

KEY LESSONS LEARNED FROM THE TRANSITION TO A MARKET ECONOMY IN ASIA, EUROPE, AND LATIN AMERICA OVER THE LAST 15 YEARS: APPLICATION TO CUBA

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Everyone agrees that the Washington Consensus did not contain all the answers to the questions of 1989, let alone that it addresses all the new issues that have arisen since then. So of course we need to go beyond it.

— John Williamson, 2004

...it is probably better to be cautious and correct than ambitious and spectacularly wrong. The poor have had too many false dawns to experience yet another one.

— Raghuram G. Rajan and Arvind Subramanian, 2005

We have to think “outside the box” about how to solve Cuba’s transition problems to a democratic market economy and we should do it now before the transition starts. Most of the people understand that Cuba’s big problems are not about economic ideology but performance. The people overwhelmingly know that the current economic and social situation in Cuba is unacceptable and that the performance of most of the transition countries in Central and Eastern Europe countries (CEEC) and the Commonwealth of Independent States (CIS) has been poor. Nicaragua has done much better than any of them in 1989–2004. For that reason it is a major mistake to get trapped into defending policies and institutions which clearly failed.

The transformation, recovery and development of Cuba’s stagnant centrally planned economy is an ambitious but important task. It also constitutes a historical opportunity to generate faster and more effective development than has ever been achieved in Cuba since the 1940s.

The 15 years of theoretical work and policy and institutional experiments in the CEEC, the CIS, Nicaragua, Vietnam, and Latin America—and almost 25 years in China and more than 30 years in Chile—have highlighted some clear paths to economic transformation, recovery and development and have provided examples of right and wrong institutional and policy decisions. Now is time for Cuba to use these rich lessons and experiences to generate prosperity and improve its people’s standard of living.

The goal of the Cuban government should be to establish a sustainable democratic market economy. In order to obtain public support for this program and to promote it, the government must simultaneously provide new incentives and opportunities for its citizens to expand their productive activities, improve their standard of living, and limit the social costs of the required adjustments.

Public support is a crucial determinant of the success of economic transition, especially one that will be undertaken simultaneously with the transition to de-

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mocracy. In order to build broad-based support, full explanation of the incentives, opportunities, and benefits of reform should be presented to the public at large, with recognition of the short-term hardships of adjustment and the long-term benefits of high economic growth. The more broadly the vision and the details of the reform are shared by the general public, the greater is the reform program's probability of success.

The strategy I present is derived from lessons learned from transition countries. It consists of a set of legal, institutional, and economic measures within a consistent, pragmatic, and realistic framework. These reforms are within reach. To grow strongly and prosper, Cuba needs to emphasize deeper, wider, more competitive and flexible markets, as well as to increase and diversify its exports while fully reinserting in the world economy.

Since Cuba functions as a centralized and relatively closed command economy, the strategy draws on both developments in recent years in Cuba and the good and bad lessons learned from other command economies that have tried to transform themselves into market economies. The lessons from transition indicate Cuba should pay particular attention to establishing a well functioning legal system and institutions and to microeconomic restructuring to avoid a catastrophic recession and a systemic vacuum: a true nightmare of neither plan nor market.² To stabilize the economy and to set up the right prices are not enough. They are necessary and important but insufficient conditions for a successful transition. When markets are not functioning appropriately and private enterprises are inefficient, price liberalization alone will not create the proper incentives.

My fundamental point is that the major challenges for Cuba's transformation are institutional and microeconomic in nature, but that the establishment and consolidation of macroeconomic stability and liberalization, and the stringent adherence to a sound macroeconomic environment, are also indispensable

if the whole transition process, which is a long and complex one, is to succeed.

MAIN CURRENT ECONOMIC PROBLEMS, CHALLENGES AND OPPORTUNITIES

Economic Situation and Main Economic Problems

Cuba's population of 12 million has been experiencing economic deterioration, instability, and repression, with shrinking living standards, over the last 20 years (1985–2005). Even before the collapse of socialism in the CEEC and the CIS in 1989–1991, Cuba's economy had operated at a fraction of its capacity, especially of its potential in human resources. After the socialist collapse, economic activity plummeted and inflation soared as the Soviet aid ended and inadequate policies exacerbated the decline, there were expanding fiscal deficits and a jump in the supply of pesos and the monetary overhang.

There is also the fast ageing of the population, with major implications for social security and health services, as well as the expanding racial and regional disparities in social development and living standards among the country's regions and ethnic groups.

Continued economic hardship and the policy of repressing informal economic activity have created frustration among the population and strained the government's credibility. Official statements in early 2005 anticipating an economic upturn have served only to increase frustration at the lack of any significant increase in disposable incomes. The government can influence inflation by using price controls and regulating the limited free markets, but the prices of goods in the retail stores—both those operating in convertible pesos and the “free” agricultural and produce markets using the Cuban peso—respond to market pressures. In the absence of debt instruments, the deficit is financed by monetization. The commitment to artificial full employment implies a large fiscal burden. Changes since mid-2003 in the rules governing economic management have centralized the control of foreign-currency resources and reversed a

2. “There was rapid collapse of institutional structures followed by a vacuum in many countries” (Campos and Coricelli, 2002, p. 816). According to Stiglitz (1999, p. 10), the wrong advice has sometimes contributed as much to the problem as to the solution.

trend towards autonomy of state-owned enterprises (SOEs). Closer auditing and greater accountability and regulation might reduce waste and corruption at the enterprise level, but bureaucratic controls have imposed further administrative costs and inhibit initiative.

