

Cuba 1990-1994:

Political Intransigence *versus* Economic Reform

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"The obstacle is political control if reform moves forward fast. We economists counter that if Cuba doesn't reform fast the authorities will definitely lose control."

◁ An unidentified economist in Cuba, quoted by Gillian Gunn in "Balancing Economic Efficiency, Social Concerns and Political Control," *La Sociedad Económica*, Bulletin 42, 1994, p. 12.

I. Introduction

The Cuban economy is currently undergoing a continuing and severe contraction under the weight of its excesses and contradictions that is progressively weakening the anachronistic socialist system and also increasing social despair, unrest, and political repression. There is alienation and impoverishment. This tragic situation is forcing a reluctant and arrogant communist party government to make necessary but insufficient policy changes and reforms, in the vain hope of forestalling a transformation to a new government committed to respect for basic human and economic rights, representative democracy and a market-based economy.

The communist authorities attribute Cuba's chronic and structural economic difficulties to the U.S. embargo rather than to the socialist system and their resistance to make major reforms. Not wanting to relinquish their exclusive control of government nor to abandon a failed system, they tinker at the edges to forestall inevitable change, while trying to sell an image of a "reformist" government that is implementing "market-friendly" reforms. They are not considering people's feelings nor their personal dignity. They appear to be following the Chinese and Vietnamese models without adopting their main related market inspired reforms. The policies adopted and partial reforms have not solved the deep and long depression, high unemployment and inflation, lack of proper institutions and low foreign investment. Cuba will emerge from the socialist period with a far weaker economy than it had in the late 1950's, both in absolute and relative terms.

While there is considerable debate about the degree to which the situation can continue to deteriorate in a country with Cuba's characteristics, escalating human and labor rights violations and deepening critical shortages of food and medicines are of particular concern to those who see it leading inexorably to a plundering of national assets or selling and/or leasing natural resources at liquidation prices to foreigners and causing permanent damage to the population, which could stall future economic rehabilitation and development. This, in turn, is likely to generate a new massive emigration of Cubans to the U.S. following a change in government, as happened in the case of Albania or, in any event, that the further the situation is allowed to worsen, the greater the likelihood of a violent ending to the present precarious regime. It is our firm conviction that while the extreme socialist nature of the system is maintained, the crippled economy will continue to deteriorate and disintegrate because of the system's inherent inability to provide for the people.

Ultimately it will be up to the Cuban people themselves to find a way out of this quagmire. This paper is based on the conviction that *the systemic economic reforms required to reverse the declining standard of*

living of the Cuban people are inevitable and either entail or will induce fundamental and irreversible political change. Cuba has started to move slowly, but surely, and seems poised for sweeping changes that could finally unleash its economic potential. The force of economic necessity is now driving stabilization and structural reform. The long-delayed own account work, "free" agricultural and industrial/artisan markets could give the momentum to push through a broad agenda of even more aggressive free-market reforms and impose the right direction in the Cuban economic confusion. The genie of entrepreneurship and individual initiative is being liberated after many months of international pressures and out of sheer necessity and cannot be put back in the bottle. The valve will eventually blow as in the case of the Chinese and Vietnamese models.

We begin this paper with a summary presentation in Section II of the protracted decay and critical socio-economic conditions that Cuba faces as a consequence of the failure of the revolution's economic system and misrule, that should be addressed by the government. The Cuban economy is characterized by severe and deep-rooted macroeconomic imbalance, structural distortions and overexpanded social services. Starved of foreign funds, Cuba is in an even worse position than could have been imagined five years ago. Section III includes a presentation of the economic measures and reforms adopted by the Cuban authorities in 1990-1994 (indeed a period of regress) and an analysis of their inadequacies and shortcomings, especially of those oriented towards stimulating a supply response that are paramount to face the crisis. Section IV presents an overall appraisal of the package of measures and reforms adopted to date and concludes with some final observations and prognosis.

II. The Unsustainable Critical Economic Course

"Cuba's economy showed signs of improvement last year but it is too early to talk of overall recovery..... 1994 ended with some positive signs, including increased foreign investment, a trend toward more balanced internal finances, and growth in tourism and domestic crude oil production."

◁ Carlos Lage as quoted by *the Miami Herald*, January 26, 1995, p. A21.

"What brought down Communism in Russia? An anti-Communist party? A coup d'etat by the army? Invasion by a foreign force? No. Communism was brought down by Communists who could no longer separate their people with an Iron Curtain from images of other parts of the world that were moving forward as they stagnated under repression. The truth could no longer be hidden."

◁ Shimon Peres, *Washington Times*, June 11, 1994, p. D1.

A. Historical Perspectives and Overview

The current economic crisis in Cuba is not just the consequence of recent events. Cuban economic trends since 1986 are a story of slowdown and eventual depression determined by blunder, mismanagement, stupidity and irresponsibility by authorities whose obligation to government was betrayed by their embrace of misconceived theories and ineptly-applied policies. The authorities precipitated and deepened a recession and failed at critical times to make the necessary corrections that would have ensured the country's rehabilitation as it struggled to survive a harsh external shock and the ensuing economic crisis. They were doing the wrong things and they were doing them badly. The results of these policies were temporarily concealed by Cuba's access to substantial external transfers. Then they ran out of transfers.

In the 1975-1985 period, one of great turbulence in the world economy, Cuba was relatively isolated from two major oil price shocks, the decline in prices of raw materials and from the debt crisis that

rocked the developing world. In spite of its inefficient economic system and artificial specialization in sugar built up over many years following a process of statization, some modest growth and progress in the social sectors took place as a result of massive economic assistance from the Soviet bloc, expanding foreign debt with Western countries and some liberalization measures implemented in the late 1970's and early 1980's. During this period, under the *System of Economic Management and Planning* (SDPE) sponsored by then-planning minister Humberto Pérez, there were positive and steady gains toward market mechanisms, material incentives, cost analysis, training of economists and managers, efficiency in capital allocation, and labor productivity. The government poured resources not only into social sectors, but also into a large bureaucracy, oversized armed forces, and inefficient state-owned enterprises paying for them with loans from Western creditors and by printing money. The USSR's assistance and foreign loans afflicted Cuba with the "Dutch disease." It rationalized an extreme socialist system with near absolute centralization in the exercise of power and elimination of market forces.

Although the partial and piecemeal market improvements did not receive enough opportunity to work, they were considered threatening by the top hierarchy and were thus brought to an end in 1986 with the "Rectification Process," when Cuba became the only communist regime that consistently backed off from market mechanisms and material incentives for work, while a wave of economic reforms was sifting through the socialist bloc. It was the triumph of dogma over elementary good sense. The general commitment to extreme socialism became deeper in Cuba; in no other country was it so fully adopted as a guiding principle. Older, less educated, less sophisticated and more ideological technocrats and managers replaced Pérez's reformists. This left Cuba incapable of repaying even interest on its loans and it defaulted on its obligations to members of the Paris Club.

The status-quo-ante was essentially reestablished and this initiated the economic crisis that persists to this day. Five of the most important and popular institutions abolished were: (1) the Free Farmers' Markets (MLC) and the government parallel markets; (2) the handicraft markets; (3) the bonuses to motivate workers for increases in productivity and quality and reductions in cost; (4) private enterprise in a wide range of trades and services; and (5) private selling, rental and construction of housing. There was also a further integration of small private farms into state controlled cooperatives and several measures to increase control of labor and wages. Growing corruption and cynicism within the communist party and the state administration accompanied these reversals. The recent economic decline and current crisis is the legacy of this shift back to a Stalinist command system and of over-reliance on bad economic policies and economic subsidies from the former Soviet Union.

Nonetheless, as had occurred during the Revolutionary Offensive in 1968 and contrary to official expectations, the vitality and resilience of Cuban initiative and entrepreneurship was still alive in Cuba and thus economic disruption and chaos resulted. It was folly to believe that Cuban society could abandon the liberalization reforms and reenter a closed system that would behave according to false ethical and moral assumptions. Inefficiency and mismanagement increased steadily, contributing to the ensuing grave economic decline and dislocation. Since then, entrepreneurship has contained large doses of conspiracy and corruption.

The situation deteriorated abruptly as of 1989 with the cut-off of Soviet preferential trade and external transfers in the form of price subsidies, financing of the trade deficit, and development and military aid (see Table 1). The landing has been very hard.

In 1990 the Castro government enacted an austerity plan called "Special Period in Time of Peace," with people being moved to rural areas, as happened in Cambodia, to produce agricultural products for self-sufficiency. The main emphasis was on reducing non-essential consumption, egalitarian distribution and transfers to the unemployed. This resulted in a costly and highly disorderly adjustment ("shock without therapy") with a deep, long and inevitable depression characterized by a drastic decline in real incomes,

unemployment and acceleration of inflation in the black market. More recently it adopted some changes in policies without undertaking sufficient macroeconomic adjustment measures, institution-building and liberalizing systemic reforms. The nature and specific design of its response has been ill-advised and plagued with inconsistencies, because the essential features of the socialist system have been retained. At times, especially from 1990 until August 1993 and in the first half of 1995, there has even been a paralysis in economic policy or at least a marked procrastination. The political wishes have overwhelmed the process of economic analysis, judgment and contingency planning. The government has stumbled tactically and strategically, and has lost macroeconomic control.

