizeable rent

In order to calculate the magnitude of the oil rent we present three different estimates. The first is the International Oil Rent Estimate of the Ministry of Energy and Oil in billions of U.S. dollars.⁴ The second calculation, our calculation, is based on international prices and the extraction costs of oil in Venezuela. The third is an estimate of the oil rent that the Venezuelan government

⁴ See MEM (various years)

receives in the form of taxes and royalties, taking into account the domestic fuel subsidy. The three calculations are presented in Figure 4.

Our estimate is based on the following equation:

$$TOR = [(AXP - APC) \times OP] - [ARC \times OR]$$

TOR= Total Oil Rent (Billion US dollars)

AXP=Average Export Price (US dollars per barrel)⁵

APC=Average Production Costs (US dollar per barrel)⁶

OP= Oil Produced (Billion barrels)⁷

ARC = Average Refining Costs (US dollar per barrel)⁸

OR= Oil Refined (Billion barrels)⁹

Our calculation shows a fairly similar trend to the ministry's, yet the magnitude of the oil rent is significantly higher. Because the ministry fails to explain its methodology, it is unclear where the differences come from. One possibility is that the ministry does not include the domestic fuel subsidy in its calculations. In these figures, the oil rent had increased since 2001 although it took until 2004 to surpass the oil rent of 2000.¹⁰ In our calculation, the rent as share of GDP grew from 13 percent in 1997 to 33 percent in 2006.

FIGURE 4

Oil Rent (Billion US Dollars)

⁵ Source: MEM (various years)

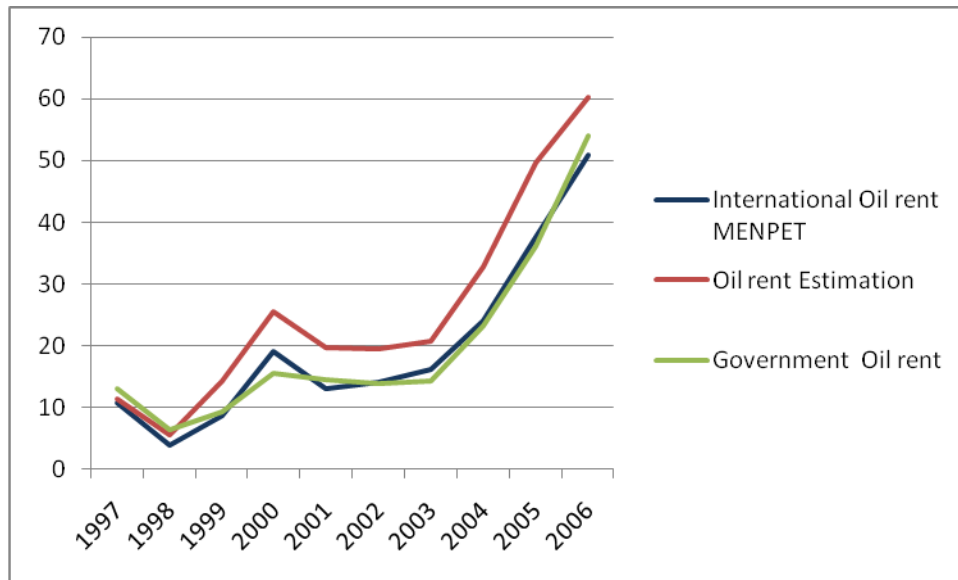
⁶ Source: MEM (various years)

⁷ Source: MEM (various years)

⁸ Source: MEM (various years)

⁹ Source: MEM (various years)

¹⁰ This difference was not at all stable from as low as 6 percent to as high as 62 percent. Another difference in both estimations is the start year of the increasing trend, whereas the Ministry estimation showed it since 2001 our own estimation showed the increasing trend only since 2003.



Source: Author's calculation and MEM (various years)

A key factor affecting the government's oil income is the domestic fuel market. Domestic fuel subsidies are part of the rent that the government transfers to consumers, through lower oil prices. To assess the value of the subsidy, we multiplied the difference between average domestic prices¹¹ and average international prices¹² of Venezuelan oil by the country's domestic consumption. As expected, the subsidy showed a similar evolution as the oil rent and increased from \$1.1 billion in 1997 to \$9.9 billion in 2006. As with the total oil rent, most of this increase came after 2003. This supports the case that the government's estimate of the rent does not include the fuel subsidy component.¹³

Adding the royalties and the most significant taxes, along with the domestic fuel subsidy, shows that the government take of oil rents was consistently greater than 60 percent from 1999 to 2006. In fact, the rent showed a rising trend during this period. The total rent generated between 1997 and 2006 was, according to our calculations, \$259.71 billion, and the government take over this period was \$200.68 billion.

Figure 5 looks where the rent is coming from. Royalty income was consistently the greatest component, representing an average 40 percent of government take from 1997 to 2006. The second most important component of the government take was found to be the domestic fuel subsidy with an average 18 percent. However, the composition of the income generators changed considerably between 1997 and 2006. The average of the period and the composition

¹¹ Domestic prices are heavily subsidized in Venezuela. As a reference, a liter of gasoline at the pump costs around 21 cents of \$1 at the official rate. Source: MEM (various years)

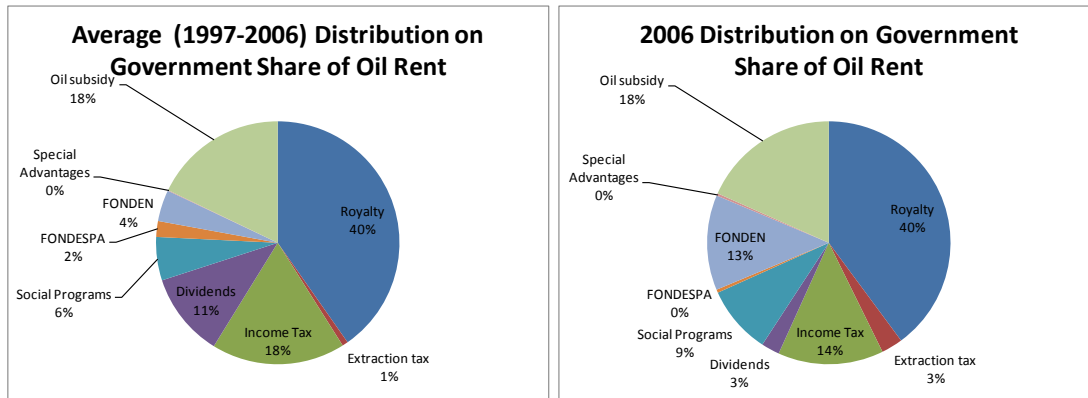
¹² As we explain later, Venezuela does not officially subsidize foreign consumers, but offers soft payment terms to them.

