

The Role of the State in a ‘Democratic’ Transition: Cuba.

Prepared for the Cuba Transition Project (CTP)
Institute for Cuban and Cuban-American Studies
University of Miami

By

Roger R. Betancourt*

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Executive Summary

In this essay we cover a variety of subtopics associated with the potential role of the state in a 'democratic' Cuba. Throughout we highlight critical aspects relevant for policy by italicizing them. First, we summarize the main functions typically assigned to the state at the abstract level under capitalism. This is done assuming a mixed economy as the operating system of society. These functions include internalizing externalities, providing public goods, commitment to restraint from abusing the monopoly of force, providing market augmenting services in socially contrived markets as well as raising taxes and reconciling all spending activities under financial constraints.

Following this discussion at the abstract level, we provide a brief review of recent reality in developed capitalist democracies with respect to the performance of these functions and draw some practical implications. For instance, the possibilities for free riding (for example pork barrel activities) in a representative system of government vary across different systems and have manifested themselves at their practical worst in systems that can be characterized as operating under 'presidentialism'.

Similar problems of collective choice affect democratic developing countries. Non-democratic ones must deal in addition with the existence of an autonomous state and the lack of a well developed civil society. In general developing countries have to deal with two problems with respect to the role of the state: namely, matching the state's capabilities to the functions that need to be performed and raising these capabilities. In some politically difficult areas, for example assessing the depth of democracy, the use of periodically available indexes to measure progress or performance, even if the indexes are subjective, is very desirable.

Transition economies provide useful lessons and difficult challenges for the roles that the

state needs to perform. For instance, the absence of an impartial judiciary in these societies makes reliance on litigation to resolve economic conflicts an inferior alternative to regulation in most settings. From the point of view of improving economic well being, the state must exhibit flexibility in the practices that it adopts while promoting the emergence and prosperity of new firms. A particularly thorny problem in these societies, which is quite relevant for Cuba, is how to prevent the early winners in the transition from blocking the reforms that benefit the majority in subsequent periods.

In applying these considerations to the current Cuban experience, it is argued that, relative to other Latin American countries for example, the state was less involved in the economy prior to the revolutionary period (1959-1989). During the revolutionary period, however, the state became more involved in the economy in Cuba than it has in most other countries, not just Latin American ones. Finally, Cuba has been involved in a recalcitrant transition since 1989 where state involvement in the economy has already started to diminish from its maximum level. Nonetheless, most informed observers expect little or no further progress in terms of pro market or pro democracy reforms until Castro's demise.

Unfortunately, even Castro's demise in the current circumstances will provide no assurance of a transition toward market mechanisms or democratic processes. Therefore, progress in these directions should be closely monitored in terms of the role the state actually plays given its basic functions. For instance, what actions does the state take: 1) to show its commitment to protect individual rights and to establish the rule of law; or 2) to allow periodic evaluation of its progress in these dimensions by outside observers? With respect to the provision of public goods, for example, one can ask in the Cuban context – to what extent does the state seek alternatives to direct provision for infrastructure; to what extent does the state

engage in democratic decentralization, as opposed to administrative decentralization, toward the municipalities in the provision of health and education services?

In sum, we discuss many direct and indirect roles that a Cuban state can play in a transition that signal a move toward what the World Bank calls the ‘competitive democracies’ outcome. Among the indirect ones, for example, a reform of the taxation of the self-employed in the direction of efficiency and equity stands out. Among the direct ones, the promotion of civil society and political participation free of coercion are obvious examples. A failure of a new government to play the roles suggested in the last section of the paper is a strong signal that early winners during the recalcitrant transition of the last 15 years have captured the new government and, more importantly, are in the process of preserving some version of the current non-competitive political regime.

1. Introduction

In discussing the role of the state in a ‘democratic’ Cuba, it is useful to start by looking at where one may want to end up ideally. We first point out modern views on the economic role of the state in society and the policy implications that follow if one adopts any type of mixed economy as a form of operating system for society. We then note some issues that arise in terms of differences between the ideal and its realization in advanced or developed capitalist societies that function under a democratic regime as well as the policy implications that follow from this gap. Finally, we also point out modern views on the role of the state in underdeveloped or ‘developing’ capitalist societies, especially those that function under a democratic regime, as well as the policy implications that follow from these views.

After identifying a set of desirable and feasible policy recommendations based on theoretical and institutional considerations, we look at the role the state has played in ‘transitions’ since 1989 and in reforming communist societies such as China to draw policy implications from these experiences. Finally, we look at the role the state has played in Cuba until the present. This provides another piece of information necessary to discuss policy implications for the role of the state in any future Cuban transition to a democracy. Incidentally, the quotation marks over the word democracy in the title are used to signal two issues: first, to reinforce the view that I don’t have a crystal ball and some stages of this Cuban transition may be quite different from what we normally associate with a democracy; second, and more generally, to stress that democracy has several dimensions and there is more than one form of a democratic system.

2. The Role of the State under Capitalism and Socialism

One fundamental difference between capitalism and socialism lies in the role assigned,

accepted or recognized for property rights by individuals under both systems. A fundamental principle under socialism is the ownership of the means of production by the state. Broadly interpreted, this can rule out the exercise of traditional property rights by individuals, except for fundamental consumption activities, as in most communist societies. By contrast, a fundamental principle under capitalism is the exercise of property rights by individuals as an irreplaceable cornerstone for the functioning of society. Broadly interpreted this justifies a wide variety of social arrangements, and under some admittedly perverse interpretations perhaps even anarchism.

The flexibility of interpretation of this fundamental difference in both systems allows us to frame or classify the various historical realizations of both systems. Also, it provides us with a philosophical but practically useful perspective from which to view the role of the state in both systems. This is especially the case under capitalism, which is the focus of attention in the rest of this section. Hence, it is useful to be clear as to what we mean by property rights: namely, the right to consume, generate income from or alienate an asset (by either selling it or giving it away).

