THE ROLE OF SMALL AND MEDIUM SIZE ENTERPRISE IN CUBA'S FUTURE

Antonio Gayoso[1]

Policy reform and investments in a post-Castro Cuba will have to pay special attention to employment problems resulting from the need to conduct rigorous restructuring and privatization of the enterprise sector, including both the manufacturing and the services sectors. Currently, the Cuban Government estimates that close to one million workers, almost 25 percent of the labor force, would be displaced if significant restructuring were to occur.

A Resolution on the Economy, announced and approved during the Fifth Congress of the Communist Party of Cuba, stressed the need to "perfect" the socialist system of production, and ignored the role that a small enterprise-based private sector could have in solving Cuba's pressing economic problems. The government, however, has not actually developed or carried out any new significant reform policy directed to address any of the problems identified during the Party Congress discussions. No meaningful restructuring has occurred. In particular, the government's position against private sector initiatives, or small privately owned firms, which could offer employment opportunities for displaced workers and managers, has hardened.

The reasons for this irresolution are probably many. In my view, however, the main ones are closely related to the conflict between the need to provide employment, and the strong reluctance, on the part of the government, to allow the creation of a private sector owned by Cuban citizens, which could lead to financial and, ultimately, political autonomy. In fact, in the economic resolution approved by the Fifth Congress, the Party affirmed that the government would stimulate small and medium size enterprises (SMEs), but state-owned ones.

We know that, for more than a year, reformist elements within the government technical cadres had identified the critical need to allow private SMEs to start. Their major justification was that only that way could the government conduct needed restructuring of state firms that would necessitate release of large number of supernumerary employees. They presented such proposals to the Party and its Central Committee, only to face determined rejection.

Basically, as has been the case with the self-employed, the government remains afraid that a vigorous, albeit small private sector would diminish its political control over a large sector of the population. The self-employed, who grew rapidly in numbers to more than 200 thousand in 1994, currently number well below 150 thousand, victims of their own economic success and consequent repressive measures the government has initiated to keep them under control. These measures include punitive taxes, high fines, as well as harassment by means of continuous inspections by several kinds of government overseers. In a post-Castro regime committed to economic and political democratization, providing the conditions to

1. An earlier version of this paper was presented in March 1999 at a meeting in Miami of the US-Cuba Business Council.

facilitate development of private small and medium size firms will probably be the most important and effective venue to initiate and deepen privatization of the economy.

The discussion that follows defines SMEs, discusses what conditions are required for their success, briefly reviews experiences in some countries in transition, identifies alternative financial arrangements that would support SMEs, focuses on the current status of this economic sector in today's Cuba, and looks at prospects for the future.

WHY SMEs

The usual convention is to define SMEs as a group of firms that employ fewer than 250 employees. Within this broad group, small ones have sometimes been defined as those with fewer than 50 employees. At the same time, many current efforts in development assistance have been focused on micro enterprise (ME), usually defined to be firms with fewer than 10 employees. These definitions are normative and do not result from any logical construct. Donors and governments have used them as tools to help allocate aid resources.

In the case of Cuba, most existing *legal* private enterprises, other than foreign investment ventures and/or state enterprises, could probably fit under this micro enterprise category. The self-employed, "cuentapropista," and the 12-seat home restaurant, *paladar*-owner, are, by definition, micro entrepreneurs. More discussion on these two categories follows later. Light industry and many service establishments, such as large hotels, now state-owned in Cuba, could be considered closer to the traditional SME definition. Yet, in 1995, according to the Economic Commission for Latin America and the Caribbean (ECLAC), 84 percent of all existing state enterprises remained large employers, using more than 200 employees, on the average. In comparison, ECLAC reports that, at the end of the 1950s, before the Revolution's accession to power, 80 percent of all non-sugar sector manufacturing firms in Cuba employed fewer than 25 persons on the average.

There are three fundamental reasons why SMEs deserve the interest they have received in transition economies. First, they are employment intensive. Second, when directly managed by the owner, they have proven to be very efficient. Third, they are a very effective means of deepening the privatization process by making private entrepreneurs of thousands in the population. In fact, SMEs are considered to be one of the principal forces underlying economic transition in Central and Eastern Europe. This is due to their agility in adapting to changing market and supply environments, their role in deepening managerial and entrepreneurial skills, their employment intensiveness, and their contribution to diversity and competition in the supply of products and services. Similar experiences have also been observed in transition countries where agricultural land tenure rights have been transferred or sold to former rural government employees.