Venezuela has set up a mechanism called "Petrocaribe" to help net importers of oil.

¹³ In other words, for the calculation of the oil rent, the government uses domestic prices for domestic sales.

in 2006 make that clear. In 1997, the main component was the income tax with 50 percent of the total government take. Yet, this was only 6 percent in 2002 and it stabilized around 14 percent in 2006. The main component in 2006 was royalty income with 40 percent of government take, versus 26 percent in 1997.

FIGURE 5.



Source: Author's calculations

Another noticeable difference is the increase in off-budget money transfers from the national oil company (PDVSA) to social programs. This mechanism consists of social programs implemented by PDVSA and two discretionary administered Funds (FONDEN and FONDESPA). FONDEN has received over \$28 billion in the last five years.¹⁴ PDVSA spent more than \$33 billion on Social Programs between 2005 and 2009. These mechanisms were on average 20 percent of the total government take and the trend is rising.

Dealing with the resource windfall

What are the mechanisms to manage the windfall? As argued by Manzano et al (2010), there have been unsuccessful attempts to stabilize fiscal expenditures in the past. In the middle of the boom in the 1970s, the government created the Venezuelan Investment Fund (FIV), which received significant off budget resources. Instead of sterilizing the windfall, the FIV invested in

¹⁴ There are serious problems of lack of transparency and accountability in these parallel budgeting mechanisms. PDVSA's financial reports for 2009 state that no money was transferred to FONDEN in 2005, 2006 and 2007, although its previous reports stated that \$15 billion were transferred to this particular fund.

Venezuela during the boom.¹⁵ It helped to create a set of energy-intensive industries, in a strategy to diversify from oil. These investments did not help to reduce volatility.¹⁶

In the late 1990s, the stabilization fund FIEM (Investment Fund for Macroeconomic Stabilization) was created during a period of low prices. The original design was relatively orthodox, with clear saving and spending rules, but quickly it was modified by the Chavez administration, making it more discretionary. The FIEM was supposed to smooth fiscal expenditures both at the central and lower government levels, but in fact, it seems to have introduced more macroeconomic volatility.¹⁷ The FIEM was used as an instrument to control the regions, because the executive got discretion over the disbursement of funds saved by the states.¹⁸ The FIEM was rendered useless by the constant changes to its rules. Essentially, with the approval of each new budget law, a new change to the fund was approved. The FIEM effectively became inoperative to the point that from 2006 to 2008 there were few additional savings added despite high oil prices.¹⁹

The last attempt at savings was the National Development Fund (FONDEN), created in 2005 with the purpose of being the financial instrument for leveraging economic growth and sustainable development. The fund's main objectives are to finance productive investments in education and health; to finance social and economic development projects at home or abroad; and to finance any other project that is in need of funds. The board of directors includes the Ministry of Finance, the Ministry of Planning and Development and the Executive Vice-President. Also, FONDEN resources are not shared with regional and local governments. With this structure, the fund is not independent and is discretionally used by President Chavez.

FONDEN's resources come from two main institutions. The first is PDVSA. The fund receives all oil windfall taxes paid by PDVSA and by private partners in joint ventures, and any additional resources demanded directly by the nation's president. The other source of funding is the

¹⁵ Between 1972 and 1981, Venezuelan exports rose from \$3.2 billion to \$ 20.1 billion. During that period the government, either through direct capital transfers or through "financial acquisitions", transferred US\$ 30.5 billion to public sector enterprises. This was done mostly using the FIV, though as public enterprises became institutionalized the transfer went directly to them. Consequently, between 1972 and 1981, the FIV had only saved \$2.5 billion in the Central Bank.

¹⁶ Furthermore, most of these firms were extremely inefficient and a source of recurrent expenditure for the central government. With the market-oriented reforms of 1989, the FIV was then put in charge of selling state assets.

¹⁷ Clemente et al (2002), using a general equilibrium model, found that the FIEM increased the volatility of most macroeconomic variables.

¹⁸ The initial reform set a low oil price as the trigger for the government to save. Therefore, the government, including at sub national levels, was forced to save in the fund when oil prices were low. Since the government had expenditure commitments, it had to issue new debt to fulfill these commitments. Therefore, the government was growing indebted in order to save in the fund. The political economy rationale of this non-optimal arrangement was that it gave the executive more discretion over the use of resources.

¹⁹ According to Central Bank figures, the FIEM held \$732 million in December 2005. In December 2008, it held \$828 million. To put these numbers in perspective, oil exports were \$39 billion in 2005 and \$87 billion in 2008.

central bank. It transfers some of the international reserves when they exceed a certain level considered "sufficient".²⁰

By the end of 2006, FONDEN held \$8.87 billion and FIEM held \$768 million. Of a total government take of rent of \$200.68 billion between 1997 and 2006, the combined savings in the funds were \$9.63 billion by end 2006.

Over time, the amounts transferred from PDVSA have not followed a predictable rule and could be considered highly discretionary. Between 2005 and 2008, the money transferred to FONDEN increased, but the rise between 2007 and 2008 was minimal, although 2008 was the year when oil prices peaked. The rise in FONDEN funds should have been higher, but claims on PDVSA funds by the government prevented appropriate contributions.

