

THE IMPLICATIONS OF GOOD GOVERNANCE FOR THE RECONSTRUCTION OF CUBA

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This paper reviews some of the recent economic literature on the role of government in market economies and in economies in transition from central planning to a market structure, and draws implications for the reconstruction of Cuba. After an introductory section which defines governance, the paper discusses how governments have a distinct role to play in advancing good economic performance, overcoming market failures, and promoting equity. Based on the public choice and rational expectations literature, it then discusses the analytical reasons of why the public sector should play a secondary role to the private sector in economic activity. The next section identifies specific areas of government influence where the international experience provides guidance to what constitutes good governance. The final section draws general conclusions and implications for Cuba.

DEFINING GOVERNANCE

For purposes of this paper it is useful to use the definition of governance of the Development Assistance

Committee (DAC) of the Organization for Economic Cooperation and Development (OECD). The DAC defines governance as the use of political authority and the exercise of control in a society in relation to the management of its resources for social and economic development.² The DAC distinguishes three aspects of governance: (1) the form of political regime; (2) the processes by which authority is exercised in the management of a country's economic and social resources; and (3) the capacity of government to formulate and implement policies and discharge government functions. The first aspect of governance falls outside the purview of this paper.³ The economic aspects of this definition encompass the management of public resources as well as the establishment of an economic and regulatory environment supportive of private sector activities.

Governance is an essential element of what North defines as "institutions," which are a key determinant of an economy's performance through time.⁴ Tanzi

1. The views expressed here are those of the author and do not necessarily represent the official views of the International Monetary Fund.

2. *DAC Orientations on Participatory Development and Good Governance* (December 1993).

3. In their comments on this paper at ASCE's Seventh Annual Meeting, Roger Betancourt and Ricardo Puerta argued that the paper should specify what type of political regime was being assumed in the analysis. Betancourt noted that there is an interaction between good governance and regime type and that the omission of this consideration is an important flaw of the paper. It is obvious that there is a relationship between governance and regime type, but I do not believe that the paper is flawed because it does not address the question of what type of political regime is necessary for the implementation of the practices being recommended. I would argue that the paper should be read as a proposal of the measures and practices that countries would need to adopt to improve governmental practices to promote economic development.

4. Douglas North, "Economic Performance Through Time," *American Economic Review* (June 1994). North defines "institutions" as the humanly devised constraints that structure human interaction, being made up of formal constraints (e.g., rules, laws, constitutions), informal constraints (e.g., norms of behavior, conventions, self-imposed codes of conduct), and their enforcement characteristics." North stresses the importance of institutions in defining the incentive structure of economies.

has noted that the collapse of the centrally planned economies and the failures of the welfare state in mixed economies have brought about an in-depth re-evaluation of the role of the public sector in an environment that is much more pro-market than was the case in recent decades.⁵ At the extreme some economists argue in favor of a minimalist state, in which the government should have very limited functions. This view is essentially justified by giving little importance to the possibility of the existence of market failures such as the existence of externalities, public goods, monopolies, and informational deficiencies. However, the retreat of the state from many activities, could lead to many problems such as the growing incidence of crime, the growth of poverty, and a progressively more unequal income distribution.

Adopting a pragmatic approach to what is the appropriate focus of governance, Guitian has observed that “the establishment of an appropriate boundary between the roles, responsibilities and activities of the public and private sectors in the economic areas remain complex, dynamic, and elusive endeavor as ever.”⁶ It remains complex because there are many areas where both sectors interact closely and there exist no hard and fast criteria to determine precisely where public action takes off, or should take off, and private activity begins, or should begin. The interaction between the role of the public and private sectors is dynamic because it varies over time with society’s preferences for public services and its willingness to finance them. Already in Cuba the interaction between the public and private sectors is beginning to change, from a rigid central planning model to one where the private sector begins to play a role in some economic activities. It is difficult in any country to gather a firm consensus about how far should government participate and interfere in the economic progress or to keep at all times the demand for public

services in line with social willingness to pay for them. Nevertheless, every society needs to lay down some demarcation between the government and the rest of the economy as the basis of design and implementation of economic policy.

The World Bank’s *World Development Report 1997* analyzes the role of the state in a changing world.⁷ It concluded that the determining factor behind the contrasting developments among the various regions of the world has been the effectiveness of the state. An effective state is vital for the provision of goods and services, as well as the rules and institutions, that allow markets to flourish and people to lead healthier, happier lives. However, the World Bank stresses that contrary to what many recommended 50 years ago, the state is central to economic and social development, not as a direct provider of growth but as a partner, catalyst, and facilitator.⁸

ROLE OF GOVERNMENTS

Governments have key roles to play in the economy.⁹ There are areas of action which are generally recognized as belonging within the purview of government, such as **defense, justice administration and public works**. But, governments also have an important role to play at the macroeconomic level by adopting **sound macroeconomic policies** to create the basis for price and external stability, sustained economic growth, and high employment conditions. Markets by themselves do not necessarily ensure appropriate levels of investment, particularly in infrastructure, human capital, and research and development. Regulation of financial institutions to enhance their soundness and safety can increase the effectiveness of this important sector of the economy.

