BROOKINGS

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Can Raúl Castro Revive Cuba's Private Sector?

With Raúl Castro's selection as president of Cuba, the post-Fidel era has begun. Raúl has affirmed that the country will remain on the Socialist path. But during his tenure he is likely to face growing pressures to reform to the Cuban economy.

Above: Newly elected President Raul Castro greets the crowd in Santa Clara, Cuba. Reuters/ Rafael Perez

Many observers predict that Raúl Castro will follow the Chinese model of gradual reform rather than the "shock therapy" pursued by the former socialist countries of Eastern Europe and the Soviet Union. But the reforms pursued by China may be ill-suited for an island nation of 11 million with a relatively small agricultural sector, located a half-hour's flight from the world's largest economy. Without rapidly reforming its inefficient state enterprises, Cuba may face the prospect of becoming trapped in a low-wage, low-productivity cycle. To avoid this, Cuba should embrace some of the lessons from successful Eastern European reformers.

No single U.S. move would have a greater impact on the direction of Cuban reform than the lifting of travel, trade and financial restrictions. Although Washington's options are severely limited by the current political-economic mood in Latin America, the United States can clear a path for a reformist Cuba to seek its own solutions and to understand the tradeoffs involved in different reform strategies.

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Raúl Castro, in his first speech to the Cuban National Assembly, promised "structural changes" and "big decisions" in the near future, adding "we have to make our government's management more efficient."

The Cuban economy is in trouble. Most of Cuba's domestic industries are operating below capacity, and labor productivity is low relative to the skill and education of the workforce. Cuba's overall debt is 40 percent of gross domestic product, excluding what it owes in expropriation claims. By most living-standard indicators, Cuba has made little progress in 20 years. The country faces a housing shortage of 700,000 units, and despite free health care, education, and rent, public services continue to deteriorate while public employees struggle to survive on salaries averaging $17 a month. Many resort to stealing goods from their government workplaces and reselling them on the thriving black market. And the dual currency system means that many necessities priced in convertible pesos are out of reach for average Cubans.

With Raúl Castro at the helm, many expect Cuba to follow the Chinese model of reform, where the gradual establishment of free-market incentives through partial economic liberalization is pursued by a one-party state. But Raúl will find that growing a private sector by slowly decentralizing economic decision-making is harder than it appears. Cuba's economic conditions have far more in common with the communist states of Eastern Europe than it does with China at the outset of its reforms, and is likely to face some of the same constraints faced by Eastern Europe in the early 1990s.

Fast or Slow Reform?

For over a decade, China's reform experience has been used to demonstrate the advantages of incremental reform—"crossing the river while feeling the stones" in Deng's memorable phrase—over "shock therapy" or the "big-bang" approaches used in Eastern Europe and Russia. But there are two problems with comparing China to the Eastern European and Soviet economies.

First, in both China and Russia, economic expansion or contraction had little to do with reform speed. A new Chinese private sector emerged because, as Earth Institute Director Jeffrey Sachs and Brookings Institution Senior Fellow Wing Thye Woo note, China in 1978 was a peasant society in which the migration of workers from low-wage, low-productivity agricultural sectors to higher-productivity private industry was relatively smooth. In 1978, over 70 percent of the Chinese workforce was agricultural. Although that proportion has shrunk by half in the intervening 29 years, surplus agricultural labor continues to flow to jobs in the steadily growing Chinese economy. By contrast, Soviet labor was primarily employed in heavy industry, restricting the availability of surplus labor flows into a "new" private sector.

