Cuba's Economic Change in Comparative Perspective

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Preface

Since Raúl Castro assumed the presidency in 2008, Cuba has been engaged in a process of updating its economic model aimed at modernizing state-owned enterprises and institutions and opening up more space for the non-state sector. The highest authorities are involved in a government-wide effort to implement this economic policy agenda. The Economic and Social Policy Guidelines (known as the Lineamientos) passed by the Sixth Congress of the Communist Party of Cuba in 2011 set forth steps to put Cuba on a new growth path, including identifying the need to unify the currency, among other necessary changes.

Some important progress has already been made. The emergence of small-scale business is visible throughout the island, demonstrating the entrepreneurial instincts and talents of the Cuban people. Most Cubans are now free to travel abroad and use of mobile telephones and the internet are slowly expanding. To improve its international creditworthiness, Cuba has successfully renegotiated some of its outstanding bilateral debts. Furthermore, in 2013-2014, the Cuban government announced a series of structural reforms which, if implemented, could be major steps forward. Deep reform of the system of state enterprises, begun as a pilot project, has been generalized, promising more autonomy for firms to retain earnings and make decisions regarding investments, employment and prices. The government has authorized the formation of non-state cooperatives outside of the agricultural sector. Recognizing the need for foreign capital and technology, in spring 2014 the government announced with considerable fanfare a new foreign investment law; it remains to be seen if it will yield important new projects. The difficult tasks of monetary reform and currency reunification are also on the official agenda.

Looking forward, many challenges remain to shaping comprehensive and coherent economic strategies that encourage sustainable economic growth, facilitate Cuba's international economic integration, and contribute to the efficiency and competitiveness of Cuba's economy while simultaneously safeguarding the revolution's gains in social inclusion and equity. To confront these challenges, it is useful to look to other international examples of economic restructuring to identify best practices for inspiration and possible application in the Cuban case.

In support of this effort, scholars at the Brookings Institution's Latin American Initiative and economists at the University of Havana's Center for the Study of the Cuban Economy (CEEC) and Center for Research on the International Economy (CIEI) embarked on a joint research project to examine Cuba's economic reforms from a comparative perspective. The project delved into three specific areas of study: economic growth with equity, monetary policy, and institutional change. The comparative perspectives focused mainly on the Latin American and Caribbean region while also incorporating relevant experiences from other regions like Eastern Europe and Asia. The papers on these topics were presented by the authors at three workshops held over the course of a year: Washington, DC (May 2013), Havana, Cuba (September 2013) and Chicago, Illinois (May 2014). They were subsequently revised following discussions at the three workshops among convened experts, including colleagues from four international financial institutions acting in their individual capacities. An executive summary, along with the final products and their recommendations, are collected in this edited volume.

Each paper is the sole responsibility of its author(s).

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Table of Contents

Introduction and Overview

Richard E. Feinberg

The Cuban economy has been mired in stagnation for over two decades. Living standards have declined, the revolution's historic gains in universal health and education and in social equality are eroding, the outdated productive apparatus is suffering from de-capitalization and technological obsolescence, and the nation's balance of payments is under severe strain. Frustrated by the lack of promising opportunities, too many of the best educated youth are exiting the island. In response to these accumulated challenges, the Cuban government has initiated a process of gradual but increasingly comprehensive economic reforms that eventually may resemble a form of mixed market socialism open to the international economy.

The six papers in this volume explore the roots of the crisis in the Soviet-style central planning adopted decades earlier, assess the initial reform measures undertaken since Raúl Castro assumed the presidency in 2008, analyze the many obstacles to be overcome, and suggest some ways forward. Among the many policy recommendations, the Cuban government should recognize the inter-related nature of economic variables—too often isolated reforms introduce further distortions and fail to produce positive outcomes—and should make clear its strategic development model. More transparent goals could improve the coherency of policymaking and help mitigate public anxieties about the future.

Readers of the six papers will appreciate that Cuba's changing model has potential: it can build upon the gains of the revolution, notably in human capital formation, better exploit its valuable natural resources in a sustainable manner, and take advantage of its strong and diverse diplomatic relations. Cuba may also be able to exploit its geographic location at the crossroads of the Caribbean—if the United States finally relaxes its onerous economic and financial sanctions.

The authors welcome the growing list of policy initiatives that expand space for private initiative and market signals, even as they underscore that the emergent private sector labors under many restrictions and state ownership and central planning maintain their dominance. The first paper by Cuban economists Juan Triana Cordoví and Ricardo Torres Pérez focuses on the need to rebalance priorities and to give greater emphasis to efficiency and growth as a sine qua non for sustaining social goals. A new development model, in their view, should allow much more space to market mechanisms and openness to global commerce and investment, but a smart state would still perform a great many strategic functions in the economy.

Economists have increasingly recognized that institutions play a critical role in economic development. In their companion contributions, Antonio F. Romero Gómez and Carmelo Mesa-Lago define institutions broadly, to encompass not only formal state agencies, but also public-private relations and regulatory regimes as well as societal norms and values. Understood in this broad sense, getting institutions right is an immense challenge. While their assessments differ in some respects, both Romero and Mesa-Lago make clear that Cuba has just begun its long journey of institutional renovation.

Mesa-Lago also offers comparative commentaries from the reform experiences of China and Vietnam, and of various Latin American nations. In comparison, Mesa-Lago finds that Cuba lags behind in many aspects, but could draw useful lessons, notably in freeing up agricultural producers, guaranteeing property rights, and welcoming diaspora capital. It should be said, however, that those Asian nations did not achieve their current levels of development in a single day and are still engaged in processes of continual improvements. Cuban social scientists are carefully studying China and Vietnam: where countries exhibit political continuity, economic gradualism appears a better fit than an all-embracing and uprooting "big bang."

Like Cuba, Costa Rica is a relatively small, middle-income economy located in the Caribbean Basin. Costa Rican economist and former Foreign Trade Minister Alberto Trejos explains his nation's economic successes, rooted in human capital development and bold, decisive engagement in the global economy. The Costa Rica case demonstrates that economic openness and social progress are not exclusive; indeed, the former may be a pre-requisite for the latter. Notwithstanding obvious differences, the parallels between the Costa Rican and Cuban cases are striking and suggest some ways forward for Cuba.

The final two chapters tackle two critical, interrelated hurdles: monetary reform and exchange-rate unification. These issues pose extraordinarily tough challenges, from both technical and political points of view. Augusto de la Torre and Alain Ize, economists with the World Bank writing in their personal capacities and drawing on vast international experiences, argue strongly for achieving exchange rate unification in a single blow. A single, competitive exchange rate would immediately eliminate many of the distortions plaguing the Cuban economy, provide positive incentives to exporters, and set the economy on a more efficient, upward growth path. But de la Torre and Ize appreciate the dangers ahead, and suggest measures to accelerate and cushion the transition. Cuban economists Pavel Vidal and Omar Everleny Peréz agree that currency unification is necessary, but prescribe a somewhat more gradual path in line with Cuba's overall more cautious approach to reform. Moreover, an intermediate stage of multiple exchange rates would give enterprises more time to adjust to new market incentives.

If the crux of the matter is Cuba's internal economic management, without a doubt many of the proposed reforms are made much more difficult by the comprehensive and punitive U.S. economic sanctions. Ironically, the extraordinarily prolonged U.S. sanctions are making it more difficult for Cuba to adopt a more market-oriented economic system.

Toward a New Growth Model

The entry by Juan Triana and Ricardo Torres offers a clear-eyed evaluation of past errors that have created an economy burdened with severe distortions and high transactions costs. Bereft of efficient price signals, the economy is laden with overly centralized, multi-layered bureaucracies unable to respond promptly to economic opportunities. These vertical, silo-ed structures further inhibit horizontal exchanges across sectors of the economy and prejudice local decision making and provincial initiative. Too often, the construction of socialism took precedence over economic development: the social agenda, however vital, overshadowed efficiency in resource allocation and labor productivity. The limited economic reforms of the post-Soviet 1990s, which did nearly cut in half the number of ministries and state entities, nevertheless fell short, due to the restrictive regulatory framework and "ideological and political prejudices regarding the market and foreign investment." Over the last two decades, growth averaged an anemic 1.8 percent per year, among the weakest in Latin America, and gross capital formation (2000-2011) registered a woefully insufficient 10.3 percent, half of the hemispheric average. A clear lesson from the Cuban experience:

without growth, social gains cannot be maintained. To be sustainable, progressive politics require economic prosperity.

For example, Triana and Torres attribute the severe housing shortage—among the most pressing social needs—to deficiencies in the state banking system and the absence of capital markets. The construction industry suffers from "technological backwardness, organizational problems, low levels of quality and systematic failure to meet deadlines, lack of motivation and scarcity of skilled labor, and de-capitalization of the national base of production of building materials, among others."

The good news is that the 2011 reform guidelines ("Lineamientos") adopted by the Cuban government and Communist Party confirm these lessons, and set forth 313 steps to elevate Cuba onto a new growth path. The Lineamientos, however, read like a bureaucratic compromise, accepting the importance of market-oriented reforms but reaffirming the hegemony of socialist planning and state-owned enterprises. As many commentators have noted, the Lineamientos lack clarity with regard to Cuba's future development model.

Triana and Torres propose a future development model that prioritizes growth and stresses market signals, and progressively reduces the state administrative apparatus in favor of indirect regulation with clear rules and incentives, compensating for the "excesses in equality" with elevated standards of private consumption and access to better quality public services. An active industrial policy can help to construct dynamic competitive advantages: bureaucratic red tape has inhibited export initiatives, leaving Cuba with a low export per capita ratio relative to other Latin American nations (U.S. sanctions have also hurt). To complement low levels of national savings, Cuba must offer a welcoming hand to foreign investment, not only for financing but also to gain access to new technologies and markets and to insert Cuban firms into regional and global supply chains. Attracting at the outset a few large multinational firms could serve as a valuable demonstration on global capital markets. Moreover, the authors suggest, Cuba should gradually engage with the international financial institutions, including the Bretton Woods system (the International Monetary Fund and World Bank), the Inter-American Development Bank, and the Andean Development Corporation, and renegotiate its foreign debt such that future debt payment schedules are sustainable.

Interestingly, Triana and Torres take note of the emergence of middle-class sectors, and the consequent necessity to design policies that integrate them constructively into the reform process. At the same time, Cuba's educational system needs updating, to incorporate new technologies and the shifting demands of the labor market. Labor policies must also respond to a demographic profile of low fertility rates and an aging population: the authors suggest policies to stimulate birth rates and the circular flows of migrants, such that Cubans could readily work abroad and at home, and some diaspora Cubans might return to their native land.

Triana and Torres conclude with a warning: in the critical formation of new institutions that promote well-functioning markets, Cuba's "prior experience [is] practically irrelevant." Such market-oriented institutions must define and protect basic economic rights, promote competition, correct for market failures and promote stability and growth, while assuring social cohesion and means of conflict resolution. In assessing the evolution of Cuba's economic institutions, the papers by Antonio F. Romero Gómez and Carmelo Mesa-Lago pursue these themes in depth.

Economic Institutions

Cuban economist Romero offers an expansive definition of institutions: a series of rules, laws, beliefs, values, and organizations that together drive individual and social behaviors. Among the most vital tasks of economic institutions is to enable sustainable growth, but also to determine and, as necessary, correct the distributions of wealth and income, correct regional inequalities, and promote social cohesion.

By these criteria, revolutionary Cuba had a strong set of institutions, even as they now appear inadequate.

Romero reviews recent efforts to renew Cuba's institutions, outlining a large number of reforms in various stages of implementation, often beginning with pilot projects, and with mixed results to date. The Cuban economist discusses on-going reforms in the state, cooperative, and private sectors, as well as the new laws governing foreign investment and free trade zones, noting that the reform process is still in its early stages and "much remains to be done." Excessive gradualism, he warns, can actually complicate matters, and "transformations of various sectors should be done simultaneously in order for the reforms to be effective." Government entities must be better coordinated and economic and social policies need to be carefully integrated. Romero adds that it would be an error to anticipate an immediate improvement in living standards: the pressing internal and external constraints are simply too great.

In considering a new institutionalism that would broaden and regulate the market economy, Romero adds a number of additional priorities including: strengthening a legal system that provides guarantees to all economic agents, including the new private sector and cooperatives; designing a competitiveness policy that removes the many existing, often contradictory restrictions; legitimizing the accumulation of profits, with institutional stimulus to their productive re-investment; opening the external sector with strong supervisory institutions; and policies that actively protect natural resources and cultural patrimony.

The State and the Market

In reviewing the multiple reforms underway, Carmelo Mesa-Lago provides additional details, and a somewhat more impatient assessment of progress to date. While applauding the general thrust of reforms, and that they have advanced much further than previous reform episodes and are highly unlikely to be reversed, he nevertheless bemoans the slow progress and states baldly: "the greatest obstacle seems to be the [central planning] model itself." Mesa-Lago asserts: "If Cuba were to follow an adapted 'socialist market' model, as in China and Vietnam (the private sector, markets and foreign investment, combined with an indicative plan and decentralization of decision making) it would achieve much higher sustained economic growth *under the Party rule*" (emphasis is mine). That is, it would be in the political interests of the elites of the Cuban Communist Party to move faster and further, Mesa-Lago suggests, citing comparative precedents. Then why don't they? Mesa-Lago asserts that stubborn opposition from within the government, from orthodox, hardline factions—fearful of delegation and a "snowball" effect—accounts for the frustrating delays and contradictory steps that have marked the Cuban reform process to date.

In a detailed evaluation of the distribution in usufruct of idle state lands, Mesa-Lago finds that the many restrictions on the use of land and on agricultural markets, including the continued repression of at-the-farm prices and inefficient state marketing of produce, explain the disappointing output results. If only the restrictions on private property and agricultural markets were lifted, Mesa-Lago believes, Cuba could accomplish food self-sufficiency in a few years, saving $2 billion in imports and generating a surplus for export.

Both Mesa-Lago and Romero applaud the visible expansion of small-scale private enterprise (legally employing close to 500,000 persons), and most recently of non-agricultural cooperatives, notably in services (cafeterias, personal hygiene), agricultural markets, transportation (taxis), and construction. The officially stated goal is for two million Cubans (40 percent of the employed labor force) to be in the non-state sector by 2016.[1] Both scholars

[1] In an earlier publication, I suggest that the percentage of non-state employment could rise even higher, if one adds workers in the un-authorized informal sector and GESPI—government employees with significant private-sector income. See Richard E. Feinberg, *Soft Landing for Cuba? Emerging Entrepreneurs and Middle Classes* (Washington, D.C.: Brookings Institution, 2013).

lament the constraints on the expansion of these potential engines of growth, including scarcity of bank credit and certain anti-growth taxes, and the arbitrary exclusion of white-collar professions from private enterprise, which is especially frustrating for recent university graduates.

Mesa-Lago urges more transparency in evaluating reforms, to facilitate scholarly analysis and mid-course corrections. No official data is available, he enumerates, on poverty incidence, income distribution, average salary by gender and race, nor on the number of dwellings sold since the 2012 housing reform. The government and Communist Party reportedly conduct public opinion surveys but do not publish them. Mesa-Lago also laments that the anti-corruption campaign has not been accompanied by transparency and accountability of state agencies and enterprises.

Comparative Experiences in Asia and Latin America

Mesa-Lago's paper notes that Cuba has seemingly chosen not to learn some of the lessons from previous reforms, notably in China and Vietnam, and in Latin America: that slow and partial change fails to generate the sought-after dynamic growth and improvements in living standards. Long ago, he asserts, China and Vietnam developed their socialist market models where the state's role was reduced to an indicative plan and decision making was decentralized. With regard to real estate markets, Mesa-Lago notes that despite some recent liberalization,[2] the buying and selling of homes in Cuba remain highly restricted, particularly for foreigners. In contrast, in China foreign permanent residents don't face restrictions and large international financial firms have opened realty branches. However, in comparing Cuba's extensive social service programs to various reform efforts in Latin America, Mesa-Lago advises that "the lesson for Cuba is not to privatize but to create a new public pension system for young workers, with a solid actuarial base, appropriate reserves and efficient administration, in order to ensure adequate pension in the long run and be a source of productive investment."

A defender of the Cuban reform process could respond that the Asian reforms also began gradually, were laden with errors and mid-course corrections, and took decades to attain their current trajectories (although in China, agricultural reform started with a bolder approach, allowing more freedom to farmers, and generated faster results). And the starting points for the structural adjustment reforms that set many Latin American countries on the road to a more sustainable growth path were far different from Cuba's Soviet-imposed centrally planned economy. When Latin American countries began their adjustment processes in the 1980s, to correct their macroeconomic imbalances and open their economies, they already possessed essentially market-driven systems. The challenges they faced pale in comparison to the hurdles that Cuba must surpass.

To add to the debates on comparative economic strategies, the paper by prominent Costa Rican economist Alberto Trejos explains the dramatically successful restructuring of his nation's formerly rather closed and protected economy, by opting for an unambiguous openness to international trade and active promotion of foreign investment. Of particular relevance to Cuba, Costa Rica's comparative advantage has been its well-educated and healthy workforce, the results of years of public investments in human capital; by constitutional mandate, education expenditures cannot fall below six percent of GDP and the entire population is covered by an efficient national health care system. Nor is Costa Rica an extreme neo-liberal story. Rather the state remains a strong player through state-owned enterprises in numerous strategic sectors, including energy and other utilities, telecommunications, and banking. Workers' rights are sustained through mandatory pensions, generous severance pay and other social assistance programs.

[2] For more, see Philip Peters, *Cuba's New Real Estate Market* (Brookings Institution, February 2014).

Costa Rica's annual inflows of foreign direct investment have been around $2 billion, coincidentally the number that Cuban minister of foreign trade and investment Rodrigo Malmierca cited as a goal for Cuba when explaining its new 2014 foreign investment law. As Trejos reminds us, FDI not only injects capital but also transfers knowledge, best practices and familiarity with global industry to workers and to domestic suppliers. Attracted by Costa Rica's educated workforce, foreign investment has diversified in dynamic clusters in electronics, medical equipment, life sciences and business process outsourcin—sectors where Cuba might also hope to be competitive. Notably, Costa Rica did not wait passively for foreign investors to discover its advantages, rather it created strong but lean and agile investment promotion agencies.

A free trade regime offers tax and other benefits (as does the new regime governing Cuba's Mariel special economic development zone) but selection now focuses on fostering international value-chains, clusters of related companies, and linkages between foreign and domestic firms. Drawing on his direct contact with foreign investors, Trejos comments that one attraction of the Costa Rican free trade regime is that the public institutions in charge of it are virtually corruption free and predictable (e.g., attached to the letter and spirit of the law) in their decisions. Not that Costa Rica is without flaws: infrastructure is in poor condition, the educational system has not fully adjusted to the evolving demands of the labor market, and the exchange rate has appreciated substantially in recent years. But Costa Rica has gotten enough right to offer its citizens relatively high and rising living standards. Two indicators of success: indices of global happiness typically rank Costa Ricans near the top, and emigration rates are well below those of other Caribbean basin neighbors.

Tough Choices: Monetary Reforms and Exchange Rate Regimes

The final two papers tackle the extraordinarily complex—and risk-laden—task of reforming the inter-related dual currency and exchange-rate systems. Cuba has two currencies, the convertible peso (CUC) which is pegged at 1 CUC: 1 US dollar, and the Cuban peso (CUP) which is fixed at 24 CUP: 1 US dollar, or 1CUC:24CUP. Yet, for firms, the exchange rate is 1CUP:1CUC, a massively overvalued Cuban peso. Recognizing that these monetary systems introduce huge distortions (segmenting the economy, sending false price signals, and complicating accounting mechanisms,) the 2011 reform Lineamientos called for monetary unification by 2016. Subsequently, the government announced it will eliminate the CUC in favor of a single currency, the Cuban peso, probably in 2015.

As Cuban economists Pavel Vidal and Omar Everleny note, the government has yet to explain just how it will implement these reforms, especially with regard to the dual exchange rate system, and manage the many inter-related economic variables, including wage levels and prices. The anticipated massive devaluation risks unleashing powerful inflationary pressures through three channels: the devaluation will increase the costs of imports both to consumers and firms; producers and retailers will seek to pass through increases in costs to their consumers; and fiscal policy may incentivize the government to pump liquidity into firms and financial institutions whose balance sheets are adversely affected by the monetary reform.

The point regarding firm vulnerability is particularly delicate. The distorted monetary system has allowed inefficient firms to disguise losses. Under monetary reform, these inefficiencies will become manifest, at which point the government can choose either to subsidize money-losing operations through compensatory fiscal injections or simply allow them to go bankrupt and dismiss workers. Yet such a cold-turkey approach could result in social unrest and, possibly, a generalized collapse of the economy.

Vidal and Everleny also worry about the capacity of even the more efficient state-run enterprises to respond quickly to new price incentives. The government has begun to implement a broad-based reform of the state enterprise sector, allowing firms more autonomy in decision making, but it remains to be seen how quickly firms are able to adjust, and just how much flexibility the economic ministries and holding companies, accustomed to issuing directives, are willing to allow subordinate firms.

Another challenge will be managing public perceptions. Vidal and Everleny worry that many Cubans mistakenly attribute low wages in the state sector to the dual currency system, and anticipate that currency unification will result in a sharp jump in real wages and purchasing power. In fact, the low wages are the result of massive featherbedding and low labor productivity, problems that will not be resolved by monetary reform alone. Vidal and Everleny urge the government to be more transparent and clear in defining and explaining its monetary policy strategies going forward.

On the plus side, the Cuban government approaches monetary reform with some advantages over free-market economies: the government still sets most prices, enabling it in the short run to repress inflationary pressures, and control over the financial sector and foreign exchange reduces the risks of capital flight and exchange-rate speculation and volatility.

Tactically, Vidal and Everleny suggest a gradualist approach toward unifying the exchange rate. Already the government seems to be following such an approach, introducing the new devalued official exchange rate sector-by-sector in purchases of some agricultural products by hotels, of certain inputs by transportation cooperatives, and in the sugar agro-industry where, for example, various transactions are recorded in three different exchange rates varying from 4CUP:1USD to 12CUP:1USD. This sector-by-sector approach follows the style of the overall reform process, where pilot projects precede generalized reform. It will allow economic agents, notably state-run firms, to adjust more gradually to monetary shocks. However, Pavel and Everleny underscore that such a multiple exchange rate system should be transitory, otherwise it would risk introducing further distortions as well as opportunities for corruption.

A more comprehensive and rapid approach to exchange rate unification is proposed in the paper by Augusto de la Torre and Alain Ize. The World Bank economists argue that accumulated international experience militates against multiple exchange rates. Instead, they propose a combination of an immediate unification of the exchange rate (whereby all CUC are mandatorily converted into the new Cuban pesos at 24:1—they discard the dollarization option) and a gradual phasing out of the taxes and subsidies implicit in the current dual exchange rate system. To achieve the latter, the currently hidden taxes and subsidies would be made explicit and converted into lump-sum taxes and subsidies, which would then be gradually eliminated in line with a pre-announced timetable. The authors propose this transitional regime of lump-sum taxes and subsidies to soften the huge production and distributional dislocations that would materialize under a "raw big bang" unification option, where an immediate unification of the exchange rate would be accompanied by an instantaneous disappearance of the currently hidden taxes and subsidies. In their proposal, a system of lump-sum taxes and subsidies would be allocated on an enterprise-by-enterprise basis to neutralize or compensate for the initial windfall losses or gains resulting from exchange rate unification.

For this "fiscally-cushioned big bang" to produce the sought-after efficiency gains, while minimizing short-run pain, de la Torre and Ize propose a series of urgent "habilitating reforms" including: the generation of a pre-exchange rate unification fiscal surplus (Cuba's fiscal position is currently in modest deficit) to facilitate monetary control; new revenue mobilization measures such as a value added tax; deep public sector governance reforms to ensure that state enterprises become more responsive to market signals, as Vidal and Everleny also underscore; and other market-oriented reforms, such as encouraging non-state firms to grow sufficiently numerous and large as to boost supply and exert competitive pressures on state enterprises.

While advocates of an immediate currency unification, De la Torre and Ize suggest a gradualist approach toward establishing the future exchange rate system. That is, initially Cuba could set a fixed exchange rate, followed by an intermediate phase of a flexible but managed rate, until finally settling upon a more flexible (but still managed) exchange rate with inflation targeting—the approach followed by many other Latin American countries today.

De la Torre and Ize note that, from a comparative perspective, the Cuba case is especially challenging in several respects. The current spread between the two exchange rates in Cuba, at 2300 percent, is by far the largest in post-World War II Latin American history, increasing the risk of a wage-price inflationary spiral. To counter this risk, the Cuban government will need to maintain very tight control over monetary expansion. Further complicating the task, Cuba's very limited access to international finance means that foreign exchange expenditures cannot exceed income during the transition. Normally, the international financial institutions help marshal valuable liquidity during major reforms, to finance a surge in demand-driven imports, dampen inflationary pressures, and facilitate debt service and other international payments, but Cuba is not a member of the Bretton Woods or other regional development agencies. Cuba hesitates to seek membership, perhaps out of ideological misgivings or fearing a U.S. veto, and hence must manage its monetary adjustments alone, relying on its own resources.

Some Additional Thoughts

In recent decades, the international community has learned much about economic development. The six papers in this volume, by leading Cuban economists and international experts with broad experience in developing countries and drawing on theoretical advances as well as success stories from a wide variety of economic models and geographies, suggest many relevant conclusions for Cuba. But as the authors underscore, none of these country cases is a semi-tropical island in the Caribbean, emerging from over five decades of central planning, still facing economic sanctions from its largest neighbor, but endowed with a remarkably well educated population, diversified resource base, and a prosperous, near-by diaspora. Felicitously, and unlike many other emerging economies, Cuba does not have to confront a demographic explosion, nor deep ethnic or religious divides. Despite hostility from the United States, Cuba enjoys good diplomatic relations throughout the world, and much good will in Latin America.

This volume makes plain that reforming the Cuban economy will be no easy task. Severe distortions have accumulated over many decades, institutional rigidities are manifest, and the government and Communist Party appear divided and uncertain on the best path forward. Success is not guaranteed, such that continued stagnation remains a possible outcome; and a botched monetary reform could catalyze a dangerous inflationary spiral. Moreover, there remains the risk of negative external shocks, against which the Cuban economy, highly dependent upon imports for food and energy and with low international reserves, remains highly vulnerable.[3] If author Romero is correct and most Cubans can anticipate no major improvements in per capita incomes in the near term, the government will have to work hard to build and maintain popular faith in the reform process. The long-forgotten Cuban consumer will have to endure a while longer.

Yet, some important progress has already been made. The emergence of small-scale business is visible in Havana and provincial towns throughout the island, demonstrating the entrepreneurial instincts and talents of the Cuban people. Prices have been lifted on a growing percentage of agricultural production, improving variety and quality for some consumers. Government spending is becoming more efficient as unsustainable social subsidies are being cut, the pension system has been partially reformed, and the educational and health care systems

[3] For a discussion of Cuba's energy vulnerabilities, see Ted Piccone and Harold Trinkunas, *The Cuba-Venezuela Alliance: The Beginning of the End?* (Washington, D.C.: Brookings Institution, Latin American Initiative Policy Brief, June 2014).

are being rationalized. Most Cubans are now free to travel abroad and return without penalty, and mobile telephones and the internet are becoming more widespread, if slowly by international standards. To improve its international creditworthiness, Cuba has successfully renegotiated some of its outstanding bilateral debts and has worked hard to remain current in meetings its hard-currency obligations. From the U.S. side, partial liberalizations of travel and remittances by the Obama administration have added some stimulus to the economy, including the emerging private sector.

In 2013-2014, the Cuban government announced a series of structural reforms which if implemented could be major steps forward. Deep reform of the system of state enterprises, begun as a pilot project, has been generalized, promising more autonomy for firms to retain earnings and make decisions regarding investments, employment, and prices. The government has authorized the formation of non-state cooperatives outside of the agricultural sector, in what could be a fascinating experiment in worker-owned small and medium-sized enterprises benefiting from official encouragement. Recognizing the need for foreign capital and technology, in spring 2014 the government announced with considerable fanfare a new foreign investment law; it remains to be seen if the government approval process gets the message and can move with alacrity to authorize important new projects.

At its most fundamental, economic reform is a political process which alters the distribution of income and opportunities. The political economy of reform is especially challenging because potential losers can be keenly aware of their impending fate whereas potential winners may not see the future so clearly. Governments, therefore, must attempt to sequence reforms such that winners quickly recognize their good fortunes and join an expanding pro-reform coalition. In the Cuban case, potential winners include farmers who benefit from new price incentives, entrepreneurs working in the emerging private sector, employees in joint ventures with foreign investors, and managers in state-owned firms who gain from decentralization. To the extent feasible, losers, including employees dismissed from state ministries, should receive compensations, such as temporary monetary subsidies and retraining for emerging labor market opportunities. The reform momentum should be strong enough to prevent early beneficiaries from seeking to protect their gains by freezing forward movement; on the contrary, the expanding pro-reform coalition should perceive the advantages of pressing forward toward a development model of rising capital accumulation and labor productivity as the only pathway toward sustainable growth and the redemption of the long-suffering Cuban consumer.

Revolutionary Cuba has proudly prioritized a progressive distribution of income, which pro-market reforms can disrupt. The Cuban polity will decide its future equity preferences, but certainly it will want to guarantee equal opportunities across race and gender, and avoid distortions that drain resources from the poorer provinces. In rebalancing priorities, policies which seek social equity should avoid disincentives to savings and investment.

Facing an uncertain future, many Cubans fear a sudden onslaught of investments from South Florida and a rush of bulldozers that transform Havana and the island's distinct regional centers into a pale ordinariness. To avert such an apocalypse, the Office of the Historian has been restoring colonial Old Havana and other historic sites, to preserve past glories and to create a major tourist destination, demonstrating that strong far-sighted planning and commercial viability can be compatible in the Cuban setting. If the rest of Havana and other towns are to become sustainable and attractive locations, then capable institutions that plan and regulate urban development, that provide smart aesthetic guidelines for architects and investors, must be in place *before* the predictable onrush of foreign capital. Similarly, only strong institutions, adequately staffed and financed, can safeguard the island's rich bio-diversity and marine life. Cuba is too beautiful, too special, to be abandoned to purely short-term market-driven solutions.

Raúl Castro has pledged to retire in early 2018, by which time we will have a good sense as to whether Cuba has begun to build these new institutions, to engineer a gradual, peaceful transition to a more productive and sustainable economy. In this "soft landing" scenario, Cuba would have re-engaged with the global economy, attracting foreign investment into diverse sectors—tourism and energy but also agriculture, bio-technology, entertainment and sports—with more and more Cubans engaged in competitive export-oriented businesses. International capital markets—including the international financial institutions and diaspora capital—will have begun to add much needed investment to bolster growth and productive job creation. At the current pace, Cubans may grow increasingly frustrated and look elsewhere for a brighter future.

As the authors suggest, now is the time for the Cuban government to accelerate reforms. Among possible policy priorities, more aggressive reforms of domestic price mechanisms could quickly bolster agricultural production, alleviating some of the pressures on the balance of payments. More open space for the expansion of the domestic private sector, notably in professional services, could not only generate more employment and investment but also build hope for the future: for a Cuban economy that is more productive and competitive, that offers more opportunities for creative innovation and youthful employment. Productivity-enhancing reforms within state-owned enterprises, however challenging, must also be among the critical medium-term goals. But getting to this soft landing will require many tough decisions and probably some good luck, as the following essays, steeped in economic realism, reveal.

Policies for Economic Growth:
Cuba's New Era[4]

Juan Triana Cordovi and Ricardo Torres Pérez

Introduction

The changes in the Cuban economic model have given rise to a notable reaction in academic circles, both in Cuba and abroad. The enthusiasm for and skepticism of the initial moments have been followed by a more in-depth and measured reflection on the strategic issues that will decide the nation's future. Economic issues have come to the fore in recent years, including the increasingly evident need for a development program in which the issues of economic growth take precedence. This paper seeks to contribute to this debate, discussing some aspects that are essential for framing a strategy that is consistent with the needs of Cuba and its people, which at the same time is viable in the contemporary international environment.

The article is organized into four main parts. First is the introduction. The second section addresses the relationship between growth and development, seen from the vantage point and particularities of the Cuban economy today. The third section analyzes in detail some factors tied to growth, based on the theoretical contributions and empirical evidence available. Accordingly, policy actions are suggested to begin to correct the cumulative imbalances and to put the country on a path to high growth. The final section summarizes the conclusions.

Development and Economic Growth

The Multidimensional Nature of Development

More than 70 years after the seminal studies on development[5] and after an almost exclusive emphasis on economic issues during those initial periods, it is now understood that development is a multidimensional phenomenon. "Development sustainability" is defined by three dimensions (economic, social, and environmental) and must be taken into consideration in the new scenario that Cuba is constructing. Previously, especially in the period up to 1990, the existence of a close link both between these three dimensions and with the expected positive results was assumed, however reality proved otherwise. Since the 1990s, the difficulty in striking an adequate balance among the three dimensions has become more visible and much more costly than expected in earlier periods, and therefore they must be incorporated into the development strategy *ex-ante*.

The challenges to fully sustainable development are significant and are influenced by the cumulative lag in some areas of development that are decisive today:[6] the relatively high standard of social services and conditions that Cuba achieved;[7] Cuba's status

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[4] This paper has been translated from Spanish to English.

[5] The reference is to pioneers of the studies that constitute the rise of "development economics," understood as the scientific sub-discipline that studies the economics of the less developed countries, i.e. the conditions, characteristics, and policies relating to the economic development of those countries. Among those authors one can cite Rosenstein-Rodan, Nurkse, Singer, Lewis, Gerschenkron, Myrdal, Hirschman, Scitovsky, Perroux, Rostow, Myint, and Prebisch.

as a small island territory with limited natural resources; and a negative geo-economic situation due to the blockade by the world's leading economic power, which impedes Cuba's access to the largest and closest market in the world and limits its participation in international financial markets and institutions.

Cuba and Development 50 Years Later: Lessons Learned?

A set of lessons can be derived from the 30 years of development experience from 1959 to 1989:[8]

i. Development has its own agenda. In the first 30 years after 1959, the development agenda and the agenda of building socialism became mixed together, yielding, on more than a few occasions, contradictory results.

ii. Enjoying advantageous external conditions does not appear to guarantee development results. Accordingly, a large part of the advantages received due to the special conditions of insertion[9] did not translate into improved productive capacities or radical changes to the characteristics of Cuba's productive sector.

iii. Social betterment should be an explicit goal of the development strategy, but its sustainability depends on social gains translating into enhanced productive capacity.

iv. The market plays an active role in that process; ignoring it generates inefficiencies that tend to thwart the very purpose of development.

v. The "local level" has its own characteristics; it cannot be understood as merely a subcomponent of the "national level."

vi. The export sector and the domestic market should not be considered polar opposites, but as complementary phenomena that are part of a single process. Efforts are needed to ensure that the "dynamic sectors" generate "spillover effects" to the rest of the national economy.

vii. Isolation from the international trends in the world economy may generate costs in the long run that offset the benefits obtained in the short term.

viii. The concentration of external dependency becomesa strategic weakness harmful to the purposes of development.

Institutions and Economic Development in Cuba

One of the lessons of recent years is that the quality of institutions is relevant for attaining development.[10] Institutions are understood to include everything from policies to state agencies and civil society organizations, along with the mechanisms for regulating them.

The state and the market are likely the two most important factors for development. Development requires not only the correct allocation of resources, a function that the market is generally able to perform efficiently, but also the attainment of objectives for which the market does not have a sufficiently effective response, thereby guaranteeing opportunities for access to services that are strategic for development, such as education and health. On other occasions the correct allocation of resources generates dynamics that promote levels of inequality which in the medium and long term are at odds with the aims of development. This is not due to market failures, but rather is the result of market dynamics, justifying and opening the door for the corrective role of the state.

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[6] Such as: international insertion; productive development; incorporation of I+D+i to production and services; the use of information and communication technologies; and access to logistic and transport circuits on a global scale, among others.

[7] UNDP, *Human Development Report 2011– Sustainability and Equity: A Better Future for All*, (New York: Palgrave MacMillan, 2011).

[8] Juan Triana Cordoví, "De la actualización del funcionamiento al desarrollo económico," in *Miradas a la Economía cubana: el proceso de actualización*, eds. Pavel Vidal Alejandro and Omar Everleny Pérez Villanueva, (Havana: Caminos, 2012).

[9] This refers to the benefits Cuba enjoyed as one of the most backward/underdeveloped members of the Council for Mutual Economic Assistance (CMEA). These include preferential access to these markets; attractive prices for its main export products (sugar, nickel, etc.); low-interest loans with long amortization periods; renegotiation of debts in arrears; and technical assistance in science, sports, and the arts, among others.

[10] Dani Rodrik, "Estrategias de desarrollo para el próximo siglo," paper presented at "Developing Economies in the 21st Century" at the Institute for Developing Economies, Japan External Trade Organization, Chiba, Japan, January 26-27, 2000.

An important initial stage of the process of institutional redesign in Cuba occurred in the mid-1990s when the State was reorganized and the number of ministries and state units was cut practically in half, reducing the number from more than 50 ministries and state units to less than 30. That process also aimed to redefine the functions of these institutions, especially the ministries, to foster the "separation of state and enterprise functions." This objective was not attained at the time.

Meanwhile, the opening that had been promoted from the early 1990s on allowed for market growth, not only by the impetus created by the "self-employed"[11] sector and the opening to foreign capital and foreign commercial enterprises, but also due to a certain flexibility granted to the state enterprises that did business in foreign currency.

In this case, several events significant for Cuba came about at the same time. First, Cuba maintained a restrictive regulatory framework (even though, without doubt, as of 1993 macroeconomic decision-making became more flexible and open, with positive impacts on growth). Second, the macroeconomic distortions were generated and deepened in the wake of the crisis from 1990 to 1993, together with sustained ideological and political prejudices regarding the market and foreign investment (which were tolerated but not assimilated into the "normal" operations of the economy). Finally, the impossibility of accessing the U.S. market has been all the more critical since 1990. All this consolidated a climate not propitious for growth or for national (state) or foreign investment.

The Need for a Macroeconomic Environment that Stimulates Growth and Investment

Increasing investment is crucial for achieving the results pursued in any development effort. This is a lesson learned. In addition, practically all the experiences observed corroborate the need to ensure a macroeconomic climate that stimulates growth, rewards investors (national and foreign), and promotes the spillover of its effects to the rest of the economy. While the management of cross-cutting policies is decisive for creating such a climate (fiscal, monetary, and exchange policies), these alone are not totally sufficient.

Recognizing that the reform initiated in the 1990s generated a legal framework for domestic investment that to some extent brought it closer to the paradigm of the West,[12] at the same time peculiarities are identified in the operation of that same legal framework that limit its contribution to investment financing. These include: the poor performance of the banking system and the absence of a capital market; the lack of competitiveness of the banking institutions resulting from excessive centralization; and the marked short-term bias of Cuba's banking institutions.[13] With respect to domestic investment, several kinds of limitations associated with the capacity to effectively promote a massive construction program have been noted. These include: technological backwardness, organizational problems, low levels of quality and systematic failure to meet deadlines, lack of motivation and scarcity of skilled labor, and de-capitalization of the national base of production of building materials, among others.

Similarly, the structure of that investment is relevant to development, although each experience is particular in terms of sources and use. In this case, while foreign investment was aimed at strategic country objectives and had a positive impact on exports and sales,[14] domestic investment did not effectively accompany foreign investment (Figure 1), resulting in a missed opportunity to internalize a major part of the benefits associated with foreign

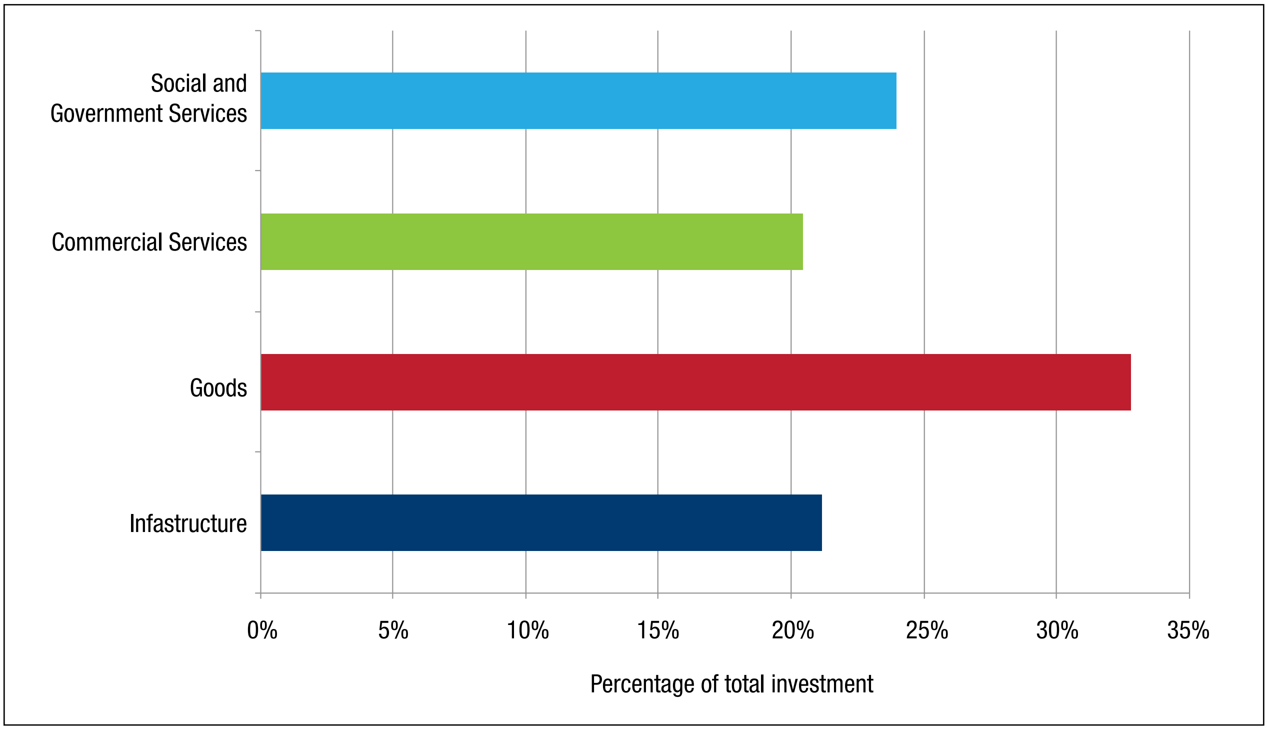
[11] This is the sector of small private enterprise in Cuba, which can only operate in activities authorized by the government, mostly simple services and small artisan production.

[12] Lidia Villar López and Víctor Rodríguez García, "El proceso inversionista y la financiación de inversiones en Cuba," *Economía y Desarrollo* 148, No. 2 (July-December 2012).

[13] Ibid.

[14] Omar Everleny Pérez Villanueva and Pavel Vidal Alejandro, "La inversion extranjera directa y la actualización del modelo económico cubano," (Havana: Center for the Study of the Cuban Economy (CEEC), 2012).

Figure 1. Investment by Sector in Cuba (accumulated (1994-2012)



Source ONEI, Anuario Estadistico de Cuba 2012 (Havana: 2013)

direct investment (FDI) and considerably reducing the multiplier effect on growth and employment.

It is also crucial to develop a policy to improve and modernize infrastructure that cuts transaction costs and contributes to the competitiveness of goods and services. Despite the gains in infrastructure development in the 1970s and 1980s, from 1990 a significant quantitative and qualitative deficit has accumulated. The technological lag in the railway system[15] and in coastal transport; decapitalization in the ports,[16] technologies and systems for storage and handling of freight; backsliding in the public transportation system; the technological lag and the low penetration of cellular telephones and of data transmission (Internet), along with the high rates charged for their use, all place Cuba far below competitive standards in the region, and are disincentives to growth and investment (both domestic and foreign).

"Updating the Economic Model" and Development: A New Opportunity

In the 1990s, the nature of the economic crisis[17] and the existence of a more restrictive international environment, especially due to the reinforcement of the U.S. blockade, made it such that efforts were concentrated on managing the crisis to ensure survival. Nonetheless, at least in discourse, development goals remained on the agenda. A heterodox program that combined fiscal cuts, wage anchors,

[15] As part of the policy set forth in the guidelines, today a project is under way to modernize the country's railways.

[16] Three projects for port modernization are under way: one in Mariel, another in Santiago de Cuba, and the third in Cienfuegos.

[17] Most specialists agree that the crisis that began after 1989 was the result of a combination of internal and external causes. Among the internal causes, one can cite mainly the exhaustion of the growth model and the limitations on the system for managing the economy. For example, from 1986 to 1989, cumulative GDP growth was null. Among the external factors one finds the notable deterioration of the international economic environment since the the mid-1980s, especially in regard to Cuba's access to international financial markets and the collapse of the Soviet Union in 1991.

import adjustment, dollarization of the economy, a fixed official exchange rate and implicit devaluation of the Cuban peso in the domestic market as well as an overvaluing of the official exchange rate, the loss of the purchasing power of wages, along with the opening to foreign capital, all made it possible for the country to survive yet generated distortions that continue to weigh down efforts to achieve growth.

Economic policy was marked by its focus on "crisis management," something which remained unchangeable until the approval of the Economic and Social Guidelines (*Lineamientos Económicos y Sociales*). Macroeconomic distortions, balance of payments restrictions, a high propensity to import, alongside a technologically backward productive sector with high levels of inefficiency as well as a major decline in real wages, are the conditions under which the transformation efforts began in 2007.

There are two clearly distinguishable stages: the first from 2007 to 2010, in which crisis management predominated, and the second, as of late 2010 (discussion of the Guidelines) and especially early 2011 (approval of the Guidelines), when the door was opened to a more all-encompassing framework. The need for an economic development model appeared afterwards and the concept is still unfolding; hence the importance of examining different perspectives. Today one can identify points of consensus on a set of issues, some of which are evident if one looks to international experience, but which are not so evident looking just at the case of Cuba:

1. Development is a necessary condition for the sustainability of "Cuban socialism."
2. Growth is essential for achieving development in Cuba.
3. Achieving high rates of fixed investment is essential for growth.
4. Foreign direct investment is necessary and plays a central role in efforts to achieve future growth.
5. Production structure policies should supplement the growth effort. In particular, changing the energy and import matrices, export orientation and the production of goods with a higher value-added should be an explicit goal of those policies.
6. Modernization of the infrastructure, with special emphasis on information and communication technology (ICT), should accompany growth.
7. Research, development, and innovation systems should be modernized and adapted to the growth effort.

