ECONOMIC REFORMS IN CUBA: WHAT'S NEXT?

Vadim Grishin

THE VALUE OF INTERNATIONAL EXPERIENCES: GEOGRAPHY VS. COMMUNIST INHERITANCE

The number of publications about ongoing changes and future Cuban transformations has dramatically increased over the last years. Many of them are trying to apply to Cuba an international experience that has successfully worked in different countries and regions, above all in Latin America. No doubt Cuba is an integral part of Latin America and the Caribbean basin, and has some common shared economic realities with many of the countries, particularly when it relates to slow growth of total factor productivity, and a widening GDP per capita gap with the United States (in Cuba that gap before the 1959 revolution was something like 77%, while today it's about 88%.)[1]

A reduction in possible approaches to Cuban reforms according to geographical prospective, however, would contain evident flaws and simplifications. While contemporary Latin American history provides many examples of transitions from authoritarian to democratic regimes, none of these countries has gone through the millstone of a bureaucratic centralized state. Allende's socialist experiment in Chile only lasted 3-years, so we cannot say that there are significant common prescriptions to such shared experiences. Most of the best results in the application of anti-crisis measures, which have been implemented successfully in many Latin American countries, are not likely to work well in the unique economic structure of Cuba, with its centrally planned economy and prevalent service sector, and its socio-political institutions. There might be exceptions, as Cuba could "import" the experience of other countries in the Hemisphere by creating modern safety nets, and adopting its "welfare state" to market realities. The country could also "export" its methodology for achieving high rates of human development in education and healthcare (out of 188 countries, Cuba ranks 69 in the global human development index, ahead of Mexico and Brazil).[2]

There are also broader and more eclectic/technocratic views that suggest Cubans should pick up the best practices and policies of successful transformations around the globe, including Brazil, South Africa, Ethiopia, and Taiwan. Such a universal approach would neglect, by and large, the structural differences, cultural traditions, and historical trajectories that all these diverse nations share with Cuba. Any country undergoing deep reforms can tackle systemic issues only in a systemic way.

Another popular point of reference for the future Cuban transformation is Singapore.[3] This tiny state, a world-class transportation hub, has championed a business friendly environment, high quality services

1. GDP per capita of Cuba and the U.S., based on Maddison (*Historical Statistics of the World Economy*) and current Cuban and U.S. statistics.

2. United Nations Development Program. *Human Development Report 2016*. New York: UNDP.

3. Spar, D. "Why Cuba Needs to Follow the Singapore Model." *Foreign Policy*, July 2015.

and integration into the global supply chain. It uniquely combined a planned, but non-monopolized economy, with modern institutions, effective governance, strong anticorruption protection, and authoritarian political leadership. Singapore's comprehensive economic and political mechanisms provided sustainable total factor productivity growth of almost 2% a year between 1970 and 1990.[4] There are two obvious and important nuances. Any nation following Singapore's "sui generis" model would need a modern statesman with the strategic vision and international stature of Lee Kuan Yew. Perhaps equally important, Singapore started virtually from scratch, or with a "clean slate," before growing into an extraordinarily successful state. In contrast, Cuba has been transitioning from one socio-economic and political adjustment to another, while inheriting the complexity and prejudices of almost 60 years of a socialist experiment that has included destructive isolation.

In terms of the complex, manifold nature of its transformation, Cuba can best be compared with countries in the former socialist bloc. From this perspective, the experience of post-communist transitions in Central and Eastern Europe (CEE), the former Soviet Union (FSU), and the market economic reforms of China and Southeast Asia, is relevant. Although the changes occurred 25–30 years ago, they could help us better understand what might happen to Cuba as it moves from state socialism to a market economic system, and detect pitfalls and opportunities along the way. Acknowledging that each transition is unique to a particular country, we should not ignore the fact that such transformations generally have some common principles and issues.

FROM ENDLESS ECONOMIC CYCLES TO MEANINGFUL TRANSITION

At the end of the day many large events appear to be driven by a relatively small number of factors, and the ability to reduce data by projecting it into these factors is a useful method for analyzing and identifying challenges and opportunities. Three main components come into play during such transitions: political, economic and institutional. Their combination varies in the regions that experienced the transitions.

