

The Political Economy of the Post-Castro Transition

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A move away from the present socialist dictatorship in Cuba could mean adopting a hybrid economic system that incorporates a large measure of state control of the economy with some market liberalization. Alternatively, it could mean quick broad and deep market opening and the effective establishment of the institutions needed for efficient resource allocation by the market. Only through radical change, as in the latter alternative, will Cuba be able to achieve economic development and benefit from a full integration into the international economy.

In this chapter I explore the political pressures likely to arise in a post-Castro Cuba, the institutional and policy reform measures needed for a successful transition to a market economy and democracy, and the way those measures should be implemented. One central proposition advanced is that a post-Castro government will have to mobilize a critical minimum mass of popular support to make the reform measures it adopts sustainable.

In the following section I present a stylized model of how key constituencies are likely to react to a reform process. Then, using such model for reference purposes, I elaborate on the required policy approach.

The Scenario

Just on economic considerations whether the end to Fidel Castro's reign results from his passing, or from other causes (a military coup or civil uprising for instance), the beneficiaries of the status quo or the groups who think they might do worse under an alternative system will attempt to preserve as much of the current system as they can. Accordingly, the emergence of a hybrid system involving some market opening and the continuation of a large measure of state control of the economy is a real possibility. The record of the "transition" economies teaches that such outcome is to be avoided (World Bank 2002, 1996).

Can a hybrid system be avoided? The eventual outcome will largely hinge on whether the current nomenklatura retain a significant measure of control. If that happened, they would attempt to maintain some of the mechanisms of socialism and/or use their positions to plunder the economy.

Let's consider the willingness of different constituencies or stakeholders to accept radical change. First however let us not forget that, in general, people are more willing to embrace radical change when an existing policy framework is deemed as failed and

when, as in Cuba, crisis and suffering have been endured for a significant period of time.

The World Bank used a graph such as the one shown above to illustrate the income gains and losses of three constituencies or stakeholders: state sector workers, oligarchs and insiders, and new entrants. The Bank defined state sector workers as workers in state-owned enterprises who do not have the skills to participate in the competitive market place. As they stand a good chance of facing unemployment with uncertain relative price changes and absolute price rises, their real income will fall. So initially they stand to lose significantly from the reforms and accordingly they are likely to oppose reforms (also Mitra and Selowsky 2002).

The oligarchs and insiders are persons who begin the transition with control over state assets or, thanks to connections, are able to assume their control soon after. In Cuba, they would be part of, or close to, the political elite of the Castro regime. Thanks to their privileged position soon after reforms start they would be able to enjoy benefits with a large component of economic rent. Additionally, given their privileges they would engage in gainful price arbitrage, tunneling and asset stripping.^{1[1]}

Finally, new entrants comprise workers and entrepreneurs who have the skills to benefit from entering the competitive marketplace. If the new entrants are workers or managers previously in the state sector, during the very early phase of the economic transition they might face losses from adjusting to new conditions – e.g., unemployment and closing of some redundant enterprises. However as they apply their skills to more productive uses in the market place they stand to gain increasingly from further reforms. Accordingly, new entrants would be strong supporters of broad and continuing reform.

In the chart the extent of reform is measured along the horizontal axis. The further away from the origin the greater the degree of reform accomplished. Hence point R_0 at the origin would indicate no reform while point R_2 and other points further out on the horizontal axis indicate more and more reform. The vertical axis indicates income gains or losses depending on whether a point is above or below the horizontal axis.

To illustrate: if the oligarchs and insiders can maintain their control over state assets or maintain privileged access to underpriced resources they will start experiencing benefits after some reform progress. Such point can be point R' . Moreover this group will support reforms (say initial privatization and some liberalization) until such point as R_1 where they maximize their gains. Reform progress beyond R_1 would make it harder for them to convert their control and connections into the same level of substantial gains. Therefore, beyond R_1 they would tend to oppose additional reforms.

^{1[1]} Price arbitrage consists in buying an asset at a low price and immediately selling it in a different market for a higher price. Tunneling refers to the diversion of cash, profits or assets for the benefit of controlling shareholders and the expense of other shareholders. Asset stripping is the practice of acquiring a company, then selling parts of it, in the hope that the cash realized from these sales will match the entire acquisition cost, meaning that the asset stripper is left with the remaining parts at nil cost.

