

# **Anarchy, State, and Dystopia: Venezuelan Economic Institutions before the Advent of Oil**

Francisco Rodríguez

Adam J. Gomolin<sup>1</sup>

**Abstract:** This paper studies the evolution of Venezuelan economic institutions before the emergence of oil exploitation in 1920. We argue that by 1920 Venezuela had developed a highly centralized state and a professionalized military. These two institutions ensured that growing oil revenues would strengthen the state structure and protected Venezuela from the resource-conflict trap into which many oil-abundant countries have fallen. We also argue that the failure to develop institutions that could mediate between sectoral demands and the state, the subordination of property rights to political imperatives and the political dominance of the commercial-financial elite conditioned the nation's response to the post-1920 influx of oil revenues.

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<sup>1</sup> Rodríguez (Corresponding author): Assistant Professor, Department of Economics and Latin American Studies Program, Wesleyan University, 238 Church Street, Middletown CT 06457. E-mail: [frrodriguez@wesleyan.edu](mailto:frrodriguez@wesleyan.edu). Gomolin: Master of Public Policy Candidate, Richard & Rhoda Goldman School of Public Policy University of California, Berkeley, 2607 Hearst Avenue, Berkeley, CA 94720-7320. E-mail: [agomolin@wesleyan.edu](mailto:agomolin@wesleyan.edu). We are grateful to María Eugenia Boza, Manuel Caballero, Yoston Ferrigni, Ricardo Hausmann, Elías Pino Iturrieta, Scott Mainwaring, Francisco Monaldi, James McGuire, Richard Obuchi, Daniel Ortega, Jaime Ros, Alberto Unanue, Eduardo Zambrano and participants at seminars at Banco Central de Venezuela and the University of Notre Dame for comments and suggestions, as well as to Homero Gutiérrez and Mónica García for first-rate research assistance. The research for this work was conducted in part while Rodríguez was a Visiting Fellow at the Kellogg Institute for International Studies of the University of Notre Dame and a Professor at the Instituto de Estudios Superiores de Administración. We are grateful for the support of those institutions. All errors remain our sole responsibility.

## 1. Introduction

During the fifty-five year period starting in 1920, Venezuela was the fastest-growing economy of Latin America. Its per-capita GDP growth rate of 3.97% a year more than doubled the average growth rate of other Latin American countries. This growth was not just limited to the petroleum sector: non-oil per capita GDP growth between 1957 and 1977 grew by a robust 3.54%, considerably higher than the Latin American growth rate of 2.28%. By 1977, Venezuela had become by far the richest nation in Latin America, with a per capita GDP 2.1 times as high as the regional average.<sup>2</sup>

During this period, Venezuela also developed a remarkably stable political system. The Venezuelan nineteenth century had been marred by wars and violent conflicts. One observer chronicled 39 national revolutions and 127 uprisings of different sorts between independence in 1830 and 1903; another one calculated 16 years of peace and 66 years of civil war since Independence.<sup>3</sup> On average, Venezuela experienced one political transition every ten years between 1881 and 1920, making it the second most unstable nation in Latin America. The twentieth century would see this change. By the mid-seventies, Venezuela had developed a stable two-party democracy that was hailed by observers as “a textbook case of step-by-step progress.” (Merkl, 1981). Venezuela

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<sup>2</sup> International comparisons are based on Maddison (2001). Venezuelan non-oil GDP is taken from Rodríguez (2004).

<sup>3</sup> See Caballero (1993, p. 34-35)

became one of the four Latin American nations with lowest frequency of regime changes after 1920.<sup>4</sup>

Most studies of Venezuelan economic performance have centered on understanding what came later: a precipitous economic decline during which per-worker GDP declined by more than a third.<sup>5</sup> This study, in contrast, will attempt to understand the institutional determinants of Venezuelan economic progress and social stability before the 1970s. In order to do so, we will take a close look at Venezuelan economic institutions before the emergence of oil. In essence, we will argue that by the 1920s Venezuela had already developed a set of economic and political institutions that would prove to be particularly conducive to stability once combined with increasing oil rents. As we will show, by 1920 Venezuela had undergone a process of economic and political centralization that allowed the resources from oil exploitation to flow directly into the hands of the central government, reducing its vulnerability to the natural-resource conflict trap into which many oil exporting countries are prone to fall (Collier and Hoefler, 2002, Ross, 2004).

The institutions that enabled Venezuela to evade the resource conflict trap also made its political system vulnerable to declines in oil revenues. We shall argue that Venezuelan economic institutions before the advent of oil were characterized by a state that emphasized the distribution of political favors through the provision of private goods and in which property rights were subordinated to political interests. We will also show that Venezuela enters the 20<sup>th</sup> century with a politically weakened landowning

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<sup>4</sup> Calculations use data from Marshall and Jaggers' (2003) Polity IV data. We refer to political transitions as changes in this index

<sup>5</sup> Hausmann and Rodríguez (2006) review this literature.

class, severely reducing the capacity of its political system to develop a cogent policy response to the problem of Dutch Disease.

This essay is an intellectual exercise in the theory of path-dependence, according to which pre-existing institutions will tend to shape the way in which an economy reacts to external changes (North, 1990, 2005). Our fundamental argument is that Venezuelan economic performance in the twentieth century cannot be understood without reference to the set of economic and political institutions that were in place before the beginnings of oil exploitation. Path-dependence is distinct from a theory of inertia or institutional hysteresis (North, 2005). As we will show, Venezuelan institutions were substantially transformed during the 20<sup>th</sup> century. They were, however, transformed within the constraints on modes of political and economic action set by the institutions that had developed previous to the beginnings of oil exploitation.

## 2. The Economic Institutions of Venezuela Prior To Petroleum

### 2.1 The Consolidation of Political Power

During the first decades of the twentieth century, Venezuela experienced a profound economic and political change. A previously divided and anarchic society was transformed into a centralized autocracy under the rule of a powerful despot. Geographically dispersed military and fiscal resources gave way to a monolithic central control over the economic and fiscal power of the state. This control supported the construction of a patronage-based structure for the distribution of resources which

allowed the channeling of individual demands through a system of political and institutional loyalties.