Practically all former socialist countries before deep structural changes, have passed through a so called "socialist investment cycle". The standard first step of this cycle is to introduce liberalizing measures, as a reaction to slower growth rates; the second is to implement policies that boost economic growth; and the third step is to prevent intensification of macroeconomic imbalances. In its efforts to modernize and "update" an exhausted socialist economic model, Cuba has been passing through the initial stages of that cycle, facing challenges when it becomes impossible to maintain stability in an economic structure that has not been strengthened with additional reforms.

On the whole, these measures have coincided with fundamental elements of Gorbachev's economic reforms, which attempted to increase the autonomy of socialist enterprises by converting them to self–financing and self-managing entities; to develop individual and cooperative forms of ownership; and to attract foreign capital through joint ventures.

The differences between these approaches and Cuba's are evident. The island country has been moving much more slowly and cautiously, while, as we know, Gorbachev's economic team failed to implement responsible macroeconomic policy, and to adopt unpopular but necessary economic decisions, particularly price and tax reforms.[5]

Cuba is still between the second and the third stages of a socialist economic cycle, and its private sector contribution to GDP is below that of the under-reformed countries in the former Socialist bloc. Cuba's private sector share is just around 24% of GDP, compared to Turkmenistan's 25%, Belorussia's 30%,

4. Giugliano, F. "Singapore's economic miracle uncovered." *Financial Times*, March 24, 2015.

5. Mau, V. *The Logic and Nature of the Soviet Economic Crisis. The Economics of Russian Transition*. Edited by Yegor Gaidar. The MIT Press, Cambridge, Massachusetts, 2003, pp. 39–40.

Uzbekistan's 45%. Why are Cuba's reforms lagging with those of many other post-communist countries?

There are at least two main, interconnected reasons: first, as happened in Russia, Eastern Ukraine, Belorussia, China and part of Vietnam, the communist system in Cuba was not just imposed on the island from the outside, but was also developed indigenously on national ground; and second, communist ideas were cemented by nationalist tradition and anti-American sentiment. In Cuba, antagonism with its powerful neighbor has always been an excuse that justifies inconsistencies in the development of the country and the population's low level of well-being.

Many forecasters see ongoing changes as a linear process—gradual economic liberalization, transferring activity away from the state into private sector, and transforming the Cuban economy into a mixed one; and a normalization of relations with the U.S., which recently have regressed, but not completely reversed, under the current administration. There are problems and advantages in any transition period when windows of opportunity for profound reforms can be opened suddenly, not knowing when more serious reforms can become feasible.

THE CURRENT CROSSROADS

Presently there are two crosscutting political and economic cycles in Cuba. One of them, related to the deep systemic crisis in Venezuela, is seriously affecting the Cuban economy. The other is a generational change of leadership in the island. These two might stimulate pressing demand in Cuba for further reform implementation.

No country or group of countries can replace Venezuela, as after the collapse of the Soviet Union, Caracas stepped in to create a new type of privileged economic relationship, and a system unfolded which did not allow Havana to have full control, because of vulnerable dependencies and unpredictable contingencies. Cuba's tourist boom, which started during Obama's rapprochement policy, did not compensate sufficiently for Venezuela's sharp drop in support, which painfully affected Cuba's public finances. As result, real GDP growth in Cuba contracted by about 1% in 2016 and likely will also be negative in 2017. The ongoing economic and political crisis in Venezuela has inevitably increased the bill for oil imports, while declining Cuban exports (primarily in nickel and sugar) have elevated the country's trade deficit above 10% of GDP. The public sector deficit has been growing as well, so the authorities have been trying to find new sources of revenue by implementing extensions of income and social security taxes on state workers and employees of foreign firms. The role of remittances has been increasing in private consumption (which is a major driver of economic growth) and as an investment resource. Nevertheless, this is not enough to support sustainable development. Cuba has to look for new capital overseas to finance its deficits and attract investments through bilateral lending (opened via the Paris Club restructuring) and multilateral credits (from the Development Bank of Central America, CAF and the New Development Bank, formerly BRICS Bank, and in the mid-term probably from the World Bank Group, WBG and Inter-American Development Bank, IADB). That may cause the country's foreign debt to grow quickly, as happened in the Soviet Union. A long-waited currency unification could be accompanied by initial inflationary shock. All these distinct symptoms signal that Cuba is heading towards the third stage of a socialist investment cycle.