Point R" marks where the reform process has advanced far enough as to permit the new entrants to derive income gains from further reforms. Note that segment R_0R'' marks the reform interval during which new entrants experience net income losses. Therefore an initial challenge to policymakers is to maintain the reform momentum so as to reach and surpass R" in the face of losses (and possible doubts) by new entrants. However even beyond R" the gains by the oligarchs and insiders are larger than the gains by the new entrants and such is the case until the reform point where the curves for new entrants and oligarchs and insiders intersect – one could think of such point as R''' (not in graph).

Now, as indicated, at point R_1 the oligarchs and insiders maximize their gains and would tend to resist reforms that go beyond R_1 . Thus at R_1 the gains to the oligarchs and insiders are much greater than the gains of the new entrants. One could reason therefore that, if people just acted in terms of gains or losses currently or already experienced, at such point the incentives for the oligarchs and insiders to oppose reforms are greater than the incentives new entrants have to favor further reform. Such would be the case up to the reform point where the curves for new entrants and oligarchs and insiders intersect. That intersection (R''') could be construed as reflecting a reform level where the gains to both new entrants and oligarchs and insiders are of the same magnitude.

Bear in mind however that, as per the graph, the state workers lose the more reforms progress. Accordingly at point R_1 the resistance to further reform on the part of oligarchs and insiders is augmented by the opposition to reform by the state sector workers. The challenge to the transition government is to move the reform process beyond a point such as R_2 after which the benefits to the new entrants are enough to compensate both the oligarchs and insiders and the state workers. Or, in other words, a reform level after which the incentives to the new entrants to exert political pressure to continue the reforms are greater than the incentives to the other two groups to do the contrary. In such light the segment beyond R_2 signals the self-sustainability of the reform process.

Another graph-related comment is worthwhile. The segment R_0R' can be construed as the (hopefully) short-duration interval during which both state sector workers and new entrants experience losses with no other group clearly gaining. (In fact, strictly at zero-reform point R_0 the state workers are experiencing some gains -- from the status quo.) Accordingly, as per the assumption of people acting in terms of stationary or past gains or losses, the new government might be faced with strong opposition to reform from the three constituencies.

The policy implications of what has been considered are that:

- (1) the new government should from the beginning stress that, provided the reform process moves ahead, new entrants will start to derive net benefits after a short period of adjustment (R_0R'') – the goal is that new entrants act in terms of expected (rather than experienced) gains;

- (2) the policy reform process cannot afford to be derailed at point R_1 where the net pressure to prevent further reform will be at a maximum (due to the combined pressure of the oligarchs and insiders plus the state workers);
- (3) only after the reform process has advanced as far a point such as R_2 will the reform process will be self-sustainable;
- (4) the transition government would further the cause of reform if it can shift the state sectors and new entrants curves upward and the oligarchs and insiders curve downward and to the right.

How can the new government produce a shift in curves as per point (4) just mentioned? Let's realize that the stylized slightly modified World Bank model inherent in the graph attempts to summarize main traits of the transition experience of countries that were communist economies prior to the dissolution of the Soviet Union. As the graph refers to a group of countries (as a whole), individual country experiences vary from country to country – for an analysis of individual experiences see World Bank (2002). This means that for specific countries the curves might be higher or lower, or the slopes more or less steep.

Moreover, the curves appropriate to the experience of specific countries reflect such factors as original conditions, speed and sequencing of reforms, how persuasively the policy reform package was presented to the nation and different constituencies, transparency as to the nature and objective of each reform, and how efficiently and effectively the reforms are implemented. Accordingly, I argue that people's expectations are critical and that the way a government approaches policy and institutional reform will impact the level and shape of the curves. This is what concerns us next.

The model and the Cuban situation

The categories new entrants, oligarchs and insiders, and state workers can be used as "classifiers or containers" that subsume narrower categories. The mapping of the narrower categories onto the main ones helps to understand the essentials of the political economy of transition reforms.

