

The Labor Market and Retirement Pensions in Cuba During the Transition: Reflections on the Social Safety Net Experience of Former Socialist Economies

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In moving to a democratic and market-based setting most of the former socialist economies have faced common problems. In these notes I will focus on two important safety net aspects. The first one relates to the labor market, employment in particular. The second has to do with what one may call the old-age, disability, and survivor pension system. I will comment on difficulties which have afflicted transition economies, are likely to arise in Cuba, and the approach I would take to deal with them. I will try to be provocative.

In the paper I use the term social safety net (or safety net for short) to refer to the set of arrangements through which a society helps its members who require income transfers to overcome poverty, or those who need income insurance as a means to protect them from old age, disability, or short-term calamities. [\[2\]](#) In such light, people affected by safety net issues as approached by me include pensioners, welfare recipients, and the unemployed.

The two critical areas I address --unemployment and pensions-- are intertwined. For example, the pension regime and labor market conditions will affect individual decisions regarding whether to remain in the labor force and the seeking of retirement pensions and social assistance.

I. Importance of the Safety Net Issues

In general, one may classify the problems that will face the policy-maker in Cuba during the early transition as of two types. The first one consists in what to do with respect to dislocations likely to be transitory. Examples are: layoffs resulting from the contraction or disappearance of old industries while still the new ones have not created offsetting sources of employment; fall in real incomes and wages as a result of falling output during initial stages of the transition; financial stress or outright bankruptcy in the pension and welfare system; potential contraction in social services (education and health) as a result of budget tightening.

The second problem relates to building the foundations for a sound safety net system. What type of education system does the country need? What labor market institutions should be established --e.g., collective bargaining, unemployment benefits, employment legislation, wage policy? What health system? How to structure the long-term social security system?

The challenge is to address the short-term problems without weakening the longer term objectives and the goal of economic restructuring. Vice-versa, how can the society build its long-term social institutions without aggravating short-term adverse events?

Aside from the humanitarian dimensions involved, decisions affecting the transitory or short-term problems are fundamental because the way the government addresses them may well determine the political viability of the reform process. The second type of problems, the long-term ones, is important because it belongs to the scope of policy decisions which, once made, are very difficult to change.

A key point is that the policy choice affecting long-term safety net issues is likely to tie the economy to a given type of evolution rather than to another. [\[3\]](#) The issue relates to the difficulty in reversing, in a democratic setting, the policy choice. In this light, decisions relating to safety nets may be much more important than those pertaining to traditional macroeconomic management.

For instance, as argued by Newberry, the initial choice of the exchange rate may have little in the way of a long-run effect on the economy --presumably because it is reversible, albeit at a cost. On the other hand, using this insight, due to political and social dynamics, choices relating to labor market regulations, and pension and welfare systems, for instance, are likely to be more difficult to reverse.

Accordingly, the labor market and other safety net issues mentioned in this paper are of no less importance --probably more-- than stabilization or other economic restructuring aspects.

II. The Labor Market

As pointed out by Flanagan (1994), the approach toward the labor market in the early transition phase of the former socialist economies of Eastern Europe has been essentially determined by the short-term objective of economic stabilization. The allusion is to the reliance on incomes policy to prevent wage-price escalation. In addition, there has been an effort to develop the labor market institutions of modern Western economies. What can one learn from such experiences?

The first thing I would point out is that, as expected, unemployment rose in these economies although its severity differed significantly across countries. Second, unemployment was of relatively long duration, a phenomenon which increases the risk of workers becoming unemployable. Third, the proportion of the inactive population rose in most of the countries (Romania and Poland were the exceptions).[\[4\]](#)

Table 1 illustrates the general pattern. The table shows how the distribution of the working age population by labor force status changed between 1989 and 1992. For example, the proportion of the working-age population of men in Bulgaria who were employed fell by 19.3 percentage points, the proportion of unemployed men rose by 9.5 percentage points, and the proportion of men out of the labor force (inactive) rose by 9.8 percentage points. The key point from the perspective of the present notes is that the proportion of the working age population depending on transfers from the rest of the society, either through unemployment benefits or pensions, rose.