A political component will play a decisive role in determining the pace and scenario of future economic liberalization. An upcoming generational transition in leadership could produce a new power configuration that would eventually support a potential coalition in favor of reforms. The changing balance between hardliners and less ideologically rigid technocrats will be pressured by tough economic realities. The ultra-conservative regime veterans, supported by some population groups, do not offer any viable instruments to tackle complex economic issues. No one in Cuba would like to go back to the emergency policies of the so called "Special Period in Time of Peace", when structural adjustments to halt an economic free fall were accompanied by huge social sacrifices. Yet, the results of those policies were modest at best.

The technocrats presently in power seem to be better equipped and educated, and could be backed by employees from extended non-state sectors (at least 1 million people). Critically important, will be the voice of a very powerful military elite. With growing autonomy of state enterprises, decentralization of management and increasing of financial autonomy, the pragmatic interests of high-ranking military offices, brought by Raúl Castro into top managerial positions, has inevitably pushed some of them toward supporting market reforms.

DOES A PERFECT TRANSITION EXIST?

What kind of transition would this be, if and when it is started? Any transition is based on the creativity of a society to develop and adopt those institutions that are best for national growth and welfare. The conventional wisdom is that a CEE type of transition, especially in a "big bang scenario", is not applicable to Cuba. In CEE, a radical and comprehensive economic reform program was accompanied by a significant political shift when opposition social forces came to power. The EU played an all-dominant role in the transition, not only lowering barriers to trade but also establishing a framework of political dialogue and harmonization of legislation. Supported by substantial technical assistance from Brussels, the CEE countries adopted institutions characteristic of the EU members, which resolved many transition problems.[6] In other words, the organic components of this model included advance democratization, creation of competitive, non-monopolized markets and allocation of inclusive institutions.

As a general rule the more urbanized, mature, and educated a society is (with broader information available from the outside world), the more demand there will be for political liberalization. We should not necessarily, however, expect the viability of a CEE type of political transformation in Cuba based on that assumption. While the mean years of schooling in Cuba amounts to 10.2 years, compared with 6 years for the average Latin American country, the majority of graduating professionals are completely dependent on the state. Internet penetration on the island is extremely low. The country's middle class is still a nascent group.

We might only guess that the idea of a European integration and a "return to Europe", which was the driving force of change in the CEE, could be replaced by an idea of "perfect transition" in Cuba that would allow the island to preserve and develop its achievements in the area of human development, and guarantee the long-term catch-up growth that happened in many CEE countries. While Polish GDP per capita was below 30% of the income level in the developed countries of Western Europe in 1992, twenty years later it reached 62%. In the case of the Czech Republic, per capita GDP was about 57% of the EU average in 1990; it grew to 73% in 2005, compared by purchasing power parity.

A perfect transition, in the broad sense, is one that permits society to achieve income coverage based on total factor productivity (TFP) growth and efficient governance. Rising TFP supports other sources of growth, such as increasing investments and exports. Skillful management of macro-micro linkages (liberalization with macroeconomic stabilization) is also an important ingredient of a perfect transition recipe. Size does matter. Cuba is too small to fail at accomplishing positive outcomes of transition, based on the best practices of previous transformations. Even strong supporters of new structural economics, favoring a dual track approach and gradual reforms, have recognized that in small countries, Big Bang reforms could eliminate all government interventions at once, contributing to small "transition cost". As a result, such economies could grow soon after implementing the shock therapy, with a smaller initial loss of output and employment.[7]

Cuba does not have the huge industrial public enterprises that many FSU and CEE countries had. Liberalization of private activity and inflows of FDI in economic sectors that have comparative advantages

6. Aslund, A. *How Capitalism Was Built. The Transformation of Central and Eastern Europe, Russia, the Caucasus, and Central Asia.* New York: Cambridge University Press, 2013, p. 305.