In an ideal capitalist world, the role of the state is to protect and enhance the value or benefits derived from these individual property rights by all members of society. Nonetheless, in satisfying this role the capitalist state often limits individual property rights. For example, laws forbidding prostitution restrict individuals' property rights over their human capital but are widely viewed, and rightly so, as improving social welfare.

With these preliminary remarks as a background, one can move on to consider the economic role of the state in capitalist systems. In one of its oldest and most recognized economic roles the state is supposed to correct for the existence of market failures due to the

presence of externalities (these exist whenever the well being of a consumer or the production possibilities of a firm are directly affected by the actions of another agent in the economy) or public goods (a commodity for which use of a unit of the good by one agent does not preclude its use by other agents).¹ In doing so, the state protects and enhances the value of the individual property rights of its citizens by addressing situations where markets, by themselves, will not generate economically efficient outcomes and in some cases may not even exist.

Externalities can also be further classified as depletable or nondepletable, depending on whether or not the experience by one agent reduces what can be experienced by another agent. This distinction is important for policy purposes because decentralized solutions to the externality problem, as opposed to the use of quotas or taxes, are only feasible when the externality is depletable. Decentralized solutions to the externality problem are less intrusive than quotas and taxes in terms of the knowledge required by the government to implement them and thus are generally favored. Hence, our first policy implication is – *the adoption of decentralized solutions to the externality problem whenever feasible*. The qualification, however, is restrictive. The decentralized solution proceeds by assigning well defined and enforceable property rights over the externality to one of the agents and allowing the agents to bargain over the externality. For this procedure to be feasible and, thus, to generate an optimal outcome the externality must be measurable as well as depletable.²

Notwithstanding the qualification, we are not discussing the null set. For instance, in

¹ The definitions of externalities and public goods are taken from Mas-Colell, Whinston and Green (1995). Incidentally, it is common usage in the literature to apply the term public goods in this specific sense to items that are goods, for example ports, as well as to items that are services, for example law and order.

² If there is asymmetric information about the benefit or costs of the externality, neither the decentralized procedure nor quotas or taxes need result in an optimal outcome.

some cases even the private sector develops institutions to internalize the externality without direct government intervention. This applies, for example, to shopping centers and shopping malls where traffic generated by an anchor store is an external benefit for the other stores. In these cases what solves the externality problem are the reduced rents for anchor tenants charged by the owners of the shopping center, e.g., Pashigian and Gould (1998).

Public goods also entail additional differentiation. Those that satisfy the definition exactly are nondepletable and the decentralized solution is, thus, not available. These public goods are sometimes referred to as pure public goods, e.g., national security, law and order, economic policy (both micro and macro), and the rule of law (including contract enforcement mechanisms through an independent judiciary). They differ from those where the degree of availability to others is affected to some extent as a result of consumption by one agent, i.e., where congestion effects are possible. This is the case for roads and other means of transportation, power, most health services, education services and telecommunications.

An additional distinction between public goods that is relevant in this context is whether exclusion of an individual from the benefits of a public good is possible. If exclusion is possible, a pure public good is really a club good, Sandler (1992, p.6), and direct government intervention in its provision, while feasible and perhaps desirable, is not necessary. This leads to our second policy implication – *in the case of pure public goods where exclusion is possible a case needs to be made for the desirability of direct provision by the state before a society chooses this option.*

Mention must also be made of a related view on the role of the state in the economic system that provides an additional dimension for differentiation among public goods and services. Olson (2000, Ch.10) discusses the role of government in promoting what he calls

‘socially contrived markets’. These markets require secure and well defined individual rights and the absence of predation, including predation through lobbying. In this view the primary active role of the state is to augment markets by providing public goods or services that secure and define individual rights, because these socially contrived markets are the ones that determine the growth possibilities of a society. Similarly, the primary passive role of the state is to constrain itself so that it is prevented from abusing its monopoly of force and from engaging in predatory behavior on its own behalf or on that of a few small groups. A most important policy conclusion follows from this passive role of the state – *the restraint evidenced by the state through a commitment to protect basic individual human rights, e.g., freedom of speech and freedom of assembly, is essential for the proper functioning of markets, especially those ‘socially contrived markets’ that underlie growth in modern economies.*

Betancourt (2003) notes that pure public goods such as law and order, a medium of exchange and contract enforcement services augment markets in this sense of securing and enhancing the definition of individual rights. They also increase market output indirectly, by increasing the gains from exchange through a reduction of uncertainty and transaction costs. Thus, the production of these services may be characterized by threshold effects and increasing returns. In contrast public goods or services such as infrastructure increase market output directly, by using additional quantities of resources and, as a result, they may be subject to diminishing returns. A policy implication follows – *special attention is required and must be*

paid to the provision of pure public goods or services that enhance and secure individual rights due to their indirect but powerful effect on economic well being in their role as market augmenting services.

We see that the role of the state in society at this abstract level is important, extensive and difficult. It requires considerable financial resources that are normally obtained through taxation. Under certain sensible conditions, these financial resources can be supplemented through borrowing and, under certain undesirable conditions, through the printing press. In any event, the performance of these functions under a financial constraint requires that the state determine priorities in the allocation of resources to the provision of public goods or services and the correction of externalities, including the provision of a safety net for the less fortunate in society. This leads to the last policy conclusion based on these ideal considerations– *the assignment of priorities to the performance of various roles by the state is indispensable in the presence of financial constraints.*

3. The Role of the State in Developed Capitalist Democracies.

When we look at the actual role of the state in developed capitalist democracies, we see a great deal of variability in the functions performed as well as how they are performed. Nonetheless, the 1980's and 1990's saw a move in most advanced capitalist societies toward deregulation in the provision of public services by the state, allowing the market to work wherever possible and using economic allocation mechanisms such as user fees in the provision

of public services. Similarly, in those areas of direct involvement by the state in public services provision, e.g., health and education, these two decades saw a move toward decentralization in the decision making toward the local level. At the same time in the area of provision of pure public goods, for example economic policy with respect to inflation and deficits, we saw a move toward centralization by allowing a supra national authority, namely the European Central Bank, to determine outcomes. Similarly, in the case of financial markets interventions have been toward centralization in terms of integrating regulations across countries or failures to regulate at all, which has been the case for off shore accounts.

