

April 8, 1992

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## PREPARING FOR A FREE MARKET CUBA PREPARING FOR A FREE MARKET CUBA

### INTRODUCTION

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Cuba today is suffering its worst economic crisis since Fidel Castro seized control in 1959. It has been forced to import water buffalo from Vietnam to replace gasoline-powered plows. It has imported 500,000 bicycles from China to replace automobiles and buses used in transportation. And for the first time in its history, Cuba is rationing cigars and sugar, normally two of its largest exports.

The fuel for this crisis is three decades of economic decline under communism. The spark that set off the decline was the withdrawal by the former Soviet Union of the \$6 billion in annual military and economic assistance, estimated to be between 15 percent and 25 percent of Cuba's gross national product. Without these funds, which had propped it up for decades, Cuba's economy is collapsing. The question now is not whether Castro will fall but when.

The collapse of the Western Hemisphere's last communist dictatorship will give America the opportunity to welcome back that island's 11 million inhabitants to the free world. Like Eastern Europe and the republics of the former Soviet Union, Cuba will face the challenge of reorganizing and rebuilding on a free market foundation an economy now in ruins. Since Cuba is particularly poor, even by communist standards, its struggle will be difficult.

**Cuban Advantage.** Yet two factors give Cuba an advantage over other ex-communist countries. First, Cuba is only 90 miles from the United States and, before Castro seized power, Cuba had close economic ties to America. Re-establishing those ties can be the basis of Cuba's future economic prosperity. And second, the huge Cuban exile community in Florida can provide quick capital and expertise to get the island's economy moving again.

Cuba's economic fate ultimately, of course, is in the hands of its own people and policy makers. When they form the post-Castro Cuban government, they would do well to establish a strategy for the short term and one for the medium to long term to guide the reform process.

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Cuba's short-term strategy should be to:

- ✓ Quickly privatize state-owned enterprises, returning them to individuals, and eliminate all state monopolies;
- ✓ Establish a stable, convertible currency;
- ✓ Establish a legal and institutional framework to protect private property;
- ✓ Liberalize trade and eliminate restrictions on foreign investment.

In the medium to long term, the post-Castro Cuban government should:

- ✗ Promote rapid development of competitive and efficient financial institutions, including stock and bond markets;
- ✗ Establish a tax structure with the least disincentives for economic activity;
- ✗ Avoid addiction to foreign aid by establishing strict guidelines that direct all aid going to Cuba to the alleviation of immediate suffering and the establishment of free market institutions.

The U.S. could aid Cuba's transition to a free market economy, easing the burden of economic reforms and helping to assure their success. A number of measures would be useful. Among them, America should:

- ☞ Restore Cuba's most favored nation trade status and, as soon as feasible, negotiate a free trade area with Cuba;
- ☞ Restore to near its 1958 level Cuba's share of the U.S. sugar quota;
- ☞ Provide only emergency economic assistance, with a set termination date, or assistance for establishing a free market, while resisting the creation of a "Caribbean Bank for Reconstruction and Development."

Free market policies of this sort have produced stunning economic successes in the Republic of China on Taiwan, the Republic of Korea, Singapore, and in Hong Kong. These have some of the fastest growing economies in the world, which have allowed them to rise from poverty to prosperity. To be sure, Cuba will face many hurdles on its path to establishing a functioning free market economy. But as the success of Cuban exiles in Florida demonstrate, if provided with economic freedom and opportunity, the people of Cuba are more than a match for this challenge.

## **CUBA'S ECONOMIC CRISIS**

**Pre-Castro Cuba.** Before Castro came to power in 1959, Cuba was a growing economic power in the Western Hemisphere. Liberal foreign investment laws, free trade policies, and an attractive tax code helped Cuba double its gross national product (GNP) between 1945 and 1958. Before Castro seized power, Cuba's per capita GNP ranked third among Latin American countries, only behind Argentina and Venezuela. Cuba's agricultural production greatly contributed to the island's economic growth. By 1958, some 58 percent of Cuba's total sugar exports went to the U.S., supplying 38

percent of America's sugar.<sup>1</sup>

Before Castro, Cuba was well on its way to industrialization. It had an extensive television network, modern roads, 9,000 miles of railroad, 100 private and public airports, and a growing tourism industry. Between 1950 and 1959, Cuba nearly doubled its hotel capacity by constructing 28 new hotels. In 1958, some 325,000 tourists visited Cuba.<sup>2</sup> Prior to Castro, Cuba had a well-educated, healthy population. Cuba's life expectancy, infant mortality, and literacy rates were as good as any in Latin America.