There is a downward economic spiral. Production is plummeting and unemployment is mushrooming. Labor productivity has nose-dived as employment has been artificially protected while production declined. Consequently, standards of living are falling substantially. This decline is the result of an abrupt encounter of an inherently inefficient system and overexpanded social services, military and administrative expenditures combined with no massive external aid. It is also the legacy of drastic allocative and structural errors and failures, together with the absence of a required adjustment in the context of a very competitive and dynamic post-Cold War economic environment (e.g., NAFTA and WTO), where even Japanese, German and U.S. enterprises have aggressively reduced their own work forces and streamlined production. In this environment it becomes more difficult for governments to subsidize exports by state-owned enterprises.

Table 1. Cuba: Main Economic Phases, 1975-1994

Period	Main Characteristics
1975-1985:	Progress under "socialism with limited markets:" In spite of a very inefficient system, some progress was sustained by massive assistance from the Soviet bloc and indebtedness with Western countries, together with liberalization measures adopted in the late seventies and early eighties.
1986-1989:	Retrenchment or stagnation under the return to recalcitrant and dysfunctional Stalinist socialism: The very inefficient system became strikingly evident and began to show signs of near-exhaustion as real foreign trade imbalances mounted due to the counter-reform, or the repeal of the liberalization reforms of the previous period. An excessive debt burden with Western countries caught Cuba in the debt trap. This period set the stage for economic catastrophe.
1990-1993:	Deepening crisis under socialism: Steep decline in output due to the cut-off of massive Soviet bloc assistance. Slow reaction and reluctance on the part of the authorities to adopt major stabilization policies, systemic reforms, and enterprise restructuring to arrest a sharp slide in living standards. The consequences of protracted microeconomic distortions and

macroeconomic mismanagement were further exposed.

July 1993: **Continued deepening crisis and beginning of the disintegration of the socialist system under a late attempt at**
1994: **"socialism with limited markets:"** Continued decline has brought the crippled economy to the verge of collapse due to ill-advised adjustment and destabilizing policies, insufficient systemic reforms and the strengthening of the U.S. embargo. Trends have been unleashed that are gradually testing the resiliency of existing institutions and values. There are ominous signs of increasing impoverishment and regressive income distribution.

The socialist regime was successful in developing widespread coverage in education, health and social security based on the extraordinary external assistance by the socialist bloc. However, the economic foundation of this widespread social coverage is, indeed, weak as the economy's deterioration has shown since 1989, and especially since 1991 (see Table 2). The authorities have erred to such a degree that Cuba is in the throes of a long-term systemic structural crisis and on the brink of economic disintegration. The recalcitrant socialist system developed in Cuba is not viable.

According to two IMF officials who visited Havana in late 1993, the decline in the Cuban economy in 1989-1993 was much worse than the deterioration suffered by any socialist Eastern European country in the transformation to a market economy. By December 1994, the economic problems that have been building in the country since 1986 and that accelerated since August 1991 reached near-catastrophic proportions.

The Cuban economy is currently in a protracted depression with substantial and ever expanding imbalances: large excess demand at current prices, high unemployment and an increasing balance of payments constraint. Cuba is an *undeveloping* country, moving back into the Nineteenth instead of into the Twenty-first Century because it appears to have difficulty in coming to terms with democracy, market economics and intellectual questioning. This is the harsh reality under which any successor or transition government will need to launch a stabilization program and initiate comprehensive systemic reforms toward a market economy in order to un-block the production capabilities of the people of Cuba.

B. The Deepening Internal Imbalance (Depression, pervasive shortages and imminent prospects of hyperinflation)

GSP per capita dropped more than 50 percent from 1989 to 1994, the deepest and most widespread depression in Cuba's history (see Table 2). The economy is expected to shrink a further 5 percent in 1995. This spiraling decline makes the depression of the 1930's look like a minor incident. Open unemployment and disguised unemployment or under-employment have reached record double-digit highs and are expanding. Carlos Solchaga, an advisor to the government, estimated that 1 to 1.5 million workers out of a total of 5 million are out of work.

People are aware of their economic backwardness and that their steadily declining standard of living is rapidly moving toward that of a subsistence economy. Effective real wages have

declined as monetary wages have remained the same while goods obtained through meager official ration allocations have declined substantially and those obtained in the black market have increased. Also, there has been a marked increase in prices on the black market and at "dollar stores."

Real salaries are so low that they do not motivate people to greater work effort. The government tries to mobilize people and even school children to work "voluntarily," but real gross productivity is very low and net productivity is very likely negative. This reflects the incompetence and contradictions of a dogmatic system that does not use its most abundant factor of production (a relatively well-educated labor force) or uses it inappropriately due to improper material incentives.

Table 2. Cuba: Selected Economic Indicators, 1971-1993

Indicator	1971-75	1976-80	1981-85	1986	1987	1988	1989	1990	1991	1992	1993
% Annual change GSP	7.5	3.4	7.2	1.2	-3.9	2.2	0.1	-3.1	-25	-14	-10
% Annual change GSP per capita	5.6	2.5	6.4	0.1	-4.8	1.1	-1	-4	-25.8	-14.8	-11
Exports, FOB (CU\$million)	2004	4.463	5.98	5322	5402	5518	5400	4410	3585	2300	2100
Imports, CIF (CU\$million)	1990	3870	6311	7596	7584	7579	8100	6415	3690	2500	1700
Sugar prod. (million metric tons)	5674	7074	7819	7467	7232	8119	7579	8430	7620	7000	4200
Budget deficit as percentage of GSP	...	...	...	2	5	10	11	16	...	...	34
External debt in conv. currency (CU\$million)	...	...	...	4985	5657	6606	...	...	6800	7600	7800

Sources: For 1971 to 1989: ECLAC, Economic Survey of Latin America, various issues; and ECLAC, Statistical Yearbook for Latin America, various issues. 1990-1993: The Economist Intelligence Unit, 1994 Report, and authors' estimates based on news reports, official statements and articles published in Cuban journal.

An aging Fidel Castro blames external factors (the U.S. embargo ("criminal blockade"), the deteriorating terms of trade and natural disasters (hurricanes, rains and droughts)) to evade responsibility for the misery that is the result of *internal* factors: (1) an inherently inefficient, economically unstable and corrupt system that penalizes and blocks individual initiative and effort, increases risk, lacks proper incentives and institutions, and is thus plagued with poor organization and very low productivity; (2) overwhelming dependence on the former Soviet Union for economic assistance and trade; (3) excessive and artificial specialization in sugar; (4) overexpanded social services; and (5) very weak adjustment policies. Terms of trade have improved since mid-1994.

The overall public sector deficit skyrocketed due to the erosion of external transfers, artificially low prices for the goods and services of state enterprises (69 percent showed deficits in 1993), and salary increases for the armed forces. Waste, fraud, over-staffing and mismanagement dogged Cuban state enterprises and social services for many years. Public sector employment and expenditures in administration, military and internal security activities are unjustifiably high. Budget data available show persistent and escalating deficits, rising from about 2 percent of revenues in 1986 to 11 percent in 1989, 16 percent in 1990 and an estimated 34 percent in 1993. A wasteful and substantial amount of spending continues to be channeled toward defense and internal security (more than 14 percent of GSP in 1993) which is an enormous drain on the economy. The social safety net expenditures increased from 17

percent of GSP in 1989 to 26 percent in 1992.

Up to 1993, there was a sizable monetary overhang (approximately 80 percent of GSP) which was the legacy of monetized high and fiscal deficits. Incomes did not decline as rapidly as production, and official prices showed only minor increases. The excess monetary assets, limited real wealth and dwarfed productive capacity threatened the Cuban economy with hyper-inflationary pressures. There was triple-digit inflation in the black market in 1992 and 1993. This led to excess demand with increasing shortages and spiraling black market prices in spite of widespread price controls and severe rationing of most goods and services. The black market boomed since 1989 in spite of increasing government restrictions. According to estimates by economists at Cuban *quangos* (government-sponsored or "quasi" non-governmental organizations (NGOs)) black market transactions on consumer goods increased from 2 billion pesos in 1990 to 14 billion pesos in 1992, two-thirds of total transactions. The almost-frozen price level is much too low relative to the stock of money; the excessive monetary stock is approximately 15 times the monthly wage bill and was expanding as a result of financing the fiscal deficits through monetary emission.

Therefore, Cuba had a mix of "repressed inflation" in official markets and soaring prices in the black market as recently as October 1994, when the "free" agricultural and artisan/industrial markets were reestablished. The symptoms of "repressed inflation" become more acute every day; although inflation is still restricted in official markets, there has been a dramatic burst of inflation in the black market after the legalization of "dollarization" and the lifting of the ban on Cubans shopping in dollar stores, following which prices were doubled. Rationing is extended to virtually all consumer goods and current quotas are barely at a subsistence level. Ration allocations are slim to satisfy minimum consumer needs and are often not honored. People spend a significant amount of time in shopping queues, searching and bartering for food and other basic necessities, as well as feeling generally "hassled" and frustrated at not being able to obtain the most basic goods and services. Too much money is chasing too few goods. The poor and those without family abroad suffer the most because they cannot supplement the meager rations in the free markets, the black market or dollar stores. There are low levels of economic incentives to workers. A sort of societal depression has set in, with the people unable to envisage a better future in Cuba. Consequently, there is a deterioration of labor discipline, motivation and morale, and increasing cynicism, resentment, pessimism, tension, and even occasional but increasing demonstrations of social unrest.