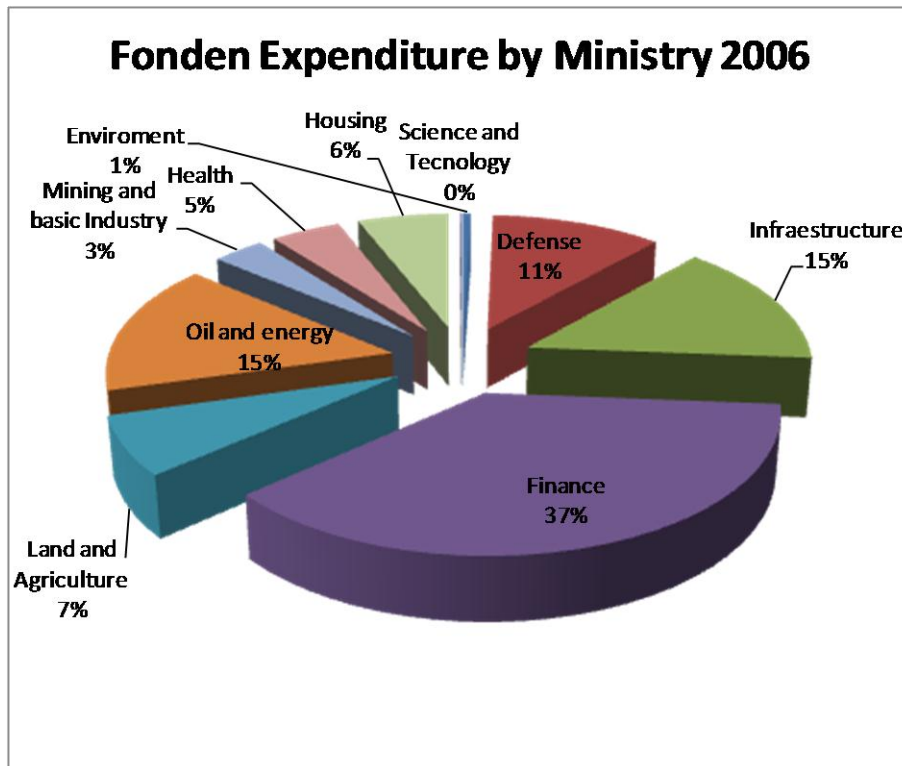
The FONDEN transfers from both PDVSA and the central bank have been erratic. The rules of transfers imply higher transfers from PDVSA when the oil price is high. Similarly, one would expect to see higher transfers from the Central Bank during high oil prices since foreign exchange reserves would rise well above the level of sufficiency. Yet, this pattern does not appear. When PDVSA transfers a large amount, the Central does not, and vice versa. In 2005, only 20 percent of FONDEN's resources came from PDVSA, whereas in 2008 over 80 percent of FONDEN's funding was made by PDVSA.

The FONDEN capital is mostly spent domestically in development projects executed by ministries. The total spending was \$9.85 billion in 2006, of which \$3.68 billion was transferred to the Ministry of Finance, \$1.52 billion to the Ministry of Energy and Oil, and \$1.09 billion to the Ministry of Defense. This represents 63 percent of the resources and does not appear to consist of social development projects. (See Figure 6.)

Surplus FONDEN resources are invested in international markets. In 2006, the investment portfolio of FONDEN was \$8.85 billion and 4.5 million Euros; 29.65 percent of these funds were invested in short-term instruments as cash deposits and 70.07 percent were invested in longer term instruments such as bonds. The nominal yield of FONDEN's portfolio in 2006 surpassed the US treasury bills rate and the LIBOR rate.

FIGURE 6

²⁰ It is important to note that these transfers are made without compensation. In other words, the balance on the Central Bank has a loss for the reserves transferred to the central government.



Source: FONDEN (2006)

3. The use of the oil rent: A poverty reduction strategy implicitly based on consumption

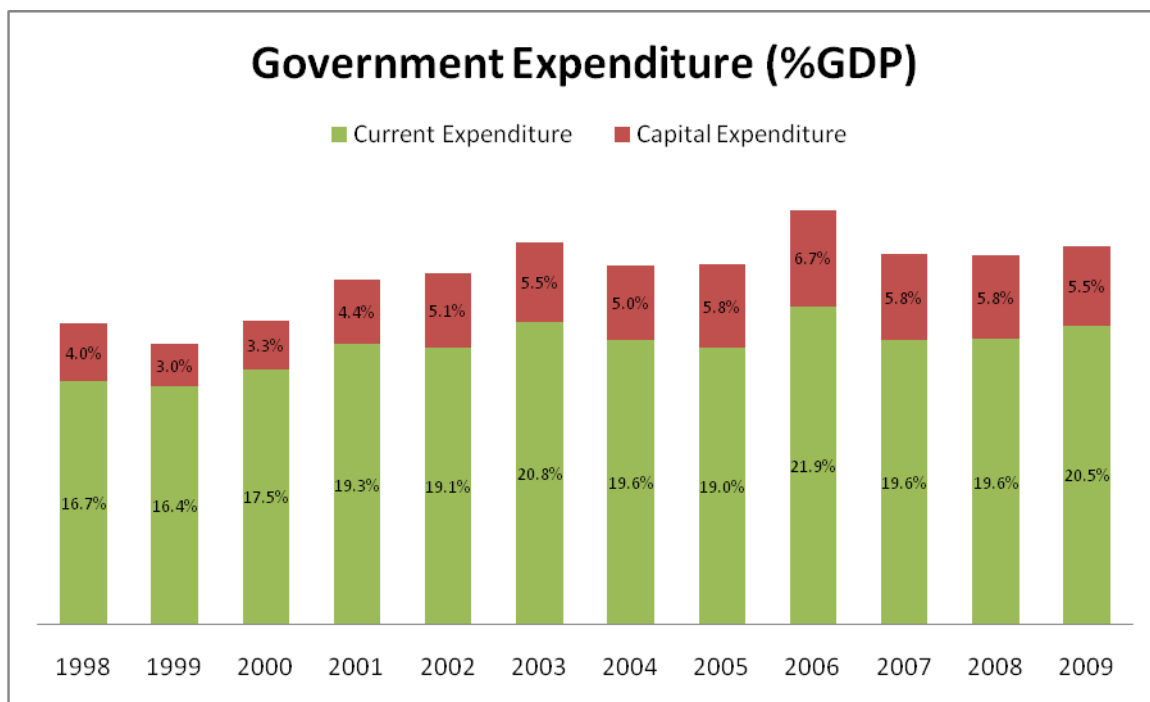
The country received a significant windfall in oil revenues -- it reached around 33 percent of GDP in 2006, and 60 percent of that went to the government. There were no institutions set up to automatically save part of the windfall, apart from dysfunctional FONDEN. Therefore, the use of the rent depended on government decisions, mostly by the executive. How was this rent used?

Expenditure priorities

Against a background of increasing rents between 1998 and 2009, government expenditure rose from 20.7 percent to 26 percent of Gross Domestic Product (GDP) in that period, underlining the government's growing dependency on oil.²¹ Oil prices at the end of the last century were low and the central government size was relatively small. As oil prices rose, the share of government expenditure as a percentage of GDP also increased.

FIGURE 7

²¹ As we explain later, this could be also a signal that government spending crowds out private investment.