Table 1 presents a cut at classifying various population groups in Cuba according to the three categories of chart 1. A group may appear in more than one of the main three categories. The table's comments section briefly introduces the rationale for the subgroup classification. Further elaboration on the table is offered in the text.

Implicit in Table 1 is the sense that the basic World Bank model of chart 1 can be used to analyze the likely reaction of narrower groups during the reform process. Moreover such analysis also sheds light on the approach needed to mobilize political support for the reform process. The next paragraphs elaborate on the Cuban population groups of table 1 and a later section deals with specific reforms and reform implementation.

In table 1 the first two groups under New Entrants are youths and middle-age workers. Why age as a selection criterion?

Except for members of the Communist Party Youth, by and large other youths are likely to support radical change in favor of democracy and a market economy. By most accounts Cuban youths see their prospects under current conditions as bleak and they are likely to face few losses and big potential gains from entry into the market sector. Accordingly, arguably, their behavioral pattern will correspond to that of the new entrants with the curve sloping upward early on after the start of reforms.

Table 1

New Entrants, Oligarchs and Insiders, and State Workers in Cuba

Groups	Comments
I. New Entrants	Policy objective is to reduce the time during which this group experiences losses and create the conditions for a faster accrual of benefits through efficient market allocation
Youths	In general receptive to change. Does not include Communist Party Youth
Middle age workers	Includes persons that have or can develop the skills required in a market economy
Small farmers and peasants	Historically opposed to control by the state
Skilled workers	Would benefit from being remunerated in direct proportion to their relatively high marginal productivity as measured by market
Unskilled workers	As the demand for overall labor services rises their labor income should rise – the faster they are able to develop market-relevant skills the more likely their support to reforms
Professionals	Many of them highly penalized by a totalitarian system that impedes or greatly restricts the practice of their professions in the open market
Managers	Certainly foreign or managers from the diaspora would fall into category. Small entrepreneurs would welcome the possibility of operating in the open. Managers of state-owned enterprises are not likely to belong here
People of faith	Many of them are among current peaceful dissidents

Table 1 (continued)

2. Oligarchs and insiders	Policy objective is to prevent that these persons capture the state and prevent
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	the advance of the reform process
Managers of state enterprises	Unless forced to compete on a level-playing field would exploit their positions of control over assets. Would oppose reforms initially
3. State sector workers	They will approach reform from the perspective of losers – accordingly they are likely to oppose reforms
Government employees	Can most of these persons realistically transfer or develop skills applicable in the private sector?
Military personnel	High level officers will sense a loss of present substantial privileges. Middle ranks and conscripts might settle for opportunities in a reformed military (including police) or might respond to incentives to join the private market.
High government officials and top party members	Would oppose reforms to preserve privileges and to avoid potential retaliation
Elderly population	Might fear change and see themselves as unable to benefit from the new order
Pensioners	Same as the elderly. Fears must be addressed through social safety net

With a median age of 35.4 years (US Census Bureau) Cuba's population is fairly young. Some 40 percent of the population is between 15 and 39 years of age and approximately 49 percent falls in the 15 to 44 age bracket. As the population aged 14 or younger accounts for some 20 percent of the population, persons 45 years or older are some 31 percent of the population.

Although the hypothesis that younger Cubans are likely to be strong supporters of radical change early on is based on a *a priori* reasoning and impressionistic evidence, the results of a recent survey back it up. The survey results indicate a correlation between age and receptivity to change and democracy. Likewise the younger the person interviewed the more likely it is that such person thinks that present conditions are bad or very bad.

The survey was carried out by the Spanish non-government organization (NGO) Solidaridad Española con Cuba. The field work took place between October 8 and November 3, 2005 and according to the NGO was carried out without the authorization or knowledge of the Cuban government. The NGO researchers interviewed 541 Cuban citizens residing in 13 provinces of the Island covering an area of more than 90 percent of the territory. The persons surveyed were chosen by random methods using strata for provinces, age and gender. The sampling error is estimated at ± 3 percentage points (Solidaridad Española con Cuba 2005).