The Agents of Development: The State, "Self-Employed Persons," Members of Cooperatives, and the "Highly Skilled Labor Force"—Is it Possible to Have a Middle-Income Sector Committed to Development in Cuba?

The role of each of these actors in the future development of Cuba is not fully defined. While progress has been made on the central idea that their dynamics should be aligned with the common development goals, past experience shows that the role of these different agents has swung back and forth.

Accepting that at present this pendulum-like performance is a thing of the past and that what is at stake is developing, it seems logical that the State should take the lead in the process and align itself with all the other actors. At the same time, this is a process riddled with difficulties and uncertainties that will require a carefully-designed legal framework.

Yet what is truly novel in that development process is the role of the (still incipient) middle-income sector. At present the positive role of the middle class in the development processes is recognized in different countries and regions.[18] The case of Cuba is more complex because the specific socio-economic

[18] Francisco H. G. Ferreira, Julian Messina and Jamele Rigolini, *La movilidad económica y el crecimiento de la clase media en America Latina*, (Washington, DC: World Bank, 2012).

and political characteristics require thinking about a "middle-income sector" differently than other Latin American countries, not only in terms of its origins, but also in light of the roles it must play in the process of economic modernization.

The role of social classes in the Cuban Revolution undoubtedly continues to be a polemic issue.[19] More than 40 years after social segments that could be described as middle class practically disappeared from the national reality, this process of updating (which today makes Cuban social actors "less equal"),[20] creates opportunities for a "relatively new social differentiation" compatible with the aims of growth and development. It is a question of knowing how viable the creation, consolidation, and expansion of a middle-income sector of sorts are in the new Cuban socioeconomic structure, and how that sector is distinguished from Cuba's "principal actors." If it is viable, then it is necessary to design policies that permit the integration of that new social sector into the new agenda of changes.

From the Path of the Unknown to a Vision of the Country: What Does Prosperity Mean in Cuba? What are the Challenges to Sustainability?

If development is always a process with a high level of uncertainty, in the particular case of Cuba this process fits within another process, also highly complex, which consists of maintaining/consolidating Cuban socialism, a goal which the political leadership described from the outset, in one way or another, as a "road to the unknown."

Moving towards development generally involves an *ex ante* understanding of the country one wishes to have. In this respect, the political leadership itself has formed a skeletal understanding of the desired paradigm which constructs a vision of the country as **"a prosperous and sustainable socialist society"**[21] that is **"less egalitarian but more just"**.[22] This is the most recent conceptualization of that desired future, which lays out the contours but does not define the details. Hence de-codifying the details of the components of that vision is an essential exercise in the country's future planning.

What specifically will define Cuban socialism in terms of the economy? An interpretation of recent events suggests that state ownership and management of key sectors and leading enterprises, along with the expansion of the private, cooperative, and foreign capital sectors, have resulted in mixed management of the economy (a type of planning different from the current one, with the addition of the active incorporation of the market) with direct and decisive state support for health and education. These elements appear to constitute the central core of that future socialism, an inalienable element of which is preserving independence.

What does a prosperous country mean in the case of Cuba? The relative ambiguity of the concept (because it entails a major subjective component associated with people's perceptions) requires that one look to specific indicators to clarify the answer.

One such proxy could be the Human Development Index and some of its components,[23] whose evolution over time is observed in the following figure (Figure 2). Several readings could be done of this indicator for Cuba, but all of them confirm the need to supplement it with other indicators, especially if one compares it to the country's evolving economic and social trends. The first comparison highlights the contrast between the improvement of this indicator and the relative stagnation of the rate of growth of per capita

[19] Carlos Rafael Rodríguez, "Cuba en el tránsito al socialism: 1959-1963" in *Letra con filo*, vol. 2, Carlos Rafael Rodríguez (Havana: Ciencias Sociales, 1983).

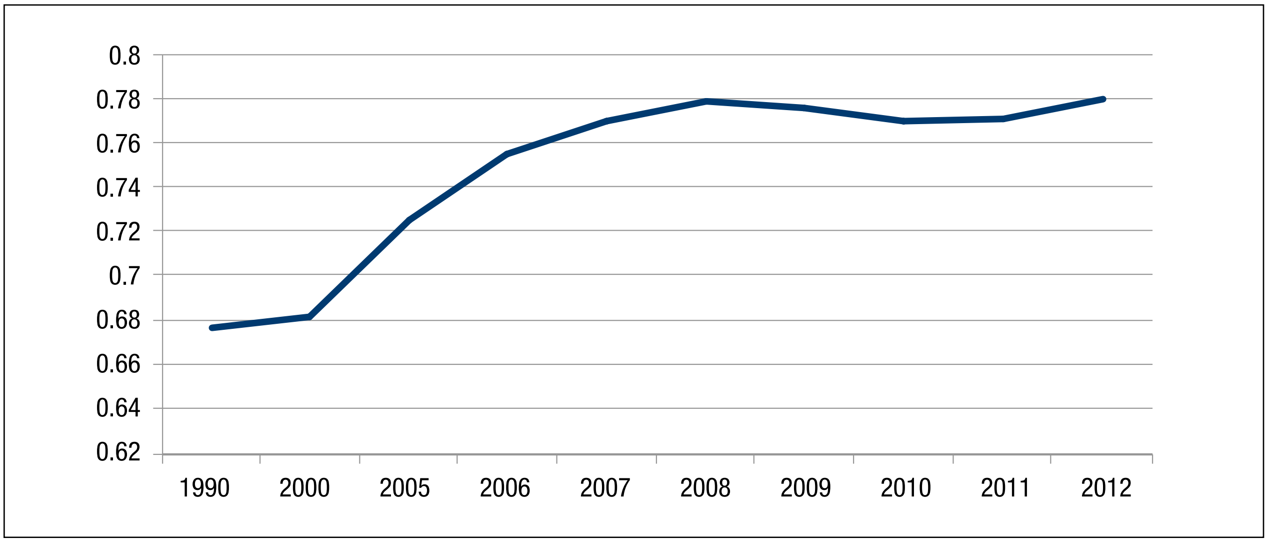
[20] Raúl Castro Ruz, "La mayor satisfacción es la tranquilidad y serena confianza que sentimos al ir entregando a las nuevas generaciones la responsabilidad de continuar construyendo el socialismo," *Granma*, February 25, 2013.

[21] Raúl Castro Ruz, "Valoramos que la actualización del modelo económico marcha con paso seguro y se empieza a adentrar en cuestiones de mayor alcance," *Granma*, December 14, 2012.

[22] Castro, *Granma*, February 24, 2013.

[23] But it should be understood that it is merely an initial approximation and is not reduced to this Index.

Figure 2. Human Development Index, Cuba (1990-2012)



Source: UNDP "International Human Development Indicators," 2013. http://hdr.undp.org (accessed March 31, 2013).

GDP in these same years and the deterioration of the real wage experienced in that same period.[24] A second element that calls into question the results of this index is that even in the 1990s, when GDP sharply declined, the HDI not only did not deteriorate, but improved. The HDI improved even though there was a general deterioration of indicators of economic efficiency and quality of life, such as diminished access to food and the quality of food, as well as a decline in transportation and electricity generation, and an increase in hidden unemployment.

The level of access to jobs that require skilled labor, improve productivity, and are adequately remunerated, as well as the level of access to modern services, could be included within the concept of prosperity along with the degree of equity in income distribution. In contrast to the rest of Latin America, Cuba has attained high standards of equality—although it is increasingly clear there is a setback in this area, partly as a result of the development process, but also due to the peculiar way in which Cuba is moving toward a new economic model. The path to development, in this case, should compensate the excesses in equality with improved standards of private consumption, especially associated with the increase in consumption in absolute terms and access to better quality public services.

In the case of sustainability[25] (a characteristic or state according to which the needs of the current population can be met without compromising the capacity of future generations or populations in other regions from meeting their needs), being a small island territory no doubt imposes a significant challenge.[26]

Nonetheless, other indicators of sustainability suggest the major challenge Cuba faces on its path to development. Cuba's demographic dynamic—the availability and use of water and arable land, for example—contributes another perspective, which in one way or another points toward the better use of existing resources and an improvement in Cuba's

[24] José Antonio Alonso and Pavel Vidal, "Reglas, incentivos e instituciones," in *¿Quo Vadis, Cuba? La incierta senda de las reformas*, edited by José Antonio Alonso and Pavel Vidal, (Madrid: Catarata, 2013) pp. 256-297.

[25] The figures used are from *Human Development Report 2011 – Sustainability and Equity*, p.164.

[26] Mindful of said study by the United Nations, Cuba's environmental footprint is 1.9 (UNDP, 2011), much less than other countries with similar levels of per capita income, yet the consumption of fossil fuels as a percentage of the total is practically 90 percent and urban pollution is also relatively high. In others, such as per capita greenhouse gas emissions, forest cover and its variation, the indicators are relatively favorable. Another angle of analysis is to refer these indicators not to population but to the country's productive capacity.

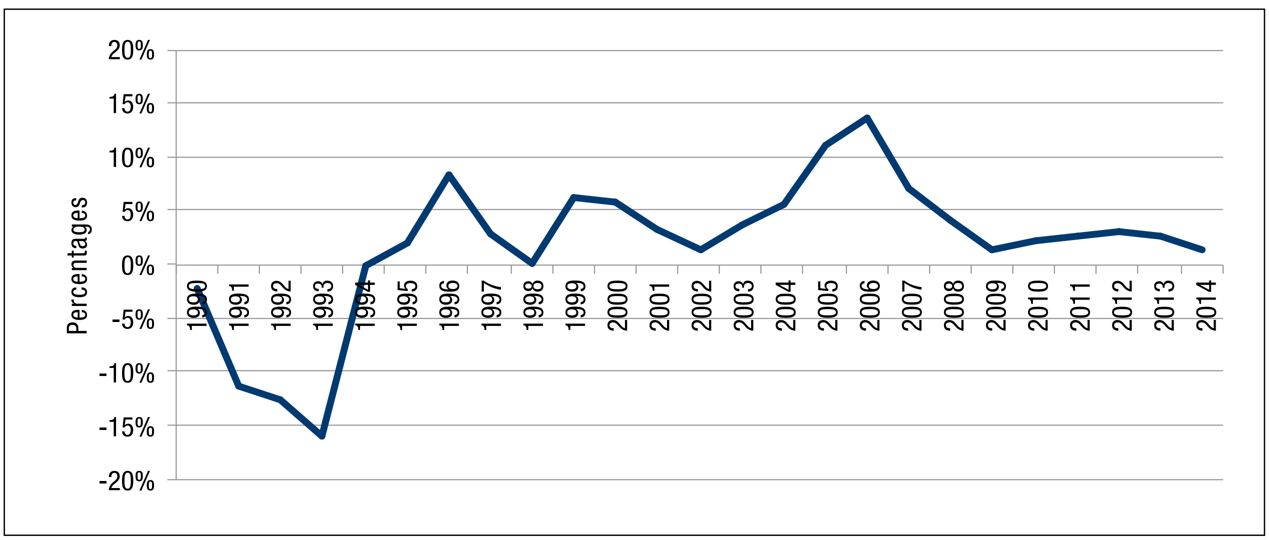
technological and organizational levels. In the medium and long-term, however, they point to the imperious need to achieve significant "technological leaps forward" that make it possible to create better conditions for attaining that sustainability. No doubt a policy that stimulates growth and makes it possible to achieve these goals of prosperity and sustainability is decisive in Cuba's immediate future.

The Need to Grow to be able to Develop: The Cuban Experience Post-Crisis.

The economic growth of any country is not an aim in itself, but constitutes an essential vehicle for attaining other important societal objectives. High growth may help create more productive jobs and reduce poverty. It also helps to obtain the resources necessary for health services, education, science, sports, and culture, among other key benefits and services. Analyzing the determinants of economic growth is one of the most dynamic core areas of economic science. The breakdown of growth based on its immediate determinants (capital and labor), and the resulting residual—Total Factor Productivity (TFP) has a long history and has been the subject of intense theoretical and empirical debates.

With the profound economic crisis of the early 1990s, the predominant focus in managing the economy was on the short-term, to address urgent situations in an exceptional period. Nonetheless, this need has shed light on the importance of addressing the country's prospective development by granting greater space to strategic matters. While Cuba began the recovery in 1994, the average growth rate of Cuba's gross domestic product (GDP) in the last 20 years has been approximately 1.8 percent annually, making it one of the lowest-performing countries in Latin America. If one takes into account only the years after 1993, the average rises to 3.2 percent.[27] This is still less than average for the region in the same period and is perhaps the most meager performance in the area. Certainly, a series of negative factors converge in Cuba that do not affect the rest of the countries in the region, but one cannot discard the possibility of this record being unsatisfactory even discounting the country's particular conditions[28] (Figure 3).

Figure 3. Rate of Growth of Real GDP, Cuba (1990-2014)



Source: Author's calculations based on ONEI (several years).

[27] Calculations based on Economic Commission for Latin America and the Caribbean (ECLAC) CepalStat, consulted in February 2013, http://websie.cl/sisgen/ConsultaIntegrada.asp.

[28] In 2014, GDP growth was planned at 2.2 percent. At the end of the first half of the year, it has only managed to grow 0.6 percent and was expected to close at 1.4 percent, confirming the tendency of continued poor economic performance.

Table 1. Estimations of the Contribution of Economic Growth Factors in Cuba

	Period	ΔPIB	ΔK	ΔL	ΔPTF
	1976-1985	6	3,42	1,49	1,09
Mendoza (2003)[29]	1986-1993	-4,75	1,76	0,91	-6,11
	1994-2000	3,81	-1,03	0,08	4,75
	1975-1985	6,45	1,7	2,56	2,19
Doimeadiós (2007)[30]	1986- 1989	0,52	1,99	1,25	-2,71
	1990- 1993	-10,03	-0,57	0,41	-9,87
	1994- 2003	3,33	-1,52	0,27	4,58
	1986-1993	-4,70	3,08	0,67	-8,45
Palacios (2010)[31]	1994-2003	4,42	0,81	-0,22	3,83
	2004-2008	6,28	1,21	1,96	3,11

Source: Prepared on the basis of works consulted.

In recent decades international experience has shown that growing at high rates is necessary for attaining development.[29] Yet that experience also tells us that along with the magnitude of growth, the quality of that growth is decisive.[30] Or similarly, if those high growth rates are attained based on deepening and consolidating a disadvantageous situation in international trade, or on extensively exploiting a country's natural advantages, or if that growth does not achieve significant changes in the structure of the economy and does not reach into those very sectors helping to increase their technological complexity, then the development impact will be significantly reduced, in part because the impacts on labor productivity and income distribution will not be long-lasting.

Cuba has experienced sustained growth since 1994, of course at rates significantly lower in the last 20 years (approximately 3 percent, depending on the reference year taken).[31] While there has been a notable structural change in the composition of exports from goods to services, this growth is also the product of a combination of the emergence of new sectors and the decline of others that had a long tradition and had traded in great volumes, such as sugar. Similarly, if one looks at the structure of output, non-commercial services (generally with lower productivity) continue to account for a decisive proportion of output and greater share of employment.

Table 1 confirms the essential differences in the style of growth and the means of addressing the crisis which began to take shape in the 1980s. The first, basically extensive, typified by relatively low restrictions on access to resources and financing, where the "opening" also meant implementing the System for Direction and Planning of the Economy, had positive effects, shown by the fact that the contribution of TFP is greater than that of capital. In the second and third period, TFP reflected the inertia in the style of the adjustment employed to manage the crisis in the first stages, with a preference for substantial cutbacks over major economic policy changes. The last of the periods, 1994-2003, shows how regulatory changes had a positive impact on

[29] Yenier Mendoza, "¿Ha sido importante el capital humano en el crecimiento económico de Cuba?" (Havana: Facultad de Economía, 2007).
[30] Yaima Doimeadios, El crecimiento económico en Cuba: Un analisis desde la productividad de los factores, (Havana: Facultad de Economía, 2007).
[31] Juan Carlos Palacios "Determinantes y restricciones del crecimiento económico en Cuba", Revista de la CEPAL No. 110, (August 2013).
[32] Commission of Growth and Development, *Postcrisis World in Developing Countries*, (Washington, D.C.: World Bank, 2010).
[33] ECLAC, *Cambio Estructural para la Igualdad: Una visión integrada del desarrollo, Trigésimo cuarto período de sesiones de la CEPAL, San Salvador, August 27-31*, (Santiago: United Nations, 2012).
[34] Always calculated at constant prices. There are several papers in which the rate ranges from less than 2 percent annual average, if one takes 1990 as a point of departure, to just over 3 percent if one takes 1993-94 as the starting point.

the recovery, even though they did not reach the necessary depth and breadth. The permanence of institutional arrangements particular to the development style of the 1980s prevented the adjustment and structural changes that began in 1994 from having a greater impact.[35] Additionally, the decreasing support shows the labor force in the first two models suggests that investment in education requires other supplements (incentives, physical capital, infrastructure, and information and ICT) to fully utilize the human capital formed.

Analysis of the Structural Factors of Economic Growth

While economic theory and empirical evidence are not conclusive as to the essential causes of sustained economic growth, a tacit consensus has formed around a group of elements that appear to determine countries' performance, albeit in different proportions depending on the specific context and particular priorities derived from diverse cultures. The analysis incorporates some of these essential factors, grouping them along two main axes: supply and demand. Within supply, the aspects related to the simple accumulation of factors and their quality are addressed. The second group includes those elements associated with demand, with a special emphasis on external markets.

In the final analysis, the interaction between them and the policies decided upon by governments leads to a certain path, subject to the restrictions and opportunities imposed by the international sphere. This sphere has become ever more important in recent decades, and requires special attention on the part of small countries whose very open economies are dependent on the external flows of goods, capital and knowledge.

Dynamics of the Population/Workforce: The Case of a Middle-Income Economy with an Advanced Demographic Transition

The labor force is one of the fundamental factors of production. Cuba's demographic profile suggests a near future contraction of the labor force, increasing the non-working age population and pressure on public finances. The aging of the population[36] and the increase in the dependency index (from 54.7 at present to 67.7 in 2025) are distinct aspects of this process. This trend could constitute a threat to sustained long-term growth, bearing in mind that due to Cuba's stage of development, it still depends on a greater availability of factors to sustain a path of high growth. Growth in such circumstances would be almost unprecedented for a developing state, since the experiences of high growth in the last 50 years occurred in countries with a growing and mostly young labor force during most of that process. Cuba will face a diametrically opposed situation.

In this regard, although one recognizes the long period over which these demographic processes have unfolded, and the fact that a change in the current trend would only begin to be perceived within a few decades, one could put a number of measures in place to cushion the current explosive path. This would allow more time to formulate other policies and begin to reap the benefits of the more immediate measures.

This process began, in fact, in 2008, with the reform of the Law on Social Security. The changes were geared toward increasing the maximum age of retirement, from 60 to 65 years for men; and from 55 to 60 years for women. This made it possible to delay, for a time, the moment when the rate of new entrants to the job market would be lower than the

[35] There are other more recent papers that obtain a breakdown of Cuban economic growth, with slight changes in the periods and methodologies employed, including, among others, Yordanka Cribeiro, *Contribución de la fuerza de trabajo calificada al crecimiento económico en Cuba*, (Havana: Facultad de Econmía, 2011). Nonetheless, the fundamental conclusions do not vary significantly.

[36] In 2011, 18.1 percent of the population was over 60 years old; that proportion will increase to 26.1 percent in 2025.

rate of those who are retiring. There was also an increase in the number of years necessary for benefiting from a pension in the general regime. These changes may help alleviate the negative impact of the country's demographic shift on the availability of public resources for covering expenditures for a growing over-60 population.

A comprehensive program is needed to stimulate the birth rate, as low fertility is one of the direct causes of the current trend. In this respect, one could work to establish a program to provide assistance to couples who have more than one child. In subsequent stages one could extend this plan to incorporate some type of facility to acquire or expand the housing of families with two or more children, increase the spaces available in day care centers (*círculos infantiles*), or cover part of the expenses associated with child care by private certified day care centers, as well as a certain amount of food. These programs, which have been tried with relative success in very different contexts, such as the Scandinavian countries, are highly dependent on an improvement in the fiscal position of the state.Thus, they should be implemented once a stable flow of resources has been secured such that macroeconomic equilibrium is not compromised.

In addition, immigration regulations should continue to be adapted in order to consolidate, in the medium term, a process of circular emigration that attenuates the drain of qualified personnel to other countries. One could think about extending additional guarantees for migrants of working age. The idea would be to guarantee, in the best of conditions, a strengthening of the ties with the country of origin. This effort runs up against a high degree of endogeneity, and this characteristic should be a sufficient argument for accelerating the transformations that take place in the economic model, especially those that have a direct impact on the capacity of persons to use their multiple talents to create individual and collective wealth and well-being, not only in the nonstate sector, but also the public enterprises in which most Cuban workers are employed. Improving the living conditions of vast segments of the population, albeit to a relative degree, could help contain the flow of migrants. For the time being, as a result of the changes in the migration regulations and uncertainty about the country's prospects, the negative balance of migration in 2012 (46,662 persons) was the highest since 1994, the year of the "crisis of the rafters." This reflects the complexity of the problem and the foreseeable negative impacts of this brain drain in the medium term.

Moreover, it may be necessary to develop closer relations with the Cuban emigrant community to facilitate greater exchange with Cuba, while at the same time extending these contacts beyond affective ties, family visits, or remittances, and toward the intellectual-productive realm so as to create conditions for some to consider a partial return to their country of origin based on identifying concrete interests in the work and business worlds.

The Quality of the Workforce

Most experts recognize that Cuba is well-endowed with human capital, the direct result of a very active education policy that includes higher education. In 2010 Cubans had approximately 10.57 average years of schooling,[37] the highest of any country in Latin America and the Caribbean, and one of the highest in the developing world (trailing only South Korea and Taiwan). On the education component of the HDI, Cuba has great educational achievement (87.6 percent of the highest possible score), once again the best in Latin America and most of the underdeveloped world (except former socialist countries and others in East Asia).

Research capabilities have also been created in several areas, with particular distinction in agricultural sciences, medicine, and biotechnology for applications related to human health. Nonetheless, in the last two decades, due to a multitude of factors closely related to the economic crisis of the early 1990s,

[37] Robert J. Barrow and Jong Wha Lee, "Educational Attainment for Total Population, 1950-2010," v. 1.0, 2010.

the quality of the education system has gradually deteriorated while other essential complements for the development of human capital such as the quantity and quality of the means of production, and expanding capabilities for basic and applied research, among others, have also experienced setbacks. Added to this is the weakness of the productive system, whereby a sufficient number of jobs are not created to efficiently absorb highly-skilled workers.

Added to this is a structure of skills in the professional and technical personnel that has not been updated fast enough to fully assimilate the major technological advances of the last two decades. These shortcomings are especially noteworthy in information and communications technologies (ICT) and foreign languages (Table 2). In addition, education and training in engineering and the natural and exact sciences were substantially cut back with the crisis. Finally, the major effort to extend the reach of higher education did not translate into a significant improvement in the quality of the graduates.

There are baseline conditions that depend on a greater endowment of resources, from more investment in updating the equipment available for training professional and technical personnel, to greater deployment of ICTs, which would help increase access to knowledge generated elsewhere. In addition, exposure to international trends should be furthered through education-abroad programs, including graduate-level education. In this area one could also make progress through coordinated actions in relation to foreign investment strategy. Such requirements have been applied by other countries to expand the spillover effects of such flows.

On another topic, increased technical training for teachers and professors is also subject to an improvement in economic performance that would make it possible to increase salaries. At the same time, gradually eliminating the monetary duality would foster a better scenario for evaluating the impact of these movements on price stability.

Physical Capital Accumulation

Current levels of investment do not guarantee the replenishment of physical capital or its expansion at the required rates. In the presence of very low domestic savings, one must substantially increase access to external savings, especially through FDI. This not only guarantees financing, but also new knowledge, technologies, markets, and insertion in global and/or regional value chains, and diversifies risk. One could put together a comprehensive strategy along these lines that includes at least these three axes.

First there is the need to increase the volume of resources and to improve efficiency in the use of domestic savings. This requires a proper framework that stimulates productive investment by national actors, public or not, which matches their treatment to that granted to foreign companies.

This requires the progressive updating and modernization of the national financial system so as to facilitate the use of new instruments and the deployment of a specialized banking system such as development banks, agricultural banks, microfinance institutions, and venture capital. Here the human resource training component is crucial, along with introducing new information and communications

Table 2. Select Indicators of ICT Infrastructure

	Cuba	Latin America
Fixed telephone lines (/100 pop.)	10.6	18.5
Mobile telephone lines (/100 pop.)	11.7	106.7
Internet Users (/100 pop.)	23.2	39.4
Broadband Internet subscriptions (/100 pop.)	0.04	7.5

Source: By the author based on ONEI, *Anuario Estadístico de Cuba* (several years) and World Development Indicators (2013).

technologies. One can look to successful experiences in this area in Latin America, both of governments and of numerous financial institutions and regional integration bodies. One must note that as growth rates improve and global productivity increases, one should generate larger volumes of domestic savings, which would amplify the scope and impact of such transformations.

A notable reserve of investment resources (and other resources, including labor) lies in progressively reducing the administrative apparatus of the Cuban State and Government. Such an initiative would free up a huge sum of resources for other productive purposes, while at the same time is consistent with an economic mechanism in which indirect regulation and the use of modern systems for planning and managing economic activity will have greater weight. It would be a substantial supplement to efforts to increase the contribution of national sources to the financing of productive investment.

Nonetheless, it is understood that due to both the conditions at the starting point and the present stage of Cuba's development, external flows of financing will be key for many years, representing all together a larger contribution than could be achieved from national sources. One must bear in mind that the average invested in the last two decades is only 10 percent of GDP, far less than the rates of 25-30 percent that have been observed for many years in high-growth economies. For that reason, a series of actions should be proposed to improve access to international financial markets that includes a gradual approach to the most important financial institutions (the Bretton Woods system), but also to other regional financial institutions, such as the Andean Development Corporation (CAF), the Inter-American Development Bank (IDB), and the Bank of the South. There are numerous political and technical obstacles, but the magnitude of the benefits suggests integrating these efforts within the transformations under way.

At the same time, there should be continued efforts to renegotiate the largest tranches of Cuba's external debt on sustainable bases. To date, favorable results have been reached with Japan and Russia, both members of the Paris Club; but steps in this direction should be accelerated. One important channel for supporting the aforementioned strategy has to do with negotiating preferential association agreements with partners with great weight in the world such as the European Union and the Union of South American Nations (UNASUR). Both blocs have some favorable conditions for successfully concluding those processes. One notable characteristic of the above-mentioned actions is the "avalanche" effect, whereby the extent to which tangible gains are attained in an area, more propitious conditions would be created for success in all other respects. This extends to the country's credit scores, which impose a huge additional cost derived from the high country risk and by the fact that only one of the three major credit rating agencies includes Cuba in its analyses.[38]

In order to capture larger-scale flows of foreign capital, a new comprehensive strategy for attracting FDI needs to be designed. Such an initiative is both essential and promising in current conditions. Along these lines, one must make progress in grasping the many contributions that can be expected from such a movement if it is conceived of as part of a vision of development looking to the future that takes into account the conditions and rules of the contemporary world. Here one can include the usual capital, technology, and market along with values of a new generation such as the creation of high-skilled jobs, insertion into global and/or regional value chains, risk-sharing, etc. In view of its expected impact, one should design a special policy for attracting large foreign businesses that can have a significant "demonstration" effect for other partners. Existing niches could also be tapped to attract more funds to small- and medium-scale projects with a local and regional impact.

[38] Moody´s. In April 2014, this agency downgraded Cuba's sovereign debt to Caa2, citing, among other things, the high exposure of Cuba's balance of payments to reduced ties with Venezuela.

At present, the Law on Foreign Investment is under review and it is anticipated that there will be a specific regime for the Special Development Zones (*Zonas Especiales de Desarrollo*, or ZEDs), among which the Port of Mariel is a pioneer. In both cases one of the bases of current tax revenues should be consistent with international practice and progress in the immediate regional environment. Otherwise it would be very difficult to ensure the success and sustainability of such policies. The same reasoning, if applied to special projects such as the ZEDs, could be extended to certain economic sectors for the purpose of fostering the best possible conditions for their subsequent advance.

Structure of Accumulation and Complementarity among Productive Factors

The previous considerations are relevant only to the extent that it is understood that one essential principle for the policy recommendations that stem from this approach is that—more important than the specific aspects—consolidating a successful and sustainable strategy for accumulating factors lies in the degree of complementarity that must be found at each point in time. Given that planners' information needs are very high, a steady advance depends on progressive decentralization and changes in the rules of the game at the microeconomic level, including the strong promotion of innovation and external competition.

Progressively reducing the distortions present in the fundamental prices of the economy plays a role here. Correcting the disequilibria associated with the dual monetary circulation and the multiplicity of exchange rates is a necessity that cannot be put off. This should be supplemented successively by mechanisms that make it possible to transmit changes in international prices to the domestic economy so as to guide the internal allocation of resources. This is especially relevant taking into account the size of the Cuban economy and its high dependence on foreign trade.

The other main component of these macroeconomic changes is situated at the level of the meso-economy. It would be especially important to design an industrial policy that would boost the competitiveness of those activities that have a special impact on accumulation and on Cuba's external insertion. In this regard, not only is the quantitative and qualitative increase in the availability of productive factors important, but in addition, a regulatory framework with adequate rewards and penalties is needed for establishing clear rules that make it possible for the economic actors to correctly channel their decisions related to the combination of available factors. Accordingly, a sufficiently flexible and modern framework is needed so that enterprises of any size and type of ownership can increasingly make flexible decisions about their levels of production, prices, type of offering, choice of suppliers and target markets, and establish various partnerships, including with foreign companies. Moreover, progress is needed on the institutional framework that supports progressive fulfillment of the fundamental markets of the economy, such as the financial market, the labor market, and the capital goods market.

Access to International Markets

One of the secular characteristics of the Cuban economy has to do with its high external dependence and the prejudicial nature of that relationship over history. Cuba's most profound economic crises have had to do with disturbances whose origins are in the external sector. In this context, one notes the country's scant export dynamism, the maintenance of a profile of low levels of diversification, specialization tied to products that are hardly dynamic in the international market, and dependency on a large commercial power at different stages. In the Latin American region, Cuba has one of the least commercially-intense economies, especially if one bears in mind its size and level of development. This condition has not changed substantially in the last 25 years, even if one takes into account the effect of the sales of services (Table 3). This performance is inconsistent with a history of high growth for open economies.

The Cuban central government should accord high priority to attaining greater trade integration based

Table 3. Export Potential of Select Countries of Latin America

Countries	Total exports/GDP		Exports of goods /GDP		Per capita total exports		Per capita exports of goods	
	1990	2012	1990	2012	1990	2012	1990	2012
Bolivia	20	45	17	41	147	1149	125	1067
Chile	31	34	25	29	775	5205	635	4482
Costa Rica	27	38	19	25	639	3542	441	2381
Cuba	**21**	**22**	**19**	**9**	**562**	**1474**	**512**	**567**
Dominican Republic	20	25	8	15	255	1416	102	876
Ecuador	29	36	24	34	318	1708	265	1591
Guatemala	23	25	18	20	176	832	136	670
Uruguay	23	27	18	20	694	3870	544	2928

Source: Authors' estimates based on United Nations Conference on Trade and Development UNCTADStat (consulted February 2013).

on negotiating mechanisms for preferential access with different partners. In Latin America, Cuba is one of the countries with the fewest preferential trade agreements, which puts its producers at a clear disadvantage vis-à-vis their competitors in the rest of the world. Preferential agreements need to be negotiated with more countries, extending to investments, protection for intellectual property, and technical barriers to trade given the strong relationship between flows of productive capital and trade in the modern world. Certainly the U.S. blockade is a major obstacle in this regard, with profound bilateral and multilateral implications. In trade, the United States accounts for almost one-fourth of world imports, but it is an even more important buyer for the countries of Latin America, which means that the cost to Cuba is much higher than what one can predict based on a static analysis. To this is added a significant qualitative dimension: it is not just one more trading partner, but a world leader in the supply of advanced technologies and a major source of investment flows.

Another sphere in which substantial changes are in order is the regulatory framework for exporters. For example, even though Cuba has negotiated some trade agreements with Latin American countries, at present most of the items subject to preference remain inactive on the Cuban side. One of the most common complaints from Cuban exporters is the large number of regulations that apply to export operations and all the red tape one must wade through. A relatively small sum of resources could go a long way toward simplifying these procedures.

One very important aspect is related to modifying the nature of the intermediation between producers and commercial operators in the external markets. At present, it is still administrative in nature, causing great inertia and inflexibility, further distancing the producers from the trends in international markets. Here one could further strengthen a group of key institutions such as chambers of commerce, both general and those that represent specific sectors, while at the same time strengthening an export promotion agency with a clear mandate. These organizations could fill the needed space, advising Cuban companies to expedite the process of coming out successfully in the external market. To this, other more specialized ones could be added based on the type of product or geographic area.

The Domestic Market

Often forgotten or undervalued, the role of the domestic market takes on new importance today as a factor for promoting growth. In this case, it is important to understand that the change in the scenario of the current Cuban economy and future trends promote an expanded role for new economic actors (small and medium enterprises, cooperatives, and private actors). The role of these new actors in creating capacities for accumulation, the process of completing the productive chains, and the introduction of process and product innovations should radically change the structure and dynamics of Cuba's domestic market. One of the essential challenges has to do with achieving the full integration of these new actors to productive activity, including access to knowledge and new technologies.

Other countries' experiences show that horizontal relations are essential in a modern economy. Along with traditional commercial relations, one also notes an increase in agreements related to investments, joint project management, integrating research and development units, strategic partnerships for accessing new markets, and many more. This type of behavior is associated with a more flexible type of organization that responds to the changes more nimbly and that is capable of constructing and sustaining competitive advantages, intelligently combining their capacities with those of other institutions that operate in their milieu.

The Cuban economic model has worked with a wide variety of barriers that limit the development of horizontal relationships among institutions, parceling up a domestic market that is already small. This creates additional difficulties for the social division of labor and specialization, which are fundamental forces for increasing productivity and, therefore, for improving incomes and economic and social development. Among the most visible barriers, one can cite the highly vertical and centralized structure of the economic system, the placement of the entities by provinces, the type of currency with which current transactions are conducted, the form of ownership, and ministerial affiliation, among others.

Given that the economic system works on the basis of a vertical and centralist model, most decisions are made at the higher-level structures for coordination. This means that the duration of the whole process is drawn out, as proposals have to be discussed and approved at the various levels, to later be implemented in the companies. In addition, given that in general these actions involve the execution of resources, and that such expenditures should be included in the annual plan of the entity and corresponding ministry, approval is even more complex because it depends on the real availability of resources in keeping with the external financial balance sheet. This presupposes certain very strong disincentives for managers when it comes to seriously thinking of undertaking an action in this regard.

In other cases, the possibility of associating or establishing some type of exchange is prohibited or limited administratively. This is the case of service companies assigned to a specific territory (province or municipality) or those that address their respective ministerial structures. As a rule, they cannot engage in transactions with entities other than those approved for purchasing their inputs, selling their production, contracting a specific service, etc. The same holds for different types of ownership, although this has improved formally in the last year. All these barriers are much more severe if the counterpart is a foreign company.

An examination of the overlap of these limitations reveals an evident contradiction. On one hand the entities are constantly called on to improve their performance, while on the other hand those same enterprises cannot respond with agility to the opportunities they identify. In the contemporary economy this capacity depends crucially on being able to establish a dense network of ties with their counterparts in a wide array of areas, but depriving them of that ability translates into a substantial reduction in their possibilities of success. This takes on a larger dimension for those that are closely tied into external markets.

Moreover, the current monetary arrangement is based on the circulation of two currencies and multiple exchange rates. It has resulted in the establishment of numerous distinct markets that operate simultaneously. Some differ in the mechanism of price formation (regulated, fixed, freely formed), others use different monetary signs (CUP, CUC, USD), and there are both formal and informal markets. In many cases one observes an overlap of supply, in terms of trading in goods and services that are very similar or even substitutes at very different prices. This process ends up feeding an informal market that operates on the basis of the arbitrage of those price differences. In addition, the growing importance of the non-state sector of the economy, which is not administratively subject to the rules of the Annual Economic Plan, has most intensely revealed that the development of markets for factors of production is lagging considerably with respect to consumer goods. In addition, the restrictions in which Cuban monetary policy has operated in the last 20 years have resulted in monetary mechanisms in which price stability has depended excessively on containing real salaries, which keeps the actual consumption of families at very depressed levels. This conspires against the necessary increase in aggregate demand, so as to make it possible to accommodate a larger and more specialized supply.

These distortions result in the process of allocation of productive resources taking place without clear signals of the relative scarcity of the various inputs, factors of production, and structure of demand. This inevitably leads to a very inefficient distribution, precisely the least desirable outcome in a context of scarcity. On top of that, the dynamic effect of this mechanism could be the most dangerous aspect. For example, the differences in remuneration among certain occupations may be inducing a shift in the skilled labor force to positions that do not necessarily require a high professional level. This may represent a gain in the short run for the individual, but it may be a waste of resources from society's point of view. Unfortunately, once a certain amount of time has gone by in such conditions it is very costly to reverse the situation, since the non-use of certain skills and know-how may result in a partial disqualification. Similar processes may be occurring in other markets, while the enormous current distortions are maintained.

Conclusions

Cuba is a special case of the paradoxes of development. Cuba is a pioneer in explicitly introducing social policies into a development strategy, with unquestionable accomplishments in terms of standard of living and social mobility indicators. Yet going back to the years prior to 1990, it is also notable for its limited capacity to tap into that unquestionable advantage, especially in the last two decades, given its scant flexibility when it comes to accommodating to a changing and often hostile external environment. A significantly less prodigious scenario and 20 years of attrition managing a crisis that began in the 1990s, have led to a re-thinking of the future in the medium to long term and to an effort to find a model of sustainable development that ensures prosperity and gains for the nation in specific areas.

The paradoxes, however, are unquestionable. On one hand, Cuba is a country with limited resources that has not succeeded in coming up with a macroeconomic and institutional design that allows it to exploit those scarce resources intensely and effectively. On the other hand, it enjoys a relative abundance of highly skilled labor for which the economic model is not able to generate adequate, productive, and sufficiently well-remunerated employment. There is also increasing recognition of the insufficiencies of the state sector along with hesitations and sustained restrictions on greater expansion of a non-state sector that has already proven it can be functional to the purposes of Cuban socialism. Characteristics include: unquestionable evidence of the insufficiency of its own resources for undertaking development and significant technological lags along with delays that are hard to understand in the opening to foreign capital; time restrictions, both political and economic, in the face of procedures that at times are excessively drawn out for making and implementing economic decisions, with an opportunity cost that has yet to be calculated (but is no doubt high); a strong aspiration to decentralize decisions in the face of a profound centralizing culture that permeates the very process of "decentralizing"; the need for "institutional innovations" that accompany the "updating of the model" in the face of the survival of institutions that were born and developed in the past that have not been able to change their *modus operandi* in any essential respect and that generate high transaction costs.

That is why the policies for stimulating growth must not be considered in isolation from the context in which they are implemented. Just in the last two years there has been a much more explicit intent to integrate that vision of growth and development in Cuba as part of the strategy for "modernizing Cuban socialism." Nonetheless, there is still a long way to go not only in terms of design, but also when it comes to applying the approved policies and learning from those experiences. One must also acknowledge that as the process advances it will be more complex, as the Cuban economy and society will become more diverse. It will then be much more necessary to truly fine-tune and coordinate those policies to be able to minimize the costs of that process.

Technical difficulties are also encountered in the initiative to move toward policies with an emphasis on economic growth. First, the skills and knowledge that Cuba's decision-makers manage to incorporate will be key. This is due essentially to the fact that for 50 years they have trained in a context and with mechanisms that are part of the problem today, and a consensus appears to be emerging in the direction that some of the coming tasks have to do with making substantial changes to the economic model. Even though certain terms are not used, it seems clear that Cuba is moving toward a model more like a market economy[39], yet the final objective does not appear to be to transition into a typical capitalist country. This has a value that goes beyond the sphere of political economy, given that the reconfiguration under way implies that the tools and policies to be fostered (for example, economic growth), would be increasingly similar to those employed by most countries. Hence the importance of drawing on the lessons learned from the experiences of other nations.

The microeconomic level is another area that may be a source of bottlenecks in implementing these policies since there have been no firms or consumers in Cuba for many decades in the standard meaning of these terms. As a result, the institutions that support the sound working of markets[40] (in which these economic actors increasingly have to make their decisions) are very weak and do not have the skills or know-how in the public administration to construct them, again due to the previous experience being practically irrelevant. This line of reasoning indicates that the scenario that Cuban decision-makers will face in the future will be no less difficult with regards to the mix of policies and instruments for directing an increasingly complex and decentralized economy. This would be the case even if economic indicators were to improve significantly.

[39] This can be observed in a number of spheres, such as: the growing weight of the non-state sector (private and cooperative); greater decentralization in decision-making for all economic actors as a whole (consumers, state enterprises, private enterprises, cooperatives); greater functionality of the price system in the allocation of productive resources; and the growing role of direct taxes (applied to the net earnings of a productive activity) in financing the State, among others.

[40] Including, among others, the definition and promotion of basic economic rights, the promotion and defense of competition, correction of market failures, promotion of stability and growth, and social cohesion and effective dispute resolution. For more details on this issue see Alonso and Vidal.

Economic Transformations and Institutional Changes in Cuba[41]

Antonio F. Romero Gómez

Introduction

In recent years (2011-2014) a process of major changes has been set in motion in Cuba that affects core aspects of the previously existing economic model. The economic transformation—structural in nature, also including reforms in management mechanisms, and in economic and administrative organization—entails changes in the political sphere and equally key institutional challenges.

The relationship between economic change and institutional change is a two-way process: institutional change is necessary for enforcing economic reform, and economic reform, in itself, changing the rules of behavior of economic and social actors, implies an institutional change. At present, Cuba is going through an economic transformation of greater reach than the country had experienced in earlier periods. Given the irreversible nature most analysts attribute to these changes, they must be accompanied by a profound institutional change, understanding this as a change in the rules, norms, and values that had prevailed in Cuba until recent years.

In light of the aforementioned, it is useful to study the institutional changes that accompany—and also those that should accompany—the process of economic and social transformation currently under way in Cuba.

Obviously, the Cuban case is characterized by a set of elements—both objective and subjective—that explain certain points of resistance to the process of change, and which make it such that this process has been based on the implementation of gradual yet continuous modifications[42] that are leading the system towards an economic, social, and institutional environment unknown to most Cubans born after the triumph of the revolution.

The fundamental purpose of this paper is to study the economic and institutional changes that have occurred in Cuba in recent years. To do so, the analysis is organized in four sections. The first highlights some recent conceptual notes regarding the discussion about institutions and economic change. The second section addresses considerations concerning the starting point of the economic and institutional changes in an effort to contextualize the Cuban reality up to the end of the last decade. The third section undertakes an analytical summary of the economic and institutional changes that have taken place in Cuba in the most recent period. The fourth section describes some of the most important institutional changes facing Cuban society today, highlighting what remains to be done. Finally,

[41] This paper has been translated from Spanish to English.

[42] In effect, not a year has gone by in Cuba since 2008 in which some regulation typical of the past has not been modified.

the main ideas contained in this essay are summarized in the conclusion.

General Context of the Discussion on Institutions and Economic Change

Institutions define the framework of incentives and penalties, of values, norms, and beliefs that shape and regulate social interactions. In so doing, institutions not only reduce their own risk and transaction costs, but also spur on collective action, resolving certain problems of coordination that arise among institutions that make decisions independently in a framework of generalized interdependence.[43]

In the recent period the most modern theories regarding economic growth and development emphasize the relevance of institutional quality in the processes of modernization and growth of economies.[44] With respect to both the discussion of the relationship between institutions and economic development, and the adaptability to change or the socially acceptable distribution of the benefits of collective action, there is a strong focus on the idea of institutional quality and its main determinants.

In estimates by Alonso and Garcimartín,[45] institutional quality is the most solid and robust factor explaining countries' development, no matter the indicator used to measure it. Many analysts tried to identify the variables that explain institutional quality, having recourse to historical or geographic factors in each country. In an earlier article Alonso and Garcimartín adopted a more analytical approach, trying first to identify the criteria that define a "quality" institution.[46] They suggest the following criteria for gauging institutional quality: (i) the capacity of an institution to promote equilibria that exhaust the possibilities afforded by the technological frontier; (ii) the capacity of the institution to draw up credible inter-temporal contracts; (iii) the capacity to reduce the uncertainty associated with human interaction; and, (iv) the capacity of the institution to anticipate changes in the social reality.

Change theory has evolved to greater complexity in explaining the economic dynamic, incorporating new factors and new economic conditions, moving from the realm of the tangible (physical capital) in identifying the factors that promote growth to another realm in which less tangible factors play an important role, such as externalities, knowledge, technology, and human capital.[47]

Sustained economic growth implies macroeconomic stability, for which there must be a stable, credible, and predictable legal and regulatory framework in the country. In addition, public finance, with its two components of revenues and expenditures, needs to be efficient, flexible, fair, and efficient. Clearly, both the regulatory activities of the state and those associated with its redistributive functions depend on the scale of and capacity for managing the public treasury. Finally, to ensure sustained economic growth, it is essential to have adequate institutions for promoting macroeconomic stability through monetary, fiscal, and exchange policy instruments.

Also among the determinants of sustained economic growth are considerations associated with the distribution of income and assets, which requires that the state correct that distribution, to that end drawing on the possibilities afforded by its regulatory activity and the policy for revenues and public spending. This task, intrinsic to every modern state, is essential given that the market strengthens

[43] José Antonio Alonso and Pavel Vidal, "Reglas, incentivos e instituciones," in *¿Quo vadis, Cuba? La incierta senda de las reformas*, ed. José Antonio Alonso and Pavel Vidal, (Madrid: Catarata, 2013), pp. 256-279.
[44] Nonetheless, we are far from having a unified and consensus-based theoretical framework for analyzing institutions and their change processes.
[45] José Antonio Alonso and Carlos Garcimartín, "Factores determinantes de la calidad institucional. Un estudio empírico", *Revista de Economía Aplicada*, Vo. XIX, No. 55, (2011) pp. 5-31.
[46] José Antonio Alonso and Carlos Garcimartín, "La calidad de las instituciones: una panorámica internacional," *Cuadernos de Información Económica*, no. 202, (February 2008).
[47] José Antonio Alonso and Juan Triana Cordoví, "Nuevas bases para el crecimiento," in *¿Quo vadis, Cuba? La incierta senda de las reformas*, ed. José Antonio Alonso and Pavel Vidal, (Madrid: Catarata, 2013), pp. 25-64.

dynamics of accumulation conducive to increasingly polarized income distribution.[48]

Finally, promoting social cohesion—an indispensable component of any development strategy and any sustainable pattern of growth—requires the existence of solid and credible institutions to represent and channel the interests of the most diverse social groups. Given that the market does not guarantee adequate distribution of economic activity throughout the national territory, promoting social cohesion also requires setting in motion regional and institution policies to correct exclusionary territorial dynamics.