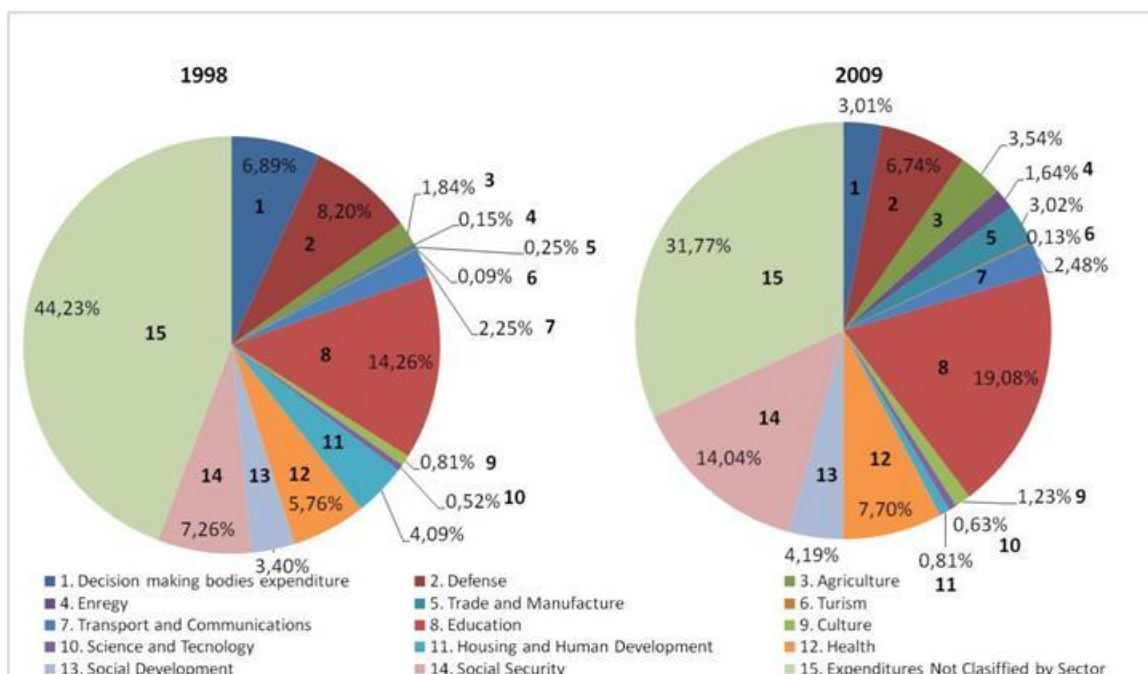
Source: Ministry of Finance

The composition of central government spending between 1998 and 2009 was on average 21 percent capital expenditure and 79 percent current expenditure (Figure 7). However, there were some fluctuations. In the first years of this period up until 2001 the share of capital expenditure averaged 17 percent. This supports the concept that capital outlays drop faster than consumption expenditure in times of recession. Capital expenditure recovered after 2000.

The distribution of public spending reflects the poverty reduction strategy of the government. Figure 8 shows the focus on the social sectors. The greatest increase from 1998 to 2009 was in education, health and social security. Combined spending on education, housing, health, human and social development and social security went from 34.77 percent of the budget to 45.64 percent in that period. The main reduction came from expenditures not classified by sector, which includes debt service and sub-national government transfers. The share of defense spending actually decreased.²²

FIGURE 8

²² Despite recent reports of arm deals between Venezuela and Russia, official figures show that defense is a low share of spending. Outside the budget, FONDEN has committed 88 percent of the resources received in projects. Of those 7.6 percent are for “defense projects”. Therefore, even taking into account the off budget allocations, defense has a declining share.



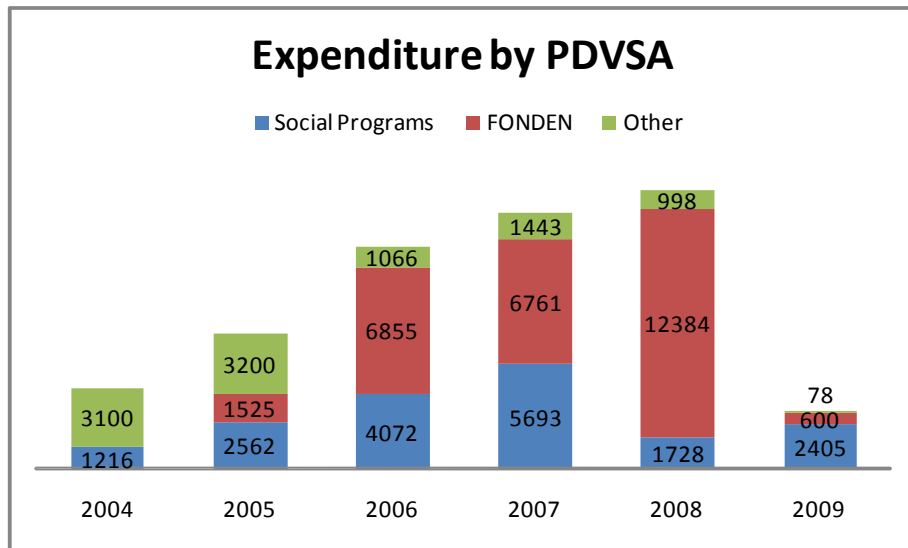
Source: ONAPRE (Oficina Nacional de Presupuesto)

Regional and local governments received less money from Caracas with the implementation of off-budget mechanisms and a strategy to reduce revenue sharing. This handed more control to the executive. Appendix 1 explains how the federal arrangements have changed.

PDVSA pays for three major programs outside the government budget. First, PDVSA pays for social programs; secondly, it transfers resources to FONDEN; thirdly, PDVSA pays directly into various similar, but much smaller funds such as FONDESPA and the Agriculture trust fund.

As seen in Figure 9, the composition of the total off-budget expenditure made by PDVSA does not follow a stable path. In the four years through 2009, more than 90 percent of PDVSA contributions went to social programs and FONDEN. To put these numbers in perspective, the 2006 public spending from PDVSA represented, in our calculation, 34 percent of the rent, 11 percent of GDP and the equivalent of 37 percent of the government's national budget expenditure.

FIGURE 9



Source: PDVSA Financial Report (2009)

The evolution of off-budget spending seems to be linked to international oil prices. A rising trend can be seen until 2008, when oil prices peaked (and, as to be expected, PDVSA's social contributions dropped significantly in 2009). Venezuela has seen a clear shift towards higher social spending, both directly through government spending, and indirectly from the off-budget vehicles. From the box we see that most of 'las misiones' imply some transfer to participants and/or subsidies.

Social Programs: “Las Misiones”

The current administration has implemented a series of social programs called “misiones”. According to Aponte (2010), on average 50 percent of these were financed with extra-budgetary resources between 2003 and 2007, mainly through PDVSA and FONDEN. Officially there are 12 “misiones” and around eight other social programs. Some of the key programs include:

Mision Robinson: for adult literacy. Originally, it was only an educational program, but now has a productive component and some type of financial support.

Mision Barrio Adentro: Provides medical care to the poor by sending doctors to live in impoverished neighborhoods.

Mision Ribas: A program for high-school dropouts to finish schooling in a parallel system.

Mision Lanceros: A part-time work program of low-skill jobs paid for by the government.