Cuba currently faces an external debt burden that is unsustainable. The foreign debt with Western countries is estimated at about 40% of its GDP; this rises to 100% if the debt with former socialist countries, based on the old official peso-rouble parity, is included. Expected compensation claims mainly with the U.S. could raise the total debt to well over 100% of GDP. The main constraint on GDP growth in the past decade has been Cuba's restricted access to external financing. Hence, Cuba is excessively dependent on oil imports and Venezuelan aid due to its mistaken foreign exchange rate policy, exacerbated by an erroneous revaluation in 2005. The external conditions remain fragile and the external sector is vulnerable.³

Cuba's economic recovery has been focused on encouraging tourism, remittances, and the mining sector, as well as limited market reforms. Since tourism income has grown quite rapidly in recent years (almost 20%) and now represents 6.5% of Cuba's GDP and 42% of its exports of goods and services, that emphasis has been well placed. However, if it is not accompanied by the development of other sectors, this strategy based almost exclusively on tourism expansion will subject Cuba to a number of problems faced by enclave economies everywhere: rising open or disguised unemployment and inequality, pervasive corruption, and declining living standards as the population ages.

Cuba's legal framework, based on Spanish law and public governance, has been corrupted and adjusted to serve the centralized socialist system. Further serious problems are major macroeconomic imbalances

with high premium of the black market over the official exchange rate and official prices; investment below replacement levels; limited, segmented, and oligopolistic and monopolistic markets without any competition and lack of incentives for organizational innovation and technological change; low morale and lack of incentives for use and allocation of talent in the labor force; a deficient functioning governance and public management at the level of the state and SOEs; ill-defined property rights; and the deterioration of the transportation, communications, water, and sewage infrastructures.

Main Challenges

The overall principal challenge is how to introduce an efficient market economy based on incentives without incurring the costs of runaway inflation, major GDP contraction, poverty exacerbation, sizable open unemployment, and increasing deterioration of income distribution that initially characterized the experience of transition countries in the CEEC and the CIS. Key areas include stabilizing the economy in the presence of a substantial monetary overhang; significant changes to economic institutions and ownership relations to avoid disorganization and the development of dysfunctional institutions; augmenting and diversifying services and industrial activities; developing the relatively failing construction sector; and reviving agriculture.

The challenge in the labor market is to create jobs and cope with (1) overall excess labor or disguised unemployment, as well as shortages in certain key skill categories and professions; (2) generally low morale and productivity; (3) potentially large adjustments of relative wages; (4) the need to revamp the system of personal income taxes and social security; and (5) the need to update education and (re) training at all levels. Otherwise, the most ambitious and

3. Venezuela supplies around three-quarters of Cuba's oil imports. A bilateral agreement allows the prices of Cuba's exports to Venezuela (mainly professional services) to move in line with oil prices. The appreciation of the unofficial exchange rate has little direct impact on trade or export competitiveness, as no international transactions are denominated in Cuban pesos, but it will increase demand for consumer goods, including imports. The appreciation of the convertible peso relative to hard currencies will increase the cost of Cuban purchases within the island for foreign visitors and businesses, and recipients of remittances. It will also increase the effective retail mark-up charged by Cuban state retailers.

well prepared will migrate to the industrialized world or to countries with better economic opportunities.

The challenge in the financial sector is to transform state controlled banks; to establish sound, safe, and effective financial intermediaries; and to mobilize new sources of resources for economic development. A crucial aspect is to prevent the financial sector from becoming a source of subsidies to loss-making enterprises, as well as to reestablish modern payment mechanisms, and international capital flows.

The design and implementation of a well-thought economic program for the transition needs to recognize the challenges and restrictions imposed on the new government by the rentier-welfare state mentality of most Cubans.

Main Opportunities

Tourism represents the main engine of growth for Cuba's economy in the short-term, both by increasing external revenues and by stimulating internal production of goods and services. With proper institutions and policies, Cuba can rapidly increase tourism, as well as remittances, and agricultural and mineral exports, thus generating the external revenues needed for other recovery measures. However, the longer-term development of tourism will require significant investment and superior management.

Cuba has a reasonably educated and healthy labor force, and its population growth is minimal. Consequently, an export-led development strategy using its highly qualified labor force should be considered.

Cuba's diaspora equals almost 20% of the population. Taking advantage of this vast reservoir of human resources, capital, business relations, tourism (family visits), and remittances presents a major opportunity for the new government.

Unlike in many other cases, the U.S. government and the international community are also prepared to support actively Cuba's transformation, recovery, and development. Its success will be affected signifi-

cantly by decisions on the extent to which the debt is cancelled or restructured. Forgiveness of half of the Polish debt in the early 1990s (Sachs, 2005, pp. 126–127), Nicaraguan debt in the 1990s, and Argentinian debt in 2005, are important and relevant precedents.