With respect to the exercise of restraint by the state through commitments to basic human rights, we have seen the repudiation of the gross violation of these rights by the Nazis before and during World War II. Almost all of the democracies of the developed capitalist world have taken actions in this direction in the second half of the twentieth century. Human rights everywhere were initially highlighted as a basic US foreign policy concern during the Carter administration, and they have remained a key issue, at least on paper, under every subsequent one. We have seen the acceptance of entitlement to these basic human rights by most developed capitalist country governments. They have become a condition for assistance to developing countries by the European Union. They have become a fundamental issue governing the rationale for military interventions by developed capitalist economies, primarily the USA, in the last decade.

Setting budgetary priorities to provide necessary public services while controlling the deficit has become almost routine in developed capitalist democracies. The EU has enshrined this fiscal policy into a numerical rule determining qualifications for admittance to the Union. The level of sophistication in the arguments has evolved from considering current deficits to considering projected deficits due to various factors in the current period. One particular issue has attracted the most attention in this context. Primarily but not solely due to long term demographic changes, most retirement systems in advanced capitalist countries will face large deficits in providing the pension system benefits promised its citizens over the next 20-50 years. These deficits will have to be met thorough current taxes, borrowing or the printing press and/or changes in the structure of the system.³

A recent example of what happens when the state fails to provide basic public services effectively to its elderly citizens was the furor caused by the excessive deaths of the elderly during the 2003 summer heat wave in Europe. The crisis led to the resignation of the health minister in France. In developed democratic capitalist societies, errors of this type are not acceptable to the citizens. Ironically, a free press was critical in ensuring that this basic human right of the elderly is provided in the future by ensuring that the error was discovered despite

³ These changes usually called ‘reforms’ can include measures as dramatic as renegeing on the contracted payments or arbitrarily postponing the retirement ages, which is a more subtle form of renegeing on the contracted payments. Of course, besides political issues of the day, these ‘reforms’ raise issues of government credibility that may extend to all spheres. After all one basic source of the problem has been the very foreseeable and relatively easy to forecast changes in the age structure of the population.

initial governmental efforts to diminish the importance of the problem.

What are the institutions through which the state carries out its role in developed capitalist democracies? And are some of them more effective than others? This is, of course, a broad topic and it has more than a single answer. Fortunately, it has attracted the attention of scholars in recent years. In a major work on constitutional democracy, Mueller (1996) points out a number of problems with the actual role performed by the state in various societies, including the United States (Chapter 1) and Europe and Japan as well as other countries (Chapter 2). In the case of the US, Mueller identifies two types of deficiencies in the actual role of the state in society : governmental failures and governmental over-achievements.

Among the failures he lists: the extreme persistence of crime in parts of some US cities; the inability to eliminate poverty despite additional governmental resources devoted to this task; concerns about the quality of education in the public school system; and the existence of large government deficits. Among the over-achievements he lists: pork barrel projects where the federal government finances public benefits accruing to particular areas that should by the logic of fiscal federalism be left to be financed by state or local governments, for example dams, subways and local roads; defense programs that have become part and parcel of pork barrel politics rather than the basis for national security; and, interventions in agricultural markets through subsidies that create inefficiencies domestically.⁴

⁴ One can also add that these inefficiencies have global effects, which the failure of the 2003 WTO meetings in Cancun brought to the fore.

Why these failures in doing too little or too much? Because governments intervene in the economy not only for the logical reasons given in the previous section but to affect the incomes of certain groups. This leads to disenchantment with the democratic system and a variety of responses, ranging from alienation to referendums. Geographical representation in the national legislature provides incentives for legislators to represent local interests at the national level. By contrast, the President gets elected by representing national interests. The separation of powers in the American system results in an executive that tends to operate nationally and a legislature that tends to operate locally. Mueller ascribes the deficits that we observe in large measure to the conflicting nature of incentives provided to these two branches of government.

He then goes on to argue that part of the problem is inherent to any democratic system, because representative democracy by definition creates a principal- agent problem between the citizens and their representatives. Nonetheless, part of the problem is due to specific US institutions. These are subject to change through constitutional reforms. From our perspective it follows that— *particular forms of governmental institutions have implications for the possibilities of free riding in a representative system and for the effectiveness of the state in performing its functions . Both need to be investigated and discussed prior to adoption.*

These two types of deficiencies in the actual role of the state in society also affect other advanced countries with somewhat different democratic institutions and sometimes they manifest themselves in different forms and sometimes in the same form. An important

difference between European parliamentary systems and the US legislature is that these systems tend to produce parties with national constituencies and these tend to represent more dispersed interests. Hence, the incentives toward pork barrel politics in which the logic of fiscal federalism is consistently violated are lower. Nonetheless, the same kind of interest group politics where governments intervene to provide income for some group prevails in different forms. The Concorde is a well-known example of monumental waste and inefficiency engendered by this type of government intervention in Europe and agricultural subsidies in Europe are at least as extensive and probably more onerous to their taxpayers than in the US. The inability to control deficits is also a source of concern in some European countries, but not in others and Mueller suggests the latter may be due to institutional variations in the parliamentary system.

Two issues on the actual role of the state are substantially different in Europe than in the US : the nature of violent crime and political instability. When terrorist organizations, e.g. ETA, IRA or the Red Brigades, or criminal organizations, e.g., the Mafia, act with impunity killing citizens and/ or depriving them of their livelihood, the state fails in providing the public good of law and order in a very visible and major way. That happens in Europe in ways that it does not happen in the US. Countries with more than 10 or 20 parties represented in Parliament rely on multiparty coalitions to form a government and these coalitions can be unstable. If so, governments become ineffective because they don't stay in office long enough to implement a program. Again that happens in Europe more often than in the US.