SMEs also play a critical role in developed economies. The United Nations Economic Commission for Europe has estimated that, in 1995, in 19 countries in Western Europe, there were 16.5 million enterprises in the non-primary private enterprise sector. Of these, 99.8 percent were SMEs, while 92 percent of the total number of enterprises were very small firms each employing fewer than ten employees. In Turkey, for instance, 95 percent of the firms are SMEs and they employ more than 40 percent of the workforce, while accounting for more than 40 percent of total exports. In Greece, small firms dominate, numbering close to 700 thousand with an average of three employees. In Switzerland, more than 190 thousand firms employ an average of 13 people each. Finally, in the Unites States, small businesses employ more than half of the labor force, contribute roughly 50 percent of GDP, and are responsible for about 45 percent of all sales in the country. In 1994, the Small Business Administration reported that there were about 22 million non-primary firms in the United States, of which 99 percent were small.

REQUIREMENTS FOR SUCCESS AND SUSTAINABILITY OF SMEs

In countries in transition, as Cuba may be in the future, there is a need to develop an enabling environment that would nurture the development of small and medium size enterprise. Such an environment includes diverse, though mutually reinforcing, elements. The following have been proven essential in Central and Eastern Europe:

- A macro economic environment aimed at stability and growth. A significant economic stabilization program that imposes hard budget constraints and minimizes state subsidies is a sine qua non. Also, the authorities must have political willingness to move decisively toward privatizing inefficient state-owned enterprises. These two elements are, in fact, present in those transition countries growing fast, such as Hungary, Poland, the Czech Republic, and Slovenia.
- Sound and transparent fiscal policies and fair and effective taxation.
- Efficient markets that foster competition through deregulation and liberalization of markets and prices.
- A legal environment that defines and protects private property rights, establishes bankruptcy procedures, allows enforcement of contracts, and adopts internationally accepted accounting standards.
- A regulatory framework that demands financial discipline from financial intermediaries and legal behavior, balanced by incentives to individual freedom and initiative.
- Existence of adequate physical infrastructure.
- Efficient and accessible financial services.
- Adequate supply of business development services, including insurance, professional accounting, quality standards, etc.
- An efficient system for disseminating markets and policy information.

Programs to stimulate SME development must also emphasize the need, thorough training and public education, to change attitudes on the part of the population. Life under highly centralized and authoritarian regimes blunts personal initiative and stimulates risk aversion. Under those regimes, sanctions for officially perceived deviant behavior are simply too onerous to the individual. The challenge, to individuals, of accepting self-responsibility and a law-abiding attitude, particularly in the face of the great uncertainty associated with transition, should not be underestimated. In the case of Cuba, pervasive internal controls, coupled with large material shortages, have forced many in the population to recur to extra legal behavior in order to attain minimal consumption levels, particularly in the case of food and sanitary goods.

At the firm level, incentives need to direct the firm toward a market-driven, not a supply-driven, behavior. Hard budget constraints and minimal or no financial subsidization would provide incentives to efficiency and business-like approaches. These attitudes, however, are not innate, they must be learned and nurtured. Experience in Central and Eastern Europe clearly indicates that direct involvement of owners in firms' management is a major factor affecting these attitudes. In addition, evaluation of SME programs in that region suggests that new start-up companies outperform privatized former state-owned firms in most sub-sectors.

Even when all conditions identified before are fulfilled, one needs to remember that failure rates of these new start-ups may/will still be high during their first five years, as it is in the United States and elsewhere. The need to provide early external technical assistance to this sector is high.

SKETCH OF EXPERIENCES IN COUNTRIES IN TRANSITION

This section is based mostly on reports recently developed by the U.S. Agency for International Development (USAID), European Bureau (ENI), based on field evaluations and two recent contractors' workshops, and on earlier reports from the U.N. Economic Commission for Europe and the European Bank for Reconstruction and Development (EBRD).

Several Central and Eastern European transition countries have recognized the important role SMEs can and have played during the restructuring process. These countries have consequently formulated policies and programs specifically to address the needs of SMEs. In the Czech Republic, Hungary, Poland, Slovakia and Slovenia, the creation and promotion of these small firms is an integral part of the privatization program and of the economic reform effort.

In countries such as Romania and the Baltic countries, SMEs have been explicitly recognized as important but appropriate programs have only started recently. In the Newly Independent States of the former Soviet Union, in Macedonia and in Bulgaria, there have not been significant changes in the legal framework regarding SMEs. In addition, privatization efforts have been slow. Furthermore, physical and financial infrastructures in these countries remain major obstacles to SME development.

In Russia, despite the slowness of the reform process and the unfavorable economic and policy environment, SMEs are developing. While only anecdotal data exist, foreign aid workers have observed the growth of numerous small businesses and the growth of others where none existed before, particularly in the area of retail stores and personal services. Independent producers have appeared, engaged mostly in assembly operations and production of spring vegetables. SMEs still face major constraints such as high taxes, corruption, a convoluted legal system, lack of financing, and now, a major exchange rate crisis.

