# Cuba's Reforms: A New Institutional Economics Perspective*

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## INTRODUCTION

This paper assesses the nature of the incipient market reforms in Cuba by looking at what they imply in terms of three related ideas about the operation of market economies.  The first idea is that there are two broad categories of markets: those where transactions are self-enforcing and those where transactions are not self-enforcing.  The second idea is that the economic functions that the state has to perform in support of these two types of markets vary enormously.   In a recent paper, Clague, et.al., (1994) note these two ideas and attempt to devise indicators of the extent to which the state is performing its functions in the second type of market.  Here we will explore in more detail the underpinnings of the first two ideas and their relevance to Cuba's reforms.  Finally, when the state is unable or unwilling to perform its functions, certain markets will not exist, or operate at a very low level of transactions, or alternative institutions will arise to substitute for the function that was to be performed by the state.  Here we will develop this third idea and draw its implications for Cuba's reforms.

The argument is developed by first looking at markets with self enforcing transactions and specifying their nature in detail, including the role of the state.  Subsequently, the reforms of Cuba's markets with self enforcing transactions are discussed.  In the third section the nature of markets where transactions are not self-enforcing is discussed, including alternative institutional mechanisms that allow these markets to exist.  Afterwards, the reform of these markets in Cuba is reviewed.  Finally, we conclude with an overall perspective on Cuba's market reforms and why they are less likely to lead to sustained growth than the ones in China or Vietnam.

## I.    SELF-ENFORCING TRANSACTIONS

Markets in traditional societies are characterized by North (1990) as inducing self-enforcing transactions due to the fact that they involve small numbers of participants, they consist of repeated exchanges and the participants have abundant information on the personal characteristics of each other. Of course, it is not necessary for a market to be a traditional market for transactions to be self-enforcing. For instance, in modern markets some institutions allow reputation mechanisms to work, e.g., credit bureaus, in the absence of the above characteristics.[1] Finally, there are some markets where enforcement and measurement issues are far less important than in other markets, namely spot markets.

[1]Incidentally, in a small country with a lack of mobility in the population, there are strong incentives for self-enforcing transactions for all frequently purchased products because they satisfy the three characteristics that make traditional markets self- enforcing.

By definition spot markets are those where most of the gains from exchange are realized at the time of exchange or shortly thereafter and at the location of exchange or nearby. This feature tends to make these exchanges self-enforcing by the two parties involved in the exchange. The jointness in time and space of spot markets is almost sufficient to eliminate the need for enforcement mechanisms. This is especially the case when products are relatively homogeneous, as in the case of spot markets for agricultural products. The relative homogeneity of these products together with the jointness feature of spot markets allows these markets to function in the absence of other characteristics that make transactions self-enforcing. Homogeneity is important because it limits the measurement problems associated with asymmetric information by the participants to an exchange.[2]

The role of the state in these markets is a minimalist role. Its main economic functions are to provide law and order, so that the gains from trade can be appropriated by the participants to the exchange, and a medium of exchange, to generate the gains from trade that a nonbarter economy provides. Alternative institutions to the state can easily arise to satisfy these two functions, e.g., private protection for caravans of traders and cigarretes as a medium of exchange in prisons. This ease of substitution coupled with the standard gains from specialization associated with high levels of transactions have led these markets to flourish throughout history and to be visible everywhere across the globe presently. Indeed, this is the case even when the state engages in efforts to suppress them, e.g., illegal or informal activities in capitalist economies and many exchange activities in command economies.

[2]Quality issues can lead to measurement problems in some spot markets. For instance, the spot market for fresh fish is affected by the possibility of spoiled fish being sold. Hence, fresh fish can be scarce in the urban areas of island nations due to the asymmetry of information on quality between the seller and the buyer.

## II. REFORMS IN CUBA'S MARKETS WITH SELF-ENFORCING TRANSACTIONS

There are at least four markets in which partial "reforms" have been introduced in Cuba that can be characterized as markets where transactions can take place with limited enforcement mechanisms: Agricultural or farmer's markets, artisan markets, self-employment markets and the market for prostitution services. Nonetheless the Cuban state continues to play a far more interventionist role than the so-called minimalist state necessary to support these markets.