While no particular set of institutional arrangements generates ideal outcomes in actual

developed capitalist democracies, can one say anything about some arrangements being better than others? Mueller (1999) concludes his analysis of fundamental issues in constitutional reform by pointing out that the worse electoral system in practice, which he calls presidentialism, is one with the following characteristics. The legislature is multiparty and, thus, all citizens are fairly represented, which is attractive, and the President is popularly elected to represent a plurality or a majority of the citizens. Mueller writes (1999, p.143) “ In practice presidentialism has led to immobilism and ineffective government...” He goes on to cite similar diagnosis of the system from a number of other scholars. Hence, one implication to draw is— *whoever proposes a presidentialist system of government bears the burden of proof in demonstrating why it will work in any particular setting.*

4. The Role of the State in Developing Countries.

The same general considerations that apply to the role of the state in capitalist democracies also apply to the role of the state in developing countries, whether or not they are democracies. The last two decades also have seen a movement in developing countries towards deregulation and privatization as a means of dealing with externalities and towards decentralization as a means of providing local public goods. Concern with controlling budget deficits has resulted in less inflationary experiences for these countries in the 1990's than before. The financial crises of the 1990's have focused attention in these countries on the need to provide pure public goods that generate market augmenting services such as contract enforcement mechanisms. Finally, there is at present a recognition in the development literature that some states are failed states in terms of their ability to protect the basic human rights of their citizens.

It is not far fetched to argue that the state in developing countries has failed more

dramatically than the state in developed ones in fulfilling these roles, especially the last two. The 1997 World Development Report on “ The State in a Changing World” makes similar points. It notes that in both developed and developing countries views on the ‘proper’ role of the state have evolved toward supporting a role as a facilitator of market activities rather than as a direct participant in market activities. In the context of developing countries the report also raises the issue of state capabilities. It notes that spending by governments is greater as a percentage of GDP in OECD countries than in developing countries, roughly 45 % versus 30% of GDP, respectively. Part of the reason for this difference is data problems, developing country data only includes spending by the central government whereas developed country data includes local government spending as well. But part of the reason for the difference is the lower level of capabilities, or ability to be effective, of the state in developing countries. Hence, it suggest two general policy prescriptions for the state in developing countries— *a need for matching the state’s capabilities to the functions that it needs to perform and a need for raising the state’s capabilities to perform its functions.*

An additional characteristic of the state in developing countries has been stressed by Findlay (1991). He argues that in many developing countries with non-democratic forms of government the state plays an independent or autonomous role. This role can’t be captured in terms of arguments about pressure groups, constitutions or voting rules. His view is that, in contrast to developed countries, the state in these developing countries has evolved independently of civil society and it frequently is more powerful and sophisticated than civil society. As a result, the balance between the passive and the active role of the state in these societies has to be understood in different terms than under a democratic system. He goes on to

develop one such model where the state can engage in various combinations of predatory and productive behavior in the provision of public goods. It follows from this analysis that one of the roles of the state in this type of countries is— *to promote the development of civil society institutions as a commitment to refrain from abusing power by empowering other groups.*⁵

Examples of the autonomous state are given by Mobutu's Zaire, as a prototype of the predatory state, and Korea and Taiwan, as prototypes of a developmental state. The latter is one that promotes economic growth successfully, through its intervention in industrial policy among other activities. According to Evans (1992), one key to the emergence of a successful developmental state is the existence of a governmental bureaucracy imbued with the notion of a merit system. While Evans does not claim this existence is enough for success, he views it as necessary so that its potential can be activated by ideological or external factors that lend coherence to its activities. Subsequent work by Rauch and Evans (2000) leads them to conclude that meritocratic recruitment is "... most important for improving bureaucratic performance."

If one turns attention to the actual role of the state in democratic developing countries, one is immediately faced with two issues: What do we mean by democracy in these contexts? And, to what extent are these democracies stable? A recent Human Development Report (2002) is devoted to the topic "Deepening Democracy in a Fragmented World". First, it notes that objective characteristics of democracy such as when the last election was held or voter turnout can be very misleading as a means of capturing the actual control people have over their lives

⁵ States can promote the development of a wide variety of private institutions, ranging from trade associations to conservation societies. This can be done through the granting of tax benefits, the creation of legal categories such as non-profits and outright subsidies. Of course, these possibilities are not limited to non-democratic regimes.

through participation in governmental affairs. Second, subjective indicators of various aspects of democracy can be subject to biases due to their very nature. I find the first limitation far more serious than the second for practical purposes.

For instance, the HDR provides five subjective measures of ‘democracy’, for example indices of civil liberties, political rights and press freedom; they also provide four subjective measures of rule of law and effectiveness of government and two indices of corruption. Despite the imperfections of these measures, they can be used to measure progress toward democracy. Some of them, for example rule of law and law and order, provide appropriate yardsticks with which to evaluate the progress of the state in performing some of its most basic functions. Thus they have the following implication – *in so far as possible the conduct of the state in performing its basic functions should be evaluated periodically with widely used, even if subjective indexes of performance*. For instance, one could use periodically available indicators such as Freedom House’s index of press freedom or the World Bank’s index of the rule of law if it became available periodically on a consistent basis.

With respect to the second question of stability of democratic regimes in developing countries, the HDR report notes “the spread of democratization appears to have stalled.”(p.13) and “Many others [countries that introduced democratic reforms] do not seem to be in a transition to anything or have lapsed back to authoritarianism ” (p.15). This makes the Chilean experience an especially worthwhile one to study, because the country has navigated the transition to democracy in a stable fashion and this transition has been accompanied by excellent economic performance. Foxley and Sapelli (1999) provide a useful discussion of many of the relevant issues. One that stands out in the present context is the following. One reason for the

stability of the system in Chile has been the design of the electoral system. According to these authors “ The Chilean system is unique in its tendency to over represent second-place finishers. It also encourages the formation of broad coalitions. The imperative to coalesce is formidable enough that Chile’s traditional multi-party system now performs much like a two party system.” (p.418).

