# MACROECONOMIC POLICY ISSUES FOR A FREE-MARKET CUBA[1]

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Cuba is undertaking a profound transformation of its traditional economic structures. This transformation is the result of several factors, some apparently leading in different directions. First, the crisis generated by Cuba's loss of the significant Soviet subsidies in the early 1990s. Second, the measures taken by the Cuban government to meet the crisis, especially the increasing reliance on foreign operators and investors to rapidly generate badly-needed foreign exchange. Third, the Cuban people's response, though highly constrained, to the government's inability to develop the country's economic base previous to 1991 and its inability since then to make up for the lost subsidies with internal reforms, even within socialist tenets. And fourth, the government's unwillingness to liberalize the economy and create the conditions by which the lifting of the U.S. embargo would benefit all Cubans and not the government establishment alone.

As a result of these factors, the Cuban economy is following a trajectory that fully satisfies neither the socialist government nor most of the Cuban population. The government would like to generate greater volumes of foreign exchange and more productivity in state-owned enterprises and farms. The average citizen would like to have food security and a minimum supply of other basic commodities like clothing, better housing, and a return to the days when health care services and education were better.

The structural transformation of the Cuban economy essentially consists of a growing reliance on foreign tourism and U.S. dollar remittances from exiles to relatives, friends, and civil society organizations, while the sugar industry and most of the traditional economy slowly deteriorate. Despite the chronic lack of reliable economic statistics, the country's economy seems to be experiencing stagnant or falling production levels in most of its industries, followed by decreasing employment, productivity, and standards of living. At the same time, agricultural and manufacturing installed capacities and physical infrastructure are in rapid decay. Topping all this, Cuba has become one of the worst credit risks in the world, with a staggering external debt that has not been serviced in many years.

The transformation of the Cuban economy to a thriving market economy will require a massive dose of external resources, mainly in the form of private investments. The resources that could be mobilized by multilateral and bilateral donor and lending insti-

1. This paper was developed in two stages: first, from my comments ["Comments on 'Economic Reform in Latin America and the Caribbean and Possible Implications for Cuba' by Claudio Loser," *Cuba in Transition—Volume 8* (Washington: Association for the Study of the Cuban Economy, 1998] to a paper by Claudio Loser ['Economic Reform in Latin America and the Caribbean and Possible Implications for Cuba" *Cuba in Transition—Volume 8* (Washington: Association for the Study of the Cuban Economy, 1998] about macroeconomic policy requirements for a Cuban transition to free markets; and second, from a paper written in 1999 for an USAID-sponsored project managed by the U.S.-Cuba Business Council. The author is very grateful to Mark Gallagher for his many valuable comments to the previous version of the paper, but remains entirely responsible for the final product.

tutions will be important too. It is a central postulate of this paper that the speed of economic recovery of Cuba after Castro will be a direct function of the volume of foreign resources efficiently invested in the country's economy. Yet to achieve a sufficiently high volume of resources efficiently invested, Cuba must have a government committed to the development of a market economy and to economic growth, to design and carry out an economic transformation of the country and to adopt those economic policies necessary to create the economic climate capable of attracting investment.

This paper focuses on some of the most important macroeconomic policy requirements of a free-market Cuba and their interrelationships. This is a relatively small but critical part of the monumental task of transforming the Cuban economy not only into a market economy but into a thriving one. The purpose of the paper is to explain some public policy issues that can have direct and, in many instances, immediate impact on the way Cuban citizens live and work. Lack of public understanding about reform programs is often one of the main causes of opposition to them, especially when the public has been subjected for decades to a daily litany of the great social, economic, and moral advantages of socialism and the evils of a free-market economy.

The transition to a market economy presents the additional obstacle that economists under socialism are rarely prepared to undertake such an endeavor as a result of some insufficiencies in their training. As is typical in socialist countries, Cuban economists are educated primarily in Marxist political economy, with certain amount of mathematics and operation research, and the administrative aspects of a socialist economy and planning. They may have some training in input-output models and statistics, but typically their training does not include price or microeconomic theory, modern macro theory, and topics in fiscal or monetary theory.

Therefore, this paper is written primarily for the Cuban economist that one day is expected to be working in the transition of the Cuban economy, and also for the educated Cuban citizen that some day is expected to have the political power to decide on these topics through a democratic process. The paper is also an attempt to show the language and approach that, in the author's opinion, is necessary to use in Cuba when the transition to a market economy can begin in a democratic context.[2]

Though the emphasis is on economic policy reform, the paper does not deal with the institutional and organizational reforms that are necessary to install a market economy. It is important to make an essential distinction between policy, on the one hand, and institutional and organizational reform, on the other. Policy is one of the courses of action available to manage a system of given institutions and organizations. A given institutional and organizational arrangement only allows for a certain set of policies. For instance, if the institution of property rights is not universally established, the legal system is not organized to guarantee such rights, and most enterprises still remain in the hands of the government, a policy to discourage consumption and stimulate savings and investments by individuals and enterprises will not work by itself. In Cuba, a great deal of institutional and organizational reform must obviously take place before or simultaneous with the macroeconomic policies discussed here. Therefore, the paper assumes that institutional and organizational reforms will take place, allowing the macroeconomic policy choices reviewed here to become feasible.