Government policies can increase the microeconomic performance of the economy to offset the presence

5. Vito Tanzi, “Government Role and the Efficiency of Policy Instruments,” *IMF Working Paper*, WP/95/100 (October 1995).

6. Manuel Guitian, “Scope of Government and Limits of Economic Policy,” in Mario Blejer and Teresa Ter-Minassian, editors, *Macroeconomic Dimensions of Public Finance* (1997).

7. *World Development Report 1997: The State in a Changing World* (Washington: World Bank, 1997).

8. *World Development Report 1997*, p. 1.

9. For a discussion of areas of government action see Joseph E. Stiglitz, “Role of Government in the Contemporary World,” in International Monetary Fund, *Conference on Income Distribution and Sustainable Growth* (June 1995).

of **market failures**. Governments can play an important role in maintaining and encouraging competition, which not only enhances the efficiency and innovativeness of the economy, but ensures that the benefits get passed on to consumers. On the environmental front, markets by themselves do not necessarily ensure adequate protection of the environment, which is crucial for using resources on a sustainable basis (e.g., beaches for tourism activities). The protection of health and safety of a country's citizens are important determinants of living standards and requires government regulation, for example, on the use of toxic pesticides which though they increase agricultural productivity, at the same time can increase the incidence of cancer.

Concerns about **equity** also call for government action. Even well-functioning market economies may yield outcomes in which large proportions of the population live in poverty. Research has shown that investment in human resources is a key ingredient for economic development and for ensuring a minimum level of opportunity for all members of a society so that they can share in the benefits of economic growth. In this process the government can play a key role. Imperfections in capital markets imply that many poor individuals will not be able to invest in their own education or in that of their children at an efficient level, or that it may be very difficult for them to maintain an adequate level of health care. Policies that enhance the accessibility of education and health to all thus can both increase equality and promote overall economic growth and efficiency.

Stiglitz has pointed out that what goes under the rubric of equity policies should really be thought of as policies to enhance living standards far more broadly.¹⁰ This is particularly true of social insurance type of programs where it is more difficult for markets to provide (or to provide at a very high individual cost) insurance against many of the most important risks individuals face. It is these market failures which at least in part explain the role of government in pro-

viding unemployment insurance, disability insurance, and health insurance (particularly for the aged).

FACTORS THAT LIMIT THE ROLE OF GOVERNMENTS

Notwithstanding the above, in recent decades there has been a growing realization that the role that government can play in the economic area is limited, and that it is easier to have the wrong economic policy to prevent the economy from performing efficiently than the correct policy to guarantee that it will. As noted by Guitian, **public choice theory** has developed a methodology to analyze governmental behavior based on the tools of market economies.¹¹ In the process this theory has contributed strongly to the skepticism with regard to the efficiency of government action and to what extent government institutions can represent the interests of the majority in a society. Public choice theory has also influenced the economics of regulation by focussing on the political elements in regulatory policy. Two main conclusions of this literature are that governments should concentrate in the provision of public goods in their activities and that, more generally, markets represent a more efficient alternative to other governmental endeavors. This literature emphasizes that there is a need to reform the incentive and institutional structures in government to reduce the costs of policy activism and increase government accountability.

While the public choice perspective questioned the role of government, the literature on **rational expectations** has focussed on the role of government policy. It has shed light on the boundaries within which policy can be expected to be helpful. For this purpose, it has stressed two basic interrelated points on the economic policy front. First, unpredictable or erratic policies, because they are hard to diagnose correctly can be very disruptive for the private sector, and second, policy should be thought of as involving the selection of well designed, stable rules of the game. Appropriate policies—interpreted as those that lay out stable norms are necessary for good eco-

10. Stiglitz, "Role of Government in the Contemporary World."

11. Guitian, "Scope of Government and Limits of Economic Policy."

conomic performance but to be sufficient to generate good economic behavior require their internalization in the behavior of economic agents.

Incorporation of the nature of policy into the behavior of private economic agents will reflect its stability which, provided it is progressively confirmed, will endow policy with another necessary characteristic: **credibility**. Policies that establish conditions for sustained economic development require credibility from economic agents. However, policy plans may need to be adapted, for example, because the attainment of economic objectives may require policy variations. Useful though these adaptations may be at times, policy adaptations run counter to credibility and carry, therefore, a cost. On the other hand, inability to alter policy when circumstances clearly call for adaptation can also impair the credibility of its stance and durability. The point is that governments in formulating and implementing their policies need to keep in mind the importance of maintaining credibility on their policies in order to be effective.