By the way of a conclusion to this section, we note the difficulty exhibited in decentralizing the provision of some public services in India and Chile as an example of an area where there is a need to raise the state’s capabilities in developing countries. In India there was administrative decentralization to the district level with respect to health and education services since independence, but this simply meant implementation independently of local government structures (the panchayati raj), Betancourt and Gleason (2000). Democratic decentralization in the provision of public services requires devolution of the power to spend and tax to local governments. While this problem has been recognized, its solution is still an ongoing process in India, e.g., HDR 2002. Similarly, the Pinochet regime initiated a decentralization process in Chile with respect to health and education (as well as other things) in the 1970’s and 1980’s, Marcel (1999). While the connection with the power to spend and tax was more clear in Chile than in India, the participation of the population was missing since decisions were made by appointed mayors. The democratic government that followed Pinochet addressed this issue by having mayors and local councils elected but, according to Marcel (1999), accountability procedures and management systems in the municipalities are still in need of improvement.

5. The Role of the State during Transitions.

An ironic feature of China’s transition to greater reliance on the market is that the two

major reforms underlying this process were the result of successful local initiatives that were subsequently adopted by the system. According to Qian and Weingast (1996), both the household responsibility system and town and village enterprises started as local initiatives in one region of the country. They were so successful, however, that shortly after their introduction the central government adopted them as the norm to be followed by all. This suggests that— *in any transition process, the state needs to be flexible enough to endorse and adopt quickly market reform activities that prove economically effective.*

Glaeser and Shleifer (2003) explain the rise of the regulatory state at the beginning of the twentieth century in the US as a response to the failure of the private litigation system toward the end of the nineteenth century. One reason for the failure of the private system was, in their view, vulnerability to subversion by large scale firms that could influence legislation, the nomination of judges and engage in protracted legal battles. They develop a model to analyze the advantages and disadvantages of alternative institutional regimes. They show that if enforcement is particularly poor one may not want to either litigate or regulate, because neither will be effective. At medium levels of enforcement regulation, usually in combination with litigation, is likely to generate socially desirable outcomes. If the costs of subversion are very high, litigation becomes the superior alternative to regulation in their model.

Their analysis is quite sobering for transition economies. If a minimal level of law and order does not exist then neither litigation nor regulation, or their combination, is likely to generate socially desirable outcomes. They offer the development of securities markets in the Czech Republic and Poland as an example. The former pursued a policy of laissez faire expecting the judicial system, through litigation, to fill the gaps. The latter followed a policy of

regulation patterned after the U.S. Securities Act. The Czech market collapsed under the weight of pervasive fraud while the Polish market developed rapidly and Glaeser and Shleifer (2003) argue that there is some evidence that in Poland the rules were enforced.

Last but not least, the recent World Bank (2002) study on the first ten years of the transition draws several broad lessons. One important lesson is the critical role of entry and growth of new firms, particularly small and medium sized enterprises, in spurring economic growth and in providing employment in these economies. It follows from this that — *establishing the conditions for new firms to arise and prosper is one of the most important roles of the state during a transition.* Another important lesson identified in the report is that winners from early stages of the reform may oppose subsequent reforms when these threaten their initial gains. It follows from this that — *the state's ability to perform its various roles in the economic system during a transition can be dramatically limited by the early winners in the transition process.*

More generally, the role of the state during transition is in some ways the same as the ideal role depicted in the first section. On the other hand, it is dramatically different in at least one way. Namely, the state needs to participate actively in the development of the institutions that underlie a market economy. Hence, in this sense its role is closer to the role of the state in a developing country.

6. The Previous Role of the State in Cuba.

The state's role in the Cuban economy naturally falls into three historical periods. The initial period prior to the revolution coming to power in 1959 can be characterized as a low level of state involvement in the economy. Mesa- Lago (2000, pp171-173) characterizes the period

prior to 1958 as one in which the Cuban state had a very low degree of ownership in production and services compared to other Latin American countries at similar levels of development. Public utilities such as electricity and telephones were foreign owned.⁶ Only in education and health did one find extensive state ownership. He also notes that there had been increased intervention by the state in the 1950's in terms of public construction and the provision of social services.

A second period is the 'revolutionary' one from 1959 to 1989. Here the role of the state increases rapidly to what one could characterize as a maximum role. Mesa-Lago (2000) calls the subperiod 1959-1960 "Liquidation of Capitalism and Market Erosion," and the subperiod 1961-1963 "Orthodox (Stalinist) Central Planning Model,". By 1963, the only economic activities left in private hands were 30% of agriculture and 25% of retail trade, mainly street vendors. Even private ownership of housing had been limited through expropriation of rental housing in 1960. There were variations in the socialist models used until 1989, including some economic liberalization in the late 1970's and early 1980's that was subsequently 'rectified', but the state played a pervasive and invasive role in every aspect of economic activity and in all aspects of life.⁷

Finally, the third period can be characterized as one of 'recalcitrant transition to a market economy'. It starts in 1989 and is to a large extent a result of the end of Soviet subsidies,

⁶ While this is true in terms of ownership, it should not be interpreted as implying that Cuba operated as a free market economy. For instance, the state was heavily involved in the most important industry in the country. Sugar quotas were not set by the market! Similarly, the need to bribe officials was a frequent complaint of businessmen.

⁷ See, for example, Mesa-Lago (2000) or Clark (1990) for details and further references about this period.

directly and perhaps more important indirectly.⁸ A number of measures were taken to deal with these dramatic changes in economic circumstances, especially between 1993 and 1995. Many of these and subsequent changes involved, albeit often in a small degree, a retreat by the state from direct participation in economic activity. For instance, areas of the economy previously closed to the private sector were opened for foreign investment. Of course, the workers must be hired from a state run employment company. In other areas foreign enterprises must be joint ventures with the Cuban state or their representatives. The possibility of having medium sized and large enterprises is limited to the privileged few, especially the military or retired military and high ranking party members. Self-employment becomes possible, but subject to extreme restrictions, e.g., it is forbidden to be self-employed in the profession where one obtained an education or to have any paid employees. Summing up, in a very recent evaluation of this period, Ritter (2003a) writes "...Cuba is in a pre-transition phase....Castro will die at some time. Cuban economic policy as well as the institutional structure will likely remain paralyzed until then."

