# The Importance of Institutionality in Economic Development

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The 2024 Nobel Prize in Economics was awarded to Daron Acemoglu, James A. Robinson, and Simon Johnson for their contributions to understanding how economic and political institutions influence economic development and societal well-being. Their multidisciplinary research on institutional issues has extended and strengthened the legacy of another Nobel laureate, Douglas North, who first highlighted the importance of democratic institutions for economic progress. However, the current laureates have taken a further step by demonstrating that inclusive institutions are fundamental for sustainable economic growth, while extractive institutions perpetuate poverty and inequality.

Now, what do inclusive and extractive institutions mean? In their work Why Nations Fail (2012),[1] Acemoglu and Robinson define them as follows: inclusive institutions are those that promote broad participation in the economy, protect property rights, foster innovation, and ensure equal opportunities. These institutions generate sustainable economic growth.

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1 Daron Acemoglu, James A. Robinson, *Why Nations Fail: The Origins of Power, Prosperity, and Poverty,* Crown Business, Nueva York, 2012.

For their part, extractive institutions are designed to benefit an elite, limit economic and political participation, and concentrate power and wealth. These institutions lead to economic stagnation and perpetuate poverty. In this work, their quantitative research compares the economic development of countries with inclusive institutions against those with extractive institutions.

And they highlight this with an example: by 1950, South Korea and North Korea had similar levels of GDP per capita, while by 2010, South Korea's GDP per capita was 10 times higher, explained by its open market economic model and a framework of inclusive institutions. To support this case, they use data on land distribution, income, and wealth to show how extractive institutions perpetuate inequality and limit economic growth.

In another study by the authors, Institutions as a Fundamental Cause of Long-Run Growth (2005),[2] published as part of the Handbook of Economic Growth, they use indicators such as the property rights protection index and the democracy index in more than 80 countries to measure the quality of institutions across nations. These findings allow them to estimate a strong correlation between institutional quality and economic growth: an increase of one standard deviation in institutional quality is associated with a 2% to 3% increase in annual economic growth.

In this work, they also analyze the impact of institutions on economic growth compared to other factors such as geography and culture. Based on historical data from more than 80 countries, they find that institutions explain over 60% of the variation in long-

2 Daron Acemoglu, Simon Johnson, James Robinson, "Institutions as a Fundamental Cause of Long-Run Growth", en *Handbook of Economic Growth,* editado por Philippe Aghion y Steven Durlauf, Elsevier, Amsterdam, 2005, 385-472.

term economic growth. Meanwhile, in Economic Backwardness in Political Perspective,[3] they examine how political elites can block economic development in order to maintain power.

In general terms, the authors make use of mathematical models and employ instrumental variables, such as settler mortality rates and pre-colonial population density, to isolate the impact of institutions on development and verify their influence. Among the quantitative elements used are settler mortality rates as an instrumental variable to measure institutional quality; econometric regressions showing the relationship between institutions and GDP per capita; institutional quality indices, such as protection of property rights and democracy; historical comparisons of GDP per capita between countries with inclusive and extractive institutions; and mathematical models to explain the political and economic decisions of elites.

## The historical approach: colonization shaped future generations

Adding a historical-geographic perspective to the background that leads us to the current Latin American and Venezuelan context, the study The Colonial Origins of Comparative Development[4] by Acemoglu, Robinson, and Johnson argues that the colonial institutions established by European powers had a lasting impact on the economic development of countries.

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3 Daron Acemoglu, James Robinson. "Economic Backwardness in Political Perspective", *American Political Science Review* 100 (1), 2006, 115-131.

4 Daron Acemoglu, Simon Johnson, James Robinson. "The Colonial Origins of Comparative Development: An Empirical Investigation", *American Economic Review* 91 (5), 2001, 1369-1401.

