

REFLECTIONS ON THE STATE OF THE CUBAN ECONOMY

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Given the recent momentous political developments between the United States and Cuba, expectations for business opportunities by US firms and private investors appear high. Yet it seems to me that these expectations are not consistent with the fundamentals underlying the Cuban economy. In fact, since the new economic reforms were announced at the end of 2010, there has been no major overhaul that can be labeled as transformative in the sense that the economy could be placed on a path of long-term economic growth. Part of this hesitancy may be due to the recognition by Cuban policy makers that many of these changes are inconsistent with other structural impediments that have not been addressed.

To be more specific, the proposed elimination of the dual currency system and exchange rate unification has yet to be implemented after being proposed in the 2011 economic reforms. It is obviously clear to Cuban policymakers that the Cuban currencies must be unified and then the peso has to be extremely devalued. In a market economy, this devaluation would spur exports and reduce imports and improve the trade balance of the country. In terms of the financial or capital accounts of the balance of payments, this devaluation would increase foreign direct investment into the country since at the current CUC /dollar exchange rate these investments are unattractive. If this devaluation occurred, the improvement in both the trade and capital accounts would increase international reserves. But in the case of Cuba, even if all the proposed reforms were implemented, the structural impediments created by the control of the economy by the State, would not permit this process to occur in an efficient manner.

These institutional impediments include the lack of well-defined property rights, the restriction in the organization of production by private individuals in many industries and occupations, the restricted use of prices to allocate resources, and government intervention in economic activity that distorts prices and reduces efficiency.

As an example, in 2011, the Cuban government transferred approximately 1.5 million hectares of land on ten-year renewable leases to private farmers or production co-operatives. Yet these farmers, who now run 70% of Cuba's farmland, could only sell up to half of their harvest to the highest bidder; the other 50% had to be sold to the state procurement agency (ACOPIO) at set prices. Given this type of institutional arrangement, agricultural production could not be increased to a point where Cuba could begin to export agricultural commodities, which it was able to do historically given its comparative advantage due to factor endowments.

Instead of the outright privatization of many state owned enterprises, it appears that the Cuban government will continue to experiment with forming them into production cooperatives, both agricultural and nonagricultural. Let me highlight the inefficiencies that this type of institution generates. First, contrary to private ownership where incentives to invest in capital improvements accrue to the individual, this incentive is distorted in collective ownership of the means of production. If farmers own their land, any returns from an investment in fertilizers, pesticides and farm equipment to increase production will accrue to them as long as they continue to produce on the land. Therefore, they make these investments

with a long time horizon in mind. In contrast, when the Cuban state transfers land on ten-year leases, the recipient farmers face the uncertainty that any payoffs after 10 years of their investment in capital will not accrue to them. This creates incentives for these farmers to make opportunistic investments that have payoffs only in the short run, that is in less than 10 years. Therefore, for efficient production the state has to transfer ownership to private individuals in perpetuity.

A similar failure occurs in these types of organizations due to the incentive to shirk by workers. Each individual's effort in the production of output imposes a direct cost to the individual, yet the output from this effort is shared amongst all persons in the group. Therefore, it is optimal for the individual to not exert maximum effort. Let me give you a simple example. If I dedicate a dollar of effort in an organization with 100 individuals and this effort leads to output expanding by \$50, then I receive \$.50. But since that effort cost me a dollar, I will decide not to exert myself since the return does not compensate me for the cost. Every other worker facing the same situation will also not expend the effort and as a result production declines. In economics this is called shirking and it occurs because of the cost of monitoring workers' effort.

The empirical evidence shows that the relatively successful agricultural cooperatives have been those where farms are owned by private individuals, al-

though the marketing aspect, the provision of information and the provision of credit may be organized as a cooperative, but not the production. Of note is that it has been shown empirically the importance of these types of cooperatives declines as a country develops. This type of problem is compounded in state-owned enterprises where the recipients of the firm's residual income or profit are not the shareholders, but the government.

In fact, just last week it was announced that 24 out of 123 state owned enterprises with negative profits over the last couple of years would be shut down. Of these 123 firms, 56 of them were in agriculture, which means that agriculture accounted for 73% of unprofitable enterprises.

With the continuing losses in state owned enterprises, which have to be subsidized by a government that cannot issue public debt or bonds, these losses must be monetized. Similarly, import requirements by these firms are a drain on Cuba's limited international reserves. If we couple this with the economic crisis in Venezuela, which has been serving as a major source of international reserves, economically Cuba faces tough challenges ahead.

Therefore, even under the most optimistic scenario of the lifting of US sanctions, sanctions that I have opposed for many years, I expect that these constraints will force Cuba to undertake substantially more radical reforms in the next year.