The rationale for including another population group, farmers and peasants, in the new-entrants class is that they have a record of opposition to government control of their produce. Accordingly, farmers are very likely to favor property rights and free markets and their behavior is likely to fit the new entrants' model. As the demand for the services of peasants is a function of how well farmers do, peasants are likely to behave as small farmers with whom they have a common interest. Note that farmers have done well on every occasion they have been allowed to sell in free markets. That is a reason why the Castro government has constrained their activities so much.

While there is no precise estimate of the number of farmers and peasants their number is not likely to be negligible. Some 75 percent of the Cuban population lives in urban areas. That means that the non-urban population includes some 2.5 million persons. If 70 percent of them are of working age they would amount to approximately 1.8 million persons. With a labor force participation rate of 60 percent one gets about a million rural workers. While not all of these will be engaged in agricultural pursuits, probably most of them directly or indirectly are. Accordingly this is a constituency of importance whose incorporation into the new entrants must be facilitated.

Skilled workers have much to gain from market opening. Therefore, this is a population group whose interests are identified with those of new entrants. Skilled workers should be able to adapt or transfer their skills to new pursuits under market competition and, as the economy and investment grow, the demand for their services will rise along with the return to their labor.

The case for including unskilled workers among new entrants is more tentative. As mentioned in the table, the demand for unskilled-worker services is likely to rise with the overall demand for labor. Hence they have a vested interest in economic growth. However, as their productivity probably will grow more slowly than the productivity of skilled workers, the rise in their incomes will very likely lag that of other workers. This group will pose a challenge to policymakers in that if unskilled workers do not develop optimistic expectations they might behave as state workers and oppose the reform process.

The interests of most professionals, that is persons with an advanced degree, are likely to coincide with those of new entrants. Hence it is reasonable to assume that they will be inclined to support the reform process.

Under present conditions professionals cannot practice on their own (i.e. cannot have their own businesses) and frequently make do through odd jobs. Market opening would mean an increase in the demand for their services as the private sector and the economy grow. Likewise, many of them would have the opportunity to own their businesses as sole proprietorships of say, medical, accounting and engineering offices.

Table 1 shows managers both under "new entrants" and under "oligarchs and insiders". The reason is that one has to distinguish between present managers of state

enterprises and other managers. "Other" managers include managers in the underground economy, small business managers in the gray economy (paladares for example) and new managers –foreign and domestic. While for the most part the interest of the "other managers" will be equivalent to that of the new entrants, to the extent they can maintain control over enterprises or assets, the managers of state firms will tend to identify with the oligarchs and insiders.

Persons of faith include practicing Christians and the faithful of other denominations that presently suffer from discrimination because of their religious fervor. Such persons will have an incentive to behave as new entrants. Naturally this category cuts across other variables such as age and worker skill. In such light persons in this group may experience pulls in opposite directions. For instance while their religious beliefs may incline them to favor the progress of reforms, as the new entrants for example, they might be state workers and thus fear reform.

Almost by definition government employees, that is civilians who are in the government rolls and do not hold top positions, are state sector workers. Government employees may include workers able to transfer their skills to the private sector. In fact, many government employees may also carry out remunerated activities in the informal or gray market. In either case there is a possibility that such persons might see themselves as having promising long term income prospects as reforms take place. To the extent this happens these individuals might vacillate between opposing market reforms and behaving as new entrants.

Nonetheless, a good proportion of government workers might find it too hard to develop the skills needed to compete in the market. Accordingly, they are likely to see themselves as losers (at least initially) and oppose the reforms. Hence it is plausible to assume that these persons will tend to behave as the state workers of chart 1.

Clearly the military form an important group. Within the military one may distinguish: (1) the high-rank officers who run the military structure on which Castro's regime is founded or who manage state enterprises; (2) the middle-and-lower rank officers; and, (3) the regular soldiers or conscripts. The perspective of each of these subgroups will vary.

As the high-rank officers enjoy positions of great privilege under Castro they most likely will see themselves as losers, oppose the reforms and follow the path of state-sector workers of chart 1. The middle-and-lower rank officers will find themselves in a more ambiguous position. While their initial inclination will be to behave as state sector workers and oppose the reform process their *status quo* privileges are much less pronounced than the high-rank officers'. Moreover, while they enjoy more benefits than most of the population, with the stagnation and continuing deterioration of economic and social conditions the relative importance of such benefits has decreased over time.