According to the authors, in regions where colonizers face high mortality rates (measured per 1,000 soldiers or missionaries), such as much of Latin America, extractive institutions were established, designed to exploit resources and labor rather than promote property rights and broad economic participation. To demonstrate this, they linked settler mortality rates and their correlation with current GDP per capita, and in turn, the quality of institutions (measured by indices such as protection of property rights) with current GDP per capita. They found that institutions account for between 50% and 75% of the variation in economic development among countries. These institutions persisted after independence, creating economic and political structures that perpetuate inequality and limit inclusive growth.

In the current context of Latin America, this theory remains relevant for understanding the region's structural challenges, such as economic inequality, institutional weakness, and the concentration of political and economic power. Many Latin American countries still struggle to build inclusive institutions that promote sustainable development and reduce social gaps. Furthermore, phenomena such as corruption, political instability, and dependence on extractive economies reflect the historical roots highlighted by Acemoglu and his colleagues, underscoring the need for deep reforms to overcome these colonial legacies.

The works of Acemoglu and North provide a compelling explanation that extractive institutions are a core element of the Venezuelan crisis and offer a framework for understanding how it might be overcome. However, the institutional change needed to transform Venezuela's economy faces enormous challenges, including resistance from political elites, political polarization, and dependence on oil. Nevertheless, their theories also show that change is possible if consensus and social mobilization can be built around the need for inclusive institutions that promote economic development and the well-being of all citizens.

## Institutions and the Venezuelan Context:

The connection between the works of Daron Acemoglu and Douglass North, both Nobel Prize winners in Economics (Acemoglu in 2024 and North in 1993), and the current situation in Venezuela is profound, as their theories on the role of institutions in economic development help explain the causes of the Venezuelan crisis and offer a framework for understanding how it might be overcome.

Theoretically described earlier, extractive institutions sound like the very reflection of what we have witnessed in Venezuela for decades: political and economic power has been concentrated in the hands of an elite (first economic and later political), which has led to the exploitation of the country's resources (primarily oil) without generating sustainable development.

In this regard, the Venezuelan government has weakened inclusive institutions by centralizing political power, eroding property rights (mass expropriations, state control of key sectors, punitive use of the tax authority, and discretionary use of the justice system), curtailing political participation through repression and the absence of free elections, and maintaining an oil-dependent economic system that benefits a political and military elite while excluding the majority of the population.

The known result has been an economic collapse, with hyperinflation, extreme poverty, and a humanitarian crisis, confirming Acemoglu and Robinson's thesis on how extractive institutions, combined with various other issues, lead to economic failure.

Along the same lines, Douglass North, in his work Institutions, Institutional Change and Economic Performance,[5] emphasized that institutions (the formal and informal rules governing human interaction) are fundamental to economic development. According to North:

- Institutions determine the economic and political incentives in a society.
- Sustainable economic change requires institutional change —that is, the transformation of the rules governing the economy and politics.
- Informal institutions (such as cultural and social norms) also play a key role in development.

In Venezuela, formal institutions (such as the judicial system, parliament, and regulatory agencies) have been weakened by political power, even in the years prior to the arrival of Chavismo. This has destroyed incentives for investment, innovation, and economic growth.

Informal institutions, such as the culture of dependence on the state (inherited from the oil rentier model), have also contributed to economic stagnation. For decades, the state has been seen as the main provider of jobs and welfare, which has limited the development of a dynamic private sector.

5 Douglass North, *Institutions, Institutional Change and Economic Performance,* Cambridge University Press, 1990.

According to North, economic change in Venezuela would require a deep institutional transformation, including the reconstruction of formal institutions that guarantee the rule of law, property rights, and economic competition, as well as a cultural shift that fosters private initiative, innovation, and economic diversification.

This process will likely not be free of setbacks; North warned that institutional change is a slow process and that reversals are common. Even if Venezuela achieves political change, economic transformation will take time and sustained commitment to building inclusive institutions.