Investment has been reduced drastically and there has been a significant deterioration of the capital stock. There is a clear inability to raise capital formation above a replacement level that would help reverse the economic decline. Unfinished investment projects were three times the new investment in 1991. Scarce resources needed for investment were used for constructing a network of tunnels and military fortifications in urban areas for unspecified purposes. There is excess productive capacity, except in agriculture and tourism. Factories are forced to close or work only a few days or hours per week due to lack of raw materials and supplies, progressive deterioration of the industrial base, as well as major transportation problems for workers. The transportation and communications infrastructure is in shambles and continues to deteriorate. The equipment is outdated. Impoverishment and environmental degradation are spreading. There is a huge and widening housing shortage. There is a lack of domestic financial assets in which people can save. The educational system is highly ideological, with an emphasis on marxist-leninist theory, designed to inculcate the commitment to failed egalitarian and communitarian ideals.

On the positive side, Cuba has a solid and broad skilled human capital base. Literacy rates, schooling and the proportion of university-trained professionals are among the highest in Latin America. However, most of the new university-trained professionals and skilled technicians do not have the opportunity to apply their skills and are becoming technologically obsolete due to the contraction of the economy. The

excessive supply is wasteful because the openings are limited and the declining returns kill the incentives for the people to continue investing in human capital. There is a lack of books, pencils, etc. in schools. Medical supplies and medicines are in short supply. Nutritional, housing and basic hygiene and sanitary conditions have been declining rapidly and have reached very low standards as living conditions continue to deteriorate. Infectious diseases that were once thought to have been eradicated, such as tuberculosis and malaria, are returning. Malnutrition is now a problem. In 1993, UNICEF reported that half of all Cuban infants showed symptoms of anemia in the first year of life. This tragic social deterioration is threatening what many consider the main areas of accomplishment of the communist party regime <education, health care, basic sanitation, and social security.

C. The Widening External Disequilibria

All Eastern European countries and those that made up the former Soviet Union have canceled their economic assistance programs and their barter trade with Cuba since 1989. Additionally, the terms of trade are now less favorable to Cuba. Sugar and nickel are purchased at world market prices rather than at the heavily subsidized prices of the previous period. Cuba is suffering a harsh external shock together with a tightening of the U.S. trade embargo as a consequence of the Cuban Democracy Act of 1992 ("Torricelli Bill"), which attempts to stop offshore subsidiaries of U.S. companies from doing business with Cuba and bars ships that dock in Cuba from entering U.S. ports for 180 days thereafter. The authorities have not shown the ability to adapt to the increasingly competitive global environment (NAFTA and WTO). Cuba's exports are narrowly concentrated in agriculture and mining. The shortage of hard currency, already serious before the present crisis, is now critical. The international reserves are virtually depleted.

There has been a dramatic compression in imports. In 1992 import capacity was 28 percent of that in 1989 and in 1993 there was a further decline to 25 percent, which is damaging to the population, since consumption levels have depended heavily on imported commodities. In 1994 imports increased, but were still at 30 percent of the 1989 level. Oil imports decreased from 13 million tons in 1989 to 6 million tons in 1992 and 5 million tons in 1993.

The fuel crisis has taken a heavy toll on production. There are widespread power blackouts and low industrial capacity utilization. Sugar exports have continued to shrink due to a shortage of spare parts, lack of adequate fertilization, breakdowns in the sugar transportation system, and lack of fuel for field operations and mill boilers. Furthermore, key economic activities are facing a run down of capital resulting from a cut-off of imports.

Shrinking foreign exchange has hampered both current production and capital formation, since domestic production of goods requires imported intermediate goods (oil, spare parts, raw materials, fertilizers, herbicides) while foreign-made capital goods are an essential component in most investment projects, especially those necessary to generate new exports. Produce rots in the fields because there are few trucks available to move it to urban markets. The situation in key activities is characterized by a slump as a result of the external shock and the drastic failure and inadequacy of balance of payments and investment policies.

The lack of sound money has its counterpart in the dollar gap that is due to a gross overvaluation of the Cuban peso. The official exchange rate is CU\$1=US\$1, with CU\$1.32=US\$1 for some tourism-related transactions, but as of January 1995, the black market exchange rate was CU\$50=US\$1. Although holding dollars was illegal for Cuban citizens until July 1993, a persistent process of "dollarization" had already been underway as Cubans began accumulating dollars as protection against high inflation and as a means of savings (because of the inflation differentials given a fixed exchange rate) and to have indirect access to special shops that carry imported goods, because of the lack of consumer goods in

government stores, as well as loss of confidence in the peso, and increasing inflationary pressures in the black market. In a way dollarization was a spontaneous market-induced demand-side monetary reform.

In per capita terms, Cuba is the most indebted country in the world. Cuba has a solvency problem, not a liquidity problem. Only interest on foreign loans could consume about half of Cuba's export earnings. Principal and interest arrears in servicing the substantial and unmanageable hard-currency foreign debt (probably now close to US\$12 billion) have made Cuba a pariah to commercial creditors, suppliers, and foreign governments. In 1986, Cuba's creditors refused to roll over short-term loans and Cuba suspended interest payments. The country now lacks basic commercial credit for trade transactions and is in default on most of its debt obligations. As of December 1994, the value of U.S. claims awarded by the U.S. Foreign Claims Settlement Commission (FCSC) was approximately US\$5.6 billion. Cuba is "off the books" for the main credit-rating agencies, meaning that no credit rating is currently being calculated. The country's risk premium (financial as well as political) is one of the two or three highest in the world, which explains the extremely high rate of return and other conditions currently being offered to foreign investors (e.g., long-term concessions and tax holidays). London-based Euromoney magazine in its latest country list (September 1994) classified Cuba 167th, the lowest of all transition economies.

Since 1989 the government has been actively pursuing a policy of promoting and diversifying exportable products and markets to receive them. As part of this strategy, it launched an aggressive campaign to attract foreign private investment in joint ventures with Cuban state enterprises, based on Decree-Law 50 of 1982, together with an "advantageous" special labor relations law enacted in 1990 (Resolution 14/90) that applies exclusively to international tourist facilities and further limits labor rights in the self-proclaimed "Workers' and Farmers' State" (*Estado de Obreros y Campesinos*).

The recent exodus of August 1994 is likely to severely affect foreign investment in general and tourism investment in particular and could determine the beginning of the terminal crisis of Cuban socialism because it is likely to cripple the main sources of foreign exchange: foreign investment and the expansion of tourism. The exodus has created an unfavorable external image and led to mass cancellations from the key Spanish tourist market. Dollar remittances from the U.S. will decline somewhat as a result of the recent prohibition but not disappear, because Cuban expatriates in the U.S. are finding alternative ways to send resources to their relatives in need through third countries.

D. The Tyranny of the Internal Blockade

Cuba is a Stalinist-style, totalitarian state with a collectivized economy, run by a rigid and unyielding military dictatorship in which almost all political power and economic decision-making is centralized at the very top, beyond the reach of voters and the discipline of the market place. There is a fusion of military, economic and political power. The legislature, the National Assembly of People's Power, meets twice a year in two-day sessions without adequate staff, so it is really a rubber stamp for whatever is presented by the executive. The formal private sector is minuscule, with extensive and intensive public ownership of property in all productive sectors: only 8 percent of agricultural land is in private hands and there are 150,000 repair and personal services shops. The civil society is very poorly developed, providing almost no organized counterweight to the pervasive and weighty influence of the state. The country is run with an iron fist by a single party that refuses to submit to free elections with opposition parties and to allow trained economists and qualified managers to design and implement economic policies.

There is intolerance and no space for open (or public) debate, dissent or even disagreement, because the leadership is extremely hostile to public criticism of its many errors and failures. In a totalitarian system, it is risky for anyone to express openly his/her points of view, and those who disagree often suffer severe

consequences. Although the regime attributed it to trafficking and embezzlement, it seems clear that General Arnaldo Ochoa was executed and several top officials imprisoned in 1989 because they were promoting *perestroika* and *glasnost* for Cuba. Carlos Aldana was summarily removed from his post on the Council of Ministers in 1993 for promoting some kind of liberalization. Cuba is virtually closed to new ideas from throughout the world. However, after the Fourth Congress of the Communist Party held in October 1991, there has been an increasing demand for decentralization and democratization of intellectual life.

Although the experiment in extreme socialism is widely discredited in Cuba, government officials, and other with vested interest in the status quo have tried to preserve the fundamental features of the command socialist regime to retain party control over the economy and have exploited fears of the costs of the transition to a market economy. Distortions create rents, which in turn create rigidities and resistance to change. Cuban news conduct a continuous and systematic campaign painting a dire picture of economic problems of the former socialist countries. The message to ordinary Cubans is clear and unambiguous: the transition to capitalism is long and painful. They also argue that the economy might soon reach bottom and start to recover, and place virtually the entire blame for the country's misfortunes on the U.S. trade embargo (which provides an excuse for the domestic distress and helps reinforce the cohesion of the power structure) and on the demise of the Soviet Union and the socialist bloc.