Accordingly the middle and lower ranks may be willing to shift their stance and support reforms. Their decision will reflect the push of public opinion and the pull offered by

market opportunities. The situation of soldiers or conscripts will be similar to that of the middle and lower ranks and the difference is only a matter of degree. Soldiers will initially be heavily influenced by the reaction of middle and lower rank officers.

Pensioners, the last population group in table 1, are likely to share the same doubts and perspectives of the elderly population and thus be wary of systemic change.

Strategic implications of constituencies' propensities

To be effective the implementation of reforms must reinforce the tendencies of constituencies favorable to the reform process, persuade those who are uncertain that reforms will ultimately work to their favor, and minimize the public opinion impact of persons who will oppose the reform process. And this must be done in a context of respect for the freedoms inherent in a democracy.

As previously noted, what eventually happens in Cuba will clearly depend on whether the leaders that emerge in a post-Castro setting are able to bring about a critical mass of agreement around a policy thrust. In that light policy implementation approaches to specific constituencies must take place in a setting in which an interim transition government:

- Operates under the aegis (or with the support) of a coalition of free market democracies;
- Explains clearly and repeatedly the need for immediate broad and deep economic reforms – the assumption is that if a critical minimum mass of people do not understand the need for the institutions of capitalism and democracy they are unlikely to endure and support the difficulties that will accompany change;
- Underlines that the authorities will move immediately to setting the foundations for a democratic system and a market economy and the steps involved;
- Announces that the interim government would be replaced after one year by an elected government (but reiterate that reforms cannot wait);
- Makes clear and ensures that during the first year of the elected government a constitutional assembly, elected by Cubans in the Island and overseas, drafts a new Constitution;
- Highlights that the Constitution would be subject to ratification at the time of electing the new government in a 1-year time frame.

Simultaneously with conveying the above points to the population, the authorities should emphasize the following constituency-specific messages to particular population groups. In all instances the authorities should be candid and clear regarding resources, difficulties, and results. The objective should be to provide hope anchored in reality but to avoid the creation of exaggerated expectations regarding the pace and magnitude of benefits, especially during the initial period.

To the young: that while all population groups will benefit from the reforms in the longer term, the younger Cubans will benefit almost immediately. To the extent this is done

convincingly the mobilization of youths in support of the reform process should be significant and take place from the very beginning of the transition. In the terminology of chart 1 this approach will shift upward the new entrants' curve.

To persons of working age and capable of working: that the government is aware of the existence of substantial demand for training and other measures to facilitate workers movement into the private sector. Accordingly, with the collaboration of private sector entities and the international community, the Cuban authorities would encourage training, education and business start-up facilities. Measures of this type would: (1) shift upward and steepen the new entrants curve; (2) shorten the time during which new entrants would experience net losses (segment R_0R'' in Chart 1); and (3) shift upward and reduce the steepness of the state sector workers curve thus minimizing their losses.

To the elderly, pensioners and disabled: that with the assistance of the international community social assistance and insurance schemes will be put in place in the early months of the transition to address the needs of these population groups. The results sought would be equivalent to an upward shift of the state sector workers curve and to a reduction of its negative slope.

To farmers and peasants: that they are free to decide what to grow and sell, to whom, and that produce prices and workers salaries will be determined by demand and supply. (The authorities should use all channels possible to communicate in clear layman terms what is meant by demand and supply and the factors behind such forces.) The authorities should make it plain that with an economy integrated into the world economy the potential for increased revenues from produce sales would expand significantly and farmers' incomes would rise accordingly. The same applies to peasant wages.

With respect to managers the key policy approach would be no preferential treatment and encouragement of business drives. This can be done by developing a stable macroeconomic environment and making it clear that firms will be subject to hard budget constraints of no preferences (more below), by minimizing the transaction costs of establishing and operating a business, by not permitting artificial barriers to capital and labor mobility, and by guaranteeing that all investors, whether foreign or domestic, will be treated equally. The specific policy recommendations offered in a later section will go a long way toward achieving the right climate for business. In terms of chart 1 the described approach implies an upward shift of the new entrants curve and a decrease of the no-gain segment R_0R'' .