ECONOMIC INSTITUTIONS AND POLICIES FOR RECOVERY AND DEVELOPMENT

Basic Considerations

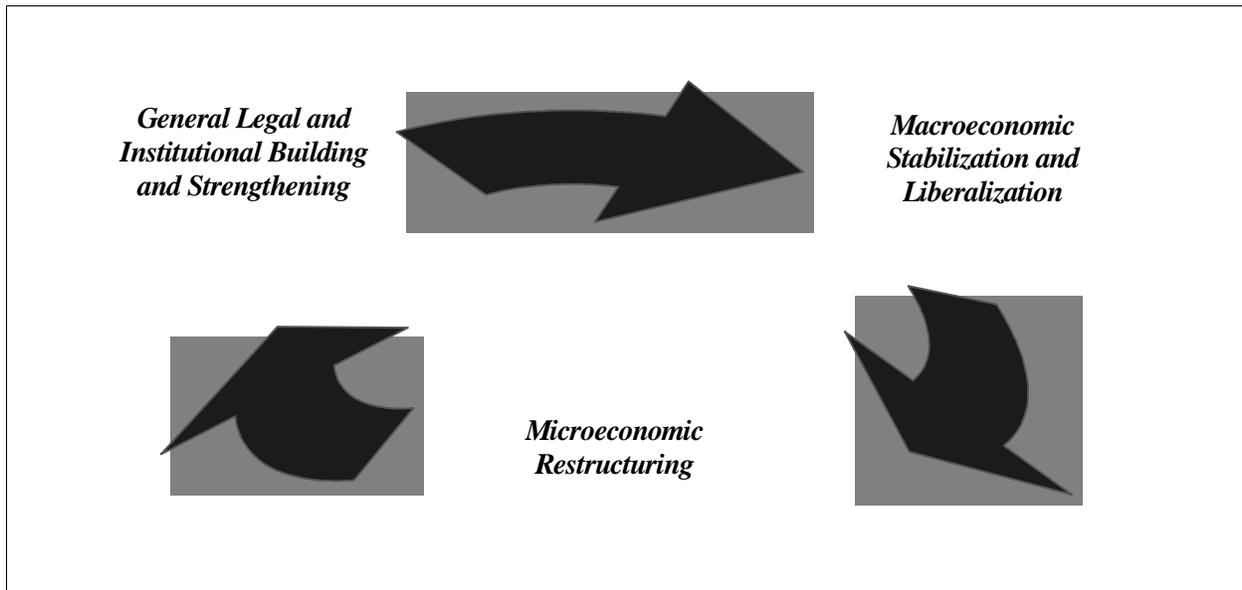
Cuba's central economic problem is low income or underdevelopment. Unless the economy becomes more productive and grows quickly, all goals will be in jeopardy, including the success of the transition itself. Therefore, Cuba's top priority is to achieve and sustain high, democratic, and equitable development. Although it is only one component in a social utility function, it facilitates the realization of other main goals (employment, financing of social programs and pensions, and environmental protection) and helps to eliminate or reduce the impact of key policy blockers (debt, deficits, uncertainty, conflicts). The second priority should be to increase investment into areas that will generate future growth. This may not be a second objective, but rather a mean of achieving the first. It is really amazing that the importance of investment as growth drivers is presently so very low on Cuba's agenda and practically absent from internal economic discussions.

Based on the lessons learned from transition economies, the following proposal defines a wide-ranging reform agenda with three main and self-reinforcing components—legal and institutional building and strengthening,⁴ macroeconomic stabilization and liberalization, and microeconomic restructuring (Figure 1). The proposal has specified goals, means, and strong and clear incentives to achieve them.

Omitting key measures, e.g., institutional reforms and microeconomic restructuring, leads to crises and delays economic growth. Partial reforms usually backfire. It is very important to keep reform momentum. If reform benefits so many and so much, why

4. North (1990, p. 3) defines institutions as constraints on behavior imposed by “the rules of the game” in society. Institutions include any form of constraint that human beings devise to shape human interaction.

Figure 1. The Three Key Self-Reinforcing and Synergic Components of a Successful Transition Process



not move forward with stronger and more rapid reforms? Sustaining the reform momentum can greatly increase the speed with which policy objectives are achieved. The whole of reforms is more than the sum of their parts because they reinforce each other. Some reforms are complementary, meaning that unless some are already in place, the others are ineffective. A potentially worthwhile reform (e.g., the privatization large SOEs) could even be harmful if its complementary reforms are missing.

Legal and Institutional Building and Strengthening

In most of the transition economies, the public institutions of a market economy are still undeveloped.⁵ This has a major negative effect on the business environment: the protection of property rights and rules to enforce contracts are generally weak; public administration is widely perceived as inefficient and lacking in transparency and accountability; and there is pervasive corruption. Institutional failures slow

change; create inequality, social tensions, and instability; and nourish additional corruption. While some countries have embarked on impressive—and often technically complex and sophisticated—“second-generation” reforms, some basic “first-generation” reforms have yet to be completed.

Cuba’s backwardness is not just a consequence of its government’s inadequacies and limitations; it is a consequence of Castro’s ideological hostility to the very idea of using the private sector, markets, and individual initiative to serve the public good. For 46 years Castro has been denigrating the private sector, the markets and the private initiative, telling the Cuban people that they are always the problem, and not the solution or at least part of the solution.

The fundamental step in the recovery process is the establishment and enforcement of a set of market-oriented institutions to modify fundamental individual and social attitudes, concepts, and behaviors, pro-

5. Today it is generally accepted that the neoliberal approach to reforms applied in the CEEC and the CIS seriously underestimated the significant need for institutional, legal, and regulatory reform early in the transition process. There have been disparities in the process of liberalization and privatization, and in the development of institutions that support markets and private enterprises. Countries where these disparities decreased during the transition performed better than where it was allowed to persist or to increase (Campos and Coricelli, 2002, p. 812). The neoliberal approach assumed that the transition would turn out fine, on the basis of wildly optimistic assumptions. Careful policy making and thinking through of potential flaws were not the strong suit of the neoliberal approach.

viding clear and strong incentives for the rapid expansion of domestic private initiatives and activities and foreign direct investment (FDI), as well as to adjust the current legal system and laws to generally accepted international standards and practices of democratic market economies. The state plays an important supportive, but decisive, role specifying and enforcing the new rules of the game and their associated implementation mechanisms that are essential to a stable environment and to reduce uncertainty and risk. The experiences of countries as diverse as the Czech Republic and Russia indicate that underestimating this critical step has created crises and delayed economic growth, while those countries that adopted a more comprehensive package have fared much better.

