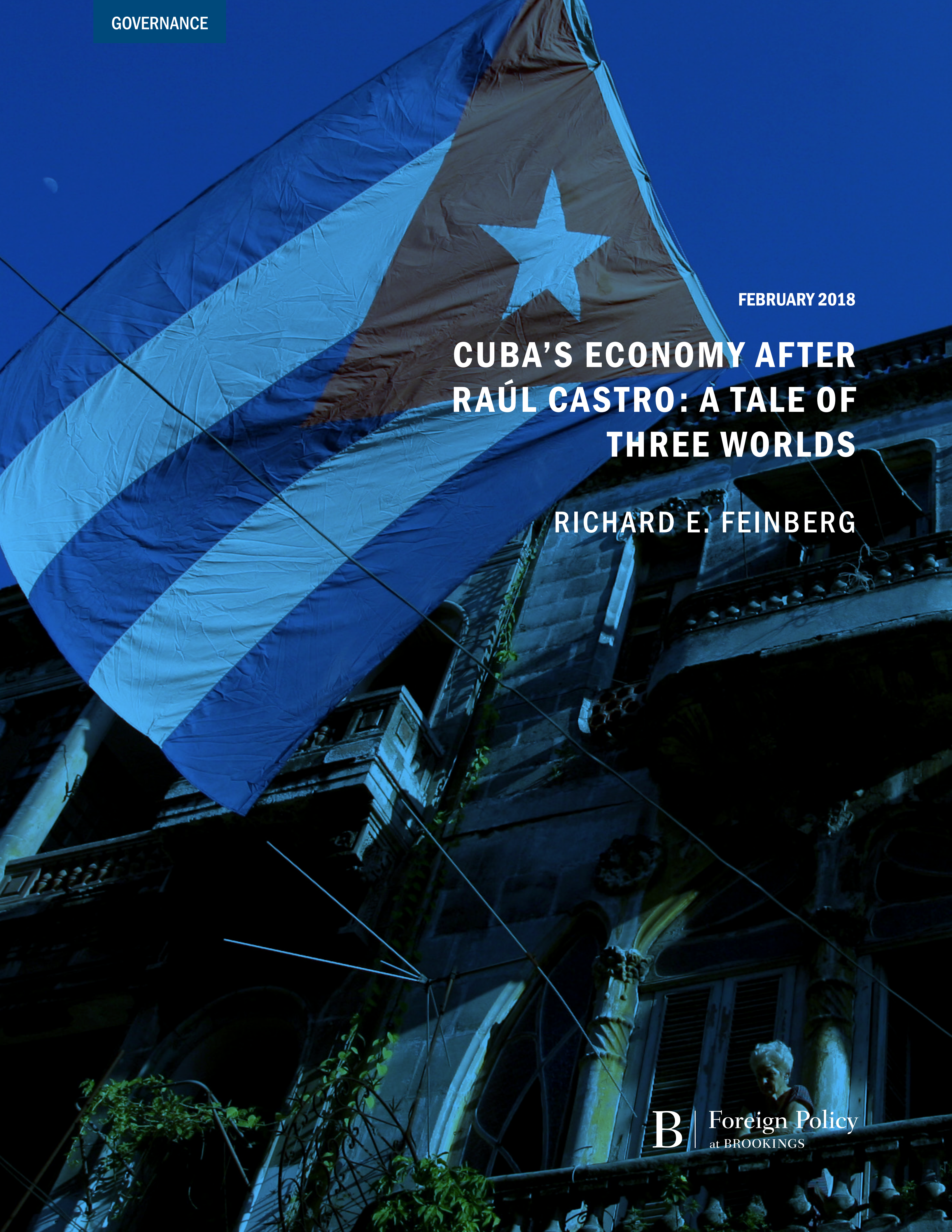

GOVERNANCE

FEBRUARY 2018

CUBA'S ECONOMY AFTER RAÚL CASTRO: A TALE OF THREE WORLDS

RICHARD E. FEINBERG

Foreign Policy at BROOKINGS

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EXECUTIVE SUMMARY

As Raúl Castro steps down from the Cuban presidency in April 2018, many Cubans are more interested in the country's future economic performance than in the retelling of heroic histories. During the decade of Castro's administration, Cuba's macroeconomic performance has been deeply disappointing—but this malaise obscures the emergence of a more complex, diversified economy. The private economy has taken off, providing jobs and income to as many as four out of 10 Cubans of working age. Qualitatively, the private economy has advanced from fragile microenterprises to more ample small-scale businesses engaged in substantial capital accumulation. Furthermore, international tourism, with the active cooperation of global partners, is another bright feature.

In the tourism sector, the creative hybrid blend of state enterprise, international partner, and national private entrepreneur is, in its proportions, uniquely Cuban. It suggests a model—tripartite-guided growth *à la Cubana*—that could be applied profitably elsewhere in the economy, particularly in two prominent if lagging sectors: energy and agriculture. Currently, non-discretionary spending on essential imports of energy and foodstuffs consumes Cuba's already meager hard currency export revenues. Yet, the island has the natural capacity to develop more sustainable national models in energy and food.

The government has gradually recognized the essential contributions that international firms can make to Cuban development—including in energy and agriculture—even if authorities have been slow to recognize that many complementary reforms will be required to create a sufficiently attractive business climate. If not in its first hundred days, then in the first few years, the incoming administration has an opportunity to redefine Cuba's economic role in the world, with a more coherent, consistent, and affirmative outlook.

Specifically, this policy brief suggests a series of realistic if ambitious economic reforms to build on gains in the domestic private economy and international tourism, to attract more foreign investment, to add new dynamism to the critical sectors of energy and agriculture, and to ameliorate growing inequalities in opportunities and incomes. The paper concludes with some thoughts on the political economy of reform and offers indicators to watch for future economic performance.

INTRODUCTION

When Raúl Castro steps down as president of Cuba in April 2018, a post-revolutionary generation will emerge for whom the 1950s battles in the Sierra Maestra Mountains are fading mythologies. Today, many Cubans are more interested in future economic performance than in the retelling of heroic histories, in better opportunities to improve the well-being of their families and communities. Will the new administration in Havana, once it gains its sea legs, possess the political strength and courage, the imagination and competence, to shake the dormant economy free from its prolonged doldrums and implement a series of bold, forward-looking reforms?

During the decade of Raúl Castro's presidency (2008-18), the overall performance of the Cuban economy has been deeply disappointing. Persistent shortages of consumer staples, energy rationing, and price inflation are features of daily life. Take-home pay in many public sector jobs fails to cover basic household needs (even taking into account various government consumption subsidies). Accordingly, the rapid pace of outward migration and brain drain is badly depleting the workforce.

This macroeconomic malaise, however, obscures the emergence of a more complex, diversified economy. Despite confronting many official restrictions, the private economy has taken off, providing jobs and income to as many as four out of 10 Cubans of working age.[1] Qualitatively, the private economy has advanced from fragile microenterprises to more ample small-scale businesses engaged in substantial capital accumulation. This heady growth of the private economy has struck fear in the state sector, such that in mid-2017 the government responded by curbing the issuance of new business licenses and threatening tough new restrictions on existing private enterprises.

