THE ILLUSION OF AN ECONOMIC RECOVERY IN VENEZUELA AND THE RULE OF LAW RESTORATION UNDER EXTREME CONDITIONS

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I

Between 2013 and 2020, Venezuela experienced a severe economic crisis, with its Gross Domestic Product (GDP) collapsing by over 80%, comparable to countries facing wartime situations. This economic collapse triggered a complex humanitarian emergency, leaving vulnerable sectors of the population excluded from essential goods and services, particularly in the food and health sectors. The Inter-American Human Rights Commission attributed the migration crisis - the largest in the region - to this emergency and gross human rights violations.

However, after 2020, a gradual shift occurred, and the economic collapse slowed. In 2022, according to the IMF, Venezuela's GDP surprisingly grew by 8%, far surpassing the Latin American average. This unexpected economic recovery garnered various labels, such as a capitalist turn that abandoned socialism, authoritarian capitalism, or the new Venezuelan economy.

It is important to note that this outcome was not a result of economic policies designed to address the binding constraint on economic growth in Venezuela. One notable factor was the lack of effective replacement for the market mechanisms that were destroyed due to socialist policies. Additionally, Venezuela continued to rank in the last position on the Rule of Law Index. This raises a significant question: how could the Venezuelan economy improve despite the absence of democratic institutions?

By delving deeper into the complex economic and political dynamics during this period, we can better understand the factors that contributed to Venezuela's economic recovery amidst challenging circumstances.

II

Acemoglu and Robinson assert that inclusive institutions, which encompass political and economic rules preventing government abuses, promoting democratic governance, and safeguarding economic rights, are crucial for economic growth. In contrast, extractive institutions favor government abuses, corruption, and decimating economic rights.

Broadly speaking, inclusive institutions are reflected in the rule of law. Following John Tasioulas, the rule of law can be defined as an institutional set that establishes the conditions the law must fulfill to be legitimate, including conformity with democratic procedures or fundamental human rights.

As an institutional set, the rule of law primarily operates as a formal concept, with the Government sanctioning the institutions embedded in it through codified constitutions, mandatory precedents, legislation, and other regulations. Venezuela, like many other Latin American countries, has adopted a rule of law model based on the supremacy of the Constitution and a rational system of rules, principles, and values that prevent Government abuses based on the separation of powers and the recognition of fundamental rights.

The Constitution recognized economic rights, including economic freedom and private property, thereby allowing market mechanisms to allocate goods and services and preventing government abuses. However, since 2002, these formal institutions have been systematically violated through centralized controls, such as price and foreign exchange controls and expropriation policies. Consequently, the market mechanisms were torn down, and society was deprived of its fundamental economic rights.

Furthermore, arbitrary policies regarding the oil industry led to the collapse of production controlled by the national oil company PDVSA. The Government also expanded an unsustainable financial debt, while non-financial debt increased due to expropriation policies. As a result, when the arbitrary policies caused the collapse of petro-dollar revenues, the Government faced financial difficulties in repaying the debt. The government continued the repayment instead of restructuring the debt, dramatically reducing imports, especially food and medicines. With the national private sector unable to meet demand, the shortage of foreign exchange contributed to the complex humanitarian emergency.

The economic recovery of Venezuela, a subject of study by the IV National Assembly since 2016, was based on three key pillars, following Ricardo Hausman's perspective: (i) legislative reforms aimed at reinstating market mechanisms, (ii) debt restructuring, and (iii) the recovery of the oil industry, primarily through legislative reforms to allow private investment in upstream activities.

According to the Constitution, these pillars were part of a broader objective: restoring the rule of law in Venezuela. For that purpose, it was necessary to reinstate the separation of powers and suppress the *de facto* legislative functions concentrated in the Presidency.

To implement these reforms, the IV National Assembly considered an Omnibus Law, a special legislation compiling the most compelling legislative economic reforms, facilitating a transition from a state-centered economy to a market-centered one. The Omnibus Law also provided a special legislative framework to implement social policies addressing the complex emergency, primarily through direct transfers to vulnerable sectors and humanitarian aid organizations.

The Omnibus Law drew inspiration from cases where state-centered economies transitioned toward market-based economies while preserving welfare policies. The ultimate goal was to promote a transition towards reconstructing the market mechanisms, empowering civil society to organize itself to supply goods and services. This legislation was part of a broader institutional transition, as the 2019 Transition Statute outlined, aimed at recovering the constitutional order.

However, between 2013 and 2016, another binding constraint emerged—the collapse of the State's capabilities.

III

State capability can be defined as the effective design and implementation of policy actions guided by the goals established in International Law and the Constitution. Various indexes measure state capability, particularly its fragility, such as the Fragile State Index, published by the Fund for Peace.

According to the Fragile State Index, Venezuela's state capacity increased until 2012, attributed to its capability to enforce centralized controls since 2002. However, since 2013, the state capacity has experienced a dramatic collapse, placing Venezuela alongside Haiti as one of the most fragile countries in the region.