Mision Vivienda: A program for housing. It includes provision of land, basic services and, in most cases, houses for low- income families.

Mercal: A network of supermarkets that do not pay Value Added Tax.

The amount of money spent on the programs not just fluctuates with the oil price, but also with elections. In 2004 and 2005, spending on the misiones came to 2.4 percent of GDP. The spending rose to 5.5% of GDP in 2006, to coincide with presidential elections. Expenditure fell to 5.3 percent of GDP in 2007, when a referendum failed to approve a constitutional change that would have implied indefinite re-election of the president and more power to the executive. In 2008, social spending is thought to have fallen fast, even though official data is scarce. PDVSA’s direct expenditure on *misiones* collapsed by 80 percent in 2008, and another 70 percent in 2009.

Despite all the money invested, the programs fail to produce resounding results. Lacruz (2006) states that the benefits of these social programs do not seem to match the amount of resources invested in them. Ortega and Rodriguez (2008) suggest great inefficiencies in the *Mision Robinson*. They estimate that the average cost per pupil was between \$536 and \$1035, well above the estimated cost estimate from UNESCO of \$61 for Latin America. In addition, they do not find a significant effect of the *mision* in literacy rates.

It has been widely recognized that the budgetary process in Venezuela is rigid, and this inflexibility affects how the government achieves its policy goals. A large share goes to local governments (see appendix). But this is decentralization in name only, since transferring money

to local governments does not imply transferring responsibilities. In most instances, the central government continues to deliver the services.

In addition, programs managed through the budget have to deal with such issues as unions and earmarks. If the government wants to achieve a particular objective, it does so via extra-budgetary allocations.

Controlling the Economy

A second official priority has been to increase state control of the economy. The government started by taking a larger stake in the oil sector, what some called a "re-nationalization" (see Manzano and Monaldi, 2010). Then the government nationalized or purchased electric utilities, banks, sugar mills, agricultural suppliers and others, spending \$22.8 billion. Though the sum is small compared to the total government rent received since 1996 (around 11 percent), it is clearly more than the amounts saved in FONDEN and FIEM. In addition, the amount of rent used for this purpose has been increasing. In 2007 the government spent around \$5.6 billion, compared to \$3.8 billion in 2008. The figure could reach \$13.4 billion in 2009.²³ The government has also set-up joint ventures with "friendly" countries in businesses like bicycle factories and oil.

This increasing state participation in the economy could have negative effects. There are signs that private enterprises expropriated or bought by the government have lost productivity after nationalization. Instead of buying private firms, the government could be spending on public power and transport infrastructure, which have not improved over the last decade.

The government also has been financing oil purchases of regional net-oil importing countries. This initiative is called "Petrocaribe" and allows for soft financing terms, such as below-market interest rates and a long debt maturity. The higher the oil price, the higher the share the Venezuelan government is willing to finance. Furthermore, payments of the loan can be made in goods as Venezuelan imports. In 2009, around 20 to 25 percent of oil exports (equivalent to 17 to 21 percent of oil production) are done through Petrocaribe or similar mechanisms that allow for loans and payments in goods.

The "Revolution": The political economy of rent use

Since the discovery of Venezuelan oil early in the twentieth century, there were two dominant views on how the rent should be spent, explained Urbaneja (1992). The first, which Urbaneja called the "Positivist" model, argued that the rent should be spent on infrastructure and developing the private sector in order to modernize the nation. This view prevailed in the first half of the century and was held by a succession of authoritarian governments. As argued in Manzano (2010), back in the 1950s, Venezuela was up there with the best of Latin America in terms of coverage of roads and electricity.

²³ These numbers are estimates, since in some cases there is still a negotiation between the government and the affected firms on the "fair" price. See ODH (2010)

With the advent of democracy came the “Democratic” view, which argued that rent should be spent on “the people”. This led to an expansion of social spending. After 1958, a succession of democratic governments achieved an impressive record improving the education and health sectors.

Both views counted on rising rents. As argued in Hausmann (2003), the rent distribution model lacked mechanisms for sharing financial pain. Once the rent declined after 1978 due to the collapse in oil production and prices, this flaw became apparent.²⁴ Furthermore, Urbaneja (1992) argued that the sudden increase in revenue due to the increase in prices in 1973 led to abandonment of an implicit system of “accountability,” when suddenly benefits were given to all sectors at once, instead of to just a few per year, making the downward adjustment harder.

This led to a prolonged economic crisis. GDP per capita shrank 23 percent -- in constant local currency -- between 1976 and 1985. After that, it remained stagnant until 2001 and poverty increased. As reviewed in Corrales (2010), most political scientists concluded that the so-called “Fourth Republic” or the “Punto Fijo Regime” suffered from excessively exclusionary politics: Political institutions became too rigid to give entry to new, smaller, non-dominant political forces, which led to an inability to implement necessary reforms, which in turn sparked anti-status quo sentiment by a large sector of the population.

Political crisis ensued. In 1989, an increase in gasoline prices prompted riots, looting and hundreds of deaths in major cities. Two coup attempts followed in 1992. The following year, for the first time in the democratic era, a president was impeached.²⁵ That same year, the traditional two-party system and Rafael Caldera, the founder of one of those parties, split from his party to win the presidency with the support of several smaller parties.

Against this background, President Hugo Chavez came to power in 1998. Chavez was a former military man who led one of the coup attempts in 1992. His political platform was based on breaking with the past and on a “revolution” that would give “power to the people.”²⁶ Chavez won with the support from members of the middle class who were fed up with the crisis. But the core support came from the poor. This explains why most of the oil rent is going to social spending. The fuel subsidy is the only major expenditure that is hard to explain as it seems to benefit the rich more than the poor, who cannot afford cars (see box).

²⁴ Oil production fell from 3.7 million bpd in 1973 to 1.7 million bpd in 1985. As documented in different sources (see Manzano, 2010), this drop resulted from a mix of policies and external conditions, including the appearance of new producers with lower costs than Venezuela, the policies of “extracting” more rents from the sector that led to the Nationalization and then OPEC quotas.

²⁵ Simply put, President Carlos Andres Perez was impeached for channeling funds to help with the security of the newly elected president of Nicaragua without proper authorization. The episode reflects Perez’s loss of political capital after implementing a program of structural adjustment. See Gonzalez, R et al. (2004) and Gonzalez, M et al. (2004).

²⁶ His main slogan in different political campaigns has been “*Con Chavez manda el pueblo*” (“With Chavez, the people rule.”)