International tourism is the brightest feature of the Cuban economy. Tourism arrivals more than doubled during the decade of Raúl Castro's rule, even if U.S. travelers became less common on Havana's streets in late 2017, as the Obama bump gave way to a Trump dip.[2] Tourism spending rippled throughout the economy, providing good incomes (salaries, bonuses, and tips) to employees of government-owned tourism establishments as well as to the private tourism economy (guest houses, private restaurants, building cooperatives, tour guides, taxis). The relative success of the tourism sector holds lessons for the rest of the economy.

Cuban authorities publically recognize that future growth will require very significant inflows of capital, technology, and marketing expertise. By themselves, Cuba's anemic domestic savings and investment rates are too slight to replace depreciated equipment, much less drive dynamic growth. Under the leadership of Raúl Castro, the government has gradually recognized the critical contributions that international firms can make to Cuban development, even if authorities have been slow to recognize that many complementary reforms will be required to create a sufficiently welcoming business climate.[3]

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1 Richard E. Feinberg, *Open for Business: Building the New Cuban Economy* (Washington, DC: Brookings Institution Press, 2016), table 6-1, 137.

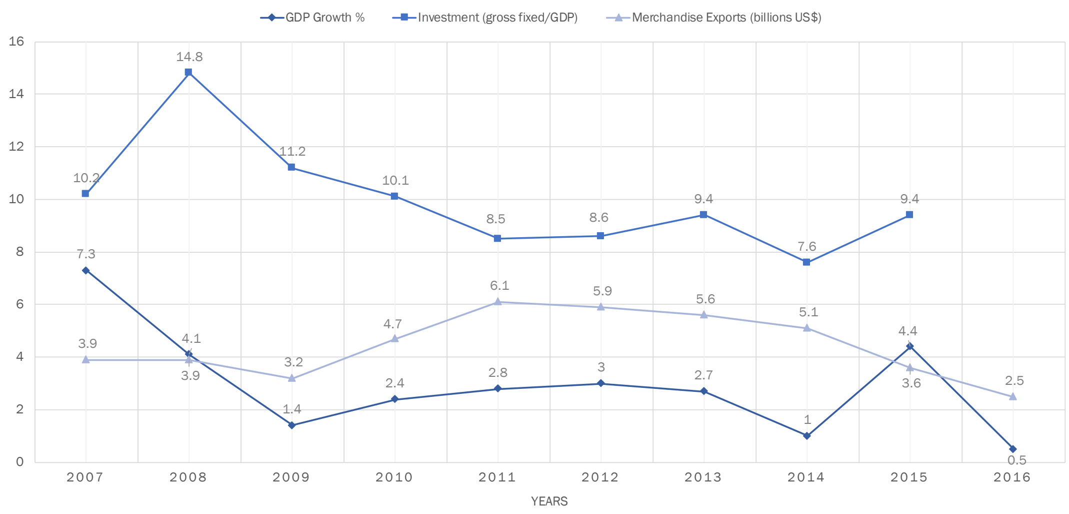
2 For a concise summary of recent gyrations in U.S.-Cuban relations by a Cuban analyst, see Elier Ramirez Canedo, "Logros y frustraciones a tres anos del 17D," *Juventud Rebelde*, December 17, 2017, http://www.juventudrebelde.cu/internacionales/2017-12-16/logros-y-frustraciones-a-tres-anos-del-17d. On the Obama era, see Margaret E. Crahan and Soraya M. Castro Marino, eds., *Cuba-US Relations: Normalization and its Challenges* (New York: Institute of Latin American Studies, 2016). Also, Ted Piccone et al., "Reactions to Trump's Policy on Cuba," *Brookings Institution*, June 20, 2017, https://www.brookings.edu/blog/order-from-chaos/2017/06/20/brookings-experts-react-to-trumps-policy-on-cuba/.

3 Richard E. Feinberg, "What Will be Raul Castro's Legacy?" *Brookings Institution*, December 4, 2017, https://www.

Together, the emergence of a private economy and the recognition of the potential contributions of international investors suggest a new model for Cuban development: a hybrid economy with three strong but interconnected legs of a stool. In collaboration and competition, the state economy, international capital, and the private economy can combine to generate tripartite-guided growth *à la Cubana*.

Steeped in an ideology of egalitarianism and social solidarity, Cubans are rightfully concerned about widening income gaps. But the answer cannot be a reversion to shared poverty. Rather, the strong Cuban state has the power to correct the inequalities that markets tend to generate, to create a socially acceptable distribution of wealth and income that is consistent with a model of inclusive sustainable development.

FIGURE 1. MACROECONOMIC PERFORMANCE



Source: ONEI, "Anuario Estadistico de Cuba," (Havana: ONEI, 2017), Tables 5.1, 5.16, 5.17, http://www.one.cu/aec2016.htm.

One challenge deserves special mention: the importance of reforming the dual monetary and exchange rates systems.[4] Cuban state workers receive wages in "national currency" (moneda nacional), the Cuban peso (CUP), whereas the international sector exchanges the "hard currency," Cuban Convertible Currency (CUC). The official exchange rate is 24 CUP equals 1 CUC. In his December 2017 end-of-the-year speech before the National Assembly, Raúl Castro explained the many severe distortions generated by this dual currency system and raised expectations once again of currency reform.[5] In

brookings.edu/blog/order-from-chaos/2017/12/04/what-will-be-raul-castros-legacy/.

4 On monetary reform, see Augusto de la Torre and Alain Ize, "Exchange Rate Unification: the Cuban Case," in *Cuba's Economic Change in Comparative Perspective*, eds., Richard E. Feinberg and Ted Piccone (Washington, D.C.: Brookings Institution, 2014); Pavel Vidal, "Desafios monetarios y financieros," in *Miradas a la Economia Cubana: El Proceso de Actualizacion* (Havana: Editorial Caminos, 2012), 97-112; and Pedro Monreal Gonzalez, "Un Programa de Estabilidad Economia para Cuba," *Cuba Posible*, November 14, 2017, https://cubaposible.com/programa-estabilidad-economica-cuba/.

5 "In this period, efforts have been reinforced and intensified with greater comprehensiveness and scope, such that we are capable of, at the same time that we unify the currency system, overcoming the existing distortions in terms of subsidies, prices, and wholesale and retail rates and, as is logical, pensions and salaries in the state sector of the economy.

"No one can calculate, not even the wisest of the wise among us, the elevated cost that the persistence of the dual currency and exchange system has meant for the state sector, which favors the unfair inverted pyramid, where greater the past, the government has repeatedly stepped back from monetary overhaul, fearing destabilizing inflation and bankruptcy of inefficient firms, potentially fueling social unrest. Nevertheless, monetary reform will be a vital step forward, but by itself will not resolve the many other fundamental problems confronting the post-Castro administration. As Raúl recognized, "the elimination of the dual currency and exchange system by itself will not magically resolve all the accumulated problems in the Cuban economy." Nor will monetary reform outline a model for future development, to guide reform efforts.

STAGNATION IN THE STATE ECONOMY

Even if we accept the official statistics, the performance of the economy has been very disappointing. During the decade of Raúl Castro's rule, average GDP growth registered 2.4 percent per year, with a tendency toward stagnation at 2 percent per annum (Figure 1).[6] As government officials have recognized, this is less than half of the minimum of 5 percent annual growth necessary for Cuba to attain a sustainable growth path.