These analytical developments as well as the empirical evidence has moved authorities in developed countries to try to replace government activism with stable, credible policies and to the abandonment of counter cyclical policy formulation as a major goal. In developing countries views have undergone radical changes in recent decades. The change in views has involved taking government out of the production and distribution of goods and services which are not clearly public in nature and focussing it instead on the provision of a framework where entrepreneurship can develop, market forces thrive and competition prevail. The change of view has been more drastic in the formerly centrally planned economies as they move to a market based system. In these economies in transition, more fundamental questions arise regarding establishing the boundary between private and public activity.

PROMOTING GOOD GOVERNANCE PRACTICES

The empirical evidence across many countries identifies a number of practices and institutions useful to formulate stable, credible, and good government policies. In general they go in the direction of what Dhonte and Kapur have categorized as going from a patriarchal or centrally planned system to a rule of law socio-political system.¹² The patriarchal system relies on the authority of the patriarch (e.g., the communist party or the head of state) to enforce “law and order” and on “far-sightedness or enlightenment” to ensure predictability. The ruler’s discretion is unrestricted in principle. The rule of law system is basically Hayek’s formulation that government in all its actions is bound by rules fixed and announced beforehand—rules which make it possible to foresee with fair certainty how the authority will use its coercive powers in given circumstances and to plan one’s individual affairs on the basis of this knowledge.¹³

Dhonte and Kapur note that in a patriarchal system, the ruler’s fiat is the organizing principle of activity and the system cannot achieve complete investor confidence, no matter how benevolent it is or appears to be. Predictability in this system is always subject to the limitations imposed by the ruler’s retained right to prey on economic output or arbitrarily alter the allocation of resources. For this reason, such a system can be effective as a means of implementing centralized initiatives, but much less so when it comes to creating a suitable framework for mobilizing decentralized initiatives. It also tends to attract investors who demand a very quick payback on their investments or less desirable investors. In contrast, Dhonte and Kapur believe that a market system preordains the rule of law by ensuring three basic conditions: free entry to markets, access to information, and the objective sanctity of contracts.

12. Pierre Dhonte and Ishan Kapur, “Towards a Market Economy: Structures of Governance,” *IMF Working Paper*, WP/97/11 (December 1996).

13. F.A. Hayek, *The Road to Serfdom*, Fiftieth Anniversary Edition (Chicago: University of Chicago Press, 1994), cited in Dhonte and Kapur, “Towards a Market Economy.”

The Implications of Good Governance for the Reconstruction of Cuba

If the rule of law system is going to substitute for a paternalistic system, there are a number of areas where government action would be fruitful:¹⁴

- Efforts to decontrol prices, liberalize the exchange and trade system, and create a money market where interest rates are market-determined can be identified as key measures that need to be implemented to permit the process of sustainable growth to start. In general, any reform that promotes competition will help reduce the incentives for corruption. The incentives to make payoffs in regimes characterized by multiple exchange rates, quotas, and credit controls are well documented. The experience of the former republics of the Soviet Union shows that efforts should be made to avoid the development of networks of informal and nontransparent arrangements between governments and vested interests. For example, in certain countries preferential treatment has been given to enterprises that have been privatized, or are still under government control, to the detriment of competition and the discouragement of investment. To the extent that the possibility for economic rents is eliminated, the quality of governance is improved.
- Early in the transition process there is a need for judicial and regulatory reform to clarify property rights; provide a legal basis for the enforcement of contracts and civil prosecution, particularly bankruptcy laws; and provide an appropriate framework for private sector activities. Well-designed regulatory systems can help societies influence market outcomes for public ends. Regulation can help protect consumers, workers, and the environment. It can foster competition and innovation while constraining the abuse of monopoly power.¹⁵
- The implementation of strong macroeconomic policies while prices are liberalized. The reduction of inflation can also indirectly improve governance. The lowering of inflation can help clarify the incidence of taxation and the factors that affect resource allocation and income distribution. Stabilization creates more appropriate conditions for investment.
- The rationalization of the public sector and the enhancement of the competencies of all branches of government—executive, legislative and judicial—to facilitate economic decision-making are important steps that need to be taken. A special effort has to be made to reduce the role of the public sector, particularly in the production of goods and services through privatization, liquidation, and restructuring. However, the process of privatization needs to be transparent and closely monitored because the possibilities for corruption are high. The success of a privatization process is enhanced if the acquiescence of employees is obtained and a broad-based ownership is generated. Soft budget constraints should be avoided for the remaining public sector enterprises for fiscal reasons and to avoid unfair and inefficient competition.
- Public sector accountability needs to be strengthened through the promotion of transparency in financial transactions, such as inclusion of extra budgetary transactions and implicit subsidies in the budget, improvements of central bank accounts, bank supervision, and external audits of government and public enterprises which can