Historical Context and Starting Point of the Current Economic and Institutional Changes in Cuba

From the triumph of the Revolution until 1976, a period referred to as one of provisional institutional arrangements (*de provisionalidad institucional*), the Revolutionary Government centralized and concentrated executive and legislative functions in Cuba. It did not distinguish between state functions and governmental functions. The laws issued by it were constitutional in nature and aimed to address all areas of social life from this single organ of public power.[49]

The permanent hostility of the U.S. administrations —through political pressures, the imposition of diplomatic isolation, espionage, economic sanctions, direct aggression in various forms including organizing plans to assassinate President Fidel Castro, and military harassment—helped to install a siege mentality in Cuba's institutional culture. In this context, the political leadership of the country understood that the concentrated control of resources and forces, the armed mobilization of the population, and discipline in citizen conduct were the best resources for gathering forces that would deter the intent of direct aggression and would make it possible to address the challenges raised by the indirect aggression.[50] Concurrently, the revolutionary state grew in size, influence, and degree of programming of social life, on the legitimate grounds of national defense.

In economic terms the model included—and still does, albeit with significant modifications—attributing decisive weight to state ownership over practically all the means of production, and according priority to large state enterprises as the fundamental form of economic organization. The direction of the economy has been based on planning with very high doses of centralization and, consequently, the role of monetary-mercantile relations in economic operations has been marginalized.

To the aforementioned one must add the effects stemming from the profound process of income and opportunity redistribution through social justice policies via state action, with the consequent social ascent experienced by broad sectors of the Cuban population during this period. This reinforced the perception that it was necessary to enshrine the state as the only instrument capable of carrying out the great revolutionary transformation and ensuring national independence.[51]

The socialist Constitution promulgated on February 24, 1976 institutionalized the new state. It had three fundamental objectives: (i) to regularize the decision-making process, (ii) to decentralize state power, and (iii) to enshrine the catalogue of citizen rights. These objectives were to be attained through the dynamic of centralization-decentralization

[48] The public institutions should set in motion corrective mechanisms that prevent the consolidation of exclusionary processes and strengthen equal opportunity among economic actors.

[49] See Santiago Díaz de Sarralde and Julio César Guanche , "Descentralización y desconexión del poder estatal," in *¿Quo vadis, Cuba? La incierta senda de las reformas*, ed. José Antonio Alonso and Pavel Vidal, (Madrid: Catarata, 2013), pp. 226-255.

[50] Ibid.

[51] Ibid.

established in the text of the Constitution. Nonetheless, the institutional system would preserve strong features of state concentration and, at the same time, determined that in the dynamic of centralization-decentralization, the central level of the State would be favored.

Since 1992, when the Constitution was amended to bring it into line with the post-Cold War scenario, the state structure has been notably reduced: there was a cutback in public sector employment, state organs were downsized, certain state functions were redefined, an effort was made to decentralize power downward (to the provincial and municipal governments), and laterally (to the ministries), there was an increase in the autonomy of the parts (ministries and other states institutions) and different levels (national, provinces and municipality levels), and measures were adopted for their operations that granted more space—albeit limited—to the market forces, with prices established by supply and demand.[52] These changes became much more evident as of 2011, with the gradual implementation of several policy measures incorporated in the Economic and Social Policy Guidelines, which were approved at the Sixth Congress of the Communist Party of the Cuba and afterwards reaffirmed by the National Assembly of People's Power, a process that will be addressed in the next section.[53]

In any event, the Cuban State continues to exhibit, at the beginning of the second decade of the 21st century, a notable degree of centralization that was expressed both territorially, with respect to the scope of authority of provinces and municipalities, and functionally, on concentrating the decision-making processes of a good part of the economic agents, mainly of the state enterprises, which are at the core of the national productive structure. The current economic and institutional reform is called upon to reduce those degrees of centralization, allowing for greater autonomy for the state enterprises and the new non-state productive actors that have been consolidating, as well as for the geographical entities. Certain advances can be noted along these lines. Obviously, this process is not easy, since it affects one of the key axes for articulating power and defining spaces for citizen participation.

Economic Modifications and Institutional Changes: Implementing the Economic and Social Policy Guidelines in Cuba

Any assessment of Cuba's economic performance after the triumph of the Revolution in 1959 would have to recognize periods in which there were gains and positive results, but also structural rigidities and bottlenecks that ultimately have held back the development of the productive forces in Cuba.

From 1959 to 1989 Cuba's total output grew at an average annual rate of 4.3 percent, which determined per capita growth of 2.8 percent, for which significant investments were made, and average annual gains in labor productivity came to 2 percent.[54] More significant is that those results were recorded at the same time as a progressive redistribution of income was brought about stemming from the profound transformations in the social structure based on the radical revolutionary process begun in January 1959, and in the midst of the iron-fisted economic sanctions—commercial and financial—imposed by the government of the United States on Cuba as of early 1962.

The changes in the international scene in the late 1980s, and in particular the disappearance of the socialist system from the world economy, undercut

[52] Indeed, the State, since the early 1990s – with the economic adjustment and reform measures begun in 1993 – renounced part of its monopoly over the economy, employment, and control of the population's incomes.

[53] Cuban Communist Party, VI Congress of the Cuban Communist Party, *Lineamientos de la política ecónomica y social del partido y la Revolución*, April 18, 2011.

[54] José L. Rodríguez, "La economía cubana," in *Estado, nuevo orden económico y democracia en América Latina*, (Caracas: Editorial Nueva Sociedad, 1992), pp. 217-223.

the bases that sustained Cuba's foreign economic relations and set in motion an acute critical dynamic in the Cuban economy starting in 1990. Those transformations required re-articulating the country's external economic relations. That re-articulation of Cuba's foreign engagement, begun in 1993, resulted in some changes in the forms of economic management as well as perceivable—though not radical—changes in the structure of ownership and employment. For some observers, the emergence of new actors who shook up the "traditional social values" of the Revolution was a "necessary evil" that should be corrected once past the critical stage and/or once the external conditions for the country's development changed.

With the ushering in of the new century, and with a gradually expanding economic relationship with the Bolivarian Republic of Venezuela—later in the context of the Bolivarian Alliance for the Peoples of Our America (ALBA)—as well as consolidated relations with the People's Republic of China, the process of changes in economic policy and economic management (weakened since the late 1990s) came to a halt and there was a certain turning back of the process of economic decentralization that had been experienced earlier. Yet the new modalities of foreign engagement, with major revenues for Cuba from the export of professional services and favorable conditions for financing fuel imports, did not prevent the re-emergence of a period of clear economic stagnation, with serious macroeconomic disequilibria and severe financial limitations, since the middle of the last decade. The structural obstacles that impeded Cuba's economic and social development were felt once again, as has happened repeatedly. Those obstacles include: (i) lack of adequate internal linkages in the productive structure, (ii) lack of any change in the profile of productive specialization (of goods), (iii) significant dependence on intermediate and capital goods from abroad to complete the cycle of major production, (iv) technological obsolescence in several areas of production, and, (v) very low economic efficiency and return on capital, which do not correspond to the levels of education and training of the Cuban workforce.

In large measure the insufficiencies of the country's economic structure and dynamic could perhaps be explained by the general characteristics of the Cuban enterprise system. In a study of the systems for managing the economy since 1959 and their impact on the productive trajectory of the enterprises,[55] two essential elements stand out. First, the development strategies promoted in this period were characterized by the absence of a systemic approach, impeding the attainment of key long-term objectives; it was not possible to implement a coherent set of strategies, policies, and instruments aimed at generating a favorable context for innovation. And second, the regulation and control mechanisms were characterized by their centralization and verticality, leaving little space for enterprises, and resulting in the predominance of large state enterprises and a practically ceremonial role for cooperatives, relegating individual entrepreneurship to a marginal role.[56]

On taking stock of the above-noted structural problems the highest-level authorities in Cuba proposed the need for a major process of structural changes in the management of the economy and in economic policy, under the rubric of "updating the economic model," which was approved at the Sixth Congress of the Communist Party of Cuba.[57] As part of that program, many changes have been introduced in the economy and regulatory system.

Among the recent modifications, several have as their purpose the restructuring of the national economy in terms of employment, ownership structure,

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[55] Ileana Díaz Fernández, "La productividad en la empresa estatal cubana," in *Economía Cubana, ensayos para una reestructuración necesaria*, eds. Omar Pérez Villanueva and Ricardo Torres Pérez, (Havana: Centro de la Economía Cubana (CEEC), 2013), pp. 193-220.

[56] See Isabel Álvarez and Ricardo Torres, "Tecnología, innovación y desarrollo," in *¿Quo vadis, Cuba? La incierta senda de las reformas*, ed. José Antonio Alonso and Pavel Vidal, (Madrid: Catarata, 2013), pp. 102-147.

[57] Cuban Communist Party.

and scale of production. This restructuring opens up more spaces and promotes a scenario in which market considerations are becoming incorporated into the design of economic regulation policies.[58] At the same time—and as a result of the dynamics described above—non-state forms of ownership and management are beginning to be consolidated, including the proliferation of new enterprises that can be classified as micro, small, and medium enterprises (MSMEs).

In large part the changes have been promoted through a procedure that is beginning to become the norm in Cuba: First an experiment is carried out; then the results are verified; the proposal is adjusted; and it is then adopted generally through the design and approval of the new legal framework.[59] It is in the area of economic relations where most of the changes have taken place in Cuba from 2011 to 2014. Accordingly, a growing sector of self-employed workers has emerged, this time with "*cuentapropistas*" (persons engaged in self-employment) who can hire other workers. A major transformation has also taken place in the agricultural sector, which is becoming stronger and developing cooperative and non-state economic entities (including not only agro-food mini-industries). New impetus has been given to the process of "*perfeccionamiento empresarial*" (entrepreneurial enhancement) in several production and state services institutions, which on occasion inspires new methods of organizing and managing productive entities. Finally, commercial, technical, and personal services institutions that had been structured as state-owned provincial and municipal enterprises are becoming cooperatives of various sorts.[60]

The process of de-statization of agricultural is especially important. One should bear in mind that the State disburses some US$2 billion annually to import food, about half of which could be saved since such food items could be produced nationally. This was explained by Marino Murillo Jorge, Vice President of the Council of Ministers and Chief of the Commission on Implementation and Development of the Guidelines.[61] For that reason, according to him, from the Sixth Congress of the Cuban Communist Party until mid-September 2013, 14 principal policies inherent to the agriculture sector had been approved, with varying degrees of implementation.[62] Among these, special mention could be made of the following structural and institutional changes:

i. As of 2008 idle lands began to be turned over to individual and cooperative agricultural producers for usufruct for 10 and 25 years, respectively, with the possibility of renewing the contract at the end of the period. In 2012 new rules were approved that make the process more flexible: (a) increasing the ceiling on the maximum area per producer from 40 to 67 hectares; (b) facilities for obtaining inputs; (c) the possibility of building housing and infrastructure on the lands, among others.

ii. In addition, a radical transformation began in the operation of the Basic Units of Agricultural Production (UBPC: Unidades Básicas de Producción Agropecuaria), the type of agricultural productive entity which since the mid-1990s had the largest agriculrtural landholdings.

iii. Since mid-2011 there has been a legal change associated with the agricultural sector and the substitution of imports aimed at developing tourism. Approval was given for agricultural cooperatives to sell directly to hotels. Now,

[58] In any event, the decision is that the plan will continue to play a central role in giving direction to the economy. In this respect, Guideline No. 1 states: "The socialist planning system will continue to be the principal means to direct the national economy…."

[59] See Alonso and Vidal.

[60] In addition, authorization has been given for public sector institutions of the economy to enter into contracts with private entities; a cooperative sector is emerging that is not limited to agriculture; and major reforms are under way in the system for agro-food distribution and in agricultural markets, among other changes.

[61] The critical assessment of the authorities themselves with respect to the agricultural sector includes the fact that of the economically active population in Cuba, 20 percent are tied to the Ministry of Agriculture, yet it contributes only 3 percent of national GDP.

[62] "Agropecuarios por la seguridad alimentaria y el avance de la economía," *Granma*, September 16, 2013, p. 8.

the regulations have been updated, expanding their options. Resolutions from the ministries of agriculture, tourism, and finance and prices, published in the Extraordinary Official Gazette No. 24 on September 9, 2013, set forth guidance for the transformation of the agricultural output collection and marketing system through more expeditious mechanisms that simplify the linkages between primary production and the end consumer. Thus small farmers—owners and usufructuaries of the land—have the option to sell their output directly to tourism entities, something they could previously only do through the Credit and Service Cooperatives (CCS: Cooperativas de Créditos y Servicios). Also, new products were added to the list of approved products. In addition, according to determinations by the Central Bank of Cuba (BCC: Banco Central de Cuba), they may open current accounts in Cuban pesos (CUP) in the country's commercial banks to guarantee the direct ties between tourism entities and small agricultural producers.[63]

iv. Also tied to agriculture, through the publication of Extraordinary Official Gazette No. 35 a regulation came into force that allows for experimental development of new formulas for commercializing agricultural output in the provinces of La Habana, Mayabeque, and Artemisa. This decision is aimed at studying, on a sub-national scale, other approaches to commercializing agricultural output that make it possible to modify, expand, improve, and then extend these provinces' experiences to the remaining provinces. This addresses the need to transform commercialization to eliminate the mechanisms that currently make it cumbersome, so as to make it more dynamic, efficient, and flexible. The idea is also to organize and improve the commercial network for agricultural goods—both wholesale and retail—making it more accessible for producers and consumers, and also more competitive in relation to all forms of production. The fundamental principles behind these provisions include giving life to more flexible management mechanisms that contribute to reducing losses in the process of commercialization and simplifying the links between agricultural producers and the final consumer, including the possibility of producers going to market on their own.[64]

v. Similarly, the Extraordinary Official Gazette published Resolution No. 673 of 2013 from the Ministry of Agriculture, which approves the updating of the social purposes of the Basic Units of Agricultural Production (UBPC), the Agricultural Production Cooperatives (CPA: Cooperativas de Producción Agropecuaria), and the Credit and Service Cooperatives (CCS). That social purpose includes the activities of production, services delivery, and commercialization. Thus, in addition to producing and selling their products, the cooperatives may buy from other forms of production and small agricultural producers—owners and/or usufructuaries—to sell them elsewhere.[65]

The economic changes incorporate various dimensions and affect a variety of sectors. For example, Extraordinary Official Gazette No. 4 of February 21, 2013, published updated rules by which natural persons who seek bank loans may offer new forms of collateral to the branches. In addition to cash, potential borrowers can present other goods in support of their application, which now include jewels, precious objects, and motor vehicles, among others. This measure supplements Decree-Law 289, in force since 2011, which updated Cuba's credit policy and expanded those who could potentially access such loans to include small farmers who show that they have legal land tenure, self-employed workers and

[63] "Nuevas opciones en la comercialización directa de productos agropecuarios," *Granma*, September 9, 2013, p. 2.
[64] "Ajustar la comercialización a la realidad de cada día," *Granma*, November 6, 2013, p. 4.
[65] Ibid, p. 5.

those engaged in other forms of non-state economic activity, and persons who intend to hire labor or purchase building materials.[66] In this respect, one should recall that Instruction No. 7/2011 of the Ministry of Economy and Planning (MEP: Ministerio de Economía y Planificación) indicated that contractual relationships between legal persons and self-employed workers or other forms of non-state economic management would operate like any other, and their payment would be in keeping with the spending limits established in the plan or budget approved for each entity. With the publication of the new rules, the payment among these actors was updated.[67]

As has been indicated, the process of economic reform in Cuba includes moving some of the small and medium state enterprises in services and small-scale industry to non-state forms of management, especially cooperatives. In early 2013, vice president Marino Murillo Jorge proposed to the Council of Ministers the approval of the first group of 124 non-agricultural cooperatives, which included various activities: 99 for agricultural markets, five for passenger-transport services, six for auxiliary transport services, two for recycling waste, and 12 for construction-related activities. Of this first group of cooperatives, 112 are from the state sector, and 12 are from the non-state sector, the latter formed mainly by self-employed workers.[68]

Since the rise of the first non-agricultural cooperatives in Cuba in July 2013, 498 have been approved by the Council of Ministers; of these, 249 have been constituted. Some 68 percent of these cooperatives have been created by governments at the provincial level.[69] In the opinion of the governmental authorities, the results of these new forms of non-state economic activity have been satisfactory. In this respect, they find that the cooperative members are content, and are well-remunerated for their efforts; the quality of the services has improved; there is a more stable presence—with greater variety and selection—of goods in the markets. One also notes a sustainable improvement in the appearance of the establishments that have been leased. Following government approval of the second group of non-agricultural cooperatives, a bidding process on state-owned restaurants that were closed years ago has begun, in which several cooperatives have participated so far. Nonetheless, there are problems that limit the potential of these new forms of economic activity, including: (a) the lack of a wholesale market where one can purchase goods, parts, and spare parts for the production or services provided by them; (b) limits on the availability of transportation equipment; (c) excessive hiring of labor; (d) deficient financial control; and, (e) refusal of some state enterprises to sell supplies and inputs to these cooperatives.[70]

In examining the impact that the changes have been having, one should consider that whereas in September 2010 Cuba had a total of 157,371 self-employed workers, by June 2014 this figure had reached 467,000,[71] particularly in restaurants and cafeterias, taxi services, retail, and rentals of houses and apartments. This last activity accounts for 15 percent of the supply of lodging available for international tourism. At the same time, as part of the changes, public-sector employment continues to fall, while non-state employment has climbed steadily since 2011.[72]

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[66] "El Banco actualiza sus garantías. Nuevas normas del Banco Central y los Ministerios de Finanzas y Economía actualizan las garantías bancarias y los pagos entre personas naturales y jurídicas," *Granma*, February 23, 2013, p. 3.

[67] Ibid.

[68] "Comienzan a funcionar cooperativas en diversos sectores de la economía," *Granma*, July 1, 2013, p. 3.

[69] "Recuperar ritmos de avance que aseguren el desarrollo socialista sobre bases sostenibles e irreversible," *Granma*, July 7, 2014, p. 4.

[70] "Cooperativas no agropecuarias habaneras exhiben satisfactorios resultados," *Granma*, November 20, 2013, p. 3; and "Recuperar ritmos…"

[71] Information from Vice President Marino Murillo Jorge, when addressing the third session of the National Assembly of People's Power, corresponding to the 8th Legislature, Havana. "Recuperar ritmos…".

[72] Omar E. Pérez Villanueva, "Análisis de la evolución reciente de la economía cubana," in *Miradas a la Economía cubana. Entre la eficiencia económica y la equidad social,* eds. Omar E. Pérez Villanueva and Ricardo Torres Pérez, (Havana: Editorial Caminos, 2013), p. 24.

By way of contrast with the liberalization that has been unfolding in the private and cooperative sectors, the allocation and control of resources in the state enterprise sector had continued to rely on centralized planning. Nonetheless, in the last two years major changes have taken place or have been announced for the enterprise sector that point to an accelerated—and very complex—transformation as of the second half of 2014. Accordingly, in a meeting of the Council of Ministers of April 3, 2013, it was emphasized that the transformations in the Cuban enterprise system were vital for achieving better economic development in Cuba. "Only by transforming the enterprise system, which is where the wealth is produced, will we attain sustainable economic development," said Vice President Marino Murillo Jorge. Among the regulations recently approved for modifying the institutional environment in which Cuba's state enterprises operate are:

- In a session of the Council of Ministers held in April 2013, the Minister of Finance and Prices announced that as of 2014 the state enterprises—in line with Guideline No. 19 — will be able to decide what to do with up to 50 percent of after-tax profits, once the commitments to the State have been carried out. So the enterprises may earmark those additional resources to increasing their working capital, investments, research, and training, and also pay their workers based on the results obtained.[73]

- With a view to pursuing the same objective, a total of 11 High-level Organizations for Enterprise Management (OSDE: *Organizaciones Superiores de Dirección Empresarial*) have begun to operate since 2013; these constitute a type of corporate entity that groups together the state enterprises in each sector. With respect to the OSDEs, the second leading official in charge of the Permanent Commission for Implementation and Development of the Guidelines told the Cuban legislature that most of the enterprises in the Cuban public sector should be grouped in 26 to 30 OSDEs. To that end, work is under way to prepare the documents that will govern that relationship based mainly on the principles of orientation, coordination, and control.[74] Nonetheless, part of this structural reorganization of the enterprises has resulted in many of them becoming "basic enterprise units" (UEB: unidades empresariales de base), a sort of process of absorption which does not contribute at all to efficiency or productivity, insofar as those new entities lose degrees of autonomy. In addition, according to several analysts the very creation of the OSDEs constitutes *de facto* a step backwards away from decentralization, there are serious contradictions between that structure and its governing documents, and with the general logic of the reform and updating of the model, and therefore they could have adverse economic results, both individually (i.e. for each enterprise) and socially.[75]

- Through Resolution No. 134 of 2013 of the Ministry of Economy and Planning, published May 20 in Extraordinary Official Gazette No. 14, the corporate purposes of the economic entities have been made more flexible. This includes giving the enterprises more independence, which will make it possible to increase their levels of production and efficiency. The idea is to leave behind the rigidity with which the corporate purposes of the enterprises were determined, which resulted in a failure to tap many capacities in the Cuban economy. Now it will be possible for the economic activities set forth in each entity's corporate purpose to be provided to any

[73] "Raúl: avanzamos a buen ritmo a pesar de los obstáculos. Sesionó reunión del Consejo de Ministros," *Granma*, April 4, 2013, p. 3.

[74] Information from Leonardo Andollo Valdés, second chief of the Standing Commission for the Implementation of the Guidelines to the National Assembly of People's Power. "Resumen de debates en Sesión de la Asamblea Nacional," *Granma*, July 8, 2013, p. 7.

[75] See, among others, Juan Triana Cordoví, *Competencia y desarrollo: una mirada desde la economía cubana*, (Havana: Center for the Study of the cuban Economy (CEEC), University of Havana, 2014); and Ileana Díaz Fernández, *Los cambios en la empresa estatal cubana en el contexto de la actualización del modelo*, (Havana: Center for the Study of the cuban Economy (CEEC), University of Havana, 2014).

legal or natural person. With this new rule, the management of each enterprise will decide on secondary activities to be carried out that are derived from the principal activity defined in the corporate purpose. Accordingly, each enterprise will be able to determine what to do with the materials that remain as a by-product of the productive process, engage in other transactions such as renting out locales and warehouses, parking, sales at one's own disposal, etc.[76]

- Another decision aimed at strengthening the management of the state enterprises was to begin to apply a new concept of "charge entrusted to the state" ("*encargo estatal*") on an experimental basis. This experiment—which involves various enterprise structures served by the ministries of Industry, Construction, and Energy and Mines—will also contribute to the gradual expansion of the wholesale market. This consists of authorizing the directors general of these enterprises to engage in wholesale to legal Cuban persons of certain surplus output and authorized services (taking into account market demand), once contracts have been fulfilled. The enterprises may approve the wholesale prices as per the correlation between supply and demand, and these prices will be applied in Cuban pesos (CUP) or convertible pesos (CUC), or both; discounts may be offered based on quality, conditions of delivery and commercialization, large volumes sales, or other commercial considerations. The start-up of this experience will make it possible for the enterprises to increase their sales volumes and profits, thereby helping to increase financial resources for their recapitalization, and boost workers' incomes. To accomplish all that, resolutions Nos. 641 and 471 of the Ministry of Economy and Planning and the Ministry of Finance and Prices, respectively, were approved. This experiment constituted a step towards what gradually began to be implemented in the enterprise system as of January 2014.[77]

- Associated with the transformations aimed at benefiting the state enterprises and their environment, Decree-Law No. 315—published in Extraordinary Official Gazette No. 37, of November 15, 2013—sets forth a new regulation for treating and managing inventory, in particular slow-moving and idle inventory. This new legal provision opens the way to solving the problem of the accumulation of idle or slow-moving inventories that have a negative impact on the national economy, although according to Alfonso Regalado—Chief of the Group for Other Sectoral Policies of the Standing Commission for the Implementation and Development of the Guidelines—this may be remedied once and for all when the restructuring of wholesale commerce is completed. The new provisions establish the means for liquidating those inventories, and to that end the Ministry of Finance and Prices also issued Resolution No. 386, which authorizes the adoption of prices determined by supply and demand as between the parties for the wholesale commercialization of such merchandise; they also establish the financial procedure to which entities should apply to receive the economic effect derived from the mobilization of inventories. It also creates mechanisms that encourage reducing them or that penalize those who increase them.[78]

- In addition, it should be noted that in 2013, Resolution No. 242 was published in Extraordinary Official Gazette No. 17; it contains the indications for the wholesale commercialization of food products, other consumer and intermediate goods, and services. This provision specifies that wholesale commercialization can

[76] "Flexibilización de los objetos sociales. Desplegando potencialidades," *Granma*, May 21, 2013, p. 3.
[77] "Continúa el fortalecimiento de la empresa estatal socialista, *Granma*, November 22, 2013, p. 2.
[78] "Inventarios ociosos. Y sin embargo, se mueven…," *Granma*, November 15, 2013, p. 16.

be done by authorized legal and natural persons. In that regard, it will be aimed at those entities engaged in retail sales to the population; social consumption and the priority programs; non-state forms of management and associated productive agricultural entities; and supporting the needs of the entities of the national economy. According to Vice President Marino Murillo Jorge, this restructuring of wholesale circulation will guarantee greater effects for the country.[79]

- Some export enterprises have also begun to benefit from the changes taking place insofar as they are gaining autonomy in the management of their budgets through the implementation of what are called Closed Arrangements for Financing in Foreign Exchange (*Esquemas Cerrados de Financiamiento en Divisas*).

The changes adopted in recent months that notably modify the general framework for the functioning of state enterprises has led to the *de facto* extinction of Decree-laws No. 252 and No. 281, which regulated the process of enterprise enhancement (*perfeccionamiento empresarial)* for the exceptional prerogatives they gave the enterprises undergoing the "enhancement" process (those "*en perfeccionamiento*") have become generally applicable with the adoption of the new regulations. In any event, new Ministry of Labor and Social Security (MTSS) regulations on salaries and their being tied to job performance, and of the Ministry of Finance and Prices (MFP) on the financial relations among enterprises in the new conditions, are being discussed, drawn up, and reviewed.[80]

The changes under way have also been reflected in the dynamic of the fiscal accounts. In 2008 total expenditures in the state budget came to 78 percent of GDP; since then the government has been applying a policy of fiscal adjustment. By 2013 expenditures were budgeted that totaled 68 percent of GDP, i.e. a reduction of 10 percentage points in relation to GDP. This has also been associated with a reduction of the fiscal deficit from 6.9 percent of GDP in 2008 to 1.7 percent in 2013.[81]

As part of this effort a review has been undertaken of subsidies and expenditures associated with social policy. The entire ministerial and enterprise management system has been reorganized, the goal being to significantly reduce payroll: there are plans for more than one million workers to stop working for the State by 2016, and to relocate in the emerging private and cooperative sector. The fiscal adjustment has contributed to the gradual exit from a default crisis which in 2008 and 2009 prejudiced outside investors, suppliers, and creditors.

Notable changes have also taken place in fiscal revenues. In 2013 a new tax law came into force that seeks to promote local development, agriculture, the formation of cooperatives, and environmental protection all through the use of tax incentives. The new law adds tax exemptions for self-employed workers and microentrepreneurs in the first three years of the start-up of their businesses. The changes in the country's budget policies and laws indicate progress, moving towards fiscal decentralization while at the same time greater autonomy will be granted to the local governments. Experiments are being conducted along these lines in the new provinces of Mayabeque and Artemisa to learn lessons that could be applied more widely.

In addition, policy instruments were adjusted in 2013 to maintain control over the printing of money, and modifications were approved in the structure of financing the state deficit, all in the framework of a taking a new look at how to improve the use of macroeconomic policy tools in Cuba. Especially important, no doubt, is the proposal for a Law

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79 "Comercialización mayorista. Hacia una forma de abastecimiento más coherente," *Granma*, June 5, 2013, p. 3.

80 Information offered by Ms. Grisel Tristá, staff member of the Commission for Implementation and Development of the Guidelines, 24th Annual Scientific Sessions of the INIE, Teatro del MEP, Havana, November 28, 2013.

81 Author's calculations based on information offered by the Minister of Finance and Prices when speaking at the third session of the National Assembly of People's Power, corresponding to the 8th Legislature, Havana. "Recuperar ritmos…"

on Financing of the State,[82] which will be submitted to the National Assembly for approval in late 2014.

In the current process of economic transformations that Cuba has embarked upon, with the co-existence of various forms of property, the role of planning must necessarily be subject to profound reconsideration; likewise the separation of enterprise functions from state functions must also be reconsidered. As such, 80 percent of the precepts and organizing principles of the entrepreneurial experiments that were approved in the directives of the national economic plan for 2014 were adopted. A significant change was also made to the indicators used at the enterprise level to evaluate the performance of these state entities[83] so as to afford the enterprises greater autonomy and at the same time to enable their managers to define on their own which indices should be used to assess their work in accordance with their priorities. Finally, the directives for the 2014 national economic plan support implementing the guideline that proposes the extinction, merger, restructuring, or transformation of those enterprises which for at least two consecutive years show negative economic and financial results into other non-state forms,[84] which will require significant legal and regulatory changes insofar as it will require adopting legal provisions for regulating bankruptcies of enterprises in Cuba.

The Cuban enterprise system—and within it, the state enterprise system—is going to have to become associated with foreign capital in order to obtain financial resources, overcome the technological lag, and find entry into international markets; this is the only way it will be able to overcome its competitive limitations. The economic reform under way requires reaching consensus on a new policy of openness to the outside world that goes beyond the limits in place since the 1990s. Major steps were recently taken in this direction by approving a whole set of provisions to regulate the businesses to be established in the so-called Special Development Zones, and with the adoption in late March 2014 by the National Assembly of a new policy and a new Foreign Investment Law. These statutory provisions imply changes in the institutional framework of the external sector of the Cuban economy. The provisions that will govern the consolidation of the Mariel Special Development Zone (ZEDM: *Zona Especial de Desarrollo del Mariel*), along with the modern infrastructure that zone will have, provide special benefits to the investments made in it. Among other aspects, it is noted in the approved provisions that the process of approving business operations will be more expeditious and all the administrative procedures will be entrusted to a "single window" that will be part of the Office of the ZEDM. According to the corresponding decree-law, this entity will have only 45 to 90 days to approve or deny investors' proposals. In addition, and according to the Minister of Foreign Trade and Foreign Investment of Cuba, the Council of Ministers will only intervene in the process of approval of investments in the ZEDM in exceptional cases, such as exploration and exploitation of natural resources, when the concession holder or user provides public services, or when an attempt is made to create a firm that is 100 percent foreign. In addition, a legal determination was reached as to the prioritized sectors and activities in this first stage of the ZEDM: (i) biotechnology and pharmaceutical industries, (ii) renewable energy, (iii) agro-food industry with the potential for import substitution, and (iv) the bottling and package industry.[85]

The recently-approved legal framework of the policy for attracting foreign investment is made up of: (a) the Law on Foreign Investment, which establishes the guarantees, the sectors receiving foreign investment, the modalities, the authorization regime, and the provisions regarding environmental protection

[82] Information from Ms. Juana Lidia Delgado, of the Commission for Implementation and Development of the Guidelines, at the 24th Annual Scientific Sessions of the INIE, Havana, November 28, 2013.

[83] Just six directive indicators, similar to the number of the so-called "limit indicators" ("*indicadores límites*"). The rest of the indicators will be defined autonomously by each particular enterprise.

[84] Information from Ms. Grisel Tristá, staff member of the Commission on the Implementation and Development of the Guidelines, 24th Annual Scientific Sessions of the INIE, Teatro del MEP, Havana, November 28, 2013.

and the use of natural resources, dispute settlement, and special regimes (banking, exports and imports, labor, taxation, and reserves and insurance); (b) the Regulation issued as a Decree, and which includes the procedures for the presentation, negotiation, monitoring and control of businesses, establishing the composition and functions of the Commission for the Evaluation of Businesses with Foreign Investment; (c) two Decisions (*Acuerdos*) of the Council of Ministers, the first of which is the publication of the approved policy and the other by which the power to authorize some international economic association contracts is delegated to the ministers of the Ministry of Foreign Trade and Foreign Investment (MINCEX) and Ministry of Tourism (MINTUR); (d) two Resolutions of the MINCEX that regulate the operation of the Commission for the Evaluation of Businesses with Foreign Investment and establish the methodological bases for the submission of the technical-economic feasibility studies of the projects; (e) the Resolution of the Ministry of Labor and Social Security (MTSS) that regulates the labor regime for foreign investment; and (f) two Resolutions of the Central Bank of Cuba, one regulating the opening of bank accounts for the cash deposit of capital contributions of foreign investors, and the other regulating the transfer abroad of foreign natural persons' assets.

The new Law that was approved features some significant differences with respect to its predecessor, Law No. 77 of 1995. These include:

1. In relation to the modalities of foreign investment established in Law 77 (mixed enterprises, enterprises with 100 percent foreign capital, and international economic association contracts), the scope of the association contracts was expanded to incorporate administration of production and services, hotel management, and professional services.

2. The regime for approving business operations was modified based on their characteristics,: (a) the Council of State will approve business operations related to the exploitation of non-renewable natural resources, except for at-risk contracts (*los contratos a riesgo*), the operation of public services or publicly-owned assets and construction of public works; (b) the Council of Ministers will approve enterprises with 100 percent foreign capital, business operations in which property rights or other rights over state property are transferred; business operations associated with at-risk non-renewable resources when a foreign public enterprise is involved or when it is aimed at developing renewable sources of energy, and investments in the enterprises systems of the public health, education, and the armed forces; and, (c) the Council of Ministers may delegate the power to approve and authorize other business operations with the participation of foreign capital to heads of agencies of the Central Administration of the State.

3. Preferences regarding foreign trade are to be granted to the purchase of national goods in competitive conditions.

4. A chapter is introduced that regulates the actions for controlling the modalities of foreign investment, and environmental protection is expanded to incorporate aspects related to technology and innovation.

5. More details of the dispute settlement regime are spelled out, particularly regarding the role of national courts.

6. The procedure for evaluating and approving businesses is amended to expedite it.

7. Provisions are made for the treatment of foreign investment once a single currency adopted.

8. It is established that foreign investment is covered by the 2012 tax statute (*Ley Tributaria* No. 113 of 2012) with the adjustment indicated in the special tax regime provided for in the Law for mixed enterprises and national

[85] "Zona Especial de Desarrollo del Mariel consolidará relaciones comerciales y económicas," *Granma*, November 6, 2013, p. 2.

and foreign investors that are party to international economic association contracts.

No doubt the elements associated with the tax benefits and guarantees given to investors in the new law are key mechanisms to attract foreign investment.

Finally, some decisions have also been made that have required adopting legal provisions to implement the timetable agreed upon by the Council of Ministers with a view to unifying the currency. After carrying out activities to train the personnel and various institutions associated with this complex process, the government issued price and accounting regulations for the state enterprises, and the Council of Ministers approved those tied to planning, the state budget, the banking system, and statistics that will guide the currency unification process; moreover, the provisions in force that have been issued in the dual currency scenario and that need to be modified this year have already been identified.[86]

Cleary, it can be said that despite existing contradictions, significant changes are taking place in the economic-productive, social, and institutional fabric of Cuba. Among these, a network of small and medium enterprises is beginning to emerge in the non-state sector of the economy[87] (although these new forms of property and management have not been labeled as such); in addition, a restructuring process is under way in the state sector, with a greater role being accorded to market relationships in Cuba's economic and social dynamic.

Nonetheless, in the process of consolidating the new Cuban economic model, which is in its first stages,[88] much remains to be done to implement a set of policy measures and statutory provisions to ensure that the economic and social transformation is integral and consistent, as it must be.

Future Dilemmas and Challenges to the Economic and Institutional Changes in Cuba

The formal institutional framework in Cuba surely maintains part of the institutional and normative structures that were particular to the preceding model, albeit with corrections. But it is true that the government has taken important steps to address the most evident institutional and political shortcomings. Indeed, changes in the Constitution are anticipated to bring it in line with the new characteristics of the system towards which the country is moving.

Analyzed in short- and long-term perspective, the new development conditions of the Cuban economy—as a result of the changes that are being implemented—make it necessary to devise an integral strategy for supporting the enterprise sector in general, and also specific policies and provisions for the development and consolidation of a dynamic sector of small and medium enterprises (SMEs). In this context, the institutional changes—a result of the changes that have been articulated—must answer to the needs of the country's network of enterprises and contribute to progress and social wellbeing. In other words, the process of economic transformation under way demands greater institutional changes so as to expand and regulate the activity of the market. Though there may be various proposals in this regard, the Cuban authorities could consider the following to be priorities in future institutional changes:

1. Strengthening the institutional framework to promote a regime of legal certainty for all economic actors who play a part in the national economy, for which it is necessary to design, discuss, and approve a Law on Enterprises. That law and its complementary

[86] Information offered by Vice President Marino Murillo Jorge in the third session of the 8th Legislature of the National Assembly of People's Power, July 5, 2014.

[87] In any event, one should reiterate that one of the main limitations—about which no changes have taken place to date—is the exclusion from activities allowed for private work of those services with the greatest value added, associated with professional activities.

[88] Vice President Marino Murillo Jorge indicated at the last session of the Cuban legislature of 2013 that the most complex transformations associated with the implementation of the Guidelines will be carried out in 2014 and 2015. *Granma*, December 20, 2013.

legal regulations should take note of the great dispersion and heterogeneity of the existing network of enterprises and those that are emerging as part of the process of changes, most of them marked by a very low level of technological development, limitations in access to information and communication technologies (ICTs), little progress in terms of participation and, in general, low productivity. At the same time, progress should be made approving the provisions necessary for consolidating entities that provide services to the enterprise sector (such as legal, consulting, auditing, accounting, market research, and product and process design). Clearly, the Law on Enterprises should be consistent with public policies that support the formation of enterprise clusters that more fully tap the linkages among industries and economic sectors so as to support the aggregate efficiency of the system.

2. Under current conditions it seems sensible to assume that the prospects for the country's development will be associated directly with greater and better integration in international markets, thus it is urgent to put in place policies that support this process and facilitate adequate management of the associated costs.[89] This requires reform of the institutional framework that regulates Cuba's foreign trade with a view to conferring greater flexibility to offset the level of concentration and centralization that still characterizes the country's foreign trade operations, and allowing non-state entities access to the export and import markets. This could help introduce a gradual diversification of the matrix of Cuba's entry into foreign trade.

3. In a country such as Cuba, establishing a competition policy as well as determining its regulations and scope of application is essential given the economic transformation under way. The appearance of new forms of ownership and new economic actors; the modification in the mechanisms of state regulation and control of the economy; the changes in planning and economic management; the new attributes that are beginning to be assigned to state enterprises; the presence of various actors in foreign trade operations; and the decentralization of the processes for determining prices (wholesale and retail) are economic changes that have propelled the appearance of markets and spaces for competition in Cuba.[90]

   It is important to understand that objective conditions for competition exist in Cuba, yet the Cuban context includes major distortions that could be overcome by designing a public policy and, consequently, legal provisions to promote and regulate competition. According to research studies, while there is no statutory or regulatory framework for competition in Cuba, several statutes are in force that contain provisions related to it.[91] Nonetheless, the category "competition" does not appear in the programmatic document for the current transformations in the economic and social model. In this respect, Triana asks whether the market is possible without competition, and notes that "whether or not it is officially acknowledged, competition exists, it's just that its repudiation (or its non-recognition) could minimize and even eliminate its positive effects on the dynamics of the economy and aspirations for development."[92]

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[89] Ricardo Torres Pérez, Ricardo "Algunas contradicciones del desarrollo económico cubano contemporáneo," in *Miradas a la Economía cubana. Entre la eficiencia económica y la equidad social,* eds. Omar E. Pérez and Ricardo Torres, (Havana: Editorial Caminos, 2013), p. 38.

[90] Competition in Cuba expressed in the growing diversity of entities that engage in the same activity has led to the appearance of a clear economic differentiation expressed in terms of prices, quality, guarantees, and post-sale services, all of which constitute typical indicators of competitive relationships.

[91] Johana Odriozola Guitart, "Derecho de la Competencia Strictu Sensu. Una aproximación a la realidad cubana," (Doctoral thesis, School of Law, Universidad de La Habana, 2003).

[92] Triana Cordoví.

The process of designing and implementing a policy and rules for regulating competition in Cuba should consider, among other aspects, the following:

(i) At present there are many restrictions on competition in Cuba, most of which have to do with legal provisions and administrative decisions of governmental entities, which indeed in some cases contradict established policies.

(ii) Some of the distortions observed today in the operation of the Cuban economy—and which stand in the way of an adequate environment for competition to generate favorable stimuli for the network of economic actors – include the direct assignment of purchasers or suppliers, limitations on the rights to acquire goods or services, or the discretional exclusion of economic actors.[93] Other restrictive practices include the limitation of trades in the new non-state sector of the economy, the exclusion of professionals from self-employment, barriers to entry, and collusion and corruption associated with excessive controls. These barriers limit the positive impact of the so-called "emerging sector" on the national economy, in terms of production and services and in terms of generating employment, and artificially reduce the possibility of elevating the technological complexity of goods and services, enabling some to obtain undeserved revenues.[94]

(iii) Granting differentiated conditions of competition to economic actors is often a common practice for "stimulating" certain sectors (for example, it is often the case with industrial policies) and while one should not discount its possible positive effect in the short term, one mustn't forget that such measures should be temporary.

(iv) Designing a competition policy does not mean defending competition to the end, but establishing the spaces in which it should unfold and ensuring that it operate adequately, promoting innovation, economic efficiency, and productivity.

4. Another area of public policy to be developed by the State in these new conditions has to do with policy towards the regions, and consequently the adoption of the set of provisions that guarantees the rights of the territories in the context of a process of administrative decentralization. Those provisions should help achieve a more homogenous distribution of productive capacities throughout the national territory. Moving forward with the adjustments, the economic transformations, and their inevitable modifications opens up new theoretical and practical concerns regarding the inequalities as among different regions or territories in Cuba, which for now do not appear to be coming to a halt.[95] Nonetheless, one should bear in mind that this phenomenon is directly related to the design of the structure and mechanisms of public decision-making. This is a highly complex issue, given that it involves decisions that affect the system of organization and representation of democratic sovereignty.[96] The reasons why the transfer of budget powers to the sub-central governments could give impetus to

[93] These constitute characteristics which, according to Triana Cordoví (2014), are almost always the result of highly centralized styles of "planning" such as those that have been used in Cuba.
[94] Triana Cordovi, "Competencia y desarrollo".
[95] Luisa Íñiguez Rojas, "Desigualdades territoriales y ajustes económicos en Cuba" in *Miradas a la Economía cubana. Entre la eficiencia económica y la equidad social,* eds. Omar E. Pérez and Ricardo Torres, (Havana: Editorial Caminos, 2013), p. 115.
[96] See Díaz de Sarralde and Guanche.

economic activity run a wide gamut.[97] Obviously, in order for the benefits of fiscal decentralization to be felt, the institutions by which inter-governmental relations are channeled must be adequately designed.

5. There are also very important areas for sustainable economic development in which international experience shows that the action of the state is key. Innovation, which is a fundamental part of research and has the characteristics typical of a "public good"; the protection of environmental resources, goods, and services caring for and protecting cultural heritage: all are strategic areas that cannot be marginalized among state priorities and for which the design and development of complex yet efficient institutions is needed.

Many economic, social, institutional, and political reforms remain to be implemented for Cuba to be able to make the most of its potential for progress, at the same time as it preserves the gains made during the revolutionary period. Obviously, the process will require great imagination and a consolidated decision to change so as to seek specific responses to a very peculiar economic and social reality, in which there is, therefore, no room for any automatic transplants of foreign experiences.

The greatest challenges facing the general dynamic of economic and social changes in Cuba (which makes the required institutional change all the more complex) include:

1. While a consensus has been reached that the logic that governed the Cuban economy over the last 40 years has run its course, and therefore structural and institutional changes cannot be put off,[98] the future scenario for the country is not clearly defined. In any event, the ultimate goal—which according to many theoretical analyses on social change is a key factor for reducing uncertainty—has never been totally clear for the common citizen or for the leadership in those countries that have undertaken a change as profound as that which Cuba now faces, insofar as the very implementation of specific or sectoral transformations involves changes in the vision for the future.

2. There is a clear will on the part of the Cuban leadership to reform, though there are obvious points of resistance in various economic and social sectors.[99] Therefore one must understand the continuing yet paused sequence of changes decided upon by the highest-level Cuban authorities. In the case of Cuba, this excessive gradualism could also imply a more complex undertaking. In many cases, the changes in one specific aspect or sector require, to make them operative, changes in other complementary spheres; that is, simultaneous transformations are needed in several areas if the reforms are to be effective. Given the interconnection among a wide diversity of areas to be included in the changes, it is practically indispensable for the reforms to be undertaken simultaneously in an effort to create the conditions for the new forms of economic organization to operate efficiently.

3. According to some analysts, excessively gradual changes result in their benefits barely affecting living conditions. Therefore they run the risk of creating increased resistance to the reform. Nonetheless, mindful of the magnitude of the challenges Cuba faces and the adverse internal and external conditions, it is practically impossible to expect an immediate improvement in the economic performance of the nation.

[97] In any event, fiscal decentralization does not always imply more efficient delivery of services. In some cases the university supply at the national level has advantages that should be considered.

[98] It was clearly formulated by President Raúl Castro, when he indicated that the country was walking along the edge of a precipice.

[99] There are several factors, in the Cuban case, that explain resistance to change, which are also tied to the starting point of the current transformations, summarized in the second section of this paper.

That would be a false reference when judging the advance in the process of economic transformations.[100] Nonetheless, one must recognize that the changes implemented have begun to systematically address the contradictions in the country's economic and social reproduction, so they constitute an opportunity to build a more prosperous country.

4. The Economic and Social Policy Guidelines, which set forth the guidelines for change, are themselves not a long-term economic and social development program. There has been discussion and review of the proposals for conceptualizing the economic model that will be built, as well as the long-term development program (to 2030), but theoretical and practically consistency is needed among these three platforms: the guidelines, the preliminary vision of the model to be constructed, and the long-term development program. Possible inconsistencies among these programmatic platforms could lead to the reform in Cuba facing contradictions whose resolution would prove costly.