Macroeconomic policy reform, by itself, will neither create a market economy nor reactivate the Cuban economy. Macroeconomic policy is only one front, among many others, to transform an entire economic system. An effective macroeconomic policy must be capable of affecting the conditions under which firms and economic agents usually operate. Without profound restructuring, the typical enterprise that operates under a socialist central planning system is not prepared to respond to an exclusively macroeconomic program for several reasons.

2. A Spanish translation of this article will soon circulate in Cuba.

First, such an enterprise is not much more than a production or service shop accustomed to following central orders measured in physical dimensions; managers have virtually no decision-making powers.[3] Second, the managers of this type of enterprise are not used to thinking about costs, prices, or profits, since a central budget system that operates blindly without the benefit of profit centers manages the financial resources. Third, because this enterprise never operated responding to market signals, it would be naive to expect that a simple price liberalization policy would quickly generate the right set of relative prices to allow the enterprise to operate more efficiently. In fact, being state monopolies, if the enterprises were to work as profit maximizers, they would increase the prices of their products well beyond competitive equilibrium levels. In Cuba, as in many of the ex-socialist countries, such an outcome would instantly create a shock among an economically and politically beleaguered population that would easily provoke a spontaneous explosion of civil unrest. The lack of organized markets and resources would not allow the economy to rapidly adjust to the new conditions.

The above considerations imply that macroeconomic policy reform must also be undertaken after or together with a rapid transformation of the productive systems of the economy to make the enterprises respond to the new economic environment. Privatization, however, is not sufficient. The privatization process must be complemented by a profound restructuring of the firms, where new management systems and cultures are created and the financial and marketing functions are reinstalled. Only when the enterprises learn to make their own decisions in a competitive market economy, can the macroeconomic policy measures be expected to have some impact.

Privatization as it was carried out in the republics of the former Soviet Union, especially in Russia and Ukraine, is not going to produce the entrepreneurial environment necessary to create a market economy. Recent experience sadly shows that simple-minded privatization, based on the artificial creation of owners forced to accept shares or vouchers of industrial property in a society educated to believe that private property is immoral, is far from an optimal way to conduct the transition from socialism to a market economy. This is why we include privatization, as a way to change the structure of property holdings, in a menu of macroeconomic policy choices, assuming, again, that a number of complementary measures will be implemented simultaneously, such as the establishment of property rights and its required organizations, the legal system within which a market economy is expected to operate, and so on.

The scope of macroeconomic policy in this paper covers five areas: fiscal policy (expenditures and taxation); monetary policy; trade (domestic and international); the structure of property holdings; and the organization and development of factor markets (labor and capital). In addition, the paper reviews a number of special policy areas that belong to the realm of macroeconomic policy, including external debt, promotion of domestic and foreign investments, external lending and assistance, and the need to supplement macroeconomic policies with public information and public education programs.

## FISCAL POLICY

### Expenditures

It is in the area of fiscal expenditures where the transition government will receive maximum pressure from the population to produce miracles. After years of neglect by the revolutionary government, needs have been accumulating in the education, health, housing, social security, and infrastructure sectors. A large proportion of the Cuban people grew accustomed to the notion that government is almighty, that any unsolved problem is a result of a decision rule not necessarily connected with a "hard budget constraint." The transition government will have to display a great of discipline to avoid falling into the

3. Even though the it can be argued that Cuban central planning has virtually ceased to exist, most Cuban public enterprises have very little autonomy to make their own decisions, and are still operating on a physical and not a financial basis.

temptation of yielding to populist pressures that will trade off short-term political peace for long-term fiscal and economic irrationalities. This section examines some of the elements or choices of what should be done by the transition government in strictly economic terms. This does not mean to underestimate the size of the political challenges or the need to strategically plan the implementation of fiscal reform.

The expenditure side of the fiscal policy of a transition government will be defined by answering the following questions:

- What should be the level of total government expenditures?
- What should be the composition of expenditures among current expenditures, capital expenditures and public debt servicing?
- How much should the government borrow externally?
- How should current expenditures be allocated?
- How should capital expenditures be allocated?

Deciding the level of total expenditures is one of the most critical decision of fiscal policy. How much should the transition government spend? Some might be tempted to answer: As much as the government can collect in tax and fee revenues plus what it can obtain in loans.[4] A more qualified answer, however, requires some technical analysis based on the theory of public finance or public economics, and is out of the scope of this paper.[5]

In any case, the volume of expenditures depends on the volume of fiscal revenues that can be collected, which, in turn, depends on the level of economic activity of the country. Therefore, in the early stages of the transition, Cuba's capacity to generate fiscal revenues will be severely limited and will grow only as the economy grows. If the transition government yields to pressures to spend more than it collects, the deficit might have to be financed by issuing money, starting an inflationary process that will jeopardize the economic reconstruction of the Cuban economy. In order to avoid such an outcome, the government will probably borrow external resources.[6] Eventually, after some years of economic recovery, internal sources can also be expected to be lenders to the government, but this will greatly depend on the credibility Cuban government administrations can earn after decades of fiscal mismanagement under Castro and before.