In this sense, the centralized Venezuela of 1920 was quite distinct from the Venezuela of the late nineteenth century. National governments in the nineteenth century were little more than formal administrative structures that lacked control over great part of the territory. As in many Latin American nations, large areas were under the political and economic control of regional *caudillos* who had the capacity—often exercised—to launch open rebellion against the central government.<sup>6</sup> One key ingredient of the *caudillos*' power was their control over customs revenues—the main source of fiscal revenue in 19<sup>th</sup> century Venezuela. The political history of Venezuela in the 19<sup>th</sup> century is in essence a succession of shifting alliances between these regional warlords that from time to time coalesced into temporary coalitions strong enough to change the central government.

This atomization reached its zenith during the two periods of institutional collapse experienced in the second half of the century. The first period (1858-1870) is usually associated with the Venezuelan Civil War; the second (1888-1899) refers to a period of internecine conflict between the fall of the Guzmán Blanco (1870-1887) regime and the arrival of Cipriano Castro (1899-1908) to power. This atomization was reversed through a slow process of consolidation of economic and political power of the state that was initiated during the governments of Guzmán Blanco and was continued during the Andean Hegemony of Cipriano Castro and Juan Vicente Gómez (1899-1935). In both cases, the figures that were able to introduce a degree of stability in the Venezuelan

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<sup>6</sup> Following Lynch (1992), we define *caudillos* as regional leaders whose authority derived from ownership of the land, access to men and resources, and a history of prior achievements (pp. 3-4).

political system were political outsiders—Guzmán Blanco was the first Venezuelan president since 1847 who did not belong to a regional faction, whereas Castro's rise to power occurs as the leader of regional troops from a region that had not been previously been involved in national conflicts.

### 2.1.1 Guzmán and the political centralization of fiscal revenues.

Antonio Guzmán Blanco was the first Venezuelan president to considerably curtail and subordinate the interests of regional caudillos to those of the central government. Guzmán was able to do this by constructing a complex alliance between business groups and loyal caudillos that worked because it was able to generate a marked increase in tariff revenues (which accounted for more than 90% of government fiscal revenues at the time). Guzmán initially rose to power as an outsider: the son of a popular Venezuelan politician who had founded the Liberal Party in the early 19<sup>th</sup> century, he became a focal point for agreement between different antagonistic regional groups in the aftermath of the Venezuelan Civil War (1858-1865). Guzmán soon realized that if he was to have a chance of staying in power he would need to forge an alliance not only with regional caudillos but also with the commercial-financial sector which controlled the sources of finance to the Venezuelan state. Guzmán thus quickly put aside the historical links between the Liberal Party and the landowning sector whose interests had traditionally been diametrically opposed to those of the commercial-financial sector.

Guzmán's ingenious plan for coalition building started with the virtual privatization of customs collection. Shortly after taking power in April 1870, Guzmán

created the *Compañía de Crédito*, a privately owned firm with minority government participation whose main purpose was to pay off outstanding government debts. The control of the *Compañía de Crédito* was firmly in the hands of representatives of trading houses such as H. L. Boulton y Cía (which controlled 30% of the initial issue of shares)<sup>7</sup> or Juan Röhl y Cía (which controlled 20%)<sup>8</sup>. The revenues of the Company, in turn, came from its entitlement to directly receive 85% of customs revenues.<sup>9</sup> This system could work well because the Venezuelan government's main source of credit came from trading houses such as the Boulton and Röhl groups, which had been set up after Independence to fill a vacuum left by the disappearance of the Spanish Crown's trading monopoly. These trading houses were not only a source of direct credit to the central government but also acted as guarantors of international loans. In 19<sup>th</sup> century Venezuela the financial and commercial sector were one and the same, so the problem of tax collection had a simple solution: to give the control of customs collection to the trading houses.<sup>10</sup> The political coalition that was to emerge as a result would prove to have significant implications for twentieth century Venezuelan political economy.

Guzmán's scheme began with the customs office of La Guaira, Caracas's main port, but soon extended to the custom houses of the rest of the country as well as taxation of unused lands, toll roads and salt mines. At every stage, Guzmán could offer the caudillos a simple deal: a share in higher levels of tax collection, or a confrontation with the central government, loyal caudillos and the commercial-financial sector, which had the capacity to bring regional governments to a standstill. The agreement would be

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<sup>7</sup> Fundación Polar (1997b)

<sup>8</sup> Fundación Polar (1997c)

<sup>9</sup> Azpurua (1997)

<sup>10</sup> For descriptions of the workings and structure of the *Compañía de Crédito*, see Floyd (1988) and González deLuca (1991).

to the advantage of all parties, as long as a central issue was resolved: to ensure that the regional caudillos could receive a continuous stream of rents once they had given up control of customs houses.

In order to address this problem, Guzmán created a set of singular institutions. Perhaps the most important one—which survives to this day—was the *Situado Constitucional*, a rule for the allocation of a fixed fraction of government revenues among regional governments. The *Situado* had been created in the 1864 Constitution as an instrument to implement the calls for greater decentralization of the Federalists who had just emerged victorious from the Venezuelan Civil War. Although Guzmán had been involved in the design of the *Situado*, its effective implementation had to wait until he became President in 1870. As shown in Figure 1, the *Situado* significantly increased government transfers to regional governments from less than 2% to more than 10% of fiscal revenue.

The *Situado* was not the only means by which Guzmán ensured that the caudillos would benefit from the alliance that he forged. As soon as Guzmán reached power in 1870, he recognized the key local caudillos as state governors and imposed a system of public, signed balloting which favored those who had military control of the region (see Quintero, 1994, p. 62). Guzmán also started a massive public works program directed through the *Juntas de Fomento*, boards that directly administered public investment projects and in which local caudillos and financiers were given seats (Pino Iturrieta, 1997). In the end, the bargain was sufficiently advantageous to regional caudillos so as to buy into it. Guzmán's administrative reforms generated a substantial increase in government revenues: from 13 million Bs. in fiscal 1871-72 to 41 million Bs. during his

last fiscal year in office, 1887-1888<sup>11</sup>. In supporting Guzmán's call to hand over salt mines to the central government, eastern caudillo José Eusebio Acosta wrote "if states are ensured the *Situado* they will have peace, regularity and progress as a consequence of the interior administration that they will be able to found." <sup>12</sup>