Agricultural or farmer's markets. In September of 1994 the Cuban government allowed the operation of locations at which farmers and cooperatives could sell a portion of their output, presumably at prices set by supply and demand[3]. By April of 1995, the supply of agricultural products available to consumers had increased substantially although prices were high ( Cuba News, April, 1995). The same source also reports, however, that the price of pork in these markets had remained constant at 40 pesos (presumably per pound) since October 1st, 1994. In any normal market for an agricultural commodity, the price should fluctuate with output, relative availability over the year, quality of the pork as well as characteristics of the location. This empirical operation of the law of one price without any deviation in the pork market suggests that a maximum price is being imposed by the state with respect to this commodity. The consequence will be the further development of black markets in which these producers will sell part of the product at a higher price to selected customers, probably those who can pay in dollars. The supply to the farmer's markets will increase more slowly than in the absence of the state imposed maximum price.

Artisan's markets. These markets were also authorized in the Fall of 1994, allowing the free sale of a wide range of consumer products through a

[3] For a more extended discussion of the recent evolution of cooperatives and agricultural markets see the discussion by Perez Villanueva elsewhere in this volume.

network of artisan markets. Excess supply of industrial goods produced by the state would also be available through these markets. Those set up in former state shops were subject to a fee of 30 pesos per meter of glass counter space per day and regulation by a government administrator. Cuba News (April 1995) reports that many vendors prefer the open air markets that are also allowed.

Self Employment Services Markets. Since late 1991 the authorization of self employment had been under discussion. In September of 1993 over 100 occupations were identified as suitable with professional occupations excluded. Among the included ones were self employment in food preparation, home restaurants or "paladares". More recently a score of other activities have been added. The government has moved recently against home restaurants on the grounds that they violated the self employment rules. It seems to have settled on allowing home restaurants that sit 12 persons or less and do not require the hiring of anyone. The explosion of these restaurants before and after their authorization by the government attests to the limited need for enforcement mechanisms in this transaction. As pointed out elsewhere in this volume by Perez Villanueva, in June 1995 self employment by professionals was allowed provided it is in an occupation other than that for which they were trained. The limitations and attacks on this activity by the government suggest a lack of commitment to market reform that undermines the credibility of other govermental pronouncements.

Market for Prostitution Services. This market is a special case of a self employment market, i.e., one that most societies restrict or regulate for a variety of reasons ranging from health to morals. After its suppression for many years during the Revolution, it has developed rapidly with the recent expansion and emphasis on tourism. The economic incentive to participate has increased tremendously as a result of the difficult economic circumstances and the dollarization of the economy in 1993. Until recently the government had ignored this activity, but in the summer of 1995 Castro denounced the activity and a crackdown may ensue. How successful it will be remains to be seen.

Reform in these markets with limited enforcement requirements has the beneficial effect of decriminalizing the survival activities of substantial segments of the population. The less interference by the state in these markets, the more rapidly they will expand even under a communist regime. The weight of history and contemporary evidence support this prediction. Except for the market for prostitution, such an expansion will have positive welfare effects on most members of the society. Nonetheless, even if the Cuban state were to eliminate all the restrictions currently imposed on these markets, their expansion would have a limited effect on solving the fundamental economic development problem of Cuba. No society can develop solely on the basis of markets where enforcement requirements are limited. While important for survival and well-being, they represent a very small part of the activities of a modern economy.

## III. NONSELF-ENFORCING TRANSACTIONS

Transactions that require enforcement are those where at least one of the two parties to an exchange has strong economic incentives not to fulfill the conditions of the exchange. Transactions in future oriented markets are of this kind. Whenever the benefits to one of the two parties to an exchange take place in the distant future, the opportunities for one party to defraud the other party loom large and provide a deterrent to the exchange in the absence of mechanisms to assure fulfillment of the explicit and implicit conditions of the exchange. The range of modern markets that have this feature is quite large. For instance, insurance markets, financial markets (including banking), markets for direct investment, consumer durables, even markets for health and legal services in some instances as well as some types of labor markets. Similarly, if the benefits for one of the two parties take place at a substantial distance from where the exchange takes place, transactions will not be self- enforcing.

