

INSTITUTIONAL REQUIREMENTS FOR SUCCESSFUL MARKET REFORMS

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As the title of my paper suggests, my comments will focus on institutions. Specifically, I wish to emphasize that what we refer to as an economic system is a set of institutions, so that economic restructuring essentially involves institutional change. In this paper I will discuss some of the institutional requirements of a market economy and consider whether the changes occurring in Cuba are a substantial move in that direction or simply a public relations ploy to improve the Castro government's image abroad.

INSTITUTIONAL REQUIREMENTS OF MARKET ECONOMIES

Markets are social arrangements by which people, either as individuals or as parts of larger organizations, exchange goods and services. The exchange itself directly increases wealth by transferring goods and services to those who value them most. More importantly, markets allow us to take advantage of scale economies and to exploit the gains from specialization and the division of labor. These gains can be amplified by physical and human capital, so that the role of markets in generating growth and wealth is as important for developed countries, where both types of capital are high, as it is for developing ones.

Unfortunately market exchange is costly. When the costs of transacting are very high, markets either do not function well or do not exist. What are these costs of transacting? Let me illustrate with a mundane example most of us are familiar with. Imagine a person who is interested in buying a computer. Such a purchase normally begins by a search process by which the customer determines the type of computer

he wants, perhaps what brands are acceptable, and where he can get a good price. This search may involve looking at computer magazines, searching newspapers for sales, listening to advertisements on the radio or television, talking to friends, or visiting computer stores. Once the search is complete the customer must arrange for payment and delivery. If anything goes wrong he may have to return the computer to have it serviced or to obtain a replacement.

As can be seen, even a relatively simple purchase can involve a significant expenditure of time and resources. What is important is that a society's institutional structure determines to a considerable extent the magnitude of these transaction costs. Suppose computer stores were not allowed to advertise. Our imaginary buyer would have found his search more difficult. Or suppose computer stores were restricted to a few locations, as were, for example, all businesses in the black townships of South Africa under apartheid? What if the computer purchaser had to operate in a highly inflationary environment, where he kept very low money balances on hand? He would have had to incur the additional transaction costs associated with converting some of his assets into money. If the government taxes the transaction heavily, that also discourages the exchange from taking place. And what if the computer is faulty and does not work? We can imagine a system where the customer has to either accept the loss or take matters into his own hands and try to get his money back. Such a problem is not a major concern in the United States, as there is a system of contract law—and courts and police to en-

force them—that reduce enormously enforcement costs for the typical customer. If the customer chooses to finance his purchase, banking institutions and credit agencies, as well as the legal system that supports them, come into play.

Imagine now much more complicated transactions such as financing and building a power plant, discovering and marketing new drugs, or developing virgin land that contains endangered species, and you can quickly see just how important is the institutional structure that supports these transactions. In general, for markets to exist and to function reasonably well, they require an institutional structure that reduces as much as possible the costs of transacting of all affected parties.

Most so called developing countries have not had institutional structures whose purpose is to facilitate market exchange and encourage productive activities. In my opinion this is the main reason such countries have not developed. Their institutions create large transaction costs in an attempt to achieve a distribution of wealth that is different from that which would arise through the functioning of low cost markets. Their governing coalitions have grabbed a bigger share of the pie at the expense of making the pie smaller for everyone. And the tools by which this has been achieved has been the countries' institutions. The epitome of this approach have been the centrally planned economies. In their purest form, centrally planned economies outlaw the private ownership of most types of productive assets and most types of economic activities and organizations. Their institutions are designed not to reduce, but to rather create, large barriers to market exchange in order to redistribute wealth to the ruling coalition, a distribution that could not be maintained in a market economy.

TOWARD A MARKET ECONOMY OR TINKERING WITH SOCIALISM?

Since a change in economic structure involves changing institutions, the question naturally arises, are the recent economic reforms in Cuba a move toward a more market friendly institutional structure? In a simple minded way, the answer must be yes. Cuba has been so hostile to markets, that practically any change must be toward greater market friendliness.

But have there been significant institutional changes? The answer to me is clearly no. Let us consider the legalization of self-employment and the creation of agricultural cooperatives as examples.

At first glance the legalization of self-employment appears to be a significant step in reducing the barriers to a type of market that is important in poor countries. On more careful examination it looks quite different.

First of all, as others have pointed out, many of the large number of laid-off government workers would probably have moved into self-employment informally in the absence of legalization. This could only be prevented through the expenditure of considerable resources on greater repression, and the Cuban government is currently in no position to do this. Besides, what does it gain by creating a large number of desperate people with nothing to lose?