The guiding light of a sound fiscal policy during the transition (and always) is the avoidance of disequilibria and, therefore, inflation. If the transition team sticks to its guns and maintains expenditures under control, its fiscal expenditure policy choices would focus on the composition of expenditures, i.e., the distribution of the available resources among three great categories of expenditures:

**Current expenditures:** Expenditures to pay for services rendered within one year of activity, typical examples: salaries of government employees (teachers, doctors, nurses, policemen, judges, etc.); supplies for government consumption (gasoline for government vehicles, medical supplies for hospitals, educational material, electricity for government buildings, etc.); and maintenance expenditures (for schools, medical centers, government buildings, highways).

**Capital expenditures:** Expenditures to pay for assets that provide services in periods longer than a year, for instance: (1) the construction of new buildings and reconstruction of old ones; (2) the purchase of vehicles and equipment in general; and (3) the construc-

4. It is assumed that the transition government will highly value price stability as a sine qua non for fast economic recovery and will avoid fiscal deficits and taxation by inflationary policies.

5. There are several methodological approaches to determine an optimal level of expenditures and taxation. One is based on the maximization of an assumed welfare function or the maximum monotonic increase of all households' welfare. Another approach is based on a typical Wicksellian criteria where households' preferences are directly taken into consideration.

6. Despite its poor credit history, many countries, especially the United States, and international financial institutions stand ready to lend Cuba significant volumes of resources the moment the government—probably in a post-Castro era—demonstrates its commitment to a market economy.

tion of highways and bridges, and reconstruction of old ones.

**Interest and capital payments of Cuba's external debt:** At the top of the transition government's fiscal agenda lies the need to define a policy to renegotiate Cuba's external debt and decide how much of the fiscal and foreign exchange revenues to allocate for this purpose. Without a renegotiation of the external debt, Cuba's international credit would be severely limited, becoming a major obstacle to the country's economic recovery. The international community, especially the United Sates, will probably assist Cuba in its efforts toward economic freedom and recovery. If, on the other hand, the transition government decides to postpone debt payments in favor of pressing domestic needs, there may be fewer resources available as the international community may not be as willing to cooperate as if the debt is recognized. It is therefore crucial for the transition government and its fiscal authorities to recognize and understand this critical trade off from the very beginning of the transition process.

After facing and resolving this challenge, i.e., determining how much will be destined to service the external debt, the next challenge is to define how and where to spend the meager fiscal resources left available among the many competing needs. Over almost forty years of revolutionary rule and close to thirty of Soviet subsidies, Cuba was able to develop lavish education programs and health care services based on subsidies, plus armed and security forces out of proportion to the size of the economy.

The disappearance of the Soviet subsidies forced the Cuban authorities to implement an extremely painful adjustment program, especially in the area of subsidies to government-owned factories that were operating at a very low level of capacity utilization. The Cuban government kept all employees fully paid in nominal terms but allowed the purchasing power of the currency to plummet. The choices of government employees in the transition will develop as the Cuban economy recovers. The reactivation of the domestic economy through privatization, trade liberalization (discussed below) and new job opportunities created by foreign direct investment may encourage government employees to switch jobs. Otherwise, they may want to demand from the government salary adjustments in an effort to recovered the old, Soviet-subsidized standards of living.

This is one of the reasons to coordinate the different aspects or fronts of an economic policy of reconstruction. Fiscal policy should not be narrowly defined as a single-target endeavor in transition macroeconomics, but coordinated with private sector enhancement and employment generation measures that would prevent pressures from a beleaguered constituency looking for fiscal magic. The allocation priorities in current expenditures should be defined around two general principles: (1) build a strong, lean, and efficient central administration capable of conducting the transition successfully; and (2) give priority to the rapid economic recovery of the country, its legal and education systems, and the rebirth of its civil society. On this basis, the priorities to allocate current expenditures would be the following:

- Guarantee a functional central government administration with special emphasis on the top executive team, fiscal and monetary authorities, administration of justice, transition management, and public order;
- Establish public kitchens across the country to feed all those that might be temporarily unemployed or displaced by the transition;
- Keep the basic education system (from preschool through nine grade) and the technical-vocational education system operational by paying teachers' salaries, and providing essential supplies and equipment (especially in vocational education);
- Maintain as many as possible public health care facilities fully functional by paying doctors and other personnel's salaries and keep a minimum of medical supplies, especially in the preventative area;
- Provide pensions to those who qualify for social security benefits with special attention to those who could not work.