This chronic stagnation was widespread throughout the state economy.[7] Production in the agricultural sector, which still employs 13 percent of the labor force, was at or below levels attained in 2005 for many crops (Figure 2). In the energy sector, domestic oil production was lower in 2016-17 than it had been a decade earlier. Despite recovery in some areas, industrial production remained below 1989 levels. In the mining sector, nickel production (Cuba's single largest commodity export) has also fallen. Just as distressing have been the extraordinarily low rates of national savings and investment, at around 10 percent of GDP (Figure 1), half of the Latin American and Caribbean average of over 20 percent. Cuba's capital stock continues to deteriorate, contributing to chronic breakdowns, delivery delays, shortages, and shoddy merchandise.

The persistent stagnation in the Cuban economy has occurred during a decade in which much of the rest of the world has zoomed ahead. In information technologies but also in industry, agriculture, and financial services, the frenetic pace of technological and managerial innovations has accelerated, leaving Cuba further and further behind.

Especially disconcerting has been the precipitous decline in Cuba's merchandise exports, itself a reflection of the stagnation in domestic production and competitiveness. Merchandise exports have collapsed to under $3 billion (2016), below 2006 levels (Figure 1). This despite the government's repeated call for export expansion (and import substitution). For some years, the willingness of Venezuela to barter oil for Cuban

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responsibility is met with lower compensation, and not all capable citizens are motivated to work legally, while the promotion to higher positions of the best and most skilled workers and cadres is discouraged, some of whom migrate to the non-state sector.

"I must admit that this matter has taken us too long and we cannot delay its solution any longer."

For the full remarks, see Raúl Castro Ruz, "We are here, and will remain, free, sovereign and independent," *Granma*, December 22, 2017, http://en.granma.cu/cuba/2017-12-22/we-are-here-and-will-remain-free-sovereign-and-independent.

6 However, some private sources suggest still lower growth rates. For example, The Economist Intelligence Unit estimates GDP growth for 2016 at -0.9 percent and for 2017 at -0.4 percent (versus the official estimate of a positive 1.6 percent), and forecasts 1.3 percent for 2018. See The Economist Intelligence Unit, "Cuba: Country Report," (London: *The Economist*, December 8, 2017), 9. See also Pavel Vidal Alejandro, "Que Lugar Ocupa La Economia Cuba en la Region?" (Washington, DC: Inter-American Development Bank, 2017), https://www.iadb.org/es/investigacion-y-datos/detalles-de-publicacion,19539.html?pub_id=IDB-PB-269.

7 For a good review, see Ricardo Torres Perez, "Updating the Cuban Economy: The First 10 Years," in *Cuba: Looking Toward the Future*, eds., William LeoGrande and Arien Mack (New York: Social Research: An International Quarterly, 2017), 255-76.

medical personnel at above market value inflated Cuba's service exports and helped to balance Cuba's current account. As this cushion is deflating, Cuba is experiencing a severe, debilitating balance of payments crunch. Authorities have had to slash imports, from a peak of nearly $15 billion (2013) down to $10.4 billion (2016). This import contraction explains growing consumer scarcities while restrictions on the importation of capital goods continue to depreciate the already exhausted capital stock.

These failures to increase production, whether for domestic or international markets, manifest the government's inability to reform the state economy (the government has deprived the private sector of channels for exporting its merchandise).[8] One good indicator of stagnation in the state economy: state sector consumption of electricity remained flat from 2000 to 2015 (while electricity consumption by the residential sector, which captures some private economy activity such as private restaurants and guest houses, doubled).[9]

Over recent decades, numerous plans, resolutions, and regulations have aimed at improving the efficiency of state-owned enterprises (SOEs). An entirely new organizational level, Superior Organizations of Business Management (Organizaciones Superiores de Direccion Empresarial, or OSDE), was inserted to provide a cushion between the state ministries and the SOEs—adding yet another layer of bureaucracy and delay.

There are several explanations for the inertia of the state economy. As economic entities, SOEs are largely shielded from price signals (currency reform may help in this regard), and rarely suffer market sanctions in the event of failure. At the level of the individual, managers are not adequately rewarded for taking risks or pursuing innovations; workers receive sub-subsistence wages (who can live on $30 a month, even taking into account various state subsidies?), resulting in large-scale pilfering and black market activities, or moonlighting a second job in the private sector.

But the most powerful explanation for the resistance of the state economy to reform is the most obvious one: Cuba remains a hyper-centralized state where all power concentrates at the very top of the decisionmaking pyramid. The state apparatus and Communist Party of Cuba (PCC) coincide in the Council of State and the overlapping Political Bureau of the PCC (and the senior reaches of the armed forces). Important decisions, and many not so important, must receive the stamp of approval at these most senior levels. Executives at SOEs are accustomed to receiving detailed annual instructions for managing their enterprises. They are neither accustomed to taking initiative nor sufficiently rewarded for doing so. Every foreign investment, even at the supposedly more streamlined Mariel Economic Development Zone (ZEDMariel), has required the sign-off of the Council of Ministers, and often it seemed of Raúl himself.

The same hyper-centralization has also frustrated numerous efforts to decentralize decisionmaking and resource allocation to local governments (provinces and municipalities).[10] Undertrained and understaffed, local officials struggle to take on new

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8 On reform of the state sector, see Ileana Diaz Fernandez, "Los cambios en la empresa estatal cubana en el contexto de la actualización del modelo," *Cuban Studies* 44, (2016): 112-132.

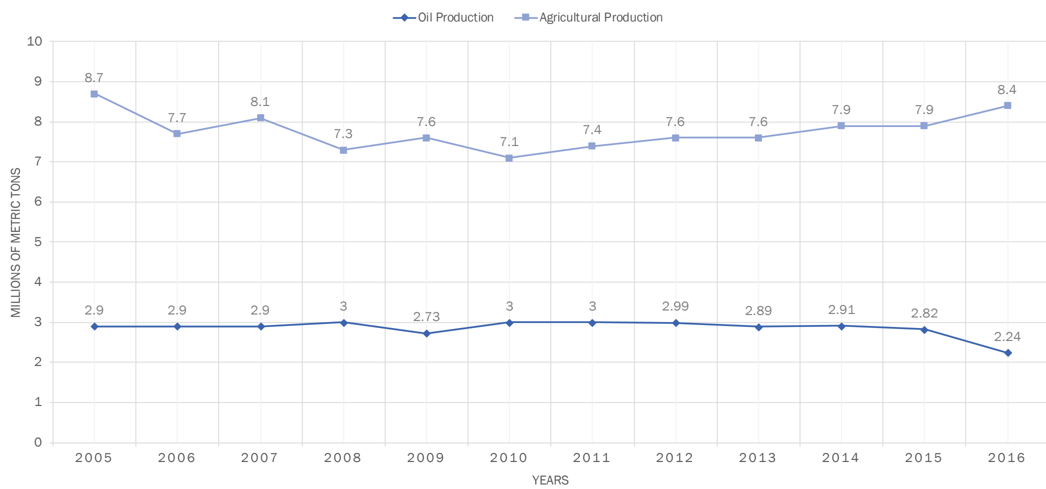
9 Jorge Pinon, "Cuba Energy Report 2016," (PowerPoint presentation, University of Texas at Austin, January 2017), slide 20. See also Oficina Nacional de Estadísticas (ONEI), "Anuario Estadistico de Cuba 2015," (Havana: Mineria y Energia, 2016), Table 10.19.