7. The Role of the State in a Future Cuban Transition.

With the previous information as background, one can now consider in more detail various aspects of the role of the state during a transition to 'democracy' in Cuba.

First and foremost, a Cuban state that pretends to guide citizens through a democratic transition *must show its commitment to the protection of individual rights such as freedom of speech and freedom of assembly and to the establishment of the rule of law.* At the abstract level, we saw in

⁸ For example, as noted by Betancourt (1996), after 1989 Cuba's price for imported oil from the Soviets went from 6\$ to 18\$ per barrel and Cuba's price for its exported sugar to the Soviets went from 21 to 6 cents per pound. Furthermore, Cuba went from receiving 13 million barrels of oil at the lower price from the Soviets in 1989, which allowed exports of 3 million at the higher price, to paying the higher price for whatever amount they imported.

our discussion of the role of the state under capitalism that this commitment is necessary for the development of markets essential for economic growth. It can not be efficiently provided by alternative institutions.⁹

At the practical level the failure to commit itself to the rule of law and refrain from abusing its monopoly of force by suppressing individual rights is the most reprehensible shortcoming of the current regime. The recent detention and arbitrary confinement of 75 dissidents and the medical mistreatment of some of them while imprisoned is sufficient to establish that: any ‘new ’ government that succeeds Castro must address a potential credibility gap in this dimension. Therefore, *in order to establish credibility any such new government should submit itself to periodic evaluations of its progress in protecting individual rights by outside observers, for example, through the use of indexes such as the rule of law index or the freedom of the press index cited above.* The basic idea is, of course, systematic evaluation by a party independent of the government in power.

Furthermore, this suggestion is not offered as a substitute to the development of an impartial judiciary. On the contrary, I view it as a complementary activity for two reasons. At the abstract level, the development of an impartial judiciary is a critical factor or input in the provision of pure public goods or services such as law and order and contract enforcement services that contribute to the rule of law in a society. These two market augmenting services are indispensable for the emergence and development of financial markets and other socially contrived markets that underlie the possibilities for economic growth. At the practical level, the

⁹ By no means should this argument be viewed as the only basis or the most important one in favor of democracy. A friend quoting from Tocqueville, C. Quijano (1994), put it best “Who seeks liberty other than itself is born to be a slave.”

current judicial system in Cuba clearly subordinates the judicial power to the executive power even at the constitutional level, e.g. Bernal (1999). Thus, *the need for reform of the basis for the judicial system and retraining of its current members is a fundamental undertaking for any new government seriously considering a transition to democracy and a market economy. This process takes time.*

Part of the role of an impartial judiciary in advanced countries is to provide for the settlement of economic disputes. Considering the gap between the current legal system and the effective operation of a private litigation system in light of the analysis by Glaeser and Shleifer (2003), *regulation or doing nothing seem to be preferred alternatives as instruments of microeconomic policy in the early stages of a transition.*¹⁰ With respect to regulation, however, one must ensure that the regulatory system is not used to prevent entry. This is a common problem when regulatory agencies are captured by existing producers or when the rents from limiting entry accrue to those holding political power. Thus, the constitutional basis of the underlying political institutions and the quality of governance will have a major impact in determining final outcomes during a transition.

With respect to the provision of public goods such as infrastructure in telecommunications (for example phones), electricity, transportation (for example roads), potable water, and sewage systems, there is a current state of disrepair in their provision that will require major investments.¹¹ *In addition to the fact that exclusion is possible for many of these*

¹⁰ On the macroeconomic policy side, the shortcomings of the current judicial system would affect the credibility of any claims of Central Bank independence made by a new government.

¹¹ For instance, one observer, Cereijo (1999), provides an evaluation of needs and their costs in several of these areas for the next five years (as of 1999). His estimates are: in

public goods, several other reasons suggest that alternatives to direct provision by the state should be vigorously sought by any new government. First, the current state of provision provides a strong signal of lack of capabilities by the state in these dimensions. Second, any new government will operate under a budget constraint that will require selection of priorities in the activities it can undertake directly. Finally, alternatives to direct public provision by the Cuban state are consistent not only with the history prior to the revolutionary period, but they are even consistent with alternatives chosen during the recent recalcitrant transition by the Cuban state.¹⁰

A somewhat different situation emerges with respect to the role of the state in education and health activities during any new transition government. First, the history of state involvement in health and education in Cuba predates the revolutionary period by many years. At the same time, in both areas there existed a substantial amount of private activity prior to the revolution although for different reasons. Second, outcomes in these two areas are claimed to be great achievements of the revolutionary period. Third, there is evidence of substantial problems in both areas during the current recalcitrant transition.

Let us start with health services. Prior to the revolution hundreds of thousands received their medical services through mutual societies that functioned on a basis similar to HMO's in the US in terms of how medical services were provided. In contrast to US HMO's, however, some of these mutual societies provided services other than medical ones and some were based

electricity, \$1.5 billion; in telecommunications, \$2.1 billion; \$1.8 billion for highways; \$1.4 for railroads; and \$1.25 for water and sewage.

¹⁰ For example, Cereiyo (1999) points out that in 1991 a joint venture between the Cuban State and a foreign enterprise, Telecomunicaciones Internacionales de Mexico SA, was created to provide cellular services.

on ethnic affiliations.¹¹ While the publicly provided health services prior to the revolution had some shortcomings, they compared favorably to other countries in the region and in some cases to developed countries.¹² Similarly, there is no doubt that Cuba made progress in health outcomes in absolute terms during the revolutionary period; there is also no doubt that in relative terms it devoted more resources to this activity than any other country in the world (and than most countries even in absolute terms). Finally, there is also no doubt that there has been a decline in the rate of progress in outcomes during the recalcitrant transition period.