5. The right to accumulate earnings in the emerging non-state sector is another matter for which a new approach should be imposed, making a break with the accumulated weight of prejudices in this regard. At present, there are severe limitations governed by a logic that is not adapted to the current moment of the Cuban economy and its medium- and long-term development challenges. The possibility of reinvesting these surpluses—and institutional stimuli to help make it happen—would complete the cycle of appropriating the results of innovation, understanding that it is likely that those who have generated those resources have identified and successfully exploited present opportunities in the new national economic context.

In sum, Cuba is in the midst of a process of profound institutional change that accompanies and at the same time is functional to the economic and social transformations that have been required as part of implementing the Economic and Social Policy Guidelines. Given the specificities of the Cuban case and the particular economic and social system that make up the starting point, institutional change requires a permanent exercise of institutional innovation, experimentation, and adaptation. Analyzing and comparing other international experiences will be useful, but inevitably the options chosen must always be adapted to a social reality that is very peculiar. No doubt institutional change entails not only approving a new legal framework, but progressively changing social actors' perceptions and judgments regarding the new rules. Approving new laws and regulations occurs at a given moment in time, whereas changing perceptions requires more time, in part because they are directly associated with perceptions rooted in individuals' behavior.

Summary and Conclusions

The process of economic changes in which Cuba is immersed, and the institutional changes that have taken place, are beginning to remove some of the regulatory and incentives obstacles that have obstructed the progress of Cuba's economy and institutions to date.

Going forward with the process of reforms will necessarily involve an exercise in institutional innovation. To encourage that process, Cuba has some assets that should be considered. The main one is the high educational level of the population. Cuba has a notable advantage from the outset, despite the negative impacts the education sector has absorbed since the crisis of the 1990s. One of the main criticisms made of the current economic system in Cuba is its incapacity to harness the huge investments made in human capital for innovation and economic growth.

[100] Torres Pérez, p. 39.

Reducing the state apparatus, clearly delimiting enterprise functions from state functions, and creating a network of heterogeneous enterprises, all recognized as economic actors who should make decisions without being tied to anything beyond observing the basic economic regulations established by the Government—by means of clear and transparent rules and norms—will no doubt promote a better institutional environment that will facilitate economic growth by improving the conditions for microeconomic operations. The rationalization and modernization of the government institutions and the creation of spaces for decentralization that strengthen "inclusion" in the effort to achieve growth are unquestionable, and that should be accorded priority in the agenda of transformations. Re-launching the non-state sector and the consequent modification of the tax system creates prospects for a significant change in the nature of the relationship between the State and the citizenry; yet this will take time and in any event will depend on the scale actually achieved by the private and cooperative sectors.

The discussion around the social equity challenges in the current process of economic and institutional changes is also crucial. This presupposes not only valuing the possible medium and long-term effects of the measures implemented, but also analyzing their consequences for different social groups and regions. One important—indeed essential—challenge is to maintain the articulation and interconnection of social policy with economic policy, which is grounded in an integral conception of development in Cuba, which had promoted economic growth alongside a more equitable distribution of wealth, universal access to basic social services, and attention to existing social problems. While in previous decades social development was accorded greater priority than economic development, the guidelines and changes implemented also introduce elements of economic efficiency and sustainability in social policy. Accordingly, the challenge in this case is to keep these spheres interconnected.[101]

Yet economic and administrative decentralization, the emergence of a non-state sector that is beginning to occupy important spaces in terms of generating income and employment, and the growing significance of market signals in the process of directing and managing the economy should fit within constructs of popular sovereignty, a process that is still incipient. In this respect, the editorial in the newspaper *Granma* marking July 26, 2013, recognized: "What we need is a people as cultured as it is educated that is the subject and not the object of the transformations, a people with broad democratic participation by all the ways and means and that accelerates the effective operation of the institutions as the only guarantee for the continuity of the Revolution."[102]

[101] María del Carmen Zabala Arguelles, "Retos de la equidad social en el actual proceso de cambios económicos" in *Miradas a la Economía cubana. Entre la eficiencia económica y la equidad social,* eds. Omar E. Pérez Villanueva and Ricardo Torres Pérez, (Havana: Editorial Caminos, 2013), p. 171.

[102] "Asalto al cuartel del futuro," *Granma*, July 26, 2013, p. 2.

Institutional Changes of Cuba's Economic-Social Reforms:

State and Market Roles, Progress, Hurdles, Comparisons, Monitoring and Effects[103]

Carmelo Mesa-Lago

Introduction

This chapter studies Cuba's ongoing process of institutional change, focusing on five central structural reforms: updating the economic model; distribution in usufruct of idle state land; dismissal of unneeded state employees and expansion of the non-state sector; modifying wage policies; reducing gratuities (including rationing) and social services; and selling/buying houses.[104] As other chapters in this volume discuss themes of monetary policy, dual currency and exchange rates, foreign direct investment, and banking, they will not be addressed here. The chapter is divided in three sections: I) institutional changes analyzed on five factors in each of the reforms: state and market roles (including state regulations and ownership), progress achieved, persistent hurdles, and comparisons with reforms in China, Vietnam and Latin America; II) monitoring of the reforms and evaluation of macroeconomic effects; and III) conclusions and ways forward.

Institutional Changes, Progress, Hurdles and Comparisons

Updating the Economic Model

State and market roles. The VI Party Congress agreements of 2011 do not substantially transform the current economic model, but seek to "update" it in a gradual manner, preserving the predominance of the central plan and state ownership of property over the market and non-state ownership of property. The agreements avoided the terms "reform" and "private" (though the latter was accepted in 2014), lacked specifics on the role of planning and the market and their interactions, had many gaps and were vague in key aspects of the model. Marino Murillo, chief of the Permanent Commission to implement the agreements, reiterated this predominance in 2013 and stated: "There will be not a transformation of property but modernization of its management," including expansion of the non-state sector and the recognition of the market. He and Raúl Castro declared that they will neither restore capitalism nor implement shock therapy.[105] However, government rhetoric may have been a euphemism to disguise actual practice.

Progress. The analysis in the following sections shows that the reforms have generally been positive and market-oriented; the agreements give the market a greater role than it has had since 1961 when central planning began. In 2013, Murillo announced a more complex and profound stage of the reform that would tackle more difficult issues in 2014, transforming and deregulating the largest state enterprises: mining (nickel, oil), steel and

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[103] The author alone is responsible for this essay but gratefully acknowledges comments or materials from Richard Feinberg, Marc Frank, Armando Nova, Omar Everleny Pérez Villanueva, Pavel Vidal and Mao Xianglin.

[104] For a comprehensive analysis of Cuba's economic-social reforms and their effects see Carmelo Mesa-Lago and Jorge Pérez-López, *Cuba under Raúl Castro: Assessing the Reforms* (Boulder-London: Lynne Rienner, 2013).

[105] Raúl Castro, "Discurso en la Clausura del Segundo Período de la Asamblea Nacional del Poder Popular," *Granma*, December 23, 2013; Marino Murillo, Informe a la Asamblea Nacional, *Granma*, July 8, 2013; Marino Murillo, report in *Granma*, July 5, 2013.

textiles. As Omar Everleny Pérez Villanueva has noted, everything must come from the overly rigid and centralized plan; instead of a facilitator, it is an obstacle and discourages enterprise performance; the government centrally assigns resources to enterprises that are not allowed to use their own resources to solve their own problems; and production levels are not decided by enterprises since most are dependent on domestic output or imports.[106] However, these obstacles are gradually being eliminated. Instead of shifting all profits to the state and the latter deciding the budget allocation to enterprises, large enterprises may retain 50 percent of their profits net of taxes for reinvestment and wage raises, giving managers more decision-making power and creating incentives to increase efficiency and production. State enterprises will be allowed to sell idle inventories at a price agreed to with buyers. Enterprises with losses for two years or more will have to turn a profit or be downsized, merged with others or shut down.[107] Enterprises could use funds assigned for the purchase of imports to instead purchase goods produced locally, without previous state approval.[108]

Hurdles. According to Raúl, updating the model has "a long and complex road ahead."[109] Several local and foreign economists believe it is a mistake to preserve a model dominated by central planning, which history has proven (in the USSR, Eastern Europe, China and Vietnam, as well as in Cuba) to be inefficient and which has caused the economic problems the nation faces.[110] Some reforms planned for 2014—including deregulation and self-financing of key state enterprises, closing those with losses, and using part of their profits for investment and wage funds—were tried in Cuba in the 1970s and 1980s, but were later abandoned. In mid-2013, two years after the agreements were approved, Murillo informed the National Assembly that a team had just been appointed "to study and understand the updating of the economic model;"[111] at the end of 2013 he reported that "the first version of the proposal for the conceptualization of the model had been elaborated".[112] Out of the 313 agreements approved in 2011, only 46 (15 percent) had been implemented by the end of 2013. This indicates the slow progress achieved toward a concrete model, enforcing the agreements, filling their gaps and clarifying vague points. Another barrier to success is the leaders' commitment to "avoid[ing] the concentration of wealth," which generates disincentives and ignores the large income inequalities already in existence. Murillo pushed to eliminate all obstacles involved in updating the model, and yet, the greatest obstacle seems to be the model itself that interferes with the reforms and their success. Finally the reforms have created some winners, but have also raised concerns among the general population about the future.

Comparisons. Cuba and North Korea are the two socialist economies with the largest role of a planned economy and state property and the smallest role of the market and private property. Conversely, China and Vietnam developed a "socialist market" model where the private sector, markets and foreign investment, combined with an indicative plan and decentralization of decision making, have spurred the highest economic growth rates in the world. Thwarting the party bureaucracy and resistance to deeper economic changes, a recent China Party meeting agreed to push forward new reforms which mandate that, in the relation between the government and the market, the latter should play a decisive role in financing and allocation of resources,

[106] Omar Everleny Pérez Villanueva, "Cuba, continuidad y cambio: El impacto de la implementación de las reformas" (La Habana, CEEC, unpublished paper, September 2013).
[107] Decreto No. 323, Deregulation of state enterprises, March 4, 2013.
[108] Marino Murillo, reported in *Juventud Rebelde*, June 3, 2013; Marino Murillo, Informe a la Asamblea Nacional, *Granma*, July 8, 2013; report in *Granma*, July 5, 2013.
[109] Raúl Castro, "Intervención en la Primera Sesión Ordinaria de la VIII Legislatura de la Asamblea Nacional," *Granma*, July 7, 2013.
[110] José Antonio Alonso and Pavel Vidal Alejandro, "Reglas, Incentivos e Instituciones," in *¿Quo vadis, Cuba? La incierta senda de las reformas,* eds. José Antonio Alonso and Pavel Vidal, (Madrid: Catarata, 2013), pp. 256-279.
[111] Murillo, Informe a la Asamblea Nacional, 2013.
[112] *Granma*, December 21, 2013.

that competition be strengthened and restrictions on land ownership be overhauled.[113] In Vietnam, both the state and the non-state sectors generate 40 percent of GDP, while the latter has the highest investment share: 38.5 percent versus 37.2 percent from the state and 24.3 percent from foreign investment.[114] Structural reforms in Latin America have mainly consisted of shock therapy and privatization; Cuba rejects this approach and takes a gradualist, slow tack that preserves the predominance of the state role. In the region, Cuba also leads in the size of the state sector, far ahead of some countries that have strengthened the role of government, like Argentina, Bolivia, Brazil, Nicaragua and Venezuela; in these countries as in the rest of the region, the market still plays the predominant role.

Distribution in Usufruct of State Idle Land

State and market roles. The only agricultural land owners are farmers who received small plots from the state at the start of the revolution, whose numbers have been steadily declining.[115] Two laws in 2008 and 2012, the second more flexible than the first, regulated the usufruct distribution of idle state land in small plots to individuals, cooperatives and state farms/entities.[116] The state keeps ownership of the land whereas the usufruct farmer (usufructuary) has the right to cultivate the plot and appropriate its fruits.[117] Although the state owns the land, tightly regulates contracts and mandates the selling of part of the crop (*acopio*), the practice of usufruct is still a step closer to the market. Moreover, if more liberalized, the use of usufruct could significantly increase agricultural output and reduce costly food imports. According to Nova,[118] essential issues to be solved in agriculture are: real land ownership (rights to decide what to grow, to decide to whom to sell the produce and to set the price); recognition of the market's key role; elimination of monopolies and diversification of marketing with autonomous marketing cooperatives; and free labor hiring.

Progress. The usufruct law of 2012 made several improvements over the 2008 law, which was quite restrictive and didn't produce results. The plot size rose from 13.4 to 67.1 hectares (165 acres), provided the usufruct is linked to a cooperative or state farm. The contract length remains unchanged for persons (10 years)[119] but it increases for cooperatives and state entities (20 to 25 years). Despite the advantage of the latter two forms, 98 percent of usufruct land has gone to individuals. The usufructuary is allowed to build homes (more than one if relatives work the land) and barns on the plot, as well as to plant orchards, all of which had previously been banned. If the contract is not renewed, the state must evaluate the investment made and reimburse the usufructuary. In case of usufructuary death or incapacity, relatives working the plot can inherit the usufruct and the investment. The tax reform granted the usufructuary a two-year exemption on personal income tax, land value and hiring labor; said exemption may be extended if the usufructuary cleans the land of *marabú* (a thorny bush difficult to eradicate). Tax on inactive usufruct land was also suspended one year.[120] Since 2011, the state has offered microcredit to those holding land in usufruct and allows them

[113] Chris Buckley, "China to ease long-time policy of 1-child limit," *New York Times*, November 16, 2013.
[114] Armando Nova González, *El modelo agrícola y los lineamientos de la política económica y social en Cuba* (Havana: Editorial Ciencias Sociales, 2013).
[115] In 1959 there were some 200,000 private farmers but their number dwindled to 23,000 in 2012 (Oficina Nacional de Estadística e Información (ONEI), *Anuario Estadístico de Cuba 2012,* (Havana, 2013).
[116] Decreto-Ley regulation of usufruct, No. 259, July 10, 2008; and decretos-leyes Nos. 300 and 304, October 22, 2012.
[117] For a comparative analysis of the right of ownership in Cuban structural reforms, see Carmelo Mesa-Lago "Los cambios en la propiedad en las reformas económicas estructurales de Cuba," *Espacio Laical*, No. 223, February 2013 and José Manuel Palli, "Superficie and Usufruct Rights in Cuba: Are They Really Insurable Rights?' *Cuba in Transition*, No. 23 (Miami: ASCE), 2013. The best study on Cuban entrepreneurship is Richard E. Feinberg, *Soft Landing in Cuba: Emerging Entrepreneurs and Middle Classes,* (Washington D.C.: Brookings Institution, 2013).
[118] Armando Nova González, "La propiedad en la economía cubana: Recientes cambios en las formas de propiedad y su impacto en el sector agrícola cubano," in *Cuba: Hacia una estrategia de desarrollo para los inicios del siglo XXI,* eds. Mauricio Miranda and Omar Everleny Pérez Villanueva, (Cali: Editorial Javeriano-SSRC, 2012), pp. 127-164.
[119] In contrast, Decreto-Ley 273 (2010) grants the land-surface right to foreign investors in luxury golf courses for up to 99 years.
[120] Ley 113, Tax reform, *Gaceta Oficial*, November 21, 2012; also Resoluciones Nos. 41-42 and 353, 2013.

to open bank accounts. All agricultural producers, including usufructuaries, are permitted to sell more to the market (47 percent in 2012) and since 2013 directly to tourist entities without co-ops intermediation.[121] Decreto 318/2013 reformed *acopio*, ended the state marketing monopoly in three provinces, allowed competition and market-price sales of chicken, pork, vegetables, eggs and non-citrus fruits. The first wholesale market to sell agricultural supplies was created in the Isle of Pines in 2014.[122]

At the end of 2012, 1.5 million hectares of idle state land had been distributed to 174,271 individual usufructuaries and 2,700 legal entities.[123] The Oficina Nacional de Estadísticas e Información (ONEI) reports 300,810 total usufructuaries in mid-2012, of which 157,948 were under the usufruct law of 2008 (the 2012 law entered in force in December) and 142,862 were authorized during the crisis of the 1990s and are now under the 2012 law.[124] Table 4 shows the changes in thousand hectares in agricultural, cultivated and uncultivated land by type of tenant (state, UBPC/CPA cooperatives, and CCS/private sector).[125] In December 2007 (before the first law was enacted) there were 6.6 million total hectares of total uncultivated agricultural land, and by June 2012, it was reduced by 62 percent to 1.4 million hectares. The state share was cut by 1.1 million hectares and that of UBPC/CPA by another million, whereas land cultivated by CCS/private grew by 1.2 million.[126] Usufructuaries neither own land as private farmers nor are they necessarily CCS members, but they ought to be in the CCS/private sector group because they were only receiving state land. The table suggests that the increase in total CCS/private agricultural land by 1.04 million hectares in 2007-2012 was probably due to state land distributed in usufruct, a figure that is 30 percent lower than the cited 1.5 million hectares. The state and UBPC/CPA shares of total agricultural land fell whereas the CSS/private sector share rose from 18 percent to 35 percent of agricultural land and from 26 percent to 40 percent of cultivated land (Table 4).

Hurdles. Despite its increased flexibility, the 2012 law is still restrictive and creates uncertainty. The usufructuary's 10-year contract will be terminated or not renewed if he fails to fulfill his obligations, such as "using the land in a rational manner" (a specification left to government interpretation—9,000 contracts were cancelled for this reason), compulsory sale to the state of about 70 percent of the crop at state-fixed prices (*acopio*, modified in 2013), hiring more workers than allowed, selling the plot investment or investing without state permit, and for public need or social interest. Despite a legal cap of 108 days, plot measurement can take up to two months due to flaws in public records and thousands of applications are delayed by lack of qualified personnel and negligence. To obtain inputs and services and market their produce, the usufructuary must be linked to a state farm or cooperative, preferably either UBPC or CPA, the two with the least autonomy.[127] It is incongruous that the usufruct was introduced to increase agricultural output, but forces linkage to UBPC and state farms, recognized as inefficient production forms.[128] More rational would be to authorize voluntary cooperatives of usufructuaries. Regardless of the noted progress, in 2012, usufruct shares in total agricultural and cultivated land were 17 percent and 13 percent respectively, and still 21 percent of the land was uncultivated (81 percent under state/UBPC/CPA). Marabú covers 50 percent of all the land in usufruct; it must be cleared to start production, but state credit cannot be used

[121] Murillo, Informe a la Asemblea Nacional, 2013; Marc Frank, "Cuba reports Little progress five years into agricultural reform," *Reuters* July 30, 2014, http://uk.reuters.com/article/2013/07/30/uk-cuba-reform-agriculture-idUKBRE96T0VK20130730.

[122] Marc Frank, "Cuba experiments with wholesale market for farmers," *Reuters,* June 1, 2014, http://uk.reuters.com/article/2014/06/01/cuba-reform-agriculture-idUKL1N0OG11I20140601.

[123] "Con el corazón puesto en la tierra," *Juventud Rebelde*, November 10, 2012.

[124] Oficina Nacional de Estadística e Información (ONEI), *Anuario Estadístico de Cuba 2012,* (Havana, 2013). Available at www.one.cu.

[125] UBPC: basic units of cooperative production; CPA: agricultural production cooperatives; CCS: credit and service cooperatives.

[126] Out of uncultivated land, the total idle part was 1,232,800 hectares in 2007 and had been cut only by 21 percent to 975,500 in mid-2012. In 2007 the idle land was 51 percent state, 44 percent UBPC/CPA and only 5 percent in CCS/private (ONEI, *Anuario Estadístico de Cuba 2012*).

[127] A law of 2012 restructures UBPC and gives them more autonomy; another of 2013 permits cooperatives ties with CCS.

[128] CCS coops and private farms produce 57 percent of all output with only 24 percent of the cultivated land (Nova).

Table 4. Distribution of Agricultural, Cultivated and Uncultivated Land in Thousand Hectares and Percentages, by Tenant Sector in Cuba: 2007 and 2012

			Non state	
Years and categories	**Total**	**State**	**UBPC/CPA**	**CSS/Private**
Area (1,000 hectares)				
2007 (December)				
Agricultural land	6,620	2,371	3,034	1,214
Cultivated	2,988	694	1,495	799
Uncultivated	3,631	1,677	1,539	415
2012 (June)				
Agricultural land	6,405	2,007	2,139	2,260
Cultivated	5,040	1,413	1,634	1,994
Uncultivated	1,365	594	505	266
Change 2007/2012				
Agricultural land	-214	-364	-895	1,045
Cultivated	2,052	719	139	1,194
Uncultivated	-2,266	-1,083	-1,033	-149
Distribution (percent)				
2007				
Agricultural land	100.0	35.8	45.9	18.3
Cultivated	100.0	23.2	50.0	26.7
Uncultivated	100.0	46.3	42.4	11.4
2012				
Agricultural land	100.0	31.3	33.4	35.3
Cultivated	100.0	28.0	32.4	39.6
Uncultivated	100.0	43.5	37.0	19.5

Source: Author's calculations based on ONEI, *Anuario Estadístico de Cuba 2011* (Havana, 2012) and *Anuario Estadístico de Cuba 2012* (Havana 2013).

for that purpose. Hence, tax exemptions are not granted. Usufructuaries can only hire relatives or seasonal workers either self-employed or in cooperatives, and the investment size is limited to one percent of the plot size. Officially, these disincentives are officially justified as preventing wealth concentration. Around 77 percent of usufructuaries lack experience in agriculture;[129] the government may offer training but it does not release public information detailing how many have been trained. The state sets the *acopio* price below the market price, which is a production disincentive. State microcredit is grossly insufficient, as are markets that sell inputs to farmers at high prices. Rules to request usufruct, sign and extend the contract, and approve or modify investment (even building a house) are cumbersome.[130] Decreto 318/2013 bans sales of beef, milk and milk byproducts, coffee, cocoa and honey; it also keeps rice, beans, corn, potatoes, sweet potatoes, taro, onions, garlic, oranges and grapefruit under *acopio* in 2013 and 2014, hence keeping these the most important agricucultural products out of the free market.

[129] "Con el corazón puesto en la tierra".
[130] Usufruct regulations take six pages of the Official Gazette (Decreto-Ley 304) versus four pages of the basic Decreto-Ley 300.

Comparisons. Cuba's agricultural usufruct reform is much more modest than their counterparts in China and Vietnam, which have a much larger market role and fewer state regulations. In all three countries the state retains land ownership, but in the two Asian cases virtually all agriculture is managed privately or by autonomous cooperatives; contracts are for 50 years or indefinite periods time (instead of Cuba's 10 years renewable under tight conditions and the risk of cancellation); there is freedom to hire workers, and investment fully belongs to owners; farmers freely decide what to sow, to whom to sell the produce and set the price based on supply and demand. There is neither *acopio* nor are prices set by the state below the market price in China or Vietnam, although in late 2013 *acopio* began to be curtailed in Cuba. The Sino-Vietnamese reform features resemble what Nova noted was needed in Cuba and their results have been impressive: countries that historically suffered from hunger are now food self-sufficient and export a surplus. Vietnam is the second largest world exporter of rice and supplies 250,000 tons to Cuba annually, half of its consumption needs.[131] Despite these notable differences, within the historical context of Cuban socialism, the usufruct is a step toward the market, albeit modest and quite restricted. In contrast, in Latin America, the usufruct is normally granted by a private farm owner, the free market and private land ownership dominate, state farms are rare, and cooperatives, where they exist, are typically autonomous.

Dismissals of State Employees and Expansion of the Non-State Sector

State and market roles. Official estimates of unneeded state employees range from 1.3 to 1.8 million or between 26 percent and 36 percent of the employed labor force in 2011. Cuba's very low open unemployment rate (1.6 percent in 2008—virtually full employment and the lowest in the world) was achieved through "hidden" unemployment—underutilization of labor or unneeded state jobs—which reduced labor productivity and wages.[132] The huge fiscal cost of this policy forced the government in 2010 to recognize the problem and the need to dismiss the labor surplus. But that, in turn, required the expansion of "non-state" jobs including self-employment, non-agricultural-production and services cooperatives (hereafter "new cooperatives" or "new co-ops") and usufruct. These market-oriented policies aim to cut fiscal costs and improve productivity and wages. Self-employment had been authorized before but not at the current magnitude and speed; the self-employed own their micro-businesses but in the new co-ops (as in usufruct), the state keeps the property and leases it to co-op members who manage the business and keep the profits.

Progress. From 2006 to 2013, approved self-employed activities expanded at a rate of 28 percent, from 157 to 201 authorized categories of jobs, including the addition of some skilled jobs. By the end of 2013 there were 2,000 small restaurants (*paladares*) and 7,500 rented rooms.[133] New cooperatives began in 2011 with barbers, hairstylists and manicurists. 222 new co-op activities were approved in 2012, and 71 more in 2014, including construction, transportation, garbage collection, produce markets, bird and shrimp breeding, light manufactures and food services.[134] Some 77 co-ops were created to market agricultural products in Havana City with the same functions as supply and demand markets.[135] In 2013, 2,401 state-premises were leased to 5,479 co-op members. In March 2014, 224 co-ops were operating and 228 more had been authorized.[136] There are 2,150 barber and hairdresser co-ops with 5,500 members.[137] The goal of this policy is for 40 percent

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[131] ONEI, *Anuario Estadístico de Cuba 2011* (Havana, 2012).

[132] Carmelo Mesa-Lago, "El desempleo en Cuba: de oculto a visible," *Espacio Laical*, 4, 2010.

[133] Resoluciones, New regulations on self-employed, Nos. 353 and 41, September 26, 2013; *El País*, June 1, 2014.

[134] *Nuevo Herald*, April 29, 2013.

[135] *Granma*, July 1, 2013; *Granma*, July 6, 2013.

[136] Marino Murillo, "Nuevo grupo de cooperativas no agropecuarias," *Granma*, March 3, 2014.

[137] Vivian Bustamante, "Comercio Interior: vender y vender bien," *Bohemia,* August 6, 2013, http://www.bohemia.cu/2013/08/06/nacionales/comercio-exterior.html.

of the employed labor force to be in the non-state sector by 2016. Effects of new co-ops cannot be evaluated due to their recent creation.[138]

Co-op members pay monthly rent to the state, purchase inputs, and freely set prices (the latter also being true for the self-employed). Spurred by the profit motive, members improve the locale, offer better services, earn five to six times their previous state salary and raise fiscal income. Co-ops and the self-employed are permitted to buy from, sell and lease to the government and tourist facilities including joint venture hotels, hire employees (not limited to family members), open bank accounts, receive micro-credit, and import household appliances. In 2013, some taxes were temporarily suspended or made more flexible. As a result, 20 state restaurants were transferred to co-op operation, and a wholesale enterprise began in the Isle of Pines to sell food, intermediate and consumer goods (computers, furniture, technical tools), and rent storage, frigorific and transport equipment. These products/services are sold to the state, cooperative and private sectors (including farmers and the self-employed) to stimulate their inception and development.[139] In June 2013 the wholesale market was regulated through contracts, competition, and free market prices set by supply and demand.[140] As a result, a co-op in Havana, Mayabeque and Artemisa now manages the first wholesale market leased by the state, based on supply and demand, breaking the state monopoly.[141] State enterprises can lease wholesale and supply markets of produce to the new co-ops, trucks to all producers, retail markets to co-ops and the self-employed (that sell at market prices), and contract produce with all co-ops that directly contract with consumers.[142]

Hurdles. Permitted activities for the self-employed are quite specific and mainly non-skilled (clowns, mimics, carters, bathroom caretakers), though few are skilled (realtors, translators, insurance agents), and university graduates cannot work on their own. Thus, an architect can be a taxi driver but not practice his or her trained profession privately. Such constraints waste Cuba's huge investment in education and obstruct the dismissal of state professional employees as well the expansion of the non-state sector. New co-ops must go through four bureaucratic stages to get approved and the final decision is left to the Council of Ministers. The government usually decides to transfer an activity to a co-op and workers can join it or be laid off, but the degree to which co-ops will be fully independent from state intervention remains unclear. Independence of the new co-ops vis-à-vis the state is questioned. Workers can be hired with a cap of 10 percent of total labor hours being worked by the co-op members and only for 90 days.[143] Inspectors burden the self-employed and often ask for bribes. Norms strictly regulate all activity, even renting public bathrooms for self-employed caretakers.[144] Co-ops must obtain a license and pay high monthly fees and taxes, including taxes on sales, services, hired labor, social security and personal income—the progressive rate is 50 percent above $2,000. Over five employees, the tax on labor applies a rate over the base salary that climbs from 50 to 200 percent according to the number of employees. Hence, the tax system penalizes the self-employed workers who create more jobs and it conspires against the state goal of laying off its unneeded workers—the tax rate is justified to avoid concentration of wealth.[145] Tax levies are high and deductible expenses low, thus inducing underreporting.[146] In addition to disincentives caused by

138 Castro, "Discurso en la Clausura," 2013.
139 Ministry of Interior Trade (MINCIN) Resolution MINCIN No. 52, February 14, 2013.
140 *Nuevo Herald*, June 5, 2013.
141 Marc Frank, "Cuba steps back from its wholesale produce monopoly," *Reuters* June 20, 2013, http://www.reuters.com/article/2013/06/20/cuba-reform-agriculture-idUSL2N0EW1K420130620.
142 Decreto No. 318, Marking of agricultural products, October 20, 2013.
143 Marc Frank, "Cuban state begins to move out of the restaurant business," *Reuters,* August 26, 2013, http://www.reuters.com/article/2013/08/26/us-cuba-reform-cooperatives-idUSBRE97P0R620130826. Archibald Ritter, "The Movement towards Non-Agricultural Cooperatives in Cuba," Miami: ASCE Meetings, August 2013, http://www.ascecuba.org/publications/proceedings/volume23/pdfs/ritter.pdf.
144 Resolución 512, Ministry of Economics and Planning on bathroom rentals has six pages in the *Gaceta Oficial*, October 31, 2013.
145 Ley 113, 2012.
146 Alonso and Vidal, 2013.

taxation, micro-credit granted and inputs sold are grossly insufficient,[147] state retail sales have a profit of 200 percent, imports are not allowed, and exports have dwindled.[148] Wholesale markets in the experimental stage give priority to the state over the non-state sector. Prices are rising and Murillo has said they will not stabilize until output increases.[149] Self-employment uncertainty (successively allowed, reduced and reauthorized) has been reinforced by recent actions: the closure of tiny business set in Havana building porches; the imposition of high taxes on sales of imported clothing and the later banning of those sales affecting 20,000 self-employed that might go underground; and the closure of home-based cinemas (including 3-D that state theaters do not show) and video-game arcades.[150] Decree-Law 315/2014 permits the confiscation of businesses and fines violators. In many cases, bureaucrats fear competition: a state-restaurant manager offering bad food and service is threatened by a nearby excellent private restaurant.

At the start of 2014, 596,500 state employees had been dismissed, amounting to 10 percent of the labor force and tantamount to 60 percent of the official target of one million layoffs at the end of 2011 and 33 percent of the goal of 1.8 million dismissals in 2014-2015. However, the creation of non-state jobs has been insufficient to absorb those who have been fired. The open unemployment rate grew from 1.6 percent in 2008 to 3.5 percent in 2012. Although the latter was the lowest in Latin America, it has been artificially reduced because of exclusion of workers not actively seeking employment.[151] Poor statistics are an obstacle to evaluating the expansion of the non-state sector. Table 5 shows the available official data in 2005-2013 on the employed labor force by state and non-state employment (the latter disaggregated by co-ops, self-employed and other private workers), but excludes private farmers, usufructuaries and land renters. Additionally, the categories are not consistent through time. Until 2011 co-op members were limited to the agricultural sector and showed a declining trend, but they rose in 2012 because new co-op members (barbers, hairstylists and manicurists) were added; "other private workers" also fell until 2010, but have increased since 2011 as workers hired by self-employed were clustered with the latter. Self-employment also declined from 3.6 percent to 2.9 percent in 2005-2010 and then rose to 9 percent in 2013. The state-sector share grew from 80.2 percent to 83.8 percent but fell to 75.2 percent in 2012; conversely the non-state share fell from 19.8 percent to 16.2 percent but jumped to 24.8 percent in 2012 due to the increase in all three components. If official data for 2012[152] on all usufructuaries (300,810), land renters and private farmers (125,812) were added to the estimated non-state sector (1,219,000), the sum would be 1.6 million, or 34 percent of the employed labor force. However, if this sum were put together with 75.2 percent of the state sector, the total would be 109 percent.[153]

In December 2013 there were 444,109 registered self-employed workers (18 percent of which were hired workers), a net of 291,509 after subtracting the 152,600 self-employed previously approved prior to the expansion of the number of authorized occupations. The 2012 goal was 695,300 and only 42 percent of that was met by the end of 2013. The 2015 goal is

[147] In 2012, 133,291 loans were granted to individuals, averaging $250; 90 percent was for purchase of building materials, leaving 10 percent for self-employed, coops and usufructuaries (*Granma*, December 21, 2012). In 2011-2013, 218,400 loans were granted, averaging $141 and only 0.2 percent to self-employed (*Juventud Rebelde*, December 19, 2013; *Juventud Rebelde*, December 27, 2013).

[148] *Havana Times*, May 9, 2014.

[149] *Bohemia*, August 29, 2013.

[150] *Granma*, September 26, 2013; Marc Frank, "Cuba shutters private theaters, threatens other businesses," *Reuters*, November 2, 2103, http://www.reuters.com/article/2013/11/02/cuba-reform-idUSL1N0IN08Q20131102.

[151] Economic Commission for Latin America and the Caribbean (ECLAC), *Preliminary Balance of the Economies of Latin America and the Caribbean 2013* (Santiago, December 2013); "Un magnífico congreso obrero," *Juventud Rebelde*, February 23, 2014; Marc Frank, "Cuba continues to trim state payroll," *Reuters*, February 24, 2014.

[152] ONEI, *Anuario Estadístico de Cuba 2012*; Raúl Castro, "Discurso en las Conclusiones del XX Congreso de la CTC," *Juventud Rebelde*, February 24, 2014.

[153] Feinberg, adding estimates of unregistered and part-time self-employed, reaches 2 million workers, 41 percent of the employed labor force and 116 percent of the labor force.

Table 5. Employed Labor Force by Type of Employer in Cuba: 2005-2013 (in thousands and percentage of the employed labor force)

Years (Dec)	Employed Labor Force (000)			Non-State Sector [a]								
		State Sector		Cooperatives [b]		Self-employed [c]		Other Private [d]		Total [e]	
		(000)	(percent)	(000)	(percent)	(000)	(percent)	(000)	(percent)	(000)	(percent)
2005	4,723	3,786	80.2	271	5.7	169	3.6	496	10.5	936	19.8
2006	4,755	3,889	81.8	257	5.4	153	3.2	456	9.6	866	18.9
2007	4,868	4,036	82.9	242	5.0	138	2.8	453	9.3	834	17.1
2008	4,948	4,112	83.1	234	4.7	142	2.9	460	9.3	836	16.9
2009	5,072	4,249	83.8	232	4.6	144	2.8	448	8.8	823	16.2
2010	4,984	4,178	83.8	217	4.4	147	2.9	442	8.9	806	16.2
2011	5,010	3,873	77.3	209	4.2	392	7.8	537	10.7	1,137	22.7
2012	4,902	3,684	75.2	213	4.3	405	8.3	600	12.2	1,219	24.8
2013	4,919					444	9.0				

[a] Excludes usufructuaries, private farmers and land renters (see text). [b] From 2005 to 2010, members of agricultural cooperatives; since 2011, likely also includes non-agricultural-production and services cooperatives. [c] Since 2011, data includes also their hired wage earners. [d] From 2005 to 2010, includes wage earners in mixed enterprises and hired by self-employed and private farmers; since 2011 those hired by self-employed are reported in the self-employed column. [e] Sum of cooperatives, self-employed and other private activities.

Source: Absolute figures from ONEI, Anuario Estadístico de Cuba 2010 (Havana 2011), *Anuario Estadístico de Cuba 2011*, *Anuario Estadístico de Cuba 2012*, and *Panorama Económico y Social de Cuba, 2013* (Havana 2014); self-employment in 2013 from *AP*, January 15, 2014; the author has estimated state, other private and non-state figures from ONEI figures, and calculated all percentages.

1.8 million, thus demanding a six-fold increase of the 2013 net amount in just two years. Out of the total self-employed, 68 percent did not have a prior work record, but were probably illegal workers that became legalized; 18 percent kept state jobs while earning extra money on the side, and 14 percent were pensioners. Only 16 percent had been fired from state jobs in 2012. The primary work activities were food, transportation, house leasing, public vendors and home-good sellers; 61 percent was not specified.[154]

Comparisons. The Sino-Vietnamese reforms have advanced much more than Cuba's in this area, as employment in the private sector goes beyond self-employment and new co-ops, engaging wage workers, and professionals can work on their own or in the private sector. In China, 75 percent of the employed labor force is in private enterprises and self-employment; they contribute between 50 percent and 60 percent of the GDP and half of total taxes; cooperatives are autonomous and usually own their business.[155] In the most developed Latin American countries, formal salaried work in the private sector predominates, but self-employment still accounts for 18 percent to 24 percent of the labor force. In less developed countries, self-employment rises to between 40 percent and 58 percent of the labor force (the highest of which is in Bolivia and Peru), and is an important source of income and wealth, without the tough restrictions imposed in Cuba.[156] Latin American co-ops normally jointly own their businesses, are more autonomous and submit to fewer regulations than in Cuba as well.

Wage Policy, Reduction of Gratuities and Social Services, and the End of Rationing

State and market roles. Wages are centrally fixed and quite depressed in real terms, and severe restrictions provoke labor-effort disincentives. The

[154] "Aumenta el trabajo por cuenta propia," *Juventud Rebelde*, August 17, 2013.
[155] Mao Xianglin, Interview with the author on China reforms. Beijing, November 8, 2013.
[156] ECLAC, *Social Panorama of Latin America and the Caribbean 2011* (Santiago, June 2012).

state provides "gratuities" and generous social services: universal free access to health care and education; large subsidies to the cost of social security pensions (prior to the 2008 pension reform, workers did not pay contributions and could retire at 55 for women and 60 for men, among the lowest ages in the region); rationed goods at subsidized prices; cheap meals in work-center cafeterias; and home ownership for most of the population. Starting in 2003, under the "Battle of Ideas" launched by Fidel, 3,000 municipal university campuses were created, significantly increasing the percentage of people in higher education. While enrollment jumped 40 times in the humanities and five times in physical education, it fell 39 percent in natural sciences and math, both essential to development. A social workers training program was also established, but those graduates were used inefficiently. Social services costs peaked in 2007-2008 taking 55 percent of the budget and 37 percent of GDP; 88 percent of the cost of rationed goods was subsidized at the cost of 25 billion CUP ($1 billion USD) in 2013.[157] Even during the grave crisis of the 1990s, gratuities and social services were not trimmed. Despite high costs, the quality of such services declined: the real average pension fell by half in 1989-2011; due to an acute shortage of teachers (prompted by very low wages), "emerging teachers" were trained in only a few months, worsening the level of incoming students at universities; health-care infrastructure, equipment and services deteriorated. Additionally, Cuba has the second most aged population in the hemisphere and rapid aging raises pension and health-care costs substantially.[158] Such economic and fiscal largesse is unsustainable in the medium and long term.[159] Raúl Castro acknowledged these problems, stating that social services must be subordinated to fiscal resources and economic capacity, and launched a program to reduce social services, eliminate gratuities and rationing. These reforms are oriented towards the market but rule out any supplementary or partial privatization of social services.

Progress. Salary reform in 2008 strived to raise wages and incentives by authorizing multiple jobs and payment for results, eliminating the salary cap and legalizing enterprise stimulus bonuses in CUC or hard-currency. Other social reforms seek to reduce budget expenses by shutting down inefficient, costly programs such as schools in the countryside, thousands of municipal university campuses and the social-workers program; setting entry quotas and tightening entrance exams to universities, and sharply cutting enrollment in humanities and physical education while enlarging enrollment in natural sciences and math. The number of hospitals and clinics was cut by 32 percent in 2007-2012 and health professionals by 16 percent;[160] the expansion of herbal medicine and acupuncture attempts to compensate for cuts in health-care curative services. The pension reform increased retirement ages by five years for both genders and established contributions made by workers, but tied to a raise in their wages. Since 1995, Cuban economists have warned that universal rationing benefits the high income group that does not need this subsidy and have hence recommended eliminating rationing and establishing social assistance targeted to the needy. Accepting this idea, in 2006-2013, Raúl Castro gradually removed certain goods from rationing and began selling them at market price, several times higher than the rationed price. These goods included beef, tubers, lard, chickpeas, cocoa, cigarettes, toothpaste, detergent, soap and liquid gas. He also cut the quota for beans and eggs by half, and reduced the sugar quota by 20 percent. Utility tariffs and prices in foreign-currency shops (TRD) were also elevated.

Hurdles. Table 6 exhibits the results of multiple social reforms. No data are available on the effects of the 2008 salary reform, which possibly helped to

[157] Rosa Tania Valdes, "Cuban food ration system marks 50 years amid controversy," *Reuters* July 12, 2013, http://uk.reuters.com/article/2013/07/12/us-cuba-reform-ration-idUSBRE96B0NP20130712.

[158] In 2010, the population age 60+ (17.8 percent) exceeded that age 0-14 (17.3 percent); the former grew to 18.7 percent in 2013 (ONEI, *Panorama Económico y Social de Cuba, 2013* (Havana, April, 2014).

[159] Carmelo Mesa-Lago, *Social Protection Systems in Latin America and the Caribbean: Cuba* (Santiago de Chile: ECLAC, 2013).

[160] ONEI, *Anuario Estadístico de Cuba 2011* (Havana, 2012).

increase the average real wage by two percentage points by 2011, though this was still 73 percent lower than the 1989 level. Expenditures in state-budgeted social services shrank from a peak of 55 percent of the total state budget related to current expenses in 2007 to 48 percent in 2012. In terms of GDP, these expenditures declined from 37 percent to 27.3 percent between 2008 and 2013. The most affected sectors were social assistance, housing, health care (despite population aging which increases health costs) and education. Social assistance was slashed by 76 percent while beneficiaries as a percentage of the population were reduced by 72 percent. Housing expenditures combined with communal services were cut from 2.9 percent to 1.3 percent; housing alone was 0.3 percent of GDP in 2012.[161] The pension reform reduced the sate-funded financial deficit (annual revenue minus expenditures) from 41.5 percent to 39 percent of expenditures in 2009-2010, but it increased again to 48 percent in 2013, the highest on record. Relative to GDP, the deficit rose slightly to 3.1 percent. In the long run, the actuarial deficit (projected revenue to pay future obligations) will intensify due to population aging and the high life expectancy at retirement age. Despite some nominal increases, the average real pension in 2012 was one half of its 1989 level.

Some social reforms have harmful social consequences. Cuts in health services affect the population, e. g., reductions in personnel, especially family doctors (reduced to one third of former numbers due to their export to Venezuela and other countries)[162] closure of some hospitals and clinics, and cuts in diagnostic tests and specialist consultations. Workers' cafeterias with subsidized prices have been shut down and replaced by a voucher system that is insufficient to buy lunch. Ending rationing is the toughest social reform. Although quotas are meager and only cover food needs for seven to ten days a month, the system is still vital for low income groups that do not receive foreign remittances. Hence, its

Table 6. Results of Structural Social Reforms in Cuba: 2006-2013

Indicators	2006	2007	2008	2009	2010	2011	2012	2013[a]
Real average wage (1989=100)	23.9	24.5	25.0	26.0	27.1	27.1	27.1	27.1
Real average pension (1989=100)	39.3	39.3	48.2	50.0	50.0	50.0	50.0	
Social current expenditures [b]								
percent of state budget	53.4	55.4	53.1	54.0	53.1	53.6	48.2	51.1
percent of GDP	28.9	33.2	36.6	36.3	33.9	32.6	29.6	27.3
Education (percent of GDP)	10.0	12.1	14.1	13.1	12.9	12.8	12.0	10.8
Health care (percent of GDP)	7.1	9.9	10.3	11.3	9.7	10.1	8.0	
Social security pensions (percent GDP)	6.7	6.4	7.1	7.6	7.6	7.4	7.3	7.2
State financed deficit [c] (percent)	37.4	35.3	40.5	41.5	39.1	41.0	43.1	48.1
percent of GDP	2.5	2.2	2.9	3.2	3.0	3.0	3.1	3.1
Housing &communal services [d] (percent GDP)	2.8	2.8	2.9	2.8	2.7	1.9	1.8	1.3
Social assistance (percent of GDP)	2.2	2.0	2.1	1.5	1.1	0.5	0.4	
Beneficiaries (percent total population)	5.3	5.3	5.2	3.8	2.1	1.6	1.5	

[a] Preliminary data. [b] Peak denoted in dark font. [c] [(current revenue - current expenditures)/current expenditures] x 100.
[d] In 2012, housing received only 14.4 percent of the combined total, and communal services 95.6 percent.
Sources: Real wages and pensions from Mesa-Lago and Pérez López, 2013; rest author's calculations and updating based on ONEI *Anuario Estadístico de Cuba 2012* (Havana, 2013) and *Panorama Económico y Social de Cuba, 2013* (Havana, April 2014).

[161] ONEI, *Panorama Económico y Social de Cuba, 2012* (Havana, April 2013).
[162] ONEI *Anuario Estadístico de Cuba 2012* (Havana, 2013).

elimination faces wide opposition. The vulnerable population has expanded due to substantial price raises in goods and public services (TRD charge a 240 percent markup), dismissals that doubled the open unemployment rate, and reduced access to family doctors. About 480,000 citizens age 60 and over are in need but only 15,825 slots are available in nurseries/asylums.[163] Raúl promised that no afflicted needy would not be left unprotected, but social assistance has been severely curtailed. Although targeting is appropriate to detect beneficiaries not really in need, the VI Party Congress agreements ended assistance to beneficiaries with relatives who can help them, failing to address the generalized level of need and the expanding vulnerable population.

Comparisons. The Sino-Vietnamese reforms disrupted the pension and health systems because they were tied to big state enterprises now largely decentralized, as well as rural communes now disbanded. In China, formal and informal co-payments were typical in education but now it is free. New systems are emerging: urban areas have medical care funds financed by the state, employers and workers, and users have a 15 percent co-payment; in rural areas, co-ops provide health care and the copayment is 30 percent; the new pension system is still in an early stage.[164] These reforms in social-service financing are more radical than Cuba's.