This collapse of state capability aligns with Francis Fukuyama's observation that political decay can diminish the State and society's capacity to achieve collective goods. Furthermore, Venezuela exemplifies that informal and social arrangements arise when the fragile State cannot provide adequate coverage, known as areas of limited statehood. As Lant Pritchett puts it, these are "deals" through which society organizes itself to address goals the fragile State cannot achieve.

These areas of limited statehood in Venezuela have given rise to illicit activities, ranging from corruption to money laundering and illicit mining operations. Transparency Venezuela estimates that these illegal activities could account for as much as 20% of the 2022 GDP.

The legislative reforms designed between 2016 and 2019 assumed that the State would be capable of enforcing those reforms effectively. However, state fragility has become *the* binding constraint, creating a significant gap between the *de jure* rule of law and the *de facto* reality. Due to the lack of enforcement capability, formal institutions remain largely ignored, paving the way for the emergence of informal and eventually illegal institutions, including organized crime arrangements.

The collapse of state capability poses a severe challenge to restoring market mechanisms through legislative reform, given the lack of Government capacity to enforce the new legislation and displace the prevailing informal institutions. However, amidst this challenge, the fragility of the Venezuelan State has also created unique opportunities to effectively rebuild the rule of law, particularly considering the resurgence of a resilient private sector.

IV

The economic recovery in Venezuela can be seen as an unintended positive externality of the State's collapse. The absence of enforcement of centralized controls allowed suppressed economic entrepreneurship to resume activities, primarily through informal institutions, sometimes involving formally illegal transactions.

In 2018, the Government of Nicolás Maduro adopted five policies that contributed to this formalization:

- **Non-enforcement of centralized price controls and economic criminal legislation:** Notably, the Government tolerated the supply of goods and services at prices different from the fixed rates.

- Unification of the foreign exchange rate: This reform resulted from the State's financial collapse, as it could no longer monopolize the supply of foreign exchange at fixed and preferential rates.

- **Tolerance of transactions in dollars**: Despite the local currency (bolivar) being the official currency, this led to an increasing *de facto* dollarization, as the dollar was never regulated as a payment currency.

- **Liberalization of private imports**: Due to the lack of financial capacity to maintain the import monopoly and the economic sanctions imposed by the U.S. Government, imports were de facto liberalized.

- **Dollarization and restrictive monetary policy**: These measures aimed to incentivize an end to hyperinflation.

Except for the regulatory reform in the exchange market, all these policies resulted from the decision not to enforce centralized controls. The market mechanisms were not formally reinstated, as the Government selectively chose to allow economic tolerance rather than promoting genuine economic freedoms.

The cumulative effect of these policies was an improvement in the constraints that previously hindered economic growth. From a broader perspective, this improvement could explain Venezuela's economic recovery during 2022.

Similar circumstances were observed in the oil industry, where arbitrary policies since 2002 and economic sanctions against PDVSA in 2019 led to a drastic decline in oil production. However, since 2021, oil production has shown signs of recovery, and in June 2023, production reached 767 KPBD, an increase of 34.56% in 2022. Surprisingly, oil production began to recover even before the Chevron license was issued in November 2022 without any institutional reforms. According to our research, this increase resulted from a de *facto privatization*, wherein rights and assets were transferred from PDVSA and its affiliates to the private sector without adhering to the formalities prescribed in the oil legislation. The Chevron license further contributed to this de facto privatization, as the international oil company was authorized to conduct activities in Venezuela beyond its legal rights as a minority shareholder of JVs.

In conclusion, the economic growth registered in Venezuela, mainly since 2022, is primarily a consequence of deals and informal institutions operating in areas of limited statehood. As Lant Pritchett's studies demonstrated, Venezuela illustrates how informal arrangements can significantly impact growth amidst state fragility. Despite the preferences of Maduro's Government towards centralized and autocratic economic control, the circumstances changed, characterized by a decline in state capability and restrictions derived from sanctions.

However, it is essential to note that the informal growth in Venezuela has not adequately addressed the root causes of the complex humanitarian emergencies, leading to an expansion of inequality. Only a select few have directly benefited from this *de facto* liberalization. Comprehensive reforms are necessary to address these issues and pave the way for a more inclusive and sustainable economic recovery in Venezuela.

V

If the economic recovery in Venezuela is primarily driven by informal institutions, the potential for sustained economic growth would be limited due to the absence of formalized institutions and necessary public goods that the private sector requires.

Precisely, there are numerous indications that the conditions that facilitated *de facto* economic growth are changing in 2023. Studies suggest that the Venezuelan economy could contract. Additionally, despite the Chevron license, oil production is far from the levels seen during Chavez's presidency when he was elected president.

Furthermore, the Maduro Government appears to be facing new circumstances. It could be expecting a sort of normalization in its international relationships after the downfall of the Interim Government in January 2023. Recent decisions to relax sanctions in the oil and gas sectors may have improved confidence that the "maximum pressure" policy is waning. These circumstances explain why Maduro's Government has retained some arbitrary economic policies that undermined market mechanisms, such as price controls and oil expropriations. Inflation is surging, and the de facto dollarization appears to be experiencing a setback. Finally, the Government is resuming import controls.