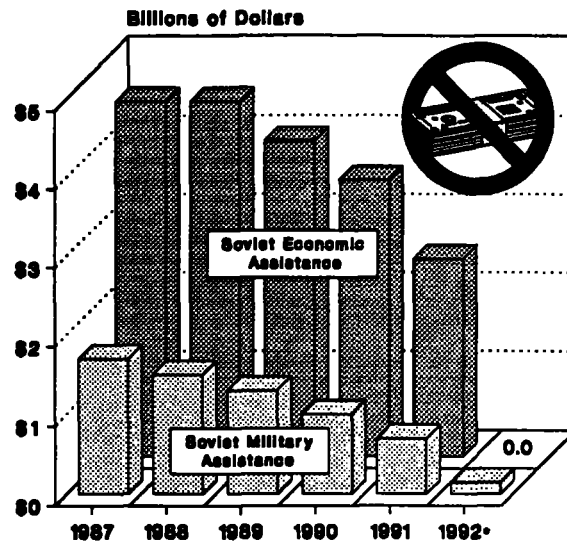
#### Communism's Tightening Grip.

After his takeover of Cuba, Castro proceeded methodically to eliminate economic, personal, and political freedom. In 1960, he created the Central Planning Board to control all aspects of the Cuban economy. His Revolutionary Fiscal Law of 1963 sought to eliminate private business and free market activities. Castro's Institute for Agrarian Reform nationalized private farms and took control of the agricultural sector. By 1964, the Institute controlled 75 percent of all arable land in Cuba. Castro in 1964 completed the nationalization of the banking system and named Che Guevara, the Argentinean guerrilla leader, to head Cuba's central bank. Castro also nationalized American-owned assets, including oil refineries, sugar plantations, and the telephone company.

In February 1960, Castro signed a trade pact with the Soviet Union in which the Soviets agreed to purchase one million tons of sugar annually from Cuba. This agreement soon allowed Cuba to exchange sugar at preferential prices for Soviet oil, raw materials, foodstuffs, and machinery. Eventually, 87 percent of Cuba's trade would be with the Soviet Union and Eastern Europe. Prior to 1959, as much as 78 percent of Cuba's trade was with the U.S.

**Changing Fortunes.** The collapse over the past three years of communism in Eastern Europe and the U.S.S.R. has meant the collapse of Cuba's preferential trade agreement with the Soviets. Deliveries of Soviet lumber, foodstuffs, and spare ma-

Chart 1  
Foreign Aid to Cuba: Abandoned  
by Russia, Castro's Isolation Deepens



\*Military Assistance estimated. Economic Assistance is amount as of April 1, 1992.

Sources: Defense Intelligence Agency, *The Cuban Economy*, April, 1989; Cuban American Foundation, *Cuba Survey*, Vol. 1, No. 1, April 1992.

Heritage DataChart

1 Victor A. Canto, Tom Cox, and Arthur B. Laffer, "Cuba Part 1: The Background," A.B. Laffer, V.A. Canto and Associates, La Jolla, California, 1991.

2 Jose Alvarez Diaz, *A Study on Cuba* (Miami: University of Miami Press, 1965).

chine parts during the past two years have been delayed due to production problems in the former Soviet republics. Last year, Moscow delivered an estimated 8.6 million metric tons of oil out of a promised 10 million tons. This was down from 13.4 million tons in 1990.<sup>3</sup>

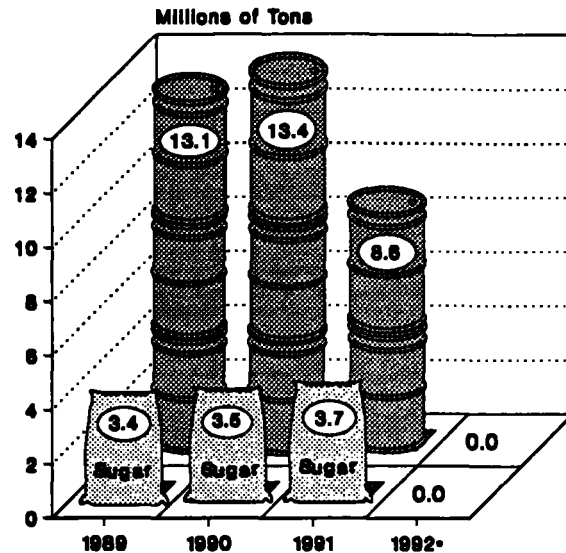
Russian President Boris Yeltsin last November 16 signed a decree freezing all future shipments of oil to Cuba. Then last December Russian Foreign Minister Andrei Kozyrev told anti-communist Cuban leaders that Russia would eliminate economic aid, effective immediately, and would curtail economic, diplomatic, and security ties with Cuba. In the future, he said, Cuba would