There is another, ideological factor. Corrales (2010) argues that Venezuela became a safe haven for extreme-leftists, at a time when it was a democracy while most Latin American countries had authoritarian regimes. Some institutions remained closed to participation but many political institutions actually offered shelter to a number of non-dominant forces. Until the 1990s, these forces, many ideologically far to the left, were not governing in Venezuela, but often found themselves in blossoming social environments. These included universities (starting in the late 1960s), the military (starting in the late 1970s), small parties and neighborhood associations (starting in the 1980s), and national and sub-national executive and legislative branches of government (starting in the 1990s).

This gave rise to the group of civilians and military who is currently leading the country. They have a hard-line leftist approach to the economy and society. This group believes that the state has to have more control of the economy, which explains the policy of nationalizations. Also, the group pushes for the expansion of their model abroad. Initially, they were governing with more traditional politicians. During his first administration, Chavez kept the finance minister of the previous administration and relied on political figures of old parties, such as Luis Miquelena, who was interior minister and came from a small traditional party, and Jose Vicente Rangel, an old-guard politician who was vice-president. The current administration has a younger generation in high posts, which comes from institutions mentioned by Corrales (2010).

Is the fuel subsidy a pro-poor policy?

Venezuela's fuel subsidy is hard to explain as policy of a leftist government. This subsidy is regressive because car owners, middle and upper classes, benefit proportionally more from it than the lower income classes, who do not own cars.²⁷ This seems to go against the government's poverty reduction policies, yet there is some historical background. Middle and upper classes are well organized and influential in political decisions. In the past, information campaigns argued repeatedly that fuel should be cheap because Venezuela is an oil producer.

It is important to mention February 1989, when the government implemented a series of pro-market reforms, especially the increase of gasoline prices. The measure was taken suddenly, without negotiations with the transportation sector, and two days before the regular pay date. Bus fares rose without notice, and many worker lacked enough money to pay for the rise. This triggered a wave of protests, riots, looting and violence that lasted two days and forced the government to declare martial law.²⁸ Once the country had stabilized the leader of the president's political party declared that Venezuela had suffered the "cold kiss of the International Monetary Fund."

Ever since, an increase in fuel prices is associated with liberal pro-market reforms. This does not mean that prices have not been adjusted since. In 1995, the government of Rafael Caldera,

²⁷ Rigobon (1993) estimated the distributional impact of this subsidy, concluding that it was regressive.

²⁸ There are no official figures on how many people died because of this event, named the "Caracazo" after the capital, Caracas. Unofficial estimates range between 300 and 500.

facing a fiscal crisis, adjusted fuel prices to close the fiscal deficit in the context of an IMF program. The adjustment came without causing social commotion. There were intensive information campaigns and public transportation subsidies. However, fuel price increases remained associated with neo-liberal policies.

History shows that Chavez has two constituencies: the popular base and the ideologists. The interests of the two constituencies are not necessarily the same. Different opinion polls have found little popular support for more radical measures. The government has even lost a referendum to make changes to the constitution that would have institutionalized a more radical leftist model.

The president tries to balance the interests of both constituencies. There have been 12 elections since December 1998 -- presidential, parliamentary and regional elections,²⁹ as well as referendums.³⁰ As a result, spending on social programs has taken priority to assure electoral success.

4. Unsustainable outcomes?

In terms of poverty reduction, Venezuela performed well from 1997 to 2008, as seen in Figure 10. In 1997, 54 percent of the population lived below the poverty line, and 23 percent was below the extreme poverty line. In 2008, only 24 percent of the population was considered poor and only 9 percent of the population lived in extreme poverty.

²⁹ Regional elections in Venezuela have national implications, since the electoral schedule implies that all regional authorities (governors, mayors and state assemblies) are elected on the same day.

³⁰ There has been one referendum to revoke the president and two on changes to the constitution.

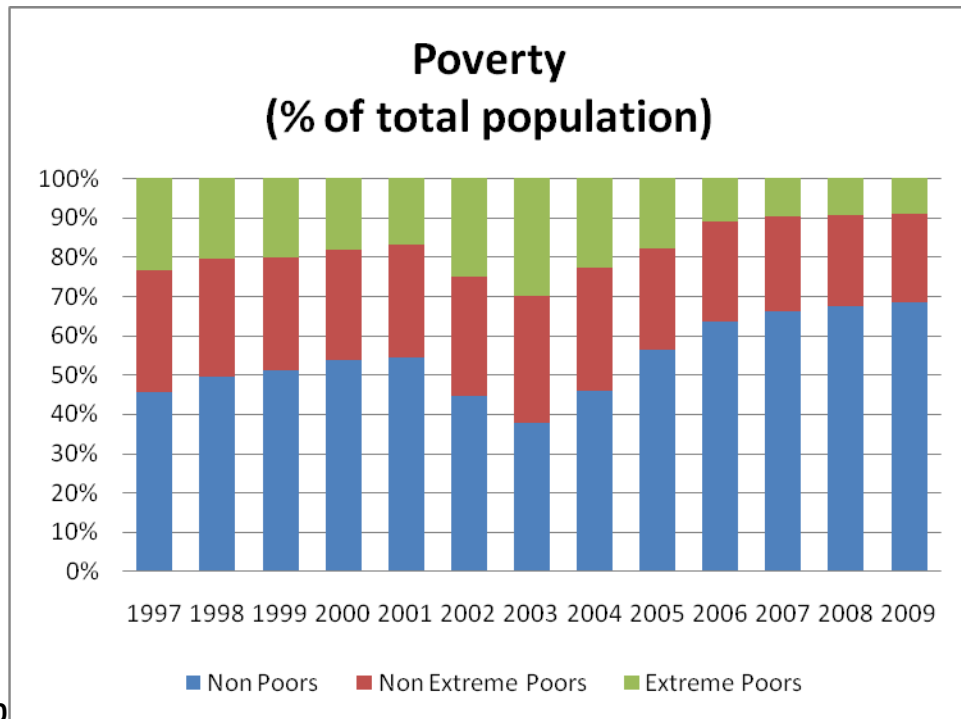


FIGURE 10

Source: INE (Various years)