In summary, the same legal institutions that contributed to the collapse in Venezuela remain in place. Market mechanisms have not been restored, and the separation of powers remains a vacuum in the institutional landscape. Dispute settlement mechanisms to ensure economic rights are absent. The collapsed capacity also hinders the Government from supplying inputs required by the private sector, such as legal certainty and electricity supply.

Maduro seems to have decided to gradually resume enforcement of arbitrary economic controls, increasing political control over the private sector. The prospect of presidential elections, theoretically scheduled before 2014, could further influence this authoritarian path.

VI

The collapse of the State's capability has led to circumstances that favor the reactivation of the private economy, even though the market mechanisms have not been fully restored. This situation has led to a reversal of the strategy the IV National Assembly envisioned in 2016. Initially, the plan was to restore market mechanisms through legislative reform and subsequently reintegrate private firms. However, in 2023, we are witnessing a bottom-up approach, where private firms gradually resurface based on informal or *de facto* institutions. Venezuela's experience aligns with the conclusions drawn by Andrews, Pritchett, and Woolcock, suggesting that informal reforms can significantly impact economic growth in contexts of state fragility.

Thus, in 2023, the challenge differs from that of 2016. Now, the focus is on reinstating the market mechanism and the rule of law while collaborating with the private firms that have reemerged as part of the de facto liberalization. This task becomes urgent when considering the signals that indicate changes in Maduro's circumstances.

Venezuela requires a top-down approach, which involves legislative reforms to reinstate the market mechanisms, and a bottom-up strategy. This strategy aims to gradually reinstate the market mechanism by leveraging the existing private firms that have resurfaced while simultaneously building the State's capability. The relationship between state capability and development is one of coevolution, making it crucial to work on both fronts simultaneously.

The theoretical framework that aids in implementing this bottom-up approach is the rule of law under extreme conditions. Since the rule of law is a formal concept, it is essential to consider how factual conditions hinder the enforcement of these formal institutions. In Venezuela's case, state fragility significantly reduces the Government's enforcement capability, leading to a gap between the *de jure* and *de facto* rule of law. Given the state capability collapse degree, this gap is particularly relevant.

Even if a political transition were achieved and the National Assembly could approve the Omnibus Law, the Government might lack the capacity to implement this ambitious legislative reform effectively. The new legislation might remain displaced by the informal institutions already in place.

Therefore, a gradual and comprehensive reform is necessary to build capabilities in both the private and public sectors, starting from the present conditions of *de facto* liberalization. These new capabilities will gradually close the gap between the *de facto* and *de jure* scope, creating favorable conditions to approve and enforce legislative reforms that reinstate the market mechanisms.

The new geopolitical conditions have favored this top-down approach. For instance, the reopening of the commercial border between Colombia and Venezuela and the approval of a bilateral investment treaty between these countries could not only prevent the informality of the Colombian economy due to Venezuela's collapse but also promote the gradual formalization of the Venezuelan economy.

VI

The current situation in Venezuela offers a small window of opportunity to capitalize on the *de facto* liberalization and pave the way for a transition towards a *de jure* liberalization, which could significantly improve the rule of law conditions. To effectively promote the reinstatement of the market mechanism and the rule of law under these extreme Venezuelan conditions, the strategy should be built on four pillars:

- **Assessment of Current Conditions**: A thorough assessment of the conditions under which private firms have resumed economic activities amidst the extreme Venezuelan environment is essential. This assessment should identify potential risk areas related to illicit activities, which could hinder the transition to formalized economic structures.

- **Designing Public-Private Arrangements**: To gradually strengthen the State's capability and reduce the rule of law gap, it is crucial to develop practical public-private arrangements. Collaborative efforts between the public and private sectors can foster cooperation and create a more conducive environment for the rule of law to thrive. Leveraging Venezuela-Colombia commercial relations could be instrumental in establishing such partnerships.

- **Identifying and Addressing External Constraints**: The impact of sanctions policies on Venezuela must be carefully examined. Identifying external constraints derived from these policies and addressing them strategically can reduce the rule of law gap and promote a more stable economic environment.

- **Supporting Democratic Institution-Building:** To facilitate inclusive development and address the complex humanitarian emergency within the rule of law framework, it is essential to support the building of democratic institutions and resilient economic structures in Venezuela. This approach will help establish a solid foundation for sustainable development and progress.

The overarching objective of this strategy is to restore the rule of law in Venezuela, but it is crucial to acknowledge the extreme conditions resulting from the State's fragility. Given the rule of law gap, relying solely on legislative or formal institutions might be insufficient. Instead, a gradual bottom-up approach is recommended to close the rule of law gap effectively. Additionally, designing a legislative framework to transition from *de facto* liberalization to a *de jure* one will be pivotal in achieving long-term stability and prosperity.

By adopting this comprehensive and strategic approach, Venezuela can navigate its unique challenges, leverage the opportunities presented by *de facto* liberalization, and ultimately establish a robust rule of law framework to propel the country towards sustainable economic growth and inclusive development.