The creation of the *Compañía de Crédito* provides a remarkable example of the institutional arrangement that Haber, Razo and Maurer (2003) have termed "Vertical Political Integration" (VPI). VPI arrangements are an institutional solution to the basic political dilemma that arises from the fact that any government strong enough to arbitrate property rights is also strong enough to confiscate them (Weingast, 1995). In VPI arrangements, sectoral or geographically-specific agreements are formed between the government, asset holders, and third parties that receive a stream of rents in exchange for supporting the contract between the government and asset holders. This is precisely what Guzmán attempted to do: to form a coalition between government creditors (asset holders), a weak central state, and third parties (the regional caudillos). A problem in making such an agreement enforceable comes from the fact that informational asymmetries between the state and asset holders will generate multiple incentives for opportunistic behavior by the government with respect to asset holders (e.g.: by claiming that tariff revenue is lower than expected). Vertical Political Integration—the granting of a powerful role in government decisions to asset holders—can help a government and asset holders institute a monitoring device that will check their incentives to renege on agreements. In this case, "it is possible for the line between the government and asset holders to become blurred—so blurred, in fact, that

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<sup>11</sup> Inflation was negligible during this period (See Baptista, 1997, p. 277).

<sup>12</sup> Cited by Quintero (1994, p. 75).

as a practical matter it is difficult to distinguish precisely where the government ends and the asset holders begin.” (Haber et al, 2003, p. 31)

Guzmán was thus successful in moving control over fiscal resources into the hands of the central government and thereby considerably strengthening the economic power of the state – at the cost of blurring the line between the state and the financier elite. However, military power was still in the hands of the regional caudillos. When Guzmán abandoned the Presidency in 1887, the complex coalition that he had engineered collapsed and the nation fell into a second period of prolonged internecine conflicts among regional caudillos similar to those of the pre-Guzmán period. The fact that the central government had direct command over most government revenues to a great extent implied that the loot from capturing the state became greater, and all regional factions jumped into the fray, leading to a 12-year period of severe instability during which Venezuela had seven presidents. After the assassination of the Liberals’ remaining national *caudillo*, governing elites decided to stave off a populist rebellion by handing power over to a small, closely knit military faction from the Andean region. This decision would have significant implications for Venezuela’s political evolution over the twentieth century.

### 2.1.2 The second attempt at political consolidation: 1899-1920

The period of Andean Hegemony (1899-1935) would give Venezuela the politically centralized state that it needed to definitively eliminate the forces of regional *caudillismo*. Although Cipriano Castro’s (1899-1908) first cabinet was formed by the group of Liberal Party insiders that had placed him in power, he quickly set himself to

work on the project of consolidating the Andeans' hold on power. The key ingredient of his strategy would be the formation of a modern national army with a centralized command system, whose members had been formed in an institutional conception of the role of armed forces as preservers of the legal order, and whose command lines were stacked with Andean loyalists. The suppression of political dissent and the virtual elimination of the pluralism of political thoughts that had been present in 19<sup>th</sup> century Venezuela would help cement a centrally controlled authoritarian state. But this was not just any authoritarian state: it was an authoritarian state supported by the establishment of a web of patronage-based obligations that operated not just by suppressing dissent but by significantly raising the incentives to actively support the system.

Castro started by devoting increasing financial resources to the purchase of foreign armaments and the modernization of the armed forces. In 1901, Castro raised the Army's active force to 30 battalions (9,000 men). He ordered the building of a shipyard in Puerto Cabello in 1906 and equipped the Navy with a cruiser, two gunboats, a brig and a transport boat.<sup>13</sup> He decreed the creation of a National Military Academy in 1903, putting it in charge of training officer corps within the traditional divisions of infantry, cavalry, artillery and engineering. This signaled an important break with the previous tradition, under which officer corps had been trained within the regular troop ranks.<sup>14</sup> The Military reforms would ensure the formation of a professionalized military that was formed in the doctrine of national defense and the preservation of the State.

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<sup>13</sup> Bencomo Barrios (1997).

<sup>14</sup> García Villasmil (1997).

Unlike Guzmán, Castro's relation with economic elites and foreign powers were extremely tense. His continuous provocation of the Caracas financiers and his refusal to pay outstanding international debts—culminating in the 1902 blockade and bombardment of Venezuelan ports by Great Britain and Germany—pushed the elite to openly embrace any alternative to or substitute for Castro. The military control of the Andean army under Castro, however, would make it virtually impossible to realize this substitution militarily. It would ultimately come through the 1908 coup engineered by his Vice-President and principal collaborator, the Andean general Juan Vicente Gómez.

In many ways, Gómez continues and deepens the process of political centralization initiated by Castro. Gómez inaugurated the School of Military Application and created the position of Inspector General of the Army, integrating and coordinating the political-administrative activities of the Armed Forces. By 1913, five years into Gómez's reign, the Venezuelan Armed Forces had already tripled in size relative to 1900.<sup>15</sup> In contrast to Castro, Gómez showed a much greater capacity to garner the support of economic and political elites. Gómez's cabinets were integrated by some of Venezuelan society's most prominent intellectuals such as José Gil Fortoul and Manuel Díaz Rodríguez and financiers such as Manuel Antonio Matos and Pedro R. Tinoco. Gómez also reestablished Venezuelan international economic relations with the key powers by returning all the concessions that had been revoked by Castro. The emerging political system was extremely stable. Supported by domestic elites, a strong, consolidated internal army and the approval of international powers, Gómez would exercise power for 27 years until his death from natural causes in 1935.

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<sup>15</sup> Ziemis (1993, p. 152).

Gómez's recipe for stability went beyond a loyal army and the support of domestic and international power groups. One of the most characteristic elements of the Gómez dictatorship is the building up of a patronage-based system for the satisfaction of individual demands by the political apparatus of the State. Gómez became the recipient of innumerable letters, communications and reports that transmitted information on both his subordinates and his enemies in exhaustive detail. Telegrams would flow back and forth between the Presidential Office and the Chief Civil Authorities authorizing the release of prisoners from the County Jail or the naming of a new clerk for the County Office. In the words of Venezuelan historian Elías Pino Iturrieta, the new political system:

conserves the antiquated stamp at the center of which are the interests and objects of the powerful Caesar. The powerful Caesar gives and takes, without mediating in his determinations ministers or ministries, formulas, statistics and newly cast offices. (1988, p. 41)

In a careful study of the fiscal policy of the Andean Hegemony, Miriam Kornblith and Lucien Quintana (1982) find that the objective of centralization permeates all of fiscal policy during this period: from the priority of expenditures on telegraphic communications, with the objective of developing a mechanism of control over functionaries and opponents to the regime across the nation, to the substitution of the *Juntas de Fomento* by a centralized mechanism for the allocation of contracts by the Executive, to the gradual but continuous weakening of the Presidencies of State.

