Cuba Transition Project

INSTITUTIONS TO ACCOMPANY THE MARKET IN CUBA'S FUTURE ECONOMIC TRANSITION

By

Ernesto Hernández-Catá

INSTITUTE FOR CUBAN AND CUBAN-AMERICAN STUDIES

UNIVERSITY OF MIAMI

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Institute for Cuban and Cuban-American Studies
University of Miami

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Executive Summary

Cuba survived the severe shock inflicted by the loss of financial assistance from the former Soviet Union, with the help of a tactical shift toward structural liberalization and macroeconomic stabilization in 1993-94. Since then, however, the momentum of reforms has been lost and the downward trend in investment since 1989 has sharply reduced Cuba's productive capacity. To continue business as usual will mean, at best, a stagnating economy unable to cope with its large domestic and foreign liabilities. A full-fledged reform must now take place—one that will eliminate the institutions of centralized control and create new institutions that will sustain an efficient, private sector based economy.

The government will have to proceed quickly with price liberalization and exchange rate unification, which will eliminate some of the most severe distortions in the Cuban economy, and simultaneously announce a rise in public sector salaries and pensions to dampen the effects of the resulting devaluation of the peso. It should then focus on encouraging the entry of new enterprises, which will require cutting red tape, reducing the corporate tax burden, and improving the legal and regulatory framework. An Agency for the Management of State Assets should be created and proceed rapidly with the privatization of *small enterprises.* It should then divide *medium and large state enterprises* between those that can be immediately privatized, those that need to be restructured; and those that have to be liquidated. Restructuring will be strictly temporary, subject to monitoring, and conditional. It will involve the application of hard budget constraints, including the elimination of tax exemptions and subsidies. As regards privatization, an emphasis on *direct sales* to concentrated outside partners rather than *voucher distribution* would be in Cuba's best interest. Concentrated investors (including foreign companies) have a stronger incentive than "insiders" (managers/workers) to maximize long-term profits, to align their interests with those of minority owners, to avoid assets stripping, and to provide capital and market experience. In some cases, however, there could be room for voucher distribution to the population or to enterprise managers/workers.

The resolution of claims by Cuban nationals on assets expropriated by the Cuban government after 1959 should avoid the complex and time-

consuming process of *physical restitution* that is likely to discourage private investment and delay privatization. Indemnification, (for example in the form of government securities or privatization vouchers) would avoid these problems. Claims of U.S. nationals on expropriated property will have to be addressed urgently, because U.S law requires a resolution before the embargo on trade with Cuba is lifted and foreign aid can begin. The Cuban government also faces a huge burden of external debt. Debt negotiations will thus be one of its most important tasks, and it will have to be handled through a well-staffed government agency. Cuba's external debts can be, and should be reduced substantially through bilateral negotiations and Paris Club rescheduling.

The reforming government will have to keep inflation under control while responding to massive demands for social safety net payments and the servicing of external and domestic liabilities (including pensions). The restructuring of the public finances will have to aim at tax and expenditure systems that maximize efficiency and accountability. In spite of the measures introduced in 1994, many taxes still suffer from arbitrarily narrow tax bases and are riddled with exemptions that weaken incentives to work and distort resource allocation. Tax rates on personal income and payrolls should be cut; tax exemptions should be eliminated and, in the longer run, the turnover tax should be replaced by a value-added tax.

Cuba's rudimentary banking system was improved by the 1997 financial reform, which created a separate central bank and authorized a number of new financial institutions. Looking forward, the Central Bank of Cuba (CBC) should act with strict independence in formulating and conducting monetary policy. In the short term at least, the CBC should adopt a policy of managed floating. As for commercial banks, the time has come for a new financial reform law that would stress: *privatization, deregulation, and free entry.*

Cuba's agriculture was transformed by the Agrarian reforms of 1959 and 1963. Large privately owned *latifundio*s were replaced by state-owned *latifundios* operated mostly by salaried workers making intensive use of machinery and equipment, fertilizers, and scientific/technical inputs. Shortages of labor were dealt with by mass mobilization of urban workers. This model did not work. Predicted yields and output levels did not materialize, and many state farms had to be subsidized through the budget.

In 1993-94 the government introduced a seemingly radical reform of the agricultural sector. More than 1,500 state farms and agricultural enterprises were transformed into cooperatives, and free Agricultural Markets were legalized. By 1995 the share of agricultural land held by the non-sate sector rose to about two thirds. The reforms reduced the average size of farms significantly and helped non-sugarcane food production to recover. However, the overall results were disappointing, particularly in the sugar cane sector where efforts to bring about the profitability of cooperatives failed, and many state farms continued to require budget support. To a large extent, these problems reflect the failure to complement the transfer of ownership with a policy of reduced government interference with the cooperatives. Many of these problems will be resolved by price decontrol, which will abolish the monopsonistic power of the state purchasing and thus eliminate the current, severe discrimination against cooperatives.

I. Introduction

The Cuban economy is now approaching a crossroads. Over the past 14 years it has survived the severe shock inflicted by the breakdown of its economic relations with former Communist countries and the end of financial assistance from the former Soviet Union. It did this, in large measure, through a shift toward structural liberalization and macroeconomic stabilization in the mid-1990s. Since then, however, the momentum of reforms has been lost and the steep downward trend in investment since 1989 has left the economy with a seriously depleted capital stock and a sharply reduced productive capacity. The alternative for Cuban policy-makers is now clear. They can continue business as usual and, at best, muddle through with a stagnating economy unable to cope with its large debts; or it can reform the present system, with the clear strategic intention of replacing it by one based on private enterprise and on the free market as a mechanism of resource allocation.

Starting conditions

There is no way to determine when and how this strategic turnaround will occur. Guessing on the possibilities is an interesting game, but one that is outside the scope of this paper. Yet, there is no doubt that the move towards a market economy and the related transformation of the country's economic and financial institutions will encounter difficulties. It is also clear that the magnitude of these difficulties will depend in large measure on the political orientation of the new government and its ability and willingness to move on with the required policy changes in spite of opposition from some elements of the population. This paper will assume that, somehow, at some point a Cuban government will take the decision to endorse reform, and that it will do so in a peaceful environment[1]. It is left unspecified whether this major step is taken by a new government or by a pre-existing government convinced of the need for change (presumably after the most staunch enemies of reform have been effectively removed from power).[2]

For the same reasons no precise assumptions are made concerning the political philosophy or the organization of the provisional government (referred to hereafter as the "reforming government"). Presumably it would be headed by a Prime Minister or Chairman, and perhaps two or three senior deputies. But their precise titles, responsibilities, and powers would have to await Constitutional decisions. In particular, the new Constitution will have to determine whether the Government is to be of the presidential or the parliamentary type. Indeed one of the most urgent tasks of the provisional Government will be to set up a Commission that would prepare a draft Constitution. Presumably, this document would be submitted to popular referendum, after which legislative and executive elections would be called as prescribed in the Constitution and under the supervision of international and regional observers. In the meantime, the government would take economic decisions, including the preparation and execution of annual budgets, by issuing laws and decrees. As soon as possible, political parties, labor unions, and business associations would be allowed to organize and to operate freely as long as they respect the laws of the country.

Historical background

For more than a decade—since the fall of the Berlin wall—the possibility of a transition of the Cuban economy from central plan to market has been the subject of considerable discussion and widespread expectations. Yet, a transition to a predominantly private economy has not taken place in Cuba, certainly not to the extent it did in other former Communist countries. The share of the private sector in the gross domestic product (GDP) now ranges from 65% to 80% in central and Eastern Europe, and from 70% to 80% in the Baltic countries. It has reached 75% in Vietnam and 80% in China. By contrast, the share of Cuba's non-state sector in total employment (the best available proxy for the private share of the economy) is now only 25%.

To some extent, a partial, first generation reform was launched in 1993-94 as a tactical reaction to the massive shock resulting from the end of Soviet assistance. The Cuban government decriminalized the holding and the use of the U.S. dollar, transformed most state farms into cooperatives, legalized private agricultural markets, and allowed some degree of price liberalization. The government also legalized self-employment, albeit subject to a number of significant restrictions, and shifted macroeconomic policies decisively toward stabilization, cutting the budget deficit sharply and thereby reducing both inflation and the monetary overhang that had accumulated since the late 1980s.[3] The government began to introduce hard budget constraints on state enterprises by slashing budgetary subsidies, and launched a program of managerial improvement (*perfeccionamiento empresarial*). A tax reform was introduced that was modest in terms of its practical budgetary implications, but did set the stage for modernizing the tax structure and improving tax administration. Finally, in 1997 the government introduced a financial reform, consisting mainly of the breakdown of the old National Bank of Cuba into a central bank and a commercial bank, and created of several financial institutions. The intent of the 1993-94 policy changes was essentially tactical, as has been often restated by Cuban officials at the highest levels and demonstrated by lack of continuity and even backtracking on the reforms. The *strategic* intention continued to be the preservation, and in the long run the triumph of "socialism". In line with this intention, the 1993-94 reforms were interrupted and in some cases largely reversed (for example, with regard to self employment). Thus, while the 1993-94 changes were a step in the right direction, a full fledged transition must now take place—one that will eliminate or restructure the institutions of administrative control and planning and create those that will sustain an efficient, private-sector based economy. Still, what has already been achieved since 1994 should be taken into consideration to avoid re-inventing the wheel.