Second, the choice of reform speed was not made by technocrats. Rather, it was a political necessity. Hungary and Poland both tried to avoid a harsh break with their socialist past through their own versions of gradual reform in the 1980s, to little avail. In both countries throughout the 1980s, the "non-state" sector expanded significantly, yet job creation and economic growth did not follow. Gorbachev himself experimented with gradual reforms in 1989 and 1990. For a time, entrepreneurial state-enterprise directors set up cooperatives, collectives, and joint ventures, in what was envisioned as a reform that would open enterprises up to market incentives and private investment. Instead, these partial reforms became little more than a way for managers and employees to strip their companies bare. In other Eastern European nations, gradualism pushed these countries deeper into economic crisis. Similarly, a series of stalemates between hardliners and pragmatists following Mao's death, combined with the ideological commitment to public ownership of the Chinese Communist Party, restricted the range of choices available to reformers.

What Kind of Transition?

As with China since the 1980s and Eastern Europe since the 1990s, the new Cuban leaders are likely to find themselves straight-jacketed by some initial economic and political conditions. And by these measures, Cuba shares far more in common with the smaller Eastern European countries in the early nineties than with China.

As of 2005, just 20 percent of the Cuban workforce is employed in agriculture. That compares closely to the situations in Ukraine (22 percent), Poland (23 percent), Bulgaria (25 percent), and Lithuania (20 percent) in 1990. Cuba's share of labor in industry (22 percent) also compares to Ukraine's (26 percent), Moldova's (20 percent), and Lithuania's (29 percent). The emergence of a new private sector in Cuba alongside an existing state-owned enterprise sector, therefore, will draw on some agricultural labor, but would more likely require movement from the labor force employed from state enterprises. Apart from government-based services, the service sector in Cuba is dominated by tourism, and has already gone through some limited reforms that have recognized foreign-held capital and partial foreign ownership in tourism joint ventures. But Cuban tourism workers are treated differently from other workers in the Cuban economy. They are typically paid part of their wages in dollars or convertible pesos, and receive, thanks to the largess of their (often foreign) employers, unofficial income. That leaves laborers in industrial state enterprises—the same labor source that forced smaller Eastern European nations to adopt rapid privatization and enterprise restructuring reforms in order to facilitate the migration of these employees to the new private sector.

Even when a private sector exists alongside state enterprises, and even when those same private companies are more productive, it is notoriously difficult to lure workers, capital, and productive inputs from the state sector to the private sector, as long as the former remain heavily subsidized. State enterprise employees in centrally planned economies benefit from a whole host of "social assets" through their workplace: health clinics, education, recreation, etc. Cuban state enterprises continue to fulfill these roles, linking the Cuban labor force to job security, guaranteed income, health, and housing and creating strong disincentives for relocation to the private sector. It is unlikely that Cuba will be able to rely on the type of workforce flows from subsistence agriculture that have been the source of China's long expansion.

Finally, it is also worth noting that, in addition to Cuba's state-owned sector, its economic size and macroeconomic imbalances resemble Eastern Europe more than they do China. Any reduction of subsidies to Cuba's state enterprise is likely to generate similar opposition by vested interests (in state-owned enterprises) and macro instabilities that impeded gradual reforms in Eastern Europe.

What Should Be Avoided?

Doing nothing

A "gradualist" reform path for Cuba would, of course, imply that the ownership of state enterprises do not change hands, at least in the initial stages. Raúl Castro will certainly be tempted to maintain state ownership to avoid unemployment and social unrest. But Cuba will not likely be able to rely on the good graces of state-enterprise managers. Indeed, there is evidence that some "spontaneous" privatization is already underway in Cuba. According to Edward Pauker and Kevin McCarthy of the RAND Corporation, many of the corporations created out of the private sector reforms in the 1990s have become profit-sharing arrangements for the Cuban equivalent of the nomenklatura, the pinchos grandes who, as with their Eastern European counterparts, have occasionally used their position to steal their companies' equipment and assets.

Vouchers

The experiences of the European transition economies have shown that different forms of sales methods produce very different types of owners, who vary greatly in their willingness and ability to make changes required to allow the firm to survive. Several Eastern European and former Soviet countries, facing the task of changing ownership in large numbers of companies, turned to "mass" privatization through the distribution of vouchers to the public. Voucher privatization was enthusiastically embraced by both reformers and external advisers, and by the mid-1990s it was the privatization method of choice in 17 Eastern European and former Soviet nations. Proponents hoped that the profit incentives unleashed would soon revive faltering, centrally planned economies.