The rise in the proportion of the working age population accounted for by the inactive population is suggestive of a strong substitution effect associated with falling real wages and, possibly, the ease with which one could apply for early retirement.[\[5\]](#) Another aspect of interest is that the supply elasticity for women seems higher than for men, something which is consistent with the experience on other countries. While it is possible that Cuba experiences similar withdrawals from the labor force, especially among women, I would expect much weaker effects if at all --i.e., I would not expect any significant changes in labor force participation rates.

The reason is that real wages in Cuba have already fallen dramatically in recent years, and given the already very low production levels, I would not expect additional serious falls in real wages during the early transition. Moreover, even if such falls materialized, if monetary overhang is quickly eliminated as in many of the Eastern European countries, and the surely very low levels of real assets, I would not be surprised if one saw the prevalence of an income effect. In other words, one may have a strong "added worker effect" that is reflected in increases in labor force participation.[\[6\]](#) This would be consistent with the increases in labor force participation for women especially in Romania, but also in Poland, that Table 1 indicates.

The rise in unemployment reflected several factors. One was the external shocks that afflicted these economies (for example, the disappearance of the CMEA) and the consequent fall in aggregate demand.[\[7\]](#) A related one was that employment creation in the formal private sector was not fast enough to absorb new labor force members and jobless workers flowing out of the state sector.[\[8\]](#)

In terms of labor market measures, to cope with unemployment governments resort to two types of policies. One is the use of passive labor market policies which may be loosely defined as policies that tend to provide workers with alternative sources of income. Unemployment insurance, welfare support, and early retirement pensions are typical passive policies. The second type is the use of measures which seek to increase the employment of labor --active policies. Which of the two types of policies is the most promising for the transition in Cuba?

Both types of policies will have to be used. However, I would favor reliance on a subset of active labor market policies.

In contrast to most of the Eastern European countries when they started their transition, Cuba has an unemployment benefits scheme (Mesa-Lago 1993). Whether, in practice, this is an advantage remains to be seen.[\[9\]](#) In any case, the transition government in Cuba will have to restructure and strengthen the financial basis of the scheme. This will call for a readjustment of benefits and contributions.

In this connection, it is noteworthy that one of the difficulties in the transition economies has been the lax controls for determining who can qualify as unemployed. This makes it difficult to separate the truly unemployed --entitled to unemployment benefits-- from persons deserving other type of social assistance, or none at all. Revamping the unemployment benefit system will call for moving rapidly to setting a modern system of unemployment registration and control.

Another problem is determining the level, duration, and basis of unemployment benefits. Should, for example, those benefits be linked to previous incomes?

My preference is for a scheme which provides benefits for a relatively short-period, front-loads the payments, and links the level of benefits to active job search and retraining. Workers should not see unemployment as an acceptable alternative status to paid employment. In this connection, I have in mind the results of recent analyses which trace high unemployment and long-term unemployment in some Western European countries, as well as in some of the transition economies, to generous and protracted unemployment benefits (OECD 1994).

I favor the front-loading of benefits as a tool for promoting the setting of independent businesses by small-scale entrepreneurs during the transition period. For example, provided an unemployed worker meets certain conditions (coming up with a reasonable plan for self-employment) the amount covering the first three months of unemployment would be paid as a lump sum soon after registration as unemployed. Such payment would not be means tested.[\[10\]](#)

Any additional unemployment benefits after the first three months would be at a lower rate, subject to very strict conditions, and disbursed periodically for a limited period --say, no more than four additional months. While the key objective of the unemployment benefit scheme has to be to protect the unemployed and his family during a short-term labor market calamity (i.e. being unemployed), it is important that the system discourage a state-dependent mentality and establish strong incentives for job search.

It is unlikely that Cuba would be able to provide unemployment benefits early in the transition on the basis of a true unemployment insurance scheme (i.e., an scheme which links benefits to previous contributions based on earnings). Such a scheme could come at a later stage. In such light the benefits scheme should be simple --a flat-rate has been used in other transition economies and has been recommended for Cuba (Mesa-Lago 1993). Nonetheless, I would favor a modified flat-rate-cum-additional-benefits scheme for a limited period for workers in firm-sponsored training programs.[\[11\]](#)

At least during the early stages of the transition, financing for the unemployment benefits system will have to come from a combination of general revenues and payroll taxes. My sense is that the system should gradually shift to an unemployment insurance system based on payroll taxes paid both by the employers and the employee. The level of benefits and contributions will have to be established on the basis of actuarial-type analyses.