It is tempting to think that the consolidation of political power by Gómez is the result of the availability of petroleum resources. However, the majority of Venezuelan historians agree that the consolidation of political power and Andean hegemony is a

process that temporally precedes the emergence of petroleum.<sup>16</sup> By 1920, when petroleum starts gaining economic relevance, the political, military and economic centralization of Venezuela had been achieved, supported by an interlocking system of political and regional loyalties and patronage-based mechanisms for the allocation of punishments and rewards. This system would have radical implications for the allocation and distribution of oil revenues after 1920.

## 2.2 Property rights and the collapse of the agro-export economy.

Although the reforms of the Andean Hegemony set the foundations for a strong, centralized political system, they did little to reconstitute the security of property rights that had come apart during the 19<sup>th</sup> century. Property rights in Venezuela were still as subordinate to the will of groups in power during the Andean Hegemony as they had been previously, and the exercise of public office for private gain was considered by and large a legitimate activity. This reality would severely curtail the capacity of the Venezuelan state to effectively carry out activist economic policies.

By all accounts, Venezuela had been one of the most dynamic and fast-growing Spanish colonies at the time previous to Independence, boasting a diversified agroexporting economy producing indigo, cotton, coffee and livestock.<sup>17</sup> To a great extent, this is a result of being exceptionally situated geographically to take advantage of expanding opportunities for trade with the Caribbean colonies of Britain and France. Although reliable estimates of per capita income at the beginning of the 19<sup>th</sup> century are

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<sup>16</sup> Urbaneja (1993, p. 77).

<sup>17</sup> Ferrigni (1999) provides an extensive review of the evidence regarding Venezuelan economic growth both before and after the War of Independence.

unavailable, anecdotal evidence points to a relatively prosperous colony, with high material living standards and a cultural and intellectual life that was considerably advanced in comparison to the rest of the region. Humboldt, for example, comments with admiration that “The consumption of meat in this country is immense. (...) The city of Caracas, the population of which was, in the time of my travels, 1/15 of Paris, consumed more than half the meat annually consumed in the capital of France.”<sup>18</sup> Venezuelan plains lancers acquired a mythical character of invincibility during the War of Independence that led Spanish Field Marshall Pablo Morillo to exclaim “Give me 100,000 plainsmen and I will take Europe in the name of the king of Spain.”<sup>19</sup>

The agricultural economy that was at the basis of this progress would enter a prolonged period of decline during the 19<sup>th</sup> century, by the end of which exports per capita would be barely half of the Latin American average.<sup>20</sup> This economy had been based on plantation agriculture carried out in large tracts of territory. Property in these expanses had been gradually consolidated from the beginning of the colony and firmly rested with a concentrated group of families that also held local political power. The institutionalized power of the elite landowners allowed them to safely maintain control of the structures of production.

Property rights in these expanses were all but destroyed as a result of the prolonged series of land expropriations that began with the War of Independence. It is estimated that, between 1815 and 1819, the Royalist administration took control of 312 haciendas, representing 70% of the lands surveyed in the 1810 census.<sup>21</sup> As Patriot forces recovered territory, they would restore ownership of some lands to their initial

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<sup>18</sup> Humboldt and Bonpland (1956[1814], Vol. 5, p. 84).

<sup>19</sup> Mijares (1988, p. 529).

<sup>20</sup> Bulmer-Thomas (2003, p. 69).

<sup>21</sup> Brito Figueroa (1996, p. 218).

owners while expropriating those of royalists. As the war dragged on, the practice of compensating soldiers and officers through land ownership grew in significance.<sup>22</sup>

The end product of this process was that while wealthy families identified with the patriot cause were able to retain and retake large parts of territory, an important proportion of land was immediately distributed between the military chiefs of the insurrection. José Antonio Páez, who leads the separatist movement that splits off Venezuela from Greater Colombia in 1830, is able to consolidate holdings of land so large so as to give him a virtual monopoly of beef supply in Caracas.<sup>23</sup> As Venezuela falls into a prolonged period of internecine wars and political instability in the mid-nineteenth century, the practice of land expropriation and looting as methods of war finance become commonplace. A traditional 19<sup>th</sup> century verse from the Plains region illustrates perhaps better than any statistic the consequent effects on the incentives for capital accumulation: “While there’s a General around/I won’t even buy a calf/ Because they, in order to steal/Out of nothing will wage war.”<sup>24</sup>

The subjection of property rights to political power does not disappear under the Andean hegemony. Gómez routinely exercises the power of expropriation that was given to him by the monopoly of violence. Landowners would frequently be pressured into “selling” their haciendas to members of the governing group.<sup>25</sup> An American official of the time recounts that:

citizens that have refused to sell their haciendas to the President-elect or to his friends at the prices they want to offer, had been incarcerated as political enemies, while their

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<sup>22</sup> See Leal (1963, p. 75).

<sup>23</sup> Castillo Blomquist, (1987, p. 32).

<sup>24</sup> Gil Fortoul (1907, Vol. II, p. 176).

<sup>25</sup> Urbaneja (1993, p. 69).

properties were used to camp troops and thousands of young billy goats would be let loose on their cacao plantations.<sup>26</sup>

In this respect Gómez and his clan are no different than the 19<sup>th</sup> century caudillos. The use of political power to accumulate personal fortunes is as pervasive and valid in the Venezuela of 1920 as in the Venezuela of the 19<sup>th</sup> century. The confusion between private patrimony and the patrimony of the Republic, which Venezuelan political scientist Diego Bautista Urbaneja has termed “patrimonialism,”<sup>27</sup> is more than a device to ensure the accumulation of wealth in the hands of the dictator. It is a system through which the State ensures systemic loyalty through the distribution of property for political support.<sup>28</sup>

In sum, despite the fact that the Venezuela of 1920 had recouped the political stability that it lost in the 19<sup>th</sup> century, it never managed to recoup a solid base of institutionalized property rights. Property in Venezuela had been institutionalized as a vehicle for the enactment of the wills of the governing group. The activity of appropriation of public resources had become a common means for the accumulation of wealth. Peace and order may have been restored, but not the security of property.