The provision of third party enforcement mechanisms is indispensable for the operation of markets in which transactions are not self-enforcing. In its absence, these markets will either not exist or operate at low levels of activity. The absence of these markets from a society or their operation at a very low level of activity leads to poverty, underdevelopment and inability to sustain growth rates over long periods of time. By now we know that a key to modern economic growth is the ability to maintain a high rate of saving and investment. Without thriving markets for financial intermediaries both the amount of saving and the efficiency of investment are significantly reduced. In addition the market for direct investments is unlikely to operate at high levels of activity if the opportunities for appropriating the benefits of the investments are subjected to a considerable amount of uncertainty.

What is the main form of third party enforcement in modern economies? An independent judiciary that protects property rights and enforces contracts. As North (1990) recognizes how one develops impartial third party enforcement through an independent judiciary is a critical unanswered question in our understanding of economic development processes. We do know, however, that in the absence of an independent judiciary alternative institutional mechanisms develop to provide albeit imperfectly third party enforcement. Thus reputation effects can act as a substitute for this function and the merchant codes of the Middle Ages performed this function well enough to allow long distance trade to materialize, Milgrom, North and Weingast (1990).

Part of the difficulties in sustaining high levels of output in transition economies arise from the difficulty of providing third party enforcement mechanisms during these transition processes. It is not enough to have a commercial code; significant resources have been devoted to its development in these economies. The code must be enforceable and enforced before it will lead market participants to engage in significant numbers of transactions.

One of the most interesting questions of the last few years is-- how has China been able to grow so fast since 1979 in the absence of an obvious third party enforcement mechanism?  A similar question is being raised by Vietnam's experience since 1989.  Clearly the Cuban regime would like to figure out the formula.

With respect to China, a number of factors operate.  An important factor in the growth of the the first ten years was the expansion of markets for agricultural products where transactions are self-enforcing and a release of state restrictions provided the opportunity for expansions.  Morover, growth in nonagricultural products was based on economic activity in the rural areas, where the features of traditional markets obtain.  In addition, the development of township and village enterprises (TVE's) under what Qian and Weingast (1995) call a "decentralized market-preserving federalism, Chinese style" has been a key factor in this growth experience.[4]

China is mainly an agricultural country and the rapid expansion of such a substantial part of the economy can carry the growth process for a while. The size of the gains from exchange is so large in China, because of its size, that it makes it worthwhile for many foreign investors to undertake levels of risk and uncertainty that would not be worthwhile in other settings.  Finally, corruption is rampant by most accounts and it can serve as a substitute for an independent judiciary in providing enforcement of contracts.  Since the use of corruption as a substitute for lack of third party enforcement is not limited to China, let me illustrate the process with an example.

[4]The key features of this system stressed by Qian and Weingast (1995) are: the provision of positive incentives for profit maximization to the TVE's, for example secure property rights to the residual income; the provision of negative incentives for profit maximization, for example hard budget constraints; and the competition inducing features of Chinese federalism, in particular the existence of a hierarchy of governments with delineated scope of authority where the lower levels of the hierarchy have autonomy over the economy within their jurisdictions.

In China, certain sectors of the economy are reserved for the state sector. Three officials of a think tank set up a company to operate in this sector by giving 70 % of the shares to over 10 different local governments. This mechanism allowed the company to operate in the state sector while the three entrepreneurs retained control with their 30%. The company made several million dollars in the first two years of operation, Ng and Yang (1995). Connections with local government officials provided a substitute for impartial third party enforcement in securing the gains from exchange.