10 On political decentralization, see Yailenis Mulet Concepcion, *Hacia una Decentralizacion con Transparentes Derechos de Propiedad en Cuba*, (book manuscript, forthcoming); Luisa Iñiguez, "Desigualdades territoriales y ajustes económicos en Cuba," in *Miradas a la Economía Cubana: Desde una Perspectiva Territorial*, eds., Omar Everleny

responsibilities; but more fundamentally, local institutions have also lacked the authority and resources to give real life to aspirations of regional decentralization. Power and money have remained in the hands of senior bureaucrats and PCC officials in central organizations located in Havana.

The paper will now turn to analyzing the steps Cuba could take to catalyze and reinforce three key components of its economy: tourism; foreign investment, especially in agriculture and energy; and the private sector.

FIGURE 2. SECTORAL OUTPUT



Source: ONEI, "Anuario Estadistico de Cuba," (Havana: ONEI, 2017), Tables 9.9, 9.10, 10.4, http://www.one.cu/aec2016.htm.

I. TOURISM BOOM: A MODEL?

In the state economy, there is a glaring exception to this dismal picture: the boom in international tourism. International tourism arrivals jumped from 2.2 million in 2006 to an estimated 4.7 million in 2017 (Figure 3), with a corresponding increase in tourism revenues (which official statistics underestimate because they do not capture all of the flows into the private sector, especially from under-reporting guesthouses, restaurants, and taxis).

The relative success of the tourism sector suggests an industrial organizational model for the rest of the economy. State enterprises have maintained the lead through Gaviota (part of the GAESA group) and two Ministry of Tourism SOEs (Cubanacan and Gran Caribe).[11] These growth-oriented SOEs have partnered with a total of 19 international hospitality firms, through various combinations of management (87 contracts) and joint venture operations (27 as of the end of 2017).[12] Cuba calls upon the French construction giant, Bouygues, to help construct many of the hotels, most spectacularly the new luxury Kempinski-managed Manzana de Gomez in Havana. The international

Pérez and Ricardo Torres (Havana: Editorial Caminos, 2014); Arturo Rua de Cabo, *Planificacion Territorial* (Havana: Editorial Universitaria Felix Varela, 2014); Yamile Perez Diaz, "Principales Caracteristicas de la Descentralizacion en Cuba," (Havana: Ministerio de Finanzas y Precios, 2003).

11 Richard E. Feinberg and Richard S. Newfarmer, "Tourism in Cuba: Riding the Wave Toward Sustainable Prosperity," (Washington, D.C.: Brookings Institution, 2016), https://www.brookings.edu/wp-content/uploads/2016/11/fp_20161202_tourism_cuba_feinberg_newfarmer.pdf.

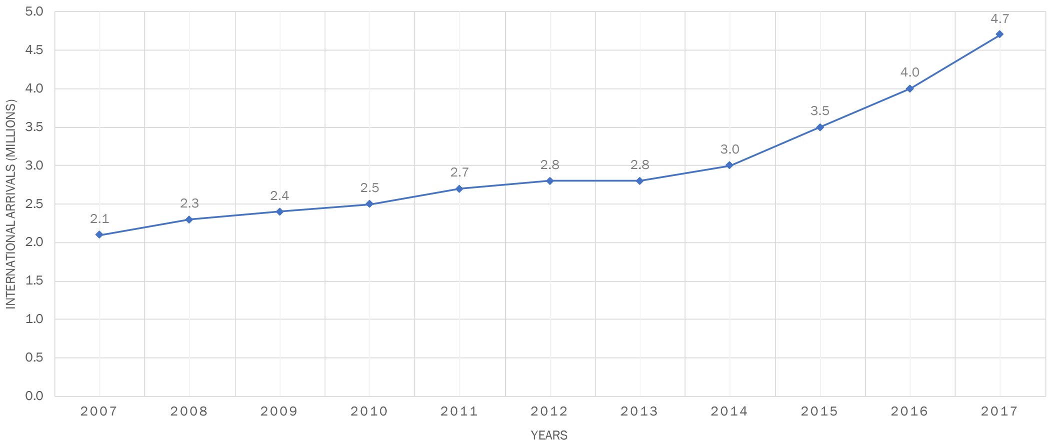
12 Yaditza del Sol Gonzalez, "Un sector que crece y sostiene el desarrollo," *Granma*, December 21, 2017, http://www.granma.cu/cuba/2017-12-20/un-sector-que-crece-y-sostiene-el-desarrollo-20-12-2017-23-12-30.

hospitality partners provide management and marketing expertise, financing for capital investment and merchandise imports, and training for personnel. In addition, the state has allowed the private economy to offer specialized services to tourists: in many cities, private operators now provide many more beds than the formal hospitality sector.[13] Private restaurants are offering cuisine at international standards. The state has transformed the taxi industry, such that drivers now either own or rent their vehicles and are entitled to the profits.

This creative hybrid blend of state enterprise, international partner, and national private entrepreneur is, in its proportions, uniquely Cuban. It suggests a model—tripartite-guided growth *à la Cubana*—that could be applied profitably to other sectors of the economy. The state retains overall control over the pace and patterns of growth (in the case of tourism, the state controls the number of commercial flights and cruise ship passengers), and is able to select a diversity of international partners. The international partners advise on product prices and quality of services (although in tourism, as throughout the joint venture sector, the state has largely retained control over employment and wages). With modest amounts of investment capital, individual Cubans and their families have demonstrated their entrepreneurial spirits and talents in meeting consumer demands.

Looking forward, and following this same hybrid organizational model, Cuba can upgrade the quality of its tourism services through greater expenditures on manpower training and building upscale boutique hotels, and broaden its tourism offerings, for example in eco/adventure tourism, health tourism, and cultural tourism. The tourism sector's efficiency and international competitiveness could be enhanced by revamping pricing incentives regarding critical inputs, particularly labor, agriculture, and imports. Here again, monetary unification would enhance the value of price signals and improve allocative efficiencies.[14] Overall, a healthy tourism sector can generate larger and larger surpluses that can help to fuel economy-wide growth.

FIGURE 3. INTERNATIONAL TOURISM ARRIVALS



Source: ONEI, "Anuario Estadistico de Cuba," (Havana: ONEI, 2017), Table 15.1, http://www.one.cu/aec2016.htm.

13 Official sources counted 24,217 rooms in private guesthouses at the end of 2017, as compared to some 68,000 rooms in government-owned hotels, many of which are located on beach resorts. See Ibid.

14 Feinberg and Newfarmer, "Tourism in Cuba."

II. FOREIGN INVESTMENT: DRIVER OF STATE REFORM

In a 2011 official document outlining proposed reforms, foreign investment was derided as "complementary," a secondary afterthought. In contrast, when addressing Havana's annual international trade fair in 2017, Raúl's minister for foreign trade and investment, Rodrigo Malmierca, sang a very different tune: "Today foreign investment ceases to be a complement and has become an essential issue for the country," suggesting a target of $2.0-2.5 billion per year.[15] The former minister of the economy and still head of the Commission for Implementation and Development, Marino Murillo Jorge, places increasing foreign investment as among the government's top four priorities.[16] However, so far actual performance has fallen far short. Especially disappointing has been progress at the ZEDMariel. Of the 30-odd approved investments, most appear to be small logistical firms or representative offices.[17] The major announced investors so far—Unilever, Nestle, Brascuba, and Ambev—are firms not new to Cuba; these multinationals were looking to expand their on-island operations even without the additional Mariel incentives.