be on its own. Kozyrev called for a democratic Cuba and expressed his willingness to cooperate with the Miami-based Cuban exiles to facilitate Cuba's move to democracy. Russia announced that it would accelerate the withdraw of some 11,000 military personnel from Cuba. Russia, meanwhile, has prevented the forced return to Cuba of some 2,000 Cuban students that are seeking asylum in Russia.

The deterioration of relations with the former Soviet Union has knocked Cuba's already weak economy into a tailspin. Cuba now must pay for all goods and services from Russia in hard currency. Cuba has shortages of most basic commodities. As a result, rationing is widespread. As Cuba becomes further isolated from the international economy, pressure will continue to build to replace Castro.

**Castro's Balance Sheet.** Today, Cuba is ruled by an aging communist ideologue who is quickly turning his country into the North Korea of the Caribbean. Cuba, once one of the largest sugar producers in the world, has seen its production drop from a high of 8.1 million tons for the 1988-1989 season to about 5.5 million tons for the 1991-1992 season. Sugar production continues to fall because Cuba cannot afford to produce or import seed and fertilizer, and because gasoline-powered agricultural equipment is being replaced with water buffalo from Vietnam.

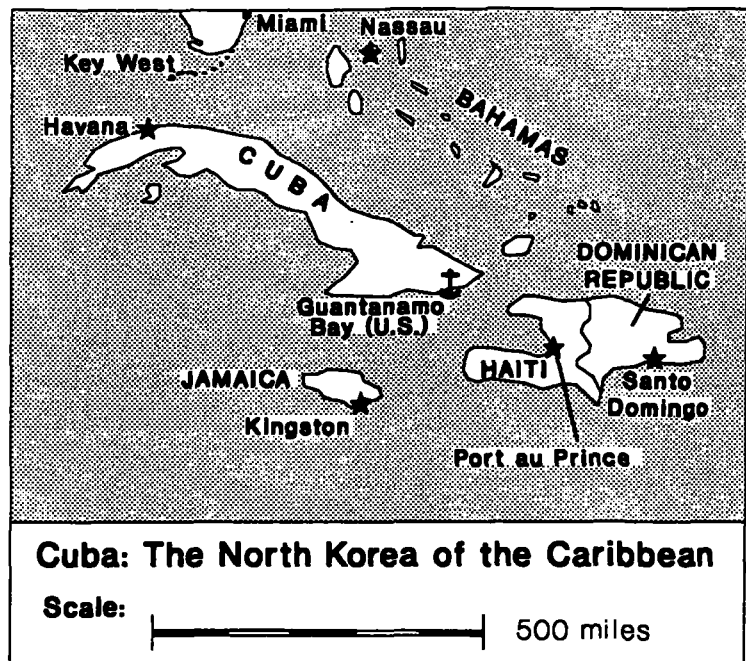
**Chart 2**  
**With Subsidies Gone, Cuba's Oil Imports and Sugar Exports to Russia Collapse**



\* As of April 1, 1992.  
Sources: *Cuba Business*, February, 1992; *Economist Intelligence Unit, Country Report, Cuba*, October 29, 1991; Ken Gluck, *Miami Herald*, "Russia, Cuba OK Trade Deal," February 1, 1992. Heritage DataChart

<sup>3</sup> Trade agreements between the governments of the Soviet Union and Cuba have always referred to amounts of oil shipments in metric tons, not barrels.