If we define corruption as any intentional departure from arm's length relationships for personal gain, Tanzi (1994), we can see this mechanism as an important substitute for impartial third party enforcement in China as well as in Vietnam. Of course, the corruption process has its limits and is likely to be a less efficient mechanism than the alternative. An illustration of the limits is provided by a recent controversy in which a McDonald's site at a prime location in Beijing was sold to a Hong Kong tycoon without consulting McDonald's![5]

Corruption in these settings is an institution that substitutes for the inability of the state to perform one of its basic functions: the provision of impartial third party enforcement. It lowers the uncertainty to at least one of the participants in the market and allows transactions to take place that would not occur otherwise. It can have a substantial positive impact on the growth rate for a period of time. Nonetheless, it is not a stable process over the long run because it generates conflicts without explicit mechanisms to resolve them. As long as the hierarchical structure of a regime is maintained without challenge, the growth process can go a long way. Market reforms, however, create new power structures that can become the basis of challenges to the original hierarchical structure. Incidentally, corruption is not the only substitute for lack of impartial third party enforcement. In

[5]This decision was eventually reversed.

dealing with foreign investors, for example, countries with weak institutional structures agree to settle contractual disputes through third party arbitration, often in third countries. Finally, more than one of these mechanisms can be in operation at anyone time in a particular country.

While corruption is by no means limited to markets with nonself-enforcing transactions or to communist regimes, it performs a more valuable economic function in these markets and in these regimes than in markets with self-enforcing transactions and in countries with alternative forms of third party enforcement. It allows markets critical to growth to operate at a higher level of activity than it would be possible otherwise. How quickly the positive contributions are exhausted and overcome by the negative ones depends on two issues important for the present discussion.

Size is one factor that has a positive effect on the impact of corruption on growth. The bigger the country, other things equal, the longer the growth process can proceed without hindrance from the inevitable conflicts that arise as a result of corruption. Political competition is a factor that has a negative effect on the impact of corruption on growth. The greater the number of participants that can grant favors to rent seekers, the more quickly conflicts will arise and the sooner the positive impact of corruption on growth will come to a halt. The logic here is similar to the logic of why a stationary bandit is more conducive to growth than a roving bandit. Just as the incentives to the bandits are different in both situations, the incentives to the corrupt politician or power holder are different in both situations.[6]

## IV. REFORMS IN CUBA'S MARKETS WITH NONSELF-ENFORCING TRANSACTIONS

[6] Interestingly, the hierarchical delineation of responsibilities in the Chinese system stressed by Qian and Weingast (1995) increases the economic efficiency of corruption by avoiding local conflicts due to political competition and by stimulating economic competition between jurisdictions through the market.

Markets with nonself-enforcing transactions are poorly developed in Cuba. For example, banking is rudimentary and other financial intermediaries are nonexistent. Clague, et.al., measure the institutional development required for these type of markets to function in terms of contract intensive money, CIM, or the ratio of money supply minus currency to money, $(M_2\text{-}C)/M_2$. Using this definition and the numbers in Perez Villanueva, elsewhere in this volume, on excess money in circulation gives a value of CIM for Cuba of .60. This puts Cuba below Uganda, Nepal, Somalia, Sierra Leone, Rwanda and Niger in terms of this index of institutional development. Hence, it supports putting a reform of the banking sector at the start of a transition program as argued by Carranza, Gutierrez and Monreal in their proposal. It does not support, however, their argument for keeping this sector under state control.

Some reforms in these types of markets have been already introduced. The most visible ones are those that affect the market for direct investment and selected labor markets. In describing the current reforms Monreal and Rua (1994) point to two types of enterprises that are now allowed to function in Cuba, which were previously nonexistent or much more limited. These are joint ventures with foreign investors and Cuban private enterprises. The process has gone farther with respect to the former than the latter. Indeed, the former have been advertising for foreign partners over the last couple of years. In the advertisements a variety of areas of operation are indicated but biotechnology related companies appear frequently. In both cases, these enterprises can be viewed as an attempt to create a market for direct investment in various sectors.[7]

[7]On September 5 1995, modifications to the foreign investment law were announced. Most of the provisions were aimed at increasing the attractiveness to foreign investors, e.g., shorter approval times for projects, possibility

of a 100% ownership, and unlimited repatriation of earnings. Free hiring of labor, however, was not one of them and to this point we will return later on.