To professionals the message should be similar to the one conveyed to youths and managers. Stylized regulations and policies should enable their quick integration into the labor markets allowing them to enjoy returns commensurate to their productivity. The impact will be to raise the new entrants curve and to shorten the net loss period R_0R'' .

Among the high-rank military only individuals who are not directly connected to torture or similar human rights crimes are relevant for the present analysis. As previously noted these persons will act either (1) as state sector workers and oppose the reforms because of the loss of privileges radical change entails, or (2) they will attempt to use their connections and influence to control state assets. If the latter, they will behave as oligarchs and insiders.

However to the extent that these persons become convinced that change of the status quo is inevitable and that no economic sector, group of firms or individuals will receive privileged treatment the high-rank military might resign themselves to change and try to apply their skills in the market place. Implicit in this approach is that all firms and economic agents will operate in a level-playing field without preferences such as subsidized credit, special tax breaks, and regulatory exceptions. By and large this policy approach is referred to in the literature as forcing firms to operate within a hard budget constraint (they have to be competitive to survive) and is essential for forcing economic agents to respect market discipline.

Also implicit in the approach is the notion that a new government will not tolerate vindictiveness, will operate within the rule of law based on the spirit that permeated the 1940 Constitution, and that persons not directly responsible for human rights violations will have an opportunity to integrate themselves in the new order. The sense of the inevitability of radical change toward democracy and a free market economy along with the prospect of being able to compete in the new order would tend to shift upward the state sector workers curve and downward and to the right the oligarchs and insiders curve. What has been described vis-à-vis the high-rank military holds also for high government officials and top party members.

The approach towards the high-rank military applies *a fortiori* in connection with the middle and lower military ranks including conscripts. Moreover in connection with persons in this group the new government should implement a plan to integrate selected elements of the group into the new army and or police force.

Currently Cuba has regular armed forces of around 60,000 persons. Looking back at Cuba's history one would think that a force of no more than 30,000 would suffice. The challenge to the new government would be to phase down the armed forces to its desired levels gradually and, as the economy expands and creates labor market opportunities, absorb elements of the old armed forces. This is a case where the social externalities do justify putting in place, as with government workers, special training, business start-up or placement facilities to help these individuals access the market place.

Moving the curves in the direction desired: policy and institutional reforms

This section summarizes the main lessons from the literature and the empirical record relevant for a post-Castro transition. Let's start by postulating that price and trade liberalization has paid off for countries in transition, that stabilization matters, and that

the efficiency benefits of resource allocation by market forces can be fully realized only if market supporting institutions are created (Falcetti, Raise, and Sanfey 2002).

In table 2 I group the lessons into two categories by impact on Chart 1 curves (also Summers 1992). I then continue with comments on specific policies and institutions.

Table 2

Broad Impact of Reforms by Effects on Constituencies' Behavioral Functions

Impact	Reforms
Upward shift in new entrants curve	Stabilization of the macroeconomy
Upward shift in new entrants and state sector workers plus downward and rightward shift in oligarchs and insiders curve	Building the institutions of capitalism and democracy

As seen on Table 2, building the institutions of capitalism and democracy will have a desirable effect on all Chart 1 curves and their implicit constituencies. Accordingly before moving on to economic and related aspects let me address essential first steps affecting basic laws and rules. Among its very first measures the new government should:

- Declare as inalienable rights the freedom of speech and association, as well as civil rights such as the institution of habeas corpus;
- State its commitment to respecting the rule of law;
- Start early on the reform of the judicial system so that it be seen as independent, fair, neutral and effective;
- Guarantee a free press;
- Promote the participation of interest groups in civil-society activities;
- Indicate that it will start work to develop and propose a system of “constitutional” checks and balances to be ratified by plebiscite;
- Create a legal framework for corporate governance, accounting systems, and transparency in the way financial institutions manage risk.
- New laws should make it clear that foreign investors will be treated equally to domestic investors, that there is no risk of confiscation and that there would not be special exchange rate restrictions.

On the macroeconomic front it is important to develop a stable macroeconomic context so that other reforms can lead to an efficient reallocation of resources. Macroeconomic stability would lay a foundation for economic growth. (Wolfe 1992).