14. In recent years the international community has placed an increased emphasis on the need to promote good governance on economic efficiency and growth considerations. What follows reflects the main conclusions reached by international organizations in this area. In addition to the already mentioned *World Development Report 1997*, see the declaration of “Partnership for Sustainable Growth” adopted by the Interim Committee of the International Monetary Fund in its September 1996 meeting and the governance guidance note of the IMF published in the *IMF Survey* (August 5, 1997).

15. The *World Bank Development Report 1997* notes that the regulatory reforms initiated in the 1980s resulted in sustained private investment in Chile’s telecommunications industry, increased service quality and competition, and declining prices. By contrast, dysfunctional regulation of the Philippine telecommunications industry—long privately owned—resulted in underinvestment and poor and high-priced service.

identify areas of poor governance. Civil service reform will be a major issue particularly as low pay levels provide a major incentive for payoffs and secondary incomes. Although this is a difficult problem, linking pension and other benefits to the elimination of corruption have worked in some countries (i.e., a public official only gets his or her pension if he or she retains good standing).

- A modern tax system needs to be adopted with an appropriate combination of direct and indirect taxes, with due concern for tax administration, efficiency, and equity considerations. Government investment should emphasize basic infrastructure and human capital needs to address some of the market failures and equity concerns discussed above. Investment in education is becoming increasingly important as changes in technologies have increased the skill premium. In industrialized countries the changes in technologies themselves have reduced the relative incomes of unskilled workers who have more of a need to acquire better skills. In this context, government has a vital role to ensure access to education which both enhances equality and economic efficiency.¹⁶ The philosophy in many developed countries is that society should provide individuals with the opportunities and resources with which to attain a decent standard of living—provided the individual exercises individual responsibility.
- Mono-banking systems of centrally planned economies where the central bank serves the function of the monetary authority as well as acts as a commercial bank need to be reformed. Commercial banking functions need to be separated from the functions of the old state banks

and a new central bank structure created to encompass monetary, exchange, research, gathering and processing of statistics, and supervisory functions of the financial system. Also, there is a need to establish legislation to permit the establishment of private commercial banks with clear prudential regulations in line with international practice.

IMPLICATIONS FOR THE ECONOMIC TRANSFORMATION OF CUBA

An analysis of the changes being implemented in Cuba to promote investment and economic growth in recent years is beyond the scope of this paper.¹⁷ Some reforms have been attempted such as the liberalization of agricultural markets and the opening of some sectors to foreign investment. However, the reforms have been much too timid and in some cases they have been reversed. Key reforms remain to be implemented. For example, the price mechanism is not permitted to play a role and Cuba still has a rationing scheme for basic consumer goods which promotes black market activities. There are serious limitations to private property and the possibility of the self-employed hiring workers is a matter of serious debate within the Cuban political power structure. A recently-approved foreign investment code exhibits many characteristics of the paternalistic system where the government reserves the right to change the rules of the game.

Overall, the process of rationalizing the public sector is at a very infant stage and its structure is not conducive to public sector accountability. It is clear that many changes need to be made before governance practices in Cuba begin to resemble the practices recommended in this paper. In these circumstances, it is not possible to avoid skepticism about the possible

16. See Stiglitz, "Role of Government in the Contemporary World."

17. For a discussion of the role of government, public sector management, and the legal framework existing in Cuba and how it would have to change in post-Castro Cuba see Ernesto F. Betancourt, "Governance and Post-Castro Cuba," *Cuba in Transition—Volume 4* (Washington: Association for the Study of the Cuban Economy, 1994). Roberto González-Cofiño, in his comments on this paper at the Seventh Annual Meeting of ASCE, noted that the United Nations also has developed criteria for good governance which includes, among others, legitimacy, freedom of association, accountability, transparency of governmental actions, and cooperation between government and civil society. He observed that Cuba did not meet these criteria.

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progress that Cuba can make in economic development unless governance practices are changed.

A reform government in Cuba would need to speed reform by making decisions that widen people's options, articulate the benefits of the reforms clearly, and ensure that policies are inclusive. To be effective it would need to pay attention to the needs of busi-

nesses and workers and work in partnership with them in designing and implementing policy. The political process would need to be opened to allow for the participation of political candidates who stand for economic reforms of the type advocated in this paper without their views automatically excluding them from the political process.