With respect to joint ventures the fact that returns are earned over a period of time and that Cuban partners must be well connected in the government generates uncertainties about the benefits from the exchange for the foreign partners. These would be reduced by the existence of an independent judiciary but are reduced far less by the operations of a law which must be implemented by a subservient judiciary. If the net gains from exchange are sufficiently large, however, it would pay some investors to participate. Several considerations can make these net gains sufficiently large. First, the business itself may be very profitable and the money can be recuperated quickly. Indeed, the Cuban government initially promoted these features in the tourism industry by trying to attract foreign investors with the claim that they could get their original investment back in two and a half years.

A second way of ensuring that the gains are sufficiently large is to reduce the uncertainty due to the lack of an independent judiciary by finding alternative mechanisms to perform this function. Thus, in some contracts with foreign investors in Cuba it has been stipulated that disputes between the partners can be resolved in a Paris court. Of course, if the dispute is with other firms operating in the system it is more difficult to employ this mechanism; it is expensive to resolve disputes in Paris. A third way is to lower operating costs by exempting an enterprise from labor laws or environmental regulations. In the tourism industry Spanish foreign investors obtained exemptions on firing provisions in the labor legislation, presumably to secure an adequate level of service provision by their employees.

With respect to the Cuban enterprises recently allowed, they are set up by appointment of the directors by the government, their ownership claims can not be traded in any markets and it is not clear where their assets come from. Conflicts among these enterprises or with other enterprises are likely to be resolved by appeals to the highest level of political contact within the party bureaucracy or the Army. While some economic progress may obtain as a result of the existence of these enterprises, it is unlikely to be long lasting in the absence of further reform steps.

A particular form of corruption has developed in Cuba for employees of foreign enterprises as a result of government legislation. These enterprises are required to pay their employees' salaries to the government in dollars and the government in turn pays these employees in pesos through the "Empleadora Nacional" (the National Employment Agency). If one wants to secure the loyalty of employees and reward differential performance differentially, it becomes very tempting to provide under the table payment in dollars, especially to key employees with important decision making responsibilities.[8] In addition selection by the "Empleadorea Nacional" implies the employee has been approved by the government to work in the foreign enterprise, making the issue of aligning the interests of employees and owners more pressing. This restriction provides a mechanism for political control, but it makes the labor market an economically inefficient allocation mechanism unless the distribution of skills and loyalty are perfectly correlated.

In labor markets for individuals with highly responsible positions, compensation mechanisms are introduced to align the incentives of the employees and the employers even in societies with an independent judiciary. Part of the rationale for this is that most contracts are incomplete due to the impossibility of specifying unforeseen contingencies. Thus, in capitalist societies executives are often paid with stock options which, depending on the particulars of the case, often serve to align the interests of the executives and the stockholders.

Cuba is a small country that is well integrated physically, and in terms of access to potential information and current propaganda. The ability to develop markets where transactions are nonself-enforcing on the basis of

[8]An interesting illustration of this problem in Cuba is available in Cooper (1995).

corruption as a substitute for an independent judiciary is limited. Moreover, the corruption underlying the limited reform process in these markets has been subjected to persistent criticism by the leadership since the summer of 1995. The wealth it creates provides alternative power bases to the current political structures. These are especially threatening because those with access to the means of corruption are also those with access to the party and army leadership structures.

## V. OVERALL PERSPECTIVES ON CUBA'S REFORM PROCESS

The first general characteristic of Cuba's market reform process is the mixed fervor with which it has been adopted by the leadership. For instance, of the packet of reforms announced in the summer of 1993 the first one to be implemented was an extremely harsh antiprofiteering law (Law Decree 149). An analysis of the economic disincentive effects of this law is available in Roque (1995). The thrust of the law is a chilling reminder that a capitalist should not be too successful. In all of the reform markets the government continues to intervene in major ways as shown in Sections II and IV. This differentiates Cuba from China and Vietnam. The market reforms have gone deeper in these two countries.[9]

[9] Incidentally, a listing of the announced reforms in Cuba and Vietnam is available in Quijano (1995).

Other evidence of doubts about market reform have been recent pronouncements by Raul Castro questioning the wisdom of proponents of reforms and their foreign contacts. This is significant because lack of support for reform from the top leadership and the consequent reversal of measures in and of itself affects the growth process negatively. For example, in a comparison of Zambia and Botswana one of the most striking differences has been the frequent changes of policy in Zambia as contrasted to Botswana. Not surprisingly the variance of CIM in Zambia is two and a half times the size of the variance of CIM in Botswana and the growth performance of the two countries differs accordingly[10].