Those activities that cannot be funded properly should be closed, permanently or temporarily, or assisted to become self-financing. This could include university education, other specialized schools and non-essential research facilities, cultural enterprises that could charge for their performances, and many others. It is uncertain to what extent the government should or could afford a universally free high-school system. Lack of proper funding (watering down the quality of education due to insufficient funding is not a good way to build a market economy) could lead to ration schooling to the most capable graduates of basic education. Private sector investments in high school (including sponsorship by religious denominations) should be facilitated but subject to rules to guarantee quality.

The new public administration should be built with efficiency and transparency as keystones. The transition government must choose between having a large payroll with low-salaried (and possibly less efficient) employees or a streamlined payroll of high-salaried (and presumably more efficient) employees. Even though the second alternative seems to be the best, the salaries that would be paid cannot be to far out of line with the rest of the economy. There will always be pressures over the authorities to employ relatives and friends, especially during the early stages of the transition when economic uncertainties will dominate the daily scene.

Capital expenditures will have a similar set of general priorities, i.e., efficient government and economic recovery. The transition government might define specific priorities after a maximum participation of the private sector in public works and general infrastructure. There will be a great demand from the public for the transition government to spend in housing projects, when in reality this should be left entirely to the private sector, though with government support to develop the necessary financial markets and other essential components of a thriving housing industry. There are other areas in which the government might be pressure to be the principal or a partial investor, but it is necessary to leave for the government the provision of public goods that cannot be privately produced. This can also include water supply and sewage systems, waste disposal systems, etc. Capital expenditure priorities of the government might be the following:

- Infrastructure directly complementary to productive investments of no interest to private investors, like certain highways, roads and bridges;
- Reconstruction of public and justice administration buildings and modernization of equipment (especially computers and peripherals, communications, transportation, etc.);
- Training of government personnel to modernize public administration;
- Reconstruction of school facilities and equipment for basic education; and
- Reconstruction of health care facilities and equipment, especially in the preventative area.

A large share of expenditures may have to be funded by external borrowing. These borrowed funds should contribute to economic growth if wisely invested, otherwise Cuba's public debt would grow and would add to the current hindrance to future economic expansion. Selling public assets to foreign investors could in principle increase the resources available to the government, but this will be limited to those assets that were never in private hands, since privatization of previously nationalized assets will be among the top priorities of the transition team. Yet even those assets might have to be used to compensate those whose properties could not be returned to the original owners for a variety of reasons. For instance, properties that were dilapidated or cannibalize under the socialist economy, and properties that could not be returned for practical reasons such as urban real estate currently occupied by tenants with no other place to live.

**Taxation**

One of the most important elements for the fiscal authorities to take into account during the transition will be the need to avoid excessive taxation. As public expenditure needs become overwhelming, the inclination to tax will exist until the level of economic activity and the tax base of the country are deemed sufficient. Tax authorities often fail to recognize that extensive taxation could be self-defeating by hurting the production and investment possibilities of a country. At the same time, other types of temptation should be avoided, especially the exemption of taxes to stimulate the growth of certain industries or attract investments rapidly.

At the outset of the transition process, the government in charge will be overwhelmed by individuals, foreign governments, international organizations, nongovernmental organizations, and corporations of all sizes, bringing attractive offers in exchange for tax holidays or privilege. Depending on the experience and the ethical and professional background of the transition fiscal authorities, they may be able to withstand the pressures and choose the tax system that is most consistent with the Cuban national interest. If they capitulate or compromise, Cuba will end up with an inferior tax system, loaded with distortions and inconsistent with the goals of rapid economic recovery.

Another general principle that should be permanently followed is that taxes must not grossly distort the relative prices generated by a market economy. In technical terms, taxes should be as *neutral* as possible, meaning that they, in general, should not burden some agents or activities more than others. The *equity* of the tax system is also important to take into account. Somewhat similar to neutrality, equity refers to how fair the distribution of the tax system is among individuals and households.

Yet the focal mission of the tax authorities during the first stages of the transition will be to determine the best feasible *tax structure*, i.e., the specific combination or set of taxes. There are many forms of taxes, for instance: those that burden the income earned by individuals in a given period of time, taxes applied to the income of corporations and business in general, and taxes applied to imports and to specific products. There are also taxes on accumulated wealth, taxes on transfers of wealth, and on transactions or sales. The question is how to choose and define the appropriate tax structure for a Cuban economy that has to undertake the double objective of creating enough revenues to finance the recovery of a very impoverished country minimizing its burden on the production system.

Taxes are not simply defined and made into laws: they also have to be administered. The mere existence of a tax law does not guarantee its enforcement and may not produce the expected revenues. An essential part of the tax system is its tax *administration* component, whose main mission is to collect all revenues that are supposed to be generated by different taxes. Since many taxpayers try to evade their share, preventing evasion is a critical function of tax administration. Yet it is important to keep in mind that the final distribution of the tax burden or *ex post* equity will result from the combined effects of the way the tax structure was defined and the actual efficiency in the collection of revenues. If; for instance, certain groups in a society are more capable of avoiding taxes than others, the actual tax burden is biased against the second group.