To increase foreign investment inflows, the government has vowed to accelerate the frustratingly slow bureaucratic approval process.[18] Nevertheless, the problems lie deeper, in ideology, senior personnel, and incentives.[19] Ideologically, Cubans are proud of their national identity but many also recognize the benefits of greater engagement with the outside world; however, Cuban authorities have lagged behind. The incoming administration—if not in its first hundred days then in the first few years—has an opportunity to redefine Cuba's economic role in the world, with a more coherent, consistent, and affirmative outlook, and more in line with popular opinion increasingly informed by internet access and overseas travel experiences.

The new administration could fully embrace partnerships with international firms (vetted in accordance with Cuba's national interests). Most importantly, the new administration can appoint fresher faces that articulate this unambiguous embrace. Where Cuba lacks the expertise to negotiate international partnerships with confidence, it could profitably engage the services of reputable consulting and investment firms.

Incentives facing the authorities who negotiate and approve foreign investments should be aligned to growth objectives; officials who approve good projects should receive rewards, not threats of "anti-corruption" investigations. And slow-gestating "pilot projects," where technologies have already been proven in innumerable international investments, could be amped up with a much greater sense of urgency and scale—especially in the critical sectors of energy and agriculture.

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15 Authorities have vacillated as to whether those goals are for investment commitments or actual capital inflows. When considered as a contribution to domestic savings and investment or as contributions to the balance of payments, recorded capital inflows would be the more appropriate measurement.

16 Marino Murillo Jorge, "Remarks before the National Assembly," (speech, Havana, December 21, 2017). However, "The Plan de la Economia 2018" projects foreign investment for 2018 at only about $600 million (this figure referring most probably to actual capital inflows).

17 The Havana Consulting Group, "Business Report," (Miami, The Havana Consulting Group, June 2017), Figure 2, 27; and "Mariel Special Development Zone," ZEDMariel, http://www.zedmariel.com/.

18 Yudy Castro Morales, "Sacudirle las demoras a la inversion extranjera," *Granma*, December 21, 2017, *http://www.granma.cu/cuba/2017-12-21/sacudirle-las-demoras-a-la-inversion-extranjera-21-12-2017-00-12-02*.

19 The comprehensive U.S. economic sanctions deny U.S. investors access to Cuban markets (with some exemptions carved out before and during the Obama thaw and not yet reversed by the Trump administration). U.S. sanctions also raise obstacles to firms from third countries, but many non-U.S. investors have been successful in Cuba. See Richard E. Feinberg, *Open for Business*, chapter 5.

Another serious obstacle to foreign direct investment (FDI) inflows has been the "control" obsession of Cuban authorities. In the broadest sense, Cuba needs to transit from a command economy to a more modern regulatory state, but this transformation will take many years. More immediately, Cuban authorities could lessen their control over related labor and input markets. In accordance with equity goals, Cuban authorities can set wage guidelines, but joint ventures should be empowered to directly hire employees and offer performance-based remuneration packages (positive steps in this direction are reportedly being taken at ZEDMariel). Joint ventures could also have more control over organizing their supply chains and, as is being allowed in the hospitality sector, be able to partner directly with the private economy (including cooperatives).

Outside of tourism and mining, joint ventures have generally not entered export markets because production costs are not competitive. Wages earned by Cuban workers are low enough; the problem has been the 95 percent tax extorted by government employment entities on payments made to them by joint ventures. The blatant exploitation of wage labor by the state discourages foreign investment and should end. Export competitiveness can also be enhanced by improving a range of infrastructure services, from energy supply and pricing, to IT access, to transportation grids, including airports, seaports, railroads, and highways—all of which will require financing and hence international participation.

Rather than perceiving FDI as a dangerous competitor to the state economy, SOEs should recognize FDI as the necessary driver of state modernization and internationalization. Over several decades, the state economy has resisted efforts at efficiency reforms, even when senior officials have publicly advocated on their behalf. Painful experience confirms that the state sector will not adequately reform itself solely from within; rather it will take external pressures—such as from joint venture partners—and incentives to drive reform. The goal could be for every large SOE (say, over 100 employees) to "marry" an international partner (allowing for exemptions for national security), even as the terms of each deal will vary, from management associations, to 50/50 joint ventures, to allowing the foreign partner majority control.

An alternative would be out-and-out privatization (so far ruled out by Cuban authorities). But Cuban SOEs are so in need of fresh capital and very few Cubans would be in a position to purchase significant shares, resulting in massive sell-outs to foreigners (or Cuban-Americans). This could generate a rapid denationalization of the Cuban economy, open the doors to widespread corruption, and elicit a political backlash. The partnership approach promises greater political control and social stability, and in the longer run, a stronger national economy.

To summarize, a pro-foreign investment strategy could include:

- Clarifying the government's pro-FDI outlook, abbreviating the bureaucratic approval process, and incentivizing officials to sign and execute deals.
- Appointing new senior officials that unambiguously embrace a new Cuban internationalism.
- Empowering joint ventures to have more control over their labor markets and supply chains.
- Improving international competitiveness by, among other means, fostering investments in basic infrastructure across the island.

- Encouraging all large SOEs to "marry" an international partner.

Priority sectors for growth-oriented reform: Agriculture and energy

Non-discretionary spending on essential imports of energy and foodstuffs quickly consume Cuba's hard currency export revenues; food imports alone consume some $1.7 billion per year, or over half of merchandise export earnings.[20] These evident threats to national security have endured for many years, without eliciting corresponding corrective measures. To equate supply and demand, the authorities have in effect depressed energy and food consumption, through combinations of rationing and high prices, to the detriment of consumer welfare. Yet, the island has the natural capacity to develop more sustainable national models in energy and food.

Agriculture[21]

Cuban agriculture is a disaster. Traveling around the island, one encounters great expanses of uncultivated lands, animal-drawn plows working subsistence farms, and depressed small towns formerly dependent upon shuttered sugar mills. Aging Soviet-era tractors outnumber the occasional shiny new Chinese machinery. For many crops, including sugar, coffee, tobacco, citrus, and fisheries, pre-revolutionary production levels far exceeded today's harvests. The shortfalls of Cuban agriculture place severe strains on the nation's balance of payments, as noted above, and deplete the diets of Cuban families. Food scarcities set up an unhealthy competition between Cuban consumers and the expanding tourism sector.

Experiments with liberalized prices and allowing farmers to directly market portions of their harvests (above government production quotas) began in 1994 during the Special Period depression, with the opening of Mercados Agropecuarios (farmers' markets). However, the anticipated increases in production did not materialize, and in recent years prices of some foodstuffs rose. Alarmed at consumer discontent, Raúl Castro partially reversed course and re-imposed some price controls.

For farmers to respond to higher prices, they would require the critical ingredients necessary to bolster production: more seeds and other material inputs including fertilizers and energy supplies; new machinery to clear, cultivate, and harvest lands brought into production; and more credit and technical assistance. Farmers also depend upon efficient systems of transportation and marketing to collect harvests in a timely and predictable manner. To incentivize investment, farmers would require greater security of land tenure. Yet, the government has failed to address adequately these complementary, vital measures. The resulting imbalances in demand and supply suggest the dangers of partial, halting reforms in systems already plagued by massive distortions, where fixing one problem can all too readily spark additional distortions elsewhere.