The latter period also gave rise to the term ‘medical apartheid’ because health services available to the nomenclature and to foreigners that pay with dollars are not available to the average Cuban. Any new democratic government needs to address the apartheid issue and the budget requirements imposed by the overinvestment in medical services.¹³ Ironically, in terms of their interactions with foreigners the Cuban medical system already functions as if it were a private medical system. For instance, Travieso-Diaz and Musa (2003) have put forth a recent proposal for classifying Cuba as a retirement haven after transition to a new regime. Their argument stresses the orientation toward the elderly and the economic success of the current system with respect to foreigners as one of the features that makes their proposal viable. They

¹¹ By the way, mutualist societies providing medical services were absent in rural areas. For a brief discussion of the system from the end of colonial times to the present see Beato (1999).

¹² For instance, the system of publicly provided stand alone emergency rooms (Casas de Socorro) spread throughout city neighborhoods made emergency care more accessible in Cuban cities than in the cities of many other countries.

¹³ Incidentally, Alonso, Donate-Armada and Lago (1994) provide the most thorough analysis to date of reform possibilities for the health system.

even name a state owned center (CITED) that currently advertises health tourism as an example.

Clearly, any new government would have to devise rules for ‘privatizing’ these medical centers consistent with efficiency and equity. That is, the benefits generated by a state owned center that is privatized can not be exclusively available to foreigners *de jure*. If they are *de facto*, because foreigners are practically the only ones that can afford their services, special provisions must be made for wider availability of their benefits or the operations of these centers must be subjected to special legislation designed to remedy, at least partially, the resultant inequity.

Concern with education prior to the revolution can be dated back to colonial times. There were widely recognized major deficiencies in the system prior to the revolution. The decline in the quality of primary education provided by the public system led to the development of a private sector to fulfill this void.¹⁴ De la Torre (1999) attributes this problem to changing the system of municipal supervision and to widespread corruption in public administration. Initially, the municipal boards of education were elected; subsequently they were appointed by the minister of education. Secondary and university education were organized in a more centralized fashion. Just as in the case of health, there is no doubt that Cuba made progress in absolute terms with respect to education outcomes during the revolutionary period and that there were some peculiarities about this progress.¹⁵ In contrast to health, however, the recalcitrant

¹⁴ According to de la Torre (1999), however, the private sector did not find filling this void in rural areas profitable.

¹⁵ For instance, Madrid Aris (1997) concludes his analysis of the sources of growth in Cuba by stating that “...most of the investment in education has not had any economic return...”.

transition period has led to dramatic declines in outcomes and to regime recognition of deficiencies in the system.¹⁶

Any new government during a democratic transition is likely to retain a substantial amount of direct involvement in the provision of health services and education to the population.

The most efficient way of accomplishing this task is by devolving power to local authorities, which means the municipalities. In the case of Cuba, however, this devolution will be a failure unless the present system of allocation of power to local government activities is reformed.

Amaro (1996) has written a comprehensive essay showing the current structure of the Cuban system, and its similarity to other former communist countries. Basically, under the double solidarity principle, there is administrative decentralization for implementation purposes but no decentralization in terms of the power to tax and spend from the centralized authority to the local ones.

Universal access to basic health services and elementary education are goals that any new democratic government is unlikely to abandon. Furthermore, private sector provision, especially in remote areas, is unlikely to be viable. Hence, direct state involvement at these levels should emphasize the efficiency of public provision. Once the focus changes toward secondary and higher education or more complex or specialized health services, however, private sector competition can be a useful tool for ensuring efficiency of public provision and in some cases it

¹⁶ For instance there have been dramatic declines in university enrollments. According to Mesa-Lago (2000), between 1990 and 1995 the university enrollment ratio decreased from 21 to 12. Furthermore the lack of training in areas such as accounting, marketing, capitalist economics and finance is a limitation of the revolutionary educational system that has been implicitly acknowledged by the Cuban government. For instance, they allowed and encouraged Carleton University to start a Masters' program to remedy those deficiencies in the early 90's. This program ceased to operate in the second half of the 1990's.

should lead to the elimination of some current activities. For instance, a US academic who traveled to the island recently reported an expansion plan from the current 50 universities to 150 future ones, Sanchez (2003). This same academic also reported that one of the current universities with 8,000 students had 12,000 books in its library, internet facilities that did not work very well, and a librarian that proudly proclaimed having an infinity of books. Private sector competition at the university level would and should eliminate some of these inefficiencies.

With respect to externalities, the most difficult set of issues faced by a new democratic government is going to be how to deal with environmental issues. Diaz-Briquets and Perez-Lopez (2000) provide a comprehensive assessment of environmental problems. An ambitious program assuming "...return to a free, Western style economic system and democratic government in Cuba." is presented in Vega and Poey (2000). A more pointed analysis on solutions is that of Leiva (1998) who notes the deficiencies in the current law and its implementation and discusses various alternative sources of foreign help in developing an environmental infrastructure. *Despite the abstract appeal of decentralized solutions, the most attractive practical approach would be the creation of a regulatory agency with international technical assistance and financial aid.* A decentralized approach creates too much room for final resolution by a private litigation system where subversion is likely to be quite high due to the asymmetry in economic power of the participants and the likely lack of independence of a judiciary in the immediate future. Incidentally, this regulatory agency is not a substitute but a complement to private sector activities. For instance, a particularly attractive one in principle is the not for profit conservation trust fund recently proposed by Maldonado (2003).