It is also important to take into account that the design of a tax system must be complemented with a legal system capable of enforcing the tax laws. The legal system, from prosecutors to defense attorneys, judges and all other personnel, must be capable of punishing, by either fines or jail terms, the tax evader as well as the corrupt tax revenue official accepting bribes from unscrupulous citizens. It is obvious that the better the public's attitude towards the payment of taxes, the less costly the administration will be. Yet it is necessary to keep in mind that without enough resources for the justice component of the tax system, not enough revenues will be collected. This consideration will serve to give a high priority to the allocation of fiscal resources to the entire tax collection and enforcement system, possibly more than proportionally in the initial stages of the transition in Cuba.

The menu of policy choices for transition fiscal authorities in a free-market Cuba is wide open, and considerable discussions should be carried out to adopt the best possible course of action. It is not the intention of the author of this paper to recommend specific solutions for Cuba at this point. The right solutions will be better determined at the time the actual transition starts. What follows is a list of the taxes that might be suitable for Cuba:

- Income tax for individuals

- Income tax for corporations
- Import tax
- Sales tax
- Capital gains tax
- Wealth tax
- Inheritance tax
- Value-added tax
- Excise tax (for specific products like gasoline, tobacco or alcoholic beverages)
- Fees for government services

The tax structure is a combination of these taxes with its corresponding rates, e.g., 5 per cent of imports, 6 per cent of sales, 11 cents the gallon of gasoline, etc. Taxes can also be imposed and administered at the national level and/or at the local of municipal level, another dimension of the transition process that presents its own challenges. It is realistic to expect that a decentralized tax system would be developed after the reform of the central tax system has been completed.

## THE MONETARY REGIME AND MONETARY POLICY

The ideal monetary conditions for Cuba during a transition to a free-market economy are: price stability (zero or very low inflation), stable exchange rates, competitive interest rates, and available credit to facilitate economic recovery and expansion. A monetary regime is the way the monetary institutions are organized and allowed to operate. Some monetary regimes delegate a great deal of freedom or *discretionary powers* to the monetary authorities and, as a result, the latter can decide how much money should circulate in an economy, or the level of the *money supply*. Other monetary regimes allow less discretionary powers and instead set *rules* within which monetary policy should be conducted.

At this point, Cuba is operating under a mixed monetary regime consisting of three formal currencies: the traditional peso, the convertible peso, and the U.S. dollar. There have been recent announcements that the newly-developed Euro will be allowed to circulate freely in Cuba as well. This presents the transition government with another set of macroeconomic policy and reform options: (1) return to the peso system; (2) stay with the current system of competing currencies; (3) use the U.S. dollar as the only legal tender; or (4) create a currency board.

The decision of which monetary regime to adopt will have profound consequences for the Cuban economy, especially on the spectrum of decisions available for macroeconomic policy, and how the economy might operate in domestic as well as in international economic affairs. Also, it is reasonable to expect that the debate will be loaded with emotional arguments, for example, whether it is patriotic to have the portrait of national heroes stamped on the notes, or whether they deserve a better means of recognition than on the national currency. Let us concentrate on the technical aspect of each alternative and consider a full return to the Cuban peso.

If the country were to return to the full reign of the Cuban peso as the only legal tender, the institution of central banking, traditionally represented by the National Bank of Cuba (Banco Nacional de Cuba) will have discretionary powers to carry out the country's monetary policy. The large issue here is whether such an alternative is desirable for Cuba. Discretionary powers in monetary policy means to have the authority to determine the money supply in the country, to manage interest rates, to manage the exchange rate with foreign currencies, to manage the stabilization of prizes, and to regulate bank reserves, credit, and other money and banking variables. If Cuba could reasonably expect that the officials in charge of monetary policy had the level of competence and integrity necessary to do a good job, the restoration of the Cuban peso as the only currency might be the most advisable course of action.

In highly prestigious and stable monetary systems such as those of the United States, United Kingdom, and Germany, among others, the personal prestige and standing of those individuals in charge of monetary policy is a major factor in the decision to entrust them with such responsibilities. Those chosen for such positions are very well known persons within their countries and also internationally—they are individuals with a long personal and professional history that spells competence and integrity. They are usually senior members of the business, financial, and economic communities of the country, individuals who inspire a maximum level of trust from all corners of their countries.

Given the economic, social, and political upheaval that Cuba has suffered during the last four decades, which persons carry the above characteristics? Who are the Cubans who could be trusted with ample discretionary powers to manage a monetary policy during the early critical years of the reconstruction? There are those who believe that not finding the right individuals to manage the monetary policy of Cuba during its transition to a market economy is too high a risk to take for a country that must attract a great mass of foreign investment for its economic recovery. The 150-year-old controversy of "discretion versus rules" is as valid today for Cuba as it has been for many countries. There are many ways in which rules could predominate over discretion. One of them is by relinquishing control of monetary policy by adopting a foreign currency directly, as Panama has done with the U.S. dollar, or by means of a currency board, as Argentina.