Short of wholesale privatization of land, what can be done? To avoid the pitfalls of past partial reform efforts, the government would be wise to proceed with a coherent reform package, bolstered by incentives and resources. A number of studies and commentaries converge around these corrective measures:[22]

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20 In 2017, Cuba imported $1.6 billion in foodstuffs and projects $1.7 billion of imports in 2018. "Plan de la economia 2018," (presentation to the Cuban National Assembly, Havana, December 21, 2017). Cuba imports 60-80 percent of its food. See The Economist Intelligence Unit, "Cuba: Country Report," 20.

21 The author would like to recognize the sage advice from William Messina on this section.

22 On Cuban agriculture, see Armando Nova Gonzalez, "Reforma en la agricultura: lineamientos y resultados recientes," in *Miradas a la Economia Cubana: El Proceso de Actualizacion*, eds., Pavel Vidal Alejandro and Omar

- Restructure the marketing system, giving farmers more direct access to wholesale and consumer markets.

- Clarify that once any farmers—not just certain types of cooperatives and not just for certain products—have met their state-set quotas, they can sell to all buyers, whether in the state, a joint venture, or private economies, and for domestic or international markets.

- Reconsider the tax system (for example, to allow farmers to deduct legitimate production costs from revenues).

- Create new financial mechanisms to provide short- and long-term credits to the agriculture sector (in cooperation with international partners, including interested bilateral and multilateral donors).

- In ZEDMariel and other development zones, create logistical centers for renting and maintaining machinery and acquiring other essential production inputs. Scale up the arrangements with Caterpillar and John Deere to sell and lease tractors to farmers.

- To encourage leasing of fallow lands, further extend leasing limits from 20 years to 99 years (or in perpetuity), and remove the many petty restrictions that inhibit investment, productivity, and innovation.

- To incentivize long-term investments, allow farmers who own their land to sell legally to other private individuals (not just to the state as is the case today), following on the liberalization of residential real estate markets.

Most importantly, the agricultural sector (but not land ownership) would be wide open to foreign investment—as already forcefully proposed, in impressive detail, in the government's "Portfolio of Opportunities for Foreign Investment 2017-2018."[23] This latest edition lists 104 agro-industrial projects (up from 76 in the previous 2016-17 edition) requiring some $2 billion in investment.[24] For example, the official document calls for foreign investment of $151.6 million to "revive, develop and increase production and commercialization of fresh citrus," with an eye toward export markets. These extensive offerings suggest that the government (ministries and state enterprises) fully recognizes the potential contribution of foreign partners to extracting Cuban agriculture from its prolonged stagnation.

So far, there appear to have been few takers. The government could survey potential investors in agriculture and agro-industry to discover the obstacles to investment and then proceed to take remedies. The government could also provide incentives to ministries and state enterprises to execute on these project proposals and require public reporting on efforts and achievements.

Everleny Villanueva, 53-72; and "Cinco economistas intercambian sobre los precios agricolas en Cuba," *El Estado como tal*, October 13, 2017, https://elestadocomotal.com/2017/10/13/cinco-economistas-intercambian-sobre-los-precios-agricolas-en-cuba/.

23 Ministerio del Comercio Exterior y la Inversión Extranjera (MINCEX), "Cuba: Portfolio of Opportunities for Foreign Investment 2017-2018," (Havana: MINCEX, 2017), https://static1.squarespace.com/static/563a4585e4b00d0211e8dd7e/t/59fa0830c8302541485fcbb2/1509558343528/Portfolio+of+opportunities+for+foreign+investment+2017-2018.pdf.

24 Specific investment opportunities are advertised in poultry (chicken, ducks, and quail), pork, cattle, milk (cow and goat), cheese, yogurt, rice, wood and wood charcoal, cacao, coffee, bananas, pineapple, carrots, sesame and peanut seeds, corn and other feed cereals, soybeans, wheat, yucca, fresh vegetables including organics, spirulina, tropical flowers, and various aquaculture enterprises (sugar remains restricted, however).

Energy[25]

When the collapse of the Soviet Union ended shipments of cheap oil, the Cuban National Assembly approved energy plans that emphasized renewables, including sugarcane biomass (bagasse). Small-scale solar systems and micro-hydro plants were installed in rural areas. Fidel Castro also welcomed a Canadian company, Sherritt International, to develop the island's rich nickel resources and to participate, with the state oil and gas company, Cupet, in shallow off-shore drilling and with the state energy company, Union Electrica (UNE), in energy generation and distribution.

Then Hugo Chavez came to power in Venezuela and replicated the Soviet practice of supplying cheap oil for barter (this time for Cuban medical personnel instead of sugar). As a result, despite some success in increasing on-shore oil (mostly low-quality, high-sulfur crude) and gas production (the country now produces around 50,000 barrels per day (b/d), or roughly 30-40 percent of its consumption needs), the Cuban energy system remains heavily dependent upon imported hydrocarbons; about half of Cuba's electric power comes from imported fuel. Earlier aspirations that deep-water drilling rigs would locate commercially viable oil deposits so far have proved illusory. Cuba's energy shortfall persists despite low economic growth (and hence low energy demand) and a small automobile fleet; per capita electricity consumption in Cuba is significantly below the average for Latin America and the Caribbean.

Drenched in tropical sunshine, Cuba should be a natural producer of solar energy. In addition, much of the island's extensive coastline would lend itself to generating wind power. Further, the island has great biomass potential, primarily from sugarcane. But despite years of being officially committed to a future of renewable energy, the country currently only generates about 4 percent of its electricity from renewables, only 1 percent of which is from wind and solar (the larger shares being biomass and hydro).

The government's goal is 24 percent of generation from renewable sources by 2030, with an officially estimated price target of \$3.5-4.0 billion in international investment;[26] even this goal seems rather modest, as many countries and regions (such as the state of California) arguably with no more favorable natural conditions, have ramped up their renewables more rapidly. Cuba is advertising many renewable projects in the "Portfolio of Opportunities for Foreign Investment 2017-2018," as it has done in previous solicitations. But no way will Cuba approach its 24 percent target at the current annual rates of investment.

Why has Cuba not been able to attract more foreign investment into renewable energy?[27] Beyond the generic problems already cited deriving from ideological and bureaucratic barriers, the structure of the energy sector presents special challenges to foreign investors. There is only one buyer on the island, UNE, a vertically-integrated utility. Typical of Cuban state monopolies, it does not release annual financial

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25 Unless otherwise noted, the data for this section are from Michael Panfil, Daniel Whittle, and Korey Silverman-Roati, "The Cuban Electrical Grid," (Washington, DC: The Environmental Defense Fund, 2017), https://www.edf.org/sites/default/files/cuban-electric-grid.pdf?_ga=2.103804675.2068108103.1515271654-477431091.1515271654.