Poland

Poland has made significant progress in its privatization program. Spurred by the country's planned accession to the European Union (EU), the SME sector has, in fact, become a major element in Poland's economy. It accounts for almost half of the GDP, and employs fully 60 percent of the labor force. Yet, membership in the EU demands increased competitiveness in this sector. Thus, the Government has developed a policy package to promote SME development. It includes legal and fiscal instruments to create a more favorable environment.

A complementary program to offer relevant business services to SME is well underway. Thirty-one business support centers have been created. In addition, the Polish Foundation for Social and Economic Initiatives, through seven local agencies, will be providing services to new start-ups. A program to disseminate information about SMEs and their role has also been initiated to raise public awareness about their importance. Finally, main responsibility for implementation of all of these programs has been vested on a newly created Foundation for the Promotion and Development of SMEs. Parallel to these efforts, there has been, as a result of a successful program carried out by the World Council of Credit Unions with USAID financing, phenomenal growth in the number of credit unions offering financial services to SMEs.

Hungary

In Hungary, there has also been a large increase in the role played by SMEs. They employ in excess of 55 percent of the labor force and account for about 50 percent of GDP. Since 1994, government programs have explicitly recognized their importance. The legal framework already exists, but there are still many impediments, particularly concerning access to capital and credit. Provision of business services has also not kept pace with rapid growth of SMEs. Most of these firms produce for the domestic market. Hungarian accession to the EU, now programmed for the near future, has become a major incentive to increase agility in providing SMEs with the capital and know-how needed to increase competitiveness. Recently, the Hungarian government established a Hungarian Foundation for Enterprise Promotion, which will provide technical services to SMEs and will also serve as the intermediary for foreign aid funds destined to SME development.

Latvia

In Latvia, successful earlier efforts in the stabilization and privatization programs were set back by the 1995 banking crisis. Consequently, SME growth has been slowed down by lack of adequate access to capital and credit. Since 1997, several programs have been underway that emphasize identification and registration of all state property, focus on strengthening the accounting and supervisory systems in Latvia, plan for the improvement of banking sector performance, support the growth of SMEs, etc. A small program to develop credit unions is successfully underway.

Romania

In Romania, the restructuring and economic reform processes have moved very slowly. Romania still faces three major challenges: restructuring the national economy; achieving internal integration, particularly in light of the country's desire to access to the EU; and how to reach sustainable growth. Last year, the government of Romania approved an SME strategy that took into consideration social stability, taxation, and financial services. This strategy covers four years. Also, the government is now committed to privatize all state entities, and to curb bureaucratic excesses. Although only anecdotal data exist, observers suggest growth in the SME sector has been insignificant. Efforts to develop a large credit union system have only yielded modest results, mostly because of legal impediments to their operations.

These experiences would indicate that SMEs have prospered only in those transition countries where governments have introduced adequate reform measures to provide an enabling environment. In countries where the old communist parties or cadres have retained significant political power, effective reform measures have been difficult to enact through parliaments. These are situations in which foreigners have little influence.

ACCESS TO FINANCIAL SERVICES: THE ROLE OF INTERMEDIARIES

Most studies of private sector development in countries in transition identify access to financial services as a critical element to the development of small and medium size enterprise. The financial system serves several important functions. It provides an accepted and sound medium of exchange and a payment mechanism within a country; encourages mobilization of resources through savings mobilization; helps to allocate resources to activities with highest returns, if market prices prevail; spreads risks by offering a diversity of financial instruments; and it leads to wider ownership of society's assets. The business sector cannot function without access to financial services. Without them, barter would be the modus operandi.

In a market economy, several elements must be in place to permit efficient functioning of the financial system: a set of macroeconomic policies that result in control of inflation, achievement of overall fiscal balance, and in the existence of realistic, market-determined, exchange rates. Macro policies should also result in interest rate policies that are low enough to provide incentives to growth. Such low rates cannot be dictated but can and should be the result of efficiently working markets.

Important elements are mechanisms to insure the absence of financial repression, which is apparent either through interest rate ceilings or through policies that direct allocation of credit on an arbitrary basis. Furthermore, the government needs to develop a supervisory/regulatory system that establishes minimum financial performance ranges and that call for periodic audits of financial institutions. In the United States, the use of the "CAMEL" rating system for both banks and credit unions, and the regulatory role played by the Federal Reserve Bank in the banking sector, and that of the National Credit Union Administration, *vis-a-vis* credit unions, are examples of transparent systems that help keep financial and management discipline in the financial sector. Other necessary elements briefly mentioned before include the establishment and protection of clear property rights, contract and bankruptcy laws, deposit insurance, and licensing requirements for financial intermediaries, etc.