### 2.3 Redistributive politics in 19<sup>th</sup> century Venezuela.

In December of 1840, Caracas residents had the opportunity to assist to the first public exhibition in the nation of a railroad car. Similar to those carried out in many other Latin American countries at the time, the exhibition generated considerable

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<sup>26</sup> Sullivan (1976, p. 266).

<sup>27</sup> Urbaneja (1993, p. 67).

<sup>28</sup> Caballero (1993) discusses how land distribution and concessions for resource exploitation were habitually used by Gómez to buy the moderation of relevant figures of the opposition.

excitement and was succeeded by a series of articles in the written press demanding action by the government to initiate the construction of a public rail system.<sup>29</sup> A response from policymakers did not materialize until 1853, when the Monagas administration finally invites offers for the construction of the Caracas-La Guaira railroad. What begins is a tortuous and Kafkaian process through which nine different contracts would be signed and revoked—often by the same administrations—with the only tangible output being a short stretch of track measuring less than one kilometer in length.<sup>30</sup> By 1867 President Falcón’s representative in New York writes him that “it was becoming extremely difficult to convince the capitalists and firms of this nation to invest in Venezuela, as already in our Republic predominates (...) an eternal and imperishable anarchy that wrests goods away from those to whom they belong.”<sup>31</sup> Finally, in 1880 Guzmán orders a concession for the construction of the track be given to a former U.S. Ambassador to Venezuela, granting his company the right of operation for a period of 99 years. Curiously, the pretext that had been given by the Secretary of Foreign Relations for disavowing the first contract had been precisely the 99 year duration of the concession.<sup>32</sup>

The delayed initiation of the construction of a rail system prevented Venezuela from taking advantage of the potential gains from the development of transport infrastructure that many other Latin American countries experienced towards the end of the 19<sup>th</sup> century.<sup>33</sup> By 1913 Venezuelan rail density was the third lowest in the region at 1.15 km per square km of land area, at approximately one-fifth of the region’s average

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<sup>29</sup> See Pino Iturrieta (2001, p. 207-8).

<sup>30</sup> Harwich Vallenilla (1997, p. 345).

<sup>31</sup> Murguey Gutierrez (1997), p. 131.

<sup>32</sup> *Ibid*, p. 129, p. 140.

<sup>33</sup> See Summerhill (1997) for a discussion of these gains in Brazil and Mexico.

(5.53 km/sq.km)<sup>34</sup>. One may be tempted to interpret this as a consequence of the grave fiscal difficulties faced by the war-torn nation. Further investigation reveals that the same Venezuelan legislators who consistently put off the appropriation of funds for railroad constructions did routinely engage in comparably costly initiatives with a different bent. The same Congress that ignored calls for railway construction between 1841 and 1845, oversaw the gradual elimination of the export duties that constituted one of the principal sources of revenues of the early Republic. The Monagas administration, which repealed the first railway contract for considering it too onerous, was however willing to approve a direct buy-back of landowner debts of a value equivalent to one year's national budget.<sup>35</sup>

Rather, the Venezuelan 19<sup>th</sup> century shows a predominance of redistributive politics targeted towards providing benefits towards specific groups and away from the provision of the type of public goods that could have been vital for generating a sustained process of economic growth. The emphasis on using private goods targeted at supporting groups as a mechanism of tactical redistribution is reminiscent of Dixit and Londregan's (1996) argument that, absent the institutionalized limitations imposed by a professionalized civil service, private transfers to supporters are likely to dominate redistributive politics. In this sense, the lack of development of an institutionalized bureaucracy, such as that developed by Chile and Costa Rica in the 19<sup>th</sup> century, may have exacerbated the Venezuelan's state chronic incapacity to provide public goods.<sup>36</sup>

This situation would change with *gomecismo*. Gómez would begin to consolidate and integrate Venezuelan public finances through a series of administrative reforms

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<sup>34</sup> Bulmer-Thomas (2003, p. 103) and own calculations.

<sup>35</sup> Castillo Blomquist, (1987)

<sup>36</sup> See Moreno (1968) for a discussion of the evolution of the Chilean civil service, and Vega Carballo (1981) for the case of Costa Rica

promoted by Román Cárdenas, Minister of Finance between 1913 and 1922. Cárdenas centralized revenue collection and expenditure allocation in the Ministry of Finance, eliminating separate accounts and earmarking rules that impeded rational management of the public finances. These reforms were used to significantly reorient public expenditures towards the administration's key goals, increasing outlays on security and defense, significantly reallocating public works programs towards the construction of highways, and completely liquidating the nation's external debt.

Gómez's rationalization of the public finances goes hand in hand with his suppression of socially redistributive discourse. The appeal to the support of the lowest echelons of society was common not only in the discourse of radical 19<sup>th</sup> century rebels like Ezequiel Zamora but also in mainstream politicians like Antonio Leocadio Guzmán. The political philosophy of *gomecismo* is perhaps best captured by the works of its key ideologue and four-time Senate President Laureano Vallenilla Lanz. He attributed Venezuela's societal implosion during the 19<sup>th</sup> century to the incapacity of its political system to maintain redistributive pressures at bay. As a solution, Vallenilla Lanz proposed the need for the concentration of power in a caudillo that would be capable of reestablishing certain rationality in collective decision-making.<sup>37</sup>

The gomecista political system would rise above the pressures which caused instability during the majority of the 19<sup>th</sup> century, such as the depletion of public rents in the attempt to satisfy multiple sectoral demands and the vulnerability of the regimes to a discourse of social justice and redistribution. The suppression of these pressures will be based in the consolidation and strengthening of a system directly managed by a single figure. Demands do not disappear: they are now satisfied through decisions

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<sup>37</sup> Ibid, p. 119

controlled by the dictator. In the absence of intermediary institutions to bring about the rational aggregation of demands, the prevalence of tactical redistribution as a political strategy was likely to reemerge after Gómez's death.