However, in this connection, as with pension contributions (as will be pointed out later), the system will have to avoid a problem that has afflicted other transition economies. The evasion of payroll contributions through informal working arrangements. One would think that breadth of effective coverage rather than high taxes is the most promising avenue.

In regard to the active labor market policies I would propose, my emphasis would be on developing:

- (1) a labor market legal setting which is seen as fair and, at the same time, allows for flexibility in hiring and firing decisions;
- (2) an integrated system of employment services which includes job-matching and information, training, and counseling and which permits competition between the private and public sectors in the provision of such services;
- (3) limited publicly-supported employment programs; and,
- (4) a program of severance pay and incentives for public sector employees.

While the transition economies (as well as others) have made use of wage subsidization to encourage employment, and while some degree of wage subsidization may be useful in Cuba in the early transition, I do not place great hope on it. In some countries (Romania is often mentioned) wage subsidization has allowed state firms to retain workers in unproductive jobs. Further, in practice, it will be difficult to distinguish the firms where the subsidy is needed for employment, from those enterprises that would have hired even in the absence of subsidies.

Nonetheless, wage subsidization may be used especially in connection with new (inexperienced) entrants to the labor force. I find the argument for using wage subsidization to promote the employment of the long-term unemployed less persuasive. The reason is that employers are likely to regard workers covered by wage subsidization as of lower quality.

In regard to public-employment programs I would encourage support for economically worthy and community-based self-help projects that translate into small infrastructure activities. The endeavors could be partially financed from general state revenues and target low-income population groups.[\[12\]](#) The trick, however, is to avoid make-work activities.

My mention of a severance pay and incentives program for public sector employees reflects my sense that, in the context of an adequate legal, regulatory, and judicial setting that promotes entrepreneurial activities, such a program could help trim the state sector and encourage entrepreneurial drives. The risk of such programs is that, unless a competitive wage structure is established for the public sector, the government might lose its most productive employees.

Three final points on the labor market. The first one is that, as argued by Flanagan, I feel that a tax-based incomes policy through which firms are penalized if their payroll or average wage increases exceed a given standard, does inhibit the process of labor reallocation and economic restructuring, really the main objectives of the transition. While I can see that as long as firms, especially state enterprises, are not exposed to hard-budget constraints wage induced inflation is a danger, the solution does not lie in an

approach that hinders the allocative function of the labor market, but in moving fast in large and small scale privatization, with the imposition of hard budget constraints, and with the liberalization of markets. [13]

The second and central point is that labor market policy cannot solve the problem of an insufficient number of jobs. The demand for labor being a derived demand means that employment will rise only as a reflection of what happens in the overall economy. The fundamental point is that the transition should generate, fast, the proper incentives for the attraction of investment resources and their efficient allocation. To me, this calls for a clear policy course, priority attention to explaining the policy course to the people, a focus on the details of the implementation, and moving broadly, quickly, and firmly rather than gradually and haltingly.

Finally, and this applies to other safety net aspects, in setting the level of payroll taxes the government has to be aware of the potential conflict between such source of taxation and the objective of generating productive employment as fast as possible. Such taxes are likely to raise the cost of hiring labor (at least in the formal sector) at a time when unemployment probably will rise and become a prime concern (McAuley 1994). Moreover, as implied earlier, too high payroll taxes may lead to informal sector growth and to tax evasion.

III. Retirement and Disability Pensions

At the early stages of the transition, the retirement systems of many of the former socialist economies have been afflicted by a common set of problems which led to the systems being insolvent. Among the generalized problems one can mention:

1. *Systems were too generous.* Retirement ages were too low and pension-to-previous-income ratios were high. For example: in Poland pensions were as high as average wages (Graham 1994); in the former Yugoslav republic of Macedonia, the per-capita income of pensioner households was estimated to be higher than the per-capita income of families dependent on wages (Marquez 1994). In most of these countries men could retire at age 60, women at 55 years of age.