Markets and institutions

Markets can be defined as social arrangements by which people, as individuals or as representatives of organizations, exchange goods and services thereby improving welfare. As emphasized by Locay (1995), market exchange involves transaction costs, and hence the need for an institutional structure—i.e., a collection of organizations and procedures based on a legal and regulatory framework—that allows markets to function well by reducing these costs. The institutional structure also serves to protect market participants, including notably those in financial markets, against systemic risks.

Economic transition from central planning—where transaction costs are very high or prohibitive—to a system where markets play a predominant role in allocating resources will require an institutional transformation involving two sets of actions: (i) the *elimination of certain institutions of central control* (such as the price control authority[4] and the dual exchange rate system), both of which raise transaction costs substantially; and (ii) the *creation of new institutions* expected to reduce transaction costs and risks, for example by providing a legal framework to protect property rights, and by designing simple and fair tax and regulatory systems to facilitate the entry of new enterprises.

Not all institutional changes fit neatly into these categories of elimination and creation. In the critical area of state enterprise reform, for example, some enterprises will have to be liquidated and others privatized, but others will have to be restructured before privatization. This is an important example of *sequencing*. Reforms, however, should not be made hostage to sequencing. The reforming government will face a number of contradictory political pressures and trade-offs at almost every decision point. It will try to sequence measures if at all possible; but otherwise it will *do what it can*, *when it can* in order to avoid paralysis. In other words, when political circumstances provide a window of opportunity to adopt important reforms, sequencing will have to take the back seat.

Another issue that involves *time* has to do with the distinction between *transitional* and *permanent* institutions. Some key institutions, such as the proposed Agency for the Management of State Assets (see section III), will be fundamentally *transitory*. The work of the Agency could go on for quite a while, depending on the political stance of the government and on the difficulties confronted in the restructuring and privatization process. (This is the *speed of reform* issue, considered in the next subsection). But the Agency cannot delay action forever without signaling its own failure. At the other extreme, the restructuring of the tax and pension systems is crucial to the long-term sustainability of a market-based economy, one that combines efficiency and fairness in proportions that are acceptable to the majority of the population. These systems aim to be *permanent*, but their full and *immediate* adoption is probably not feasible given their complexity and the likely shortage of financial and human resources early in the transition.

The speed of reform

The question of the speed of reform has been one of the most controversial. By now, however, there is a mass of historical and statistical evidence showing that the countries that take an early start in implementing substantial reforms perform better after a few years than the slower and more timid reformers.[5] Summing up the findings of the empirical literature, a World Bank report (2002) indicated that output in the former centrally planned economies was significantly correlated with current and past actions to liberalize the economy. Other factors also matter, however, including macroeconomic stability, the geographic proximity to well functioning market economies, the degree of financial repression, the "memory" of markets, and the incidence of armed conflicts during the transition. The empirical literature for Cuba is less extensive, partly because of limitations with the data. However, there is strong statistical evidence that real GDP during the 1990's was negatively influenced by the intensity of exchange rate distortions and positively correlated with the size of the non-state sector and the extent to which hard budget constraints had been imposed on state enterprises.[6]

Institutions and policies

It is clear from the experience of the former communist countries that good economic decisions cannot be made and implemented in an institutional void. For example, to privatize state enterprises without an institution duly empowered and properly equipped to implement the privatization strategy is to open the door to the kind of "spontaneous privatization" that occurred in Gorbachev's Soviet Union. This will induce managers and other "insiders" to engage in "tunneling[7]" and asset stripping. Conversely, institutions without appropriate policies are often unhelpful and sometimes even dangerous. For example, it makes no sense to set up a well staffed restructuring and privatization agency if it fails to enforce hard budget constraints on the state enterprises, i.e., if enterprises continue to receive subsidies and/or get away without paying their taxes in full. The managers of these enterprises will have no incentive to increase efficiency and attain profitability, and they will be tempted to engage in asset stripping and tunneling. Therefore, enterprise losses will continue at the expense of the taxpayer and the minority shareholders.[8]

As the World Bank rightly concluded, "even a good institutional framework backed by massive subsidies cannot overcome the negative effects of inappropriate policies." (World Bank 2002, p. 38)

The opening act. The task of a genuine reform-minded government will seem daunting at the beginning of the process. That government will have to proceed quickly on those measures required to avoid serious shortages (and therefore political discontent) and foster the irreversibility of the reform process. In this respect, the experience of the former communist countries leaves no doubt. The first action will have to be one of institutional destruction: the complete ***liberalization of prices,*** including the elimination of the price control branch of the Ministry of Finance. The immediate adoption of this measure will:

- avoid speculative purchases of consumer durables and industrial supplies and materials in anticipation of large price adjustments when liberalization finally occurs,
- eliminate any incentive for arbitrage between regulated and black market prices,
- and save the government more than 2 billion pesos, around 6 % of GDP, in subsidies associated with price differences[9],
- more fundamentally, in the longer-term, market determined prices will direct resource allocation to the production of those goods and services that individuals wish to buy (as opposed to those the government planners wish them to purchase). It will also reveal to all market participants the relative cost of goods and the true profitability of enterprises.

For all these reasons, price decontrol is the exception that confirms the pragmatic principle: "under political pressure, do what you can, when you can." *Prices must be decontrolled up front*. A number of former communist countries liberalized most or all prices at an early stage of the reforms: Poland, Hungary, Russia and the Baltic states, for example. They did not regret it. After the initial and brief surge in prices,[10] liberalization took care of the shortages and queues, improved the quality and the variety of goods, and turned out to be a popular measure that proved very hard to reverse. It is important to recognize, however, that price decontrol in Cuba, and the associated elimination of the rationing system (or what is left of it), could result in a temporary surge of some prices to unaffordable levels, and disorderly conditions along the distribution system could create temporary shortages, particularly in isolated areas of the country. For these reasons, the prior creation of a strictly time-limited food aid program by the U.S. government could make a valuable contribution to the initial success of the reforms—an initiative suggested years ago by Antonio Gayoso.

The second action should be the ***unification of the exchange system*** through the abolition of the official exchange rate and the authorization to banks and exchange bureaus to buy and sell foreign currencies without limit. This action will have far-reaching favorable consequences, as it will eliminate one of the most severe distortions affecting the Cuban economy. In some areas, however, its effects will require compensatory actions. Since unification is likely to bring about a large devaluation of the peso and therefore a large fall in the dollar value of peso-denominated incomes, it will have to be coupled with an across-the-board increase in public sector salaries and pensions, This increase should be far less than the full magnitude of the devaluation, but large enough not to cripple the purchasing power of this large segment of the population. The confiscation by the current government of a major part of the dollar wages of Cubans working for foreign companies or joint ventures will be immediately eliminated on both economic and ethical grounds. Of course, wage determination in the private sector will be left to owners and workers.

II. Encouraging the Entry of New Enterprises and the Growth of Self Employment

The key objective of the next round of reforms in Cuba should be to build a productive system based predominantly on private enterprise and market competition. Cuba is still far from that goal. As mentioned earlier, the share of the private sector in the economy is still very low compared with most other transitions countries. There are three ways to increase the share of the private sector: to privatize existing state enterprises (the topic of section III), to foster the emergence of new private enterprises, and to encourage existing private enterprises to grow. There is considerable evidence from both statistical correlations and surveys that new enterprises have played a major role in dampening (and in some cases, like China, eliminating) the initial contraction of output and in fostering rapid growth thereafter.[12]

Analysts of state enterprise reform in the transition countries have emphasized the importance of combining **encouragement and discipline.** (See World Bank, 2002). Discipline will be most important in dealing with state enterprises awaiting privatization or liquidation. Encouragement, which is essential to attract new enterprises, aims at providing incentives for competition and long-term profit maximization as the best way to attain efficiency, job creation, and responsiveness to consumer preferences. It requires, in addition to price decontrol:

- ✓ A decisive *effort to cut red tape* by developing a simple and transparent registration process, avoiding duplication between government agencies, designing clear and concise application forms widely available, and establishing a reasonably brief timetable for each phase of the registration process.
- ✓ The creation or improvement of the *legal and regulatory framework* for bankruptcy, accounting, disclosure, and shareholders rights.
- ✓ Support for the central bank's efforts to keep inflation low and develop of a sound and efficient banking system.

It is not realistic to expect that this institutional framework can be completed before new enterprises are allowed to enter the market. Enterprise formation thus will have to proceed while work on the regulatory system is ongoing. This an area where gradualism and perfectionism can become the enemies of reform and where it will be necessary to cut a few Gordian knots. For example, the experience of formerly planned economies suggest that, given the urgency of establishing bankruptcy proceedings, it is better to begin operating with an imperfect legal framework and then to refine it over time.

Part of the growth of the private sector in Cuba could come from the existing self-employment sector. It should be relatively easy to expand the scope of this sector by:

- ○ reducing the currently excessive taxation of the self-employed, and
- ○ eliminating regulations that restrict size (e.g., number of tables in a restaurant); *hiring* (only close relatives can be employed under

present law), and *exclusion of certain professions* (there is no reason why doctors, educators, lawyers, accountants and economists should be denied the possibility of working as self employed because they "owe" their career to the state).