## Growth or Economic Development: What Do Countries Aspire To?

Robert Solow defined economic growth as the sustained increase in the production of goods and services in an economy —driven by the productive factors of capital and labor— primarily measured through GDP. This concept focuses on quantitative aspects, such as the size of the economy, without guaranteeing improvements in quality of life.

On the other hand, economic development is defined by Amartya Sen and Joseph Stiglitz as a broader concept that involves improvements in the well-being of the population, including aspects such as education, health, social equity, and access to basic services. It is measured with indicators like the Human Development Index (HDI) or income distribution. The main difference lies in that economic growth can occur without structural changes or social benefits, whereas economic development seeks sustainable and equitable progress that positively impacts the quality of life of the entire population. In other words, economic growth is neither a necessary nor sufficient condition to guarantee development, but for development to occur, economic growth must exist.

Aligned with this debate, a phrase I often use to conclude one of my first classes in the second-semester economics program is this one by Robert F. Kennedy where he said:

> "Too much and for too long, we seemed to have surrendered personal excellence and community values in the mere accumulation of material things. Our Gross National Product, now, is over $800 billion dollars a year, but that Gross National Product —if we judge the United States of America by that— that Gross National Product counts air pollution and cigarette advertising, and ambulances to clear our highways of carnage. It counts special locks for our doors and the jails for the people who break them. It counts the destruction of the redwood and the loss of our natural wonder in chaotic sprawl. It counts napalm and counts nuclear warheads and armored cars for the police to fight the riots in our cities. It counts Whitman's rifle and Speck's knife, and the television programs which glorify violence in order to sell toys to our children.
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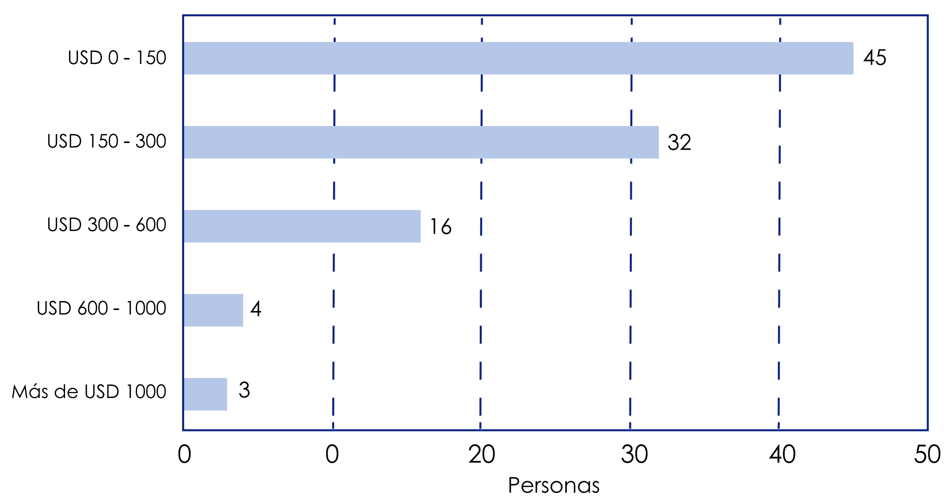
> Yet the gross national product does not allow for the health of our children, the quality of their education or the joy of their play. It does not include the beauty of our poetry or the strength of our marriages, the intelligence of our public debate or the integrity of our public officials. It measures neither our wit nor our courage, neither our wisdom nor our learning, neither our compassion nor our devotion to our country, it measures everything in short, except that which makes life worthwhile. And it can tell

us everything about America except why we are proud that we are Americans."[6]

## The "extractive institutions trap"

Both Acemoglu and North agree that countries with extractive institutions face a difficult "trap" to overcome, since the elites benefiting from these institutions have little incentive to change them. In Venezuela's case, the governments of recent decades and their allies have built an extractive system that allows them to maintain political and economic power, even at the expense of the majority's welfare. This is reflected in the fact that by July 2024, 7% of the population earned monthly incomes below USD 300, contrasted with only 3.0% earning more than USD 1,000.