2. *Systems in disequilibrium.* Frequently one finds systems in which the present value of the payments received is much higher than the present value of the contributions. Accordingly, the current economically active generation transfers resources to the retired over and above the returns on the financial assets that might be purchased with the contributions. This had at least two consequences. One is that the systems did not encourage savings. The second is that the systems encouraged early retirement. In Poland, for example, 25 percent of the pensioners retire early.

If the proportion of the economically active population in the total population were rising, there would not necessarily be a problem. However, the common situation was one where the population of retirement age will grow faster than the economically active population during coming decades. This is the situation in Cuba (Mesa-Lago 1993).

What this means is that, *at some point*, the system will have to change to one that links benefits to contributions and that finances itself through invested savings rather than through transfers.

3. *Inadequate records and controls.* Data on contributors are faulty or frequently missing. Due to inadequate controls, malfeasance and misrepresentation are widespread problems, especially in connection with disability pensions. Moreover, it was possible to work full-time while receiving a pension.

4. *Tax base and collection difficulties.* As contributions were based on payroll taxes, a frequent

occurrence, a fall in registered employment along with rising unemployment meant a reduction in the tax base. Likewise, the collection and allocation of funds has often presented the difficulty that contributions went to the budget and disbursements were dependent on the politics of annual budgetary allocations.

5. Lack of separation of the social-assistance-for-the-elderly and the savings-for-old-age functions. One finds that a high proportion of pensioners in these countries often receive minimum pensions. This suggests that, for these persons, the pensions are a form of welfare assistance rather than a return based on previous savings by them or their employers. My point is not that such assistance not be granted, but that the system must distinguish between welfare and retirement pensions. One reason is that the sources of financing should differ in the long term. It would seem appropriate to finance welfare assistance from general fiscal revenues. Retirement assistance, on the other hand, would be linked to previous contributions.[\[14\]](#)

To cope with these problems, countries have had to adjust the levels of benefits and broaden the contribution base. The latter has been hindered to the extent that private firms do not report or contribute.

My sense is that Cuba will have to do something similar. Retirement ages will have to be adjusted upward and benefits may have to be revised downward. Simultaneously, the transition government will have to improve existing methods of revenue collection and payment so that both take place timely and cost-effectively.

However, action along the lines mentioned should be based on actuarial analyses that serve to identify what is needed for greater financial stability in the short-term and financial equilibrium in the longer term. Such analyses would simulate the sensitivity of the financial condition of the pension system to changes in such variables as replacement ratios (the ratio of the retirement payments to previous income), raising retirement ages and equating the retirement age for women and men, taxing benefits, and the adoption of flat-rate pensions during different periods. It is encouraging to see, from other works presented in the 1994 ASCE meetings, that such type of work has already started.[\[15\]](#)

While one could think in terms of a totally privatized pension system (a la Chile), given the lack of adequate financial institutions it is probably more realistic to think in terms of a mixed system in which a public pension system coexists with private pensions.[\[16\]](#) From this perspective, a medium-term priority consists in establish a second-tier system of personal security accounts that could be used by the owner to provide annuities after a certain age (whether working or not), retirement income, and other uses consistent with income security provisions.

Such a second-tier of security accounts would complement the modified old age, disability, and survivors social system run by the public sector, and be geared especially to the needs of the new emerging private sector. In this new complementary system, pensions could be determined by the contributions made by the subscribers plus the earnings from the investment of the funds contributed. The personal accounts would be managed by private sector institutions under an adequate regulatory, monitoring, and supervisory framework.

The rationale for the proposed private second-tier pension system is that it would create an additional source of income security, help promote the development of financial markets and savings, and help instill a sense of personal responsibility for one's own future. Naturally, the development of this type of second-tier security mechanism would be contingent on the pace of the privatization and liberalization of the economy.

IV. Summing Up

To conclude, I wish to stress that the strongest foundation for an effective social safety net is a well-functioning labor market. In the democratic transition, Cuba will have to move fast to ensure that the labor market allocates skills where they are most productive and allows the relative price of labor to reflect its scarcity relative to capital.