After a significant increase in social spending in Latin America, a leveling off or decline, including in Cuba, began in 2010-2011. Despite this, the share of GDP used for social spending in Cuba is still twice the regional average.[165] In several Latin American countries, structural reforms privatized part of social services, often with adverse results. In health care, competing private for-profit corporations (HMOs) were created and expected to improve care and reduce costs, but in practice HMOs charged high premiums and co-payments, excluded pre-existing conditions, and imposed higher fees to women in their child bearing years and the elderly. In Chile, a pioneer in social reform, services in the public health sector deteriorated and later required significant investment, but as they improved, the population enrolled in HMOs declined from 25 percent to 16 percent whereas the public sector expanded. The Cuban pension reform was modest, limited to altering some parameters rather than fostering structural change.

Half of Latin America fully or partially privatized social security pensions from 1981-2011, increasing the capital accumulated in private funds and improving managerial efficiency of individual accounts. However, reforms failed to expand labor-force coverage, in most cases competition did not work, administrative charges were very high, and transition costs have been much greater and lasted longer than initially projected. Re-reforms in three countries between 2008 and 2010 have increased the state role in such pensions. Two closed the private system and moved all the insured and their funds to the public system. Chile kept the private system but improved it with higher pensions, enhanced social solidarity and gender equity, and strengthened competition. Aside from a few exceptions, public pension systems face growing financial and actuarial deficit, as well as inefficiencies, and pay low pensions.[166]

Selling and Purchasing Dwellings

State and market roles. The urban reform of 1960 confiscated most housing, forbade its sale and rental, decreed that homeowners could only keep one home, virtually banned private construction, abolished mortgages and granted tenants the right to pay monthly rent to the state for 20 years to become homeowners. A positive outcome was that 95 percent of the population now owns their own homes,

[163] "Los retos de enevejecer," *Juventud Rebelde*, November 14, 2014.
[164] Xianglin.
[165] ECLAC, *Social Panorama of Latin America and the Caribbean 2012* (Santiago, March 2013).
[166] Carmelo Mesa-Lago, *Reassembling Social Security: A Survey of Pension and Health Care Reforms in Latin America* (Baltimore: John Hopkins University Press, 2012); Carmelo Mesa-Lago, "Re-reforms of Privatized Systems," *Zeitschrift für ausländisches und internationales Arbeits- und Sozialrecht* (Munich, 26: 3), 189-316.

but there were adverse effects as well. The rate of state housing construction was much lower than population growth, and many homes are in severe disrepair due to lack of maintenance (resulting from absence of construction materials, state restrictions on building, and the inefficiency of the government agency for repairs) and hurricanes that in the last ten years damaged one million dwellings, equating to 28 percent of the stock of 3.88 million units.[167] The official housing deficit is 600,000 units, but the true amount is closer to one million by the author's estimate. The National Institute of Housing reports 1.17 million homes (30 percent of the stock) to be in mediocre or poor condition.[168] In Centro Habana, 49 percent dwellings are in bad shape and 9 percent are in critical situation; 230 edifices collapse daily, and 24,311 residents live in temporary shelters.[169] To ameliorate these problems, building of private homes (termed "self-effort") was permitted as were housing swaps (*permutas*) of homes of supposedly similar value. However, in practice *permutas* triggered bureaucracy and corruption. The housing reform[170] is an important move towards the market.

Progress. The 2011 reform authorizes the sale and purchase of homes for Cuban citizens and foreign permanent residents at a price freely fixed by seller and buyer, ownership of a second home for recreation in the countryside or the beach, the right to inherit a home and for emigrants to pass it to relatives (or sell it before leaving the island). In addition, the reform permits sales of building materials at market price, grants subsidies for those in need with homes damaged by hurricanes to buy such materials, concedes some tax exemptions, and expands state microcredit (90 percent of which is to build/repair homes). Those eligible for the subsidy include home owners, tenants in a multifamily dwelling, and renters of state buildings. Two Supreme Court rulings in 2013 implicitly acknowledged a previous illicit transaction and authorized its payment in dollars, suggesting that the government wants to legalize prior transactions and improve market security.[171] In 2013, the market-set collateral guarantee was reintroduced on jewels, precious metals, agricultural equipment, cattle and crops, as well as mortgages on recreation houses and empty lots but not on principal homes.[172] Housing capital, which had been frozen for 50 years, can now be sold to change residence, invest in microbusiness, buy a cheaper dwelling and use the remaining funds to improve life, or get a small capital to settle abroad.

Dwellings transferred between November 2011 and March 2012 totaled 14,310, of which 80 percent were donations (probably legalization of prior illegal sales) and 20 percent were sales. In November 2012, 45,000 accumulated transactions were reported (without disaggregating those sold and donated) and 80,000 more in 2013 alone for a total of 125,000, or 3 percent of the stock.[173] And yet, it is reported that 100,000 homes were informally sold, similar to the number of formal transactions. A 2013 survey gave an average house sale price of $31,498 (a fortune in Cuba), ranging from $21,464 in Villa Clara to $59,191 in Playa Havana, but $500,000 in Miramar and $2 million for a penthouse in Havana.[174]

Subsidies for poor families to repair their homes damaged by hurricanes were 566 million CUP from January 2012 to March 2013, granted to 33,431 beneficiaries, an average of 16,960 CUP ($700) per person/household. The maximum subsidy to build a dwelling of 25 square meters is 85,000 CUP

[167] ONEI, *Informe Final del Censo de Población y Viviendas 2012* (Havana, 2013).
[168] Daniel Benítez, "Cuba's Housing Situation," *Havana Times*, July 9, 2013.
[169] Marcelo Martín Herrera, Documentary "Elena," exhibited in ICAIC, Havana, April 2013.
[170] Decreto-Ley No. 288, Housing reform, November 22, 2011.
[171] Circular 265, April 2013; *Cubaencuentro*, September 10, 2013.
[172] Cuban Central Bank, Instrucción 1, 2013.
[173] "Aumenta la compraventa de viviendas en Cuba," *EFE*, December 3, 2013.
[174] John Arlidge, "Cuba, home of the oddest property market," *Financial Times*, June 21, 2013; Peter Orsi, "Despite hurdles, Cuba real estate market buzzing," *AP*, April 30, 2013; Benítez 2013; Emilio Morales and Joseph Scarpaci, "Mercado inmobiliario en Cuba: Una apertura a medias," Miami, *The Havana Consulting Group*, May 2013.

Table 7. Housing Construction Total and by Builder in Cuba: 2006-2013

Indicators	2006	2007	2008	2009	2010	2011	2012	2013
Dwellings built								
Thousand units	111.4	52.6	44.8	35.1	33.9	32.5	32.1	25.6
Units per 1,000 inhabitants	9.9	4.6	4.0	3.1	3.0	2.8	2.8	2.3
Dwellings built by (percent of total) [a]								
Population	69.9	52.0	52.8	40.4	33.7	27.5	28.9	47.7
State	26.7	42.6	41.8	55.4	64.0	70.6	69.6	52.3

[a] Dwellings built by cooperatives made the difference to 100 percent.

Source: ONEI *Anuario Estadístico de Cuba 2011* (Havana, 2012); *Anuario Estadístico de Cuba 2012* (Havana, 2013); and *Panorama Económico y Social de Cuba, 2013* (Havana, April 2014).

($2,500), a substantial sum in Cuba, and 5,000 or 10,000 CUP ($208 and $417) for repairs depending on the work needed.[175]

After peaking at 111,400 in 2006, the number of dwellings built dwindled to 25,600 in 2013, while the rate of units built per 1,000 inhabitants fell from 9.9 to 2.3 (Table 7). Despite positive steps taken, houses constructed by the population declined from 70 percent of total construction to 29 percent from 2006 to 2012 whereas those built by the state rose from 27 percent to 70 percent. Preliminary data for 2013, however, show a reversal to 48 percent and 52 percent respectively, an indication that reforms might be having better results on this front.

Hurdles. The major impediment to the sale of homes is that supply is higher than demand due to Cubans' low purchasing power. The average annual wage is 5,580 CUP ($232) and a very cheap house costs $5,000 so it would take 21 years of wages. Cubans also lack basic knowledge on how to evaluate their property and set a market price: no appraisers exist, and, due to the bad state of most dwellings, the buyer must invest about 50 percent over the asking price to repair the house, a fact that few know. Mortgages on primary residences are still banned and lending banks for housing don't exist.[176] To sell a home it must be recorded in the municipal property registry and the transaction must be conducted by a notary public (*notario*). The registry was virtually abandoned and out of date because few cared to record their home or update its status; an attempt to create a national cadaster in the 1960s was abandoned. Only 17 percent of home owners have registered or updated their property status.[177] There are additional hurdles to home sales including the insufficient amount of public notaries; until late 2013, realtors were banned, although they worked illegally and now charge a 5 percent commission; architects cannot work as self-employed, obstructing dwelling construction and repair. Advertising is limited to signs at homes, places where buyers and sellers meet, and a few web sites with low population access. The Cuban TV also began announcing sales in 2013, a step in the right direction.[178] Previously a 4 percent sales tax on the selling price was levied, but that requirement was suspended in 2013. As noted, state budget allocation for housing comprises the second lowest amount of public spending and has been decreasing. The 2013 state plan for the sale of housing construction materials was 2.3 billion CUP or $96 million,[179] but actual sales reported in the first quarter were 539 million CUP

[175] Acuerdo Consejo de Ministros No. 7,387, Regulation of housing subsidies, May 6, 2013; *Granma*, May 6, 2013.
[176] Morales and Scarpaci; Jeff Franks, "Cubans on the move as new real estate market grows," *Reuters,* March 20, 2013, http://uk.reuters.com/article/2013/03/20/uk-cuba-housing-idUKBRE92J05A20130320.
[177] Based on ONEI, *Informe Final del Censo de Población y Viviendas 2012* (Havana, 2013).
[178] Arlidge; *Granma*, July 11, 2013. The website *EspacioCuba* has 2,500 listings and 30-40 daily customers (Orsi). According to Morales and Scarpaci, 100,000 homes were listed in mid-2013.
[179] Murillo, Informe a la Asamblea Nacional, 2013; Franks.

($22 million) below the plan, because of insufficient equipment, low quality products, high prices and slow stock mobilization due to price rigidity.[180]

Legal procedures and regulations on building homes, selling houses and receiving subsidies are all cumbersome as well. A building application requires eight visits to four state agencies, which takes at least 132 days.[181] Nationals cannot own more than two homes and non-resident foreigners are forbidden to buy houses; it is unclear if foreigners can own apartments built by Cuban companies in authorized luxury resorts.[182] Municipal authorities decide who qualifies to build and also set priorities for subsidies, inspectors evaluate the applicant construction plan, materials needed and transportation costs, and the municipality makes the final decision. Detailed rules also define what goods can be bought with the subsidy at TRD.[183] Corruption, fraud and law infractions exist: to cut taxes the sale price is given as a fraction of the real one; donations hide new purchases; subsidies and construction materials are provided to persons that are neither needy nor have dwellings damaged by hurricanes; officials are bribed to approve illegal deals; foreigners buy homes and place their titles in the name of a Cuban relative or friend.[184]

Comparisons. China's ownership rights are much more liberal than Cuba's. The property law of 2007 allows national and foreign investors to own homes under construction on state-owned land and, once completed, grants the right to sell, lease and mortgage such rights for 70 years for residences (automatically renewable) or 40-50 years for industrial and commercial businesses. China does not have a unified national housing system; in Beijing a resident family can buy two homes and a child 18 years old or older can buy another two, and there is no limitation on commercial use. There are no restrictions on foreign permanent residents and large international companies (Blackstone, Morgan Stanley, and Goldman Sachs) have realty branches in China. Such property rights have led the real estate industry to make huge profits from a frenzy of eager buyers (many foreigners) that keep real estate prices bubbling.[185] The home ownership rate in Cuba is the highest in Latin America, but no other country has so many restrictions and regulations on ownership, investment, buying/selling, building and repairing of homes imposed on its nationals and particularly on foreigners. Mexican trusts (*fideicomisos*) allow foreigners, through a domestic bank, to hold real estate titles for 100 years, generating huge investment with little risk.[186] Mortgages exist throughout the region and most countries have housing lending banks that facilitate credit and construction. On a positive note, Cuban subsidies to the needy for home construction/repair are generous by regional standards.

Reform Monitoring and Evaluation of Macro Results

Reform Monitoring

The VI Party Congress neither provided a timetable to implement the agreements of 2011, nor set priorities or a sequence of actions. The Permanent Commission reporting to the Council of State is in charge of coordinating, monitoring and overseeing implementation of the agreements. Chief of the Commission Murillo said that it has the authority to make changes to the agreements or propose new ones, and that it was developing a plan through 2015 that would be strictly fulfilled.[187] Twice a year, Murillo reports to the National Assembly on the agreements' progress. The PCC First National Con-

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[180] Buenítez; Bustamante.
[181] *Granma*, July 8, 2013.
[182] Palli.
[183] Acuerdo No. 7,387, 2013; *Granma*, May 6, 2013.
[184] There is a two-tier market: Cubans mostly buy small, cheap houses whereas foreigners with Cuban connections acquire the most expensive properties (Franks). *Diario de Cuba*, March 20, 2013; Murillo, Informe a la Asamblea Nacional, 2013; *Granma*, October 4, 2013.
[185] Palli; Xianglin.
[186] Palli.
[187] Gerardo Arreola, *La Jornada*, March 28, 2012.

ference in 2012 stipulated that the Party is responsible for fostering and overseeing compliance of the agreements, especially updating the model, and to ensure that they do not become a "dead letter".[188] The Central Committee meets twice annually to review progress and prepare a report on the agreements' implementation. The leadership of the Party and of the government should closely oversee the process and, when appropriate, make adjustments to correct negative trends. The General Comptroller Office also exercises control over the reforms affecting the non-state sector; Director Gladys Bejarano reported a new stage in the implementation process in which statistical information would be a tool of management and monitoring, facilitating informed criticism, and the fight against corruption.[189] The National Office of Tax Administration (ONAT) controls taxes in the non-state sector. The mass media must also provide regular, reliable information on the progress achieved and hurdles faced to keep the population informed regarding the reforms and any alterations that are made.

The creation of oversight entities and mechanisms to monitor the agreements' implementation is an important step as well, but several agencies are involved in the process without clear coordination and data exchanges. Reports are brief and broad with scant figures; in some cases, years pass without reporting a policy outcome or updating key data. Additionally, the National Assembly does not allow for frank debates on the progress of the economic reforms, and is not provided with sufficient data for informed discourse. Evaluating the effects of the reforms demands a robust statistical base. The Permanent Commission may gather such data, but it has not publicly released it despite Raúl's call to do away with secrecy and to keep the people informed. ONEI lacks statistics on usufruct; the number of usufructuaries began to be published in 2013, but figures are still needed on cultivated land, production, yields, sales and prices, disaggregated by producers (state farms, cooperatives, private farms and usufruct). Meager data is available on credits given to farmers, their purpose, and repayment performance, and also on inputs sold to them. No data has been published on the impact of the 2008 salary reforms, poverty incidence, income distribution, average salary by gender and race, and number of dwellings sold or donated since the end of 2012. The party and the government conduct public opinion surveys, but don't publish them (although a few scholars conduct and publish limited surveys). So far no surveys have been released about the people's views on the reforms and desired changes. In 2013, Minister of Finance and Prices Lina Pedraza reported a significant quantity of unpaid personal income tax and under-declaration of income due to weakness in the state tax collection system. ONAT has an obsolete information system (e.g., deceased self-employed are still enrolled, payment delays on file for those who actually paid on time) that must be updated in 2014 and must make short-run changes to adjust to the new stage of the reforms.[190] Moreover, the fight against corruption, one of Raúl's key targets, has not been accompanied by transparency and accountability of state enterprises and agencies.[191]

Macroeconomic Results

In most cases it is not possible to attribute macroeconomic performance to the reforms because of other factors that could not be isolated; but as Table 8 illustrates, macroeconomic indicators have not improved since the implementation of the reforms. **GDP.** Growth rates declined from 2007 to2009 due to domestic problems and the global crisis. Although a partial recovery process began to take place, growth slowed to 2.7 percent in 2013 (below a 3.6 percent goal), the sixth lowest rate in Latin America; the officially projected growth for 2014 is 1.4 percent below the goal of 2.2 percent.[192] Growth

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[188] *Granma*, January 29, 2012.
[189] *Granma*, July 5, 2013.
[190] *Granma*, July 6, 2013.
[191] Antonio Romero, "Transformaciones económicas y cambios institucionales en Cuba: Una aproximación crítica," (Washington, D.C.: Brookings Institution, August 2014).
[192] "Reunión del Consejo de Ministros: Tomando el pulso a la economía cubana," *Granma*, June 23, 2014.

Table 8. Reforms and Macroeconomic Performance in Cuba: 2006-2013

Indicators	2006	2007	2008	2009	2010	2011	2012	2013[a]
GDP constant prices (percent)	12.1	7.3	4.1	1.4	2.4	2.8	3.0	2.7
Capital formation [b] (percent GDP)	10.4	9.7	10.8	5.4	8.6	7.7		
Agricultural output (percent)	-7.5	19.6	0.6	3.3	-5.1	5.0	0.5	
Ibid (percent GDP)	3.2	3.7	3.6	3.7	3.5	3.5	3.7	3.6
Crops output (2005=100)								
Tubers and plantains	85.5	92.0	83.5	86.8	87.4	88.5	90.7	86.9
Vegetables	83.4	81.2	76.1	79.5	66.8	68.8	65.9	75.1
Cereals [c]	101.3	110.7	104.3	118.9	106.7	126.0	137.2	150.4
Beans	66.4	91.5	91.5	104.2	75.7	125.2	119.6	122.2
Citrus fruits	67.2	84.5	70.6	75.6	62.2	47.7	36.7	30.0
Other fruits	91.1	95.7	90.1	91.3	93.0	99.7	117.8	112.9
Cacao	102.5	66.7	53.2	67.1	82.6	73.0	98.0	
Tobacco	114.2	98.5	82.6	96.9	78.8	76.5	75.0	
External trade (billion pesos)								
Import of goods	9.5	10.1	14.2	8.9	10.6	14.0	13.9	14.8
Export of goods	2.9	3.7	3.7	2.9	4.5	5.8	5.9	5.7
Agricultural [d] (percent of total)	0.5	0.4	0.4	0.5	0.3	0.4	0.4	
Balance of goods	-6.6	-6.4	-10.5	-6.0	-6.1	-8.0	-8.0	-9.1

[a] Preliminary data. [b] Gross fixed capital formation. [c] Rice and corn. [d] "Agricultural/cattle products by groups."

Sources: ONEI *Panorama Económico y Social de Cuba, 2012* (Havana, April 2013); ONEI *Anuario Estadístico de Cuba 2012* (Havana, 2013); ONEI *Panorama Económico y Social de Cuba, 2013* (Havana, April 2014); and author's calculations including crops output index.

averaged 2.5 percent in 2009-2013 whereas 5 to 6 percent is needed to spur adequate development. Minister Yzquierdo blamed the poor growth on Hurricane Sandy, non-fulfillment of hard-currency revenue, planning flaws, bad investments, insufficient credit and low labor productivity.[193] Raúl recognized that "still GDP performance is not noted in the average Cuban family economy."[194] Gross fixed capital formation fell from 10.8 percent to 7.7 percent in 2008-2011, vis-à-vis 25.6 percent in 1989, with a regional average of 22.7 percent, versus 50 percent in China and Vietnam.[195] In both indicators, performance has been well below planned targets.

Agriculture: Nova argues that the agricultural sector is decisive and strategic because of its spillover has multiplying effects in other sectors of the national economy.[196] If this sector does not have the expected results, as has happened in recent years, the multiplying effect is negative. Agricultural output decreased 5 percent in 2010 and grew 0.5 percent in 2012 (a quarter of the goal of 2.2 percent); as a percentage of GDP it was stagnant from 2007 to 2013 (Table 8). The output index shows that by 2010, two years after the first usufruct law, output in all crops except cereals was substantially below 2005, although by 2013 also beans and some fruits had exceeded that level. ONEI preliminary reports

[193] Adel Yzquierdo, Informe a la Asamblea Nacional," *Juventud Rebelde*, December 19, 2013.
[194] Castro, "Intervención en…"
[195] ECLAC, *Preliminary Balance of the Economies of Latin America and the Caribbean 2012* (Santiago, December 2012); Pérez Villanueva.
[196] Nova.

show that in 2013, non-sugar agricultural output grew 2.6 percent but there were significant declines vis-à-vis 2012: citrus 18 percent, tubers and plantains 4 percent (plantains 26 percent and potatoes 18 percent) and non-citrus fruits 4 percent.[197] In 2012, milk and eggs fell 17 percent. Conversely, vegetables grew 14 percent, cereals 9.7 percent and beans 2 percent.[198] With very few exceptions, all output indicators are well below 1989 levels.[199] Cuba's General Auditor attributes the lack of results in usufruct to the failure to change the mentality of state entities and their leaders.[200]

The usufruct effect on agricultural output is difficult to measure because it is not disaggregated within the CCS/private sector (where it must belong) but usufructuaries were the only to receive idle state land. Also, the more flexible 2012 usufruct law entered in force in December and its full potential cannot be assessed until final data are available for 2013. The CCS/private sector share in total cultivated land by crop expanded in 2011-2012 and in the latter year ranged from 89 percent to 97 percent, except for citrus and beans where the state had a majority. The sector share in total agricultural output also rose and oscillated between 85 percent and 97 percent with the same two exceptions noted. Finally, sector yields in most crops were higher than those of the state. Total agricultural output virtually stagnated in 2012, but while state production declined in nine out of ten products, CSS/private sector output rose in six out of ten, which could be interpreted as a usufruct outcome.[201] And yet, data for 2013 contradict such interpretation: CSS/private sector output contracted in six areas and rose in four whereas the opposite was true of the state sector.[202] One explanation for this oddity is that private and usufruct farmers are diverting output from state *acopio* to the market, but this should have been the case in 2011-2012 also.

Exports/imports: The balance of trade in goods ended in a deficit for the entire period (2006-2013), reaching a record of $10.5 billion in 2008,[203] which led to debt insolvency. After proper policies were enacted, the deficit shrank but rose again to $9.1 billion in 2013, the second highest in history. Due to poor domestic performance, the share of agriculture and livestock in total exports was minimal and fell from 0.5 percent to 0.4 percent; food imports account for 70 percent of consumption and rose from $1.5 billion to $2 billion in 2011-2013.[204] Cuba's heavy trade-economic dependence on Venezuela is risky because of the latter's economic-political problems, coupled with the lack of tangible macroeconomic results.

Comparisons. In the initial six to seven years of the Vietnam reform, more aggressive reforms led to it having higher GDP growth rates, investment, agricultural output and exports than Cuba, despite being under a similar US embargo.[205] People in China and Vietnam are satisfied with the reforms because they resulted in improvement in living standards but in Cuba the lack of economic results and some adverse social effects have not generated such positive feelings.

Conclusions and Ways Forward

Institutional reforms are advancing in Cuba and are positive overall. They include the establishment of microcredit, bank accounts and wholesale markets for the non-state sector, the sale of homes which was previously banned, and inheritance rights of usu-

[197] ONEI, *Panorama Económico y Social de Cuba, 2012*; ONEI *Anuario Estadístico de Cuba 2012*.
[198] ONEI, *Panorama Económico y Social de Cuba, 2013*.
[199] Mesa-Lago and Pérez-López.
[200] Gladys Bejarano, "Octava Comprobación Nacional de Control Interno," *Granma*, March 3, 2014.
[201] Based on ONEI *Anuario Estadístico de Cuba 2012*.
[202] ONEI *Sector Agropecuario Indicadores Seleccionados, enero-diciembre 2013* (Havana, February 2014).
[203] ONEI yearbooks refer to "pesos" not specifying if they are CUP or CUC; ECLAC gives same data in US dollars.
[204] *Granma*, December 15, 2012; Raúl Castro, "Intervención en la Primera Sesión Ordinaria de la VIII Legislatura de la Asamblea Nacional," *Granma* July 7, 2013; ONEI *Anuario Estadístico de Cuba 2012*.
[205] Pavel Vidal, "Reforma y crecimiento económico: Comparación entre Cuba y Vietnam," Chicago, unpublished paper, LASA Congress, May 2014.

fructuaries and home owners. These are the most important reforms under the revolution. Furthermore, many of them either lack a precedent—mass dismissal of unneeded state employees, elimination of or reductions in gratuities and social services, home sales, and commercial relations between the state and non-state sectors—or they have advanced much more than previous reforms, like self-employment. The reforms are oriented towards the market. For example, prices are set by supply and demand in home sales and self-employed/co-op services; the self-employed own their tiny businesses; new co-ops are managed by their members who enjoy the profits; and the number of economic agents has expanded, as has the competition between them. The reforms try to increase efficiency and production, but while they have not improved legitimacy, levels of uncertainty have grown.[206] Key structural changes and components of the new model are still missing: integral price reform, elimination of monetary duality, a realistic exchange rate, and bank system restructuring. The reforms are being implemented slowly (albeit with more dynamism in the last two years), and they have not produced tangible results. The reforms still fall far behind the Sino-Vietnamese reforms, and Raúl has less than four years left to complete them. Cuba's reforms run counter to the shock therapy typical of Latin America, where the market and private property predominate even in countries that in recent years have reinforced the state role. It is highly unlikely that the reform process be reversed, as has happened before, because of the magnitude of the socio-economic troubles accumulated over 55 years of centralized state socialism and the lack of feasible alternatives. Summarized below are the most important conclusions and some suggestions for moving forward.

Updating the model. The Cuban economic model is not being transformed but updated gradually, preserving the supremacy of the central plan and state property over the market and non-state property (though with the latter expanded). Most Cuban academic economists seek a more balanced mix of planned economy and state-owned property with an open market and non-state-owned property. Updating the model will be a long and complex process which has been unsuccessful in other former socialist countries, as it has in Cuba. Several key components of Cuba's changes in 2014in the largest state enterprises were attempted before and then abandoned. It took 33 months to organize a team to study and conceptualize the first version of the new model. The greatest obstacle to the reforms seems to be the model itself. If Cuba were to follow an adapted "socialist market" or mixed economy model, as in China and Vietnam (which have a private sector, open markets and foreign investment, combined with an indicative plan and decentralization of decision making) it would achieve much higher sustained economic growth under the Party rule.

Usufruct. The Sino-Vietnamese experience shows that agricultural reform is pivotal. Cuba's agricultural reform is mainly executed through usufruct and has required a second law, more lax than the previous law but still restrictive. At the end of 2012 there were 174,271 usufructuaries but 142,862 had been working the land for 20 years without a significant role in increasing agricultural output. Officially, usufructuaries received 1.5 million hectares of agricultural land, but it is possible they only received one million. The average plot size was either six or nine hectares, much lower than the 13 or 67 hectares respectively allowed in the two usufruct laws of 2008 and 2012. Either 33 percent or 54 percent of usufruct land was not yet producing at the end of 2012, probably the result of the hurdles analyzed. New usufructuaries have been working for five years but agricultural output declined in 2010, stagnated in 2012 and possibly rose slightly in 2013. Cuba could accomplish food self-sufficiency in a few years, save $2 billion in imports and generate a surplus for export, if it shifted to indefinite usufruct contracts with the right to decide what to plow, to whom to sell produce and to fix all prices. *Acopio* should be eliminated completely.

[206] Alonso and Vidal.

Dismissals and expansion of the non-state sector. Statistics for 2012-2014 that include accurate disaggregated data by type of employment are needed. The dismissals plan is far behind the goal, yet open unemployment still rose to 3.5 percent in 2012, even excluding those not seeking jobs. Since 2010, the state sector has declined whereas the non-state sector has expanded. Despite the increase in self-employment, members of new co-ops and their hired manpower, total net job creation has not grown enough to absorb the state-employment surplus. To dismiss unneeded state employees, save substantial resources and raise state wages, more flexibility is crucial to expanding the non-state sector. To accomplish this, the state must permit self-employment in skilled, high-value-added jobs for university graduates, authorize medium-sized enterprises and co-operative ownership of businesses, allow true co-op independence, reduce excessive taxes on non-state workers, halt government measures that create uncertainty, and expand microcredit and wholesale markets.

Social reforms. Social expenses were cut 7 percentage points relative to both the state budget and GDP. Most cuts are rational and efficient but rising unemployment, fewer goods sold by rationing, ending gratuities and escalating prices have caused adverse social effects and expanded the vulnerable population while social assistance expenditures were slashed by 76 percent. The pension reform neither reduced the financial deficit funded by the state nor improved actuarial equilibrium. And yet, universal free access to education and health care continues, and pension coverage of the labor force is one of the highest in Latin America.

Cuba has rejected the structural social reforms in the region that privatized pensions and health care, and also avoided the Sino-Vietnamese disruption of those systems. But access and quality of social services have deteriorated and, despite salary reform and nominal increases, the real average wage is 27 percent of its 1989 level and the real average pension 50 percent of its 1989 level. A social safety net to protect the needy and vulnerable should be financed with tax-reform revenue. Allocation of health funds could improve targeting the most essential needs (water and sewage infrastructure, as well as geriatric hospitals and asylums, instead of reducing the already quite low infant mortality). Education expenses could also be reduced, eliminating costly programs such as foreign student fellowships. The Latin American lesson for Cuba is not to privatize pensions but to close the current system and create a new funded public pension system for young workers (with supplementary individual accounts), with a solid actuarial base, appropriate reserves and efficient administration in order to ensure adequate pensions in the long run and provide resources for productive investment.

Housing. This is considered the most serious social problem even though 95 percent of the population owns their own home, the highest home ownership rate in Latin America. Despite steps to stimulate home building, the rate of new homes built fell by 77 percent from 2006 to 2013 and from 70 percent to 29 percent of those built by individuals although an upbeat reversal occurred in 2013. The sale and purchase of dwellings at market prices liberates housing capital that has been frozen for half a century. There were 125,000 home transactions between 2011 and 2013, which accounts for 3 percent of the housing stock. These were mainly donations but another 100,000 homes were sold reportedly informally. These meager results are due to a number of complicating factors: supply far outstrips demand given low purchasing power; foreign investment is precluded (although it happens anyway); owners lack knowledge of the market; excessive regulations; the property registry has been outdated for half a century and only has 17 percent of owners registered; no mortgages are permitted on main residence and there is a lack of housing financing banks; architects are banned from working privately; there is an insufficient number of public notaries and realtors were only authorized in 2013; and Cuba has experienced a slowdown in construction-materials sales. To get better results, foreigners—including émigré Cubans—should be permitted to buy houses or help their relatives do so, mortgages should be allowed on main residences, credit should expanded with the help of foreign countries and NGOs, architects should permitted to work privately, the non-state sector should play a key role in the construction industry, and a housing lending bank should established as in many Latin American countries

Monitoring. Several state agencies and mechanisms have been created to monitor the reforms, the most important being the Permanent Commission, but appropriate coordination and sharing of data among them is needed. Despite periodic Commission reports, there is no statistical series on the reform effects, which are essential for proper assessment and adjustments, transparency, and accountability. More public debate at the National Assembly on the reform results is necessary, as well as critical evaluations by the news media.

Macro effects. The macroeconomic effects of the reforms are difficult to evaluate due to a lack of statistics and the inability to isolate other factors that may have an impact on performance, but agricultural output fell or was stagnant in three of the last four years. Effects on GDP are even more arduous to assess, but growth rates in 2011-2013 were among the lowest in the region and the reforms have not helped to increase them. Agricultural exports are a tiny fraction of the total and the reforms have not reduced costly food imports due to negative/stagnant agriculture output.

Why are the reforms so slow and cramped with obstacles, taxes and disincentives that conspire against their success? According to Raúl, the reforms are complex and difficult, take time to achieve results and must not be hurried so as to avoid costly errors. Alonso and Vidal argue that the slow path may be a way to face the resistance of potential losers like the bureaucrats.[207] Critical opponents claim that there is no real intent to reform and that all the reform efforts to date have been a ploy to win time. It is plausible that a conflict exists within Cuban leadership; the most advanced members push for the reforms but the hard-liners—fearful of delegation and loss of economic power and a "snowball" effect—attach controls, regulations and taxes which they justify by arguing that they avoid wealth concentration. Such conflict leads to compromises that breed an ineffective hybrid model, unable so far to bear the results required to improve living standards and get the population support and legitimacy. Raúl has been in power for more than seven years and his reforms have not yielded tangible results. He has promised to retire in February 2018 when his second five-year term expires and he will be 86. Thus, less than four years are left for him to complete the key institutional changes the nation urgently needs.[208]

[207] Alonso and Vidal.

[208] Cuban economist Ricardo Torres has stated: "We don't have the luxury to spend six more years dealing with relevant issues in which we must advance much faster" ("Las perspectivas dependen de nuestra habilidad," *Trabajadores*, September 18, 2013).

Economic Growth and Restructuring through Trade and FDI:

Costa Rican Experiences of Interest to Cuba

Alberto Trejos

Development is the result of many policies and national characteristics regarding economic and extra-economic issues. No country in Latin America is developed or even close to it, a stark reminder that the job is hard and largely pending. But the region is very heterogeneous, not only in terms of income—where there is a 15 to 1 difference between the richest and poorest nation—but also in terms of relative strengths and achievements. Several Latin American countries display, along with salient policy failures, some successes worthy of study and, perhaps, emulation.

The purpose of this paper is to discuss one of those examples of progress—namely, the internationalization of the Costa Rican economy after economic reform beginning in the mid-1980s—and the extent to which it represents a useful reference when discussing policies aimed at the growth prospects of another nation in the region: Cuba.[209]

Over the last 30 years, Costa Rica has implemented, in a fairly consistent manner, significant reform in its trade, foreign investment and other related policy areas. This yielded some valuable results in terms of the volume and composition of its exports, the sectorial composition of its economy, and the volume and nature of the foreign direct investment (FDI) it attracts. Overall, the nation has made some progress over the years; for example, it ranks second in Latin America in terms of cumulative output growth (PPP) in the three decades after 1980, and first in the proportional fall of its extreme poverty rates.[210] Costa Rican progress can be largely attributed to this trade and investment performance.

Introduction: Cuba and Costa Rica

Some of the strengths on which Costa Rica built this successful trade policy strategy are similar to the most salient advantages of the Cuban economy, in

[209] For comprehensive—albeit old— surveys of the academic literature on the effect of trade liberalization on income and growth, the classic reference is Sebastian Edwards, "Openness, Trade Liberalization and Growth in Developing Countries" in *Journal of Economic Literature* 31 (September 1993), pp. 1358-1393 and "Openness, Productivity and Growth: What do we really know?" in *Journal of Economic Literature* 108 (March 1998), pp. 383-398. For some more recent references, see the introduction of Pedro Ferreira and Alberto Trejos, "On the Output Effects of Barriers to Trade" in *International Economic Review* 47, No. 4 (November 2006) pp. 1319-1340 and "Trade in Intermediate Goods and Total Factor Productivity" in *Review of Economic Dynamics* (2012). For an excellent and modern summary of the more applied literature, see Juan Blyde, Carlo Pietrobelli and Christian Volpe, *Políticas de Internacionalización para el Desarrollo Productivo*, Mimeo, (Inter-American Development Bank, 2013). In the context of this project, and specifically directed at the Cuban case, see Richard Feinberg, *The New Cuban Economy: What Roles for Foreign Investment?* (Washington, D.C.: Brookings Institution, 2012).

[210] According to the World Development Indicators, the fraction of the Costa Rican population living under the extreme poverty line ($1.25 per person per day) fell from 9.2 percent in the early 1990s to 2.2 percent in the mid-2000s. The fall regarding the alternative poverty line ($2 per person per day) fell from 18.8 percent to 6.4 percent. Proportionally, no Latin country achieved a larger fall in the former, and only Chile in the latter.

particular the relative abundance of human capital. As such, it is worth considering the applicability of Costa Rica's policy experience to Cuba. Costa Rica's poor showing in other areas, such as infrastructure, only enhances the interest in this case.[211]

Costa Rica and Cuba make an interesting comparative case for other reasons, besides the fact that both have made investments in education and healthcare—which far exceed expectations given their (similar) levels of income and development:

- Both nations place a high value on the role of the state in promoting more equity in income distribution.[212]
- While Costa Rica has moved away from its past leanings toward central planning, the country has not shared the privatization impetus of the rest of the region and still holds a very large fraction of its economy in the form of state-owned enterprises.[213] In other words, some long-held aspects of the Costa Rican economy, as compared to other Latin American examples, would be more familiar to the contemporary Cuban analyst.
- Minerals and fossil energy resources play a small role in Cuba's resource endowment, as in Costa Rica but unlike most of the region. This implies that both countries must confront their growth challenges while facing deteriorating terms of trade; both growth and significant change in the industrial composition of output and exports are necessary in order to move toward their development objectives. Human capital is at the forefront of the strategy. Employment must improve in quantity and quality, along with the creation of economic conditions that reduce incentives to emigrate. These are parallel challenges on which Costa Rica has done well, largely due to its export performance and ability to attract the right kind of FDI.

Before the mid-1980s, a closed Costa Rican economy exported barely $1 billion annually in goods and services. These exports were largely concentrated on three undifferentiated and unprocessed agricultural commodities (coffee, bananas and sugar), and sales from the import-substitution manufacturing base to a captive regional common market. Since then, after significant trade liberalization and further promotion policies, the volume of exports has multiplied by 18. More to the point, exports have also diversified so that those original commodities represent less than 8 percent of the total, no other product represents a similar concentration, and 3000 different lines of

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[211] Most analysts agree on several policy areas where improvement has been slow and irregular. Reform worked toward macroeconomic stabilization, a reduction of the role of the state in the economy and, especially, internationalization. In other areas, policy has been erratic and government has lost effectiveness. The problems—financial and administrative—in its capability to execute infrastructure projects in transportation and energy, the inability to cope with some safety and security issues, the perception of corruption in government officials by the general population, recent concerns about the long-term financial sustainability of the current pension schemes and healthcare institutions and the slow pace with which the formal educational system has adapted to new challenges, needs and opportunities, are all examples of policy areas where Costa Rica has not been a success.

[212] For instance, according to UNDP data, in 2009 Costa Rican household income derived from the market displayed a far from enviable 0.452 Gini coefficient, and a 31.2 to 1 ratio between the top and bottom deciles. However, through social services, transfers and other policies, the corresponding numbers after the intervention of government transform into net household incomes with a far better 0.324 Gini and a 6.9 ratio. Other UNDP data show that, despite the high disparity in pre-government market incomes, the heads of household that can be described as "Upper and middle class, owners, experts, professionals and management" has grown from 28.5 percent of the labor force in 1987, to 32.3 percent in 1998, to 40.9 percent in 2008, clearly a positive trend. Some other social indicators, on the other hand, have not improved in the same period. Besides direct redistributive policies through the transfer system, the Costa Rican state mostly seeks equity through the provision of universal healthcare and education, the funding for the housing of the poor, a social security (solidary pensions), and the protection of worker´s rights. Health efforts are singularly important, as the country has—for instance—the second highest life expectancy in the hemisphere (second after, precisely, Cuba). According to the last census, the proportion of households in "precario" (irregular property rights over their dwelling) has fallen to 0.8 percent, the number in "tugurio" (dwellings of unacceptable quality or characteristics that do not satisfy the legal requirements) to 0.5 percent, and adding those in "cuarterías" (rented rooms), it reaches 0.7 percent. Before the efforts of the housing funding system, these numbers were in double digits.

[213] In Costa Rica, the government still has a legal monopoly on fuel and fuel distribution, electricity distribution, water, alcohol production and a few other activities. In other activities, the legal monopoly has been broken, but the government still keeps dominant companies with overwhelming market share in telecoms, power generation and insurance, and over 50 percent market share in banking.

goods and services are exported.[214] Further, with diversification has come sophistication; the prevalence of differentiated products and services[215]—mostly those in which the availability of human capital, scientific and technical abilities can be utilized—and the capacity to meet quality standards are the key competitive characteristics. As Umaña et.al have documented, nearly all manufacturing exports by the late 1980s consisted of product lines typically prevalent in either very poor or very closed economies. Since then, the country has shifted the composition of production—with exports as a driver—towards the kind of product lines that one would associate with developed nations. An updated version of their analysis is presented in Figure 4.[216]

Some of the previous results would not have been possible if the country had not managed to attract significant FDI. Multinational corporations provide capital that enhances domestic labor productivity without using funds from the domestic savings pool and import new technology to the country, improving current productivity and transferring knowledge, best practices and familiarity with global industry to workers or domestic suppliers. More importantly, FDI provides a different kind of "market access" as it is often the case that a country possesses the labor and other resources that enable it to competitively produce a particular good or service, but lacks organizational capability of an entrepreneur or company. Costa Rica's inflows of FDI have grown rapidly, reaching a record level of $2.3 billion in 2012. Even if it no longer has the highest per-capita levels of jobs, income, exports or implied change in output composition and productivity, Costa Rica arguably has the most successful FDI receipts in the region, since almost all of this investment is in advanced manufacturing and services (which carry smaller price tags than, say, infrastructure projects or mining investments, yet have larger transformative potential).[217]

Our thesis is that some aspects of trade and investment experience in Costa Rica, particularly in terms of policies and strategies, are applicable to Cuba. To that end, the rest of this paper proceeds as follows. The next section describes the key strategic policies that allowed the above-mentioned performance in exports and FDI in Costa Rica, along with the reasons why some of those choices could be relevant

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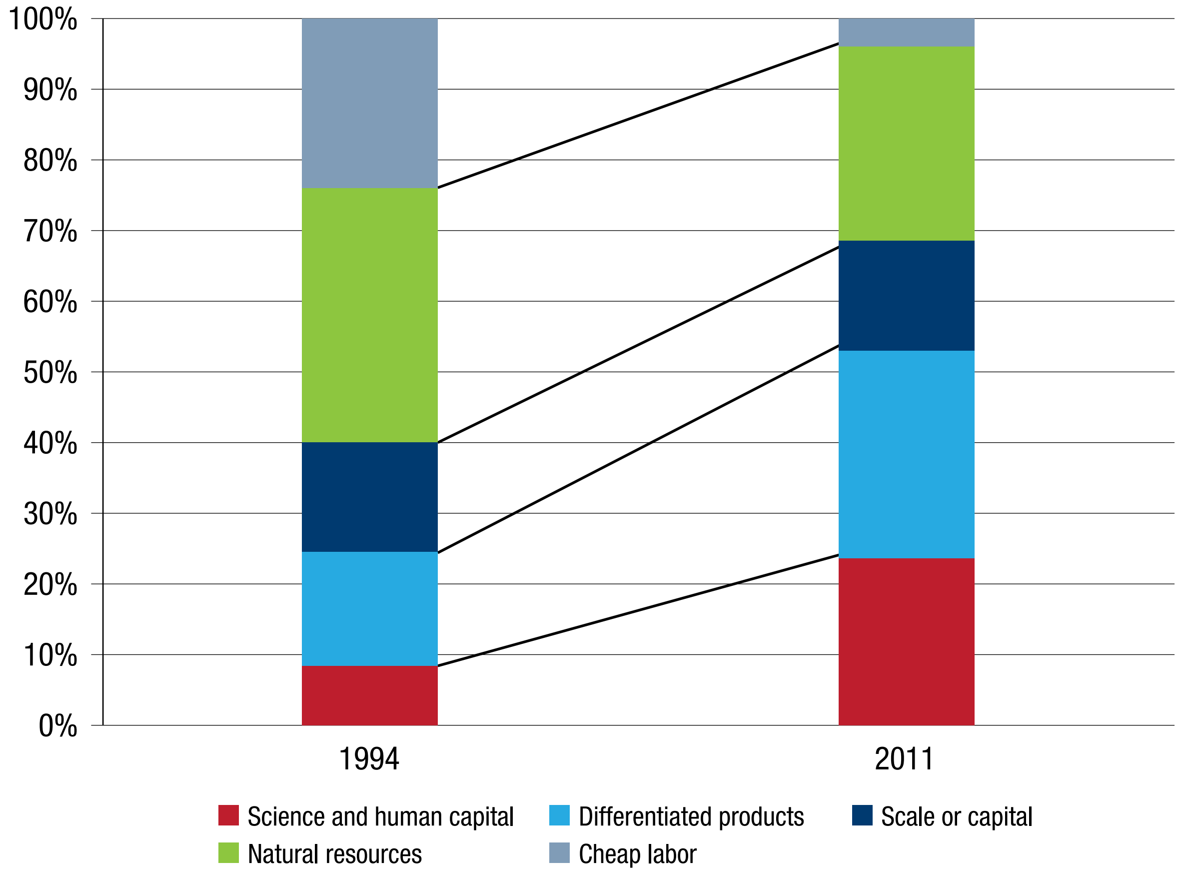
[214] Despite the prominence of electronic and computing equipment (about $2 billion) and medical equipment (about $1.2 billion), these categories are in fact composites of a variety of differentiated goods and companies and their weight relative to total exports is far below the historical levels of concentration. For instance, back in 1982 the four traditional commodities represented 61.4 percent of the exports of goods, with coffee alone amounting to 27.2 percent.

[215] Service exports are an increasing share of total Costa Rican exports, now approaching a quarter of the total gross exported value (and, since service activities tend to be very vertically integrated, they represent an even higher share of exported value added). The originally successful service export industry since the late-1980s was, of course, tourism; Costa Rica now receives nearly $2 billion in net tourism revenues and well over 1 million tourists. This is, of course, very important in a country of 4.5 million people and approaching $45 billion GDP. Costa Rican tourism is very well positioned in a high-value niche (ecological and adventure travel), with enviable levels of service, duration of stays, repetition of stays, expenditures per day and other similar industry indicators. More recently, there has been a fast growth in business process operations: IT and software development, outsourcing, call centers and, professional and management services of increasing complexity and value. After 2010, these services have made a net contribution to the balance of payments exceeding that of tourism; unfortunately, there are no statistics about gross exported value, employment levels, remuneration, or the like.

[216] Umaña et.al group manufacturing products in five categories, depending on whether the most important competitive driver in the industry is the availability of 1) cheap unqualified labor, 2) a key natural resources to process, 3) a captive market or specific capital good, 4) the capability to differentiate and add quality or 5) the availability of scientific and technical personnel. Manufacturing exports in the last two categories—which one could associate with the manufacturing supply of a developed country—grew from nearly zero before reform, to 25 percent by 1994 (when total manufacture exports reached $1.6 billion) and an impressive 53 percent by 2011 (when the total reached $8 billion). Meanwhile, the first two categories—the more typical manufacturing supply of a poor economy—are now below 32 percent. Similar changes have occurred in service exports, where tourism and call centers are giving way to much more complex business processes. Sanjaya Lall, John Weiss and Jinkang Zhang, "The 'Sophistication' of Exports: A New Measure of Product Characteristics," Working paper 123, *QEH Working Paper Series* (Oxford University, 2009) create a measurement technique for what they call "sophistication of output", apply it cross-country, and come to similar results in the case of Costa Rica. To the extent that the sectorial makeup of the economy relates to development—say, because the reward structure of antiquated industries or their degree of positive externalities falls short of new activities with more sophisticated technologies and better resource requirements—this is the kind of change we would like to see in most of Latin America, and in particular in Cuba.