SMEs and other business firms require access to long and short term financing, on reasonable terms (market), to function properly. Credit, unless provided from abroad, depends on the financial institutions' ability and capacity to mobilize local/national savings, directly or through access to capital markets, on the part of financial institutions. Without adequate savings mobilization there cannot be a significant lending or investment program. Price stability, market interest rates, and cost efficiency in the operation of financial institutions, not only determine the viability of the latter, but the ability both to mobilize savings and provide the different length maturities businesses seek to meet their credit needs.

SMEs face special difficulties in gaining access to financial services. Earlier, we defined SMEs as those with 250 employees or fewer. In advanced countries, given high capital/labor ratios, an SME at the higher employment range could be a rather large company with millions in sales. In transition countries, however, scarce data available suggest that most SMEs employ far fewer people than the upper limit we usually use to define them.

In assessing risks and costs associated with the provision of financial services to SMEs, banks and credit unions must take into account a number of factors. For example, first, small, new start-up SMEs will have no established track record upon which to judge their credit worthiness, or the savvy of their owners/ managers. Second, loan size sought may be too small to be attractive to a formal lending institution whose minimum transaction costs may be too high to realize a return on such an operation. Third, the SME may seem riskier if its product line is new or not diversified. Fourth, firm's assets may be difficult to price, thus diminishing their value as collateral. Fifth, financial institutions know of the high risk implied by SMEs' high mortality rates worldwide.

In addition, financial institutions face a number of risks and other issues. Suggested before is the credit risk, i.e., the risk of no repayment. Financial discipline would dictate that institutions maintain minimum though significant capital/asset ratios and make adequate provisions for loan losses.

There is also a liquidity risk. If mobilized savings or other money sources are mostly short term in nature, long term loans cannot be granted, as this time imbalance could result in institution getting into a crunch should many members seek to withdraw concurrently, when the institution's liquidity is tied up in the loan portfolio. In developed financial systems, there are a number of technical and institutional ways to deal with this issue, e.g. access to central bank lending, establishment of central liquidity facilities that permit inter-institutions lending, owned by the financial institutions themselves, etc. But it takes time before these second tier institutions can be created.

Finally, there is an interest rate margin risk. An institution could commit to a given interest rate to be paid on medium term savings instruments which could not be covered if market driven rates on loans decrease to the point where the institution cannot raise enough revenue to face its financial and other costs. Consequently, financial institutions must set a number of provisions and reserves to prepare for these risks should they appear.

INSTITUTIONAL ALTERNATIVES

This section briefly sketches three different types of financial institutions which have proven effective in providing services to SMEs. These are commercial banks, credit unions (financial cooperatives), and village banks.

SMEs have also had access to several other important sources to satisfy financial needs. They will be highlighted but not covered in detail by this discussion. The most visible source is governments, which may provide SME oriented business services and financing on their own, or with the support of foreign development aid. Second source is business_suppliers, who frequently provide significant levels of credit and even technical assistance to SMEs. The example of feed suppliers in the poultry and egg sector in Latin America is one case. In the 19th Century, suppliers' credit was one of the largest sources of credit for small enterprises in the United States. A third source is families. Although no hard data exist, extensive information suggests that families are the most important source supporting new starts. In many cases, families are also the largest suppliers of employees in the new ventures.

Commercial Banks

Commercial banks are profit-seeking institutions that mobilize savings from individuals and capital markets and provide financial services for the purpose of making money for their stockholders. Their capitalization originates from private investors. Banks are highly regulated institutions that try to maintain strict financial discipline to accomplish their business goals.

In transition countries, SMEs, particularly smaller ones, usually have a hard time accessing bank credit. This may be the result of higher risk presented by usually weak or new SMEs, their lack of collateral, and the relatively small size loans they seek. Consequently, transaction costs are relatively high and banks may not be able to underwrite loans for them at a cost that allows a net return on investment. This problem is compounded by the fact that, in transition countries, most banks remain state run, or are new, or re-structured former state banks. Thus, the level of management skills found in the sector is not high enough to insure sufficient operational efficiency to be effective in dealing with small-scale operations.

In addition, bank officers still lack the experience and the feel required to dealing with smaller firms. One of the facts of transition from socialist systems has been a continuous popular mistrust for private property, engendered by decades of policies antagonistic of the private ownership approach.

Some of the problems mentioned before could be eased with foreign aid or government-supported loan guarantee programs that effectively decrease the risk level for banks. In addition, governments and commercial associations can provide education about the nature and role of SMEs, and facilitate the exchange of information that would allow better knowledge of SME owners as individuals and as entrepreneurs. In some countries, banks have adopted solidarity/group-lending approaches, which help achieve lower underwriting costs and lower loan delinquency levels. Whether these practices are feasible early in the transition process remains to be seen.