#### 2.4 The Political Victory of the Financial Elite

Nineteenth century Venezuelan political economy was marked by the political divisions between landowners and the commercial-financial sector, respectively organized around the Liberal and Conservative parties. The 19<sup>th</sup> century starts with a period that Venezuelan historians often call the "Conservative Oligarchy" (1830-1848), under which financial and trade policies generally favored the commercial classes. The Liberal Party rises to power in 1848 after José Tadeo Monagas, elected with support of the Conservatives, appeals to it in a bid to build an alternative power base. Its strength was derived from an unusual combination of landowner support and appeal to an egalitarian discourse designed to garner the support of the free mixed-race individuals who formed the incipient middle classes in Venezuela at the middle of the 19<sup>th</sup> century. The attempt to sustain this complex coalition would produce a large degree of instability in the liberal governments between 1848 and 1870. In the end, these governments would prove incapable of sustaining a stable environment and their failure would prove to substantially undermine the power of the land-owning classes.

The virtual destruction of cattle ranching in Venezuela precisely during the governments of the Monagas Brothers (1847-1858) is indicative of the incapacity of Liberal governments to protect even their own constituents. The Monagas proved powerless to stop the activities of the bands of cattle thieves of the Plains region. These

bands concentrated their activities in the contraband sale of leather, a quicker and far more effective way to earn profits than the commerce of meat or the continued raising and reproduction of livestock, given the necessity of quickly dispatching the stolen goods. The efforts of the government to stop the practice were ineffective and constantly interrupted by political disorder.<sup>38</sup> Ultimately, cattle ranchers were hurt more by the liberal government of the Monagas governments than by the previous Conservative governments: exports of livestock fell from 699 thousand Bolívares in 1847 to 189 thousand Bolívares in 1859.<sup>39</sup>

As we have argued above, Guzmán Blanco is able to reestablish a certain level of economic order after 1870, by engineering a political pact with the commercial-financial class and putting aside the historical links between the Liberal party and the landowning elites. The political agreement with the commercial class is maintained during the governments that succeed the *Guzmanato*. Manuel Antonio Matos, brother in law of Guzmán Blanco and one of the founders of the privately-owned *Banco de Venezuela*, became a key figure in the political economy of Venezuela. As the State's main creditor, the *Banco de Venezuela* acquired a considerable degree of bargaining power. When Raimundo Andueza Palacios assumes the presidency in 1890, the *Banco de Venezuela* accepts the refinancing of the debt of the central government with the condition that Matos assume the Ministry of Finance. In 1895, Matos heads a cabinet of national understanding put together by Joaquín Crespo in a desperate attempt to endow his regime with some measure of financial and political stability. This cabinet lasts six months, but in 1897 Matos returns to the Ministry of Hacienda as a result of a financial

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<sup>38</sup> Matthews (1976, pp. 106-111).

<sup>39</sup> Baptista (1997, Table B-16).

agreement with the agonizing Crespo regime. In parallel, other commercial groups led by H.L. Boulton y Cía. will form the *Banco Caracas*, with less political visibility but a comparable amount of economic power.<sup>40</sup> After 1894, these groups will coordinate their actions through the Chamber of Commerce of Caracas, which will become a body of vital political importance in 20<sup>th</sup> century Venezuela.

The comfortable relationship between the commercial-financial classes and political power will temporarily collapse during the administration of Cipriano Castro. Faced with a refusal to refinance the public debt in 1899, Castro decides to publicly humiliate the bankers, hauling them through the streets and throwing them in prison. The bankers gave in, but subsequently occupied themselves with organizing the 1902 *Revolución Libertadora*, which constitutes the most serious threat to the Andean hegemony. Though the *Libertadora* would be defeated, it constituted a formidable example of the political power of the financial classes. Ultimately, even the Andeans pledged their power to these sectors: one of the first actions of Juan Vicente Gómez was to name Manuel Antonio Matos as Foreign Minister in 1910.<sup>41</sup>

The understanding on the part of Gómez of the necessity to reach a political agreement with the financier elite significantly contributed to his stability in power. Gómez generated a web of links with these elites, some of who became his key advisors on economic matters. Vicente Lecuna, director of the *Banco de Venezuela* and President of Chamber of Commerce of Caracas, visited Gómez weekly and designed a monetary reform in 1918, while figures such as John Boulton, Nicomedes Zuloaga, Inocente Palacios and Carlos Delfino maintained continuous communication with the Chief of

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<sup>40</sup> Harwich Vallenilla (1976, pp. 216, 230).

<sup>41</sup> While Matos stayed barely a year as Foreign Minister, he maintained a permanent correspondence with Gómez until his death in 1929. See Acosta et al (1986).

State. By 1920, the power of the commercial-financial class had become firmly entrenched. This configuration of political power will play an important role after the end of the 19<sup>th</sup> century. A strong exporting sector would have been able to pressure for decisive measures to counter-balance the change in relative prices generated by the influx of petroleum resources. However, by 1920, the weakened land-owning sector held little capacity to influence the formation of such policies.

### 3. Petroleum Arrives

The start of petroleum exploitation in the 1920s would have profound effects on Venezuela's economy and society.<sup>42</sup> Between 1900 and 1920, per capita GDP had grown at a rate of barely 1.8 percent; between 1920 and 1948, it would grow at 6.8 percent. By 1958, per capita GDP is 4.8 times what it would have been had Venezuela had the average growth rate of Argentina, Brazil, Chile and Peru.<sup>43</sup>

We have argued that there are four key characteristics of the Venezuelan political system into which petroleum would make its entry in the 1920s. First, political institutions were characterized by a strongly centralized state apparatus supported by a web of patronage-based obligations and loyalties. Second, the exercise of public power was pervaded by a lack of clear distinction between the private and the public and a subordination of property rights to political imperatives. Third, intermediary institutions between individuals and the public sector had failed to emerge, with redistributive politics temporarily occluded by the power of a repressive regime. Fourth,

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<sup>42</sup> Oil exports in 1920 accounted for only 1.8% of total exports. Ten years later, that figure had risen to 85% (Baptista, 1991, p. 94)

<sup>43</sup> All calculations are based on Maddison (2001)

the landowning-exporting class had effectively lost the political battle of the nineteenth century to the commercial-financial elite. These four characteristics would have significant effects on the way in which oil revenues would affect Venezuelan society.

### 3.1 The substitution of the patronage-based system.

The most important political transformation suffered by Venezuela in the twentieth century was the substitution of an authoritarian state by a democratic society with effective civil and political liberties and high levels of popular participation. Promoters of the democratic program in the early twentieth century had to contend with a formidable opponent: a politically centralized state, reinforced by an armed forces whose institutional design was particularly propitious for stability, and with abundant economic resources that could be directed toward sustaining power. The innovation of the emerging political leaders is the creation of political parties with broad memberships that can defeat the patronage-based structure of the state by reproducing it.