The insufficiently authorized "free" markets, private entrepreneurship, free choice of work, and private property have placed the economy in a straitjacket, but are considered by those in power to be the symbols of the stability and continuity of the socialist model. The pervasive sense of corruption, fraud and privilege among high-ranking public officials (the *nomenklatura*), which are inherent components of the socialist system due to its lack of accountability, have been long standing sources of popular discontent and widespread denunciation, which worsening scarcities (evidenced by a severe nutritional crisis as traditional systems of management and control break down) have seriously aggravated. Most of the consumer items traded on the black market are stolen, misappropriated or diverted from state-owned enterprises or government distribution channels. This has brought about a moral and ethical decay and lawlessness that is disintegrating the society. Economic survival depends on black marketing, speculation, connections and bribery. Enterprising members of the *nomenklatura* have been given ample opportunity to enrich themselves (via cooperating with foreign investors in joint ventures with local entrepreneurs who have been acting illegally, better housing, and other assorted perks).

The state controls most economic resources, allocates them through rigid and highly centralized planning, has almost complete monopoly over foreign trade, and distributes goods and services to the population through a rationing system that provides a fertile ground for administrative corruption because there is a widening gap between official prices and free and black market prices. Inefficiency in government is pervasive. There are extensive and comprehensive bureaucratic constraints and controls for state enterprises and the production and distribution of agricultural goods. All significant changes and major decisions are delayed. There are excessive, irrational, rigid and complex norms and regulations for every activity, lack of goods and factors of markets, of legal market contracts and transactions, and an absence of such concepts as individual freedom, self-responsibility and managerial efficiency; therefore, lack of incentives and myriad distortions to efficient economic behavior are basic, substantial and widespread.

Political credentials govern managerial promotions and appointments, producing widespread dissatisfaction of middle-managers and technicians and demoralization among younger professionals. The government has largely ignored human rights, governance and the physical environment. There is a systemic disfunction, unaccountability and illegitimacy of the public sector. Abysmally inefficient economic structures and large monopolistic and oligopolistic state enterprises ("*consolidados*" or trusts controlled by the corresponding central ministry) dominate production and the structure and organization

of distribution. Cuban collectivization is broad and deep; consequently, millions of microeconomic relations simply do not exist and the state, which is inherently incapable of managing them, is even more so at a time of major dislocations.

The structure of prices bears little relation to costs of production and to relative scarcities and opportunity costs, and the exchange rate is extremely distorted; they do not promote a good allocation and utilization of resources. Reliance on moral stimuli and unpaid voluntary work (labor mobilization techniques) in defense of socialism and the motherland leads to low labor productivity that the present crisis has exacerbated. The financial market is fragile, narrow, underdeveloped and passive, with the *Banco Nacional* (Central Bank) and its branch offices playing the role of rudimentary commercial banks and with very negative real interest rates. Unions are political organizations whose major task is to transmit and explain government directives to workers and ensure that party policies are implemented at the level of enterprises, with emphasis placed mainly on the need for rigid discipline at the work-place.

III. Main Economic Policy Measures and Reforms Adopted since 1990 to Face the Crisis

"Some say that if these measures have to be taken we are already late. They argue that this process of collective discussion is a delay that unnecessarily protracts the implementation of measures which will help solve our problems."

◁ Renato Recio, *Cuba News*, February 1994, p.11. ▷

"We have not renounced socialism as our common objective....We have to be ready to conduct necessary changes to adapt to present world conditions ◁without renouncing our ideas and without renouncing our objectives."

◁ Fidel Castro, *Time*, February 20, 1995, p.58. ▷

One of the most serious criticisms of the communist government's handling of the Cuban economic crisis over the last six years (1990-1995) has been the lack of a clearly thought-out and sustained strategy.

The Cuban economic system virtually ground to a halt from 1989 through 1993. At first, the authorities only promoted joint ventures with previously banned foreign private investors vigorously, reoriented international links based on tourism and biotechnology, professed to encourage self-sufficiency in agricultural goods (the autarkic Food Program), adopted harsh austerity measures to adjust to lower levels of consumption and productive employment, and exhorted ordinary Cubans to work harder than ever as a means to forestall or altogether avoid the implementation of reforms. By July 1993 it was clear that this strategy of using old methods for dealing with new shocks was unrealistic and unworkable, because the macroeconomic environment became unsustainable with a very weak supply response. Futile reliance on dogmatism resulted in lost time and exacerbated the crisis.

The continuing major decline of GSP, including a historically low sugar crop in 1993 (4.2 million tons), and the increasingly competitive world economy finally forced the introduction of some ground-breaking but improvised, cautious and modest elements of a stabilization program and market economy. The reforms involve merely changes within the system and are very slow paced (see Tables 3 and 4). A distinguishing feature of the Cuban reforms is the attempt by the leadership to preserve the extreme socialist character of the economy.

The principal reforms enacted since 1990 are:

- *Reduction of the fiscal deficit*, through
 - ◁ partial price adjustment in alcoholic beverages and tobacco, agricultural products, public services, medicines, oil, and school lunches; and
 - ◁ reorganization of the administrative apparatus to reduce the staff involved in the state oversight of the economy, the other ministries, and the armed forces.
- *Dollarization of the economy*, i.e., legalization of possession and circulation of foreign exchange and relaxation of restrictions on travel and remittances by Cuban expatriates.
- *Promotion of foreign investment* in the form of joint ventures with widening and deepening relaxation in allowed areas of activities and terms and conditions.
- *(Re)Authorization for own-account work by individuals*, i.e. limited steps toward private sector activity in the services sector allowed in 135 trades, crafts and services.
- *Pseudo-decentralization and pseudo-debureaucratization of economic decision-making*, namely
 - ◁ cooperativization of state farms and arrangements for private exploitation of non cultivated plots of less than one hectare; and
 - ◁ decentralization of some foreign trade operations.
- *Allowing market forces to influence prices.*
 - ◁ Reestablishment of "free" agricultural markets.
 - ◁ Establishment of "free" industrial-artisan markets.
- *Introduction of the free convertible peso.*
- *Bonuses for workers in some tradables.*
- *Establishment of a few corporate businesses.*
- *Freezing of savings accounts over 10,000 pesos.*

In May 1994, several undefined stabilization measures that were long overdue to reduce existing internal and external imbalances were adopted and others still undefined were announced (e.g., taxes on income and property, and a convertible peso. Once again the government failed to address the urgent need for fundamental economic change and reform that are no longer a matter of *whether* they will come to Cuba, but *when* and *how*. In October 1994 some additional reform measures were adopted. Thus far, the process has been timid, hesitant and confused. Macroeconomic policies and the institutional framework still do not provide the necessary incentives for rapid economic recovery and sustainable growth over the medium term. The government needs to look beyond stopgap reaction and piecemeal reforms and consider the longer term with a package of comprehensive reforms.

Table 3. Cuba: Summary of Main Economic Measures Adopted to Face the Crisis, 1990-1994

< TD ALIGN=left>Perverse and adverse selection

Measures	Year Enacted	Major Objective	Scope and Design	Execution	Direct Effect Results	General Net Effect
Reduction of Fiscal Deficit	1994	Stabilization	Incomplete and Insufficient	Faulty and delayed	Insufficient and Inadequate	Positive but minor (party successful)
Dollarization of the Economy	1993	Mobilization of external resources	Wrong	According to plan	Insufficient and inadequate	P erverse and immiserizing
Promotion of Foreign Investment	1990	Mobilization of external resources	Incomplete and insufficient	Faulty	Insufficient and inadequate	
(Re) Authorization for Own Account Work	1993	Expansion of aggregate supply	Incomplete and insufficient	Faulty and delayed	Insufficient and i nadequate	Positive but minor (partly successful)
Pseudo- De centralization of State Farms	1993	Expansion of aggregate supply and enterprise restructuring	Incomplete and insufficient	According to plan	Insufficient and inadequate	Positive but minor (partly successful)
Allowing Market Forces to Influence Prices	1994	Expansion of aggregate supply and restructuring	Incomplete and insufficient	Faulty and delayed	Insufficient	Positive but minor (partly successful)
Overall Package		Stabilization, mobilization of external resources, expansion of aggregate supply and enterprise restructuring	Incomplete and insufficient	Mixed, generally faulty and delayed	Insufficient and inadequate. They will not do the trick	Minor (partly successful), with some perverse, immiserizing and adverse selection elements

In 1995 there appears to have been a loss of momentum on economic reform. There have been a limited increase in the number of occupations in which own-account work is permitted and *paladares*, which were closed at the end of 1993, have been re legalized. Any economist knows that the first rule in stabilizing and recovering an economy is consistency, precisely the rule that has been ignored by the Cuban authorities repeatedly in dealing with the crisis.

Reforms must be deepened and extended. The existing distortions and rigidities that inhibit private sector activity and impede flexible supply responses need to be removed quickly, both to encourage a more efficient use of existing resources and, eventually, to attract new ones. Sustained improvements will not happen until the structural transformation of the economy is well advanced and the private sector, both

the foreign investors and *the Cuban population*, have acquired enough confidence in the permanency of past reforms to step up investment in the country.