Encouraging Entry of New Enterprises, Exit Mechanisms, and Competition: The expansion of new private activities currently inhibited by government controls and policies providing very simple and easy conditions for entry, such as obtaining all necessary permits and notifying and filing with all requisite authorities, as well as the extend of recognized and protected property rights, and establishing the basic freedom to carry out economic initiatives and activities, are very important and should receive first priority (Svejnar, 2002b, p. 21; Djankow et al, 2000).⁶ New entrepreneurs are particularly strong supporters for rule-of law, competitive markets, and democracy.

The limited accumulation of individual wealth under the centrally planned system and the significant fixed costs associated with large-scale production indicate that most newly-created enterprises will be small and medium. The development of new small and medium enterprises (SME) would be a major source of employment and growth, generate a quick supply response, especially in services and manufacturing, and correct the historical bias toward large enterprises.

In view of the importance of new enterprises, the Cuban government should use legal, moral, and economic measures to spur their growth and to reduce their transaction costs. Therefore, the economic measures should include defining secured and protected property rights, favorable tax treatment of reinvested income, the availability of locations for rent or sale, and the quick development of an efficient and competitive private commercial banking system that makes credit available. It is also desirable to spur foreign investors and expatriates to bring in capital, technologies, management expertise, and marketing know-how, and to establish new enterprises by providing them with a clear and nondiscriminatory legal system access. FDI has played a substantial role in transition economies, particularly as carrier of new technologies, but it has been unable by itself to compensate the negative trends in domestic investment in the CEEC and the CIS. Efficient exit mechanisms (bankruptcy laws, hard budget constraints for SOEs, established procedures for conducting financial restructuring, etc.) are important for prompting the exit of non-viable enterprise, for debt enforcement, and for the entry by more efficient new firms. Policies that promote and increase competition are important to strengthen and to reinforce market selection effects and for investment in cost saving technologies. Restricting or regulating monopoly power is absolutely essential.

Promoting Micro and Small Enterprises: Developing and strengthening micro and small enterprises is a major step in the direction of sustainable and competitive development but it requires top down positive administrative actions. Small enterprises generate 60% of GDP in OECD countries. These countries apply special preferential measures, including tax measures, intended to improve the economic and technological environment for small enterprises, and to facilitate their establishment and growth. The

6. For example, in Bolivia an entrepreneur must complete 20 procedures taking at least 82 business days and pay US\$2,696 in government fees to meet government requirements for starting to operate a business. However, in Canada he/she can complete two procedures and finish the process in roughly 2 days by paying US\$281 in government fees (Djankov, 2000, Table III). The procedures include: safety, health, environmental, tax, labor, and a residual category, which is labeled "screening." Heavier regulation of entry is generally associated with greater corruption and a larger unofficial economy.

most important reasons cited for having such preferential policies are that small enterprises face proportionately higher transaction costs; there are market imperfections; these enterprises provide broader benefits to society beyond the economic benefits; and important social goals are involved (Åslund and Johnson, 2004).

Rapid entry by many small new entrepreneurs quickly drives down prices. There is robust evidence of this in some transition economies—e.g., Poland (1990–1991) and Ukraine (1998–1999). Also, a broad force for liberalization is induced to reduce quickly regulatory costs and taxation, by prompting existing entrepreneurs to demand liberalization and lower taxes.

The way to begin this process of promoting micro and small enterprises in a society like Cuba's is by drastically lowering the barriers to entry into the formal economy for micro and small-scale entrepreneurs. A helpful way is combining taxation, regulation, and licensing in one single measure—namely, a low lump-sum tax for small entrepreneurs. This lump-sum tax should be fixed for a long-time and collected only once or twice a year. None or minimum bookkeeping should be required, and the interaction with authorities should be minimized.

Establishing and Developing a New Legal System and the Independent Judiciary to Enforce It:

There is a positive association between the rule of law and economic and institutional reforms. The rule of law and equality under the law require a judiciary independent of the executive and legislative branches. It can only exist when the government has no or little influence or control over the judicial system. When the rule of law and equality under the law prevail, there is a good foundation for a well functioning market system, property rights are protected, and contract rights are enforced in a timely, fair, impartial, predictable, and uniform fashion. Lessons from Chile and other transition economies suggest that the legal system should be simple, comprehensive, operational, and enforceable, and that the drafting of new laws should involve both lawyers and economists.

Encouraging Civil Society Organizations: The recent experience of transition economies makes clear

that an open economic and political system can only flourish where there is a strong and independent civil society that enables citizens and organizations to present their views and interests to the government, to contribute in some important public decisions, and to create a culture of transparency. A strong civil society protects citizens and organizations against potential abuses by the government, making it accountable, makes democracy truly participatory, and promotes the central government to report more regularly and more fully to the public at large and to the legislative.

Civil society institutions, civic organizations, professional associations, business associations, and the press are crucial means of achieving a balance of power between the people and the state. That is why the emergence and development of a strong civil society is imperative and should be particularly encouraged. Hence, the Cuban government should use legal, moral, and economic measures to motivate the expansion of NGOs through very easy and simple conditions for entry and relative simple regulations for their operation.

Public Administration Reform and Accountability

Mechanisms: The current size of Cuba's government is unjustified. Not only is the existing bureaucracy excessive, but it is also deficient in some areas (e.g., tax collection, and promotion and support to SME). Functional and organizational adjustments to downsize the public sector and to improve the quality of public governance and management of the government bureaucracy are prerequisites for a successful design and implementation of the transition and economic development program and its key policies.