7. Lin, J.Y. *The Quest for Prosperity. How Developing Economies Can Take Off.* Princeton and Oxford: Princeton University Press, 2014, p.199.

could improve resource allocation, create employment opportunities, and achieve dynamic growth, by compensating for losses from the inevitable bankruptcy of non-viable public firms. EU countries could play a significant role in sharing their experience of post-communist transition and channeling those EU resources to Cuba. As Cuba's important traditional partner, Spain could undertake an effort to lead this process.

LESSONS LEARNED AND FUTURE SCENARIOS

Much more inspiring examples for Cubans have always been China and Vietnam. Both countries have implemented a set of market reforms, partial property right reforms, and gradual institutional adjustments that avoid stabilization policies and radical changes in the political system, where the communist party grip has continued although with a high degree of decentralization and focus on economic results. China and Vietnam went through two shocks: transitioning from a traditional to an industrial society and from an administrative to a market economy. On the economic side of the equation there are a number of real differences that make it impossible for Cuba to replicate the Chinese and Vietnamese experiences, including the comparative size of the countries' markets, their level of initial development, and their speed of reforms—all of which have mattered for growth at the macro and micro level. Cuba has a unique mix of underdeveloped country issues with developed-world problems, including a demographic shift toward a quickly aging population and prevalence of the service sector in the country's economy.

Starting with the introduction of a new land tenure mechanism in rural areas (called the household responsibility system), China and Vietnam quickly moved to a supply and demand model in agricultural production, allowing for 30-year land contracts or even for an indefinite period of time. It was accompanied by other rural reforms for grain procurement and the opening of access to fertilizers and farm equipment. Before those reforms, Chinese agricultural output grew about 2.7%, and after reforms by 8.2%. The reforms eventually led to largely market based prices and resource allocation. In Cuba farmers have received renewable land contracts for only 10 years, with limited access to inputs like credit, fertilizers, and agricultural machinery, and with government control over production, mandating a part of the sale of crops to the state at prices below market with over taxation. As a result, average agricultural growth after the reforms has been only 1%.

Driven by improved productivity and capital formation, private sector industry, trade and services are incomparably more advanced in China and Vietnam than in Cuba. Both countries have become important links of the global value chain (GVC), managing to attract a considerable volume of FDI, while capitalizing on openings to foreign trade, specialization and large-scale operations. Participation in GVCs has enhanced the productivity, sophistication and diversification of exports. In the context of GVCs, the export competitiveness of China and Vietnam has been fundamentally linked with access to competitive intermediate imports and efficient services in global markets. Border costs get amplified with production processes that involve multiple border crossings. Foreign rules and standards (regarding intellectual property rights, product standards, etc.) take on heightened importance as prerequisites for value chain integration, while foreign investment—typically thought of as a substitute for trade—becomes a key driver of exports and competitiveness in international markets. Such transformation has been impossible without limited state interference in business and household activities.

At least two specific components of China's transition could be particularly valuable for Cuba: the Chinese experience with Special Economic Zones (SEZ), which were an efficient instrument for economic opening and capitalization of innovation, and the role of overseas Chinese (Huáqiáo), who have been a leading economic force in the investment in China's SEZs. Many Chinese economic zones were initially designed to shift the country from import-substituting practices to export-led growth policies by fostering foreign direct investment, enabling technology transfer, and participating in GVC. Experiences with economic zones in many countries have demonstrated that facilitating upgrades and diversification in production and services, supporting the creation of infrastructure, and testing and supporting new economic policies and approaches are critical elements for success.[8] To ensure that these zones remain economically sustainable and deliver positive externalities, an implementation of broader policies is necessary, such as the elimination of ring-fence restrictions and support of wider reforms and economic growth strategies. The free zone of port Mariel in Cuba could become a center of development only after further dramatic cuts in bureaucratic procedures inside this zone and more consistent reform policies in the island country. Important side of the success equation is related to gradual removal of U.S. sanctions, which could permit transform port Mariel in a major transshipment center, receiving new Panamax vessels after passing through the Panama Canal to the U.S. East Coast, with feeder services providing direct connections from Mariel to Gulf Coast ports.[9]