These measures could be implemented quickly and result in a significant rise in employment opportunities, thus helping to absorb part of the inevitable lay-offs associated with the restructuring or liquidation of certain state enterprises. They would help to absorb part of the existing excess supply of doctors and teachers by encouraging the development of private clinics and teaching institutions. Finally they would improve the performance of rural cooperatives, as explained below in section III.

III. Disposing of State Assets

Given the importance and complexity of the state enterprise problem in Cuba, it will be essential to create, at a very early stage, a strong, autonomous, and well-financed agency that will preside over the transformation of this sector. A rapid and fair solution to the problem of compensation for former owners of property will greatly contribute to the success of the Agency in fostering privatization and, more generally to the overwhelming need to re-capitalize the Cuban economy.

The Agency for the Management of State Assets

The Agency will identify medium and large enterprises and divide them into three categories: those that can be immediately privatized; those that need to be restructured before they can be privatized; and those that cannot be satisfactorily restructured and will have to be liquidated, possibly after separating those parts that are candidates for restructuring and/or privatization on an individual basis.

Liquidation will result in layoffs, creating the need for a short-term unemployment compensation system that would give time to the unemployed workers to find alternative jobs. Initially the system would be financed by a part of the existing *tax on the utilization of labor* (see section IV) and by privatization revenues. It must be emphasized that liquidation will not be an entirely novel procedure for Cuba. Several state enterprises were closed as part of the 1993-94 reforms, and in 2003 the government closed several large, unprofitable sugar mills.

Restructuring will have three fundamental characteristics. It will have to be:

- *strictly temporary:* the Agency will specify a timeline to bring the company to profitability, at which time the decision to privatize or liquidate will become irrevocable. During the period of restructuring, the Agency will be empowered to consider offers for privatization from investors who are willing to complete the restructuring on their own. The agency will not block or delay privatization if a serious offer is available.
- *subject to monitoring and control:* the agency will monitor the progress made at regular, pre-specified intervals. A system of inspection will ensure that asset stripping and other forms of theft do not occur, and if they do that they are punished as a criminal offense. The agency will propose legislative and regulatory action to make tunneling illegal.
- *conditional:* the Agency will specify conditions as part of the restructuring and monitoring process. The conditions may involve the sale of certain assets, the abandonment of certain unprofitable production lines, the payment of debts and taxes in arrears according to a reasonable schedule, improvements in corporate governance notably with regard of asset stripping and tunneling and, if needed, personnel changes.

As indicated earlier, the application of **hard budget constraints** will be of particular importance to state enterprises undergoing restructuring. Except as mandated by the Agency (and then on a strictly temporary basis) state support, including tax exemptions, subsidized credits, and privileged access to inputs or to foreign exchange should be eliminated. In the area of subsidies, the Cuban government has already made considerable progress, as explained below in section IV. Finally, it is only fair that enterprises be relieved of any unwarranted government-imposed burden. While many of the quasi-fiscal activities performed by state enterprises apparently had been eliminated by 1999, it is reported that some industries (for example, sugar mills) still provide free services to workers. These services should now be privatized or, if this is not immediately possible, the government should shoulder their cost.[13]

Is it realistic and appropriate to impose hard budget constraints on enterprises in a poor society like Cuba, with a high rate of unemployment? The answer is yes for two reasons.

- ✓ First, the maintenance of soft budget constraints is by no means cost free. Subsidization (whether through the budget or through the banking system) involves a transfer of resources from the general population to the enterprises that receive the subsidies. *In addition*, it involves a dead-weight loss for the population as a whole. Consider the case of negative-value added enterprises, of which there are probably many in Cuba. The present contribution to national income of these enterprises is by definition negative, and therefore the imposition of hard budget constraints would result in the closure of the enterprise and therefore a rise in net national income. This rise should help to compensate the workers that have been laid off and that cannot immediately find a job.
- ✓ Second, is possible that the productivity and profitability of some state enterprises will increase with price liberalization, for example because output prices rise by more than input prices. The result would be a gain in efficiency and a rise in national income.
- ✓ Third, in several cases, hard budget constraints have been already introduced by the present government. A number of state enterprises have been closed (notably large sugar mills) and state subsidies have been sharply reduced since 1994. (See Table 2 in section IV). It is difficult to understand why a reforming government could not eliminate the remaining enterprise subsidies (1.3 % of GDP in 2001) when the present government has been able to slash them from more than 30% of GDP since 1993.

Privatization. Selecting the method of privatization for medium and large enterprises will be one of the Agency's most urgent and important tasks, even in those cases where privatization is delayed pending restructuring. The feasibility of any particular method will depend on the political climate and on the orientation and strength of the reforming government at the time of privatization. However, the experience of other countries in transition indicates that a combination *of direct sales to concentrated outside partners* (as the primary method) and *voucher distribution to the population* (as the secondary method) would be best in Cuba's circumstances. This combination of methods was used in Bulgaria, Estonia, Latvia, the Slovak Republic and Kazakhstan. Hungary also used direct sales to concentrated outsiders as the primary method, with considerable success.

In summarizing the lessons of privatization in former centrally planned economies, a World Bank (2002) report concluded that direct sales to concentrated outside investors have significantly outperformed privatization to diffuse owners and/or insiders through voucher distribution or manager/worker buyouts. This results from three key factors:

- concentrated outside investors have a stronger incentive than insiders to maximize long-term profits, to align their interests with those of minority owners and to avoid assets stripping;
- in general they are better equipped than "diffuse" investors or former managers to provide capital, market experience, and competitive drive;
- direct sales have an advantage over voucher privatization in that they produce privatization revenue, for which the government will have a critical need in the early stages of reform.

Thus, there are strong arguments in favor of direct sales to concentrated outside investors. It should be recognized, however, those governments that engaged in mass privatization to diffuse owners and worker/managers (for example Russia and the Czech Republic) did have some important considerations in mind.

In the first place, mass privatization can be politically popular, provide a sense of equity, and help create a broad constituency for the reforms. The sense of equity would be illusory, however, if insider groups manage to acquire control of the firm and proceed to maximize short-term gains through asset stripping and capital flight. Of course this outcome could be avoided through strong governance rules, (including rules to protect minority shareholders and to prevent insider deals), through surveillance by banks and other creditors, and by state of the art accounting and disclosure standards. But it takes time to set up these institutions. In the meantime there is little to prevent abuse, delays in restructuring, and pressures for state subsidies, and, as a result, a loss of popular support for the privatization program.

In the second place, voucher privatization could be implemented very rapidly, without waiting for the selection of appropriate outside investors. Thus it would create "irreversible facts" that would reduce the likelihood of a communist comeback. This argument was particularly important where there were few concentrated domestic investors with enough capital to become dominant owners, and where privatization to foreigners was judged to be highly unpopular. How much of a problem this could be in Cuba remains to be seen, particularly if Cuban-Americans are counted among the "foreigners". As for the advantage in terms of speed, the argument has to be qualified: voucher privatization does have an initial edge in terms of implementation, but that does not mean that enterprises privatized through this method will be restructured faster (or that they will begin operating on a profit-maximizing, competitive mode earlier) than the enterprises bought by concentrated outside investors.

Altogether, direct sales to outside concentrated interests appear to have produced the best results, notably in Hungary and Estonia, and Kazakhstan. Moreover, this method can be used as the primary method in a menu that could also include voucher privatization, but keeping in mind a number of important caveats.

- Direct sales to outside investors must be based on open, fair and transparent methods such as competitive auctions or tenders. Sales to political well-connected investors have typically produced inferior results, as in the case of Slovakia, and should be avoided. This, of course, is easier said than done. Ultimately, the outcome will depend on the honesty and political determination of the reforming government.
- In the selection of buyers, individual or concentrated strategic investors should, other things equal, be preferred to investment funds, holding companies or banks.
- Foreign investors should be allowed to participate in the bidding process. Experience shows that they are usually among the best

providers of capital, technology, and administrative experience, and they are used to operate in a competitive environment. To those who object that this would be tantamount to selling the nation's assets to foreigners the answer should be: first, that countries open to foreign direct investment (such as Canada, Chile, Mexico, Switzerland, and Singapore) have maintained an independent foreign policy; and second, that Cuba's de-capitalized economy will need foreign saving and investment to grow, particularly in the early stages of the reform.

- The share of any single enterprise sold to concentrated outside interest should be well above 50%, preferably above 70 %, so that owners have a strong incentive to pursue long-term profit maximization rather then personal gain at the expense of minority shareholders and taxpayers.

One last question remains: would it be possible for Cuba to follow the example of China and leave the hard task of restructuring the state enterprise sector for later? After all, China managed to avoid the severe contraction that affected most other formerly planned economies and grew very rapidly throughout the period of reform. The answer is that Cuba is not China: it has about 75% of its economy in the non-agricultural sector compared to only one fourth in China. The encouragement provided by the Chinese government to agriculture, services and village-type industries stimulated a very large segment of the economy and allowed the government to achieve rapid overall growth, while postponing the imposition of hard budget constraints on the state enterprise sector.[14] Cuba is more like Russia in this respect. It will have to restructure or eliminate state enterprises to free capital and labor so that new private firms can use these resources.[15] Thus, postponing the problem—a problem that China, incidentally, must still confront in full—does not seem to be a realistic option in Cuba. China also differs from Cuba in two important respects: it has a very high saving rate; and it has allowed a large increase in foreign direct investment inflows from market economies. This is where Cuba should imitate China.