Source: Ecoanalítica

In that sense, the absence of an inclusive institutional framework hinders the transformation the country needs to significantly improve its prospects.

6 Robert F. Kennedy, Speech at the University of Kansas, March 18, 1968.

## The relationship between political and economic institutions

According to Acemoglu and Robinson in Why Nations Fail, political and economic institutions are deeply interconnected and determine the success or failure of nations.

Inclusive political institutions, which promote broad participation and guarantee political rights, tend to generate inclusive economic institutions that foster innovation, investment, and economic growth by protecting property rights and offering equal opportunities. Conversely, extractive political institutions, which concentrate power in the hands of an elite, often give rise to extractive economic institutions designed to benefit a few at the expense of the majority, limiting sustainable economic development. Essentially, political institutions shape economic ones, and the latter reinforce the former, creating either a virtuous or vicious cycle depending on their nature.

In this regard, the authors emphasize that inclusive political institutions are a necessary prerequisite for the development of inclusive economic institutions. Inclusive political institutions distribute power more equitably, limit the abuse of power, and enable the creation of economic policies that benefit the majority.

Conversely, extractive political institutions concentrate power in the hands of an elite, which perpetuates extractive economic institutions.

## Perspectives for 2025: Tied to the Institutional Bottleneck.

Bringing the discussion to the current moment in Venezuela, the economic outlook for 2025 is marked by the significant political and institutional deterioration following the contested presidential elections of July 2024, as well as the consequences this may have on the sanctions policy of the Trump administration in the U.S. This clearly illustrates the impact of the institutional framework on the country's growth, and our scenarios are essentially framed within this context.

In the event that licenses granted to companies such as Chevron and Reliance —together representing more than 30% of oil exports— are revoked, the outlook for 2025 will deteriorate significantly. These licenses have been key to maintaining a certain level of stability in oil production and national revenues, so their removal would have a profound impact on the Venezuelan economy.

Chevron's license, which participates in production through four joint ventures, and Reliance, which handles the marketing of Venezuelan crude in Southeast Asia —accounting for nearly 50% of Venezuelan crude demand— have allowed Venezuela to maintain limited but stable oil production. They have improved conditions of critical infrastructure in extraction, financing, and access to international markets. Without them, Venezuela would face greater difficulties placing its oil in the international market due to sanctions.

Without these licenses, production could gradually decline by 20 to 30%, leaving the average production level in 2025 at around 700,000 barrels, given that PDVSA currently lacks the technical and financial resources to sustain current extraction and refining levels.

Furthermore, this could lead to an increase in clandestine exports —using old tactics such as turning off vessel GPS, transferring cargo at sea, or flying flags other than Venezuela's— or to an increase of discounts on crude prices, reducing revenue per barrel. Likewise, the lack of foreign investment and maintenance in oil infrastructure would worsen, accelerating the sector's collapse. This would have long-term effects, even if sanctions are eased in the medium term.