The idea of creating this type of party is originally elaborated by Rómulo Betancourt, who separates himself from communism in the 1930s to form the party that subsequently becomes Acción Democrática (AD). After various failed attempts to mount an effective opposition to the regime of López Contreras (1936-1941), Betancourt promotes the idea of substituting the Marxist-style vanguard party for a party with ample membership. This decision was intrinsically tied to that of the formation of a multi-class party, in a style similar to the Peruvian APRA, but distinct from the majority of the parties of the left in Latin America during this period. The idea of directing the approach toward an ample spectrum of society forced the founders of AD to put

particular emphasis on the growth of its membership, developing an explicit strategy through which each member was required to present at least one new candidate to enter the party within an established period of time.<sup>44</sup> According to Lieuwen (1961), by 1945, “the directives of the national organization could show subordinate and disciplined bodies in practically every district and municipality of the Republic.”<sup>45</sup> At this date, Betancourt boasted that his party counted 100 thousand members.<sup>46</sup>

Such a party formed a formidable potential base of support for any government. This is the reason why it is called upon by a group of disaffected military leaders led by Andean Marcos Pérez Jiménez plotting a coup against Medina in 1945. AD arrives in government with a broad membership base that is ready for the occupation of the positions of power that had been left in place by the post-gomecista system and rapidly takes control of middle and lower-level positions in public administration.

Unlike many other populist parties in the region, AD and its Christian Democrat counterpart COPEI became the dominant institutionalized actors within a stable political system. Their success came from being able to substitute a patronage-based web constructed and strengthened by the governments of the Andean hegemony by a system of loyalties and favors articulated through populist political discourse and practices. This was facilitated by the availability of high oil revenues. It wasn't simply a consequence of revenue growth. It was the result of the confluence of expanding rents, the existence of a pre-existing fiscally and politically centralized state, and the need to provide a viable political alternative to a system of patronage-based obligations and rewards.

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<sup>44</sup> Sosa Abascal (1995, p. 253).

<sup>45</sup> Lieuwen (1961, p. 65).

<sup>46</sup> Caballero (2003, p. 243).

### 3.2 Other institutional interactions.

Other characteristics of Venezuelan political and economic evolution after 1920 can also be understood as responses to the interaction between growing oil rents and pre-1920 institutions. The lack of clear distinctions between public and private ownership was a key element in the failure of many interventionist policies during the Democratic period, such as the 1960 Agrarian Reform. AD's ambitious project was thwarted from the outset by the pervasive use of land distribution to favor party loyalists. From the beginnings of the program, there were accusations that members of the party in power had received preferential treatment in the division of lands. Credits to farmers were distributed weekly to representatives of AD-controlled agricultural syndicates that would in turn allocate them among farmers.<sup>47</sup> At the same time, tenancy was useless without access to credit and materials, which were directed by financial institutions of the state characterized by high levels of corruption and patronage. The end result was an exacerbation of inequality in land distribution.<sup>48</sup>

Similarly, the lack of intermediary institutions to mediate between particular distributive demands and the necessity of the provision of public goods led to a reemergence of tactical redistribution in the post-gomecista system. In the absence of other institutions, political parties began to fulfill the function of intermediaries with the state. In a careful study of Venezuelan industrial policy over the post-war period, Jonathan Di John (2006) shows that the high levels of factionalization and clientelism

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<sup>47</sup> Powell (1971, p. 156).

<sup>48</sup> From 1950 to 1971, the share in productive agricultural units of plots of less than 5 hectares declined from 53.67% to 42.84%, while that of those with more than 20 hectares increased from 16.69% to 25.24% (Orta, 1981)

of the Venezuelan political system impeded the Venezuelan state from effectively carrying out the targeted interventions that were required to transition beyond the initial stages of import substitution. The end result was a low level of monitoring of state-created rents, excessive entry of private sector firms in protected sectors, and massive proliferation of public sector employment.

Another example of the predominance of redistribution over private goods provision is manifest in Venezuela's low levels of internal taxation. Venezuela's fiscal system is characterized by similar levels of expenditure to the rest of the region, but relatively low levels of non-oil taxation.<sup>49</sup> Clara López Obregón and Francisco Rodríguez (2001) have argued that Venezuelan tax laws were routinely made more flexible whenever the nation had a positive petroleum shocks. In contrast, the tendency of the Venezuelan state to underinvest in infrastructure in comparison to the region is significant: According to Calderón and Servén (2003), in the early eighties Venezuela devoted just 0.49% of GDP to public investment in telecommunications, electricity and transport infrastructure, substantially less than the 2.48% average of the region.

The effects of the political dominance of the commercial-financial class in the beginning of the 20<sup>th</sup> century can be seen in the nation's political response to the exchange rate appreciation that occurs after 1920. In 1933, the U.S. decides to devalue the dollar in the aftermath to the Great Depression. Since Venezuela was bound to a gold standard, this decision produced an immediate appreciation of the Bolívar from an exchange rate of 6.77 Bs/\$ to one of 3.56 Bs./\$. By that time, Brazil and Argentina had already devalued and various Latin American nations followed suit shortly after April of 1933. Venezuela did not. Henrique Pérez Dupuy, the founding banker of the *Banco*

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<sup>49</sup> See Karl (1997).

*Venezolano de Crédito*, argued that “monetary devaluations steal confidence and create instability and injustice.”<sup>50</sup> Vicente Lecuna, President of the *Banco de Venezuela*, also openly opposed the devaluation. The López Contreras administration finally imposed a system of multiple exchange rates which partially compensated coffee and cocoa producers by entitling them to exchange export revenues at rates of 4.60 Bs./\$ and 4.30 Bs./\$, an offsetting compensation that was less than 1/3 of the resulting appreciation.

The effect on tradable goods production of the resulting appreciation was what one would expect; the share of tradables in non-oil production fell from 38.3% in 1920 to 16.2% in 1950, while coffee and cocoa exports would virtually disappear by the 1950s. This appreciation and the consequent demise of the tradables sector should not be seen as an inalterable consequence of the revenue influx. Governments can and often do implement short and long-run policies to counteract real appreciations. In Venezuela, however, policymakers were scarcely worried by the appreciation and did little to react to it. The oil boom had come to a nation in which the sector that could halt this appreciation—the tradable producing sectors—had lost all ability to influence policies.