Perhaps the most prudent course of action during the early stages of the Cuban transition to a market economy would be to adopt an eclectic solution: leave the current system as is. The result would be a mix of systems and doctrines. The peso regime, subject to discretionary policies, would represent the old economic system. The dollar regime, subject to rules and with discretionary power, would represent the new economy, the one that has to be created almost anew and for which it is necessary to attract a sizable volume of foreign resources.

It is important to take into account that by sacrificing discretionary power and relying too much on one or more foreign currencies, Cuba would lose a certain degree of autonomy in the management of its overall economic policy. Adjustments in the monetary aggregates that could be well justified to compensate for external shocks would not be available. At such times, the lenders of last resort would be foreign banks or governments. Also, reliance on a foreign currency means the loss of seigniorage (the advantages accrued to the issuer of a reserve asset). In a thorough evaluation of what would be best for Cuba, however, the loss of seigniorage would have to be compared against the cost of not having a reliable monetary system. Since some of the benefits of having a national currency can not be quantified, the final choice of monetary regime can be expected to be difficult.

## TRADE LIBERALIZATION

In the early stages of the transition to a market economy by the ex-Socialist countries of Central and Eastern Europe there was a great deal of debate about which strategy was best, one of "shock therapy" or one of "gradualism." The reality is that there is not such a dichotomous choice. There are certain measures that can, and should, be implemented rapidly, while others require more time. Most forms of trade liberalization can be achieved by shock therapy, for instance, the total liberalization of markets and most or all prices. Even if extreme inequalities in the distribution of income may be present at the time of the transition, to the point that some families may be confronting starvation and other hardship, it would be better to apply direct subsidies to such families instead of continuing with the rationing system. Cuba has endured the current system since 1962, which introduced a severe distortion of prices in the economy. Currently, dollar-based stores catering to recipients of U.S. dollars in Cuba show prices that correspond more closely to international levels. Prices in Cuban pesos of goods traded in domestic liberalized markets are also consistently different from old rationed prices and appear to be more closely aligned with the international and national prices.

One of the first steps towards trade liberalization, besides the radical elimination of the rationing system, is licensing all of those wanting to go into commerce and providing the facilities to do so. Licensing procedures should be swift, efficient, and inexpensive. The official wholesale and retail distribution networks may continue to function to avoid additional deterioration of the precarious food supply system, but they would have to compete with private distributors until the official system disappears or is divested from the state. This is equally valid for the distribution and transportation networks of exports and imports. The state monopoly on all forms of trade must be broken overnight. The problem is that the newly established merchants may not have the means to develop this activity, including locale, inventories, transportation, and storage facilities.

The reactivation of commerce should be considered among the top and most urgent priorities of the transition government, especially with regard to food supply. As this is implemented, emergency measures must be taken to avoid the advent of intermediation and transportation monopolies that will impair the reconstruction of the national economy. The liberalization of the commercial sector will also serve to create a massive volume of employment which is necessary to absorb the redundant labor created by the revolutionary government in other sectors of the economy during the last four decades. It will also serve to create new national private enterprises.

## PRIVATE SECTOR DEVELOPMENT AND RESTRUCTURING

The socialist enterprise in normal times is little more than a shop generally used to produce, in physical units, whatever was decided at the highest levels of government. The situation today in Cuba is worse in the sense that many enterprises are paralyzed after the loss of the Soviet subsidies and the country's inability to maintain and develop markets for its exports on a competitive basis. Thus, the existing state-owned enterprises do not have a management system and are not used to operating under the simplest financial imperatives. They hardly have an accounting system, and the financial management function is unknown. Marketing is totally non-existent (with the possible exception of some of the new "mixed" enterprises) as well as personnel management. Most of these enterprises had an inflated payroll, but perhaps today, as a welcome result of the current Cuban crisis, many of them have reduced their labor force since they had to lay-off workers in the early 1990s.

A rapid recovery of the Cuban economy requires a quick and satisfactory solution to the property claims of Cuban national and foreigners alike. The legitimacy of the effort to build a free-market economy, which is based on private property rights for all, and the credibility of the transition government and the country as a whole in building a free market system, will depend crucially on the way the claims are processed. Cuba will not have enough resources to immediately compensate with cash payments the owners of those properties that can not be returned. Therefore, it will have to issue long-term bonds recognizing those claims. Those properties with identifiable owners should be returned as soon as possible in order to put them to productive work to support a fast recovery.

Since Cuba's staggering external debt represents a heavy burden on the country's prospects for economic recovery, compensation could be kept at a minimum level by paying those claimants whose properties can not be returned in the form of government assets that were never privately held, such as factories and installations built during the last forty years. Another way to finance the claims is by granting tax exemption certificates negotiable in secondary markets. This, of course, will have to be carefully controlled in order not to reduce excessively the tax collection capabilities of the reformed fiscal system, particularly in the early years of the transition. Also, it is important to keep in mind that privatization is not simply the divesting of state properties to the private sector: it is also the development of activities that disappeared altogether from the Cuban economic scene as a result of political and ideological reasons.