Secondly, by legalizing self-employment the government can hope to raise some revenues through licensing fees and taxes. Thirdly, through heavy regulation it can focus its resources on preventing the types of economic activities it does not want, namely successful ones. Consider the case of home restaurants, the “paladares.” Despite their very limited nature, some proved successful, and the government's first reaction was to make them illegal. I understand they are legal again, but the episode shows the opportunistic nature of the government, instability in the rules of the game, and lack of commitment to true reform. If the Cuban government was serious about expanding the role of markets, it would have made self-employment legal, subject to some simple regulations. Instead it has amended the penal code to make it easier to prosecute “profiteers,” and it has limited the success people can achieve by such restrictions as not allowing the hiring of employees. Earlier this year, *The Miami Herald* reported that the Cuban Government had imposed millions of pesos in fines in the first quarter of the year for violations of the self-employment law. The government's message is clear: if you need to engage in self-employment to survive, do so, but do not go beyond survival or you'll be punished.

The new system of agricultural cooperatives sounds similar to what China had before it changed to private property. That which the Cuban government would consider as a major reform, the adoption of a system of agricultural production that was used by the Chinese more than twenty years ago when their economy was centrally planned, tells us a great deal about just how centralized the Cuban economy has become.

The motivation for the shift from state farms to cooperatives seems to me to be similar to the motivation for allowing limited self-employment: to offset to some extent the immediate impact of the external shocks Cuba has experienced with the fall of the Soviet Union. The availability of foodstuffs can not decline so much that the survival of the regime is threatened.

While I would not be surprised if the cooperatives show some improvement relative to the state farms, at least in the short run, we should not exaggerate how different the two are. Both share many of the problems common to socialist methods of production, and both are consistent with central planning. The literature on the Chinese cooperatives identifies many potential incentive problems and several reasons for why resources may have been used inefficiently. When the Chinese shifted to private land ownership agricultural output rose substantially, as did the rate of growth of productivity. The lesson most of us would draw from the Chinese experience is that if you are serious about increasing farming output, you liberalize agricultural markets and move to a system of private land ownership. The lesson drawn by the Cuban government seems to be that private land ownership will create some very successful farmers, which are to be as feared as the successful self-employed.

These examples illustrate that the implemented reforms do not involve a change toward an institutional structure that supports markets. In the presence of a legal code that punishes economic success, and a demonstrated willingness to enforce it, even retroactively, future “legalization” of other forms of economic organizations, such as small firms, are meaningless. The Cuban government’s view of economic

reform is to tinker with socialism at the edges—permit a few very restricted markets, decentralize decision making slightly—but not the sort of institutional restructuring that would compromise the socialist nature of the economy. This should not surprise us. Important members of the government, such as Raúl Castro and Alarcón, as well as lesser spokesmen have repeatedly stated that the purpose of the reforms is to restructure socialism—to make it more productive and efficient—and not to pave the way toward a market economy.

Even if the reforms are yet not substantial, some may argue that their tentativeness is natural at this stage. As those in favor of reform as well as those against it struggle, the result is likely to be slow and confused, and we may even see temporary changes of direction. Are we really witnessing the first steps to what ultimately will be dramatic reform? I believe not, and the reason lies in the nature of the regime and the situation its leaders find themselves at home and within the international community. To see this we need to digress a bit.

INSTITUTIONAL CHANGE AND DEMOCRATIC REFORM

It is often argued that any economic reforms in Cuba aimed at greater reliance on markets and the lessening of centralized decision making will be unsuccessful if unaccompanied by democratic reform. Since the current economic reforms are not accompanied by political liberalization, by this argument the reforms will fail. I do not agree with this view. The historical experience, especially in the post-war period does not support the notion that democracy is necessary for successful, market oriented institutional reform. In fact, it may well be that authoritarian regimes are in a better position to implement such reforms. Chile, China, Singapore, South Korea, and Taiwan, are all examples of economies that have experienced major market friendly institutional change and rapid economic growth under authoritarian regimes. Even Hong Kong and Japan have had much of their institutional structure imposed on them from the outside. Meanwhile, democracy in the transition economies of Eastern Europe has sometimes hindered institutional change toward market economies.

Nevertheless, when one looks across all countries, democracy appears to be positively related to economic growth and with the types of institutional structures that are necessary for markets to function well. I believe the primary line of causation, however, runs from economic reform to democracy. There are at least three reasons for this. First of all, institutional restructuring aimed at reducing transaction costs and encouraging productive activity generates increases in wealth and more rapid growth. With higher incomes people demand a greater say in how they are governed. Secondly, they have greater means at their disposal to challenge the power of the government. This is particularly so if some individuals are very successful and accumulate some wealth, becoming pockets of power separate from the government. This is one reason the Cuban government cannot tolerate individual economic success. Thirdly, the freedom of movement, the decentralization of control of the means of production, and an improved system of communication which are necessary in a market economy, make the logistics of a challenge to the government easier.