### 3.3 Alternative routes of development: Venezuela and early 20<sup>th</sup> century Mexico.

This essay has presented a path-dependency explanation of Venezuelan political and institutional development. In essence, we have argued that Venezuela’s long period of prosperity and stability from the 1920s to the 1970s is more than a mechanical reaction to the influx of oil revenues: it is a result of the interaction between this influx and the nature of existing institutions. Venezuelan political actors were constrained to

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<sup>50</sup> Cited in Sosa Abascal (1995, p. 394).

act within the framework of a strongly centralized state and a web of patronage-based obligations. They developed political strategies that were adequate responses to the interaction between those constraints and the expanding opportunities generated by growing oil revenues.

Perhaps the best way to illustrate this point is by means of a comparison with another Latin American nation which experienced a parallel surge in its export sector at the beginning of the century. Between 1910 and 1920, Mexico experienced rapid growth in oil production, bringing it to supply one quarter of the world's oil output by 1921. In contrast to Venezuela, this surge in oil exports did not bring about greater political stability. On the contrary, the period beginning in 1910 corresponds precisely to the collapse of Mexican political institutions and the succession of internal wars between regional groups known as the Mexican Revolution.

A fundamental difference between Mexico in the 1910s and Venezuela in the post-1920 period is that Mexico did not begin a process of centralization and consolidation of national public finances nor the modernization of the Armed Forces at the time at which oil revenues start to grow. By the second decade of the twentieth century, Mexican states enjoyed considerable fiscal autonomy, allowing them to determine mechanisms for revenue collection with minimal harmonization with the national regime.<sup>51</sup> Despite Porfirio Díaz's (1877-1911) attempts to consolidate fiscal power, he was never able to concentrate fiscal collection in the hands of the central government. Nor did Mexico develop a professionalized armed forces: Díaz decided to scrap the project for modernizing the military because of fears of the accumulation of power by the Minister

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<sup>51</sup> Courchene, Díaz-Cayeros and Webb (2000), Careaga and Weingast (2003)

of War and initiator of these reforms, Bernardo Reyes.<sup>52</sup>

At the end of the Porfiriato, there was a multiplicity of groups of regional power that enjoyed access to economic and military resources, allowing them to articulate a challenge to the dominion of central power. The first military challenges to central power proved precisely to be regional in nature—Bernardo Reyes had established his base of power as Governor of the State of Nuevo León and Francisco Madero, who succeeded Díaz in 1910, was from one of the richest landowning families in the State of Coahuila. The geographical and social dispersion of political power generated high incentives for oil companies to themselves become involved in financing contending factions.<sup>53</sup>

The absence of a professionalized military, the high degree of fiscal autonomy of Mexican states, and the existence of multiple centers of regional power meant that an influx of oil revenues did not have a stabilizing effect. If anything, its effect could have helped further destabilize Mexican society, by raising the rents that could be derived from capturing national power. As in Venezuela, institutional development was affected by initial conditions.

#### 4. Concluding Comments

This paper has argued that the impact of oil on Venezuela's 20<sup>th</sup> century political and economic evolution can only be understood within the framework of the institutions that Venezuela had developed by 1920. If Venezuela had been characterized by the

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<sup>52</sup> Hammet (1999, p. 205).

<sup>53</sup> The extent to which they did so is a controversial issue. See the discussion in Brown (1992, Chapter 3).

geographical and political atomization of Mexico in the 1910s, it is probable that it would have fallen into an escalation of political conflict similar to the Mexican Revolution. If Venezuela had been endowed with a professional civil service such as that of Chile and Costa Rica in the 19<sup>th</sup> century, it may have made a transition toward democracy with a series of solid intermediate institutions capable of mediating among sectoral demands and attenuating the distortionary effects of redistributive politics.

Venezuela's accelerated 20<sup>th</sup> century growth coincided with the strengthening of an institutional structure that depended on the availability of economic resources. As oil revenues started to decline in the early eighties, the patronage-based democratic system proved incapable of managing the necessary scaling down of demands. The inadequacy of its response led to a crumbling of traditional structures and the emergence of a set of new political actors grouped under the banner of the Bolivarian revolution. The study of the interaction between the institutional constraints that resulted from the evolution that we have chronicled and the intentions and actions of these new actors forms a logical next step in the articulation of a new analytical political and economic history of Venezuela.

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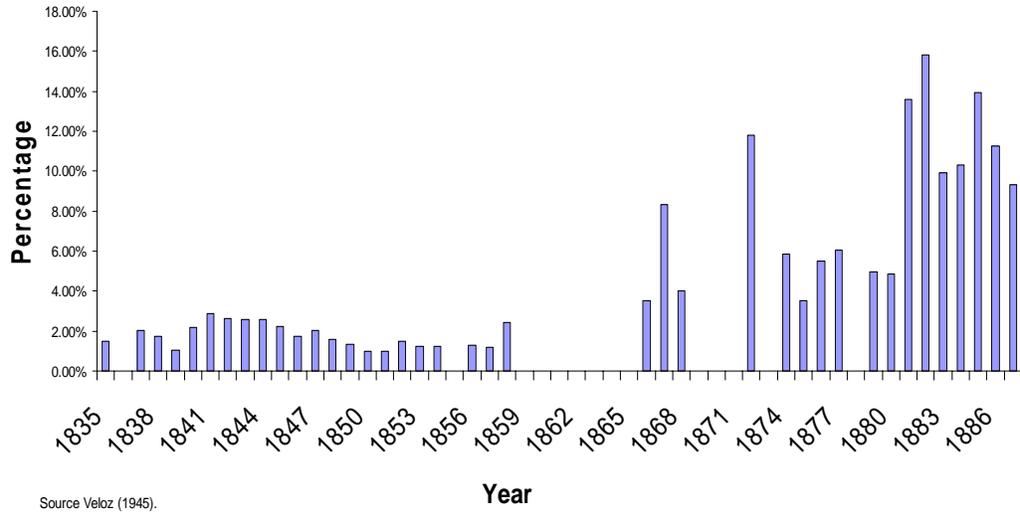
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**Figure 1: Transfers to states as % of Central Government Revenues**



Source Veloz (1945).