To achieve macroeconomic stability it will be necessary to carry out monetary and fiscal policies geared to limiting money supply growth to a rate consistent with the growth of real output. The guiding notion is to help prices and wages align with real costs and productivity as prices are freed without the distortion caused by inflation. Moreover, jointly with the measures below, and with monetary and fiscal discipline, the peso can be allowed to float to its equilibrium level.

Building the institutions of capitalism and democracy calls for:

Property rights enforcement. Such enforcement involves a categorical commitment to the protection of property rights and contract enforcement – this includes the right to transfer the ownership of property, the right to sue, and an effective system for settling disputes. Property rights include intellectual as well as other forms of intangible property.

An issue relating to property rights involves how to address the claims of the rightful and primary owners of property confiscated by the Castro government. The position advocated here is that the new government should make it clear that those owners will receive either fair compensation or that, to the extent possible, their properties would be returned to them. A plan of action for property restitution or compensation should be announced early on (more below). There are two advantages to such policy course: in correcting what was a “moral wrong” the new government would avoid what would be a festering long-term source of internal conflict; the policy would send a clear message that the government is truly dedicated to the defense of property rights, a factor that would encourage investment.

Resource allocation by the price system. This calls for immediate deregulation of price and wages. Such deregulation should be accompanied by simple and in no way onerous norms affecting business activities (e.g., permits and standards), low marginal tax rates, and the imposition of hard budget constraints on firms (e.g., no credit subsidies and no preferential tax treatment including allowing the buildup of tax arrears).

Flexible labor markets. As workers become redundant in old-non-competitive enterprises their absorption in the new economy (new enterprises) should be encouraged by formal termination arrangements involving lump-sum payments and retraining (this would be part of the social safety net interventions). The new government should not attempt to carry redundant workers in their old places of work as that would hinder factor reallocation, strain fiscal finances, and slow down the overall reform process – as indicated here social safety net measures would help counter pressures to do the contrary.

Effective intermediation by banks. To foster a banking sector that mediates effectively between savers and investors Cuba will have to develop banks that issue credit according to the perceived borrower potential to payback rather than on the basis of political connections or preferential criteria. Setting, early on in the transition, the supervisory and the regulatory framework for the banking and financial sector is a must.

This includes establishing an effective a regulatory authority for bank supervision. Likewise the central bank must be an independent entity separate from the ministry of finance as well as from other banks.

Capital Market Development. Along with laying the foundations for an effective banking sector, the government will adopt regulations to facilitate the expansion of capital market institutions such as insurance companies and financial asset exchanges including futures markets.

Privatization. The approach should be a quick privatization of small enterprises and piecemeal but fast-paced privatization of the large enterprises (these may consist of firms known as “national” and “provincial”).

In the case of larger enterprises, privatization should break state monopolies and safeguard the promotion of competitive markets. Prior to privatization the government would decree freedom of entry and exit to/from industries and would open the economy to international investors and free market trade. The privatization of the large enterprises would be done by means of open and transparent negotiations according to preset rules ending in direct sales of firms or assets to individuals, corporations, or group of investors.

While privatization of existing firms and assets is important, given the policy and institutional changes proposed here one would expect that the main impetus to privatization would result from the creation of new enterprises. Likewise, the privatization process would be reinforced by the privatization of selected services previously provided by government entities – garbage collection for example.

There is ample scope for the generation of economies arising from business clusters and linkages. In present-day Cuba links among enterprises are scarce – although they might be stronger in the underground economy. Once barriers to entry are eliminated erstwhile underground activities will surface and, together with new-investor firms, they will offer a foundation for economic growth. Moreover, free market conditions will make obvious the productivity differences that lie hidden today and that will serve to allocate resources to their most productive use.