Most important is the commerce sector, as indicated previously, in all of its forms: domestic and international, retail and wholesale, commodities and services, large and small. The commerce sector generates a large proportion of the total employment and also offers investment opportunities to small savers and entrepreneurs. In addition to promoting the commercial sector as part of a privatization strategy, the transition government could facilitate and encourage the development of the service economy, from professional services for the business sector (accounting, legal, advertising, travel agencies, printers, etc.) to repair shops and personal services (barber shops, automechanics, beauty salons, gymnasiums, etc.). Other professional services should be allowed to operate freely even if the government decides to maintain a presence in some of them, for instance, health care, education, engineering, etc. Especially important for the development of a market economy and a democratic system is private journalism in all of its modern forms, from newspapers to radio, television and other media including Internet facilities.

## LABOR MARKETS

Traditionally Cuba had strong labor unions whose rights were obliterated by the Cuban government during the past 40 years. Though many of the old rights of the Cuban workers basically depended on the economic conditions that existed in the past, and it will take some time before those conditions are recreated in the country, there may be some tendencies to create labor conditions that would be inconsistent with the need to quickly develop a free-market economy.

For Cuba's economic reconstruction, it is necessary that all markets, including labor markets, function under maximum efficiency and flexibility. Monopolistic and monopsonistic organizations that impede free market development must be avoided. Labor codes must contemplate the rights of all workers and not only the benefits of those who belong to trade unions. For instance, unrealistic minimum wage legislation or other policies will benefit those who already have a job, but will make the cost of labor higher and those workers with fewer skills may not find jobs if the level of salaries does not correspond to current economic conditions.

The best economic environment for workers is when an economy is growing with such an impetus that enterprises compete in the labor market for the best workers. At the same time, the standard of living of the workers essentially depends on the level of labor productivity that enterprises can achieve, a factor that itself depends on the ability to introduce technological innovations that, even when they are labor-saving, tend to increase the competitiveness of an economy to the point of making it capable of creating jobs elsewhere in the system.

One of the most important obstacles in Latin America to generating employment and high standards of living in recent years has been the existence of labor legislation that seems to protect the worker on an *ex ante* basis, which tends to be deceptive. Economics is a counterintuitive science and frequently betrays the appearances of certain measures with totally opposite results. The transition government will have to make a great effort to explain to the working class and trade union organizations the workings of labor markets in the context of free markets and the need to become competitive to meet the challenges of globalization.

## CAPITAL MARKETS

The development of capital markets or, more generally, financial intermediation, should be entirely in the hands of private investors, national or foreign, but the transition government would create the legal and institutional framework in which they would operate. The options for the transition team are many. For instance, some sources believe that the development of a banking industry should be entirely left in Cuban hands, only allowing foreign banks to enter Cuba after the national banking industry is sufficiently strong. That would make the entire Cuban economy wait for the development of the Cuban banks, an option that could slow down significantly the economic recovery of the country. This type of consideration could be extended to other types of financial intermediaries, such as insurance companies, mortgage providers, and investment banking among others.

Another area of important decisions for the transition government will be the development of a stock exchange where equities could be freely traded and capital could be collected for new investments. One advantage will be the facilitation of raising investment capital for new ventures or for selling government debt instruments, which could be a boost for the economic recovery of the country. Some might argue that a too-early development of capital markets would open the door to hot capital that would bring a measure of financial instability to the country, jeopardizing the success of the transition.

An interesting alternative is to engineer the development of Cuban capital markets together with privately owned pension or social security plans. This could create strong incentives for Cubans to dedicate a good portion of its expectedly growing incomes to savings, reducing somewhat the growth of their consumption expenditures, and creating the conditions for an enhanced retirement income stream.

## EXTERNAL DEBT, INTERNATIONAL ASSISTANCE, AND INVESTMENT

It has been mentioned earlier that the extraordinary size of Cuba' external debt will constitute a major obstacle to the country's fast economic recovery. The debt payments must come from the fiscal revenues generated by taxation, reducing the volume of resources necessary to finance government expenditures.

The external debt obligations of the Cuban state, however, must be recognized by the transition government. In the current context of international economic and financial affairs, business conducted between states must be recognized by its citizens, even if some obligations were made during an unpopular or corrupt administration. The alternative of ignoring the debt is unthinkable; Cuba would not qualify for future credits that are indispensable for a rapid recovery. Yet the service of the debt will have to be made according to Cuba's ability to pay, which can be expected to grow as the economy recovers.

In the meantime, it will be necessary to renegotiate the debt with the lender countries and entities and negotiate a certain amount of debt forgiveness. It is important that the Cuban authorities in charge of rescheduling the debt also take advantage of the rich experience of other countries, many of them in Latin America, about debt rescheduling. Some debt payments may be made in government properties that were never privately held, but the assessment of the corresponding values of the properties must be conducted with utmost transparency.