The Problem of Claims on Expropriated Property

One of the most difficult problems confronting the reforming government will be the existence of claims on Cuban state property by previous owners that were expropriated by the Cuban government after 1959.

Claims of Cuban nationals. We deal first with the claims of Cuban nationals, and next with those of U.S. nationals. The claims of previous owners cannot be ignored for ethical reasons, because of the requirements of Cuban law itself, and because of the need to establish the credibility of the reforming government. Furthermore, as long as the problem remains unresolved, there will be adverse confidence effects on private investment, both domestic and foreign, and on the process of privatization.

There are two basic options: *physical restitution and indemnification.* Restitution has a strong appeal from an ethical perspective but it may cause a great deal of discontent among Cuba's residents and damage the popularity of the entire privatization process. In addition, a solution based on restitution will create a degree of uncertainty that will discourage private investment and delay privatization. As pointed out by Locay and Ural (1995): "Transition economies need to privatize quickly. Under a policy of restitution, title to property is not clear. Under indemnification, the resolution of claims can proceed independently of the process of privatization."

The problem with restitution is that the *period of uncertainty* could be long because in many instances the process can be complex and conflictive. Travieso-Diaz (2002) mentions circumstances in which the implementation of restitution may turn into an administrative nightmare or become simply unsolvable: "The property may have been destroyed or substantially deteriorated; it may have been subject to transformation, merger, subdivision or improvement" or it may have become part of a joint venture between the Cuban government and foreign, non-U.S. investors. In the case of residential property and small farms eviction of current tenants may be required, which may be difficult under present Cuban law and politically disastrous (as, for example, in the case of farmland that has become property of small farmers or cooperatives).[16] Nevertheless, it has been argued that, in some cases at least, restitution still may be need to be considered:

- Locay and Ural maintain that state enterprise managers have an incentive to delay privatization and to lobby accordingly. Restitution, they argue, would introduce another set of actors, the former owners, who would lobby for quick privatization. What enterprise managers in Cuba consider to be in their own interest remains to be seen, however. It is quite possible that—like in Russia—Cuban managers will lobby not for delaying enterprise sales, but for quick worker/manager buyouts.

- It has been argued that restitution is better than indemnification because the latter would be more costly to the government in a situation of budget stringency. As Locay and Ural themselves point out, restitution does avoid the need for government compensation payments but it also deprives the government from privatization revenue.

From an economic point of view, the arguments in favor of restitution are not very convincing. Since there are strong practical arguments in favor of indemnification, the best solution may be to offer claimants a menu of non-cash assets including Cuban government securities and privatization vouchers that could be used by former owners to acquire an interest in their former properties if they wish. In that case, and to favor concentrated ownership, the requirement that no more than 30% of the firm be acquired through vouchers could be waived.

Claims of U.S. nationals on expropriated property will have to be considered for all the reasons given in discussing claims of Cuban nationals and, in addition, because U.S law requires resolution of this problem before the embargo on trade with Cuba is lifted and foreign aid can begin anew. The U.S. Administration may be willing to exercise flexibility, depending on the political program and the good will of the reforming government, but there may be a limit. Moreover, considerations of political credibility and investment climate also should prompt the reforming government in Cuba to resolve the issue rapidly. As noted by Travieso-Díaz this could be done in two ways: through negotiations between the Cuban and the U.S. governments; or through a Cuban Claims Resolution Program.

In **government-to-government negotiations,** the U.S. Department of State would negotiate with Cuba on behalf of the U.S. claimants, and the results of these negotiations would be binding on the claimants. Under the Cuban Claims Program of 1964, the U.S. Foreign Claims Settlement Commission certified claims by U.S. nationals amounting to $1.8 billion. With interest added at rate of 6% per annum, the present value of this sum would be $6.4 billion. Travieso-Díaz is right, of course, that the reforming government would be simply unable to pay such a sum, given the need to face other external and internal liabilities and what is likely to be a difficult fiscal situation. However, precedents indicate that similar agreements negotiated by the United States in the past typically involved payments by the confiscating country of considerably less than 100% of the estimated value of claims, and did not include payment of interest. If these conditions were applied to Cuba, the total payment required would be less formidable.[17]

The other alternative would be the **participation of U.S. claimants in a Cuban Claim's Resolution Program,** which of course would require prior consent by both governments and by the claimant.[18] Here again, the main options would be physical restitution and indemnification. For reasons given above in discussing the settlement of claims by Cuban nationals (and to be consistent with the treatment proposed in that case) physical restitution should be eschewed in favor indemnification in the form of government securities or privatization vouchers, a method that worked well in Hungary, for example. Vouchers could be used by U.S. corporate claimants to become shareholders, or even to acquire controlling ownership, in the confiscated enterprise.

IV. Restructuring the Public Finances

The reforming government will face massive demands for a social safety net, the payment of external and internal liabilities (including pensions) and the costs of restructuring the state enterprise sector. In addition, it is essential that the reforming government maintain the record of macroeconomic stability achieved by the present government since the stabilization plan of the mid-1990s. For economic as well as political reasons, the government should avoid rigorously any reliance on payments arrears and the inflation tax. Numerous empirical studies document the relation between output contraction and inflation in the transition countries; and the problem of payments arrears was one of the major headaches of the reformers in Russia. In these circumstances it is imperative for Cuba to build a tax and expenditure system that maximizes efficiency, accountability, and transparency, and that helps to satisfy the state's revenue needs without crowding out the emerging private sector.

Reforming the tax system

Tax reform should be a long-term project as one of the desirable institutional changes, including notably the introduction of a value-added tax (VAT), which couldn't be implemented overnight. Tax reform also should be cautious and evolutionary, as the state cannot afford the risk of losing major sources of revenue in the early part of the transition. It should take into account changes introduced in Cuba since the adoption in 1994 of the Tax System Law (*ley 73)*. Before 1994, state current revenue came almost entirely from four sources: a turnover tax (*impuesto de circulación*), contributions to social security, contributions from state enterprises, and "other" transfers from enterprises, which involved in large measure foreign trade price differentials financed by the USSR (mainly on oil imports and sugar and nickel exports).

As indicated in Table 1, government revenue stagnated `from 1988 to 1993, even in relation to a rapidly falling GDP. Revenue from the turnover tax and revenue associated with Soviet financed commodity price differential plunged, although this was partly offset by a rise in contributions from state enterprises and non-tax revenue –which includes fines, fees, charges for the use of state land by mixed enterprises (notably in the tourist sector) and royalties.

Table 1. Cuba: State Revenue

(In % of GDP)

	1988	1993	1994	2001
Total revenue	**56.6**	**57.3**	**62.6**	**48.2**
"Old taxes"	55.4	45.1	36.2	24.0
Turnover tax	26.9	19.9	13.1	*9.3*
State enterprise contributions	7.1	10.4	10.9	4.4
Other transfers from enterprises*	18.2	9.2	7.9	6.3
Social security contributions	3.2	5.6	4.3	4.0
"New taxes"	--	0.4	9.0	19.1
"Special" excise taxes**	--	--	8.5	*9.0*
Corporate profits tax	--	0.2	0.2	5.5
Personal income tax	--	0.2	0.5	1.1
Other payroll taxes	--	--	0.1	3.5
Nontax revenue	1.2	11.7	17.4	5.1

Sources: Oficina Nacional de Estadística (1991), CEPAL (2000), and author's estimates.
* Includes price differentials in foreign trade, other enterprise contributions and other net external receipts.
** Mostly on tobacco and alcohol.

In 1994, Law 73 introduced new taxes from which combined revenue rose from virtually zero in 1993 to 19 % of GDP (40 % of tax revenue) in 2001. During the same period, "old taxes" fell from 45 % to 24 % of GDP. The new taxes introduced by Law 73 were as follows:

(i) As of 1996, the *tax on corporate profits* was extended from private and mixed enterprises to all enterprises at a rate of 35%.

(ii) "Special" *excise taxes,* mostly on tobacco and alcohol, were phased in, and now account for nearly 20% of current revenue.

(iii) A very progressive *personal income tax* (with a marginal tax rate of 50% for incomes above 60,000 pesos a year) was introduced. However its coverage was and remains very narrow. Wages paid in local currency are exempted, as are, apparently, the confiscatory taxes levied by the government on the salaries paid in foreign currency by foreign enterprises to Cuban workers. The rate on this tax is unknown, (but reported to be as high as 95%), and it is not clear whether or not the proceeds are reported in the budget statistics, and if so how.

(iv) *A tax on the utilization of the labor force,* in principle at a rate of 25%, but subject to rebates on the regular social security contribution, and to exemptions, notably for joint ventures.

(v) A new sales tax was created to be levied on agricultural markets and industrial fairs, with tax rates differing sharply according to the province.

Lorenzo Pérez rightly concludes that the tax reform of 1994 was a significant step in the right direction even though its implementation has been very gradual. He is also right in that most taxes still suffer from arbitrarily narrow tax bases and are riddled with exemptions that diminish buoyancy, weaken incentives to work, and distort resource allocation. The recommendations that follow aim mostly at resolving these problems.