A second characteristic of Cuba's reform process is that it must rely for sustained growth over the long term on the expansion of markets where transactions are not self-enforcing. After initially timid steps at the macroeconomic level, the government has done enough adjustments to be acknowledged by a previous critic, Solchaga (1995a). Nonetheless, the same critic went on to argue that the next two obstacles lie in the creation of a private labor market and a private enterprise market, Solchaga (1995b). In these two markets transactions are not self-enforcing. Unless third party enforcement mechanisms are developed, these recommendations are of limited value. It is precisely in these future oriented markets where the lack of impartial third party enforcement provides the greatest roadblock to expansion.

A third characteristic of Cuba's reform process is that the beneficial effects in terms of growth of a deepening of market reforms are likely to be far more limited than those in Vietnam and China. First, Cuba is a small,

[10]For a discussion of these issues in the context of Zambia and Botswana see R. Tanner,"A Case Study of Contract-Intensive Money and Institutional Quality in Two Developing Countries: Zambia and Botswana," Senior Honor Thesis, U. of Maryland, April 1996.

highly urbanized country. Thus, the ability of spot markets in rural areas to sustain growth is limited by the small size of its market, foregoing gains from specialization, and by the small share in output of rural based economic activity. Both of these factors are far more favorable in China and Vietnam. For example, as of 1990 67% of China's population and 78 % of Vietnam's population was living in rural areas while 25 % of Cuba's population lives in rural areas, HDR (1994). After the initial Chinese liberalization in 1979, agricultural output grew at the hefty rate of 7.4% a year between 1980 and 1987 and nonagricultural output in rural based enterprises is likely to have grown faster, since total output grew by 10 %.

Second, markets where transactions are not self-enforcing are less likely to arise or to operate at high levels of activity in Cuba than in these two countries, because an important substitute for the lack of an impartial judiciary ( corruption) is a less effective mechanism in a small well integrated country with potential competition for the political spoils than in large poorly integrated markets with limited (local) political competition as in China and Vietnam. Cuba's small size and the potential political competition internally and from a nearby exile community make the use of corruption as a substitute mechanism for impartial third party enforcement a two-edged sword for the regime. Moreover, these same factors limit the gains to be attained even if the government were to liberalize, because of the dissipation of exchange gains due to rent seeking activities. Interestingly, in both China and Vietnam their greater size and limited political competition facilitates the use of corruption as a substitute mechanism for impartial third party enforcement when transactions are nonself-enforcing.

Of course other factors play an important role in growth. For instance, saving and investment rates in Cuba, when measurable, are likely to be much closer to other Latin countries than to China. Gross domestic investment in China was estimated at 38% of GDP in 1987; corresponding measures in selected Latin countries are: Argentina 10%, Colombia 19%, Costa Rica 21%, Venezuela

24% (WDR, 1989). Furthermore, in terms of other fundamental characteristics Cuba is closer to the former Soviet Union and its Eastern European satellites than it is to either China or Vietnam, Perez-Lopez (1995).

For those who hope for a transition where market reforms go in tandem with some form of a democratic process, this analysis raises one issue that deserves further attention. The limited growth capabilities of Cuba due to size, urbanization and the effects of corruption on growth are not going to go away with the demise of Fidel Castro or the communist regime. Hence, it may be useful to seek insights into the processes that bring about impartial third party enforcement as well as other institutions that make democracy work and civil society prosper.

For those who hope for a transition where market reforms go in tandem with some form of a socialist process, this analysis raises two issues that deserve further attention. First, in the best of circumstances the growth possibilities of a socialist process in Cuba are far more limited than in China and Vietnam. Second, the failure of the leadership to unequivocally embrace the reforms is itself detrimental to the growth process. Furthermore, this second issue suggests that a gradual process of reform, as proposed by Carranza, Gutierrez and Monreal elsewhere in this volume, provides the seeds for its own demise. Because it creates plentiful opportunities for reversal of various measures by the top leadership.

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