As the economy grows, the external debt will become proportionally less significant, even if Cuba incurs additional debt to partially finance its economic recovery. Most of the fresh indebtedness should be long-term and at rates lower than internationally competitive levels given the country's low economic standards.

It is important to underline that foreign assistance will be far from sufficient for a rapid economic recovery of Cuba. Most of the resources must come from direct investments in new plant and equipment. It is impossible to overemphasize the importance of making the economic recovery of Cuba dependent on investments rather than on aid. Even though the resources that could be borrowed from international financial institutions could play an important role in Cuba's recovery, the country must be prepared to use such resources effectively. There is no basis to take that effectiveness for granted since it depends on the combined competence, integrity, and sense of national duty of the Cuban officials in charge of all the different phases through which such resources go before they materialize in concrete and finished projects.

The paradox of creating a free-market, private sector-based economy in Cuba or in any other country is that it has to be created by the public sector, which is not to be trusted these days in Cuba as defenders of the national interest. The ability of international financial institutions to identify the right projects for Cuba is very limited. It would be equally unwise to expect that the lack of a national capacity to use foreign resources consistent with Cuba's national interest will be compensated for by the officials of the international financial institutions.

The economic recovery of Cuba will basically depend on (1) the enterprises that can be restructured; and (2) the enterprises created by new investments. It would be foolhardy and a waste of resources to assign government agencies to promote investments in predetermined industries or sectors of economic activity. There are those who believe that an *ex ante* identification of potential projects is something that competent bureaucrats can do on behalf of entrepreneurs. Experience shows that, to the contrary, the intervention of government sources in investment decisions can be more disruptive than useful. The investor knows his activity and knows how to invest. No one knows better than him/her what it takes to make a venture succeed and, whatever that substance is, it is seldom found in a ministry, a state-owned enterprise, a think tank, or a political party.

The government's role in this regard is in creating the "right" macroeconomic policy environment; facilitating basic operations like business registrations and permits, opening bank accounts and accessing legal and accounting services; developing simple tax rules and transparent procedures, etc. Even though corruption does not seem to be a strong deterrent to business development in many countries, the lack of corruption is a big positive factor in a country's ability to attract foreign investments.

A word on the nationality of investment. As the phenomenon called globalization advances, financial capital has gained such a degree of international mobility that it has lost a great deal of its national origin. The advantage of globalization for a country like Cuba is that it can attract as much capital as the country needs for its recovery and development as long as Cuba understands the requirements of the corresponding investors. Such a level of understanding would be reflected in the macroeconomic and other policy measures that the transition and successive governments take. The same is valid for Cuban capitals as they will have identical opportunities to be invested in Cuba or elsewhere, because they respond to exactly the same incentives.

## CONCLUSION

Perhaps the most challenging aspect of a Cuban (or any other) transition to a market economy is the need to plan and implement the transition with a great deal of attention to a large number of operations and actions that must take place almost simultaneously. As one of the last socialist countries, Cuba should benefit from the accumulated experience already in existence in this regard.

Avoiding the most glaring mistakes can be achieved by formulating a strategic plan of economic reform. Yet it is necessary that this plan be a part of a more comprehensive strategic plan. Economic reform of this depth cannot succeed if it neglects to include concepts and coordinated actions to develop a legal system that represents the institutional and organizational framework of a market economy. Privatization, for instance, cannot advance if property rights are not guaranteed in the new legal system. A new legal system cannot be created by "shock therapy." It requires time to develop a body of laws, especially in a democratic, participatory society, and the organizations, the human resources, and the accumulation of practice over time.

One of the most dramatic mistakes of international funding agencies and technical advisors in other former socialist countries, especially Russia, was to implement privatization strategies themselves already faulty, and failing to recognize the legacy of 70 plus years of Marxist education, not simply indoctrination. One of the results of such a legacy was that an overwhelming proportion of the population believed that holding private property of the means of production was immoral. It was an obvious result of badly improvised privatization *blitzkrieg* that the least scrupulous members of those societies would take advantage of the privatization opportunities before the common citizen did.

Cuba should avoid such costly mistakes. Even though Marxist education might not have taken hold in Cuba as it had in the Soviet Republics, and even though the current economic crisis and the people's reliance on black or limited official market activities might have erased many of the prejudices planted against a free-market economy, the reform program should take these elements into consideration. It is absurd to implement a macroeconomic reform program in a newly-inaugurated free society without making an effort to repeatedly explain to the public the meaning of each of the reform components.

Macroeconomic policy is not to be dictated, no matter how technically sound the program is. Without the support of the critical mass of the population, opinion makers, legislators, and other leaders of the political establishment and civil society, a theoretically perfect but badly understood program will fail. Public education and information is a necessary component in a Cuban strategy to advance towards a free-market economy and it should be a ubiquitous and permanent feature of future efforts of economic reform in a democratic context in Cuba, as in other countries.