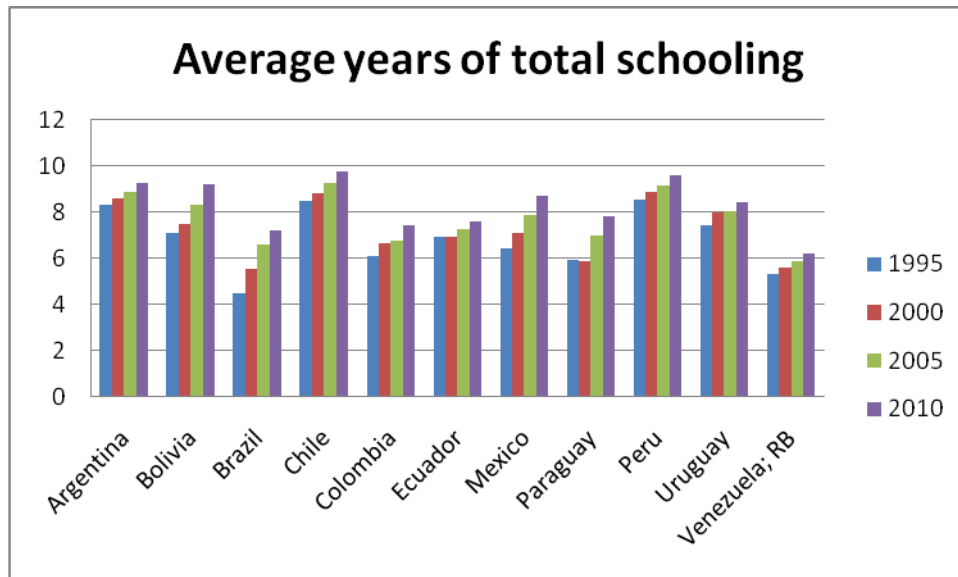
Poverty reduction was done in a context where per capita GDP growth (2.4 percent) was slower than the average for oil-producing countries (3.7 percent) and Latin American oil producers (3.4 percent). Data indicates that the poverty reduction programs funded by PDVSA and the government are having a significant effect. As expected, these policies had a similar impact on the overall inequality in income distribution. Venezuela's GINI Index, which measures income inequality, came down from 48.79 in 1997 to 43.44 in 2006, pushing Venezuela in the process from rank four in South America to number one.

Considering these reductions in poverty, education indicators are not encouraging. As seen in Figure 11, the average years of schooling among people over 25 years was 5.29 in 1995, the lowest in South America, and 1.56 years lower than the South American average. In 2005, the average years of schooling was 5.8, and still the lowest of South America. It was, in fact, 1.85 years lower than the South American average. Despite a stated focus on education, the gains in human capital are low.

The results reflect two other deep problems. First, the social programs were generally poorly designed, with little focus on targeting, quality and outcomes. Secondly, structural problems were not addressed in the educational system. Venezuela has had a public education expenditure system similar to an inverse pyramid, with most of the expenditure going to public universities. In addition there are issues of quality as well as problems with teacher assistance and infrastructure. The social programs increased demand for education, but supply constraints have not been addressed.

It is clear that human capital is important for poverty reduction. Spending on education should be primarily focused on the base of the pyramid, the public school system, instead of on the top, on public universities. Proper education can help reduce poverty by increasing labor productivity and increasing wages for the poor.

Figure 11



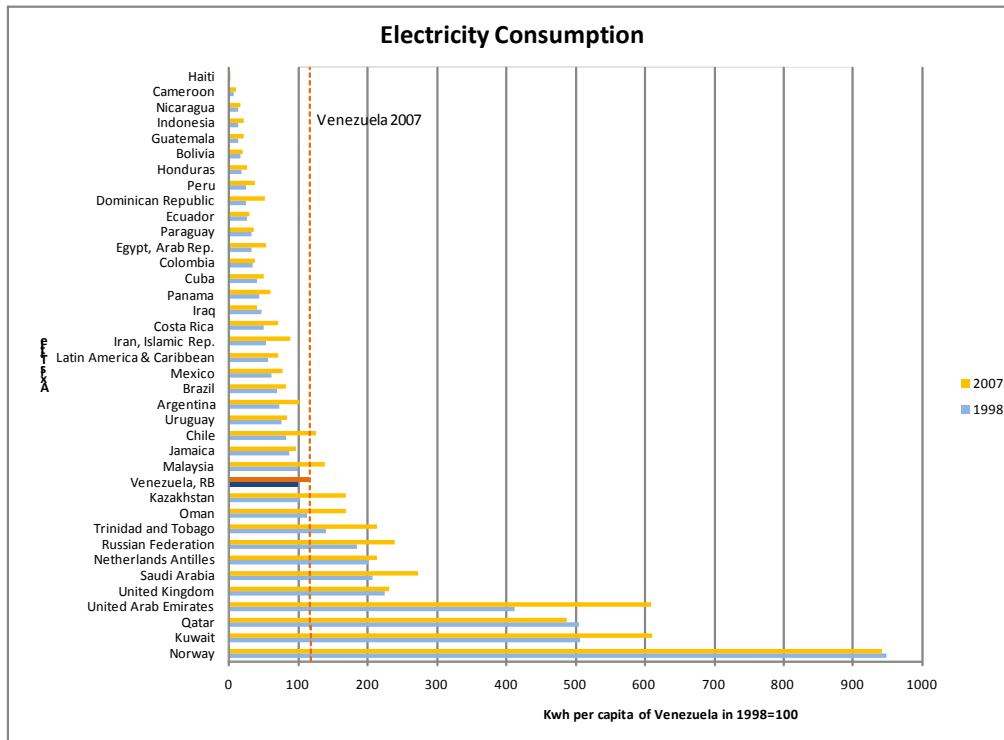
Source: World Bank (2010)

Even where the system works, are the results sustainable? To sustain gains in poverty reduction it is important to generate economic growth. But growth is soft, and private investment has been lagging, due to the policy of nationalizations and a perceived negative environment for the private sector. In 1997, private gross capital formation was 15 percent of GDP, low by Latin American standards. The average for 1997 to 1999 was 16 percent. In 2009, it represented 10 percent of GDP and the average for 2007 to 2009, when the nationalizations increased, was 9 percent. Private investment actually fell in real terms.

Moreover, public goods and services did not help make the private sector more productive. Whereas most South American countries had expanded their road networks, Venezuela did not build a single mile between 1997 and 2000. Likewise, Venezuela's electricity production has not kept up (see Figure 12). It has lost much of its leading edge over other Latin American and oil producing countries, as these countries have been expanding their coverage, such as Chile.³¹ In 2001, Venezuela had better broadband access (in per capita terms) than the average in Latin America but that fell below that average by 2008. Also, some oil countries that had lower internet access in 1997 (Malaysia, Qatar, Russia), now have better access. Therefore, despite the oil boom and available resources, other Latin American and oil producing countries have been catching up with or surpassing Venezuela in terms of public infrastructure.

³¹ In other words, the growth rate of the Venezuelan coverage has been low given its initial level.