Banks definitely have an important role to play in the future of financial intermediation in Cuba, although they may not be the best tools for all future enterprise groups in the private sector. The country will require extensive investment in revamping of infrastructure and industrial plants. Suffice to say that current investment levels in Cuba are not high enough even to cover depreciation of existing plant. In addition, existing production facilities in most sectors, ranging from sugar mills to light industry, are seriously deteriorated for lack of maintenance and renewal. Most industrial technology in the country is Soviet-based, obsolete, and incapable of achieving competitive levels in cost or quality necessary to succeed in world markets. Equipment needs in the transportation sector are exceedingly high.

In addition, commercial banks will need to play a major role in the foreign trade area. Cuba must regain, for its exports, market share in markets that have been closed to it during the last four decades.

In early 1997, under Law-Decrees 172 and 173, the government undertook a reform of the banking system. These decrees redefined the role that had been played before by the Banco Nacional de Cuba (BNC). Since the early days of the Revolution, the BNC, in addition to its functions as the central bank, played all of the banking roles otherwise played by commercial banks in other countries. Decree 172 created a new, separate, Banco Central de Cuba (BCC), to play the central bank role. Decree 173 established new rules to govern the creation of new financial intermediation institutions in the country. Overall licensing and supervisory authority was delegated to the BCC. The impact of these decrees is difficult to gauge, but they are intended principally to provide services to foreign entities doing business in Cuba.

Finally, there has been a government savings bank, the Banco Popular de Ahorro (BPA), founded 15 years ago. This bank has a large number of branches throughout the country. According to government press announcements, the BPA has four million clients. Of these, 157 thousand clients have received loans. In addition, 370 thousand clients use the bank to pay their monthly housing costs. But the number of loans to individuals has declined considerably. In 1998, for example, the BPA granted less than 20 thousand loans. This level was merely 10 percent of the number of loans granted in 1989. The BPA, which originally served only individuals, now is allowed to provide services to enterprises and to engage in foreign exchange operations. No information exists regarding the range of services the bank plans to offer these two new client groups, but the bank announced it would be now involved in foreign trade operations.

For the past decade, the BPA has also been used to handle processing and delivery of the increasing volume of remittances from Cubans living overseas. Information available suggests that, with Canadian assistance, this processing has been fully computerized and based on international credit cards. This is an important role, as remittances have become the largest net source of foreign exchange at the government's disposal. No numerical data are available about the Bank's financial operations.

Credit Unions

Credit unions operate on a different basis than banks. Basically, they are financial cooperatives. Credit unions were first organized in Austria around 1855, by a group of small rural producers who had no access to commercial banking services.

In a cooperative, members are the owners and govern the organization on a democratic basis of one member, one vote. The institution, if well run, relies principally on members' savings to finance its lending operations and services, not on outside subsidies or government transfers. Thus, credit unions recycle community savings into local community loans. A credit union uses the market as the arbiter of the rates it charges on loans or pays on savings. Its major objective is to provide financial services to members. Credit unions do not target loans.

Although not seeking profits, a credit union is a business, not a charity. Costs must be covered. Borrowers must pay back. Savings must be attracted by competitive rates paid on deposits. Lending rates must be competitive in the local market as well. The cooperative must maintain a minimum capital base, not dissimilar to that of banks, as related to assets. In the United States, for instance, the current average capital/asset ratio for all credit unions is around 11 percent, a level somewhat higher to that of the banking industry in the country. Also, financial provisions for loan loses must be made. In addition, the central bank or similar entity should regulate financial cooperatives in a way that is no less stringent than that use for commercial banks.

The bulk of credit unions in developing and in transition countries serve a membership of lower income individuals who have limited or no access to financial services. Their socioeconomic status is a handicap to this access. Also, the demand from these individuals for a supply or relatively small, costly to process, loans usually make them unattractive clients for commercial banks. Prospective members need to have a capacity to save, but it has been proven that this capacity exists even in the poorest productive groups and countries. Without access to formal institutions' financial services and in the absence of credit unions, these individuals depend on usurers and on scarce family resources to finance productive activities, thus limiting the potential for new business starts or additional growth.

Credit unions are usually defined in terms of a common bond. That can be a place of employment, a profession or trade, or a community where members live. They serve only members. This approach leads to better knowledge of fellow members and facilitates group pressure and solidarity to insure loyalty and low delinquency rates. Where credit union members all work for the same company, it is easy to reach agreement with companies' management to discount loan payments directly from salary, effectively collateralizing loans with a most valuable asset, the member's salary. In a similar manner, members can ask payroll departments to discount fixed amounts for their savings accounts in the credit union.