Cuba's GNP, while not easy to estimate accurately, apparently did not grow at all between 1986 and 1989. In 1990 its GNP fell by 10 percent followed by a 20 percent drop in 1991. In the first quarter of this year alone, GNP shrank by a further 20 percent. Cuba's hard currency reserves fell from \$242 million in 1985 to \$50 million last year. Cuba's national debt to Western countries rose from \$45 million in 1959 to \$8 billion in 1990.<sup>4</sup>



After steady growth in the standard of living before 1959, Cuba today has seen its living standards fall. In fact, using purchasing power parity, which takes into account currency devaluations, exchange rates, and inflation rates, Botswana, Gabon, and Nicaragua, have higher living standards than Cuba. It is clear that after 33 years of Castro's reign, Cuba's economy is in ruins.

## A FREE MARKET ECONOMIC PLATFORM FOR CUBA

Post-Castro Cuban leaders will face the need to revive a dead economy quickly, to provide basic goods and services, and in the long term to ensure economic growth and prosperity for all Cubans. In this, Cuba can learn from the experiences of other less-developed countries and ex-communist countries which economic policies work best and which should be avoided. Leaders of a free Cuba would do well to study the success stories of Taiwan, South Korea, Singapore, and Hong Kong, which have moved from the less-developed to the developed world.

Future leaders of a free Cuba also should remember that there was considerable corruption in the pre-Castro government. Not all Cubans felt that they shared in the benefits of the free market. Indeed, frustration over perceived or real limits on opportunity caused some initially to support Castro. But rather than granting equality of opportunity, Castro made all Cubans equally poor. To avoid the fear that a corrupt socialist regime will be replaced by a corrupt capitalist one, leaders of a free Cuba must take care to make their free market revolution a popular one, allowing economic liberty and opportunity to all Cubans.

<sup>4</sup> Figures in 1990 dollars.

The new Cuban government should develop policies for the short term, to allow Cubans again to work and produce, and for the long term, to ensure that market reforms are institutionalized and that economic progress endures.

The short-term policies would include:

- ✓ **Quickly privatize state-owned enterprises, returning them to private individuals, and eliminate all state monopolies.**

Cuba must move quickly to transfer productive assets to individuals, that is, to privatize state-owned enterprises. This is crucial because the sooner individuals, as owners of enterprises, can benefit directly from these efforts, the quicker the production of goods for consumption or trade will grow. Privatization in other ex-communist countries often has been delayed as policy makers sought to determine the value of state-owned assets before they were sold to private investors. One reason for this has been to guarantee maximum revenues to the government. Another has been to prevent prospective owners from paying too little for assets. But these reasons should be secondary to getting production going as quickly as possible.

The adverse effects of slow privatization are evident in Nicaragua. Since Violeta Chamorro won the democratic elections for the Nicaraguan Presidency in February 1990, few publicly owned enterprises have been privatized. As a result, there has been little foreign investment in that country. This has contributed to the zero economic growth rate for 1991. To avoid such problems, a new Cuban government would do well to transfer state-owned assets to the private sector quickly and equitably, and to make it as easy as possible for people to stake claims on nationalized assets.

A new Cuban government will have at its disposal a wide range of techniques that may be used alone or in combination to transfer government assets into private hands. Smaller enterprises could be sold quickly to their employees. Larger enterprises might first be reorganized and sold to their workers under employee stock ownership plans. An enterprise reorganized as a joint-stock company might also be sold to the general public.

**Inviting Foreign Investment.** Foreign investors could be allowed to purchase shares in such a firm. This would bring more capital to the enterprise than the purchase price since the foreign investor seeks to make certain that the new enterprise is productive and profitable. Foreign investors also would bring advanced management techniques and technology to a company. In Mexico's special *maquiladora* factories, which are owned totally by foreigners, workers acquire skills and work habits that help them not only to be productive workers in these factories but to be better workers when they move on to other enterprises. Some employees from such factories eventually leave and start their own businesses.

Some larger state-owned enterprises in Cuba such as public utilities might be broken up into smaller units and then sold. This would allow free market competition to establish efficient and quality utilities.

To ensure a proper market environment for newly privatized companies, and to spur the creation of other private businesses, the new government of Cuba should remove all prohibitions against private providers entering any sector of economic

activity. That is, even as the government attempts to sell off its enterprises, monopoly rights for government industries should be abolished.

When Castro's government came to power, it confiscated businesses, private homes, and the assets of foreign companies. After Castro is gone, many former property owners will attempt to recover their assets. Yet, as has been the case in many post-communist Eastern European countries, the need to afford justice to the victims of communist theft can cause problems and delays in economic reform. In some newly freed countries in Europe several claims sometimes are placed on the same property. In Czechoslovakia privatization of several state-owned companies was postponed because of last minute claims on them. Officials in these countries also must determine, in cases where property cannot be returned, how much compensation former owners should be paid. And since Cuba has been under communist rule for only 33 years, a decade less than Eastern European countries, there likely will be more Cuban claimants to lost property.