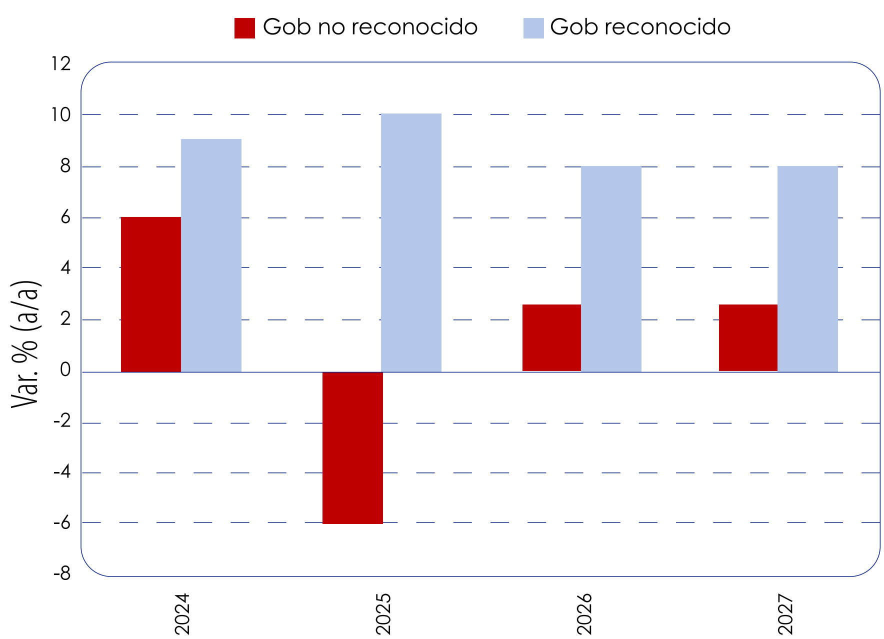
The elimination of these licenses would significantly reduce the government's dollar revenues, further limiting its capacity to import essential goods, fund social programs —thereby increasing inequality— and stabilize the exchange rate. The worsening economic and social crisis could trigger a new wave of migration, as studies by Delphos indicate that 20% of the current population wishes to leave the country if no political change occurs in the short term.

This would result in greater dependence on informal labor and remittances. With diminished oil revenues, remittances and the informal economy would become the primary sources of foreign currency access for the country and essential support for families.

Along these lines, the government would face difficulties maintaining exchange rate stability, which allows us to anticipate in our baseline scenario a greater devaluation of the bolívar —its smallest devaluation in a decade was in 2024, at 44%— and an increase in inflation compared to the end of 2024, which stood at 48% year-on-year. Informal dollarization —which the government is likely to facilitate again by removing or reducing the Tax on Large Foreign Currency Transactions, authorizing dollar transfers, and lowering cash withdrawal costs in banks— would continue benefiting a minority with access to foreign currency, while the majority of the population, dependent on the bolívar, would face greater difficulties.

The Venezuelan economy, which has shown signs of stabilization in some sectors thanks to dollarization and partial opening, could contract again after accumulating 19% growth in the period 2021–2024. This recovery is weak in terms of conditions and small mathematically: it barely offsets the 77% decline the economy suffered between 2014 and 2020. These years of low growth still imply that the economy is 72.6% smaller than it was in 2013.

That said, without an agreement that advances the country's reinstitutionalization, we foresee at least a 5% GDP contraction in 2025, especially if the oil sector —which remains the main engine of the economy— is severely affected.




Source: Ecoanalítica

In the coming years, if the low recognition of the government persists, the economy would continue in that cycle of "stability in the pit," as has been mentioned before —referring to the economy's failure to resolve its institutional problems and structural flaws, such as poor functioning of basic services, international sanctions, lack of internal and external financing, low consumer purchasing power, among others. As a result, the best outcome would be stabilization or maintaining low growth levels, given the limitations to advance on a path of broad-based, sustained growth close to double digits —as would be expected for an economy that contracted to a quarter of its size in the past decade.

Venezuela's economic situation in 2025 clearly reflects how institutional deterioration can constrain a nation's progress. Inclusive and functional institutions are the cornerstone of any sustainable recovery, and without them, the country faces a cycle of low growth, where gains are fragile and setbacks are severe.

However, even in this bleak scenario, there is a powerful lesson: structural change and reinstitutionalization are not only necessary but also possible. Global economic history shows that nations that manage to rebuild their institutions, foster trust, and open themselves to the world can reverse decades of crisis. Venezuela has the potential to emerge from this institutional bottleneck, but it requires bold decisions, political agreements, and a genuine commitment to the well-being of its people.

The future is not written. While the challenges are immense, so is the capacity of Venezuelans to endure, adapt, and forge a path toward prosperity. The key lies in recognizing that progress will not come from temporary measures, but from a profound, albeit gradual, change that allows the economy and society to flourish once again.