- For the medium term, replace what remains of the turnover tax by a *value added tax* with a unified tax rate and no exemptions by type of payer or by commodity, except possibly a general exemption for food as an anti-poverty device. The VAT demands a careful and relatively long preparation, but since there is some urgency in eliminating the turnover tax the work should begin immediately.
- For efficiency reasons, and to reduce the revenue losses stemming from tax rate cuts, *exemptions and tax preferences of all kind should be eliminated from the system.* This will also diminish lobbying, corruption and rent seeking.
- The marginal *tax rate on personal income* is too high and discourages work effort; it also involves exemptions that discriminate against the private sector and the self-employed. Tax rates should be considerably reduced and applied to all incomes above a certain threshold (to avoid taxing the very poor). The tax should be extended to all salaries and wages but, in the case of state enterprise workers, brackets should be reviewed after exchange rate and price liberalization to avoid an overly severe effect on after-tax wages.

- The various *payroll taxes* are too high for those who pay them, thus weakening the demand for labor. But many do not pay these taxes because of various exemptions, thereby introducing widespread distortions There should be a leveling of the playing field combined with a substantial lowering of the top tax rates.
- At present, Cuba's provinces have no taxing authority and their deficits are covered by central government transfers. Provinces could be allowed to raise revenue from property taxes and certain excises. As a counterpart, provincial deficits should be subject to statutory limitations.

Reforming tax administration.

The reform of tax administration began in the second half of the 1990's with the creation of the National Office of Tax Administration *(Oficina Nacional de Administración Tributaria, or ONAT*). This office appears to have worked well and should be reinforced as the new round of tax administration reform proceeds. ONAT already has taken steps in the right direction: it has improved the registration of enterprises in all sectors of the economy (state, private and mixed enterprises as well as cooperatives) and significantly increased the number of persons (including among the self employed) that have been provided with a tax identification number. More recently, tax forms have been revised and simplified, tax audits have become more widespread and, most importantly, a *large taxpayers'* unit has been established within ONAT.

Restructuring government expenditure.

As indicated in Table 2, government expenditure continued to rise during the first stage of the "special period", as the government sought to protect social spending while increasing sharply subsidies to loss-making state enterprises. The state budget deficit surged from less than 7% of GDP in 1989 to 30% in 1993, but this trend was reversed by the stabilization program and spending dropped from almost 90% of GDP in 1993 to 50% in 2001—still a high share by international standards. This time all categories of expenditure fell in relation to GDP, including social spending and capital formation, and there was a 28-percentage point reduction in subsidies to cover state enterprise losses—an astounding number, even by the standards of post-communist transition countries. As a result, the fiscal deficit plunged and so did the excess supply of money that had been accumulating in private hands since the late 1980s.

A strong case for additional cuts in government spending remains, even if the large reduction registered since 1993 is taken into consideration, for the following reasons:

- To reduce the absorption of saving by the government and help the much needed crowding in of business fixed investment.
- To avoid a rise in the fiscal deficit with its likely adverse implications for the money supply and inflation, at a time when tax revenue from certain sources (income and payroll taxes in particular) may need to be lowered to provide appropriate incentives to the private sector.
- To protect social services and to finance the new unemployment insurance fund.
- To clean up the balance sheets of certain state enterprises and banks. This would apply to firms that had been adversely affected by government-imposed social obligations and distortions (resulting, for example from price controls or the dual exchange rate system).

Expenditure reduction will be facilitated by price decontrol and enterprise reform. As shown in Table 2, these actions will allow cuts in subsidies estimated in 2001 at $8\frac{1}{2}$ % of GDP (almost 17% of total state expenditure). In addition, it may be possible to reduce military expenditure (other than pensions and salaries) and to eliminate budgetary support for the Cuban Communist Party and other political organizations.

Should the current supply of social services and the existing degree of equality be maintained?

There is a widespread view that any reforming government will have to satisfy the aspirations of the Cuban people with regard to (i) the provision of public goods and services and (ii) the maintenance of the degree of social and economic equality achieved by the present government.

Table 2. Cuba: Government expenditure*

	1989	1993	1994	2001	Change 1993-2001
	(In percent of GDP)				
Total expenditure	**66.9**	**87.7**	**69.6**	**50.5**	**-37.2**
Subsidies to enterprises	16.7	37.1	20.7	8.6	-28.5
Subsidy for losses	12.8	32.7	16.9	1.3	-31.4
Subsidy for price differentials	3.2	4.4	2.5	6.1	1.7
Other subsidies	0.7	0.0	1.0	1.1	1.1
Support to cooperatives (UBPCs)	0.0	0.0	0.3	0.2	0.2
Social outlays	17.5	23.5	19.3	19.4	-4.1
Education	7.9	8.3	6.6	7.6	-0.7
Health	4.3	6.5	5.2	5.8	-0.7
Social security	5.3	8.7	7.5	6.0	-2.7
Capital formation	14.7	12.3	13.2	6.4	-5.9
Other outlays	18.0	14.8	16.4	16.1	1.3
Memo: Fiscal balance (deficit -)	-6.7	-30.4	-7.0	-2.4	28.0

Sources: Oficina Nacional de Estadística (2001), CEPAL (2001), and author's calculations.
* Includes central and provincial governments.

There is indeed considerable anecdotal and survey evidence that most Cubans wish to retain some of the social benefits that they now receive (pensions, education, health). In a 1998-99 poll of Cuban exiles in the United Sates, 90 % and 71% of the respondents believed that free services for education and health, respectively, should be maintained after the transition.[20] Clearly, the reforming government will have to take these indications into account, for both ethical and political reasons. But the immediate task may not be as hard as is may appear at first sight. First, combined spending on education, health and social security dropped from

23.4 % of GDP in 1993 to 19.4 % of GDP in 2001, as shown in Table 2.

Second, restructuring budget revenue and expenditure along the lines indicated earlier in this section should help to maintain the provision of public goods and services at current levels, provided these are well targeted (Cuba cannot afford social services for the rich) and efficiently delivered. It should be clearly explained to the public, however, that someone has to pay for these social outlays. It used to be the Soviet tax payer; now it must be the Cuban tax payer.

Not surprisingly, the survey evidence indicates much less support for the maintenance of the "existing degree of equality" than for the continuation of social services. Cuba, in fact, is a country with profound and growing inequalities with regard to disposable income, wealth, and access to public goods and services, coupled with regional and racial inequalities. In his most recent book (2003), on which much of this sub-section is based, Mesa-Lago explains the many sources of inequality and, in spite of the paucity of official data, goes on to provide rough but credible estimates of their magnitudes.

- **Real wages** in the state sector fell by about 37 % from 1989 to 2000 while they rose in the private sector. In fact, the dispersion of public sector wages may be higher than suggested by the official wage statistics, because beginning in 1994 the government started paying bonuses in dollars to employees in certain sectors (i.e., mining, electricity). For 2002, Mesa-Lago estimated that monthly wages in the state sector ranged from 200 pesos (teacher at starting level) to 700 pesos (senior officer in the armed forces). In the private sector wages ranged from 520 pesos (for low paid domestic servants) to 50,000 pesos (for certain agricultural producers) and up to 50,000 US$ for internationally known artists and performers.

- Approximately 6.7 million Cubans (about 60 % of the population) received US$ 813 million in **private remittances** from families and friends abroad in 2001. This represents an annual average of US$121 per recipient, or a little more than the *average* monthly salary paid in the state sector.[21] Thus, even if he is unemployed, the average recipient of transfers makes at least as much as the average wage earner and some recipients probably earn much more. Anecdotal evidence also suggests that the size of the remittances declines substantially the further the recipient is from Havana, the Province with the highest income per capita.

- Although there is little statistical information on private balance sheets, the breakdown of bank deposits by size suggests that there has been a growing **inequality in the distribution of wealth** in the 1990s.

Budget procedures and controls

The Cuban authorities have sought to improve budget control and preparation with actions ranging from the improvement of accounting procedures to the training of personnel to prepare macroeconomic forecasts. There is little recent information, however, on how much progress, if any, has been achieved in building a **Treasury** within the Ministry of Finance. Treasury systems help governments manage their resources by providing payments processing, accounting, reporting, and financial management services. (See Potter and Diamond, 2000). Ideally, these services are provided on a fully integrated and automated basis, ultimately covering not only the accounts of the Ministry of Finance but also those of other government agencies and ministries. The Treasury concentrates financial resources in a Treasury Single Account (TSA) with the central bank. The IMF has extensive experience in creating treasuries in transition countries, and its assistance in this area would be invaluable.

An important task of the Treasury will be to ensure that extra-budgetary funds, i.e., funds not approved as part of the budget process, are fully integrated within the TSA and ultimately phased out. Before transferring their operation on budget, (or eliminating them if appropriate) the Treasury will have responsibility and authority to audit these funds and, in cooperation with the independent Accounting Office and the appropriate law enforcement agencies, to investigate their operations. If warranted, the Treasury will coordinate efforts to recover government assets unduly placed abroad, and will help to prepare for judicial action.