**Reviewing Property Claims.** To privatize state-owned assets and to make certain that previous owners recover their property or receive compensation, the new Cuban government would do well to establish a privatization oversight agency and a property claims court. The oversight agency would coordinate and implement the privatization program. It also would process claims for confiscated assets. The independent property claims court, meanwhile, would review cases in which there are several claimants for a given asset, or other complications. In such cases, the privatization agency would act in accordance with the claims court decision. If such cases cannot be decided within a certain established time limit, the agency would proceed with its plans to dispose of assets. As a result, privatization would not be delayed. When the court finally reached a decision, the winners of the case would receive compensation.

The privatization agency might avoid court delays and conflicts by providing legitimate claimants to confiscated assets with "vouchers" of a value depending on the size of their claims. These vouchers could be used to bid on state-owned assets being sold by the agency. Thus, former owners would be given preference over other investors.

The agency should establish a time limit in which all claims must be made. In addition, a certain percentage of the proceeds generated from asset sales might be set aside to compensate people with legitimate claims to assets that did not win back their property through the bidding process. While compensating former owners of private property is important, the overriding goal of the privatization policy should be quickly to return government-owned enterprises to the private sector.

✓ **Establish a stable, convertible currency.**

To facilitate economic activity, international trade, and privatization, the new government of Cuba should move quickly to establish a stable, convertible currency. A growing, advanced economy cannot exist without a sound currency. A currency serves as a store of value, something people can save to use for later purchases or investments. It also functions as a medium of exchange, allowing businesses and individuals to trade with one another. To perform these functions a currency must keep its value over time. That is, it must not be inflated.

Some reformers may suggest that Cuba's current central bank, the Banco Nacional de Cuba, be given the task of making Cuba's peso a stable currency after Castro goes. Yet, it was this bank that ran the printing press to fund Cuban budget deficits, and to provide massive subsidies to the public sector. The Cuban bank sets its exchange rate at a \$1.25 per peso. Yet the Cuban black market rate, which gives a clearer indicator of the peso's worth, is 10 cents per peso. Central banks always are subject to political pressures and other temptations to manipulate the money supply for some short-term gain that produces long-term problems.

**Currency Board.** Rather than working through the current system, a new Cuban government should abolish its central bank and establish a system in which the currency could not be manipulated easily by the government. The new Cuban government simply could use the U.S. dollar for its currency. This, however, could create political problems. National pride might cause the Cuban people to not accept the U.S. dollar as "their" currency.

Johns Hopkins University economist Steve Hanke and George Mason University economist Kurt Schuler suggest that ex-communist countries set up independent currency boards to establish a convertible domestic currency and instill confidence in money by operating separately from the government.<sup>5</sup>

A currency board issues notes and coins that are backed directly by a foreign currency, such as the U.S. dollar. Citizens and businesses could exchange these notes and coins for dollars, or any other established currency, basket of currencies, or commodities, at a fixed rate. Market forces, rather than a central bank, would determine the money supply. Over 60 countries have utilized currency boards since 1900. Hong Kong and Singapore are notable examples of economies with very stable currencies overseen by currency boards.<sup>6</sup>

**Available Assets.** To make this work effectively, Cuba will need some hard currency or commodity to back its peso. Because of its likely future trade and investment ties with the U.S., the dollar is an obvious choice. Though Castro's treasury now is empty, on Liberation Day the new government will not be bankrupt. Several American telephone companies, for example, owe the Cuban government's phone company about \$100 million for processing overseas calls to Cuba. Because of the U.S. economic embargo on Cuba, imposed in 1962, American phone companies have not been allowed to turn over the money to Cuba. Moreover, the U.S. currently controls about \$80 million in seized Cuban government assets. These funds and assets will be available to a free Cuban government. As soon as possible after Castro falls, the new Cuban leaders should announce that they will use a portion of these funds to back a Cuban peso.

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5 Steve H. Hanke and Kurt Schuler, "Currency Boards for Eastern Europe," *Heritage Lecture No. 355*, December 12, 1991.