These key policies have to be redefined substantially, i.e., the role of the state as the provider of macro stability and of a stable and enforceable legal system, and have to strengthen and protect property rights, to improve the quality and productivity of government goods and services delivery, and occasionally correct market imperfections. The central government has to be competent and strong to design and implement a well-thought economic program. Regulatory services should be established to provide independent oversight. Public contracts should be award-

ed by transparent public bidding. The goal of depoliticizing public administration should be pursued: however, it might conflict in some instances with the goal of achieving the highest level of professional capacity.

The Meaning of the Varela Project: The Varela Project includes three basic institutional measures to start and facilitate the necessary transition to a democratic market economy in Cuba. These measures will open necessary spaces for a free participation of all citizens within the political and economic life of the society. Specifically, they will: (1) guarantee freedom of association, to give citizens the opportunity to defend their interests, to form part of government decisions, and to contribute to society with their efforts and initiatives in every field; (2) amend the Electoral Law to make the elected authorities directly accountable to those who elect them; and (3) provide citizens with the right to create private enterprises, either private property as well as cooperative, and mixed enterprises between workers and the State, and allow the enterprises to freely hire their own workers.

Macroeconomic Stabilization and Liberalization

Achieving and maintaining macroeconomic stability and enhancing liberalization are critical for political and social stability, as well as for the success of microeconomic restructuring and for the consolidation of the new legal and institutional framework. The more soundly based macroeconomic policies are, the more resilient the economy is to external shocks and global downturns. The successful Chilean and Chinese experiences show that the only sustainable choice is to continue reforming and enhancing the macroeconomic environment (consolidating stabilization, and deepening and widening liberalization) consistent with the increasing improved allocation and restructured system at the enterprise level. There are strong doubts of the virtues of instant economic orthodoxy and its speedy application as the path towards economic stability and liberalization. Gradual and sequential strategies have worked well in some countries.

Price Liberalization for Goods and Factors, Tariffs, and Subsidies: While short-term political con-

siderations may make it tempting to maintain price controls, the experience of transition economies suggests that prices should be allowed to be aligned swiftly and closely with world market prices. A particularly valuable lesson from Chile and the transition economies is that the opening of an economy closed to the world can be carried out relatively fast and successfully. The government can free prices of tradables and keep temporary trade protection through a relatively uniform structure of tariffs that will be reduced over time.

Liberalization of agriculture and some services, by reliance on free market prices, low levels of state regulation, and true decentralized decision-making by economic agents, have produced outstanding results in China and Vietnam. It appears that the stage is set for Cuba to provide similar incentives to economic agents, who revolutionized China and Vietnam's agriculture and services (Domínguez and Erickson, 2005, p. 234), including granting managerial autonomy and full economic independence to the UBPC. It could also encourage immediately SME in manufacturing and transport sectors for private and collective investment.

The starkly different experiences of China, the CEE, and the CIS suggest that the policy toward state-owned and state-subsidized enterprises (i.e., UBPC) should allow some temporal continuity in subsidies to promote adjustment and avoid collapse, but should also provide clear and strong incentives for enterprises to restructure—defensively and strategically—in an increasingly competitive environment. For recovery and development to be successful, the program needs to be made credible (e.g., carried out as specified).

The advantages of the two proposed measures, tariffs and subsidies, are that they (1) are politically more acceptable than a overall shock or big-bang treatment with its destabilizing effects and will avoid widespread social safety net expenditures; (2) stimulate a rapid transition to efficient resource allocation; and (3) generate tariff revenue for the government in the early reform phase when special social and other programs require additional government expenditures.

Currency, Central Bank and Monetary Policy, and Foreign Exchange Rate Regime: In order to achieve macroeconomic stability and the basic condition for an export-led expansion, the government should devalue the peso, unify the exchange rate, and peg the Cuban peso to the dollar (or Euro) as the successful Polish initial program did (Sachs, 2005, pp. 122–127). Until this basic adjustment is made, the economy will continue to be plagued by dislocation and perverse incentives and will face barriers to full integration between the domestic economy and the external sector. This adjustment might be disruptive in the short term, but significant progress towards unification could potentially encourage a sharp upturn in the formal sector of the domestic economy. Moreover, pegging its currency to the dollar (or Euro) will give Cuba a stable convertible currency in the current account of the balance of payments and thus increase capital, technology and managerial inflows that are needed to restructure and modernize the economy and set up the conditions for rapid export expansion. Foreign trade liberalization usually improves economic performance and consumers benefit from the lower prices. Revenues from the immediate expansion of tourism and remittances will make it easier for Cuba to preserve external balance, while promoting economic transformation, recovery and development and maintaining acceptable social programs.

Cuba should develop an independent and accountable central bank. Priority should be given to modernization of the payments and settlement system; establishment the authority and capacity of the central bank to design and execute monetary policy through instruments such as prime interest rates, reserve requirements, and open markets operations; and the faculty to regulate and supervise independently the licensing and conduct of deposit banks. The central bank should be independent of the political process and directors should be appointed for staggered terms and stand accountable to the legislative or to both the legislative and the executive. Experience from transition economies indicates that the central bank's most difficult task will be to pursue a tight monetary policy to consolidate stabilization after price liberalization, and when government revenues

fall and insolvent SOEs face bankruptcy in the absence of additional subsidies. The existence of an independent central bank will also provide Cuba the option of switching from a fixed to a flexible exchange rate. The availability of this alternative has proved rather useful in most transition economies over time (Svejnar, 2002b, p. 4).

A gradual introduction of full convertibility à la Chile could be useful, first for foreign enterprises and investors, then for trading companies, and later for domestic enterprises and citizens.

Given that Cuba is seeking to start as a new democratic market economy, it makes sense for it to qualify relatively soon for most-favored-nation treatment and favorable quotas into the U.S., E.U., and other markets in product categories where import quotas exist, so that export can expand and the foreign exchange rate could be liberalized as soon as possible.