Instead, groups of insiders and speculators acquired majority stakes in these firms, usually by exploiting poorly-regulated capital markets, and the limited information available to most voucher-holding citizens. Investment funds began offering "deals" to convince citizens to sell their vouchers for cash, and by the mid 1990s, had acquired controlling interests in most voucher-privatized companies. Lacking oversight and regulation, many of these investors enriched themselves by diverting cash flows while leaving worthless, debt-ridden shells for other shareholders.

A voucher program in Cuba could, very likely, suffer a similar fate, creating a coterie of well-connected investors able to grow richer quickly by exploiting disorganized and ill-informed shareholders, fueling resentments and frustration among ordinary citizens.

Direct restitution

Much more contentious will be the need to resolve expropriation claims in a manner that does not interfere with Cuba's economic reforms. Potential hold-ups in the settlement of these claims can derail Cuba's efforts to revive its economy, since private investors are unlikely to put money into entities that have unclear titles, outstanding claims, or other liens on their assets.

These claims, naturally, will remain a roadblock to the normalization of U.S.-Cuba relations unless they are effectively and quickly resolved. But compensation should not mean that former enterprise owners or their descendants automatically become current owners, or that commercial land be directly restituted. Direct restitution is notoriously complex. Compensation amounts must be estimated based on discounted cash flows, something that is difficult in post-socialist countries. In Eastern Europe, restitution claims tended to place heavy burdens on weak judicial systems, and often held up enterprise reforms where facilities were located on land subject to restitution claims. Privatizing nationalized companies by restoring ownership to pre-Castro owners, would involve similar problems on a grander scale.

Making Reform Work

Just as the Eastern European experience identifies the traps to be avoided, the experience can also illuminate how Cuban reform can lead to higher growth, productivity, and job creation.

Enforce financial discipline

Loss-making companies, even after they have been privatized, have several ways of avoiding financial discipline. They obtain cheap loans from state-owned banks. They stop paying taxes. Or they stop paying bills to suppliers (especially utility and power companies) —suppliers who, in turn, have their own reasons to avoid their own bills. In some cases, they stop paying wages. But these never-ending chains of debt can be broken if these entities lose their open access to public finances. In technical language, the first step in reviving the private sector is to "harden budget constraints" by eliminating the flow of public funds to persistently loss-making enterprises, cutting off banking credits, and creating a level financial playing field with regard to taxes, customs duties, environmental regulations, licenses, permits, and fines.

Combine restructuring with privatization

By far the trickiest part of private sector reform in socialist economies involves transforming state enterprises from (usually) inefficient and unproductive entities into engines of a new economy. Many of the lessons from the Eastern European transitions in the 1990s were effectively applied to the last country in the region to undergo significant reforms: Yugoslavia. Serbia and Montenegro in particular—did not begin the large-scale reform of its economy until Milosevic was removed from office in 2001. As with other Eastern European nations, private sector reform proved to be contentious, driven by factionalism, and politically charged. Yet privatization in Serbia was remarkably smooth, has not lead to large increases in unemployment or industrial unrest. As with Cuba, many Serbian firms were actually structured as worker's cooperatives rather than "state enterprises."

"Restructuring" in Serbia did not mean that loss-making companies were bailed out, but rather, that the company would "gear up" for privatization by separating its good from its bad parts, selling the former and liquidating the latter. The Serbian Government put together a list of firms, all of which were loss-making, but that were thought to contain salvageable assets. A typical firm on the list was expected to undergo "segmentation" (division into core and non-core assets, likely viable and likely non-viable units, etc.), incorporation of new companies created from parts of the old one, and sale of the remaining parts through in a competitive auction. Although it may make little sense to restructure companies that are bound to fail, the political reality is that governments will almost always try to resuscitate failing companies if they cannot be sold. Better then, to make their liquidation more politically palatable.