V. Reforming and Creating Financial Institutions

Before 1997, Cuba's banking system was rudimentary. It comprised three institutions only: the National Bank of Cuba, which acted as the country's central bank and monopolized corporate banking activity; the Popular Saving Bank which took deposits from and lent to the household sector; and the International Financial Bank which operated in freely convertible currency. The payments system was inefficient (in the words of the current President of the Central Bank himself), the level of automation of transactions was very low, and payments among individuals were conducted in cash. There was no money market, and the intensity of rationing in goods market resulted in the accumulation by households of a monetary overhang. In those circumstances, as was typical in centrally planned economies there was virtually no role for monetary policy. The financial system will need a second generation of reforms. Before that, however, the authorities will have to make a crucial choice on the type of exchange rate system that will follow unification.

The Exchange Rate System

In the first half of the 1990's, fixed exchange rate regimes became popular as ways to "anchor" domestic monetary policy to the policy of a key currency country—presumably one with low inflation like the United States or Germany—and thus gain credibility for a domestic anti-inflationary policy. The idea was carried one step further by proponents of *currency boards*—institutions that tie domestic monetary expansion rigidly to changes in international reserves, thus fixing the exchange rate (allegedly "forever"), and eliminating the need for a central bank. These institutions have worked fairly well in small transition countries with a disciplined fiscal policy, like Estonia and Latvia. However, in larger countries that were unable to keep fiscal policy under control, both currency boards and pegged exchange rates failed to deliver the promised improvement in credibility and ended up provoking a severe financial crisis.[23]

What was shown recently in Argentina, and in the 1990s in Mexico, Russia, and some of the East Asian countries is that credibility cannot be acquired simply by creating an "institution". Credibility must be *earned* by pursuing consistently disciplined policies, and most crucially fiscal policy. It also became clear that the illusion of a perpetually fixed exchange rate could be dangerous in a world of high capital mobility, particularly if there are doubts about the government's ability to avoid payments arrears and excessive monetary financing. And there will be doubts in the case of Cuba, particularly early in the reform process. By contrast, a *managed float* will give the country some seignorage, retain a central bank that will be needed in any event to enforce banking regulation and supervision, and will provide a limited degree of flexibility in monetary policy. A floating peso will also eliminate the need to calculate the initial "equilibrium" real exchange rate, which nobody really knows how to do anyway. Last but not least it will give the authorities time to demonstrate fiscal discipline and build up the credibility of the fiscal and monetary authorities. To conclude, at least for the short term, the Central Bank of Cuba, like the Bank of Canada and the Bank of Mexico, should pursue a policy of managed floating.

The Central Bank

The financial reform of May 1997 created a separate and genuine central bank out of the old, undifferentiated, National Bank of Cuba. Looking forward, the Central Bank of Cuba (CBC) should be the sole institution in charge of formulating and conducting monetary policy which, in turn, would aim "to achieve a non-inflationary sustainable growth"—a quote from CBC President Soberón Valdéz with which it is hard to disagree. To avoid compromising this objective, and in particular to discourage any thought of large-scale monetary financing of the fiscal deficit, the central bank should be strictly independent. This would help establish the credibility of monetary policy and promote a degree of exchange rate stability, even within the proposed managed floating system. It would help if independence was guaranteed by law, and even by the Constitution, but this would not be enough. The respect for the independence of the central bank will remain the moral responsibility of the government and the symbol of its commitment to serious management of state affairs as opposed to political expediency. No institutional gimmick can substitute for the integrity of political leaders, which in turn will hinge on the exercise of the people's civic duties.

Initially, the instruments of monetary policy would be crude: (i) control of banking system reserves through statutory requirements (which already exists) and (ii) management of the discount window including through changes in the discount rate. As soon as a Treasury bill market can be organized, the central bank would keep its discount rate within a narrow band around the Treasury bill rate. As soon as the market reached sufficient depth, the CBC would begin operating through outright sales/purchases of bills and then through repurchase agreements. Throughout this process, technical assistance from North American central banks would be most useful. It should be stressed that under no circumstances should the central bank provide subsidized credits to specific enterprises or banks, as this would derail efforts to impose hard budget constraints on enterprises. While it would not be too risky for the central bank to finance fiscal deficits of the magnitude registered in the late 1990s (2 to 2½ % of GDP), the medium term objective should be to eliminate central bank financing to the government—which, in principle, is specified by current Cuban law—including indirectly through other financial institutions.

In addition to its responsibility in the area of monetary policy, the CBC should remain in charge of bank supervision and regulation, an area where some progress appears to have been made since 1997. In a relatively small country like Cuba, there does not appear to be a need for multiple regulatory institutions, although it has been argued that institutional redundancy could help to limit corruption. The CBC should also be a member of an intergovernmental task force, including the Ministries of Finance and Interior and the relevant law enforcement agencies, to investigate and avoid financial fraud, including money laundering. As indicated earlier, the central bank will collaborate closely with other government agencies and concerned line ministries in a number of important areas including privatization and external debt management.

The Banking System: Privatization and Restructuring

In addition to creating a separate central bank, the reform of May 1997 retained the National Bank of Cuba as a commercial state bank concentrated in foreign trade activities, and the Popular Saving Bank, which was granted a license to operate as a universal bank. The new law also created 14 new financial institutions: an investment bank, a universal bank (The Bank of Credit and Commerce), a foreign trade bank, (the International Trade Bank) a service bank (the Metropolitan Bank), and 10 non-banking institutions (including a network of exchange bureaus, a trust company and 8 financial companies). In addition, 14 foreign financial institutions were given a license to open representative offices in Havana. This reorganization was accompanied by the beginning of a process of automation, the introduction of credit and debit cards, and a 25% reduction in banking system personnel.

The reform of 1997 was undoubtedly important and useful, but the process of modernization appears to have been slow. For example, Soberón Valdéz (1998) indicated that exchange bureaus operated 86 points of sales and that 75 teller machines would be operating at the end of 1999. These are very small numbers for a country with a population of 11 million. Moreover, the liability side of the banking system's balance sheet remains rudimentary. Even though time deposits in pesos and in freely convertible currencies have been authorized, they appear to account for a very small fraction of total bank liabilities, which remain overwhelmingly in the form of demand and saving deposits. And while the structure of interest rates has become gradually more diversified since 1997, it remains rigid and subject to administrative control. The time has now come for a new financial reform law, which should have three elements: *deregulation, privatization, and free entry.*

Deregulation should apply both to the instruments that banks are allowed to offer (in terms of liquidity characteristics, maturity and denomination) and to the corresponding interest-rate structure. Interest rate controls should be phased out and banks should be allowed to set rates freely and competitively; indeed they should be required to do so under the relevant anti-monopoly and pro-competition laws and decrees. This will be needed to avoid collusion and to ensure that the banking system evolves in the direction of satisfying the demands of households and enterprises. Qualified banks will be allowed to accept offshore deposits and make offshore loans subject to strict limits on their net foreign currency positions.

Banking system **privatization** should proceed *pari pasu* with deregulation. Most of the recommendations provided above for the privatization of non-financial state enterprises should also apply to banks, including the preference for direct sales to concentrated strategic partners. The full benefits of deregulation should be extended only to those banks that have been fully privatized and to newly created private banks. Deregulation will be managed gradually in the case of banks that may need to be restructured before they are privatized. The long and painful experience of many developing countries suggests that the establishment of government-owned development banks is not advisable. However, the apparently good record of an efficient and honest pre-revolutionary official development institution suggest that judgment may have to be suspended until the issue can be thoroughly discussed.

Free entry. The creation of new banks will no longer come at the initiative of the central bank or any other government agency. New financial institutions, including banks but also brokers and insurance companies, will be allowed to enter the financial system as long as they meet with the conditions required by existing laws and regulations. Should this also apply to foreign banks? President Soberón Valdéz (1998, page 11) said that the CBC's strategy was "Not to grant licenses to branches of foreign banks considering the weakness of the national financial institutions, the need to maintain tight control over our scarce resources and the lack of a consolidated legal infrastructure and supervisory skills." To be sure, the "weakness of national institutions" and the lack of "legal infrastructure and supervisory skills" are serious problems, but they can and should be remedied with central bank support. As for the "need to maintain tight control over our scarce resources," it cannot be satisfied through administrative controls. If we have learned anything from the emerging market crises of the past decade it is that capital flight and instability can only be avoided through sound monetary and fiscal policies and strong supervision of financial institutions by the central bank.

Creating other financial institutions. An important characteristic of the Cuban financial system is the inexistence of freely functioning financial markets. Of the highest priority will be the creation of a secondary *market for vouchers* and voucher funds, which will be needed as part of the privatization process. Reform in other areas, albeit not of the highest degree of urgency, should start fairly rapidly at the short end of the maturity structure.

- *A Treasury bill market* will help the government manage its short term financing needs and create an invaluable instrument for the conduct of monetary policy by the central bank. It should serve both as a market where the Treasury can issue bills and as a secondary market where banks, pension funds and individuals, as well as the central bank, can buy and sell these securities. The interest rate on T-bills should be freely determined by supply and demand, including open market operations by the central bank. Technical assistance should be sought at an early stage, particularly from the U.S. Federal Reserve System and from the IMF.
- An *inter-bank money market* would give banks considerable flexibility in managing their reserves and help them to arbitrage interest rates. Consideration could also be given to a market for bank certificates of deposit—CDs already exist but they would have to be made negotiable.
- With privatization and the creation of new industries, the need for a *stock market* eventually will become apparent. While the government can provide encouragement and should provide the regulatory framework, the momentum for creating an equity market will have to come mainly from the private sector.