Expenditure Control and Taxation: The shift to a democratic market economy implies that the fiscal system should be designed to operate through established and steady rules, rather than administrative discretion. The main task in the fiscal area is to create a system of government revenue generation through a well-designed tax system, based on a combination of direct and indirect taxes, rather than on *ad hoc* taxes, surcharges and fees, as well as on expenditure controls to reduce substantially or eliminate unnecessary and privileged expenditures. Also social programs should be targeted to the neediest population groups in the initial stages of the transition. This will allow the government to achieve and maintain fiscal balance, while at the same time promoting economic development and keeping an acceptable level of social services.

Success is not automatic and the experience of transition economies suggests that the government may lose control over important revenues and incur in unexpected new expenditures during the recovery and development phases of the transition process. However, fiscal balance is paramount to achieve and consolidate stabilization. The government should not rely on extra-budgetary expenditures financed by central bank credits. The preferable method of fi-

nancing is through the sale of treasury bills and loans from independent commercial banks. Foreign debt should not be used to finance fiscal deficits. In order to be able concentrate most of the current public expenditures on the social sectors, the government should start a public concession program first with maintenance and repairs of basic infrastructure and subsequently with new major basic infrastructure projects.

Foreign Debt Forgiveness and Financial Assistance: Countries with high debt tend to have low growth, and debt relief can help poor countries grow. Debt relief can effectively provide predictable additional resources directly to the fiscal budget through the cancellation of repayments that no longer have to be made. Since Cuba is a highly indebted and impoverished country, establishing a democratic market economy and political stability cannot be accomplished without the willingness of the debtor countries to cancel or reduce significantly the external debt and provide financial assistance for economic recovery.

Most of the obstacles to recovery and development can be overcome through trade and private capital inflows. However, some public projects related to basic economic and social infrastructure are primary candidates for foreign technical and financial assistance, especially from multilateral financial institutions (MFI). Financial assistance should be strictly conditioned on creditworthiness, consistency with a general acceptable economic program, and demonstration that the projects and programs financed by the MFI are reasonably well implemented. Cuba should request the Inter-American Development Bank, and other MFI, to create, lead, and monitor a consultative group to coordinate the international technical and financial assistance for the transformation, recovery and development program.

Microeconomic Restructuring

Evidence from the transition economies indicates that it is fairly difficult to consolidate macroeconomic stability in the absence of significant microeconomic restructuring. Supply side measures with their associated productivity gains are required for the steady improvement of allocative efficiency of re-

sources, and the reduction of transaction and input costs. These measures will facilitate the defensive and strategic restructuring of SOEs, will increase human resources mobility, as well as improve the quality and flexibility in resource utilization and allocation in the financial and labor markets to reduce their conspicuous imperfections.

In the special circumstances of the former German Democratic Republic (East Germany), the reunification made possible not only to stabilize and liberalize the economy literally overnight, but also to introduce some of the necessary institutions in a relatively short period; however, some of them are still not effective or widely accepted. Particularly, the microeconomic restructuring of the existing production capacity has taken even there many years and actually is still under way.

Privatization of SOEs: The state should disengage as quickly as possible from the day-to-day functioning of enterprises in almost all sectors; however, privatization of SOEs requires adequate private property legislation and establishing rules for privatization. The reasons for privatization center on government failures and on the politicization of enterprises in the socialist system. Among its main benefits are: improving efficiency; increasing production, employment and competition; imposing market discipline; and extending ownership and control to citizens.

The speedy privatization of small- and medium-sized SOEs appears to be economically and politically suitable. Proceeding quickly with privatizing these enterprises with fair and equal access to information and auctions has generated substantial benefits in terms of increasing efficiency and competition, higher production, employment generation, and political support to the economic and political reform process. SME are more adaptable, have fewer controls, and have lower capital requirements than large enterprises.

The emphasis on the speedy privatization of large SOEs has not been very helpful (Svejnar, 2002b, p. 28 and Zinnes et al., 2001). In the worst instances a combination of insider and crony privatizations have resulted in a very high concentration in asset owner-

ship and political power, and in a weak impact on enterprise performance and restructuring. Where ownership is concentrated and “new oligarchs” capture the state, they favor the status quo of partial economic reforms and a non-transparent political process. Concentrated ownership and economic power have created strong vested interest in monopolistic and rent-seeking behavior. Privatization alone has no effect on growth; privatization combined with corporate reforms has a positive impact through restructuring. The privatization of large SOEs, however inefficient they may be, is likely to be politically sensitive—especially in the natural resources area.⁷

Large SOEs require introducing an effective system of corporate governance, modernizing accounting, audit, managerial incentives, and internationally accepted financial disclosure standards and practices (Svejnar, 2002b, p. 6). Some large SOEs can break up into smaller enterprises, which might provide a basis for more effective corporate governance by the stakeholders and greater competition.

The political acceptability and legitimacy of the privatization process is very important in its own right and can have important consequences for the future performance of privatized enterprises.⁸ It is very difficult to undo the damage caused by an initial privatization to ineffective owners through subsequent trading of ownership titles.

The consequences of hasty and ineffective privatizations are likely to be both severe and persistent. Ineffective privatization can often be linked to decisions made concurrent to the decision to privatize. In cases where the climate is not ripe for privatization to be effective, patience may indeed be a virtue. Under these circumstances, it is advisable to concentrate on reforming mismanaged SOEs while they are still

publicly owned until the climate is right instead of rushing to privatize. The government should also establish an effective regulatory system for enterprises that are natural monopolies before privatizing them and to promote strategic restructuring.