To achieve such objectives the transition government will have to move quickly to disencumber the labor market of barriers to labor mobility and the economy of obstacles to a rise in the demand for labor. As indicated above, in my opinion this requires a fast pace along a broad range of reforms. I would discourage reliance on any form of incomes policy for any extended period of time --no more than a few initial months.

In the area of pensions, the priority will be to cope with the short-term problem of insolvency while setting the foundations for a system that links benefits to contributions, separates social assistance from retirement income, does not encourage early retirement, and complements public with private pensions.

Table 1. Change in The Labor Force Status of the Working Age Population in Selected Countries, 1989-1992

(percentage point differences in the distribution)

	Bulgaria	Czech Republic	Hungary	Poland	Romania	Slovak Republic
Men						
Employment	-19.3	-5.7	-14.6	-10.7	-6.5	-14.3
Unemployment	9.5	1.8	10.0	9.4	5.3	8.8
Inactive	9.8	3.9	4.6	1.3	1.1	5.6
Women						
Employment	-23.0	-9.9	-13.8	-10.3	0.2	-20.1
Unemployment	11.8	2.6	7.5	10.6	9.3	9.7
Inactive	11.2	7.3	6.2	-0.3	-9.5	10.4

Source : Flanagan (1994)

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Footnotes

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[1] I acknowledge helpful comments by Carmelo Mesa-Lago. [Back to Text](#)

[2] The reader will note that in the literature the term safety net is not always used in the same way. My concept is broad enough as to include labor market arrangements that affect a person's capacity to secure productive employment. [Back to Text](#)

[3] On the importance of policy decisions that are hard to reverse see David M. Newberry (1991). [Back to Text](#)

[4] On these points see Flanagan (1994) on which this section draws heavily for its background information. [Back to Text](#)

[5] See Flanagan (1991) for a discussion of income and substitution effects in the context of these countries. [Back to Text](#)

[6] In other words, additional family members would engage in income-earning activities to arrest the fall in family income. [Back to Text](#)

[7] However, one is to note that the present Cuban government acknowledges the existence of substantial unemployment in the country. Bearing this in mind, as with further deterioration in real wages, the future transition in Cuba may involve less of an unemployment shock relative to the experience of other former socialist countries. [Back to Text](#)

[8] Needless to say, analyses of these issues have been limited by the great shortcomings of existing labor market information. It is difficult to know, for example, the proportion of workers absorbed in the unregulated (informal) labor market, or the proportion of workers who were counted as unemployed while in reality they had sources of labor income. Nonetheless, for the purposes of the present paper --the big picture-- existing analyses are useful. [Back to Text](#)

[9] In principle it will provide an administrative framework which the new government might use. However, the extent of the usefulness of existing structures in the context of rapid change to a market economy is an issue. [Back to Text](#)

[10] A similar proposal has been made by Gustavo Márquez for the former Yugoslavian republic of Macedonia. See Marquees (1994). [Back to Text](#)

[11] I was not able to include in these notes a review of the record of such programs. My sense is that the experience has been mixed and that an analysis of the issue is worthwhile to identify what works and what does not. [Back to Text](#)

[12] The experiences of the Chilean Emergency Employment Program in the mid-seventies and the Bolivian Emergency Social Fund of the mid-eighties are probably relevant.

[13] A hard budget constraint means that firms will not get automatic financing from the banking system

to cover costs, will have to pay debts or face bankruptcy, and cover their costs out of their own income.

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Regarding market liberalization, one should underline that the lack of housing has been a barrier to labor mobility in the former socialist economies. The same problem is likely to be present in Cuba unless the housing industry is able to react dynamically. Accordingly, there will be a need for a policy setting that does not hamper the construction sector. This has implications for price (rent) policy, as well for the policy course regarding the return of confiscated properties or compensation for them. [Back to Text](#)

[14] See Marquez (1994). [Back to Text](#)

[15] See the papers by Ricardo Donate and José Alonso and Armando Lago in the present volume. [Back to Text](#)

[16] Mesa-Lago (1993) makes a similar recommendation. [Back to Text](#)