Liquidate companies that cannot be restructured

Governments are also, for obvious reasons, extremely reluctant to use administrative tools to bankrupt companies that are un-sellable. Rather, they let ill-equipped courts deal with these matters, often clogging up the judicial system, and preventing newer companies from scooping up the usable land and equipment from these older companies. Eastern European countries that managed bankruptcy well (Poland, in particular) resisted the temptation to rely too heavily on the courts, instead establishing special agencies or governmental units that could initiate bankruptcy proceedings against companies continuing to receive subsidies, but which had not undergone restructuring and sale of their parts, by a certain deadline.

Don't forget the secondary market

One of the mistakes made in Eastern European reforming economies was that, following privatization, many reformers assumed that capital markets would take care of themselves. Consider the contrast between the Czech Republic and Poland. The Czech Prime Minister Václav Klaus, refused to establish a regulatory body for the securities exchange, fearing it would bring capital markets to a standstill. In 1997, following a series corporate scandals, he finally relented and established a securities regulator. In Poland, on the other hand, rules for a securities commission were put in place during privatization. As a result, Poland avoided the asset theft and expropriation that was common in the Czech case.

Is There a U.S. Role?

There are few signs that Cuba will seek lessons from Eastern European rather than Chinese economic history anytime soon. Unfortunately the U.S. embargo, the Helms-Burton Act, and the overall poisonous relationship between the U.S. and Cuba now precludes the U.S. from providing any guidance or assistance in matters of Cuban economic reform. A recent poll of Cuban Americans by Florida International University shows that, for the first time, majorities support allowing U.S. companies to sell medicines and food in Cuba, U.S. citizens to travel and remit incomes there, and no single U.S. move would have a greater impact on the direction of Cuban reform than the lifting of these restrictions.

Any hope for dramatic changes in the U.S.-Cuba relationship hinges on how Cuba and the U.S. choose to resolve the problem of expropriation claims. In the U.S. alone, approximately 6,000 claims by U.S. nationals totaled $6.8 billion (about 25 percent of Cuba's GDP) in 2002. A number of alternatives to direct restitution have been proposed, and their joint acceptance will greatly increase the likelihood that the embargo will be lifted. In particular, the U.S. should consider accepting what several observers have recommended: a negotiated lump-sum payment from Cuba to the U.S., on behalf of U.S.-based claimants. By this method, the U.S. government would negotiate directly with the Cuban government to receive a one-time transfer that would be distributed to all claimants who have agreed to abide by certain conditions. Doing so would smooth the path for the significant diaspora investment that would likely flow to Cuba.

Cuba, of course, would find it impossible to pay out anything close to $6.8 billion. But if similar settlements between the U.S. and Eastern European nations are taken as precedent, the resulting agreement would be less than 100 percent of the net present value of the total amount, and would not include interest payments. If these conditions were applied to Cuba, the resulting total would be considerably less. The government-to-government approach is preferable to the alternatives, such as granting physical restitution of property, or shares in privatizing enterprises to claimants, or direct payments from the Cuban government.

Washington's options in Cuba are also severely limited by the current political-economic mood in Latin America, which is decidedly anti-reform and anti-privatization. Washington should also be concerned with China's growing influence in Cuba—which will include not only significant investments in oil exploration and the restructuring of a nickel plant built by the U.S. in the 1940s, but perhaps a military installation-a trend that is part of China's broader effort to make inroads all over Latin America.

But the U.S. can easily envision the consequences of economic turmoil in Cuba. While strong advocacy of rapid reform in post-Fidel Cuba is very likely to be counterproductive, the U.S. can, at minimum, clear a path for a reformist Cuba to seek its own solutions and to understand the tradeoffs involved in different reform strategies.

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