Figure 12



Source: World Bank (2010)

At the same time, institutions in Venezuela have deteriorated, especially in recent years. According to World Governance Indicators (WGI) the Voice and Accountability Index in 1996 was 0.08 and was superior to Peru, Paraguay and Colombia. In 2008 the index hit -0.59, the worst in South America and 0.81 lower than the continental average. Worldwide, Venezuela was in the 51st percentile rank from low to high on this index in 1996. Venezuela's position plummeted to the 30th percentile rank in 2008.

In terms of rule of law, Venezuela's conditions also declined over the last decade. The Rule of Law Index in 1996 was -0.60 and was the third worst after Colombia and Peru. In 2008, this Index experienced a significant decrease reaching -1.60, the worst in South America, and 1.14 lower than the continental average. Worldwide, Venezuela was in the 30th percentile rank in 1996, from low to high on this index. The country's position in 2008 plummeted to the second percentile rank. This positions Venezuela as one of the ten countries with the worst rule of law.

As for corruption, Venezuela's Control of Corruption Index was -10 in 1998, just above Equator' and Paraguay, and 0.59 lower than the South American average. Venezuela's Control of Corruption Index reached -1.20 in 2008, becoming the country with worst control of corruption in South America, 0.91 lower than the South American average. Worldwide, Venezuela was in the 24th percentile rank from low to high on this index in 1998. In 2008, this position had plummeted to the 8th percentile rank.

Though the government disputes these rankings, it acknowledges there are problems. In its annual report, the General Comptroller recognizes that a lack of institutional structure has led to resource waste, from unfinished projects that are already paid for, to money transferred to communal councils³² that have not given a proper accounting of its use. Most notorious are instances of wasted food.³³

All these indices demonstrate the deterioration of Venezuelan institutions and overall transparency and accountability. This erosion of institutions explains, in part, the wasted resources and lack of effectiveness of policies.³⁴ It raises concerns about the sustainability of the gains in poverty reduction.

5. Conclusion

In this paper we showed that Venezuela's oil rent has increased, mostly because of rising world crude oil prices. Oil production has not grown and Venezuela has under-performed compared to other producers.

This windfall in oil rent has been mostly appropriated by the government through different channels such as the national oil company, which is still the biggest producer in the country. PDVSA has been forced to contribute to off-budget funds. These vehicles allow the central government to avoid rent sharing with other levels of government and allow for less scrutiny.

In terms of priorities, the main objective of the government has been to spend money to alleviate poverty, with mixed results. Venezuela has made important progress in poverty reduction. In addition, the government has dedicated resources to bolstering the role of the state in the economy, such as expropriating or buying numerous private enterprises. This has impacted private sector investment.

The Chavez Administration came to power promising a “revolution” with radical left-leaning ideas. Its spending mirrors its main constituencies: poor people and ideologues. Yet, the

³² Communal Councils are a mechanism set by the current administration, to bypass local and regional government. The idea is to transfer resources directly to the people but in reality this weakens the federal system. See Manzano et al. (2011) for a complete description of evolution of the federal structure in Venezuela.

³³ In one of the best-documented cases, in 2010, millions of tons of rotten food were discovered in different ports and distribution centers. Social programs were supposed to deliver the food.

³⁴ A final consequence of the different objectives of the rent distribution is the pressure of the government cash flow when oil prices go down. Only about 45 to 50 percent of the total oil production is fully paid. There are no precise numbers, but given the different financing agreements and domestic subsidies, the government receives only a fraction of oil revenue. It is estimated that 20 to 25 percent is sold through Petrocaribe. Some 16 percent is sold in the domestic market at a loss. Finally, the government contracted a loan with China to be paid with oil. Around seven to nine percent of production goes to pay this loan. In 2009 when prices fell due to the international financial crisis, the government cash flow felt the pressure.

administration's poverty reduction strategy might be unsustainable for three reasons. First, social programs usually do not have any conditionality and do not address structural problems. As a result, there has been no substantial improvement in human capital. Second, economic growth has been relatively low as well as private investment. This has created insufficient opportunities for poor people to improve their situation. Finally, a deterioration of institutions has undermined public policy. A lot of money is not reaching its target.

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Appendix: The decline in revenue sharing between levels of government.

One of the main characteristics of Venezuelan fiscal regime is the revenue sharing arrangement with lower levels of government.³⁵ Until 2009, three main mechanisms served to decentralize public spending.

- Constitutional Revenue Sharing: This arrangement consisted of the distribution of 20 percent of the Ordinary Fiscal Income to sub-national levels of government, of which 80 percent went to states and 20 percent to municipalities.
- Special Allocations Law: This arrangement consisted of the distribution of a minimum 25 percent of the Collected Fiscal Income to sub-national levels of government. Of this, 42 percent went to state governments, 28 percent to municipalities and 30 percent to communal councils.
- Intergovernmental Decentralization Fund: This consisted of the distribution of no less than 15 percent of the Income collected from the Value Added Tax to sub-national levels of government; 42 percent of this amount went to state governments, 28 percent to municipalities and 30 percent to communal councils.

In 2010, the Intergovernmental Decentralization Fund was eliminated, and an Inter-Territorial Compensation Fund was created. This fund does not have a rule for allocations. Instead, its income sources are decided by the Executive Power, the sub-national levels of government and other sources defined by law. The creation of this fund reflects the decreasing transparency and accountability of the central government.

One of the main challenges present in the management of fiscal revenues is the rigidity of the budget law. Various legal entitlements and earmarks account for a high proportion of the Venezuelan formal budget (Budget Law).

Revenue sharing to sub-national governments represents about 27 percent of the ordinary budget.³⁶ Further inflexibility results from salaries and debt service. Puente (2005) estimated that more than 50 percent of the ordinary budget is highly inflexible,³⁷ thus about half of this rigidity is due to revenue sharing. These limits constrain the central government's overall fiscal effort.

³⁵ See Manzano et al (2010) for a review of the federal system and its relationship with the oil sector.

³⁶ Historically, these rigidities can be explained by a political economy argument. In order to control the political pressure of sub-national government for a higher share of the oil rent, revenue sharing arrangements had to be made. These arrangements were set out in the constitution in order to gain credibility. Since the rule cannot be adjusted easily, the central government ended up with a highly rigid budget.

³⁷ Other entitlements and earmarks include: the severance payment fund (one percent of the ordinary budget); the Judicial Branch (two percent); the Social Security Fund (1.5 percent of salaries in the public administration) (Puente, 2005).

This helps explain the efforts to bypass the formal budget and use mechanisms of parallel budgeting. These off-budget vehicles provide the central government flexibility because they are not bound to the same legal entitlements and earmarks as the formal budget. Because of a larger use of these parallel funds, spending by sub-national governments went down between 1998 and 2007, compared with rising spending by the central government. Local and regional expenditure has decreased as oil prices rose.