A critical role of the state in a future Cuban transition is to provide the resources through taxation for a variety of expenditures and to prioritize the areas of expenditures through the budget process, including social safety net ones. Gallagher (1999) provides a number of reasonable suggestions for a desirable tax regime during a transition based on other experiences. Perez (2000) reviews these experiences and goes on to discuss Cuban progress along these lines in the 90's with respect to tax regime, tax administration reforms, the budget process and public spending. He sees the 1994 tax reform as mixed in terms of ability to raise revenue, enhance incentives and improve equity. He is complimentary toward tax administration reform in terms of registering taxpayers, but not much else, and toward budget process reforms in terms of transparency at the theoretical level, but not at the practical level. He identifies public spending as the area of reform with the least progress, noting that it still accounts for 50 % of GDP in 1998 and one fourth of this spending is transfers to state enterprises. Finally, Mesa-Lago (2003, p. 87) reports a very practical regressive result of these reforms: namely, 55.7% of taxes collected by the Cuban government in 2001 were indirect ones.

Ritter (2003b) provides a more pointed critique of the tax regime as it applies to the self-employment sector. He shows that taxation of the self-employment sector is inefficient, because it discourages new firms, and inequitable, because taxation of joint ventures between foreign enterprises and the Cuban state is less onerous. *Any new transition government must reform the taxation of self-employment towards a more efficient and equitable structure, since this sector is likely to provide a substantial number of new firms in any economically successful transition.* More generally, the state should promote the development of small and medium sized enterprises. Nevertheless as Gayoso (1999) points out most current small and medium sized

enterprises in Cuba are state owned enterprises. Thus, this promotion is likely to be intimately tied up with the privatization process of these enterprises.

A particularly difficult problem facing any new transition government is choosing priorities and raising revenues to satisfy the commitments to a social safety net. Following Buttari (1994), it is useful to make a distinction between short-run and long-run issues. In the short-run some of the dislocations associated with restructuring have already taken place. In view of the still considerable amount of state involvement in the economy, however, the process is far from finished. Just as Buttari (1994) notes, the central short-run issue is not reforming specific features of the labor market but the speedy creation of new jobs by stimulating economic activity in all sectors.

Long term issues represent a different problem. A social safety net can include a broad variety of issues. In their comprehensive analysis of reform alternatives Alonso, Donate-Armada and Lago (1994) consider health, unemployment insurance, welfare and retirement benefits together. Other writers include education under social services and an argument can be made that housing should also be included. Regardless of the classification one prefers, the reality is that in real terms spending on all these categories of social services has declined in Cuba between 1989 and 1998. This can be ascertained from the numbers reported in Mesa- Lago (2003, p.108). Any new government will have to confront this problem and the extent of the problem will depend on when the actual change takes place.

Retirement benefits differ from the others in that there is a substantial inter-temporal separation between contributions to the system by an individual and the receipt of benefits by that individual. Retirement benefits represent the more intractable problem faced by a new

government because standard forecasts of changes in the demographic structure of the population make the current provisions of the system unsustainable.¹⁷ Projecting at rates prevailing in 2000, Donate Armada (2001) calculates that pension expenditures in 2050 would take up about 50% of the social expenditure budget that also includes health and education. An important contributor to the problem is the mandatory retirement age: 60 for males and 55 for females. An easy solution for a new government would be to postpone the retirement age for males and females, but this could become a politically difficult solution for any government without the backing of a substantial majority of the population. Popular alternatives in other places such as the introduction of private social security accounts will face the difficulty in Cuba of a profound underdevelopment of the financial system under the current system.

This brings us to the last and most difficult topic in the role of the state in a future Cuban transition: the design of a new political system. There seems to be widespread agreement that there will not be much serious movement toward democracy or the market until Castro dies. What happens at that point? If hard core non-reformers or what Corrales (2002) calls ‘duros’ or hard-liners succeed Castro, they will continue previous policies. Indeed, they may even pretend to pursue small political or economic openings in order to gain outside resources while retaining control. If reformers or soft-liners succeed Castro, other more interesting possibilities open up.

Classification of transition regimes by the World Bank would label the hard-line outcome as one in which a “non-competitive” political regime prevails. If reformers succeeded Castro, the outcome may end up as “concentrated political regimes” with some multi-party competition

¹⁷ This has been noted in a number of articles by various authors, especially Donate-Armada (1994, 1995, 2001) but also see Roque Cabello (1996), Mesa-Lago (1996), Perez, (1998), and Diaz-Briquets (2002).

but limited political competition through curtailed civil liberties or as “competitive democracies” with a high level of political rights and extensive civil liberties.¹⁸ Ernesto Betancourt (2002) has proposed recently the “competitive democracies” outcome as the desirable one for Cuba. He goes on to discuss how *successful privatization is a key element in bringing about the ‘competitive democracies’ outcome in reality*, and proposes various aspects of support for such a process (including technical assistance by multinational organizations). In a similar spirit, but in a more speculative tone, Sanguinety (2001) ranges quite widely and relies on Olson’s analyses of collective action to develop alternative scenarios for a post-Castro world. Of course, not all of them lead to the “competitive democracies” outcome.

Unfortunately in the event of Castro’s demise it will be difficult to ascertain the true nature of the regime that follows. Furthermore if a new regime asks for time in adopting reforms, it would be unreasonable to refuse the request. Of course, the actual but unannounced intention of the request could easily be to solidify a non-competitive regime. In so far as the state undertakes to play the roles suggested here, however, it would provide reassurance that the reforms are in the direction of “the competitive democracies” outcome and not in the direction of early winners blocking reforms in a non-competitive setting. Along these lines any future government that promoted *the development of civil society*,¹⁹ *the education of citizens with*

¹⁸ A fourth outcome in the Bank’s classification is ‘war torn regimes’. Since this outcome seems less likely than at least two of the other three outcomes in Cuba’s case, it will be ignored.

¹⁹ A most reliable single signal of promoting civil society by a new government would be the release of the recently imprisoned dissidents and other political prisoners.

respect to the operation of markets and democracy,²⁰ and the participation of citizens in the choice of a political system²¹ would be playing a role consistent with the “competitive democracies outcome”.

²⁰ On the need for education with respect to the market and democracy in transition economies see Sanguinety (1995).

²¹ Free elections to a constitutional convention or open debate of the merits of documents such as, for example, “La Patria es de Todos” would be reliable signals of the state’s desire to encourage citizen participation.

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