26 Doreen Hemlock, "Cuba's Energy Revolution," *CubaTrade Journal*, (November/December 2017), 40.

27 For a listing of international investments in renewables in various stages of development, see Panfil et al., "The Cuban Electrical Grid," Table 3; and Doreen Hemlock, "Cuba's Energy Revolution." Hemlock underscores that some of the announced projects have not yet secured the requisite international finance. On plans by the European Union, see Ivet Gonzalez, "Inestabilidad petrolera impulse salto de Cuba en energias limpias," *Inter-Press Service*, February 2, 2018, http://www.ipscuba.net/economia/inestabilidad-petrolera-impulsa-salto-de-cuba-en-energias-limpias/.

statements. Most probably, UNE loses money; as the Environmental Defense Fund report concluded, "Even with favorable oil prices and agreements, heavily subsidized retail electricity rates and low productivity at aging centralized power plants likely make it very difficult for UNE to avoid net losses each year." In light of its mandate to subsidize electricity as well as its lack of financial transparency, UNE's credit quality is weak on international financial markets.

To address the island's chronic energy crisis, the authorities could consider the following measures:

- Make UNE the poster child for state enterprise transparency—and hence a good partner for future public-private partnerships *à la* Sherritt. An additional benefit: by releasing detailed financials, UNE would make more transparent the costs and benefits of energy subsidies and facilitate rational policy analysis.

- Change from a system of secret bilateral deals (which make some international firms uncomfortable) to a transparent and open competitive procurement process for energy generation.

- Build on some initial "pilot" alternative energy projects (wind, solar, biomass), where the technology has already proven successful elsewhere, and scale up rapidly.

- Undertake feasibility studies to consider scaling up massively with bagasse, thereby rejuvenating sugarcane (and giving new life to entire regions).[28] Experienced Brazilian firms have long sought to partner in such an ambitious endeavor; the foreign enterprise would provide the capital and technology while Cuba grows the sugar, maintaining ownership of the land. First, however, Cuban authorities must overcome their ideological objections to a foreign presence in sugar.

- Call upon Hyundai—already present on the island—to help further build out the nation's distributed generation grid, which has, among other benefits, resilience to hurricanes. Cuba has diplomatic relations with North but not South Korea. The time has come for Havana to formally recognize Seoul.

- Chinese diplomats and visiting business executives have expressed frustration at Cuba's slow pace of change. Chinese investors could do much more, especially in energy and infrastructure, if they encountered a warmer investment climate.

These measures alone, however, even if enacted quickly and forcefully, might be insufficient to generate the required financial resources. Smartly, Cuba is active in the multilateral Global Environment Fund (GEF), which has funded a small-scale solar energy project. Cuba may be on the verge of gaining eligibility to the extra-regional resources of the European Bank for Reconstruction and Development (EBRD). But the serious resources for infrastructure development, in energy generation and specifically renewables, await in the multilateral development banks, most notably the World Bank, the Inter-American Development Bank, and the Andean Development Corporation.[29]

28 The author is indebted to Jorge Pinon for this insight.

29 Richard E. Feinberg, "Cuba and the International Lending Agencies," *CubaTrade Journal*, (November/December 2017). Among other advantages, IFI membership could also help to mobilize financial resources to ease the pain accompanying monetary reform.

Over the years, Cuban authorities have feigned interest in the major Washington, DC-based international financial institutions (IFIs), but have never signaled serious interest in negotiations. Yet, Cuban national energy and food security now demand action. Traditionally, Cuba has feared that the United States could block membership. Today, the increasing diplomatic isolation of the United States in many international forums may open new opportunities for alert Cuban diplomacy.

III. UNLEASHING THE PRIVATE ECONOMY

In the last decade, the private economy has boomed. The number of authorized self-employed people (cuentapropistas) rose from some 150,000 in 2008 to about 580,000 in 2017, and authorities had approved 439 non-farm cooperatives.[30] But these numbers are just one indicator of the new strength of the private economy. Unable to survive on the wages paid in the state economy, an unrecorded number of Cubans (some with government day jobs, some who have dropped out of the formal labor market) work in the informal sector, in gray area occupations. In the agricultural sector, there are some 200,000 land-lease farmers (usufructuarios) and another 50,000 purely private landowners; to those, some would add members of rural cooperatives, especially the CCS (cooperatives of credit and services, where landowners have pooled their resources). Taken together, up to 40 percent of the labor force has at least one foot in the private economy.[31]

The government does not publish data on investment by the private economy. One major source of investment capital for households and private enterprise is remittances. If we estimate remittances conservatively at $2 billion per year and assume investment rates of 30 percent, the private economy would be investing some $600 million each year (coincidentally, precisely the amount of foreign investment inflows projected by the government for 2018).[32] To that $600 million, we could add an unknown amount of investment from other sources of household savings and from reinvested profits. By making productive use of these various sources of investment capital, the private economy is driving national growth.

Nor does the government break down national output by public-private production. In the tourism sector, Richard Newfarmer and I estimated that the private economy accounts for about one-third of tourism revenues, or some $1 billion per year.[33] For the total economy, Emilio Morales estimated that the private economy generates about 18 percent of the gross income of the economy.[34] Whatever the current breakdown, there is no doubt that the booming private economy has been gaining market shares on stagnant state firms. Indeed, it is precisely these dramatic trends that so alarmed the government that in August 2017 it temporarily ceased to issue new licenses for many previously authorized professions; the authorities said they needed to review business regulations to prevent

30 Marino Murillo Jorge, "Remarks before the National Assembly." Also, ONEI, "Organizacion Institutional," (Havana: ONEI), Table 2, http://www.onei.cu/ryc/organizacioninstitucional/trimestral/Tablas1y2.pdf.

31 Richard E. Feinberg, *Open for Business*, Chapter 6, 131-171.

32 Juan Triana,"Dos décadas de inversión en Cuba: ¿antesala del 'momento chino' de la reforma?" *El Estado como tal*, January 9, 2018, https://elestadocomotal.com/2018/01/09/dos-decadas-de-inversion-en-cuba-antesala-del-momento-chino-de-la-reforma/.

33 Feinberg and Newfarmer, "Tourism in Cuba."

34 Emilio Morales, "Thaw and reforms create a middle class and new balance of power in the Cuban economy," (Coral Gables, FL: Association for the Study of the Cuban Economy, June 2017), https://ascecuba.org//c/wp-content/uploads/2018/01/v27-morales.pdf.

abuses and to forestall the unseemly accumulation of private wealth. Probably the deeper concerns are that a growing private economy could eventually challenge the hegemony of central planning and even the political monopoly of the PCC.

The growth of the private economy is not just in numbers but also in quality. What began as mini-enterprises have, in many cases, grown into genuine small-scale businesses, replete with formal business plans, marketing strategies, significant numbers of full-time and contract employees, and a widening diversity of product offerings. For example, guesthouses have become multi-unit boutique hotels, storefront barber shops have evolved into Miami-style hair salons, and family construction businesses have become cooperatives with dozens of skilled members. Paladares (privately-owned restaurants) have growth from offering informal family dinners to professional establishments serving world-class cuisine.[35] Families with a single ice cream making machine cranking out a few flavors and irregular service have given way to handsome ice cream parlors with dozens of flavors.[36] Potentially, the private economy could stand on the verge of its next wave: toward diversified expansion, as businesses invest in their own value chains, establish new branches or franchises, or diversify into related lines of business—unless the government effectively prohibits such activities.

The private economy has reached a critical mass whereby its own members serve as consumers for its products. At upscale hair salons and ice cream parlors, well-heeled Cubans rub shoulders with expat business executives, diplomats, and in-the-know tourists (even as restrictive measures by the Trump administration have reduced the numbers of U.S. visitors). Advertising agencies, accounting services, private event planners, interior decorators, and day care providers cater to the needs of fellow Cuban entrepreneurs. (Private businesses serving Cuban consumers have proven less vulnerable to the volatility of international tourism.) A healthy, self-reinforcing cycle of production and consumption now characterizes the private economy.