VI. Managing the State's Debts

Problem and Strategy

Cuba faces an enormous burden of external debt. The government reported external obligations of almost $11 billion at end 1991, one half of which was to official bilaterals, one-third to private financial institutions, and most of the rest to suppliers. At nearly $1000 per head, this made Cuba one of the most heavily indebted countries in the world. In addition, Cuba owes, but refuses to pay, a large sum to the Russian Federation. This sum, variously estimated between $15 billion and $20 billion, represents debt previously contracted with the former Soviet Union.

There is little point in arguing whether Cuba's debts to Russia are or are not morally justified. (This author believes that they are not.) However, the point is that those debts, just or unjust, are legally liabilities of the Cuban State and not just of the government that happens to be in power. It is also important to recognize that Russia is a member of the Paris Club, both as a creditor and a debtor. Therefore, Cuba will not be able to restructure or reduce debts with official bilateral creditors at the Paris Club, or to conclude arrangements with the IMF or the World Bank, unless it begins serious negotiations with Russia. At the same time, Cuba's debt to Russia could be substantially reduced through bilateral negotiation (as had occurred in the case of Russia's claims on Nicaragua, Peru and many African countries). More generally, Cuba's external debt to all creditors could be significantly reduced through Paris Club rescheduling, unilateral forgiveness, London Club negotiations, and through debt reductions mechanisms such as the Highly Indebted Poor Countries (HIPC) initiative administered by the World Bank and the IMF.

The conclusion of this discussion is twofold. First, Cuba will have to join the IMF as soon as possible, something that will require help from the United Sates and other friendly members of that institution. Without membership in the IMF there is no access to the World Bank, and no Paris Club rescheduling. This underscores the need to create a small but high-level commission to centralize negotiations with the Bank, the Fund, and other international organizations. Second, the government should create a well-staffed agency to conduct international debt negotiations.

The Agency for the Management of the External Debt

The reforming government should create immediately a high-level, semi-autonomous agency under the supervision of the Governor of the Central Bank and the Minister of Finance—a proposal previously enunciated by Luzarraga (1995), among others. It would work in close cooperation with the Treasury and other relevant state institutions. The Agency will:

- conduct all external debt negotiations.
- monitor key aspects of the external debt situation including the daily schedule of amortizations and interest payment in light of

the availability of international reserves, and the surveillance of all government ministries and agencies to avoid any unwarranted accumulation of new debt and the emergence of new arrears.

- serve as an advisor to the government on the appropriate level and composition of the foreign debt, taking into account prospective debt-service estimates and the international outlook, particularly for world interest rates. The final decision on new government loans exceeding a certain threshold will have to be taken by the government on a case-by-case basis. The agency will be responsible for the strict monitoring of these loans, and the immediate reporting of possible debt-servicing difficulties.
- The drawing, on an urgent basis and in cooperation with the Agency for the Management of State Assets, of a plan to separate the foreign liabilities of the government from those of the state enterprises.

It is clear from the description of the Agency's responsibilities that it will need to have access to the high-level financial specialists, nationals and foreigners, including those currently operating at the CBC. But something similar was said of the Agency for the Management of State Assets and other key institutions. This underscores the difficult trade-offs that will confront the government in the early stages of the transition between the speed and quality of reforms and the need for a strong fiscal policy. It also indicates that financial and technical assistance on the external debt by friendly governments and international financial institutions will be important and welcome, including assistance to pay contracts with foreign advisors. While the agency will have to be well staffed, it does not need to be in charge of all the governmental activities concerning the external debt situation. For example, data collection and preparation, and much of the background analysis could remain in the hands of the Ministry of Finance and the Central Bank of Cuba, or other agencies.

VII. The Agricultural Sector

Agriculture is an important but not a predominant activity in Cuba. In 1990, employment in the agricultural sector (defined to include narrowly defined agriculture, forestry, hunting and fishing) accounted for 24% of total employment. This compares to 71% in China, and 13% in Russia.

The Agrarian reforms of 1959 and 1963 transformed Cuban agriculture into a predominantly state-owned sector where large farms using very high levels of input per worker were subject to a centralized and vertical administrative and command structure. Using Burchart's (1992) expression, privately owned *latifundios* were replaced by state-owned *latifundios,* and farmers, converted into salaried workers operating with heavy doses of machinery and equipment, fertilizers, and scientific/technical inputs. Shortages of labor were dealt with by (mostly compulsory) mass mobilization of urban workers. This new model of agricultural production did not work. The yields and output levels that had been predicted did not materialize, and many state farms had to be subsidized by the state budget. Moreover, beginning in 1972 Cuba became part of the "socialist international division of labor" which called on her to specialize in the production and export of sugar and citrus fruits, while cereals and other foods were largely imported.

The severe problems of state-owned agriculture were compounded when, beginning in 1989, Soviet aid began to disappear. Already in 1992, inputs had declined to about 25% of their levels during the 1980's, labor shortages were becoming more acute, and there was a growing dependence on imported foods and an erosion of discipline in the state-owned sector: By way of example, the state distribution system received only about one third of production with one third remaining in the agricultural sector and another third going to the black market.

In September 1993, the government introduced a seemingly radical reform of the agricultural sector. More than 1,500 state farms and agricultural enterprises were transformed into cooperatives, including notably the **Unidades Básicas de Producción Cooperativa (UBPCs)**, with the aim of increasing output and productivity, reducing the excess demand for labor, cutting costs and eliminating state subsidies. About 40% of the agricultural land was loaned indefinitely to the UBPC's. With other cooperatives and private farms also growing, the proportion of agricultural land held by the non-sate sector, including private farmers and all types of cooperatives, rose to about two thirds in 1995. Some concluded that Cuban agriculture had been effectively privatized. Others, like Burchardt (2000) disagreed. While the reforms reduced the average size of farms significantly, they failed to bring about the profitability of the UBPC's, and the sector continued to require budget support. What went wrong, basically, was that the creation of the UBPC's was not accompanied by an appropriate reduction in the role of the state in the agricultural sector.

The transformation of state farms into agricultural cooperatives in 1993 and the legalization of **Agricultural Markets** (*Mercados Agrícolas*) in 1994 were important, albeit partial steps toward the transformation of Cuba's agricultural structure. Agricultural Markets have played an increasing role: although they are theoretically a *residual* supplier (i.e., they sell amounts in excess of those required by Ministry of Agriculture quotas) they are reported to account for as much as 60% of the daily caloric requirement in the City of Havana. The opening of Agricultural Markets caused the price of many foodstuffs to decline and, unlike the preexisting black markets that operated predominantly in dollars, they conduct sales in pesos thus making surplus production available to the entire population. Last but not least, the shift toward the private and cooperative sectors helped non-sugarcane food production recover from its depressed levels in 1994. (See Messina, 1999).

In spite of these successes, the overall results of the reforms were disappointing, particularly in the sugar cane sector, and some UBPCs have continued to require state support. Most of the sector's problems appear to reflect the failure to complement the transfers of ownership with a policy of reduced government involvement and encouragement to the new cooperatives.

- **The harmful effects of price controls on farm output.** UBPC's must sell a share of their output at state regulated prices which are well below free or black market prices, thus distorting resource allocation and reducing the profitability of the cooperatives. In 1994, the government authorized the UBPC's to sell in free agricultural markets that part of their production in excess of the quotas set by the Ministry of Agriculture's purchasing agency (*Acopio*). That was a step forward. However, inasmuch as the government continued to maintain de *facto* quotas in favor of the state, and that these quotas were subject to controlled prices, the profitability of UBPC's continued to be adversely affected.

- **State influence over the price and allocation of inputs.** UBPCs and other agricultural producers were also affected by price controls on supplies and materials, machinery, fertilizers, and other inputs. It is difficult to determine exactly how these controls affected the profitability of farms. According to Burchardt, however, "the State acquires the products of the UBPC's at low prices while it sells supplies and inputs, as well as services, at high prices." (Burchardt, page 68) Thus, the state operates as a monopsonist in the provision of inputs, and in that sense the system resembles those of neo-colonial cotton enterprises in some West African states. There are also allegations of discrimination by the Ministry of Agriculture in terms of the provision of inputs (including fertilizer, tools, transportation and warehousing), with higher quantities and better quality of inputs being assigned to state farms at the expense of cooperatives.
- In principle, the UBPC's have a large degree of autonomy in decision-making. In practice, **state intervention in the affairs of cooperatives** has remained pervasive and has limited the managerial autonomy of the farms. This has involved. *inter alia*, intimidation of Cooperative leaders by Ministry staff and by members of the official *ANAP*, or National Association of Small Producers. Alvarez (1999) thoroughly documents these problems with regard to the small, but vocal and efficient, Independent Agriculture Cooperative Movement born in 1997.

In conclusion, the UBPCs have not attained their objectives of raising productivity, providing incentives to increase output, reducing the excess demand for labor in Cuban agriculture, and lowering Cuba's high dependency on food imports. Some of the UBPC's problems will be resolved by breaking the state's monopsonistic position. In particular, price and exchange rate liberalization will take care once and for all of the central problem of price distortions; will probably help some of the cooperatives to become more profitable, and in some cases to compete with foreign production. In other cases liberalization will reveal the incapacity of some farms to survive without subsidies Government pressures and intimidation of UBPC personnel should cease, and cooperatives should be free to sign contracts with any buyer without obligation to provide preferential access to the state purchasing agency. Government support should be phased down, with any remaining subsidy clearly justified by externalities or as compensation for costs previously and unjustifiably imposed by the state. If profitability cannot be re-established, the UBPC's will have to be privatized.