Table 4. Cuba: Impact of Policy Changes and the Collapse of the Socialist Bloc on Economic Growth

System Economic Management and Planning , 1975-1985`	Rectification of Errors 1986-1989	Collapse of Socialist Bloc 1990 1991	Special Period in Times of Peace 1992-1994
Free farmers' markets and government parallel markets.	Abolished		Reestablishment of "free" agricultural markets, Oct. 94.
Handicraft markets.	Abolished		Establishment of "free" industrial-artisian markets, Dec. 1994.
Generalized bonuses to motivate workers to increase productivity and quality and reductions in costs	Abolished		Bonuses for workers in some tradeables, May 1994.
Private enterprise in a wide range of trade and services	Abolished		(Re)authorization for own account work, Sept. 1993.
Private selling, rental and construction of housing	Abolished		
Enactment of foreign investment legislation, May 1982.	No active promotion of foreign investment		Active promotion of foreign private investment, 1993-1994. Sectors and conditions have been relaxed.
Contracting of significant foreign debt.	Default on foreign obligations		Dollarization of the economy, August 1993.
Fixed exchange rate with a minor black market.			Fixed exchange rate with an expanding black market. Free convertible peso. Dec. 1994.
Quasi- fiscl balance	Increased fiscal deficit	Limited austerity measures	Reduction of fiscal deficit, May 1994.

% Annual Change in Gross Social Product (GSP)	1986: 1.2	1990:	1992: -14.0
	1987: -3.9	-3.1	1993: -15.0
	1988: 2.2	1991:	1994: -5.0
	1976-80: 3.4	1989: 0.1	
	1981-85: 7.2		

A.Reduction of the Fiscal Deficit

Increasing prices of selected goods (e.g., cigarettes, alcoholic beverages, gasoline) and rates for public services (e.g., telephone, transportation, water, sewerage, mail and electricity), curtailing of some free social, sports, and cultural services, as well as reducing the bureaucracy in the ministries and armed forces, eliminating some government agencies and putting state enterprises on notice of the gradual reduction of subsidies and consequently of bankruptcy, are painful but necessary and unavoidable measures to reduce the fiscal deficit and to eliminate the main *flow* cause of the inflationary pressures. The announced objective of the government is to reduce 11,600 positions in 32 ministries. However, the monetary overhang is also a very important cause of the inflationary pressures (the *stock* cause).

The legalization of self-employment has also helped reduce the government payroll and has increased revenues. The authorities also announced that at the start of 1995 they will impose taxes on real estate and some services (advertising), on income from self-employment, and on Cubans who earn from foreign sources. The plan also includes provisions for taxes on salaried workers when the economy improves. However, the package as a whole is insufficient to eliminate the enormous fiscal deficit, which cannot be sustained long-term. Preliminary data for 1994 indicates that the budget deficit dropped from 5.1 billion pesos in 1993 to 1.4 billion pesos.

Some of the specific fiscal measures are incorrect in their design because they are not intended to eliminate both the macro and micro-rationing. Specifically, some medicines that were previously distributed free are now rationed. The authorities still do not understand that rationing is an inefficient instrument for distributing scarce goods nor the relative importance of the obstacles to stabilization that it continues to create. They have a difficult time grasping that it is better to subsidize low-income families directly than to attempt to provide a good at an unrealistically low price to the entire population, which results inescapably in a high black market price, is subject to favors from the *nomenklatura*, and discriminates against the lowest income brackets.

Measures taken to restore stability must not conflict with long-term reforms because they can easily destroy credibility. Such would be true, for instance, if as a result of the needed stabilization measures, the country were to maintain widespread wage and price controls and other prohibitions and regulations, which are incompatible with the aim of promoting a competitive, dynamic and market-oriented economy. The Cuban authorities do not realize that if prices are liberalized, there will be a strong stimulus to produce more, and the result will be greater production and lower prices than black market prices.

Also, most of the measures have been timidly and inappropriately applied because they were announced many months in advance, thus fueling immediate inflationary pressures by increasing incentives for hoarding, thereby exacerbating the shortages. Moreover, in our opinion some of the measures, such as charging for school lunches, are unnecessary from a social point of view. The school lunch program is one of the services that should be free due to its unique social benefits.

The fiscal measures should be more comprehensive, better-designed and appropriately implemented because of the depth, diffusion and persistence of key and complex economic disequilibria (inflationary

pressures, fiscal deficit, low productivity of most employees, trade imbalance, monetary overhang and debt overhang). Some of the most important and necessary measures have not yet been enacted. They should include both the revenue and the expenditure side: a significant reduction of the armed forces budget (the government announced a 50 percent cut for 1994, from 14 to 7 percent of GSP), security apparatus and administrative bureaucracy, and a significant rationalization and modernization of the enormous amount of social expenditures to improve performance and quality of service. They should also ensure that all state enterprises are self-financed, that is to say, they should be managed by economic criteria in order to eliminate the fiscal deficit and restore efficiency as a central value. Moreover, the fiscal measures for stabilization should be applied immediately without any further delay in order to reestablish the relevance of a public sector that is now a burden for society. The Cuban people will be forced to live through a regime of constrained public budgets for many years to come. However, we consider that government, through high standard of performance with limited though effective staffing, has very important tasks: to ensure and foster competition (especially when there are important externalities) to provide public goods, and to change the market distribution of income.

B. Dollarization of the Economy

Legalization of dollarization, announced in July 1993 and enacted on August 13, 1993 through Decree Law No. 140, was intended to stimulate external remittances from Cuban expatriates to their relatives in order to siphon in dollars at a time of extreme shortage of foreign exchange. Dollars are now used as a store of value, a unit of account and a medium of exchange. *De facto*, dollarization, or increasing the substitution of the dollar for the peso, also makes it possible for Cubans to sell goods and services to tourists and foreign visitors, thus resulting in capital flight through the sale of assets. The government justified this measure because the country, due to its external and internal disequilibria, cannot mobilize other types of needed external resources, such as short-term capital movements and multilateral official assistance, which could provide long-term vital support to the reform process. However, alternative measures would have achieved similar results without destabilizing the society by increasing inflationary and social pressures. Dollarization led to inevitable across-the-board devaluation of the peso because it induced a strong demand for dollars.

Dollarization has myriad perverse side-effects, conflicts and trade-offs with other stabilization policies and structural reforms (the so-called "composition of instruments problem") and with the package of measures as a whole due to the lack of domestic instruments for savings, the marked fiscal deficit, the large difference between official and black market prices, the lack of integration between dollar and non-dollar markets, and the severe controls on employment and economic activities. Among these perverse effects and conflicts are:

- (1) people are now saving in foreign exchange instead of domestic financial assets and even using foreign exchange in a wide and expanding variety of transactions (a reverse of Gresham's Law). This reflects that the cost of holding pesos is high and implies a transfer of resources from Cuba to foreign countries for seigniorage, or an *immiserizing* effect;
- (2) it dramatically boosts the velocity of the peso, increasing the effective monetary overhang and the "repressed" inflationary pressures, and thus public confidence in the peso has plummeted and its value has deteriorated accordingly;
- (3) it has exacerbated the duality of the economy, increasing the importance of black market transactions; hence incentives to work within official non-dollar labor markets have been further undermined, while those to work in informal or underground markets have grown; moreover, formal and informal markets frequently collide with and undermine each other;

(4) it has unnecessarily intensified social and racial tensions, inequalities and privileges, resulting in a deterioration in egalitarianism and the development of social stratification, because it favors people with expatriate relatives; and

(5) dollarization is a measure that reduces fiscal income due to the loss in seigniorage, limits flexibility in macroeconomic policy, especially in stabilization attempts, increases the vulnerability to macroeconomic imbalance and exogenous shocks, and shows hysteresis or irreversibility as seen by the experience of several Latin American countries. That is to say, it can be difficult to reverse if there were that possibility.

The general net effect of this measure is extremely negative given its many perverse and immiserizing effects and the conflicts it engenders, that outweigh its benefits in terms of the mobilization of external resources (estimated between US\$400 and \$500 million per year). Further, it has contributed to the mobilization of foreign exchange but not to the degree expected by the government, because prices in the dollar stores have been raised too much and people have resorted instead to the black market for goods.

Initially the black market exchange rate of the peso fell even more dramatically than the rise in black market prices. The government adopted some administrative measures for the liquidation of tax payments in the "free" agricultural and artisan/industrial markets that quickly ended the dramatic slide of the black market peso's exchange rate from CU\$120=US\$1 to CU\$40=US\$1 (in October and November 1994) and partially de-dollarized the economy. We can expect the convertible peso to reduce the demand for dollars by controlling foreign currency circulation better (see Section III.G). These were good maneuvers to reverse some of the previous erroneous measures by the government that had unduly increased the transaction demand for dollars.

Cuba has the shallowest and most underdeveloped capital market in Latin America. The mobilization of adequate internal and external savings, postponed by dollarizing the economy, is still required to ensure the required investment and to make it more accessible to non-traditional investors. However, economic, institutional and legal changes are necessary to activate domestic and foreign savings and ensure a better allocation of saving.

Cuba should establish simple, clear, succinct, uniform norms and procedures to encourage foreign private remittances and should exchange them at a free market exchange rate instead of dollarizing the economy. In this respect, the country needs at least a partial convertible currency to sponge up the dollarization of the Cuban economy and gain control over the stability of macroeconomic variables (inflation, interest rates and the exchange rate). In the final analysis, the keys to end the dollarization process are the establishment of a stable-valued high-confidence domestic currency and appropriate real interest rates.