[217] FDI comes in many forms: green-field, when the investing company is creating an operation from scratch; acquisitions, when it is acquiring a running enterprise; real estate, obviously when it is purchasing domestic land and its resources, perhaps to develop them or infrastructure concessions, when it is forming a domestic company that builds or operates an asset for the state, etc. In terms of value, mining acquisitions and infrastructure concessions often carry the larger price tags.

Figure 4. Composition of Manufacturing Exports, Sorted by the Key Competitive Driver of the Industry



Source: PROCOMER

and applicable to Cuba. Section 3 discusses some errors that Costa Rica may have committed along the way and that may be avoided in the Cuban case, while Section 4 delves on the key differences between the Costa Rican strategic starting point in the mid-1980s, and the Cuban situation today. Finally, Section 5 concludes, pondering what is reasonable to expect and what cannot be achieved from a strategy like this, especially in the absence of complementary action in other areas of economic policy.

The Costa Rican trade and investment strategy

A large number of policy choices, social decisions and intangibles underlie the Costa Rican performance in exports and FDI attraction. Here, we attempt to organize them around the following categories.

Education and Human Capital

The key competitive advantage for Costa Rican exports and, more saliently, for Costa Rica's FDI inflows, is the remarkable productivity of the Costa Rican labor force and, in particular, its comparatively high levels of training and education. For over a century, Costa Rica has spent significantly in public education, training, and healthcare. Enrollment rates are high: by constitutional mandate, education expenditure cannot fall below 6 percent percent of GDP and scores on internationally comparable tests (like PISA) are slightly better than those of other developing countries of similar income. Traditional academic education is complemented by technical education (in high schools) and a job training system, which tends to be in tune with the specific industry needs. Life expectancy is very high, with the entire population covered by an efficient national health care system.

Costa Rica was already relatively well endowed in human capital before economic reform, but its economy demanded little of that resource. Manufacturing and services catered to a closed and underdeveloped domestic market, and very simple unprocessed agricultural products for export require little training and technical sophistication in their production and management. The state bureaucracy was a very large part of demand for human capital. This means that, as reform has progressed, the entry of qualified labor into the export segment of the economy has been facilitated not only by the flow of entrants to the job market, but also by a stock of older qualified workers already in the system who shift from jobs where their abilities are underutilized.

Costa Rican blue collar workers, in general, have a strong and well-earned reputation for productivity; they seem to possess strong "soft-skills" that enable them to operate well in demanding markets or as part of global corporations. These skills include the ability to work in teams, learn from abstract content (as opposed to only direct experience), adapt and learn as they progress, communicate effectively, and remain disciplined and rebelliously creative.[218]

Consequentially, a more open Costa Rican economy has proven a competitive export location for products, services and niches in the market that demand high technical standards and specialized knowledge. In a Hecksher-Ohlin sense, its comparative advantage lies in products that use human capital intensively. Furthermore, the nature of the labor market has been changed by the emergence and entry of national and international companies that produce those products for export. Because human capital abundance is hard to fake or substitute, the position in the market of those companies and products is strong.

Openness to Trade

A country that is closed for imports is closed for exports. This is a well-argued fact in basic economic theory. When an economy is closed to imports, the resulting artificial profitability of the protected sectors aimed at the domestic market diverts resources that otherwise would have been allocated to export activities. Furthermore, domestic prices of tradable intermediate inputs will be higher if the market is protected, raising costs and creating an anti-export bias that drains the competitiveness of the final, exportable product.

In Costa Rica, unilateral trade liberalization came quickly during the 1980s. Early in the decade, as in the previous two or three decades, tariffs averaged over 100 percent, including prohibitive rates for most products. By the mid-1980s tariff rates began to steadily fall, with the average at 85 percent, reaching 6 percent in 2002 and only 2 percent today. This means that for the overwhelming majority of products, producers for the domestic market face international competition. This has created a competitive pressure that helps raise productivity, allowing consumers to buy and producers to source their inputs at lower prices. It has also allowed, in most industries, a base on which to build export growth.

Market Access

Costa Rica belongs to the Central American Common Market (CACM), an integration effort which has been fairly successful in generating trade. Established in the late 1950s, CACM was initially

[218] See Ronald Arce, Ricardo Matarrita, Alejandro Roblero and Alberto Trejos, *Desarrollo del talento humano para competir en la atracción de inversión extranjera directa*, Mimeo, (INCAE and CINDE, 2012) for a description of the surveys and measurements available to assess the Costa Rican historical strength in human capital, as well as the current challenges being faced by its educational system, which are detailed in the next chapter.

intended to be a mechanism to enlarge the domestic market and, thus, properly implemented an import substitution strategy. As import substitution came to an end and these economies opened to global trade, the regional market lost importance. Recently, however, the market has grown quite dramatically, representing as much as in $11 billion of intraregional trade in 2012. Now its driver is not the common external barrier, but rather the geographic proximity and the complementarity of these economies— so it makes sense for companies to see the region, rather than a single country, as the "domestic market." The integration effort is quite mature—there is a common external tariff on most products; free intra-regional trade on all but one good (sugar); customs legislation, regulation, registries, sanitary and phyto-sanitary protection; coordinated technical norms; and regionally-negotiated block trade agreements with several large parties.

Preferential market access is enjoyed not only for exports to the neighbors, but also for markets representing over 90 percent of non-oil trade. In particular, Costa Rica has negotiated free trade agreements, on its own and as part of CACM, with its three largest trading partners (the United States, the European Union and China), other developed nations (Canada, Singapore), other immediate neighbors (CARICOM, Mexico, Panama) and other countries in the hemisphere (Peru, Colombia and Chile). Therefore, Costa Rican products enter those markets paying lower tariffs and confronting fewer non-tariff barriers than their more relevant competitors, like Asian manufactured products or South American tropical agriculture. Furthermore, these agreements provide a binding legal basis for trade and investment. Since Costa Rica is the "small" partner in most of these relationships, it tends to do better when there is a binding legal basis, rather than informal interaction.

Exchange Rate and Currency-Related Policies

Management of the exchange rate is perhaps the most important macroeconomic measure affecting export growth. On the one hand, the exchange rate level determines the profitability of exports, since a local company would mostly face costs in the domestic currency and obtain revenues that are linked to foreign currency, so the relative value of costs to revenues—that is, the profit rate—would be proportional to the exchange rate.

On the other hand, the volatility of the exchange rate is also important. It adds significant risks to production for export since it introduces a variable wedge between the units in which costs are measured in the present and the units in which revenues are measured in the future. Export activity typically carries some additional risks as compared to normal domestic production, including international logistics, international marketing, performance of foreign economies, etc. As such, it is clear that adding risk to the proposition of exports does very serious damage to growth prospects.

Some countries have chosen to intervene in the currency market in order to undervalue the local money, hence pushing their exports growth strategy. Perhaps the clearest example of this is China. Although it is not the most desirable of options for other objectives, like reducing inflation or keeping the value of domestic incomes, it is a tempting option to push export competitiveness with such a simple instrument.

Other countries in Latin America do not necessarily push down the value of their currency, but rather try to compensate market forces. This is the case of exporters of raw materials who are enjoying unusually good terms of trade, but whose non-commodity exports are affected by the "Dutch disease." This is also true of countries, such as Costa Rica, facing significant influx of capital due to the current distortions in global interest rates and financial markets.

Costa Rica aggressively managed its exchange rate between 1985 and 2006 by keeping the real exchange rate nearly constant with the purpose of increasing the competitiveness of its exports. The actual policy was to make very small daily adjustments to the nominal fixed exchange rate, which were pre-announced and calibrated to equal the difference between domestic and international inflation rates.

The original purpose of the policy was to simply to take the real exchange rate variance out of the equation, but as time progressed and productivity growth (especially in the export sectors) exceeded that experienced by trading partners the exchange rate level was arguably distorted towards undervaluation, further pushing exports. The consequences of this are studied in the next chapter.

Incentives

Back in the mid-1980s, when Costa Rica's push towards export promotion started, one of the key instruments for export promotion was a subsidy known as a Certificado de Ahorro Tributario (CAT). This certificate was an asset tradable in the financial market which could be used (by the recipient or the purchaser) as a credit at tax-payment time. Exporters would be issued a CAT worth 15 percent of the gross value whenever they shipped a new product (meaning anything but the original four traditional agricultural exports) to a new market (meaning not Central America).

Blunt as this instrument was—in the sense that some recipients of the incentive probably were already profitable without it, others were in the business only to get the incentive, and still others easily found ways to corrupt the system—it did compensate the initial entrepreneurs (at the time, mostly local) who entered export businesses in new lines for the first time. Entry was risky and involved a lot of previously unmeasured costs (figuring out the true nature of the international market, organizing international logistics, assuming new risks, etc.) that were not present when producing for the domestic market.

In other sectors—in particular, in tourism—similar incentives and subsidies were applied, at least in the early stages of the growth process. With a better design, they not only targeted entry into the activity, but also linked to performance indicators and the qualitative evolution of the industry.

It is hard to argue that the CAT was not effective in inducing some eventual exporters into the market—just like it is easy to imagine, at least in theory, a better system of incentives. Today, something like this would be legally untenable before the WTO and politically impossible to justify. CATs lasted for nearly a decade, until the late-1990s, when it became clear that they were unnecessary, unforgivably expensive and a large source of corruption. Nevertheless, in other places where there has been little room for entrepreneurship and the initial risks associated with entry into export activities would be large, something like this incentive may play a role.

Free Trade Zone Regime

Another intervention, considered by some a subsidy, is the existence of a free trade zone (FTZ) regime. In the case of Costa Rica, this is less related with government-run locations and serves more as an alternative legal/fiscal regime in which companies can choose to participate.[219]

A company may enter this regime whether it is physically located in a privately-owned, industrial park designed for this purpose or in a stand-alone location. To qualify for the regime, the company must meet certain conditions and subject itself to strong controls and measurements.

In the first version of the regime (the law that existed until 2007) the main requirement for an FTZ company was a performance requirement: that it would export a certain percentage of its output. In exchange, the main concession was the exemption from certain taxes (including taxes on profits) for a period typically lasting 15 years, renewable under some extreme conditions. Instead, companies paid a much lower "canon" for the space and services occupied.

[219] In many countries, especially in Africa, FTZs consist of government-owned industrial parks, often near ports or in disadvantaged areas, offering special conditions to any company operating from them.

Companies were also allowed to bring in imported inputs and capital goods free of tariffs through an expedited process significantly simpler than the ordinary import-export process.[220] In the current version of the law (passed through congress in 2007) the tax exemption is no longer total—although FTZ companies still pay significantly less than regular companies—and its magnitude depends on features like a company's expenditure on training Costa Rican workers, investment in research and development, local reinvestment, growth, etc. Furthermore, under the new law qualification for the regime is harder for companies located in San Jose's Great Metropolitan Area and looser for those established in regions of lower human development. The key condition is no longer a performance requirement, which was illegal through a WTO ruling that interprets a fiscal incentive designed that way as an export subsidy. Rather, conditionality is linked to the industry and other operating characteristics of the company. Emphasis is now placed on fostering international value-chains, clusters of related companies and linkages between domestic and foreign companies. In particular, the tax exemption to a direct exporter is extended proportionally to its domestic suppliers of key inputs. Nationality is not a condition to participate in the regime.

Manufacturing exports from FTZs in Costa Rica have a gross value roughly 2.5 times that of non-FTZ manufactures, while non-tourism exports of services are roughly half in FTZs and half not. The dynamic clusters in electronics, medical equipment, life sciences and business process outsourcing are taking place mostly within the regime.

Some analysts have argued that this type of regime is just a subsidy scheme by another name and that by competing with each other different locations are just engaged in a "race to the bottom" that only benefits multinational corporations. While some of that may be so, the fact of the matter is that companies in certain key industries do face very attractive fiscal conditions in other places and a country that does not compete along this dimension may have a tough time growing in those industries.[221] Furthermore, it is interesting to note that companies whose fiscal benefit expires choose to remain in the FTZ regime although the legal controls and limitations are stricter, meaning that the other aspects of the regime (in particular, the expedited import-export processes and the geographical proximity of similar companies) hold value.[222]

Fostering Institutions

Costa Rica has three key institutions with the mandate of promoting development through the successful internationalization of the economy.

First, it has a specialized Ministry of Foreign Trade which is not part of an Economy or a Foreign Relations Ministry, as in other Latin American countries: Ministerio de Comercio Exterior (COMEX). COMEX is small but agile and historically has not been subjected by law to all the civil-service restrictions that afflict the rest of the state (for instance, it attracts better professionals, pays more, and can hire and fire at will). Despite its size and limited mandate, it is a politically influential institution, especially due to the public attention to the negotiations of international

[220] If an FTZ company chooses to sell part of its output in the domestic market, it does pay income tax on that portion of its profits and pay tariffs on that portion of its inputs.

[221] An interesting example of an alternative is the case of Mexico, Chile and Ireland, which no longer offer a differentiated fiscal regime for this type of industries. In order to do so they significantly reduced the tax rates for all companies. In Costa Rica, ordinary companies pay 30 percent profit tax and, if foreign, an additional 15 percent on the repatriation of the dividends. Cutting these rates for the economy as a whole would perhaps be unaffordable for fiscal reasons and expecting that local and foreign companies that pay zero elsewhere would stay here facing 40.5 percent total tax rates would simply be naive.

[222] The author has also heard from some executives in these companies that a reason to stay in the regime is that the public institutions in charge of it are virtually corruption free and predictable (e.g, attached to the letter and spirit of the law) in their decisions, while being outside the regime makes one subject to problems of transparency and rule of law coming from the rest of government.

trade agreements. In addition to the negotiation, implementation and oversight of those instruments and of trade policy in general, COMEX is charged with promoting a competitive business climate for export promotion.

Second, and organizationally linked to COMEX, is Costa Rica's Trade Promotion agency (PROCOMER). PROCOMER, funded by fees from administering the export-import process and the canon paid by FTZ companies, is in charge of fostering the quantitative and qualitative growth of exports through very varied activities. PROCOMER is exceptionally flexible within the usually rigid rules for the Costa Rican state (the law describes it as an institution of "maximum deconcentration"). Among its programs are training initiatives like the Creando Exportadores program, which teaches international marketing and logistics to the management of established domestic firms; market intelligence about specific products and places; advisory services for small exporting companies; events for potential buyers to see samples of Costa Rican products and even promotion of the "image" of Costa Rican output. It also runs a program (Costa Rica Provee) to promote linkages between large multinationals operating in the country and local small and medium enterprises that could be their providers. It has small offices in a few key capitals.

Third is the Costa Rican Investment Promotion Agency (CINDE), an NGO founded with USAID support in the 1980s to help train and encourage small agricultural exporters of new products. As the years passed—and especially as Costa Rica ceased to be a natural target for foreign aid—the institution evolved into a small, local private organization funded through an endowment and the sale of services, whose main purpose is to promote hi-tech greenfield FDI. It does this by acting as an informational bridge and informal competitiveness expert to potential investors by channeling their concerns and problems after establishment and advising or lobbying the government and congress on problems that the country encounters in the competition for FDI. Much smaller than other institutions of its kind, CINDE is almost always cited among the best investment promotion agencies in the world and is quite distinct from the others as it is not a part of government or funded by the Treasury.

While economic theorists are often fond of assuming that, if profitable opportunities exist, entrepreneurs will find them, the Costa Rican experience is that if a country is small enough it will take a while for foreign companies to find it and if it is poor enough the same will happen with the local entrepreneur. In the absence of institutions that solve the immediate problems, channel information in both directions and reduce the riskiness and entry costs, it is likely that multinationals would pass up places like Costa Rica and go to "safer" (by which we mean larger, or better known, or easier to argue from the distance of corporate headquarters) locations and small local companies would more often stick to the comfortable domestic market.

This institutional arrangement also has the benefit of avoiding certain conflicts of interest regarding FDI and the FTZ regime, since PROCOMER, the organization in charge of overseeing and collecting fees and canons from the companies, is separate from both the institution promoting their entry (CINDE) and the institution authorizing their participation in the FTZ regime (COMEX). The arrangement has also created an environment that is very welcoming to the potential FDI, by providing a predictable set of rules, plenty of information that facilitates decisions and reduces risks, a mediator than can help investor and regulator understand each other and, in general, a "voice on its side" that speaks its language and sees its points.

Costa Rica already provides a fairly welcoming legal regime for FDI. By Constitutional mandate, any firm operating legally in the country is endowed with certain common rights, which are not subject to the nationality of the company or its owners. The country has also signed a number of FTAs and over 40 bilateral investment treaties which grant investors an extra layer of guarantee over both those rights, and the right to arbitration (typically at the

UN or the World Bank's arbitration units) in case of violation. Added to the simplicity of the paperwork and the role of the supporting institutions, greenfield, productive FDI aimed at exports finds a very welcoming and trustworthy environment and access the excellent human resources that make up Costa Rica.[223]

Industrial Policy (or Lack Thereof)

Traditionally in Latin America, policy was inclined to distort across different industries, with the state making very strong interventions by determining which industries to enter as an entrepreneur and which industries to promote the entry of the private sector through taxation, subsidies and other "blunt" policy mechanisms. This type of industrial policy seemed to be based on a view that certain sectors and activities were desirable and part of a development process, even if their growth did not come from becoming better at producing in those sectors. It was also based on the notion that government has enough information and probity to make these policy decisions wisely and transparently.

After the 1980s crisis, many policymakers in the hemisphere became of the view that this type of distortions caused by sector-specific policies was very damaging; neutrality across industries was a better choice. Unless there was clear evidence of externalities, public goods or other well-justified market failures that the policy was compensating for, horizontal policy (i.e., common across industries) was thought to be better.

We are now seeing the intellectual pendulum swinging back on this issue, as a number of scholars have raised the point that the success of some Asian countries seems to emerge largely from well selected "vertical" industrial policies, according to both data and to narrative. Furthermore, the argument goes, profitability across different sectors is not the sole determinant regarding the desirable composition of the economy, as clearly there are some activities that can be more strongly associated with development and others with poverty.

Do Costa Rican export promotion and FDI attraction policies focus on fostering "picking winners" in specific industries? Perhaps the best way of describing the existing policy is that government does not pick winners, but rather follows them. That is, the Costa Rican state does not apply any blunt policy instruments (like credit restrictions differentiated taxes subsidies etc.) that select across sectors. However, the fostering institutions have plenty of soft instruments (like selecting in which activities to train labor, or to conduct research, or contact companies etc.) which strongly target specific industries, based on the market evidence of existing entrants in those industries or in "similar" activities.

Take, for instance, the growth of the emerging sector that produces medical devices and, more broadly, inputs to the global hospital industry. It would be false to claim that policy considers this type of activity as equivalent to others—say, sewing cotton garments. Medical devices are the kind of product in which we would like to grow, as it requires high-technology, uses well qualified workers, provides space to differentiate products according to quality, and possesses other characteristics that make this industry more likely to emerge in a developed country than in a poor one.

It would be naïve for the fostering institutions to ignore the fact that we have already managed to acquire some companies in that activity. Once some

[223] One must add the caveat that the above is true for export-oriented greenfield FDI, but not for other forms of FDI. For instance, Costa Rica is closed to mining investment (the law specifies that due to environmental concerns, there is a moratorium on most mining endeavors) and the facilitating institutions don't see as their role to help investment aimed at the domestic market, real estate investment, or the acquisition of ongoing operations. Furthermore, the laws granting rights to minority stockholders are weak and the restrictions on large acquisitions, especially of companies registered in the stock exchange, are arcane. Finally, companies who do business with the government (build infrastructure, BOT public facilities, or provide services to the general public charged to the Treasury) find a nightmare of controls and, worse still, harshly inquisitive attitudes by Congress, press and the Comptroller General. But, all this aside, for private, aimed-at-export, greenfield FDI, the legal and institutional regime in Costa Rica is as attractive as any in the world.

participants in that industry are present, it becomes easier to convince others to enter. Furthermore, once some key companies in those industries flourish, there is more value in attracting the providers of their key inputs to the country as part of intelligent "cluster" policy.

Does this mean that the country should offer stronger instruments like differentiated tax rates or public services, government subsidies, or something else to promote that industry at the expense of others? The answer seems to be no, as government is still in general inefficient and corruptible when making this type of decision.

Regarding some policy areas, government is simply "doomed to choose," paraphrasing Ricardo Hausmann. It is impossible, for instance, to create infrastructure and other public goods without making choices about design and location) that are not neutral across industries. The same goes for specialized training and college education.

What about farming? What policies affect the land usage in different crops, for example? In agriculture, the key policy instrument has been the removal of tariffs and other barriers to imports. Through its effect on relative prices, trade liberalization has induced a shift in land use, from some of the crops the domestic market consumes, to others for which the land is better suited. As tariffs in agriculture have fallen over the last 20 years, 120,000 hectares (or a quarter of the available arable land) shifted from certain grains, like yellow corn, to exportable products where comparative advantages are present. This change along the extensive margin explains almost all the productivity growth in Costa Rican agriculture in that period, the fastest in the hemisphere.[224] In a way, opening the economy and fostering exports has been the agricultural industrial policy in this period.[225]

As another example of Costa Rica dabbling in productive development policy, the changes in the new FTZ laws are aimed at promoting linkages between domestic and foreign firms, participation of domestic companies in international value chains and healthy dynamics in productive clusters like electronics, advanced manufacturing, medical devices or BPOs. In those, more than choosing a particular sector to promote, the policy aims to get the market dynamics right.

Competitiveness

Costa Rica's competitiveness performance—understood as the quality and availability of traits and institutions that are outside the control of specific firms, yet affect total factor productivity—is quite varied. Look, for instance, at the results in the Global Competitiveness Index compiled by the World Economic Forum. Costa Rica's rank in what the index considers to be simple, basic tasks is dismal, especially in all categories related to infrastructure.[226] Meanwhile its performance in the indicators of those more complex things that one would associate with development—especially all that relates to human capital and technological readiness—is very high.

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[224] In the meantime, according to FAO data and TradeStat, Costa Rica has become the sixth largest agriculture exporter per capita and second largest per area in the world outside of intra-European trade. Output per worker in agriculture has grown from 40 percent to 75 percent of output per worker outside agriculture, with the corresponding convergence between rural and urban human development and poverty indicators.

[225] This is not ideal. One would have hoped to combine the cleansing and productivity-enhancing effects of trade liberalization along the extensive margin, with a more active government policy along the intensive margin to deal with the many externalities, public goods, social and other market distortions that are common in agriculture. Sadly, these types of efforts by the Costa Rican state regarding agriculture were sacrificed during the fiscally-lean decades of the 1980s and 1990s. This implied that the social cost of this efficient shift in land use was higher than necessary: many farms ended up changing owners in order to change crops. For further analysis of these matters, see Alberto Trejos, "Trade, the Efficient Use of Land, and Agricultural Productivity: the Case of Costa Rica and Lessons for Africa" in *Perspectives In Agriculture: Strengthening Africa's Performance*, Discussion paper 2010/06, (Brenthurst Foundation, 2010).

[226] The fact that many of the components of the index are measured on the basis to opinion polls rather than hard data, on the other hand, leads to exaggeration. Costa Rica, for instance, ranks in "seaports" below some landlocked African countries and below Nicaragua, a neighbor whose firms actually utilize Costa Rican ports instead of their own. On matters that evolve very slowly—again, like infrastructure—the index tends to oscillate very wildly, and to be very correlated to the short-term popularity of the government. Nevertheless, the data do paint a broad picture.

Part of the issue is the philosophy with which many Costa Rican productive services are organized. Take, for instance, infrastructure. The network is organized in a very bottom-up way, with noticeable underinvestment in the key arteries (large ports, airport, and the main highways) but a very rich network of capillaries. For example, while the expressway linking the two main cities with the airport has half the lanes that it should, and boasts a perennial traffic jam, almost every little town has a paved road entry, power, clean water and telecoms, plus schooling and healthcare infrastructure. The former failure is very visible and clearly documented, but perhaps the latter success is more important, especially for the competitiveness of sectors like agriculture and tourism and the participation of the rural population in the dynamic labor market of the new sectors.

Like infrastructure, the paperwork and bureaucratic cost of regulation is also extremely burdensome. Construction permits often take months to be granted, regulatory decisions are often guided by form rather than content, private operators are often left in a legal limbo. Several efforts of trade of paperwork facilitation and simplification have been performed over the years, but have in general failed because the bulk of the regulatory burden seems to be court-mandated. Further, the current political mood of the country leads to more regulation, not less. To some extent—but only some—export companies and especially FDI are somewhat isolated from this problem by the nature of the FTZ regime. Yet, while Costa Rica's institutional and legal environment would seem like heaven for companies that utilize private resources to export,—thus related to government only in its regulatory role—those firms that need to interact with government as a key supplier or costumer may instead find themselves in a hell of unclear rules, corruption, slow bureaucracy and erratic decisions.

Costa Rica has invested consciously in its brand name, making sure that the label "Made in Costa Rica" adds rather than subtracts value. In a 1996 study, researchers at the INCAE business school measured that being located in Costa Rica allowed tourism companies to charge prices with a 15 percent premium, and campaigns like "No Artificial Ingredients" have positioned the environmental merits of the country very well in the mindset of potential travelers. Rather than wasting large budgets in very expensive mass advertising, CINDE and PROCOMER focus their message to industry events and one-to-one public relations where the returns are maximized.

A final topic that may be worthy of mention, in which Costa Rica performs comparatively well in the Global Competitiveness Index, is the area of labor relations. This is an area that varies very significantly across countries and strongly determines productivity, the flexibility of the productive sector and the well-being of the general population.

Workers' rights are very important and need to be protected if the fruits of growth are to be well shared, but the way in which workers represent their interests and the means by which their rights are implemented may be in some places an additional institutional strength –building consensus, facilitating information flows, creating healthy incentives to performance—while in other places it becomes a source of cost and volatility, impair intra-industry mobility and creative destruction, prolong unemployment and foster a misallocation of resources that would affect labor productivity.

Costa Rica demonstrates a very interesting case with regard to this issue. Costa Rican labor is very strongly protected by laws ranging all the way back to the 1940s. These include mandatory coverage by a national healthcare insurance scheme, a universal—now fully-funded—mandatory pension scheme, generous severance pay, workers compensation, maternity and disability and a myriad of other social schemes. These rights are granted by law to all workers, are not specific to certain labor employer relationship and can be demanded by the worker through the state, which allocates resources to the oversight and compliance of labor laws.

This means that workers are adequately protected, in a manner predictable by law, and companies know exactly what are they getting into, through an institutional arrangement that is significantly less confrontational and wasteful than collective bargaining. Union membership in the private sector is, therefore, remarkably low, with most employers and employees preferring instead to organize along "Solidarismo", a very peculiar labor arrangement.

Solidarism organizes labor through associations that operate independently at a firm rather than industry level, usually with a close direct connection between the employee, the union officer and the employer. They are funded by contributions from the employer, who provides a monthly deposit to the union in the worker's name for what would be the worker's severance, to be utilized in a savings-and-loans type arrangement for the workers. The worker keeps the money regardless of whether the termination of the labor contract is of a severance-induced nature or not.

Many solidarity unions branch their activities in other directions; for example, some firms outsource to their solidarity associations certain services and inputs, or engage them into profit-sharing mechanism. In that way, the employer finds a route to improve the well-being, morale and productivity of the worker, while the worker benefits and finds his interests aligned with those of the company. An overwhelming majority of Costa Rican private sector employees choose to participate in solidarity unions, rather than the more traditional and aggressive unions.[227] This allows for a situation in which labor and player relationships are almost entirely devoid of aggressiveness and friction. Employer-employee relationships are, as a result, very non-adversarial.

Mistakes and Lessons Along the Way

We have said that Costa Rica's wealth of human capital, the offspring of many decades of investment in health and education, is the country's main competitive advantage. But there are some growing weaknesses in the educational system which put in danger not only the sustainability of the success experienced so far, but also the capability to extend services to the entire labor force and the rest of the economy.[228]

In the last few years, education planning has focused on raising the budget allocated to the task and raising enrollment rates at all levels, especially the fraction of the corresponding age group that completes high school. These matters are, of course, important, but not the only dimension along which the system can improve.

First, consider the mix between technical and vocational education, on the one hand, and traditional humanities education on the other. Despite the fact that students demonstrate significantly higher interest in the former (with very low dropout rates), it only involves 7.5 percent of available high school seats, and falling.[229] Meanwhile, the traditional route is still designed—as half a century ago—as a preparation for university, seemingly useless for students who know they will not follow that path. Both employers and students believe education ends with the "third cycle" (that is, end of ninth grade), with the rest of high school being valued only as a university requirement, with no apparent intrinsic value.

Another mix problem happens in public university, where the fraction of the seats assigned to engineering, basic sciences, computing and health

[227] Some analysts question whether this is really a choice, as employers are often as keen to encourage solidarism as they are to discourage the formation of unions. But clearly, in my experience, workers seem to value the opportunity of solidarism strongly and sincerely, while the radicalism of traditional unions—which prevail among public sector workers—and their inclination to engage more in political matters than in labor representation, weakens their appeal.

[228] The ideas and data in this section largely come from Arce, et al.

[229] As a reference point, technical and vocational high school reach 75 percent of the students in Finland, 66 percent in Germany, and over 50 percent in most other European countries, despite the fact that those countries have much higher enrollment rates in higher education than Costa Rica.

professions falls well short of student and job market demand. A high fraction of applicants to those fields are being pushed against their will away from opportunity and into social sciences and education. Thirty consecutive years of excess applicants in some fields and excess places in some others has not led the system to reallocate resources. This problem is made more difficult because the university curricula are very rigid, forcing students to become specialists in a field, with little flexibility to mix training in that field with other abilities, or to graduate as a generalist familiar with several fields. Today's production processes, especially in the provision of exportable services like BPOs, demand and reward workers that have mixed abilities in several areas, while specialists are already quite available. Soft skills among Costa Rican university graduates are worsening, while similar skills measured on blue collar workers are exemplary.

The process of tariff reduction, key for the export success, also could have been fine-tuned. Costa Rica managed to open to trade very aggressively throughout the 1980s through unilateral tariff phase-out, and then at the slower pace of barrier reduction associated with international trade negotiations after the 1990s. In general, doing this was politically difficult, but the results have been very satisfactory. Still, three weaknesses deserve attention.

First, the phase-out process was unbalanced across goods, with tariffs coming down very quickly for most sectors, with exception to a few products (mostly crops), whose growers had the necessary political clout and were able to maintain untouched protection. The discrepancies and price distortions this generated were great, and the political vested interests proportional.[230]

Second, some of those phase-outs were very quick, without any parallel support offered to the affected producers. Many farms needed to change ownership in order to change crop output. In those cases, the transitional cost could have been much lower had a different combination of policies been implemented.

Third, the industries of import, distribution and retail of certain goods are very concentrated in oligopolies or monopolies, and in those cases the reductions in import barriers do not reflect automatically and fully in domestic relative prices, impairing the benefits from trade. Costa Rican antitrust legislation is somewhat modern, but the institutions in charge are weak and, more to the point, mostly focus their attention to other industries.

The choice of reducing to almost zero the short-term volatility of the real exchange rate was wise, as it created a much safer environment for entrepreneurs to experiment with entry in export markets and for local and foreign companies to add predictability to their profitability.

The mechanism chosen, on the other hand, implied that the average level of said real exchange rate remained roughly constant for nearly 30 years. Because productivity grew faster than in trading partners, by the end of the period the Central Bank required such large transactions in the currency market to implement the policy that it largely lost command over its overall monetary policy. This also implied that, once the system was reformed to allow better monetary control and the reduction of inflation, the massive appreciation that came as a result was a very large obstacle for future export growth performance.[231]

[230] Perhaps the worst case is rice, a crop with a few large and very competitive industrialized producers who do not need protection to be profitable, along with a number of very small growers in land without proper irrigation, for whom the best support would be to help them transit to another product better suited to their location. Although the policy has been to maintain high protection and a vast system of subsidies in the name of the latter, these instruments are designed in a way that implies the benefits are mostly received by the former. Interesting descriptions of the situation appear in Umaña (2009) and Jorge Cornick, *La organización del sector público para PDPs exitosas*, Mimeo, (Banco Interamericano de Desarrollo, 2011).

[231] As the currency started to float, other phenomena have conspired to the appreciation of the colón, including the significant inflow of short-term financial capital caused by the distortions in the international markets after the great recession. At the moment of this writing (mid-2013) the colón has appreciated in real terms nearly 40 percent relative to four years ago, thus bringing along a significant deceleration and difficulty in further export growth.

The design of the CATs, the export subsidy described in the previous chapter, left much room for improvement. The design choice was to make the subsidy proportional to an easy-to-calculate variable—in this case, the gross value of export—so that there would be little room for subjectivity in the calculation. Despite this rationale, the CAT system was very easy to manipulate (by, say, falsifying invoices) or even corrupt. For example, a company was found to be simply exporting ice, at a loss, to itself. Additionally, while many entrepreneurs clearly needed a push to take this leap into the unknown, giving everybody a push of the same size was probably suboptimal. Calibrating the parameters of the support to more specifics of the transaction probably would have been better, especially if the payment had not been in a cash-equivalent but rather into the assigning of resources to reduce some real inefficiencies and real costs that the exporter had to face. Finally, it was clear that the subsidy lived for far too long and should have at best been a transitory policy very early in the reform process.

We described also in the last chapter the system of FTZs and the way it was reformed in 2009. While controversial, we hold that such a system is necessary to remain competitive in certain sectors for which the terms of tax treatment are simply too heterogeneous across countries. In Delgado and Trejos[232] calculations of direct and indirect contributions to taxation by one specific large firm in the FTZ system reach the conclusion that indirect contribution (the extra payment that workers, service providers and owner of resources make to the state because their income is more valuable than it would have been selling to somebody else) is larger than tax exemption. So, in net terms the system is probably not even a drain—at least not a large one—on the tax revenues. Nevertheless, the design, negotiation and lobbying of the 2009 reforms demonstrated several lessons that would have been useful earlier on. First, giving a complete tax exemption was probably unnecessary, since there are positive yet small rates that can be applied and yield some revenues, if designed in a way that they net out from tax credits applicable in their home country. Second, once one has a positive tax, even if the rate is low, one can provide incentives as credits against that tax for companies to do things that government finds desirable or that the market under-provides, like training or R&D. Third, the incentive did not differentiate between the conditions to enter an FTZ in the developed heart of the country, versus its very poor periphery. This similarity in the rules implied that government could not push companies to establish themselves in areas of lower development. Further, as the country made progress, companies in very backward sectors would leave the Metropolitan Area. However, but of reallocating to a poorer part of Costa Rica, they would move to another country altogether. Fourth, and finally, the FTZ system should have contained or otherwise extended not only direct exporters but also their local suppliers from the beginning. At the very least, the rules should have been designed to avoid creating a negative distortion that led companies to try to source abroad, because sourcing locally was administratively onerous.

Finally, we address issues related to export competitiveness. A lesson from every successful exporting country is that rather than hoping to be ideal in every possible aspect of productivity and the business climate, the target should be to find a winning combination of attractive traits or advantages. One can argue that, in the case of Costa Rica, the macroeconomic environment, human capital and quality of the labor force, clarity of the rule of law, favorable fiscal regime, assisting institutions and very welcoming labor relations constitute such a winning combination. Nevertheless, some of the current salient weaknesses do hurt and carry a serious cost.

The poor condition of the country's infrastructure is perhaps the largest competitive weakness in

232 Félix Delgado and Alberto Trejos, *El Impacto macroeconómico de la presencia de INTEL en Costa Rica*, (Consejeros Económicos y Financieros, 2006).

Costa Rica. For reasons that are not pertinent here,[233] the government simply lost its ability to legally perform any infrastructure project of significant size, after the decade-long hiatus in such investments that took place as a consequence of the financial crisis of the early 1980s. We are getting to the point where the costs caused by bad logistical infrastructure, and the complexities and delays associated with dealing with government and regulation in general, are too onerous to compensate for other positive traits, valuable as they may be.

Another aspect of general competitiveness that causes concern is energy. As of the late 1990s, Costa Rica became one of the few nations in the world that required no fossil fuels for electric power generation, due to decades-long investments by the public utility, ICE, in renewable energy capability. Not only was this a very significant environmental achievement, but also provided a guarantee of high-quality energy whose price did not need to vary along with the oil price. Over the last few years, however, construction of generation capacity has fallen behind, and today 9 percent of energy is generate through hydrocarbons. If no large new plants come in line till then, this percentage could reach 50 percent by 2021. This problem is due to the combination of the same limitations to public investment mentioned above, a set of barriers erected by the state and congress against private investment for these purposes (driven by ideological reasoning) and poor decisions regarding pricing and exchange conditions.

Conclusions: On the Applicability of This Strategy to Cuba

The remaining question is the applicability of the Costa Rican story to the Cuban reality. The similarities between the potential competitive strengths of the two countries lead us to believe that some of the experiences that are described in the previous chapters could be of some value and use for Cuban policy makers. Other similarities and opportunities need to be ascertained, including a more detailed, quantitative comparison between the human-capital endowment of the two countries, in order to assess the value of the effort and to guess where the low-hanging fruits could be.

Some concerns and pending questions arise right away, however. One of them is the role of the Cuban entrepreneur. While prominent, FDI is not the lead character of the Costa Rican story, the domestic exporting company is. One can easily imagine that Cuba could aim, with limited adjustments within its current economic structure, to attract similarly impressive multinational corporations as Costa Rica. But the applicability of this story to Cuban growth largely depends on the capability for the Cuban entrepreneur to do its part or the Cuban state enterprise to take its place. It is not our objective or place to recommend an appropriate economic design for Cuba. One is compelled, however, to identify points where the Costa Rica-Cuba analogy gets most tightly challenged.

Another difficulty in applying some of this story in the case of Cuba comes from timeframe. The global economy is very different now from what it was in the early 1980s. One example is the willingness, before the current wave of FTAs, which rich countries had then to grant unilateral preferential market access to poorer partners. Another example is the inflexibility of current multilateral rules regarding the design of new FTZs or, in general, other exports subsidy schemes, for mid-income countries.

Finally, the current global macroeconomic climate—let alone the peculiarities of Cuban macroeconomic management—pose some limitations on matters like real exchange rate policy, currency convertibility, etc.

Despite these difficulties we contend that there are components of the Costa Rica story that are applicable and interesting for Cuba, yielding purpose to the broader project to which these pages belong.

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[233] See instead Jorge Cornick and Alberto Trejos, "Political and Institutional Obstacles to Reform", in *Growing Pains in Latin America*, ed. Lilliana Rojas-Suarez (Washington, D.C.: Center for Global Development, 2009), pp. 153 – 191.

Monetary Reform in Cuba Leading up to 2016:

Between Gradualism and the "Big Bang"[234]

Pavel Vidal Alejandro and Omar Everleny Pérez Villanueva

Introduction

The general objectives of the Cuban economic reform were set forth, in broad strokes, in the document "Guidelines for Economic and Social Policy" ("Lineamientos de la Política Económica y Social"), approved in 2011 during the Sixth Congress of the Communist Party of Cuba (PCC). Two objectives stand out in the chapter on monetary and financial policy: First, expanding microfinance, an objective for which legislation is already in force and which is gradually moving forward; and second, mention is made of the dual currency, a matter on which specific actions have yet to be decided, and on which there is great uncertainty. These two appear to be the most important elements of change in monetary and financial policy as part of the ongoing reform of the Cuban economy, and 2016 has been put forth as the deadline for attaining the objectives.[235]

As of December 20, 2011, three commercial state banks began to offer bank loans and financial services to self-employed persons and microentrepreneurs, and expanded banking facilities for private agricultural workers. The new legislation has already offered positive, yet discrete, results.

As of late 2013, new expectations have been raised regarding the dual currency since the official note published in the newspaper *Granma* announced that soon a group of actions would be taken in the enterprise sector, and then in the social sector, with the aim to move the economy toward a single currency—the Cuban peso.[236] From 2011 to 2013 the government had organized some monetary-exchange experiments in certain enterprises and select sectors, which offer hints as to the type of monetary reform that is considered most likely.

Whatever strategy is ultimately decided on, the main measure that the Central Bank must take to eradicate the distorting parallel circulation of two national currencies—the Cuban peso (CUP) and the convertible peso (CUC)—is the devaluation of the official exchange rate of the Cuban peso, a matter that has been put off for more than 20 years.

It is in this context that this article examines the monetary experiments already in place and what they tell us about future monetary reform, so as to then analyze the costs and benefits, as well as economic policy responses, associated with the eventual devaluation of the official exchange rate.

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[234] This essay is the result of the project carried out by the Universidad de La Habana and the Brookings Institution, which made possible the debate about these monetary-financial issues and others at the workshop held in Havana in September 2013, and thereby included the impressions and suggestions of Augusto de la Torre, Richard Feinberg, Antonio Romero, Carmelo Mesa-Lago, Guillermo Perry, Saira Pons, Ricardo Torres, José Juan Ruiz, Alberto Trejos, and Juan Triana, among others. It has been translated from Spanish to English.

[235] For a lengthy description of the current reform in Cuba one can see the texts by Carmelo Mesa-Lago, *Cuba en la Era de Raúl Castro: Reformas Económico-Sociales y sus Efectos* (Madrid: Editorial Colibrí, 2012) and Omar Everleny Pérez, "La economía cubana en el 2012: La actualización de su modelo económico," in *Miradas a la Economía Cubana*, eds. Pavel Vidal Alejandro and Omar Everleny Pérez Villanueva (Havana: Caminos, 2012).

[236] See the newspaper *Granma*, October 22, 2013.

One of the key aspects to be decided is the pace of monetary reform. The analyses and conclusions of this article show a group of arguments that would justify guaranteeing, in all areas possible, a gradual transition as the best strategy for Cuba's monetary reform. Nonetheless, given the major gap between the two exchange rates, at certain moments abrupt devaluations ("big bang" style) will be required to meet the goal of having a single currency in 2016.

The analyses set forth in this text do have not empirical backing, as they have to do with actions that have yet to start; moreover, they do not have precedents in the Cuban economy. The assessments that are presented take into consideration the mechanisms of monetary and financial transmission recognized by theory and international experiences, and in that context an effort is made to select those that will have the greatest chance of finding expression in the Cuban economy given the characteristics and particularities of its monetary policy and of Cuba's banking and financial system. It is also crucial to be able to understand the origins of the distortions present today, which go back to the crisis of the 1990s and to the economic policy responses adopted at that time. Therefore, the value-added of the conclusions presented rely on this evaluation of the origin and context of the monetary and financial problems that the Cuban government is now proposing to resolve.

For reasons of length it is not possible to address at the same time the issue of microfinance and dual currency. This paper focuses on the second issue.

The Banking System and Reform

In the 1990s the Cuban financial system was subject to a profound transformation. A two-tier banking system was created that replaced the previous scheme of a single bank that performed at the same time central banking functions and commercial banking functions, as was typical in socialist systems. In 1997 the Central Bank of Cuba was established as the lead organization for banking supervision, the payments system, and monetary and exchange policy.

To some extent the banking system was able to accommodate the reform pushed in those years after the disappearance of the socialist bloc. This process also included opening up tourism, foreign investment, and remittances, restructuring the state enterprise system, and partially freeing up spaces for the small-scale private sector, among other changes approved at that time by President Fidel Castro.[237]

New commercial banks and non-banking financial institutions appeared in the financial system. All are state-owned, but they have the power to make decisions on loans within certain general parameters defined by the Central Bank. The door was opened to international financial institutions, which legally were established as offices representing the parent companies. Some of them have been engaging in credit operations and financial services, yet their operations are subject to the many pressures and limitations that stem from the sanctions imposed by the United States government on Cuba.

At present, the Cuban financial system is made up of eight state commercial banks, one mixed bank with Cuban and Venezuelan state capital (Banco Industrial de Venezuela-Cuba), nine non-bank state financial institutions, and 15 offices of foreign financial institutions. The financial system achieved certain progress in the modernization, computerization, and development of new services and instruments for capturing savings and allocating credit.[238]

The Central Bank has continued to set interest rates on demand deposits and fixed-term deposits in the state banks, while it has defined narrow ranges for interest rates on loans. A certain degree of competition was

[237] A lengthy description of the Cuban reform of the 1990s can be found at ECLAC, La Economía Cubana: Reformas Estructurales y Desempeño en los Noventa, (Mexico City, D.F.: Fondo de Cultura Económica, 1997).

[238] For more details on the changes the Cuban financial system has experienced, see Carlos Pérez, "Metodología para la Planificación y Gestión de la Política Monetaria en el Segmento Población de la Economía Cubana," (Doctoral thesis, Universidad de la Habana, 2012).

established among the different financial institutions, albeit within a very limited framework. The interbank market never took off, beyond interbank deposits and specific credit operations among the financial institutions.

The reform of the financial system, like all the other transformations of the 1990s, came to a halt in the 2000s; several proposals for change were left pending, some of which are trying to resume today under the presidency of Raúl Castro. For example, the development of the interbank market and the financing of the fiscal deficit by means of issuing public debt are two aspects mentioned in the current reform, even though there is not much clarity as to the steps that will be taken to advance such aims. In this new stage it appears that the more in-depth changes to the banking system will be associated with the expansion of microfinance.

Cuba's financial institutions have been giving loans mainly to the state enterprise sector, and only in a very controlled way in the sector of households and private agricultural producers. The financial restrictions on the private sector had to do not only with credit, but also the impossibility of using bank payment instruments and current accounts.

The new legal framework in which self-employed persons, microenterprises, and private agricultural workers could operate financially was published in the Official Gazette 40 of November 2011.[239] The current financial measures of the Cuban government allow one to classify the new policy as an opening to micro-lending and microfinance. The volume of expected loan amounts (a few hundred dollars), the recipients of such loans (individuals, small agricultural producers, and microenterprises), as well as the characteristics of the guarantees allowed (not backed by mortgages) situate the new financial operations in the field of microcredit. The opening also extends to microfinance, given that microentrepreneurs will receive financial services in addition to loans, specifically managing current accounts and the use of bank payment instruments.

As of July 2013, a total of 271,152 loans had been made for more than 1.5 billion pesos (62.5 million dollars at the exchange rate for the population). The banking authorities themselves consider the figure of loans applied for by the private sector to be discrete. Given Cuban banks' scant prior experience with microcredit, the technological difficulties, and the limited alliances with local actors, among other limiting factors, the figure of loans made so far should be considered positive and as an indicator of the potential that could be deployed if appropriate measures continue to be adopted. No efforts should be spared in this regard, given that the growth of the private sector requires such financial support for its take-off and sustainability.