Credit unions, while apparently limited in their ability to serve SMEs by their restrictions on whom they can serve with financial services, namely members only, do provide extensive services to SMEs and micro entrepreneurs. This is because small and medium size entrepreneurs compose many "common bond" groups. Furthermore, research has shown that SMEs involved many family members, all of whom contribute to the enterprise, some of whom belong to credit unions. Thus, loans to individual members frequently support creation and expansion of small enterprise owned by the family. In Ecuador, for instance, data show that in excess of one-third of the system's loan portfolio is loaned for enterprise purposes. In Honduras, over 50 percent of loans go to both rural and urban-based small enterprise.

Financial cooperatives use volunteers, which keeps operational costs low. Finally, cooperatives help educate people about the principles of self- governance and about the responsibilities that democratic control implies. Credit unions should play an important role in a Cuba undergoing transition from central controls.

Currently, there are no autonomous financial cooperatives in Cuba. There are, nonetheless, close to 2800 so-called Credit and Services Cooperatives (CCSs) in operation throughout the island, grouping more than 150 thousand agricultural producers. The CCSs are not true financial cooperatives in the sense we have used here to define them. They are, instead, groups of farmers organized at government initiative to facilitate producers' negotiations with *acopio*, the government monopsonistic purchasing agent for all agricultural and food products. *Acopio* is also the only legal source of agricultural inputs, including credit, in the country. There are actually no data about the CCSs' level of activity or quality of operations. During the last several years, however, reports from independent farmers suggest that CCSs are more instruments of state control than facilitators of economic activity.

Village Banks

Village banks, usually sponsored by developed country non-governmental organizations (NGOs), have become important conduits for credit during the last decade. These NGOs, in association with local NGOs, will organize small credit groups, called village banks, composed by about 25 members, usually women. Loans are given for productive purposes only in amounts, which, by tradition, should not exceed US$300. The central goal is to reach micro entrepreneurs amongst the "poorest of the poor."

Village banks have been successful in reaching millions of poor women. They have experienced, however, large client drop out rates. Nonetheless, they have been instrumental in the training of their members on the basic disciplines of borrowing and paying back. Loan delinquency ratios have been low. Village banks have grown very rapidly worldwide, perhaps with the exception of Central Europe and the European parts of the former Soviet Union. This may be the result of the fact that, in this group of countries, local NGOs are scarce and loan needs may well exceed the US$300 limitation preferred by the methodology.

Savings mobilization in village banks has not been a major concern, although there is some forced savings involved in the approach, savings which cannot be withdrawn until the member quits the bank. A major disadvantage with the model is the very short-term nature of loans. They must be paid back in four months, only allowing the financing of short-term working capital needs, and are more relevant to rapid turnover retail market traders than to more sophisticated production or assembly. Thus, if a micro entrepreneur member of a village bank grows fast, he/she can soon reach a ceiling that could constraint their growth potential. An additional problem hampering the institutionalization of village banks is their informal nature. They are usually neither legally registered nor regulated or supervised. Thus, maintenance of financial discipline in the system falls, not so much on the group, but mostly on the sponsoring NGOs. Significant problems have been reported.

Because they do not mobilize savings, village banks are fully dependent on external, usually largely subsidized, assistance funds. Thus, achievement of financial sustainability is not possible under the current model. That said, village banks, because they are reaching a client group that banks do not serve and credit unions cannot target, play a very useful function as sources of finance to a large group of very small producers. These limitations will not preclude village banks from playing an important role in support of the self-employed and in providing critical education in basic individual financial discipline in a future Cuba.

In summary, each of these three institutions serves a different niche of the market, with only slight overlaps:

- Commercial banks would support the recovery of the industrial base, major infrastructure, and help intermediate foreign trade operations.
- Credit unions would attend a large number in the population who would be perceived as too risky or too small to be profitable clients for the commercial banks.
- Village banks could serve the very poor potential entrepreneurs who require a high level of attention and help to succeed, or who do not have access to a credit union "common bond."

Obviously, during the initial period, perhaps for five years or more, the country will be a net borrower, as domestic savings and foreign exchange would likely be well below the needs of reconstruction. Foreign credits and foreign investment will be needed to fill these temporary gaps. The three alternative institutions we have discussed, nonetheless, will have a useful role in providing financial services to different population groups in a Cuba in transition.

STATUS OF SMEs IN CUBA

It would be simple to say that privately-owned small and medium size enterprise is not allowed in Cuba. Indeed, that was the case for more than thirty years. During this period, only the state could hire workers and it owned all productive enterprises. A lone exception was the small farmer sector, a remnant of the pre-Revolutionary period, accounting for roughly 10 percent of the country's agricultural land, in farms smaller than 12.4 hectares (32 acres). These small farmers were allowed to hire retired agricultural labor to assist them in farm work. Any other productive activity, if in private hands, was illegal and punishable by law.