C. Promotion of Foreign Investment

After the demise of socialism in Europe, foreign firms, especially from Canada, Europe and Latin America, showed a keen interest in "beating the U.S. competition" or obtaining a competitive advantage by being the first to invest in Cuba. However, through the end of 1994 foreign investment has been extremely cautious and considerably short of expectations, since if foreign firms perceive that risks are pervasive, they will limit the level of their investment. Therefore, the magnitude of foreign investment was no more than US\$500 million through 1993 and US\$1,500 million through 1994. Decree-Law No. 50 of February 15, 1982 does not establish restrictions on repatriation of profits and dividends, and profits from tourism and related ventures enjoy a 10-year tax holiday. The government has looked at this as a way of mobilizing external resources and penetrating foreign markets rather than as an instrument to modernize a very backward economy. The greatest disincentive now to foreign investment in Cuba is the

high risk of doing business, reflecting the fragile political environment, uncertain property rights, a weak and arbitrary judicial and legal system, and excessive latitude in the management of economic policies.

As pointed out by Carlos Solchaga, former finance minister of Spain and currently an advisor of the Cuban regime, as well as in an article in *The Economist*, the legal framework governing joint ventures with foreign investors (Decree-Law No. 50) encourages arbitrariness and corruption on the part of civil servants and hinders investment due to its case-by-case approach which requires time, paperwork and causes delays, thus increasing significantly the transaction costs of doing business in Cuba. This contrast with the Chinese experience, where there has been a marked decentralization to the provinces, "giving an inch, taking a mile". Decree-Law No. 50 also has many ambiguities, is complex and places the applicants at the mercy of government officials who can interpret provisions without explanations; in other words, it does not require transparency and fair and equal rules for all.

Bureaucrats have a keen interest in exacerbating the appearance of uncertainty to make their authority more valuable to potential investors. There are no efforts to disseminate information about assets or about how to operate them. The Cuban authorities are not forcing foreign investors to compete adequately for national assets and concessions, thereby reducing their potential market value.

The communist "reformers" who have ruined the economy over the past 36-plus years are *de facto* plundering enterprise assets and granting concessions over national assets and natural resources to foreigners in extremely good and unwarranted deals in a vain attempt to ensure the precarious regime's long-term survival and to eventually gain international political acceptance and economic assistance. They are also partially privatizing large enterprises without ending their status as monopolies, such as in the recent case of EmtelCuba, the telephone company. Therefore, there are little incentives for the joint-venture to become more efficient, offer lower prices or develop new services.

Anarchic and discriminatory foreign investment deals and concessions by which communist "reformers" grant part of the nation's wealth to foreign investors and appropriate the other part for themselves, cannot be justified on fairness and efficiency grounds and will not stand. On efficiency grounds, they are unjust deals that attract the worst investors (adverse selection) set a terrible precedent and discourage political support for needed impending privatizations, foreign investments and competition. On fairness and moral grounds, sizeable proportions of ownership of assets and concessions of natural resources should not be given to those foreign investors who, by violating basic human and labor rights, are able to reap unacceptable gains, nor to those responsible for creating the current chaotic economic situation and crushing democracy. Cuba is very likely to attract massive foreign investment from Cuban expatriates and U.S. investors in the future as soon as there is a more friendly investment and property rights environment. Therefore, any future Cuban government should, *at a minimum*, place heavy fines on foreign investors who have been violating basic rights and abrogate one-sided and unfair concessions, as well as all those that include assets illegally confiscated from prior owners.

The inappropriate manner in which foreign investment is taking place in Cuba is resulting in strong resentment and adverse reaction on the part of the Cuban people against the fire-sale prices of state enterprises and the granting of onerous concessions to foreign investors. This strategy is segmenting the economy and having corrosive effects on the legitimacy of foreign investment. It is hard to imagine that private foreign investment will provide a major source of funds to Cuba in the near future unless the system moves to a simple, more transparent and rules based framework and to respect basic human and labor rights. Progress based on foreign investment is much more than transferring resources. It requires undertaking the hard, complex and often sensitive work of institution-building and strengthening. Cuba needs dramatic changes both in the legal basis for foreign investment, and in the way in which enterprises are sold to foreigners and behave. Under the precarious Castro regime, Cuba will remain distinctly less attractive to foreign investment than most of its neighbors, and thus seems doomed to lag

ever further behind the more dynamic societies of the Caribbean Basin and Latin America.

Has foreign investment helped Cuba? We think not. The result is Cuba has less assets, while some imperative reforms have been postponed. Viewed in this light, Cuba's foreign investment law needs to be revised. The new law should rule out the use of discretion and ensure that difficulties are solved within the existing legal framework. The best way to encourage foreign investment to expand into areas where Cuba has a comparative advantage is by providing an incentives structure that does not discriminate among different activities and is stable over time. Cuba should also offer domestic investors the same conditions as those for foreign investors without any special incentives or privileges. Expatriate Cubans investing in the country should be considered foreign investors. Domestic investors should be accorded the same rights and should be subjected to the same supervision and restrictions as foreign investors, except that domestic investors would not enjoy repatriation and remittance rights. < P> **D.**

(Re)Authorization for Own Account Work to Increase Aggregate Supply by Individuals

Microenterprise development in Latin America has proven to be one of the key instruments for lifting people out of poverty, while at the same time spurring creativity and innovation. Also, the new small private companies created from scratch after communism fell in Eastern Europe, is the most dynamic sector in those countries. Private sector activity with own-account work in trades, crafts and services, from taxi drivers to hairdressers and computer programmers, approved in the Fourth Congress of the Cuban Communist Party in October 1991, was enacted two years later, on September 8, 1993 (Decree-Law No. 141 on Independent Labor) largely because the authorities could not afford to do otherwise because of the increasing violation of the law prohibiting it. Although by its very nature this type of detailed regulation violates the basic right to freedom of choice of work and stymies individual initiative, it has been a necessary first step to allow the unemployed to make their own way and to build and develop a market economy by stimulating private sector-led economic growth and unleashing productivity through incentives and competition, markets, decentralization, and the pursuit of self-interest. However, the lack of an adequate institutional and organizational system (private property, free exchange, capital accumulation, contract enforcement, minimum rule of law, market mechanisms and incentives) and the many regulations that hinder the effort of private enterprise have not yet changed significantly for their smooth operation to stimulate aggregate supply.

Therefore, authorization of own-account work in 135 trades is insufficient. For example, own-account workers must pay to receive a state license and a presumptive monthly income tax; licenses can be rescinded and workers re-deployed to other sectors of the economy. The number of regulations is very large, seldom clear and often inconsistent, so they can neither be followed nor effectively supervised. The authorities still do not allow own-account work by university trained professionals or management personnel in their area of expertise; nor the association of own account workers in cooperatives or enterprises; nor the hiring of non-family workers or other types of contractual arrangements; nor can they "compete" with the state; nor can state enterprises purchase goods or services from the self-employed; nor can they engage in the free commercialization of agricultural goods. There is lack of legal guarantees of property rights, legal access to financing, the right to contract and to form joint ventures with one another and with state and foreign firms.

There are severe penalties for persons engaged in unauthorized work, or working without a license, or reselling something they did not make, as each producer must also be the retailer. The government almost immediately flip-flopped on this in December 1993, when the most successful privately-run restaurants and taxi activities were shut down because they offered "unfair" competition to inefficient state enterprises and "were getting out of control." However, large restaurants shut down have reappeared in the form of several small restaurants because there is no effective deterrent at a time of intensive violation of the multiplicity of laws.

The government still does not recognize that own-account work requires laws to protect property, a commercial code, accounting standards, a financial system and privatization. The minimalist normative concept of limited initiative must be expanded significantly in order to unleash real incentives for Cubans to strive and to improve their lot. Feeling of impotence for the relative futility of daily effort must be overcome.

Marked economic success, that is to say, any accumulation of riches, is retroactively illicit and without appeal to any court of law, according to Law 149 of May 5, 1994, which undermines the credibility and commitment to the liberalization process, which is of central importance. There have been some confiscations of property and assets since June 1994. It is interesting to note that Article 26 of the 1976 Cuban Constitution provides that "any person suffering damages or loss of income or value unduly caused by public officials or government agents during the performance of their duties has the right to claim and obtain the corresponding reparation or indemnification as provided by law." The authorities are trying to demonize the "*macetas*," persons accumulating wealth amid the country's economic crisis. Black marketeers are punished because they are supposed to be in conflict with the interests of farmers and middlemen. Also the participation of middlemen is very limited because the authorities pursue middlemen reaping unseemly profits.

E. Pseudo-decentralization and Pseudo-debureaucratization of Economic Decision-Making

The transformation of state farms into basic units for cooperative production (UBPC) or cooperativization of state farms (Decree-Law No. 142 of September 15, 1993), and decentralization of some export operations are first and significant managerial and technical measures, albeit insufficient ones, to improve resource allocation and monitoring, overcome the chronic, fundamental and grave problems of economic rigidities, disorganization and inefficiency of state enterprises to become less bureaucratic and more participatory. UBPC start the demise of state and collective farms, can lay off inefficient workers and cut back excess personnel. With the establishment of the UBPC, the state sector's share of total agriculture fell from 75 to 34 percent while its share of cultivated land dropped from 80 to 25 percent. This is a striking change in land tenancy. It offers the *form* but not the *substance* of flexibility and accountability to unleash the initiative, effort and energy of workers and managers. The essence is administrative, not economic decentralization. The current management style in Cuba includes an excessive adherence to rules, a fear of decision-making and a culture of self-censorship that is the result of an onerous system of controls, all of which severely inhibit capacity for initiative and innovation.