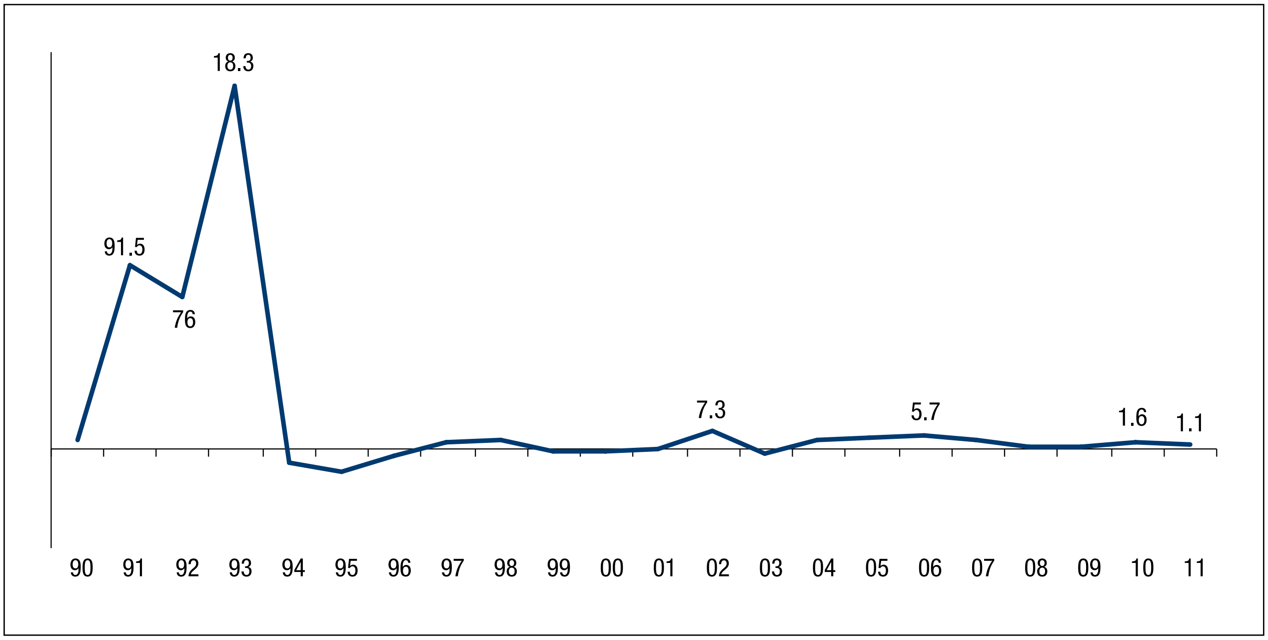
Monetary and Financial Equilibria

Figure 5 shows inflation since 1990 measured by the consumer price index (CPI) in Cuban pesos. One notes that in the period from 1991 to 1993, inflation climbed to two- and three-digit figures, yet as of 1994 the economic authorities succeeded in controlling price increases.[240] The main determinant of inflation in the 1990s was the increase in the fiscal deficit, which rose to more than 30 percent of GDP. The government increased fiscal spending to support the public enterprises that became unprofitable as a result of the crisis, and thereby was able to contain unemployment, which reached only 8 percent. At the same time, social spending in nominal terms was held steady (education, health, social assistance, and subsidies for the food basket), and thousands of families were kept from falling into extreme poverty. The fiscal deficit was monetized and provoked an excessive increase in the money supply at a time when, moreover, demand for money for transactions diminished due to the 35 percent contraction of

[239] Ministry of Justice, *Gaceta Oficial de la República de Cuba* No. 40 (Havana, November 2011).

[240] The measurement of the Cuban CPI has accumulated some deficiencies such as not including the markets in convertible pesos and not changing the basis for weighting goods and services since 1999; the result of which it is likely that official inflation is underestimating actual inflation by several percentage points.

Figure 5. Inflation in Cuban Pesos (1990-2011)



Source: Created using data from the Central Bank of Cuba (2008) and the National Office of Statistics and Information (ONEI) *Anuario Estadístico de Cuba* (several years), www.one.cu.

GDP. The result was increased inflation and the loss of more than 80 percent of the value of state wages, which were frozen in nominal terms but in real terms absorbed the cost of the crisis. In this way, the cost of the crisis was distributed among state employees; it was the alternative to massive unemployment and to extreme poverty for thousands of families.

Later, fiscal adjustment measures and the gradual recovery of economic growth made it possible to control inflation. While the Central Bank has helped keep inflation below 10 percent, it does not have an inflation objective explicitly defined, nor has it developed a monetary policy scheme that would enable it to propose one.

Monetary policy does not yet use conventional monetary policy instruments. Planning and centralization have been the main instruments used to regulate aggregate demand in the economy. It does not appear that monetary policy is designed to transition from the current moment to the use of conventional indirect instruments such as open market operations, reserve requirements, and the discount rate. In a context of controlled interest rates, low competition, and the absence of an interbank market, the transmission mechanisms through the banking system—in order to indirectly influence credit levels, the money supply, and ultimately demand and prices—have turned out to be inoperative for monetary policy. In addition, the possibility of using open market operations has been vetoed by the non-existence of a market in internal public debt. Nor are there Central Bank bonds or any other instrument that can be used to collateralize any type of operation for expanding or contracting the monetary base through the discount window.

Price stability during the decade has some visible fundamental determinants: First, the government's direct control over part of the prices (more than 40 percent of the CPI in Cuban pesos); second, having maintained on average a low fiscal deficit (approximately 3 percent of GDP); and third, control over the exchange rates of the Cuban peso and the convertible peso.

Low inflation is a major advantage of the current Cuban reform in relation to the 1990s, when a group of fiscal and monetary stabilization measures had to be proposed. Monetary policy can therefore focus on other objectives, such as eliminating the dual currency and promoting the convergence of exchange rates.

Nonetheless, the currency reform to be implemented may well pose challenges to maintaining monetary and fiscal stability. The strategies set in motion to eliminate the dual currency, to devalue, and to achieve convergence of exchange rates will require compensatory fiscal measures (at least transitory ones) for the enterprises and families affected; all of that could squeeze fiscal accounts on the spending side, and ultimately usher in inflation. In addition, the necessary devaluation of the exchange rates will be passed on to consumer prices. In other words, both the fiscal deficit and inflation will receive pressures through monetary reform, which will have to be navigated by the economic authorities.

Moving on to other aspects of monetary policy, while the Central Bank has been able to keep inflation under control, it has not been able to avoid the occurrence of other types of monetary imbalances. Since 2008 the Cuban economy began to suffer a crisis that was, all at once, a debt crisis, a banking crisis, and an exchange crisis. The external shocks and the financial centralization measures decided upon in prior years were the fundamental causes. The mistakes in the monetary policy design that accompanied the convertible peso after the de-dollarization in 2003 and 2004, including the lack of rules or transparency in relation to the issue of the CUC,

Table 9. Causes of the Cuban Financial Crisis in 2008

1. Balance of payments crisis since 2008 triggered by three external shocks: worsening terms of trade, a nefarious hurricane season that required additional food imports (as well as supplies for repairs to housing and infrastructure), and the international crisis with its transmission channels to external financing and Cuban exports. These shocks acted on a balance of payments that was already suffering from fragilities after the slowdown in the export of medical services to Venezuela.
2. The elimination, since 2003, of the currency board (caja de conversion) that controlled the issue of convertible pesos (CUC), without setting any monetary rule to replace it. Previously, for each convertible peso in circulation there was a dollar on reserve at the Central Bank, but when this system was ended, and not replaced by another monetary rule, the Central Bank had unrestricted freedom to print convertible pesos. Although the data is not public, the facts show that up to 2009 a sum of convertible pesos was issued far greater than the reserves in foreign currency required to support its convertibility.
3. The recentralization of financial resources since 2005. In 2005, the Single Account of the State (Cuenta Única del Estado) was established, where businesses are required to deposit their profits, pay taxes, and make other payments in foreign exchange and convertible pesos. Centralization may be considered another factor promoting the banking crisis to the extent that it provoked a concentration of the financial risk in a single economic agent, in this case, the central government. It was not the first time the government has confronted a crisis in its finances; the difference is that previously it did not have such strong repercussions on the balance sheets of the banks, as liquidity was more diversified among the current accounts of the different state enterprises.
4. Another factor that aggravated the financial crisis is the fixed exchange rate policy. A timely and gradual devaluation of the exchange rate of the convertible peso would have helped re-establish equilibrium in the balance of payments. It would have generated incentives in favor of import substitution, increased exports, and made tourism prices more competitive. From 2005 to March 2011 the exchange rate was kept fixed at 0.92 CUC for 1USD. Only in March 2011 was it devalued 8 percent to return to the parity of 1CUC:1USD.

Source: Pavel Vidal and Mario González-Corzo, "Cuba's Banking Crisis: Macroeconomic Antecedents, Principal Causes, and Recent Policy Responses," in *International Journal of Cuban Studies* 2, No. 3/4 (December 2010), pp. 201-213.

also contributed to the Cuban financial crisis. Table 9 summarizes the main causes of the 2008 Cuban financial crisis.

The stabilization of the Cuban banking and financial system could not count on the help of an international lender of last resort, given that Cuba is not a member of the main international financial institutions.[241] Venezuela's own economic problems have rendered impossible an exercise of this type on behalf of its main economic ally or from the newly established Bank of the South, of the Bolivarian Alliance for the Peoples of Our America (ALBA).

The only option for the government is to implement a pro-cyclical adjustment policy to resolve the solvency problems behind the liquidity crisis and to be able to generate financial surpluses so as to pay off the debts little by little. The government of Raúl Castro has implemented an adjustment of imports, investments, and fiscal outlays; controlling spending has been almost an obsession for the new government. As a result, it was able to reduce the current accounts deficit of the balance of payment, the fiscal deficit returned to values close to 3 percent of GDP, and the banking crisis was solved.

In addition, the government has been able to make a series of agreements with its international creditors to reduce the external indebtedness. It secured an agreement to postpone payments of the debt service with China until after 2015, Japan forgave 80 percent of the debt pending since the 1980s (approximately US$ 1.4 billion), Mexico also forgave 70 percent of a debt valued at US$ 487 million, while there is also an debt agreement with Russia with the defunct Soviet Union.

Origin and Current Status of the Dual Currency

The dual currency began with partial dollarization in the 1990s, associated with the economic crisis, the disequilibria, inflation, and depreciation of the exchange rate in the informal market. In response to the resulting lack of confidence in the Cuban peso, the U.S. dollar began to replace it in informal markets as the means of payment and unit of account. In 1993 dollarization was officially recognized and extended to the business sector, both national and foreign, which was beginning to grow as part of the policy of attracting foreign direct investment. Ever since, both the Cuban peso and the U.S. dollar circulated in tandem, with institutional recognition.

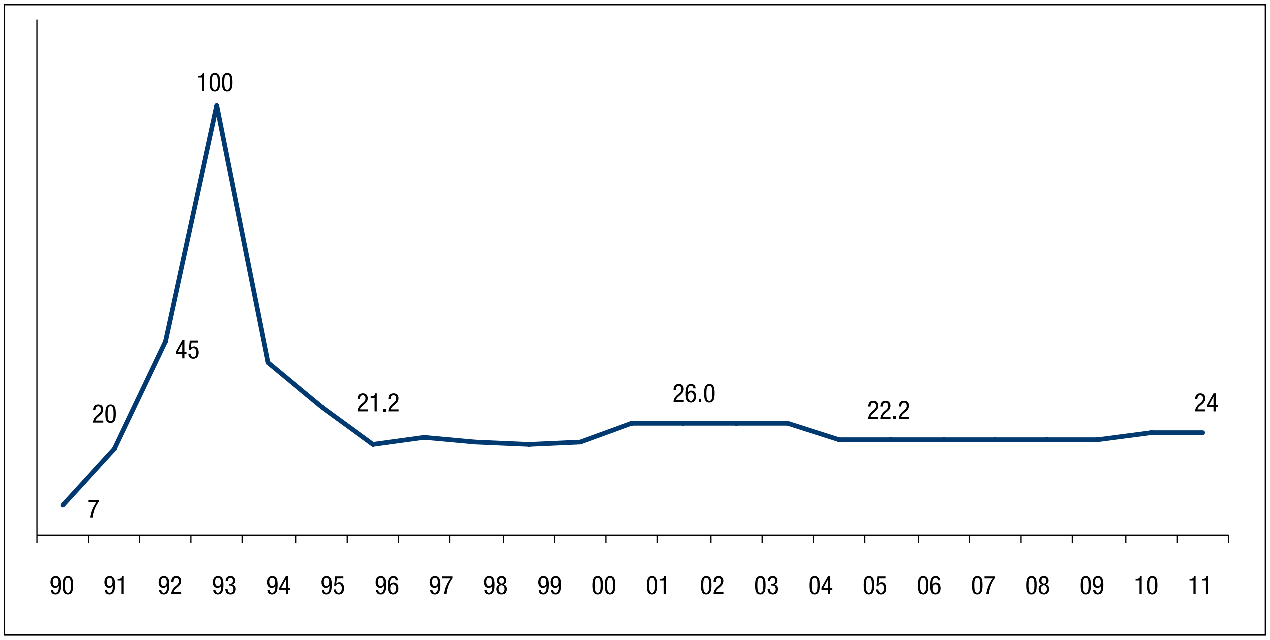
After the recovery of fiscal and monetary stability for several years, in 2003 and 2004 the government set in motion a group of actions that shifted to the convertible Cuban peso, or CUC, the functions played by the U.S. dollar. This has led to the current situation in which the economy is no longer dollarized, but the parallel circulation of two currencies is maintained, now between the Cuban peso and the convertible peso, both issued by the Central Bank of Cuba.

The convertible peso was first printed in 1994 but its circulation as a means of payment in retail markets was very limited. It was created with an exchange rate pegged to the U.S. dollar (1CUC:1USD) and a currency board that backed it until 2003. Nowadays the convertible peso maintains parity with the dollar, but there is no rule to regulate its issue.

In the 1990s, along with the dual currency, another factor was introduced that was much more distorting: the duplicity of exchange rates. The exchange rate for the Cuban peso suffered an enormous depreciation with respect to the dollar in the informal market during the 1990-1993 period, when it climbed from 7CUP:1USD to 100CUP:1USD, which was a main determinant of inflation in those years. In response to a set of adjustment measures, mainly fiscal measures, the exchange rate appreciated from 1994 onward. Since then, the exchange rate has held stable (see Figure 6).

[241] See Richard Feinberg, *Reaching Out: Cuba's New Economy and the International Response* (Washington, D.C.: Brookings Institution, 2011) for an analysis of Cuba's possibility of becoming a member of the IMF and other international financial institutions.

Figure 6. Exchange Rate of the Cuban Peso to the U.S. Dollar (1990-2012)



Source: Created based on official data from the Central Bank of Cuba (several years).

As we indicated, the depreciation of the Cuban peso began in the 1990s in the informal market. In 1995 this parallel exchange rate was assumed by the recently-established state network of currency exchanges that engages in operations with the population and with the tourists (Cadeca: Casas de Cambio S.A.). Nonetheless, the new value of the Cuban peso never extended to the accounting and exchange operations of the enterprise sector. The public enterprises and organizations continued operating with the exchange rate of the 1980s: 1CUP:1USD. Even today the population and tourists change at 24CUP:1USD at the currency exchanges, but the official exchange rate that is used to record national accounts and the finances of the state enterprises and public organizations continues to be 1CUP:1USD. It is prohibited for the enterprises to turn to the currency exchanges and arbitrate with the differences in exchange rates, which is difficult anyway as the currency exchanges only engage in operations involving small amounts of cash. Foreign and mixed capital firms also use the exchange rate of 1CUP:1USD to record their expenditures in Cuban pesos, which are basically limited to payment of wages to national personnel.

Table 10 summarizes the exchange rates of the Cuban peso and the convertible peso for the exchange operations of the population and tourists at the currency exchanges (Cadeca) and for the finances and accounting of the public enterprises and organizations.

Table 10. Exchange Rates (2013)

	Population and tourists (Cadeca)	Public enterprises and organizations (Official)
Cuban peso/ convertible peso	24.0	1.0
Convertible peso/U.S. dollar[b]	1.0[a]	1.0
Cuban peso/U.S. dollar[b]	24.0[a]	1.0

[a] A 10 percent tax is applied to the exchange of dollars in cash.

[b] The exchange rate with respect to the Euro and other foreign currencies varies daily depending on the value of the dollar in the international market.

Source: Authors' calculations based on official data from the Central Bank of Cuba (several years).

The excessively overvalued exchange rate of 1CUP:1USD has enormous costs for the enterprise sector, distorts economic measurement, and accordingly has a negative impact on the efficiency of economic decisions and resource allocation. The excessive value of the Cuban peso hides subsidies and keeps a series of enterprises artificially profitable and another group deceptively unprofitable; in other words, it distorts the enterprises' balance sheets and fiscal accounts. In particular, it has a negative impact on the export sector and all national producers with the potential to compete with imports.

The overvaluation of the exchange rate of the Cuban peso has also impeded its free convertibility for the enterprise system.[242] The enterprise sector is divided into two based on the predominant type of currency, which operates as a disincentive to foreign investment, provokes absurd segmentations, and reduces linkages, weakening the economy in the extreme.[243]

By understanding the origins of the duality of currencies and its interrelationships with the dual exchange rates, one is able to appreciate that the main measure the Central Bank should take to eliminate the dual currency is devaluing the Cuban peso in the enterprise sector, a matter that has been postponed for more than 20 years. Partial dollarization and the monetary and exchange duality was the monetary policy strategy of the 1990s that was useful for avoiding devaluation of the exchange rate in the enterprise circuits. That strategy was extended in time, leading to the accumulation of enormous distortions throughout the network of enterprises.

Monetary Illusions

As we already noted, the Guidelines approved at the Sixth Congress of the Cuban Communist Party ratified the elimination of the dual currency as one of the economic policy objectives, yet details of the plan of action were not offered. The Guidelines do not say much about the dual currency, just this paragraph:[244]

> *Progress will be made toward the establishment of a single currency on the basis of labor productivity and effective distribution and redistribution mechanisms. The complexity of this goal will require rigorous preparation and implementation, both objectively and subjectively.*

The paragraph confirms that eliminating the dual currency will be a gradual process. There is talk of preparation on the subjective level, since for the population at large the dual currency tends to be associated with the low purchasing power of wages and inequalities, which is not so. A few comments are in order on this aspect.

The low wages in Cuban pesos and the possibility of being able to have greater private income in convertible pesos or foreign exchange has created the impression that the dual currency causes inequalities, when in reality it is the low productivity of the state sector that conditions the low wages and, accordingly, fosters inequalities.

The strategy for distributing the cost of the adjustment in the 1990s among state workers, in combination with the opening of the economy to tourism, remittances, foreign investment, self-employment, and other private sources of income for the family, has revealed a huge income gap between families dependent on wages, pensions, assistance, and state subsidies, and those families that have been able to gain access to other private sources of income. The inability of the state enterprise sector to recover

[242] If the convertibility of the Cuban peso at the exchange rate 1CUP:1USD were opened up today, international reserves would not cover the demand for dollars. That is why the state enterprises that operate in Cuban pesos receive the foreign exchange for imports through the centralized allocation in the annual economic plan.

[243] Pavel Vidal, "Monetary Duality in Cuba; Stages and Future Perspectives," in *Cuban Economic and Social Development: Policy Reforms and Challenges in the 21st Century,* ed. Jorge I. Domínguez, et al, (Cambridge: Harvard University, 2012).

[244] Communist Party of Cuba, *Lineamientos de la Política Económica y Social del Partido y la Revolución*, Sixth Congress (Havana, April 2011).

productivity and wages more than 20 years after the disappearance of the Soviet Union has made inequality a structural (and not monetary) problem.

The dual currency has actually helped to conceal the real structural causes of low state wages and differences in income, which are associated with the low productivity and inefficiency of the state enterprise sector. It is interesting to note that a system that has promoted equality by statizing the economy is today creating inequalities due to the inefficiency of its state enterprise system.

A monetary illusion has been created among the population that by eradicating the dual currency family incomes will automatically rise and inequalities will vanish; yet people do not understand that the fundamental costs of the dual currency are in the enterprises, therefore, that is where the immediate beneficiaries will be found, and it is through this means that the benefits will reach families. Some generations of Cubans still hold the economy of the 1980s in Cuban pesos as the ideal, and the expectation of returning to that status once all prices and incomes return to that currency. They forget, however, that that status depended on Soviet subsidies, and that today a harsh adjustment is required along with a revision of the model that makes it possible to boost productivity as the only way to increase wages and reduce their disadvantage with respect to other sources of income.

Points of Consensus and Unknowns with Respect to Monetary Reform

Based on partial information that has been provided and the characteristics that define the Cuban monetary and exchange scenario, one can consider the following options as the most likely to be followed by the Central Bank in an eventual program for doing away with the dual currency. Perhaps they are the points on which there is greatest consensus among the economic authorities, which were confirmed in one way or another in the official note published in the newspaper *Granma* on November 22, 2013:

- The Cuban peso is the currency that will remain as the only monetary sign; the convertible peso should disappear over time. The government's preference for the Cuban peso is based on several factors: (i) it's the historic currency; (ii) most family savings are in Cuban pesos; the population maintains confidence in this currency, which is bolstered by public expectations that it will become the only currency in circulation; (iii) wages are denominated in Cuban pesos, paying the equivalent in CUC would further cast light on the low level of real wages in the state sector; this does not have an effective economic impact, yet it does have a political and psychological impact on people; (iv) the national accounts, state budget, and decisive sectors such as agriculture record their operations in Cuban pesos.
- The main measure that the Central Bank will adopt to eliminate the dual currency is devaluation of the exchange rate of the Cuban peso in relation to the U.S. dollar in the enterprise sector (the 1CUP:1USD exchange rate will increase), so as to bring it closer to the exchange rate for the population (24CUP:1USD).
- It is expected that the 1CUC:1USD exchange rate will remain constant in the coming years. Although there could also be a simultaneous devaluation of the CUC in relation to the dollar, this does not appear to be the path selected according to official statements and the exchange actions taken on an experimental basis until then.
- The exchange rate of the Cuban peso in the currency exchanges would remain constant or, if possible, it would be revalued (the 24CUP:1USD would decline, and with it the 24CUP:1CUC exchange rate).
- The elimination of the dual currency will be a gradual process. While 2016 is the deadline for meeting the objectives of the Guidelines and the monetary reform begins in 2014, one would be considering a three-year period for

doing away with the dual currency. Perhaps by then the peso will not have been fully reestablished as the only currency, but one would expect that by then all the enterprises will be operating with the same exchange rate as that which applies to the population, and that all prices would be recorded in Cuban pesos. The CUC could survive a few more years as a reserve currency and for opening savings accounts. Even though the preference is for a gradual transition, the major gap between the exchange rates of the Cuban peso in the enterprise sector and for the population (2,300 percent) would require, at some point, a faster pace in the devaluations. The experiments that have been implemented, in fact, assume a devaluation of the Cuban peso in the enterprise sector that is quite significant, as the rate of 10CUP:1USD represents a 900 percent devaluation in relation to the official exchange rate of 1CUP:1USD.

While there has always been a preference for gradual monetary reform, confirmed several times by the Cuban authorities, and which moreover is consistent with the pace at which the rest of the reform is being carried out, there has been a debate between two possible ways to implement it. In other words, there appears to be two alternative strategies for gradually devaluing the official exchange rate of the Cuban peso:

(i) *Comprehensive reform:* It would consist of implementing gradual devaluations of the exchange rate of the Cuban peso for all enterprises.

(ii) *Reform by sectors*: Gradual incorporation of some sectors to a particular exchange system with a devaluated official exchange rate.

In summary, "gradual" can refer to either time or sectors, or a combination of the two. Some official statements and certain experiments already implemented point to a monetary reform that above all would follow the second strategy. Let's take a look at these experiments.

As of December 1, 2011, the use of a special exchange rate of 7CUP:1USD was begun for direct transactions (without intermediaries) between hotels and restaurants, on the one hand, and agricultural cooperatives on the other. The decision benefits the hotels and restaurants, which can now acquire national products with their income in CUC (or dollars) at lower prices due to the devaluation of the peso from 1CUP:1USD to 7CUP:1USD. It also benefits the agricultural cooperatives, which can gain direct access to a national market to which they did not have access due to the dual currency. Although officially that decision is not recognized as a devaluation, the decision *de facto* creates a new special rate of exchange for those transactions. Later, in 2013, by Resolution 9 of the Ministry of Finance and Prices, the special exchange rate increased to 10CUP:1USD.

Another clue to future monetary changes comes from the experiment that began in 2013 with a group of state enterprises. This experiment is aimed at endowing them with greater powers in their economic and financial management, and greater autonomy in relation to control by the ministries. On the monetary level, it has been announced that all these enterprises' transactions will be carried out in Cuban pesos; they will operate with a different exchange rate, and will be able to buy and sell foreign exchange at the Central Bank without exchange controls. There is no precise information on the exchange rate that will be used, but it appears that it will be situated at 10CUP:1USD or 5CUP:1USD.

Moreover, in some media the story has circulated that from the second half of 2013 the sugar agroindustry began to use multiple exchange rates for its accounting and transactions different from the official rate of 1CUP:1USD. As of this writing, it is known that three different exchange rates are used, 12CUP:1USD for recording export revenues, 7CUP:1USD for recording imports, and 4CUP:1USD for oil imports from Venezuela. This would suggest a transition to a much more elaborate/extensive multiple exchange rate regime as an alternative to the overvalued official exchange rate of 1CUP:1USD.

The last available sign that provides information about the future strategy of monetary policy is to be found in the recently created transportation service cooperatives, which will be able to purchase imported and domestic inputs such as fuel, tires, parts, space parts, and others, not at the official exchange rate of 1CUP:1USD but at an exchange rate of 10CUP:1USD.[245]

In summary, the new exchange rates for the enterprise sector will probably be situated around 10CUP:1USD, and given that the convertible peso maintains parity with the U.S. dollar, it means that 10CUP:1CUC, which represents a 900 percent devaluation of the Cuban peso in relation to the U.S. dollar and the convertible peso. Evidently, the solution to the dual currency will also follow the style of the rest of the reform, in which first experiments are organized, and then a general program is adopted based on the experiences.

The convergence of the exchange rates would be more transparent and direct with a comprehensive reform; it would avoid passing through arrangements with more multiple exchange rates, which is complicated to manage and control. The disadvantage is that it may entail great costs to the sectors least prepared for a new exchange rate scenario. The pressure from these less prepared sectors for the devaluation could delay the adjustment of the exchange rate.

The second strategy makes it feasible to accelerate the evaluation in those sectors that are best prepared to assume and respond to a new exchange rate, but has the disadvantage that it may complicate even further the exchange rate scenario and one may lose control over the possibilities of arbitrage among the different exchange rates. The multiple exchange rates in the enterprise sector would allow space for arbitrage, and would render accounting and exchange operations difficult and extremely complicated, which would be a breeding ground for bureaucracy and corruption.

The economic literature is abundant in showing the inefficiencies such an exchange policy option would entail for the allocation of resources and the deformations it can cause in measurements of international competitiveness, which means, when it comes to establishing exchange rate subsidies and taxes, discretionally promoting quasi-fiscal policy approaches and a lack of transparency in State expenditures and revenues.

The period of multiple exchange rates is a thing of the past internationally as an effective option for exchange policy regimes, due to their proven inefficiency and due to the high costs they entail. The most recent experiences in the region, in both Venezuela and Argentina, provide new evidence of those costs. This is why one would hope that devaluations by sector in Cuba represent just a transitory mechanism for garnering experiences and accelerating the devaluation, but that the final intent should be to generalize the devaluation to the entire enterprise system, and to obtain a definitive convergence with the exchange rate for the population.

The experiment with several exchange rates for the sugar agroindustry, in particular, should not be generalized to other sectors. The trend toward convergence, putting in place general rules, and looking to international best practices should prevail over the trends that today still indicate that Cuba is continuing to construct a "handmade economy," far from international standards, and in which discretion prevails.

Let us now examine the unknowns that remain unanswered in the official statements and in the experiments under way, and with respect to which it is not possible to infer the future trajectory with any reasonable certainty. Next, a few of these elements of the strategy for eliminating the dual currency are related that the Central Bank has yet to define publicly:

- Pace of the devaluations and how long the sector-based differences will remain. It remains to be known how and when the

[245] The newspaper *Juventud Rebelde*, October 13, 2013.

experiments will be extended to the rest of the enterprise sector and how the devaluation of the official exchange rate will continue to the point of convergence with the exchange rate for the population.

- The way the impact of the devaluations on prices will be managed, whether price controls will be maintained and whether the pass-through will be directed administratively, or whether an autonomous adjustment in wholesale and retail prices will be allowed. That will define to what point the nominal devaluation will represent a real devaluation of the exchange rate.

- Response of fiscal policy to the impact of the devaluation on the enterprises, families, and consequently the structure and balance sheet of the State budget.

- The decisions that will be made in relation to the enterprises that remain unprofitable after the devaluation and the forms of support that will be given to the state enterprises with the potential to take advantage of the new exchange rate.

- General timetable for the measures and role in each stage of the state enterprise sector, the non-state enterprise sector, and families.

- The extent and manner in which foreign investment and mixed capital investment would be included in the circuit in Cuban pesos. Two important points here are whether they need to move their balance sheets to Cuban pesos, and the changes that could occur in the wages that foreign and mixed capital enterprises pay to the state employer institutions.

- Role of the market in determining the equilibrium single exchange rate. Possibility of creating a foreign exchange market for enterprises, banks, and other organizations.

- Degree of convertibility of the Cuban peso. Exchange regime that will accompany the Cuban peso. Whether or not an exchange control will be established for the purchase of foreign exchange with Cuban pesos.

- Monetary policy that will sustain the Cuban peso after eliminating the duality of currency and rates of exchange.

The definition of these points will mark the true depth of the monetary reform and the scope it will have on the functionality of the real sector of the economy. One of the disadvantages of a gradual reform compared to a "big bang" strategy is the uncertainty it casts on future monetary changes. This has repercussions in the form of investment projects coming to a standstill, higher transaction costs, and the loss of credibility of monetary policy. The only way for the economic authorities to mitigate this uncertainty is by announcing the sequence in which the monetary reform will be carried out from now until 2016.

Costs and Benefits of the Devaluation of the Official Exchange Rate and Economic Policy Responses

Given that the devaluation of the official exchange rate of the Cuban peso is the main action that the Central Bank has to decide to take in order to overcome the dual currency, it is worthwhile analyzing the consequences of a measure of this nature, as well as the economic policy options for taking them on. It is actually very difficult to anticipate, much less to measure, the various effects that the official devaluation will have on the Cuban economy, since prices have not changed for decades in the enterprise sector. Combining economic theory with the particular characteristics of the Cuban economy, next we related some of the impacts that appear to be more foreseeable:

Effect on Balance Sheets

The devaluation of the Cuban peso will result in changes in almost all the proportions, relative prices, and financial results of the enterprises, banks, and other institutions. The balance between assets and liabilities of the enterprises will change, as they will be multiplied by a different exchange rate. The losers will be the financial balance sheets that show a mismatch of exchange rates, that is, whose debts in convertible pesos and foreign currencies are greater than their assets in those same currencies. And those institutions whose situation is the opposite in their balance sheets from that just described, will be favored by the measure.

The devaluation will create traumas in the financial situation of the enterprises, but it is aimed at promoting more transparent accounting balances that more accurately reflect the economic realities. This is probably one of the most difficult balances to strike through economic policy. On the one hand, one must get the devaluation to have an impact (it should be a real devaluation, not just a nominal one), that changes the financial situation of the enterprises and that leads to a better allocation of resources. The "maladjustment" that comes from the measure is its main contribution, since one starts from an initial situation in which the overvaluation of the Cuban peso deforms the financial indicators of the enterprises and distorts the correct price signals for efficient decision-making. Yet on the other hand, this shock cannot be unmanageable for the enterprises, so as to provoke a collapse of economic activity. Gradually introducing the devaluation may indeed help strike a satisfactory balance between the two effects.

Inflation

Costs in convertible pesos and foreign exchange, expressed in Cuban pesos, will increase when multiplied by a higher exchange rate. Enterprises can pass this increase in cost to the final prices of the goods and services they sell. Many of those goods and services represent costs for other companies. High transfer is expected in an economy in which two currencies circulate and there is a high dependency on imports.[246] Thus, through inflation, there would be consequences for almost all organizations and markets.

The economic authorities should avoid an inflationary spiral, with a view to conserving monetary stability and with the objective of having the nominal devaluation of the exchange rate becoming a devaluation of the real exchange rate. The ministries of Economy and Planning and of Finance and Prices have control over most prices in the enterprise system, so the transfer of the costs to the final prices will be a matter for economic policy decision-making. To keep inflation from reaching consumers, the price subsidy for the retail markets should be increased, a decision that will put pressure on the fiscal accounts balance.

It is worth reiterating that it appears that actions need to be defined to cushion (albeit not eliminate) the effects of the devaluation. Economic policy should guide and regulate the maladjustment" the economy will experience when the real exchange rate is changed, but in reality the effects should not be avoided, but managed, so as to avoid creating inflationary spirals or unmanageable shocks for the enterprises, or shocks that would have excessively high social costs.

Banks

The banks Banco Popular de Ahorro (BPA), Banco de Crédito y Comercio (BANDEC), and Banco Metropolitano (BM), which are the ones that take in deposits and make loans in Cuban pesos and in CUC, will suffer the direct balance sheet effect. Yet actually all the banks, including the remaining ones that operate only in CUC and foreign exchange, could be impacted by the sequelae/aftermath of the devaluation given the various financial interrelationships among the enterprises, and between them and the banks.

[246] Eduardo Hernández, "La Elección Cambiaria: Propuesta para Cuba," (Doctoral thesis, Universidad de la Habana, 2011).

A worsening of the financial situation of certain enterprises due to the balance sheet effect in a situation of an exchange rate mismatch, would reduce their ability to pay their debts and, as a result, would hurt their creditors. The banks should therefore take the necessary measures and prepare their portfolios, simulating said scenario. Stress tests need to be used to determine the vulnerabilities of the banking system to devaluation and to prepare it to make the appropriate decisions.

Tradable Goods and Services Sector

Evidently, devaluation has a number of impacts and costs for the business sector, but it will also generate benefits. Exporters will see increased profitability and competitiveness. All the domestic output in the tradables sector will see a relative improvement in its competitiveness vis-à-vis imported goods and services.

For these benefits to materialize the state enterprises must have greater autonomy. Therefore the sectoral experiment being designed should not only help transform the enterprises' exchange system, but also their management mechanisms, so as to move to greater autonomy. The state enterprises, which will be most impacted by the devaluation, need some room for maneuver to respond to the new environment and to react so as to tap into the opportunities that generate changes in relative prices.

One of the weakest points to ensure the benefits of devaluation surpass its costs is the fact that the realization of benefits depends on the responsiveness of state enterprises, yet there is always doubt as to their flexibility to respond to a new set of incentives, particularly in a centrally planned economy and where the bureaucracy has become too strong. Accordingly, the structure of the Cuban economy, supported by great state enterprises that answer to a central plan, makes for additional challenges to the devaluation.

Financial Account of the Balance of Payments

One should not expect the devaluation of the official exchange rate to provoke an outflow of capital in the balance of payments, as could be the case in a market economy with an opening in the financial account. As just indicated, the enterprise structure of the Cuban economy is based on state firms, whose financial operations are controlled through the annual central plan that is approved and monitored by the Ministry of Economy and Planning. As part of the reform, steps are beginning to be taken to make the centralized planning mechanisms more flexible, but not to the point that the government loses control of the enterprises' international financial flows.

Foreign and mixed capital enterprises, for their part, operate mainly in dollars or in convertible pesos, so they would not have the opportunity to engage in speculative operations in Cuban pesos, which are also restricted by the lack of convertibility of the Cuban peso for the enterprises.

Families' financial assets and their currency portfolio decisions would not have to be directly impacted by the devaluation of the official exchange rate. In the family sector there would be speculative financial movements based on changes that may occur in the exchange rate in the currency exchanges (today set at 24CUP:1USD) and related to the expectations that they create as to the consequences of the monetary reform for the value of their savings. The authorities have experience on how to handle these events; for example, the Central Bank has in its recent history the de-dollarization of 2003 and 2004.

In summary, the controls on capital movements and exchange control will annul any chance of a massive outflow or inflow of capital to the Cuban economy and overreaction of the exchange rate as a result of monetary reform, beyond specific speculative episodes that could occur in families' financial decisions.

Domestic Economic Integration

The benefits of the monetary reform would not be limited to the changes in relative prices and to greater transparency in accounting balance sheets; rather, the correction of the exchange rate will make it possible to open up convertibility of the Cuban peso for enterprises, which would have a very positive effect on the strengthening of the domestic market. Once the enterprise sector that has revenues in Cuban pesos can freely buy convertible pesos and foreign exchange with that currency, it will be more integrated to the rest of the domestic economy and with international trade; in addition it will begin to be more attractive for foreign investment. By opening up to convertibility of the Cuban peso in the enterprise sector, the economy will be more integrated and interrelated, segmentations would be eliminated, and linkages among the organizations would appear.

Performing all transactions in a single currency and with an exchange rate that is not overvalued will enormously reduce transactions costs, will entail gains in efficiency, competitiveness, and business integration, and will strengthen the domestic market. These benefits, which will be perceived at the end of the monetary reform, are what should lead the monetary authorities to persist and expedite in all possible respects the convergence of the exchange rates. The short-term complications must not lead one to lose sight that the economy as a whole stands to gain (national enterprises, government, foreign investors, and families) once all transactions can be done in a single currency.

Foreign Firms

The devaluation of the Cuban peso would not appear to have major consequences in the short term for foreign investors, given that today they operate in convertible pesos and foreign exchange, and their ties with the economy in Cuban pesos are limited due to the lack of convertibility of that currency. Obviously, foreign investors should monitor the consequences of the devaluation on the state enterprise system as a whole, monetary-financial stability, and the fiscal balance, given that these are macroeconomic factors in which they are indirectly implicated.

The effect on wage costs is uncertain, since foreign companies do not hire or pay their employees' wages directly, but rather do so through a state enterprise employer, which today receives the wages in dollars and then pays the state workers in Cuban pesos. Monetary unification, in the medium term, would render that mechanism pointless, yet one would still need to know under what new rules the international hiring of Cuban workers would operate. To learn more about the consequences for wages one must await further information about the future monetary strategy.

In the medium term, foreign and mixed capital enterprises could gain space when the Cuban peso is fully convertible and operates as the only means of payment nationally. The domestic market would be more attractive for foreign investment, for their opportunities—today limited to exports and the sectors that operate in convertible pesos – would be expanded. When the currencies are unified, the whole economy will potentially be of interest to the international investor. When all the enterprises work with the same means of payment, the foreign and mixed capital enterprises could become more integrated with the national enterprises and thereby reduce their costs while at the same time having a greater multiplier effect over the domestic economy.

One would have to know in the future whether firms with international capital would be required to put all their accounting and financial balance sheets in Cuban pesos. In that case, the exchange risks for the foreign investor would be associated not with the convertible peso, but with the Cuban peso and the monetary policy and exchange regime that will support it.

Families

It is most likely that the elimination of the dual currency would not have direct and immediate effects on the population. The population already suffered the direct effect of the devaluation of the exchange rate in the 1990s; the agricultural markets and all private business have been working since the 1990s with the exchange rate of 24CUP:1USD. Obviously, multiplying the prices of the markets that today operate in convertible pesos by 24 , to take them to Cuban pesos, has almost no implications for the population.

In the event that the transfer from convertible pesos to Cuban pesos in retail prices is done at an exchange rate below 24, then there could be a favorable wealth effect. Nonetheless, one should not have much hope in a possible revaluation of the exchange rate of the Cuban peso in Cadeca in the short term; international experiences indicate that in situations of multiple exchange rates convergence also tends to the highest (most devalued) exchange rate, which is usually closer to equilibrium.

In the medium term there would be an appreciation of the exchange rate at the currency exchanges once the devaluation of the exchange rate and currency unification effectively promote exports, larger inflows of foreign investment, and a fall in the demand for imports.

Returning to the possible short-term impacts, it should be noted that while one should not expect direct impact on the population, there would be indirect mechanisms of transmission, given that the official devaluation of the Cuban peso impacts enterprises that pay wages and intervene in the chain of value that influences the prices of consumer goods and services. Therefore, one must learn how the authorities will manage those potential impacts on wages and consumer prices, that is, how they will manage the inflationary implications of the devaluation; whether, for example, they will allow the enterprises favored by the devaluation to be able to pay their workers higher wages, or allow the increase in production costs in Cuban pesos to be charged in the prices to the end consumers.

Fiscal Policy

The devaluation of the Cuban peso will effectively give rise to costs and benefits, the difference is that most of the costs of the devaluation are certain and immediate while the benefits appear as opportunities and will take time to completely materialize. That is why it is essential that economic policy accompany monetary reform, in particular fiscal policy. A group of compensatory measures should be designed for those enterprises that are impacted by the immediate costs of the devaluation yet have the potential to benefit from the new exchange opportunities.

Economic policy should adjust its instruments to buffer this temporary gap between the costs and benefits of the devaluation: subsidies, taxes, credit policy, and the allocation of resources through the economic plan should define measures to support exporters and all the enterprises that have the potential to take advantage of the devaluation. That would mean tension in the fiscal balance on the expenditure side that should be offset by a renewed tax policy. One option is to capture a percentage of the positive balance sheet effects in state enterprises. Fiscal policy, in this first stage of the monetary reform, is even more important than monetary policy.[247]

Unfortunately, the country will have to take on this complex process of monetary unification without the help of the international financial institutions, with very limited international reserves, and in a moment of low economic growth. Nonetheless, one cannot continue waiting for the "ideal moment" to undertake it; the structural reforms need the monetary reform.

Monetary Policy

In the first phase of the reform, monetary policy could continue to be implemented as it has been to date, supported by direct instruments of monetary control and in coordination with fiscal policy, which depend on the mechanism of monetization of the fiscal deficit. Nonetheless, by 2016 one would expect that the minimal conditions will have been created to begin to implement a monetary policy that more effectively sustains the credibility and stability of the single currency. To that end one must continue the

[247] The design of fiscal policy required for these circumstances is beyond the intended scope of this article.

transformations of the banking system that were left pending since the 1990s, while completely eradicating the practice of financing the deficit by monetization. There is a need to develop the inter-bank market, the primary and second market for public debt, to make interest rates flexible and subsequently freed up, and to use conventional indirect monetary policy instruments such as open-market operations, reserve requirements, and the discount rate.

Lessons should be drawn from the mistakes made in monetary policy associated with the convertible peso and the de-dollarization of the economy, and that were determinants of the Cuban financial crisis in 2008. Monetary policy for the Cuban peso as of 2016 has to consider transparency and the explicit definition of objectives and rules as an essential part of its instruments and ultimate objectives. Perhaps by 2016 all the changes that monetary policy needs will not be completed, but as much as progress as possible should be made in those areas considered most essential to the credibility and guarantee of stability of the Cuban peso.

Conclusions: Between Gradualism and the "Big Bang"

Monetary and financial policy have two main objectives through 2016: the expansion of microfinance and the resolution of the dual currency. For the first objective a legal framework is already in place and some results can be reported after more than two years of implementation. For the second objective, there is less information about the strategy to be followed; available signs point to a gradual reform by sectors.

Carrying out the monetary reform by sectors will make it possible to gain experience and promote more pronounced devaluations for some enterprises, but it will be complicated to control arbitrage, corruption, and the other costs associated with multiple exchange rates. Multiple exchange rates should constitute only a first step in monetary reform; by 2016 there should be definitive convergence of the value of the Cuban peso for the entire economy.

The structure of the Cuban economy, based on large state enterprises, justifies a gradual devaluation of the exchange rate and not the application of a "big bang" approach. The domestic private sector (self-employed persons, microentrepreneurs, and private agricultural producers) have already been working since the 1990s with a devalued exchange rate. Nor will there be direct effects of the devaluation of the official exchange rate on foreign investment. Therefore, the gains from devaluation will have to be guaranteed by the response of the state enterprise sector, which needs more time to react due to the greater bureaucracy, rigidity, and subordination to the ministries. In order for the response to be effective, more room for maneuverability? is required for its management, making the central planning mechanisms more flexible and aligning the workers' and managers' incentives with the impacts of devaluation in their enterprises; that is, the effects of the devaluation should not remain on the balance sheets of the state enterprises, but rather should reach the wages they pay.

Gradual change will not only facilitate the response of the state enterprises, but also the response of economic policy. One cannot anticipate all the impacts of devaluation, given that this is a price that has not changed for decades in the Cuban economy. One cannot start from the assumption that the economic actors and the government will know how to manage the exchange-rate shock. While it is necessary first to define the sequence of monetary transformations and the general rules under which it will be possible to respond and cushion the exchange-rate shock, corrections will have to be made along the way to fiscal policy, and credit policy for exporters, among others. In addition, a time is needed to adjust accounting dynamics, IT systems, contracts, bureaucratic mechanisms, among other operational aspects that have to be accommodated, for they are designed to operate with an exchange rate that has not changed in decades. Therefore, introducing the changes gradually will also give the economic authorities time to react.

The 2016 deadline implies that, even though there is a preference for gradual introduction of the reform, there will have to be pronounced devaluations of the exchange rate to attain converge of the official rate 1CUP:1USD and the exchange rate for the population, 24CUP:1USD. Indeed, the experiments that began in 2013 consider an exchange rate for some enterprises around 10CUP:1USD, which means a 900 percent devaluation of the official exchange rate, which could be classified as a "big bang," albeit reduced to some companies and on an experimental basis.

A question that will have to be defined going forward is the monetary and exchange regime of the Cuban peso as of 2016. It seems sensible to think that initially such a regime should prioritize convertibility and credibility, which could be guaranteed with a fixed exchange-rate system, or with some monetary rule. Second, the exchange-rate regime should include flexibility as the top priority and move progressively to arrangements that make viable a larger float in the value of the currency and monetary policy independence.

One of the disadvantages of a gradual reform in relation to a "big bang" strategy is the uncertainty it casts over future monetary changes. The economic authorities have as a factor in their favor control over capital flows; that certainly reduces the speculative options and overreaction of the exchange rate associated with expectations on future monetary and exchange actions. Nonetheless, monetary uncertainty may paralyze investment projects of the emerging non-state sector, or of foreign business interests, and complicate management in state enterprises. The only alternative the economic authorities have to mitigate this disadvantage is to more clearly explain the monetary reform up to 2016.