As of this writing, the Cuban authorities were debating a series of new regulations intended to increase official controls over the private economy and constrain the size of private firms. Among the measures reportedly under review: an upwardly-sloping wage scale (whereby wages rise as more workers are hired); capping guesthouses at four rooms (unless specifically authorized); a more complex bureaucratic process for authorizing new business licenses; and monthly reporting by local authorities cataloguing violations. Another measure apparently intended to reduce underreporting of income: mandating that all business revenues and expenditures pass through an account at a government-owned financial institution.

However, Cuba could move in another, more positive direction: fully embrace the private economy and remove artificial restraints. For example, the government could replace its current list of authorized professions with a negative list of prohibited activities, declaring all other legal activities as open for business. In the meantime, the list of authorized activities could include white-collar professions—architects, engineers, lawyers, accountants, economic consultants, and informational technologists, among others. This relaxation of restrictions would reduce the brain drain of talent (to emigration or less-skilled but more remunerative jobs in tourism), while promising quality services to both private and state businesses (including joint ventures).

35 Anya Von Bremzen and Megan Fawn Schlow, *Paladares* (New York: Abrams, 2017).

36 Richard E. Feinberg and Claudia Padron Cueto, forthcoming, *Cuba Trade Magazine*.

The government is also reportedly reviewing the tax regime applied to the private economy. The guiding principles should be to widen the tax base by reducing tax rates and evasion, while creating incentives for investment and job creation. The current upward-sloping tax on labor (whereby labor taxes rise as more employees are hired) is obviously counterproductive.

Other liberalization measures could include the ability to import and export and to have access to wholesale markets. Formal legalization of private businesses would place them on a more solid legal foundation, and among other benefits, would facilitate access to bank and equity finance.

SQUARING THE CIRCLE: SENSIBLE SOLUTIONS FOR SOCIAL EQUITY

Social equality is a founding principle of the Cuban state.[37] Many Cubans, including those generally skeptical of other socialist ideals, are alarmed at the growing disparities of wealth. The government publishes no up-to-date statistics on income distribution, but poverty levels have surely risen, as the result of un- and under-employment, official reductions in social subsidies and welfare stipends, and rising prices.

Especially disconcerting is the decline in quality in what most Cubans see as the jewels of the revolution: health care and public education. The physical structures of hospitals and schools are in stark disrepair and basic tools—medical instruments and drugs, information technology (IT)—are in shockingly short supply. Underpaid medical professionals are fleeing the island and teachers are seeking opportunities outside of the classroom. In doctors' offices and in public schools and universities, well-educated but inexperienced young personnel struggle to fulfill their obligations. While not yet apparent in official statistics, unofficial evidence suggests the quality of social services is being compromised.

Clamping down on the private economy—however politically tempting as a populist measure—cannot be the answer to these social problems. On the contrary, a thriving private economy is a partial answer to social distress—by offering employment, quality services, and paying taxes that can support better public health and education systems. The other classic answer to widening income gaps is progressive taxation. The strong Cuban state can develop the capacity to design and implement a viable, more modern tax system as the source of state financing.

CONCLUSION: THE POLITICAL ECONOMY OF REFORM

Raúl Castro broke important taboos by legitimizing the key concepts of global economic integration, foreign investment, and private initiative.[38] But not all of his colleagues are following in lock-step. Over six decades, the vanguard party has become the rearguard party, lagging badly behind popular opinions and aspirations. The historic task of the successor generation will be to bridge that governance gap—and to give the Cuban population the quality economic governance it so rightly deserves.

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37 For good compilations of recent essays by Cuban social scientists see Jorge I. Dominguez et al., eds., *Social Policies and Decentralization in Cuba* (Cambridge: Harvard University David Rockefeller Center for Latin American Studies, 2017); and Mayra Paula Espina and Dayma Echevarria, *Cuba: Los Correlatos Socioculturales del Cambio Economico* (Havana: Ruth Casa Editorial, 2015).

38 Richard E. Feinberg, "What Will be Raul Castro's Legacy?" *Brookings Institution*, December 4, 2017, https://www.brookings.edu/blog/order-from-chaos/2017/12/04/what-will-be-raul-castros-legacy/.

Economic reform is not easy. It requires a committed political leadership, an empowered team of smart technocrats, and well-prepared bureaucrats able and willing to execute orders. It also requires public support from well-informed and enthusiastic constituencies. Recent reform efforts have suffered from shortcomings in each of these areas.

The Cuban government is accustomed to relying on the PCC and its mass organizations (among labor, women, and youth) as its power base. This strategy ignores the newly emerging forces in Cuban society that could expand the bases of support for reform policies. The growing private economy may compete with some SOEs, but if properly cultivated could become an important pillar of a pro-reform movement (as the Chinese Communist Party has recognized). Educated technocrats in and out of government would likely embrace a reform drive; working with international agencies, the government could initiate a large-scale program of advanced training at overseas universities and institutes in reform-related topics. Similarly, the government has tended to tolerate its cultural elites, striking out only when directly challenged; more positively, the authorities could recognize that many of its cosmopolitan compatriots would embrace policies of economic openness and pluralism.

As the new administration takes charge in 2018 (even as Raúl Castro will remain head of the PCC), observers can watch for these indicators:

- Does the new administration articulate a clear economic reform strategy that is at the same time ambitious but realistic, that sets priorities, and that addresses some of the key issues outlined here, including the tripartite hybrid economy (state and private economies and foreign investment), and declare that higher output in agriculture and energy are urgent matters of national security?
- Does the new administration appoint and empower a dynamic team of reform-minded ministers and senior advisers?
- Does the administration reach out to build constituencies outside of the PCC inner core, to engage the private economy, the educated middle classes, and independent civil society organizations (even as many are already PCC members)?
- Do authorities perceive an expanding private economy as a threat to the state or as a welcome partner in growth?
- Does the government telecommunications monopoly, ETECSA, accelerate broad public access to the internet—critical not only for democratizing information flows but also for economic modernization? If implemented promptly, the reported plans for an undersea fiber optic cable from Mexico to Cuba appear promising.
- Does the government recognize the widening gaps in income and opportunity and therefore accompany disruptive changes with well-resourced measures to assist at-risk populations?
- Does the executive branch pursue political reforms, promised earlier but seemingly sidetracked, to begin to decentralize some political power to the national legislature and provincial and municipal entities? Such political decentralization would reinforce an economic reform agenda.

The new administration in Havana may prefer to move gradually, initially to focus perhaps on monetary reform and on a limited list of low-hanging fruit, as it consolidates its own political position. Even so, it could begin to enunciate its medium-term strategy, to give the population some confidence that a more prosperous future awaits.

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ACKNOWLEDGEMENTS

The author would like to acknowledge these friends and colleagues for their valuable comments on previous drafts of the paper: Jorge Dominguez, Collin Laverty, William LeoGrande, William Messina, Richard Newfarmer, Ted Piccone, Jorge Piñon, and Manuel Alejandro Valdés. The publications of many Cuban scholars, without whose generosity and research this work would not be possible, are recognized as appropriate in the footnotes throughout the paper. Ricardo Cerda-Manzo provided most capable research assistance.

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