In enterprises that continue to be operated as SOEs, getting them to function efficiently is difficult; and achieving the flexibility and responsiveness to adapt to new demands, new technology, and challenges is even harder. Therefore, subsidies should be clearly identified and gradually eliminated; they should not interfere with required defensive and strategic restructurings.

As the experiences of Poland and the Czech Republic show, the government with the active support of the labor unions could prevent managers and organized groups from appropriating assets and economic rents when controls are lifted (World Bank, 2004, p.44).

There is a positive influence on earnings and productivity from privatization of large SOEs to outsiders, particularly to foreign investors. The lessons from transition economies suggest that the government needs to adopt transparent procedures that yield the best market price and minimize the marked disadvantage that ordinary citizens may face vis-à-vis foreign investors and expatriates. The relative success of privatization in achieving the goal of increased efficiency depends on the range of groups that the government is willing to invite to the auctions, which is typically determined by the method of sale. In general, privatizations that are limited to insiders or domestic groups have been less successful by this standard than those that have invited outsiders and foreigners. Using public bid auctions will ensure that the former criterion is met, but it may result in many state assets being acquired by foreign investors and

7. In Russia, speed and simplicity were more important than real institutional development. Although vouchers were introduced, the motive for their use was to expedite the process rather than to achieve distributional equity. Later arrangements were far more biased towards insiders and voucher-phase winners. It would be fair to say that privatization could have been much better from both the efficiency and equity standpoints had leaders focused on assuring fairness with respect to access and information and breaking up monopolies. Only a small elite had the connections (both political and in the underground economy), which made it feasible to get control of most of the state's most profitable former assets. Russian privatization seems to have created a deepening divide between the rich and poor.

8. The Yukos affair in Russia and the initial announcement of the new government in Ukraine are compelling reminders of the vulnerability of property rights acquired through a privatization process that lacks legitimacy.

expatriates. Therefore, for political considerations, the government may wish to distribute packages of shares (preferably minority packages) of some large SOEs to workers/managers⁹ or to the population at large. This scheme gets around the marked disadvantage of citizens, provides potential entrepreneurs with collateral for credits, ensures that citizens benefit by receiving some return on capital rather than just labor income, and is often widely viewed as being fair. However, its success in terms of efficiency and welfare relies heavily on a well functioning legal and institutional system.

Development of a Sound and Safe Financial Market: The progress of financial reforms has given a boost to economic activity. In order to establish a well functioning and consolidated financial market, the government should create competitive and sufficiently capitalized commercial banks, and protect creditor rights.¹⁰

Ownership incentives alone are not enough to induce large firms to be run efficiently. The oversight that comes from well-regulated and well-supervised financial institutions is also needed. It is very important to establish an independent banking superintendency that establishes provisions for nonperforming loans and regulated credit risk. Therefore, a commercial bank program should focus early and appropriately on getting in place the basic legal, regulatory and supervisory framework for a safe and secure commercial banking system, as well as accounting, auditing, and internationally accepted financial disclosure standards and practices required for a market-based financial system. Commercial banks will have a key role in mobilizing and allocating financial resources. There is the need for training of bankers, bank supervisors, lawyers, judges, accountants, and auditors.

Commercial banks should not be burdened with the task of phasing out enterprise subsidies and permit their recycling in the form of new non-performing loans. Lessons from CEEC transitions suggest that even partially state-owned banks usually accumulate new non-performing loans and that most privately created domestic banks fail.¹¹ Hence Cuba should consider selling most, if not all, domestic banks to foreign investors or to joint ventures, a model that has proved to be quite effective in the CEEC (Svejnár, 2002b, p. 23); however, this requires the enforcements of laws such as property rights, collateral, and bankruptcy. Foreign banks can bring new technologies, products, ideas and professionals that are lacking in the domestic financial markets, as well as provide safety and security to the local savers that do not trust the new domestic system. The basic self-regulatory, oversight, full disclosure, and operating efficiency of stock markets should be used in reestablishing the Havana stock market.

Fostering Human Resource Mobility and a More Flexible Labor Market: Apart from tourism and remittances, well-educated human resources could serve as an important engine for Cuba's economic growth, especially in services and manufacturing. Low levels of unemployment have grown into double digit figures and the labor participation rates have decreased in most CEEC (Campos and Coricelli, 2002, p. 807). This can be explained by the initial recession and the relative high remuneration, including fringe benefits, high social benefits for the unemployed, and strictly regulated labor contracts.

Foreign trade liberalization is not necessarily beneficial if the labor market is distorted and lacks adequate mobility. In principle, the gains from trade reform come through labor reallocation. Workers move within a given activity, from less efficient firms

9. "Stakeholder privatization coupled with stakeholder empowerment will tend to reunite the *de facto* control rights and *de jure* ownership rights in a self-enforcing system of corporate governance" (Stiglitz, 1999, p. 15).

10. The financial market includes the banking sector, capital markets (mainly stock market and securities markets), and non-bank financial institutions, mainly pension funds and insurance.

11. Commercial banks face the problem of providing credit in a new context in which they lack the proper information and the expertise to act efficiently. Previous information on enterprises is irrelevant because the arbitrary system of taxes and transfers made profitability a bad indicator of efficiency of firms.

to more efficient ones, and across activities, from those that are inefficient to those in which the country has a comparative advantage. Workers evade high transitional costs. The transition from declining activities into expanding activities is held back if the labor market is not up to the task. Labor market reforms complement trade reforms.

The command and rentier nature of Cuba's economy has created a mentality of dependence on state assistance. Changing this mentality is a major challenge and will take time. In the short term, the government needs to stimulate productivity-enhancing labor mobility and a high rate of employment creation by private firms allowing new forms and more flexible labor contracts, while striking a balance between introducing new strong incentives and maintaining an adequate social safety net. In the long term, a key goal should be to improve and adjust the educational level and skill composition of the population. Retraining schemes should be decentralized, personalized, and made obligatory for people being assisted by the safety net.