Exchange Rate Unification: The Cuban Case[248]

Augusto de la Torre and Alain Ize

Introduction

Since 2011, the Cuban authorities have placed exchange rate unification as one of their top policy priorities. Indeed the current dual exchange rate system—whereby a one-to-one exchange rate for the "convertible peso" coexists with a twenty four-to-one exchange rate for the "Cuban peso" (both against the US dollar)—introduces severe and pervasive distortions with costly consequences for resource allocation and the growth potential of the Cuban economy. At the same time, the unusually large (by international comparison) spread between the two exchange rates exacerbates the transition costs and thus constitutes one of the main reasons delaying their unification.[249]

This paper reviews from an international perspective the challenges faced by Cuba in unifying its exchange rate system and compares various options to meet this objective. It argues in favor of an immediate unification cushioned by a system of lump-sum taxes and subsidies to be phased out during a preannounced transition period. By allowing for relative price changes to operate in full from the start, the immediate unification would maximize efficiency gains. At the same time, by cushioning the Cuban economy from potentially large transitional pains—including fiscal revenue losses, productive dislocations, inflationary outbursts and distributional effects—the lump-sum taxes and subsidies would ease the transition, thereby boosting policy credibility. These lump-sum taxes and subsidies would be set on an enterprise-by-enterprise basis so as to fully neutralize, initially, the windfall losses or gains that individual enterprises would otherwise make upon the unification of the exchange rate.

By replacing at the outset the taxes and subsidies *implicit* in the current exchange rate spread with

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[249] For information on the economic situation in Cuba and the circumstances underpinning the exchange rate system, see Roberto Orro, "The Cuban Dual Monetary System and Challenges Ahead," in *La Economia Cubana: Reformas Estructurales y Desempeño en los Noventa,* eds. David Ibarra and Jorge Máttar (ECLAC, 2000); Gabriel Di Bella and Andy Wolfe. "A Primer on Currency Unification and Exchange Rate Policy in Cuba: Lessons from Exchange Rate Unification in Transition Economies" *Cuba in Transition 18* (2008): 50-62; Silvia Dreher, "Monetary Policy in Cuba," *Cuba in Transition 19* (2009): 286-291; Pavel Vidal, "Monetary Duality in Cuba: Stages and Future Perspectives," in *Cuban Economic and Social Development: Policy Reforms and Challenges in the 21st Century*, eds. Jorge I. Domínguez, Omar Everleny Pérez Villanueva, Mayra Espina Prieto and Lorena Barberia, (Cambridge: David Rockefeller Center for Latin American Studies, Harvard University, 2012); Pavel Vidal, "Monetary and Exchange Rate Reform in Cuba: Lessons from Vietnam," Institute of Development Economies, Japan External Trade Organization, 2012; Pavel Vidal and Omar Everleny Pérez Villanueva, *La Reforma Monetaria en Cuba hasta el 2016 : Entre Gradualidad y "Big Bang"* (Washington, D.C. : The Brookings Institution, 2013); and Richard Feinberg, *Soft Landing in Cuba: Emerging Entrepreneurs and Middle Classes*, (Washington, DC: The Brookings Institution, 2013).

explicit taxes and subsidies of equivalent magnitude, the traumatic effects the unification would have on impact would be eliminated. Thereafter, however, both the enterprises and the government will have to adjust, albeit gradually, because the lump-sum taxes and subsidies would be phased out according to a preannounced timetable. But such adjustment process would be facilitated by efficiency gains, given that—at the margin—the incentives faced by existing enterprises to invest and produce would be completely independent of the lump-sum taxes or subsidies which, by definition, would be set as an absolute amount that does not vary with productive effort (or lack thereof). In effect, the incentives faced by *existing* enterprises would be at par with those faced by the *new* enterprises. However, to facilitate a positive supply response (i.e., to ensure that the change in relative prices associated with the exchange rate unification leads to an early materialization of efficiency gains) and to further ease transition pains as lump-sum subsidies are phased out, important habilitating reforms will be needed, particularly as regard the governance of state-owned enterprises and a retargeting of subsidies.

The rest of the paper is organized as follows. Section 2 briefly reviews the international experience on exchange rate unification, based on the academic literature, some statistics about the evolution of exchange rate regimes across the world, and a comparison of current Cuban spreads and macroeconomic conditions with those prevailing at the onset of unification in other Latin American countries that underwent similar experiences in the not too distant past. Section 3 focuses on what is special about Cuba and what this implies for policy. Section 4 compares and contrasts the pros and cons of four policy options. Sections 5 and 6 provide rough sketches of how the proposed fiscally-cushioned big bang option would work for two specific sectors of the Cuban economy, specifically the foreign-managed tourism industry and the state-owned importers and local producers, respectively. Section 7 concludes by discussing key habilitating reforms (fiscal, monetary and public sector governance) and some sequencing issues. It also briefly addresses the related yet distinct issue of currency unification.

Some Lessons from International Experience

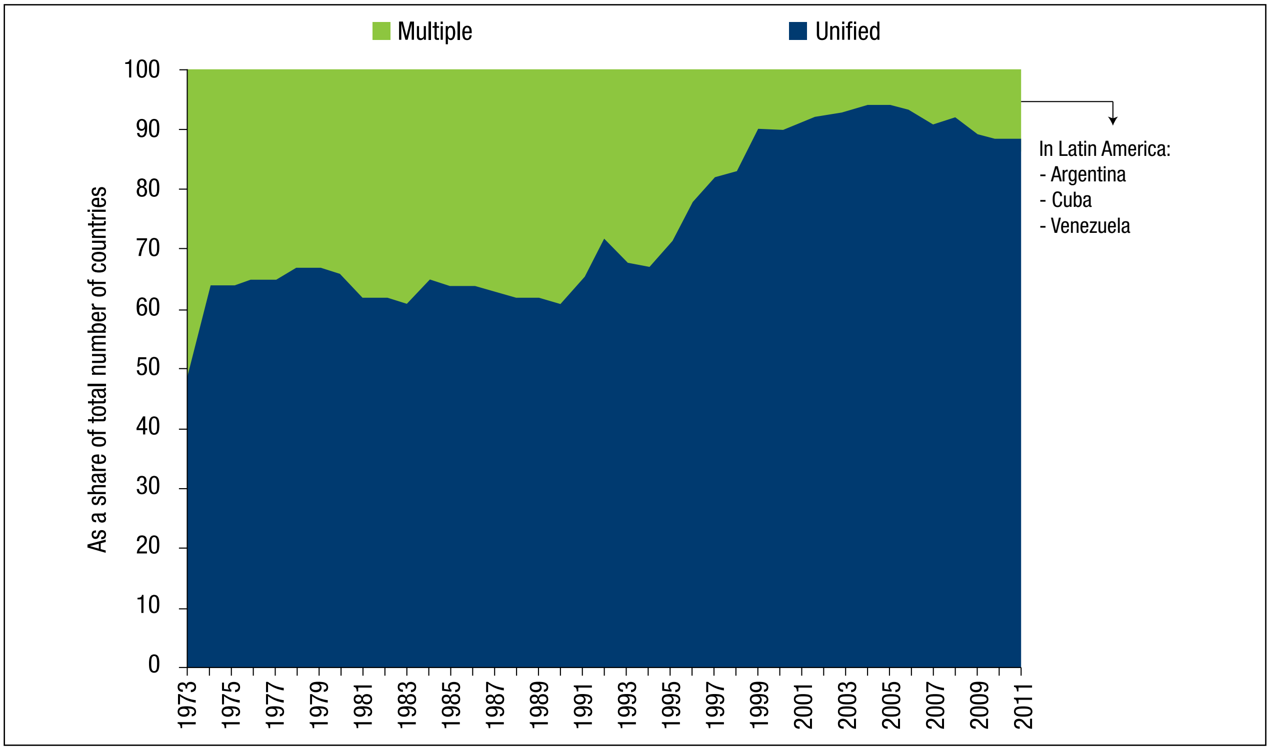
Understanding well what caused the original dislocation that led to a multiple exchange rate regime is the inescapable starting point for defining a successful policy agenda towards exchange rate unification. Typically, multiple rate systems emerge after a large shock hits the economy that exerts substantial pressure on the foreign exchange market and calls for a major depreciation of the equilibrium real exchange rate. The shock can be a *supply* shock, such as the deterioration in the terms of trade that severely weakens the external trade account or an increase in world interest rates that sharply raises the servicing costs of the country's external debt. Or it can be a *demand* shock, such as a surge in local demand for foreign assets (capital flight) triggered by financial repression and/or unsustainable macro policies. In the first case, the required exchange rate depreciation reflects the deterioration in the country's purchasing power; in the second case, it reflects the relative price change needed for reducing the country's demand for tradable goods so as to allow its citizens to transfer their assets abroad.

To avoid a politically explosive fall in real wages and a rise in inflation due to an increase in the cost of imported inputs, governments may introduce a dual exchange rate regime. The more depreciated "free rate" (the market determined rate) is used for capital account transactions and "non-basic" imports, while the "official rate" is used for "basic" imports and "must-surrender" export proceeds. In theory, this can help limit inflation, protect socially sensitive economic activities, channel resources to developmental priorities, and redistribute income progressively (including by avoiding rewarding the owners of foreign currency-denominated assets through devaluation-induced valuation gains).

In practice, however, dual exchange rates typically cause large efficiency losses. The exchange rate spread acts as a tax on exports (through surrendering requirements) and a subsidy on "basic" imports, which are detrimental to the country's exporting and import-substituting productive activities, thereby hindering economic growth and job creation. Differentiating between "basic" and "non-basic" imports can give rise to similarly severe resource misallocations and opacities. In all cases, the exchange rate spread causes growing wedges between private and social interests that translate into enforcement nightmares and multifaceted, socially destructive rent seeking activities. The costs of such distortions accumulate and worsen over time, particularly in the case of a supply shock that calls for a permanent real exchange rate adjustment. As dual rates persist and become fossilized throughout the economy, they end up causing increasingly pernicious and ingrained segmentations between the winning sectors (that found access to preferential exchange rates) and the losing sectors (that did not).[250] *Exchange rate unification should therefore originate both static efficiency gains (i.e., a better allocation of existing resources, so that more income and output can be generated with the same labor, land, and capital that are already available today) and dynamic efficiency gains (i.e., the income expansion arising from the process of accumulation and better use of resources over time).*

Reflecting the growing awareness of such efficiency costs, but also improved macro-monetary policy frameworks, the share of countries with multiple exchange rate regimes across the world has steadily declined over the last forty years, albeit with a slight resurgence in the last 5 years (see Figure 7). In Latin America, this resurgence included some churning between the return of parallel rates in countries that had successfully unified their exchange rates (Venezuela and Argentina) and the successful

FIGURE 7. WORLD SHARE OF MULTIPLE VS. SINGLE EXCHANGE RATE REGIMES, 1973-2011



Sources: Kenneth S. Rogoff, Aasim M. Husain, Ashoka Mody, Robin Brooks, and Nienke Oomes, "Evolution and Performance of Exchange Rate Regimes," IMF Working Paper WP/03/243 (International Monetary Fund, 2003) and International Monetary Fund (IMF), *Annual Report on Exchange Rate Arrangements and Exchange Restrictions* (AREAER), Washington, D.C., various years.

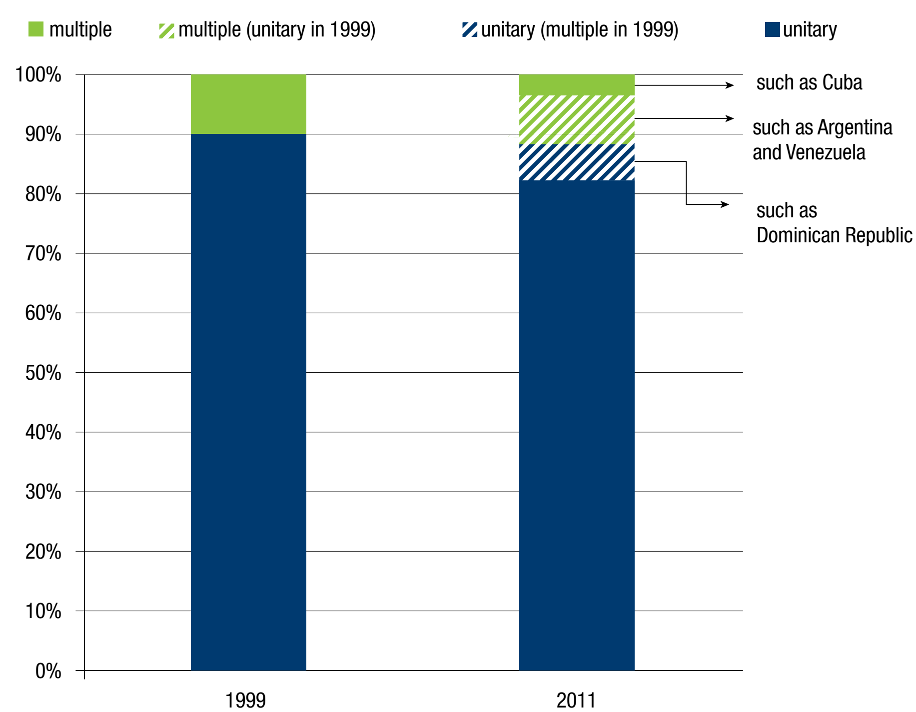
[250] Pierre-Richard Agenor, "Parallel Currency Markets in Developing Countries: Theory, Evidence, and Policy Implications," *Essays in International Finance No. 188* (Princeton University, 1992) provides a good summary review of the literature on parallel exchange rates, including causes, welfare impacts and policy implications. Jacob A. Frenkel and Assaf Razin ("The Limited Viability of Dual Exchange Rate Regimes," NBER WP No. 1902, (1986)) analyze the restrictive conditions under which a dual exchange rate system that separates capital from current account transactions can be sustained indefinitely.

recent unification of the exchange rate in countries with formerly dual exchange rate regimes (such as the Dominican Republic; see Figure 8). Arguably, however, multiple exchange rates appear to be for the most part a species on the verge of extinction.

Conversely, the persistence of multiple exchange rate regimes in the few remaining countries that still have them is likely to reflect in part the challenges and costs associated with exchange rate unification. These costs depend on the roots of the original split. In countries where the originating shock was a demand shock resulting from financial repression or poor macro-monetary management, a reversal towards sounder macro-financial policies may be all it takes to discourage capital flight and, hence, absorb the pressures that led the parallel rate to deviate from the official rate in the first place. Instead, in countries where the shock came from the supply side and where the factors behind the shock still endure (for example a permanent worsening in the terms of trade), unification is likely to have more substantial costs. This is because in these cases unification is likely to take place at the most depreciated (parallel) rate, rather than at the most appreciated (official) rate. Thus, absent offsetting mechanisms, a large depreciation of the official rate can have substantial inflationary and redistributive implications.

The post-unification equilibrium exchange rate is typically expected to lie somewhere within the two exchange rates in effect before the unification. The reasoning behind this expectation is straightforward. A depreciation of the more appreciated (official) exchange rate should reduce the demand for basic imports—thereby freeing some foreign exchange—or promote exports—thereby allowing additional foreign exchange to come in. As this additional supply of foreign exchange finds its way into the market, it should allow the more depreciated (parallel) rate to strengthen. Thus, as one continues depreciating the official exchange rate, the two rates should gradually move towards each other, eventually converging somewhere inside the initial spread.

Figure 8: Churning Between Multiple vs. Unified Exchange Rate Regimes, 1999-2011



Notes: Countries with multiple exchange rates in 2011 but with a unified rate in 1999 are Angola, Argentina, Eritrea, Georgia, Guinea, Kyrgyz Republic, Malawi, Maldives, Mongolia, Nigeria, Sao Tome and Principe, Sudan, Ukraine, Uzbekistan, and Venezuela. Countries with a unified rate in 2011 but with multiple rates in 1999 are Afghanistan, Belarus, Botswana, Cambodia, Dominican Republic, Egypt, Iran, Lao, Libya, Russia, and Turkmenistan. Source: IMF AREAER online database.

In practice, however, because the demand for basic imports is generally fairly inelastic and the response of exports to a more competitive exchange rate tends to take time to materialize (e.g., it is short-run inelastic), the depreciation of the official rate is unlikely to free much foreign exchange, at least in the short run. If so, unless there is a sufficiently deep, forward-looking foreign exchange market that anticipates future foreign exchange inflows, the two rates will tend to meet close to the bottom of the range, i.e., close to the parallel market rate.[251]

Moreover, the above reasoning assumes that there is no change in the demand for foreign exchange coming from the capital account. But this will not be the case if expectations of post-unification inflation (more on this below) induce a shift towards the dollar (e.g., if there is a *private* portfolio shift toward the dollar), or if the central bank starts accumulating foreign reserves after the unification (e.g., if there is a *public* portfolio shift toward the dollar). In both cases, the post-unification single exchange rate could well depreciate (overshoot) beyond the pre-unification parallel rate.[252]

Unless offset through fiscal adjustments (more on this below) a one-time post-unification inflation can generally be expected from the pass-through of the official exchange rate depreciation to inflation (e.g., *cost-based inflation*).[253] Moreover, the rise in

Table 11: Post-Unification Inflation in Selected Latin American Countries

Country	Beginning of Unificataion Process	Pre-Unification Premium	Phasing	Point-to-Point Annual Inflation: 3 months before unification begins	...3 months after	...12 months after	...24 months after
Venezuela	Mar. 1989	202 percent	Fast	36 percent	103 percent	81 percent	36 percent
Argentina	Feb. 1989	53 percent	Gradual	372 percent	460 percent	8163 percent	232 percent*
Peru	June 1989	166 percent	Gradual	3414 percent	5704 percent	1968 percent	207 percent*
Ecuador	Sept. 1992	27+ percent	Gradual	50 percent	64 percent	46 percent	27 percent
Dominican Republic	Oct. 2003	10+ percent	Fast	26 percent	40 percent	52 percent	0 percent
Cuba	?	2300 percent	?	4 percent	?	?	?

Notes: Premium is defined as the average spread between the parallel and official rates as a percent of the official rate in the last quarter before unification. Phasing is defined by the duration of the coexistence of official and parallel rates after unification—"fast" is less than 3 months. * 28 months after, to capture the effects of the formal introduction of Convertibility in April 1991 (Argentina) and the final currency unification in August 1991 (Peru). Sources: The Economist Intelligence Unit; International Currency Analysis, Inc., World Currency Yearbook (formerly Pick's Currency Yearbook), (Brooklyn, N.Y.: various issues); AREAER (several publications); Pick's currency yearbook (several publications); Miguel Kiguel and Stephen A. O'Connell. "Parallel exchange rates in developing countries," *The World Bank Research Observer* 10, no. 1 (1995): 21-52; Nancy P. Marion, "Dual exchange rates in Europe and Latin America." *The World Bank Economic Review* 8, no. 2 (1994): 213-245; Ethan Ilzetzki, Carmen M. Reinhart, and Kenneth S. Rogoff, "Exchange Rate Arrangements in the 21st Century: Which Anchor Will Hold?" (2008), Steven Kamin, "Argentina's Experience with Parallel Exchange Markets, 1981-1990," Board of Governors of the Federal Reserve System International Finance Discussion Papers, no. 407, 1991; International Financial Statistics (IFS) database.

[251] This is what Agenor finds in the experience of exchange rate unifications in a number of African countries during the 80s. He concludes that "the post-unification exchange rate is typically close to the pre-reform parallel rate, casting doubts on the argument that the equilibrium exchange rate is an average of the official and parallel rates".

[252] See Saúl Lizondo, "Unification of Dual Exchange Markets," *Journal of International Economics* 22 (1987): 57-77and Pierre-Richard Agenor and Robert P. Flood, "Unification of Foreign Exchange Markets," IMF WP/92/32, 1992.

[253] However, such supply side pressures may be relatively subdued in countries where domestic prices already reflected for the most part the parallel rate (rather than the official rate).

the price level may turn into a permanent rise in the *rate* of price increases when the initial supply shock leads to wage-price spirals that are accommodated by a weak (or not credible) monetary policy (e.g., *expectations-based inflation*); or when the unification gives rise to lasting fiscal imbalances (e.g., *demand-based inflation*) resulting from the loss of quasi-fiscal income generated by the dual exchange rate regime (in particular, an abrupt reduction in the implicit taxation of exports).

Table 11 provides a bird-eye view of post-unification inflationary experiences in Latin American countries that have unified their exchange rate in the not too distant past. The table shows that post-unification inflation tended to be higher in countries with high pre-unification inflation (Argentina, Peru) or in countries with high pre-unification spreads (Venezuela, Peru). By contrast, for countries with relatively low pre-unification inflation and spreads (Ecuador, Dominican Republic), post-unification inflation was relatively subdued. For Cuba this is both good news and bad news. While pre-unification inflation is low, the spread is way above anything observed in other countries of the region.

The Case of Cuba

The Cuban dual exchange rate system overlaps with a dual currency system. The latter consists of the Convertible Peso (CUC)—a fully convertible currency that exchanges at one to one against the dollar—and the Cuban Peso (CUP)—that exchanges at 24 to one dollar.[254] Hence, the dual currency entails dual exchange rates. For simplicity, we will use in what follows "CUC" to refer to the more appreciated CUP rate (1 per 1 USD) and "CUP" to refer to the more depreciated CUP rate (24 per 1 USD).

The two systems responded to the same initial shock although they are sustained by different motives. The dual exchange rate system goes back to the early sixties when a separate exchange rate was used for trade with the socialist countries, particularly the former Soviet Union. The market segmentation was abruptly exacerbated during the 1990-1993 period when the political changes in the former Soviet Union led to a redefinition of commercial relations with Cuba that resulted in a huge worsening in Cuba's terms of trade. The CUC was subsequently created (in 1994) to limit dollarization—by providing an alternative to the US dollar as a unit of account and a store of value—in the environment of rapidly rising and highly volatile inflation that followed the adverse terms of trade shock. This overlap and common origin has led many observers to see the dual exchange rate and the dual currency systems as "joined at the hip." But they are clearly driven by different motives and pursue different objectives. Exchange rate unification can thus be conceptually and practically de-linked from the currency unification.

What makes the case of Cuba special when compared to other cases of dual exchange rate regimes in Latin America? At least four features stand out. First, because the origin of the Cuban dual exchange rate system is primarily real (linked to a terms of trade shock) rather than financial (linked to capital flight), it basically amounts to a *quasi-fiscal scheme.* It taxes exports and some other types of foreign exchange incoming flows while subsidizing basic imports. This is both good news and bad news. It is good news because it mitigates concerns about speculative financial turbulence during unification. Such concerns are further limited by the fact that much of the population's savings are already held in the form of cash dollars (hence do not generate a pent-up demand for dollars) while most bank deposits (whether in CUPs or CUCs) belong to public enterprises (hence are unlikely to trigger speculative shifts into dollars). However it is also bad news because, unless fiscally neutralized, the exchange

[254] Actually, the CUP exchanges at 24 CUP per dollar households and at 1 CUP per dollar for the state enterprises and institutions. Persons can exchange dollars or CUCs for CUPs (at 24 to 1), as well as CUPs for CUCs (at 25 to 1), in the exchange bureaus (Cadecas). State enterprises and institutions conduct exchange transactions with the Central Bank and are prohibited from using the Cadecas to arbitrage between the exchange rates. There are no indications at this time, however, of a significant spread between the 24 per 1 USD rate at the Cadecas and the rate in informal transactions on the street. For details see Vidal "Monetary Duality in Cuba…".

rate unification will unavoidably have large re-distributional implications, making the former sellers of CUCs better off and the former purchasers (and their clients) worse off. While such re-distributions can be offset through bold yet temporary fiscal means, the sustainability of the unification in the medium-term will require comprehensive fiscal reforms (more on this below).

Second, the spread between the two exchange rates in Cuba, at 2,300 percent, is by far the largest in post-World War II Latin American history. This implies that there is a significant risk that the pass through effects of the depreciation of the CUC rate may unleash a wage-price spiral. To avoid it, a premium will need to be placed on maintaining a very tight control over monetary expansion during and after the unification.

Third, the Cuban the government can exert control over the actions of public enterprises arguably more than in other countries. This may complicate some things and facilitate others. The materialization of efficiency gains would require a sufficiently elastic supply response (in the form of decisions to increase investment and production) to the changes in relative prices. But this supply elasticity depends on the quality of relative price signals and on the responsiveness of decentralized economic actors to such signals (and to other market incentives), both of which are likely to be weak or sluggish in the large state sector of the economy. On the plus side of the ledger, however, the control of public enterprises by the government can also help limit price increases on the most basic goods during the transition (more on this below).

Fourth, Cuba has limited access to international finance. This is an important further complication. Indeed, concessional finance, if available, could facilitate unification by allowing expenditure to exceed income during the transition.

Exchange Rate Unification Options

In view of the constraints mentioned above, *the key challenge for Cuba is to balance the short-term reallocation pains of the exchange rate unification with its medium and long-term efficiency gains.* Over time, by boosting the size of the cake, efficiency gains should provide plenty of room to offset the initial reallocation pain. Thus, in the end, unification should be a win-win for all. Indeed, the achievement of such efficiency gains is the *raison d'être* of unification. The problem is that the size of the cake is likely to be largely given in the short-term, as the increase in the capital stock (including in foreign direct investment—FDI) and reallocation of resources that are required for efficiency gains will likely take time to materialize. Thus, unless cushioned in some way, the raw initial impacts of unification (fiscal revenue losses, productive dislocations, inflation outbursts, and regressive distributional effects) could be quite painful.

A successful transition strategy should thus pursue two objectives. First, to limit the short-term pains until efficiency gains materialize and come to the rescue. Second, to boost the pace at which such efficiency gains materialize. The extent to which these two objectives are fulfilled should therefore provide the basic measuring rod with which to compare and rank available unification options. We distinguish four typological options.

Option One may be labeled *raw big bang*. It consists in unifying the exchange rates on day one. To limit initial income effects (hence balance of payments and foreign exchange market pressures), the CUP rate would remain unaltered—that is, the rates would be unified the rate of 24 (new) pesos per dollar. The elimination of the CUC exchange rate would thus imply that all exchange transactions would thereafter take place at the single new rate. The main advantages of this option are its simplicity and initial credibility. It can be implemented with the stroke of a pen. Moreover, by doing the whole adjustment up-front and not leaving anything hanging, it would signal at once the authorities' full commitment to unification. On the minus side, however, it does not address at all the objective of mitigating the pain while efficiency gains materialize. The one time devaluation of the CUC rate would have large up-front fiscal, redistributive, reallocation, and inflationary costs. The economic and political consequences could thus be so traumatic as to render the whole experiment unviable.

Option Two can be labeled *sector-by-sector gradualism*. It would consist in gradually depreciating the CUC rate towards the CUP rate on a sector-by-sector basis, that is, in different degrees and at different speeds for different sectors. On the plus side, by spreading the pain by sectors (hence over time), this option would be less traumatic than Option One. In addition, it could give the authorities some scope for experimentation, hence better control over the entire unification process. On the negative side of the ledger, however, this option would also spread the gains over time. By delaying the relative price changes across sectors (hence the supply response) it would limit the scope for efficiency gains. Thus, Option Two would meet the objective of mitigating the pain better than Option One, but at the cost of falling behind as regard the objective of front-loading and maximizing the gains. In addition, the more Option Two seeks to give the authorities a margin of control (i.e., unannounced, discretionary adjustments), the more policy uncertainty it would create, especially because there may be a tendency to postpone dealing with the most distorted sectors. At the extreme, Option Two might even raise doubts as to whether the unification reform will ever be completed. Such uncertainties would likely promote a wait-and-see attitude, thereby further delaying the supply response. Last (but not least), the even greater multiplicity of exchange rates during the transition could further segment markets and distort price signals, impeding in particular the efficient resource allocation across sectors.

Option Three may be labeled *economy-wide gradualism*. It would consist in preannouncing a path of gradual convergence of the CUC rate toward the CUP rate, which would apply uniformly to all sectors, actors, and activities in the economy. By spreading the pain over time, Option Three would be less traumatic than Option One. Because of its economy-wide application, it would be "cleaner" than Option Two, thereby avoiding the additional cross-sector distortions of this latter option during the transition. On the minus side, however, Option Three suffers from similar, albeit less intense, drawbacks as Option Two. It is quite comparable to Option Two in terms of mitigating the initial pain. And while it would do much better than Option Two in terms of front-loading efficiency gains, the materialization of these gains would likely be insufficient to offset the transitional pain. The pain would be of lower intensity but would last over a more prolonged period. Moreover, Option Three carries a risk of policy uncertainty leading to self-fulfilling failure. As in Option Two, by spreading the adjustment over time, investors under Option Three would also be induced to pursue a wait-and-see attitude, just in case the unification's pain would lead to a policy interruption. By postponing efficiency gains, the lack of supply response could further raise transition costs. In turn, by eventually inducing the authorities to abandon the preannounced adjustment path, this could end up validating the initial skepticism and turn it into a self-fulfilling prophecy.

Option Four may be labeled *fiscally-cushioned big bang*. As in the case of Option One, the two exchange rates would be unified on day one at the (new) rate of 24 pesos per dollar. However, to mitigate the initial pain, the shadow taxes and subsidies implicit in the dual exchange rate would be replaced by explicit, revenue neutral, non-distortionary *lump-sum* taxes and subsidies. The latter would apply to each enterprise that is currently conducting any transactions at the CUC rate.[255] Take the example of an enterprise that sold X dollars at the CUC rate during a full calendar year prior to the unification (hence received in exchange X pesos). After unification, the enterprise would now receive 24*X pesos at the unified exchange rate. Hence, on year one after the unification, the enterprise should be subject to a lump-sum tax of 23*X pesos, leaving it with the same X

[255] The amount of, say, the annual subsidy or tax implicit in the exchange rate spread that is received or paid, respectively, by each individual enterprise is known because the central bank keeps records on the amounts of CUCs sold to or purchased from each enterprise.

pesos after the unification as before. The lump-sum tax would then be gradually phased out over a period of n years. For example, the tax might decline to 15*X pesos on year 2, 7*X pesos in year 3, and might be altogether eliminated in year 4. Similarly, an enterprise which benefitted from purchases of Y dollars at the CUC exchange rate during a full calendar year prior to unification would benefit from a lump-sum subsidy equal to 23*Y pesos during a full calendar year after unification. As in the case of the lump-sum taxes, the lump-sum subsidies would then be gradually phased out.

Option Four would maximize efficiency gains because it would allow from the start all economic actors (both old and new) to operate under a new set of relative prices, hence market-oriented incentives. Indeed, provided that appropriate safeguards are put in place (more on this below), the enterprises' decisions on investment and production would be totally unaffected by the lump sum taxes and subsidies. In effect, the virtue of lump-sum subsidies or taxes is that their absolute magnitude does no change with the intensity of production and efficiency-enhancing effort (or lack of effort) of the enterprise in question. Yet, unlike Option One, Option Four would be far more effective in shielding the economy from the transition pains, first by neutralizing them through lump-sum taxes and subsidies and then by offsetting (much if not all of) their impact through efficiency gains. Thus, this option would much better address the pain/gain balance.[256] It does require, however, an adequate and non-trivial preparation, including major concomitant changes in economic policy, as discussed in Section 7. Before doing so, however, in the next two sections we illustrate the basic features of Option Four (*fiscally-cushioned big bang*) by sketching how it would be implemented in the case two key sectors of the Cuban economy: the foreign-managed tourism industry and the sector of importing state enterprises.

The Foreign-managed Tourism Industry

The current system for foreign-owned tourism services entails very large efficiency losses. Because foreign hotel operators must pay for labor in dollars at the CUC exchange rate but the employee receives her payment in CUP, the CUC-CUP spread implies a heavy tax on local labor. Out of every dollar paid by the hotel operator, the worker receives only 1/24 dollars (about 4 cents), with the state retaining the remaining 23/24 dollars (about 96 cents) as a tax.[257] While this arguably allows the Cuban government to capture and redistribute much of the rents from the tourism industry, the tax distorts the allocation of productive resources in a major way and the high labor costs faced by the hotel operator severely discourages job creation, undermines the quality of hotel services, hinders new FDI, reduces tourism inflows, and promotes stealth employment (direct but not legal sale of labor services) in the tourism sector.

A *raw big bang unification* (Option One) would be traumatic on impact because of its major re-distributional effects. As long as average wages remain where they are today (which is likely to be the case if hidden unemployment remains prevalent in Cuba) and hotel prices do not decline (which is likely to be the case as long as competitive pressures do not build up), foreign operators would effectively benefit from rents conducive to large windfall profits. Conversely, fiscal revenues would collapse, thereby undermining the government's ability to compensate the losers and generating (via a widening fiscal deficit) demand-side upward pressures on prices. Foreign operators would have more dollars to repatriate and this would weaken the balance of payments (BOP) to the extent that such repatriation is not compensated by new FDI inflows, which would take time to materialize.

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[256] Unifying at the CUP rate (24 pesos per 1 USD), rather than any other rate, is critical to fully neutralize the initial income effect of the unification, since the lump-sum taxes and subsidies would be computed that rate.

[257] Labor payments are made not directly to the worker but to a state-managed employment agency.

Instead, the windfall gains and losses that would occur under a *raw big bang* could be initially fully neutralized under a *fiscally-cushioned big bang* (Option Four) through a dollar-equivalent lump-sum tax paid by each hotel operator in accordance with the average value of foreign exchange transactions at the CUC rate it conducted over the previous year(s). Once set for the first year, the lump-sum tax would be gradually phased out over a predetermined period according to a preannounced phase-down schedule. Because each operator would have to pay the tax no matter what and the amount to be paid would be independent of what the operator does (or does not do) in Cuba, the tax would be non-distortionary (i.e., it would have no impact on the operator's investment or production decisions). For the system to work, however, the operator should not have the option to default on its tax obligations, for example by selling out its Cuban venture and exiting the country. The simplest way to prevent such default is via internationally binding contracts, so that operators would have to honor their commitments whether they leave Cuba or not.

As long as competitive pressures remain moderate, the exchange rate unification, by lowering labor costs, should boost the *marginal profitability* of both existing investments (i.e., expanded hotel occupation) and new investments (i.e., expanded capacity). Thus, existing enterprises should expand capacity and improve quality of service so as to secure and expand their market share in anticipation of greater competition. On impact (with the current stock of FDI), employment and service quality should rise, thereby raising tourism inflows. As a result, BOP and fiscal pressures should ease. Over time, the new rules of the game should boost new FDI and promote local investment, further benefitting the BOP and fiscal accounts. This would in turn allow for a smooth phasing down of the lump-sum taxes. Over the longer term, labor productivity should steadily increase, allowing for real wages to rise and the real exchange rate to appreciate, much as has happened in other economies in transition.

While the existing hotel operators would not incur any competitive disadvantage (at the margin both new and old would compete under the same plain level field), they could object to the deal by arguing that the lump-sum taxes will erode their *average profitability* looking forward. They could fear that as new entrants come in and/or existing operators start competing more aggressively against each other, hotel prices would fall, thereby eroding their average (after lump-sum tax) profit margins. Yet, there are at least three strong counter-arguments to this line of reasoning. First, because the existing hotel operators can take full advantage of their installed capacity and knowledge of the local market, they should be the main beneficiaries of the initial boost in profitability and can position themselves to take the best advantage of any new business opportunity that becomes available as a result of unification. Second, even if profit margins become compressed due to increased competition, volume increases should offset much, if not all, of the decline in profit margins. Third, even in the worst-case scenario of a transient decline in the average profitability of existing Cuban hotels (due to the payment of lump-sum taxes in a more competitive environment), because the current owners (or managers) of these hotels are mostly large international chains, they should be able to absorb this decline without much impact on their bottom line.

State-owned Importing Industries

Consider now the case of the state-owned importing industries. Again, the current system entails huge efficiency losses. Using the CUC rate for basic imports and the CUP rate for wages amounts to subsidizing basic imports while penalizing the consumption of non-basic imports. While this may contribute to evening out welfare across Cubans, the implicit subsidization weakens the central government's finances, penalizes the employment-generating production of importables and promotes instead the importation of basic finished goods or of the inputs needed to produce them locally, thereby pressuring the BOP. Exchange rate unification should thus result over time in a much improved allocation of resources as enterprises take full advantage of the low local labor costs and other comparative advantages.

However, as in the case of the tourism industry, a *raw big bang unification* could be quite traumatic on impact. This would be the case if the state enterprises responded to the unification as private enterprises would, i.e., by seeking to cut their losses. They would raise prices, thereby triggering supply-side inflation, and cut down on employment in the face of declining demand, thereby exerting contractionary pressures on the economy. While this would improve the BOP and (depending on public finance responses) the central government finances as well, it would raise unemployment and erode the purchasing power of low-paid workers.

Alternatively (and perhaps more realistically), the initial impact under a raw big bang would just affect the public enterprises' accounts and nothing else. The enterprises would continue importing and producing in the same fashion but just run large deficits that would need to be covered by high and now explicit subsidies, as the subsidies implicit in the previous (dual) exchange rate system would come to the surface. The basic problem with this second scenario, however, is that granting such subsidies automatically would fundamentally undermine the central government finances (as the government would no longer receive the income from the exchange rate spread) while taking away the incentives for public enterprises to become more responsive to market signals, cut their costs, and improve their efficiency (business for them would basically continue as usual).

Option Four *(fiscally-cushioned big bang)* would obviate the above problems by replacing the inefficient import subsidy with a dollar-equivalent lump-sum subsidy that initially fully neutralizes the fiscal, BOP, and inflationary impacts of the exchange rate unification. As in the case of the tourism industry, the subsidies would be gradually phased out over a period of years. This would immediately enhance budgetary and public sector transparency. In particular, loss-making enterprises will come out fully into the open. The explicit subsidies should thus help promote accountability and market responsiveness. The fact that the unified exchange rate would apply to all foreign exchange transactions should help enhance competition, hence market discipline and responsiveness. Indeed, all enterprises (existing state enterprises as well as potential new private entrants or emerging public competitors) would operate from the start under the new rules of the game.[258]

This being said, for public enterprises to alter their behavior it is crucial that the unification be accompanied, as soon as feasible, by appropriate reforms of their governance as well as by an in-depth reform of the scheme for subsidizing basic goods. Otherwise, the enterprises could, as in Option one, continue conducting their business as usual. They could simply wait for the government to extend the subsidies indefinitely into the future under the threat of social upheavals induced by across-the-board subsidy reductions leading to price increases. To prevent such outcome, the public enterprises should be initially required, as a counterpart to the subsidies they will receive, to set their *pricing decisions* so as to limit price increases, particularly on the most basic goods (indeed, the subsidies should make stable prices consistent with profitability). At the same time, however, to ensure that efficiency gains do materialize, the enterprises' *production decisions* (i.e., the choice of inputs) should be nudged towards cost minimization and profit maximization. Indeed, this is where the mix of the government's control of public enterprises and market forces should come handy, one focusing on

[258] The option of staggering the *fiscally-cushioned big bang* unification over a period of time on a sector-by-sector basis remains open. Thus, sector A (say, the tourism industry) could enter at once the single exchange rate regime while sector B (say, the state-owned importing industries or the exporting sector) could remain for a little while under the old regime. This option might give the authorities (or the affected enterprises in any given sector) more preparation time where absolutely needed. This would be superior to Option Three (*economy-wide gradualism*) in that, even when applied on a sector-by-sector basis, the non-distortive nature of lump-sum taxes and subsidies would more effectively stimulate decisions to invest and raise production and, hence, yield greater efficiency gains from the outset. As long as all enterprises in any given sector are brought it together into the unification scheme (instead of phasing in only a few, discretionally selected firms within a sector, while leaving other firms within the same sector shielded from competition), the resulting distortions should be limited and the market complications manageable.

(temporarily) stable prices while the other focuses on profit maximization.

However, notwithstanding the efficiency gains obtained over time by enterprises as they reorganize their production under the new market prices, some price increases will become unavoidable as subsidies to enterprises are gradually phased out. A comprehensive reform of the public subsidy scheme will therefore also be needed in due course to limit the social impact of such increases while limiting the fiscal costs of any remaining subsidies. We expand below on both of these key issues.

Habilitating Reforms and Sequencing Issues

As noted, for the fiscally-cushioned big bang approach to work optimally, there is a need for careful preparation, including the introduction (not necessarily before the unification but certainly as soon as feasible) of a number of crucial habilitating reforms. The first area that would require habilitating reforms is the fiscal area. As discussed earlier, the shadow taxes and subsidies implicit in the current dual exchange rate system will first need to be replaced by transitional lump-sum taxes and subsidies calculated for each enterprise affected by the exchange rate unification. Subsequently, however, the lump-sum taxes and subsidies will need to be themselves replaced by permanent, well-designed taxes and subsidies.

On the tax side, the government may need to revisit and adapt the tax system from the perspective of a new long-term, market-oriented environment. This may include first of all revising the taxes that have linkages to the foreign exchange market, such as FDI or trade (import and export) taxation. But it may also involve introducing or touching up for revenue mobilization purposes some domestic taxes such as the value added tax.

On the subsidy side, the government may likely need to introduce a well-focused system of (cash or coupon) transfers *targeted* to the most basic goods and lowest income households. As noted above, unless this is done, the government would probably be facing an unsavory choice between a rapid but socially traumatic phasing-out of the subsidies and an indefinite prolongation of an unwieldy, inefficient, costly (and hence ultimately unsustainable) subsidy scheme.

In all cases, a *healthy fiscal position* would facilitate the transition. A *pre-unification* fiscal surplus could allow the government to accumulate foreign reserves that could subsequently be used to "finance" temporary post-unification BOP deficits. A strong *post-unification* fiscal position would greatly ease monetary control.

At the same time, *public sector governance reforms* would also be essential to ensure that state enterprises become more responsive to market signals. Enterprises should be given market-compatible mandates (i.e., cost minimization and profit maximization) and their performance assessed (and their managers rewarded) accordingly. Based on the newly emerging market prices, accounting practices should be simultaneously revisited to identify unviable state enterprises and facilitate their closure or restructuring. Inter-enterprise claims across balance sheets should be netted out and restructured as needed.

These governance reforms should ideally be accompanied (or followed as soon as possible) by *market-oriented reforms*. In particular, the entry of non-state firms should be encouraged to boost supply, both directly and indirectly (i.e., by exerting competitive pressures on state enterprises). It would also be desirable for efficiency purposes to disengage state firms from intermediating the business activities of private firms and citizens by, for example, allowing companies in the tourism sector that have foreign capital participation to select and hire their workers directly.[259]

[259] Under the fiscally-cushioned unification option, the fiscal loss that would result from allowing companies in the tourism sector to hire employees directly would be fully offset by the fiscal gain associated with the lump-sum tax on these companies.

To maintain inflation under control and allow the exchange rate to play a more substantial buffering role, the scheme will require the gradual *strengthening of the central bank's monetary instruments and management capacity*. This in turn is likely to require reforms to facilitate the gradual development of the interbank and exchange rate markets, as well as a sound and more vibrant financial intermediation.[260]

A flexible exchange rate regime, if feasible from the start, would arguably be desirable, as it would help smooth out the unification process. In the short term, it would help identify the equilibrium post-unification exchange rate and reduce the risks of emerging exchange rate misalignments. Indeed, as firms previously transacting at the CUC rate start to respond to the change in market prices, thereby lowering the demands for imports and raising the supply of exports, some appreciation of the exchange rate is likely to materialize. Over the longer term, further appreciation pressures are likely as efficiency gains translate into purchasing power gains (hence real exchange rate appreciations). A flexible exchange rate system would thus have the benefit of allowing the real exchange rate to appreciate through nominal appreciation rather than inflation. At the same time, it would help absorb external shocks and limit de facto dollarization.

However, a flexible exchange rate regime may not be feasible because the reforms to establish the market and institutional infrastructure necessary to allow an independent monetary policy with exchange rate flexibility will take time to implement, and waiting for these conditions to be in place might excessively delay the unification. Moreover, maintaining a fixed exchange rate immediately after unification might help stabilize expectations at a time of substantial, potentially discomforting changes. It might thus be preferable to first unify the exchange rate system and then move gradually to a more flexible exchange rate system, following a three-phased agenda of monetary reform:

- *Initial phase*: a fixed exchange rate with control of central bank credit expansion and of excess liquidity in the interbank market
- *Intermediate phase*: a flexible (but managed) exchange rate with monetary-aggregate targeting
- *Final phase*: a still managed but more flexible exchange rate with inflation targeting

One final issue to be considered is *currency choice and unification*. As noted earlier, this is a conceptually and practically different issue than the one that has occupied this paper, namely, the choice and unification of the exchange rate. The issue of currency unification arises because Cuba currently has, in addition to two exchange rates, two currencies (the CUC and the CUP) that act as units of account, means of exchange, and stores of value.[261]

When it comes to the issue of currency choice and unification, there are three main options: (i) formally adopting the dollar as the single currency; (ii) maintaining a dual currency system; and (iii) adopting the (new, post-unification) Cuban peso as the single currency. The pros and cons of these three options are as follows:

- *Full dollarization* would be unwise, as it would increase Cuba's vulnerability to adverse terms of trade or other large shocks, especially by magnifying their recessionary impact. It would rely on inflation or deflation as the main channels for real exchange rate adjustment. Given that shocks to Cuba are not necessarily symmetric to shocks to the United States (the country that issues of the dollar), the equilibrium real exchange rate in Cuba would need to adjust in directions that would not necessarily coincide with those needed by the U.S. economy. Hence, under full dollarization, Cuba would lose the option to use its own currency as a policy instrument and shock absorber.

[260] See Vidal and Villanueva.
[261] Actually, Cuba has more than two currencies if the dollars or Euros that Cubans hold in cash are taken into account.

- *A dual currency system*, whereby the new (post-unification) peso coexists with the CUC may have some advantages. In this case, it would be better if CUC bills disappear and the CUC continues to exist solely as an *electronic unit of account* in which bank deposits and loans could be denominated. The CUC would retain the one-to-one relation and convertibility to the U.S. dollar, which would be in turn backed by a currency board arrangement. Maintaining the option of saving and lending in CUCs might help the economy re-monetize while confidence in the new peso builds up. However, as long private citizens prefer dollars in cash, the shift of savings towards CUC-denominated deposits is likely to be limited. Instead, by fragmenting credit and reducing market depth, the dual currency can hinder and delay the process of strengthening monetary management. At the same time, as long as state enterprises continue to be the main depositors, there is little risk of a depositor flight into dollar cash.
- *Full peso-ization* is therefore arguably the preferred option. It would imply that, simultaneously with the exchange rate unification, all CUC are mandatorily converted into new pesos.

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