If this analysis is correct, the Cuban government is between a rock and a hard place. If it does not liberalize its economy, the grossly inefficient structure of central planning, in the absence of Soviet subsidies, imperils the regime. If it makes real reforms and moves toward a market economy, it also sows the seeds of its own destruction.

One may ask why Cuba cannot follow the Chinese example of genuine market reform without political liberalization? I believe the answer lies in the simple fact that China is a powerful country with a large market, and Cuba is not. Economic reform in China was followed by calls for democracy and greater political freedom, culminating in the demonstrations of Tiananmen Square. These demonstrations were brutally crushed, with relatively mild protests from the international community.

Imagine a similar uprising in a more market oriented future Cuba still controlled by the Castro regime. Even if the repressive apparatus of the state is successful in squashing the rebellion, it cannot be expected that the reaction of the rest of the world will be a

mild as it was following Tiananmen Square. At a very minimum the U.S. would push, probably successfully, to extend the embargo to include Europe and Latin America. I think a naval blockade by the U.S. would not be out of the question, and neither would be outright military intervention. Cuba's small size, its proximity to the U.S., and the presence here of a large and vocal exile community, pose risks to the Castro regime from economic liberalization that the Chinese leaders never faced.

While Cuba cannot follow the Chinese example, it certainly is not following that of the Soviet Union. Cuba's economic reforms may resemble those of the ex-Soviet Union, but in Cuba there has been no political liberalization. The ruling class in the ex-Soviet Union may have believed it could open up the system politically and remain in power. If so, it was partially wrong. I say "partially" because while the old regime collapsed, many in the nomenklatura have retained positions of political and economic power. Even Mikhail Gorbachev has not done badly for himself. I understand he heads an international environmental organization. But in Cuba the revolution is too recent, and a political transition is not likely to be so kind to its ruling class. Can any of us imagine an ousted Fidel Castro heading efforts to save the rain forest, or just simply enjoy his wealth in peace on the Costa Brava?

DESPERATE TACTICS OR LONG-RUN STRATEGY

The economic reforms that Cuba has implemented are not going to create the sort of institutional change that will move that country toward a market economy. The Cuban government admits this. In fact, its spokesmen go out of their way to assure those elements in Cuban society that depend on its paternalism, and in turn provide it with political support, that the system is not going to radically change.

The reforms refer to entities such as firms, banks, and NGOs, that we find in market economies. These entities, however, have little resemblance to the real things. It is as if the Cuban government claimed to have copied a foreign car based solely on a photograph of the exterior. It may look like a car from the outside, but the internal mechanisms that make a car

what it is, would be absent. Economic entities in market economies exist within an institutional structure that makes them possible and rational. That structure is completely missing in Cuba, and in my opinion is not likely to be created by the current regime. The current reforms simply recycle known forms of socialist economic organization. I see no reason to believe that they will function any better in the Cuban context than they have elsewhere. The best the regime can hope for is a marginal improvement that will allow it to survive the present crisis.

Government spokesmen have claimed that the reforms are part of a long-term strategic restructuring of the Cuban economy. I am extremely skeptical. The reforms all smack of a tactical response to the immediate problems caused by the cut-off of Soviet aid. I have this image—I am sure it is wrong in its particulars, but perhaps correct in its essence—of the Cuban leadership sitting around wondering if the stop-gap measures they have been forced to take could be used to their advantage. Someone then suggests that if they can be packaged as part of a grand design to restructure the Cuban economy—making sure, of course, that nothing fundamental is

changed—it can be used to improve Cuba's image abroad. "Cuba is no longer rigidly dogmatic," the plan seems to say, "we are primarily interested in productivity and efficiency, just like all you potential investors out there." Who knows, if properly marketed, maybe it could even help remove the American embargo.

In closing, if we judge the reforms as to how significantly they will shift Cuba toward a market economy, I believe they will turn out to be a complete failure. If they are viewed as a new way of substantially increasing productivity and improving efficiency within the socialist framework, again I believe they will fail. As an aid for the regime to survive the current crisis, they may well succeed. As a means by which the regime can improve its image abroad, the reform package may also prove useful. In my opinion, they are not the first tentative steps toward a market oriented Cuba. I do not believe we are witness a child who is starting to crawl and will eventually, after many falls and scrapes, learn to walk. Down that path is disaster for the current leadership. I believe they understand that very well.