In September 1993, under Law-Decree 141, as part of a number of measures to address the worsening crisis resulting from the collapse of the Soviet Union and the end of Soviet subsidies, the government decided to allow self-employment in a number of carefully identified activities. The idea was to find work for thousands displaced from manufacturing plants which could not function without subsidies or outside the protected embrace of the Soviet sponsored Eastern European common market. The authorization was subject to a number of critical restrictions: college graduates, teachers, and other professionals were not authorized to be self-employed in their areas of expertise or training; fees and taxes were instituted; the self-employed were not allowed to hire others; and the use of intermediaries between producers and consumers was prohibited. The official decree also stated that state enterprises could not purchase any product or services from the self-employed, unless authorized in advance,

Additionally, under Resolution 4/95, the operation of small home restaurants of no more than 12 chairs (the so-called *paladares*) was also authorized. The latter are allowed to "hire" close family members to work in the restaurant. Two to three people are usually employed in these venues. Again, relatively high minimum fees and non-returnable taxes were initiated to apply to these small firms. Both measures were carefully written to make clear that the concept of privately owned SME remained ideologically unacceptable. Despite this rigor, anecdotal information suggests the existence of a number of very small private enterprises in the repair and maintenance sector where each of several "employees" holds a self employment license, thus seemingly working together in the same locale, though not for a putative owner. But examples of this are rare and the activity remains illegal.

In February 1994, under Decree 186, promulgating rules to implement Law-Decree 99 of 1987, the government also approved sanctions and very high fines for those breaking the rules and limitations on self-employment.

These measures were taken against a backdrop of other changes in policy. These policy changes included the reactivation of agricultural markets (that had been closed in 1986 on ideological grounds) where agricultural producers can sell selected products once compulsory production quotas are delivered to the state's *acopio*. Sales of many products, such as beef, seafood, and others were prohibited. The use of intermediaries was also prohibited. Only producers can sell their own products. In addition, under Law-Decree 140 of August 1993, the government legalized the tenure and circulation of foreign hard currency. Because of the latter measure, *paladares* owners and the self-employed could now choose to operate in the dollar sector. If so, their fees and taxes would be dollar-denominated.

The government has constantly and openly acknowledged its misgivings and reluctance in approving these measures. In their view, they have been only justifiable because of the needs of the "Special Period," instituted to deal with the consequences of the demise of the Soviet Union. Despite this official frown, more than 200 thousand people rapidly sought and received licenses. Hundreds of small restaurants opened their doors. Many believe that the rapid growth in the self-employed frightened the government. Not much time passed before several high government officials started to decry the "illegal" and "immoral" enrichment they said was occurring among many of the self employed. Many a speech has ranted against the growth of a cancerous petit bourgeoisie. Rules have been tightened and increasingly harsh "inspections," accompanied by very stiff fines, have become the rule. The number of licensed self-employed has tumbled and many *paladares* owners have turned in their licenses. Exact numbers are not available.

Needless to say, many observers believe that extra legal self-employment had existed all along, as it did in the old Soviet Union. Furthermore, many are convinced, even within the Cuban government, that a large extra-legal self employment force remains active, the common citizen having no other choice to make ends meet. But the environment is not enabling. Rather, it is designed to contain and control the sector, not to give it incentive to grow.

A very perverse though interesting example of how the system in place works is the fact that self-employed trades people are constantly suspected of purchasing their raw materials from people who steal them from state enterprises and warehouses, the only places where such items can be found. This is, of course, illegal. Yet, the government has steadfastly refused to sell the same raw materials to the self-employed, so they can be purchased legally. Currently, however, with the opening of dozens of dollar stores designed to soak up foreign exchange in circulation, some raw materials, particularly in the food sector, have become legally available, although at very high dollar prices. Government inspectors now demand that receipts from these stores be shown to prove the self-employed have purchased his/her materials legally.

During the later part of 1998 and in 1999, official declarations from the highest levels of the Cuban Government have increasingly denounced intermediaries, illicit enrichment, price gouging, and other "exploitative" ways of the free market. These declarations and the increased harassment of private initiative are consistent with the intentions and recommendations of the Economic Resolution of the Fifth Congress of the Cuban Communist Party in 1997. It explicitly directed the government to stimulate small and medium size enterprises in the socialist sector and to "perfect" socialist enterprise.

In summary, while there are without doubt a large number of enterprises in Cuba that could be classified as SMEs, most remain state-owned. Even in the case of the joint ventures with foreign investors, such as tourist hotels, many of the physical installations are owned by the Cuban government and operate under management contracts with foreign tour companies. In the agricultural sector, two types of medium size cooperative institutions, semi-soviet style in structure, are under direct control of the government that, in most cases, retains ownership of the land.