In some transition economies, non-space labor mobility has been considerable from old to new enterprises, with most mobility being through voluntary quits rather than through involuntary layoffs. People in these economies tend to change occupations rather than move geographically (Ibid, p. 808). To facilitate inter-sectoral, occupational and regional mobility, the government should help establish retraining institutions. Regional mobility will be improved by a well functioning housing market, and modern transportation and telecommunications infrastructure networks. The public provision of labor market information will facilitate and support all three types of mobility.

Cuba's high urbanization rate means that trade unions may become important players. The government should pursue policies that are conducive to cooperative labor-management relations, thus reducing industrial conflict and increasing labor productivity.

SEQUENCING AND SYNCHRONIZING

Choices are always necessary given the limitations on any government's focus, time, and resources. The

economic thinking on the pacing of adjustments and the sequencing of reforms has been changing over time. Each country has to choose the appropriate speed of adjustment and sequencing of reforms by evaluating its specific factors. The optimal pacing and sequence is country specific (Nsouli et al, 2002). With the appropriate and well defined reform strategy, the likelihood of success is great; and success of reforms could strengthen their sustainability. Success is reinforcing. Hence, success rather than speed is of the essence.

The following proposal for reform sequence and synchronization attempts to use the coherence, synergies, networks effects, and potential externalities among the main reform components, and to promote sustained high rates of economic growth and social improvements. Sequence refers to the order in which specific reforms are introduced; it involves the order in which reforms are undertaken across areas of reforms and within areas of reforms.

Institutional and policy measures are optimally sequenced and synchronized in three main phases to maintain reform momentum and because some reforms are prerequisite to further reforms. The proposed speed and sequence of economic reforms try to balance reform feasibility, adjustment costs, policy credibility, and risk assessment. Also the proposed package of reforms is complete, internally consistent, and properly sequenced and synchronized to achieve the best results.

Phase 1: The preparatory phase in which the government carries out the basic reforms below with international technical assistance to initiate full economic recovery. These market-oriented reforms are required to enable the Cuban economy to fully recover. A successful reform prescription is to start with some measures that are feasible, sensible, and have wide support, like an enhanced Project Varela (approximately one year). To increase the chances of success, the government needs to specify reform priorities and be realistic in terms of what is achievable over a specific time. This will enhance program ownership.

- Adjust the legal and institutional system to encourage private initiative, to sanction and secure

Key Lessons from the Transition to a Market Economy

- property rights, and to be conducive to a democratic market economy.
- Publicize the reform program to gain public support and enable citizens and the organizations of the civil society to form accurate expectations.
 - Boost up tourism and remittances, and re-establish free exports generating enough funds for maintaining nutritional, educational and health levels, and carrying out basic recovery activities.
 - Encourage, support and simplify the entry of new enterprises, both domestic and foreign.
 - Provide special incentives to encourage the creation of SMEs.
 - Adjust and develop the legal system and enact and implement new simple, clear and operational laws for a democratic market economy.
 - Encourage and support the creation and development of civil society organizations.
 - Carry out the first phase of public administration reform to enable it to function effectively in a democratic market economy. Create and staff new public institutions consistent with the new legal and institutional system.
 - Liberalize prices for goods and factors of production and open up the economy to foreign trade.
 - Devalue the peso, unify the exchange rate, and establish a pegged currency to the dollar (or Euro).
 - Establish an independent and accountable Central Bank.
 - Establish expenditure controls for unnecessary and privileged public expenditures.
 - Provide imported supplies to schools, hospitals and other key social institutions to improve the quality of the social services.
 - Request foreign debt cancellation.
 - Request technical assistance for key policy and institutional reform measures from MFI.
 - Establish property rights for privatized firms and the regime for privatization of SOE.
 - Reform existing financial institutions and establish a regulatory and supervisory system to assure the safety and soundness of commercial banks.
 - Flexibilize labor contracts.
 - Design new training programs for an effective social safety net, including education, healthcare and pension reform.
- Phase 2:** The consolidation phase of the economic recovery, in which the government introduces the main systemic reforms (below) for high and self sustained development of a democratic market economy (approximately one year). Radical changes in property and market relations would be introduced.
- Carry out the first diagnostic checks of the legal and institutional shortcomings and adopt corrective actions.
 - Allow enterprises to adjust and start operating on the basis of free prices for goods and factors, and profits rather than centralized commands.
 - Carry out tight monetary and fiscal policies to consolidate stabilization.
 - Carry out repairs and maintenance of infrastructure projects through public concessions.
 - Introduce main fiscal reforms (tax and expenditure controls) to assure and maintain fiscal balance and consolidate stabilization.
 - Request technical and financial assistance for key economic and social infrastructure projects from MFI.
 - Privatize small and medium SOEs.
 - Corporatize large SOEs. Break up some large SOEs into non-monopolistic units and improve their corporate governance.
 - Privatize through open public bidding the large SOE with exportable and potential exportable goods and services to maximize income from privatization.
- Phase 3:** The initiation of the principal development phase, during which the government consolidates and enhances major economic adjustment measures (below). Cuba starts to move much faster and deeper into a democratic market economy for high and self sustained development.
- Establish an administered floating exchange rate.
 - Gradually reduce tariffs and subsidies for enterprises.
 - Carry out new major infrastructure projects through public concessions.

- Privatize the remaining large SOEs or their main assets.
- Complete the development of a well functioning financial sector with new financial institutions and instruments.
- Facilitate labor mobility and launch retraining and new educational programs.

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