The UBPC can lease land and animals from the state for an indefinite period of time and retain part of their profits for reinvestment purposes. The UBPC organize themselves and select their own leadership. However, inability to make key economic decisions is the Achilles heel of the decentralization program, particularly in the implementation of activities that affect the enterprises importantly and on a daily basis. The selection of the crops to be planted is made by the state, and compulsory procurement of inputs and marketing of production for agriculture is still in place. Compensation is not related to productivity. Very low prices discourage cooperatives and private farmers from producing the badly needed crops. Only authorized UBPC can sell their production surpluses at the "free" agricultural markets. This is a salutary, but limited, measure in the right direction, due to forced sales to the government at submarket prices.

The decentralization of some export operations has been a reaction to the new world business environment because new exporting relationships are with commercial firms rather than with countries, as in the past.

True decentralization in decision-making and competitive relations are still needed to increase efficiency and flexibility by empowering management to exert control over the enterprise's activities and key decisions. It is necessary to improve the efficiency and impact of public investment, stimulate

technology improvement and encourage better production practices. Cuba at least needs a type of decentralization along the lines of the one that took place in 1975-1985. Also, as Alvarez and Puerta have shown, where individual responsibility and personal and family exploitation were preserved, there were successful producers, and they accounted for a greatly disproportionate share of total production.

F. Allowing Market Forces to Influence Prices

1. The Reestablishment of "Free" Agricultural Markets

The authorities announced their intention to again permit "free" agricultural markets, a more controlled variety of the free farmers' markets (MLC), and enacted the measure on September 30, 1994. The measure was imperative because agriculture has been struggling and most Cubans are living on the brink of subsistence. Farmers can once again legally sell the surplus they produce. The new policy will encompass everything from state farms, military state farms, and the new UBPC to individuals who grow vegetables in their own yards. However, some products will be excluded (i.e., milk, coffee, tobacco, cacao, etc.). A related law of October 7, 1994 liberalized transportation by making it possible for any owner of transport facilities such as trucks to contract directly with farms to move foodstuffs to markets.

Now that farmers can make profits, they will grow more food and the black market prices will gradually come down. This is a partial and inadequate measure because farmers cannot select what they produce, have to sell most of their production to the government at very low prices, must request a license and sell their surpluses at selected government's places where they will pay taxes and rent. However, it is also a major and significant boost to the new UBPCs.

Once again, as happened with own-account work, the principal concern has been to maintain the socialist system (that is strangling Cuba's economy) as intact as possible, even at the cost of economic performance and impoverishment. Numerous, detailed and strict curbs are still in force and seem intended to prevent the emergence of autonomous internal economic power (to reduce and control the booming black market by legalizing and suffocating it) rather than to unleash productive forces. The emphasis is on obligations and restrictions rather than on rights and freedoms. The new agricultural markets exhibit more similarities to the erstwhile government parallel market that existed in 1980's rather than to the MLC.

It is also obvious that two features of the recent partial and cautious reforms toward "socialism with limited markets" are bound to end in failure, because they are inadequate and insufficient. First, the communist "reformers" do not really believe in workable competition and intermediation, so the new measures will not lead to operationally and well-functioning markets. Prices and wages remain controlled. International trade continues to be restricted, so the international market provides no real competition for domestic production. Entry by new firms into existing markets really does not take place; chronic shortages and excess demand mean that new enterprises cannot get started or cannot survive because they cannot obtain necessary inputs, especially those of foreign origin. Second, the "reformers" have little or no interest in privatizing enterprises. They completely neglect or misjudge the enormous inefficiencies that come from lack of proper ownership of even small-scale enterprises. They fail to realize (or perhaps they know very well) that the "insiders" of the state enterprises, managers and workers, can seriously distort enterprise behavior to their advantage. It is likely that as a result of the very low wages being paid that constitute a disincentive to work and an incentive to engage in other illicit activities, workers and managers extract "presents" from the firms and "bribes" outside the firms, stripping the enterprises of income and assets.

The current system, or the application of a few selected market mechanisms within the framework of an extreme socialist economy, is an arrangement that inhibits work incentives, increases risks and invites

irresponsible economic behavior. It is impossible to fully integrate Cuba to very competitive world markets unless healthy competitive markets and private ownership are allowed and encouraged. Ultimately, the recent partial reforms are modifying incentives and economic behavior, but in limited and sometimes imprudent, perverse and risky ways.

2.Establishment of "Free" Industrial-Artisan Markets

On October 26, 1994 a new system of sales of artisan, consumer and manufactured goods was established with deregulated prices very similar to the "free" agricultural markets where individuals and state enterprises can sell goods at designated locations and have to pay a transaction tax, equivalent to a sale tax. The aim is to undercut the black market and to stimulate production. Factories can sell any surplus above their production quotas.

Supply-side measures, such as own-account work and "free" markets, should be more comprehensive in order to expand productive capacity by freeing and increasing mobility, adaptability, flexibility and efficiency in the utilization and allocation of resources, as well as in eliminating distortions and rigidities in incentives, reducing risks, enhancing the role of competitive market forces, and improving microeconomic efficiency. Specifically, an overhaul of the prevailing price system and of the role of the public and private sectors is required. This implies elimination or reduction of constraints on factor mobility and use, administratively determined prices, distortions between domestic and international prices, artificially determined real exchange rates, most government interference (unnecessary and noxious prohibitions, regulations and controls), as well as reducing the relative size of government activity within the economy. Also, basic rules and regulations are needed to define and strengthen private property rights, contracts and the functioning of markets.

In sum, *the Cuban authorities are keeping their own internal blockade almost intact*. They are more interested in maintaining economic control and political power than in improving economic performance through economic rationalization, better incentives and reduction of risks. Unless required structural adjustments take place, insufficient stabilization and liberalization measures alone cannot lead the crippled economy to a feasible and sustainable growth path.

G.The Free Convertible Peso

The Cuban authorities enacted a new convertible peso on December 20, 1994. This free convertible peso will exist alongside the old peso, is at a par with the US dollar and can be used to buy in dollar stores. The free convertible peso is supposed to substitute eventually, both the old peso and the dollar. There is no clear exchange rate between the old peso and the convertible peso nor there is an obligatory exchange of dollars for the new convertible peso. Initially the convertible peso moved the exchange rate for dollars downwards.

We consider that it is necessary to have a realistic exchange rate between the convertible peso and the old peso that allocates efficiently the scarce foreign exchange resources, induces the mobilization of additional ones and for the effective reunification of the dualistic economy. Also, that it is indispensable to stimulate internal savings and exports with an appropriate exchange rate policy and strong pro-export bias in the incentives scheme, and that it was folly to use the dollar instead of a national currency for transaction purposes or even to attract needed foreign investment. Hopefully the free convertible peso will be properly designed and implemented to avoid additional perverse incentives and reactions through wrong exchange rate and monetary policies.

H.Bonuses for Workers in Some Tradables

The authorities have successfully tried to motivate workers to increase productivity in some tradable activities (exports and import substitution, i.e., oil production, electrical generation, biotechnology, some fishing, ports, cement, steel) with a pay package that includes a monthly payment of US\$20 (in certificates of convertible pesos) per worker. It began with an experimental package in dollars to improve the maintenance and operation of the electric power plant in the city of Matanzas in July 1994.

What is needed is a market-determined wage scale that really motivates workers to work harder with a larger reliance on material incentives and wage differentials. The wage and salary structure essentially ranges from 80 to 480 pesos per month. At the unofficial exchange rate, this wage rate from US\$2 to US\$6 per month. This rate promote irrational and dysfunctional labor markets and rent seeking activities in an very open labor surplus economy.

I. Few Corporate Businesses

Some enterprises have been established with control of management given to persons loyal to the regime without full ownership being granted. Stock is given to these executives, but it cannot be sold. That is, any manifestation of disloyalty could mean loss of the position and, in the absence of any property title, there are no rights to whatever profits are generated or to the physical assets of the enterprise. Such corporations require communist party approval to be registered.

J. Freezing Savings Accounts

The announcement in May 1994 that savings account balances of more than CU\$10,000 would be frozen (a total of approximately CU\$7 billion) frightened account holders and led to some panic withdrawals and purchases of tangible goods, but the measure has not yet been implemented.

IV. Overall Appraisal of the Recent Package of Measures and Reforms

"We have severe difficulties, serious problems, but it would be dead wrong to assume that the country is blowing apart."

◁ Ricardo Alarcón, *The New York Times*, September 4, 1994, p. 12.

If you don't know where you're going, any road will get you there.

◁ Cheshire Cat, in *Alice in Wonderland*

The authorities appear to be improvising awkwardly. Rather than engaging in a serious self-critical analysis of the current situation and address the basic cause of the situation, they continue to contend that the economic crisis is due to the U.S. embargo. They are boxed-in measures that are disorganizing the economy or leading it into grave and contentious chaos, and inflicting unnecessary misery on the population. The Cuban government still lacks a clear and compelling vision of the weakness of the socialist system, its normative economics has many flaws, it has been reactive to exogenous changes, and it has lacked flexibility, imagination, courage, and effectiveness in putting meaningful stabilization policies and fundamental transformations into effect, even in the face of the current economic crisis.