There are also hybrid regimes, established in a majority of the FSU countries, whose unfinished and unsuccessful transition remains as points of reference, but certainly not attractive ones. These regimes include common patterns of highly monopolized markets that deter structural economic reforms; formal polyarchies with strong authoritarian trends; under reformed institutions; concentration of wealth and power in the hands of oligarchs; high levels of corruption, and significant portion of population with lost identities and a strong nostalgia for the benefits of state socialism. Cuba can escape such maladies only by creating an environment of change that breaks the hold of vested interests and moves steadily in implementing market reforms, economic liberalization and institutional reforms. The current timid reform policies in Cuba are failing to address existing challenges. If short-term considerations of preserving the status quo take the upper hand, inadequate reforms could lead to stagnation, and, sooner than later, to a full-scale crisis. Although this might create an opportunity for change, it would be a painful and very uncertain way of getting there.

In a worst case scenario of failed or broken transition, Cuba could also drift toward what has become the mediocre Caribbean model: weak institutions, widespread corruption, high levels of monopolization, with prosperous but isolated clusters of tourism within poor general economic performance, environmental degradation, and rising inequality. Cuba's present hard-earned advantage of having developed human capital would be squandered. Without inclusive growth, social gains would not be maintained.

CONCLUSIONS AND POLICY OUTLOOK

Cuba continues to be a land of deferred growth, with an old style command economy that has fallen short of its potential. It has many symptoms that could be called a "socialist disease": low productivity of labor and capital and growing technological lag, not only in relation to developed, but also developing economies; a large military establishment that is a burden on Cuba's economy; the reality of having lost competitive industries; a deteriorating agricultural sector; and low standards of living and consumption. This is not a random phenomenon: shortages and delays in development are not only due to some mistakes in policy or to some negative coincidence of circumstances, but rather to deeply rooted properties of the system.

On the one hand, the country is still hampered by a "tropical" version of Marxist ideology, which has created additional constraints on its development through internal stop-lists, non-democratic behavior and filters that cloud its perception of the world. Some reforms have been started but Cuba is still far behind all of the other former socialist countries, with exception of North Korea. Some possible future reforms are viewed by the country's elite as a threat to internal stability. The fear of losing one's grip on

8. Akinci, Gokhan and James Crittle. "Special economic zones: performance, lessons learned, and implications for zone development." Foreign Investment Advisory Service (FIAS) Occasional Paper. Washington, DC: World Bank, 2008; Farole, Thomas and Gokhan Akinci, eds. *Special Economic Zones: Progress, Emerging Challenges, and Future Directions.* Washington, DC: World Bank, 2011.

9. Miller, Greg. *Cuba fast growing Mariel targets transshipment cargo*. May 18, 2016, JOC.com; https://www.joc.com/port-news/international-ports/cuba-port-plans-be-transshipment-hub-after-us-lifts-embargo_20160518.html

power dominates the landscape. The risk of "political default" is seen as a much more serious peril than the threat of economic collapse. The power elites have neither a clear strategy, nor a clear agenda. Important ongoing reforms, such as exchange rate unification or a further extension of the private sector have been stalled. The monetary rewards of delaying reforms from the public budget act as a narcotic. There is an evident vested interest on the part of rent seekers to postpone any adjustments. Paradoxically, they are the beneficiaries and simultaneously the slaves of this process of delay.

On the other hand, Cuba is an island of hope. There is a growing understanding that one cannot preserve the status quo forever and that changes are inevitable. The notion that stability is all-important and justifies lack of change does not work any more. An attempt has been made to hedge political and economic risks and create symbioses of market economy components on a socialist platform. These efforts, that have taken place before in other socialist economies, create leaks in a foundation. Trying to satisfy different interest groups, Cuba is slowly sliding into the category of a hybrid regime. The country's elites are still dreaming of inventing their own wishful eclectic model that combines some capitalist monetary policies with socialist fiscal management. Neither the price of success nor the cost of failure of such an experiment has been evaluated properly because of the fear of full reforms opening a Pandora's box. There is a demand for change in Cuba—what is not known is whether a generational shift in the country's leadership and the Venezuelan crisis would cause a set of modest adjustments or introduce deep structural reforms, whether the country would be following a post-Washington or Beijing consensus.