In fact, it is this policy environment, and the widespread state ownership of the means of production, that clearly suggest the lack of intention and willingness to move towards transition in Cuba. Yet, the situation also points out the multiple challenges and opportunities that will exist once a political decision is reached to open the economic and political system.

FOCUS ON THE FUTURE

The preceding discussion has identified a number of policy measures considered necessary conditions to the creation of an environment that enables rapid growth of small and medium size enterprises. In regards to Cuba, the tasks ahead seem daunting. Some observers have suggested, nonetheless, that, if the regime in power disappeared, the time period needed for Cuba to regain its economic health and dynamism would be relatively short. They base this optimistic view on several factors: Cuba is close to the United States, the largest unitary market in the World. Cuba has a highly educated population. Cuba's productive potential is high because of its land, climate, and mineral resources. Tourism and a host of export activities could be put quickly into high gear to achieve high growth rates and wellbeing levels. If free, American and Cuban-American tourists and investors and the hard working traditions of the Cuban people would make that miracle possible.

The experience of Central and Eastern Europe provides a more cautionary tale. Given the widespread deterioration and technological obsolescence of Cuba's industrial plant and physical infrastructure, a very large level of investments will be needed that may not be absorbable rapidly nor profitable, given the state of Cuban society, its mores, and its available markets, both national and international. Furthermore, the technical skills of the population, learned to compete within the inefficient former Soviet Bloc, may be inadequate for modern Western technology. There are certainly serious deficiencies in knowledge and skills regarding how a market oriented system works, how to follow standard accounting procedures, how to calculate cost of production, or even how to do business planning.

There are, in addition, difficult legal issues to settle before a semblance of social stability appears. While writing a modern commercial code would be somewhat easy, settling the issue of property rights on lands and plants confiscated by the Revolution will be very difficult. Who would build a plant on a piece of land without having clear property rights to it? What do you do with the population that now occupies houses and property previously and legitimately owned by others? Thus, a number of difficult political decisions will have to be made by a transition government that will affect the speed at which recovery is attained.

In a sense, these more pessimistic views tend to support the case for strong emphasis on developing an appropriate enabling framework for small and medium size enterprise. Many firms could be created in the transportation, small-scale manufacturing, services, and technology sectors, where many of the property/legal issues highlighted before would not generally apply. Within a relatively short period, pent up demand for many of these products and services would support rapid expansion of SMEs, thus fueling employment creation and focus on self improvement as an antidote to the anomie and illegality of current existence in Cuba. A significant constraint would be the high import coefficient of some SMEs.

BIBLIOGRAPHY

"Banco Popular de Ahorro." *Trabajadores* (June 17, 1998).

Citizens Network. "Harnessing the Power of the Private Sector." Unpublished report prepared for USAID meeting on The Future in Eastern Europe and the FSU, 1998.

Naciones Unidas. Comisión Económica para la América Latina y el Caribe. *La Economía Cubana: Reformas Estructurales y Desempeño en los Noventa*. México: Fondo de Cultura Económica, 1997.

Organization for Economic Cooperation and Development. "Regulatory Reform for Smaller Firms." Unpublished paper. Paris, August 1999.

Peters, Philip. "Against All Odds, Cuban Small Business Finds a Way." *The Wall Street Journal* (November 30, 1998).

PSD. "Business Development Services for SME Development: Improving Practice and Learning" Unpublished paper presented at USAID conference. Washington, DC October 28-29, 1998.

"Reglamento Más Severo para Cuentapropistas." *El Nuevo Herald* (July 7, 1998).

Silcox, Stephen C., et al. "A Comparative Assessment of Specific Aspects of USAID Programs to Develop Small and Medium Size Enterprises in Bulgaria, Poland, Russia and Ukraine." MSI unpublished report to USAID, October 31, 1997

"Speech by Fidel Castro on the Credit and Services Cooperatives." *Trabajadores* (June 16, 1998).

United Nations. Economic Commission for Europe. Various articles and news in its electronic webpage, 1998-1999.

USAID. "SME Growth and Development in the 21st Century: Vision for the Future and Assistance Strategy." A Summary of 9-17-98 Meeting of Implementers. Washington, D.C., September 1998.

USAID. "Evaluation of Private Enterprise in the ENI Region: Draft Summary of Findings and Recommendations." LBerger and Checci Consulting Co. Washington, D.C., September 1998.

Webster, Russell. "Private Enterprise Growth in Eastern Europe and the Former Soviet Union in the 21st Century: Creating a Vision for the Future." MSI unpublished report. Washington, D.C., February 1999.