Economics can tell us how to achieve our objectives but not what these objectives should be. There has been a lack of a coherent, articulate and detailed blueprint for the main reform measures to be taken and the sequence and speed in which they would be implemented. The adopted piecemeal measures and reforms are incoherent, inconsistent and ill-conceived in design; incomplete in scope and extent; incorrect and delayed in execution; and, consequently, inadequate and insufficient in impact. Reforms and policies once undertaken are difficult to undo. That is why it is important to get things right the first

time (or, at least, as right as possible). It is easy, but wrong, to dismiss their effects as small on grounds that the government can offset them with new measures or reverse them.

The adopted measures and reforms as a whole are not contributing to mobilize sufficient external resources, nor significantly stabilizing or liberalizing the economy, nor providing sufficient incentives or reducing risks, nor stimulating virtuous economic behavior, nor building a wide range of proper institutions, developing attitudes and establishing practices that are necessary to make a major transformation to develop a healthy economy and reestablish the country's productive capacity. Most of the changes seem *cosmetic and symbolic* rather than *fundamental* (muddling through in the hope of an eventual economic recovery). There have been sequencing errors, especially the delay in dealing with the fiscal deficit, own account workers, the "free" agricultural and industrial/artisan markets and the bonuses to workers. They are stop-gap measures forced by the external circumstances and designed to plug an ever-increasing number of holes in order to stay afloat. More precise, broad, long-term, coherent and well-planned actions are required before stabilization, economic rehabilitation and growth can begin in earnest. At the very least, the authorities need to stop underplaying the situation and quit ad hoc policy making and handle the economic crisis more methodologically and with a broader perspective. It is not like the gradual, but comprehensive, market-inspired Chinese strategy.

The Communist Party (which is the sole party authorized, as provided in Article 5 of the Constitution of 1976) thus far has not favored making sufficient macroeconomic adjustments for reducing excess demand (through monetary, fiscal and exchange rate policy changes) or undertaking systemic liberalization, deregulation and institution-building because it considers that they can erode its firm political control, as happened in the USSR and Eastern Europe. Ever widening circles of Cuban society are considering not only that their leaders cannot *solve* the crisis, but are a major *cause* of it, because of the consequences of failed policies and because they are an impediment to change, that the transformation into a market economy may be the only solution to the economic crisis. To fool all of the people is very difficult under the present circumstances.

We are not advocating a big-bang or global shock approach to liberalization reforms, because it is impossible to bring an immediate change in attitudes, expectations, behaviors, practices and institutions in a very short time, but rather a more coherent, integral and rapid approach. Doing everything at once would impose unnecessary social, political and economic strains and uncertainties. Also, the quality of the capitalism to be created will depend on the design and speed of reform. The authorities have proven their ignorance and arrogance in suggesting that there is no alternative to their proposals. They are not only going slow with urgent fundamental reforms but are aggravating prevailing conditions and are not distributing the costs of adjustment well. Some kind of immediate shock is necessary to avoid an inflationary spiral, perhaps mitigating it by trade liberalization, economic aid and by serious measures to energize supply improvements, or clear and serious incentives, to reduce risks and to increase production and efficiency. As long as everyone is confident that the government's course is feasible and will be maintained, then changing behavior and reallocation of resources will take place.

The results of the "reform plan" of the Special Period are apparent for all to see. The economy is still in a shambles. GSP, exports, employment and the supply of rationed goods continue to contract. Unemployment is high and expanding, and social policies and own-account work seem to be less than effective to deal with a persistent underclass that remains impoverished. The fiscal deficit and the monetary overhang are still too high. The price level and the official exchange rate continue to be largely dissociated from the real money supply and the real value of domestic currency and capital. There are not enough and proper incentives to work and increase aggregate production and efficiency. The limited market mechanisms allowed recently are disastrous: a ruthless market without basic institutions and rules, while at the same time having myriad and wrong restrictions, regulations and controls that severely hinder the freedom and initiative to create and innovate and are antagonistic to development.

The piecemeal measures and reforms are simply shortsighted, are too little and come too late to alleviate the overall crisis of the Cuban economy, and unless they are the first steps that presage a vast and fundamental transformation process, are unlikely to have much effect because they fail to address the essential features of the command economy that are still retained. In some areas, the measures and reforms have not even reached the depth and diversity of those of the late 1970's and early 1980 's that were reversed by the Rectification Process in 1986 (free farmers' and artisan markets and own account workers), or have not been adopted at all (generalized salary incentives and housing markets). *They provide cold comfort to a society richly experienced in disappointment and frustrations.*

Simply put, the measures do not address the lack of competitiveness of Cuban products and of saleable exports nor the ever-widening technological gap vis-a-vis the reformist Latin American and Caribbean countries. Cuba has slipped far behind in many of the technologies that will count most in the future. If things keep going the way they are, Cuba will have the weakest economy in the Hemisphere. Cuba must move into a new export strategy by adding value to its basket of exports, in order to gradually deemphasize basic commodities and focus on products with higher potential for earnings. Instead, the reform measures are increasing the macroeconomic imbalance, enhancing the duality, dislocation and disintegration of the economy and increasing social inequity, making the system more macroeconomically unstable and socially explosive, due to their perverse, immiserizing and adverse selection effects. They, in sum, do more harm than good. The "hard political heart" also has the "soft economic head."

Indecision and even erratic reversals in basic economic policies, rules and regulations have been a constant throughout the Castro period. The stance on economic policies has been reversed frequently. This further destroys confidence and diminishes the credibility of some of the recent changes, especially in view of Fidel Castro's ideological bigotry and strident anti-capitalism speeches at the special sessions of the National Assembly in late December 1993 (when no agreement was reached on further adjustment and reform measures), on January 1, 1994 in celebrating his 35 years in power, and in early May 1994 (when agreement was reached on some adjustment and reform measures). When announcing most of the recent changes, he again made clear that the moves were "concessions" in direct response to Cuba's severe and deep-rooted economic crisis. He also stressed his commitment to maintaining the essence of the socialist system, as had been strikingly evident in the changes made to the Constitution in 1992 and 1993. Hence, these statements are folly and generate the reasonable doubt about how long these partial measures will remain in effect, as well as difficulties in reading signals that are so deliberately mixed and ambiguous, and make economic reform an increasingly risky political proposition.

It can be predicted that economic conditions in Cuba will continue to deteriorate, and that the impending collapse or transformation of the socialist system is unavoidable. The insufficiency of the measures and reforms will not be able to reverse the overall downward trend and lead to defeat on all fronts, in the economic arena, as well as in the political and social spheres. The current strategy is simply doomed to failure. Cuba is moving away from extreme socialism in an absurd, painful and distorted way. Without comprehensive economic reforms, the prospects for economic rehabilitation are bleak. The government has been ineffectual, and thus irrelevant, to deal with the major issues.

In the end, the rigidity of economic policy and intransigence in adopting pragmatic and fundamental changes means that the precarious socialist regime stands arrogantly and defiantly alone as an isolated anomaly and a vestige of the Cold War, with no feasible, consistent and comprehensive strategy to reverse the process of decline, with negative consequences concerning efficiency and productivity and even social fairness, thus compromising its own survival. *"Socialism or Death" has an ominous ring: the end will come sooner rather than later.*

We hope this chaotic, irrational and insufficient transition will end soon, because it is likely to have

unforeseen social and political consequences. Cubans are suffering harsh doses of austerity only to find that the sacrifices they have endured are senseless and fruitless *«shock without therapy»*. Production cannot go beyond the point where its organizational and institutional structure allows. It is time for the government to intervene systematically and function well for markets to operate effectively, by controlling key macroeconomic variables, mainly inflation and balance of payments disequilibria, to attain and maintain internal and external balance. It is also necessary for the government to strengthen and improve its capability to design and implement economic policy and market-friendly reforms. New institutions are essential to shape the form, substance, direction and pace of economic recovery and expansion. It is an inevitable transformation that demands careful analysis and, above all, thought.

Cuba desperately needs a coherent, consistent, complete and stable set of policies and well developed program of effective systemic reforms to encourage economic agents to overcome the current rigidities and respond quickly, efficiently and equitably to its long overdue and imperative transformation needs. A core concept to kick-start the economy is to work simultaneously in several areas with timely and coordinated measures in each area, within an integral and comprehensive policy framework. In terms of results, isolated and fragmentary policies do not compare favorably to those generated by interactive policies.

It is also important to provide transparent signals of the intention of economic policies and put in place a clear set of basic "rules of the game." These rules should be stable and predictable, thus facilitating dynamic behavior from economic agents. To the extent the signals and rules are unclear and unstable, it is easy to predict that the results will also be chaotic and faulty.

The Cuban authorities ought to take seriously the challenge of preparing for the Twenty first Century. They have to think internationally for the future and to adapt to the ongoing globalization processes. Though economic development is hardly all that matters, it surely is true that a decent standard of living and a growing economy provide the foundation for that which groups and individuals deem important (good health, education, peace of mind). Yet these benefits, deriving from a growing economy, do not flow equally to all; they come instead as rewards to successful organized societies. An economy experiencing slow or negative rates of growth, with per capita income levels static or falling, is less happily placed than one which remains competitive and adaptable.

We are not gloomy in the sense that Cuba is predestined to sink into some Nineteenth Century morass. But Cubans must change to achieve stability, social justice and lasting peace, and this will require transformation, upheaval and economic, political and social consequences. The time has come for fundamental rethinking and actions