While as discussed above, restitution to prior owners would be part of the privatization process, housing merits special considerations. Given the housing shortage in Cuba restitution could take place as per a phased scheme such as follows:

First stage: the property rights of previous owners or heirs are recognized with the limitation that they cannot exercise eviction within a given time period (perhaps 2 years) during which tenants are obliged not to cause further deterioration of the houses;

Second stage: previous owners or heirs start receiving compensation for the revenue lost during the Castro era – such compensation might take the form of government

bonds financed from general government revenues with payments starting two or three years after issuance;

Third stage: present tenants start paying at least a nominal rent to previous owners one year after regime change;

Fourth stage: the rent is adjusted as open free markets for housing and labor develop no later than two years after regime change;

Fifth stage: after two years the owners can exercise full property rights.

An alternative to a scheme such as the above would be to give the previous owners and heirs the option of renouncing to their property rights in return for an annuity for life subject to transfer to their own heirs at time of death. Previous owners or their heirs could be given the option of choosing between the first or second alternatives.

A social safety net to protect the needy and the newly unemployed will play a pivotal role in making reforms along the lines proposed here feasible. During an initial phase social policies will help dissuade the segment of the population that would initially suffer from the regime change from opposing the reforms, and likewise help muster support for the reforms. The essential impact would thus be of shifting upward and diminishing the slope of the state workers curve. Nonetheless it should also have an impact on reducing the net less loss segment of the new entrants curve (R'R").

Social safety net measures will also help address the output and employment dislocations that may arise from the liberalization of the economy and its integration with international markets under competitive settings. One should note however, that while a contraction was typical among the former Soviet economies after regime change, the contraction is likely to be less severe in Cuba. The reason for this view is that Cuba would be starting its reforms from very low levels of output and after the huge shocks of having lost the Soviet subsidies.^{2[2]}

It bears noting that the perspective taken in this paper is that there is 2-way causality between social safety net efforts and economic growth. Without economic growth the country would not be able to sustain its social safety net. On the other hand, without an early, even if relatively thin social safety net, the implementation of reforms needed for economic growth will be a quite difficult, perhaps elusive, task. If the latter happened the growth potential will be greatly impaired.

Conclusion

In this paper I have described how specific population groups are likely to react to the prospect of a fast-paced deep and broad market and political opening in Cuba. I have

^{2[2]} While those subsidies have been partially replaced in recent years by subsidies from Venezuela the latter are not comparable in magnitude to the former.

also attempted to take into account the ways policies and new institutions should be implemented and presented to the Cuban people in a new context of democracy.

I have stressed the need to prevent narrow vested interests from capturing the state by taking advantage of their position and connections. Likewise I have suggested measures geared to facilitating the integration and support of various population groups for the new order and, simultaneously, to dissuade likely opponents from obstructing the reform process. Both objectives can be achieved only if the vast majority of Cubans see the transition as a means to a situation that offers opportunities for the betterment of all members of the society.

To such ends the paper has underlined, among other points, the need for simplifying regulatory procedures, setting a level playing field for all enterprises, encouraging productive drives (for example by avoiding high marginal tax rates and securing property rights), the creation of an effective social safety net that protects the needy and the provision of reliable infrastructure services for the citizenry. Much of this can be done with the collaboration of the international community and the contributions of Cubans in the Island and abroad. Moreover, Cuba's integration in a free trade area of the Americas agreement or in a free trade bilateral agreement with the United States can play a catalytic role in accelerating the reforms and the benefits derived from it.

No less important is the requirement that the authorities undertake a proactive role in explaining that while reforms may involve some initial dislocation, the faster the reform process advances the better for the great majority of Cubans. A key point to drive home is that eventually all Cubans should benefit from peace, liberty and the freedom to make economic choices. This requires that individuals develop the ability and the willingness to shed many of the habits developed under socialism and learn the new ones needed to operate in a market-based democracy (Desai 1995).

All in all it is essential to realize that, whether because of conceptual errors or poor or incomplete implementation, failed reform processes can so discredit reforms that Cubans may look for "third-way" approaches that in reality would extend present-day calamities (Krueger 2005). In fact this is what explains the so-called current shift to the left in some Latin American countries.

It is essential that the new authorities leave no doubt as to their resolution to impose hard budget constraints on firms, to liberalize and open the economy, to maintain price stability, and not to permit asset stripping or tunneling from old to new enterprises. The opposition to reform measures is likely to be proportional to the lack of credibility of the government. The weaker such credibility the stronger the opposition.

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