VII. Other Sectors

The External Sector

Direct investment flows have been on an upward trend in Cuba since the early 1990s, peaking at an average of more than $700 million per annum in 2000-01. It should be noted that these are official balance of payments numbers reported by the Cuban authorities, and that various analysts report much lower numbers.[24] However, there does not appear to be any good reason to reject the balance of payments numbers. Still, on a per capita basis these flows are small compared to those registered in the countries of central Eastern Europe and the Baltics. The importance of allowing foreigners to participate in the privatization process has already been noted. In the same spirit and for similar reasons, obstacles to foreign direct investment in general should be abolished, with the exception of those related to the control of organized crime.[25] The authorities have made some progress in this area, as foreign direct investment has been selectively liberalized; Spain, Canada and Italy are presently the major sources of foreign direct investment. The reforming government should open-up the economy to investors of all countries, including the United States.

On **trade policy,** it will be important to eliminate import quotas, permits, and other administrative import controls, which have been used with greater intensity since 2001 because of shortages of foreign exchange, and replace them with a unified and a relatively low tariff with no preferences or exemptions. This would reduce distortions while maintaining a source of easily collectible government revenue. Cuba is a member of the World Trade Organization, and any trade policy action will have to be consistent with Cuba's obligations under this institution. The reforming government will ask the United States to lift as soon as possible the embargo on U.S. trade with Cuba (which should have a modest positive effect), and all restrictions on travel to Cuba by U.S. residents (which could have a significantly favorable impact on Cuba's tourist receipts. It will also ask the United States to eliminate any ceiling on remittances by U.S. residents to Cubans residing in the island.

Education

A discussion of Cuba's educational system would go well beyond the scope of this paper. However, there is an aspect of education that is important to the development of a healthy market economy and that will have to be tackled in due time. As reported by Madrid-Arris, (2002) Cuban tertiary education has favored systematically the education of physicians and teachers at the expense of, business managers accountants, and economists. Clearly, the rationale for this asymmetry is political: the desire to advance the educational and health objectives of the government, which have been an important part of official efforts to show a "progressive" and "human" image of Cuba worldwide. It has also reflected Fidel Castro's contempt for business sciences in general. One can agree or disagree with this orientation, but two points seem undisputable. First, the educational system of the future will have to be one that the country can afford. Second, as underscored by Madrid-Arris, the educational system of a developing, market-oriented economy must supply the professionals that are in high demand in the labor market, in order to contribute to overall growth. Cuba cannot afford to maintain the existing excess supply of schoolteachers and doctors via government subsidies.[26]

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END NOTES

[1] Edward Gonzáles lists a number of possible successor transition regimes: communist regimes led by hard-liners, by centrists, or by reformers, a military-led regime, and a democratic regime.

[2] A scenario involving domestic violence would make the transition much more difficult, among other things because it would deter private foreign investment and seriously affect the tourist sector.

[3] For a more complete treatment of the 1993-94 policy package and its effects on the Cuban economy, see Pérez-López (1995) and Hernández-Catá (2000).

[4] This is currently a part of what is now called the *Ministry of Finance and Prices.*

[5] See for example Gelb, de Melo, Denizer, and Tenev (199) and Hernández-Catá (1997).

[6] See Hernández-Catá (2003).

[7] Tunneling refers to the practice of expropriating (typically by managers) part of the income or the assets belonging to the state or to minority shareholders. It may take the form of supplying inputs, or selling assets, at below market prices, ("transfer pricing") or transferring regularly certain sums to another company without real counterpart. Tunneling has been detected in many countries, including developed countries, but it has been particularly pervasive in some transition economies, including the Russian Federation. Unlike theft, tunneling is generally not illegal and it is subject to vague legislation that complicates judicial action. Tunneling is often associated with capital flight.

[8] Another striking historical example is that of East Germany in the 1990's. In spite of major institutional advantages, the initial contraction experienced by the East German economy was more severe than in most other transition countries because exchange rate and wage policies pursued in the context of German unification severely damages its competitiveness.

[9] Based on official budget estimates for 1992.

[10] The problem in Russia was that the government had spoken for some time of price liberalization and had forecasted very large increases for some products. This fueled speculative purchases of consumer and producer goods in anticipation of decontrol, resulting in severe shortages. When liberalization was finally implemented, on January 1st, 1992, some prices surged in line with expectations but then came down rapidly as market participants realized that their expectations had been exaggerated.

[11] How exactly will the devaluation affect the real exchange for each product and therefore the profitability of each producer is very difficult to determine in

advance, because the simultaneous occurrence of output and input price liberalization together with the devaluation of the official peso exchange rate will mean different outcomes for different producers. The important thing is that the new price structure will improve resource allocation. As for the current account of the balance of payments, what matters is the difference between aggregate output and aggregate expenditure. The former should rise owing to privatization and other structural reforms, and the latter should soften as a result of restrained macroeconomic policies. On both counts, the current account balance should improve.

[12] The World Bank (2002) reports that the share of employment in small enterprises (taken as a proxy for new enterprises) in Belarus, Kazakhstan, Russia and Ukraine ranged between 10% and 20% in 1998. By contrast, this share was about 50% in a group of leading reformers comprising the Czech Republic, Hungary, Latvia, Lithuania and Poland—about the same share as in the European Union.

[13] Only a part of these services is included in the state budget under the heading of "contributions from enterprises". (See Table 1).

[14] China did, however, exercise tight political control on asset stripping, albeit not with complete success.

[15] See Hernández-Catá (1997), for a theory of transition as a gradual shift of resources from "old" to "new" enterprises. The growth of "new", efficient enterprises is facilitated, with a lag, by the liquidation of "old", inefficient, enterprises. The lag reflects the time it takes to restructure the capital released by "old" enterprises—with "capital" being interpreted broadly as including not only machinery and equipment but also structures, marketing, training of labor, and output quality and design.

[16] Travieso-Díaz suggests that these cases could be handled through *substitutional restitution,* i.e., "the transfer to the claimant of other property, equivalent in value to the one confiscated."

[17] The experience of similar negotiations between Cuba and non-U.S. foreign countries indicates similar features. For example, Spanish claims on Cuba were estimated at $350 million but only $40 million were ultimately paid by Cuba, and that was 6 years after the settlement. By way of illustration, if these parameters were applied to the U.S.- Cuban case, payments by Cuba would amount to $206 million.

[18] Travieso-Díaz suggests a third alternative: direct negotiations between U.S. claimants and the U.S. government. While this method could make some sense in the context of large state enterprise sales to strategic partners, it may well cause a serious problem of perceived conflict of interest.

[19] The turnover tax is based in part on the difference between regulated wholesale and consumer prices. With full price decontrol, this method would become

meaningless and it would be virtually impossible to operate the turnover tax.

[20] University of Florida poll. For the results of this and other surveys see LeoGrande (2002).

[21] Peso figures are converted into U.S. dollars at a market exchange rate of 26 pesos per dollar.

[22] Among the serious accounting problems of Cuba's budgetary system was the use by some sectors (including sports, health, and the armed forces) of entrepreneurial activity to cover their deficits, the accounting of certain budgetary activities on a net rather than a gross basis, the distortions introduced by the dual exchange rate system and the failure to include debt service due but not paid on some external liabilities.

[23] Many of these problems also apply to a system of *full dollarization* except that in that case the ultimate risk would be a crisis of arrears instead of a foreign exchange crisis. As in the case of currency boards, elimination of the central bank would result in the loss of seignorage and of the institution in charge of bank supervision and regulation. Moreover, dollarization could be politically unpopular and should not be introduced without a popular referendum on whether the demise of the national monetary symbol was acceptable to the population.

[24] See, for example, Cruz (2003), page 1 and endnote 1, page 26. CEPAL, however uses numbers that are close to those published in the official Cuban statistics.

[25] Foreign investments exceeding a high threshold will be subject of a time-limited investigation, in cooperation with their home country's law enforcement agencies, concerning the integrity of their management and the existence of any criminal record. The reforming government cannot afford to have important segments of the economy fall in the hands of drug cartels or other international criminal organizations.

[26] This excess supply explains why Cuban doctors and teacher are found all over sub-Saharan Africa, from Zimbabwe to Namibia—an interesting aspect of Cuba's *internacionalismo*.

About the Author

Ernesto Hernández-Catá, a Yale Ph.D., teaches economic development and growth at The Paul Nitze School of Advanced International Studies, The Johns Hopkins University, Washington, D.C. For about 30 years he worked for the International Monetary Fund where he held a number of senior positions including Deputy Director of Research in charge of the *World Economic Outlook,* head negotiator with Russia, and Deputy Director of the Western Hemisphere Department. When he retired from the IMF in 2003 he was Associate Director of the African Department and Chairman of the Investment Committee of the *Staff Retirement Plan.* Previously he had served in the Division of International Finance of the Federal Reserve Board, and taught macroeconomics at The American University.

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