6 Steve H. Hanke and Kurt Schuler, "Currency Reform in a Market-Oriented Cuba," *The Cuban American National Foundation*, Washington, D.C., Forthcoming.



✓ **Establish a legal and institutional framework to protect private property.**

The core of the free market system, from which all other principles derive, is the right of individuals to own and dispose of private property. Proclaiming the rights of individuals to own private property is relatively easy. More difficult is guaranteeing these rights, especially against government abuse, and providing the means for their protection. Privatization, free exchange, and a stable currency will bring prosperity only if economic liberty, the right to own property, and to contract freely with others to trade property, is protected.

To achieve these goals, a new Cuban government should start by re-establishing the commercial code of business that existed in Cuba before Castro. Such a code provides the environment in which all economic activity occurs. It defines, among many other things, what a contract is, what constitutes a buyer and a seller, and how disputes are arbitrated. An institutional framework, moreover, must exist to enforce contracts, and arbitrate disputes. An independent judiciary is necessary for the objective resolution of disputes.

Understandably, after suffering for three decades under the repressive and arbitrary directives of communist bureaucrats, Cubans might regard all government officials as enemies. Thus, to give the people confidence in a new system, post-Castro leaders must establish a judicial system with its own binding, independent powers to protect the integrity of private property and the right to contract.

✓ **Liberalize trade and eliminate restrictions on foreign investment.**

Free trade is particularly necessary for countries attempting to overcome decades of economic decay under communism. High tariff and non-tariff barriers add to the costs of machinery, equipment, and other goods necessary to increase productivity. Trade barriers also price consumer goods out of reach of many workers and lower the living standards of others, removing incentives to work hard and be productive. A 1987 World Bank report concludes that countries with more open trade policies have faster growing gross national product rates than countries with closed borders.

Trade was very important to Cuba's economy before Castro, accounting for 57 percent of GNP. And the U.S. was Cuba's principal trading partner. Reestablishing trade ties with the U.S. and the rest of the world thus is a key to Cuba's economic recovery.

A free market Cuba should begin by bringing its trade practices in accord with the General Agreement on Tariffs and Trade (GATT). Even though Cuba was an initial signatory of GATT in 1947, and remains a member to this day, it has drifted from the free market principles laid out in GATT. Cuba should start by signing the Harmonized Tariff Classification and Coding System to bring its trade accounting methods in line with the rest of the world. Cuba, in addition, should amend and clarify its customs laws to harmonize them with international trade standards.

These reforms should be made with an eye on a future free trade area with the U.S., or on entering the North America Free Trade Area under the Bush Administration's Enterprise for the Americas Initiative, which seeks to incorporate the entire Western Hemisphere in a free trade zone.

The communist government of Cuba nationalized all foreign assets in the 1960s. Under Castro, Cuba prohibits majority foreign ownership of any business. Even minority foreign participation is allowed only in a few special cases. Yet foreign investment will be necessary to energize Cuba's economy after Castro falls. Foreign investment has both short-term and enduring benefits. It immediately adds capital to the economy for modernization and innovation, creating jobs and providing wages for local workers. Moreover, the government of Cuba might turn over state enterprises to foreign investors if, in exchange, these investors pay off part of Cuba's foreign debt. Such debt-equity swaps have been especially successful in Chile and used to a lesser extent by other Latin American countries.

## Investment Opportunities In A Post-Castro Cuba

Although much of Cuba's economy is underdeveloped, many Cuban industries could be attractive for foreign investors. Some examples:

**Airlines.** The Cuban airline industry offers significant investment opportunities in a free market Cuba. Cuba's geographic position makes it ideally situated for international traffic. Cuba's main airline, Cubana, already has flights to most major cities in Europe and Latin America.

**Mineral Resources.** Cuba has the fourth largest nickel ore deposits in the world, an estimated 19 million tons. Cuba also has substantial copper and chromium deposits.

**Telephones.** Cuba's telephone system has not been modernized significantly since Castro seized power. In 1986, it was estimated that Cuba's phone company could handle 540,000 calls at a given time. A fire in 1988 in Havana's main telephone exchange destroyed switching equipment and lines, cutting this handling capacity by half. By 1988, the Cuba phone company could only handle about 150,000 calls. The price tag for rebuilding the Cuban telephone system is estimated to be at least \$2.5 billion.<sup>1</sup> In a post-Castro Cuba, the new government would do well to privatize the existing telephone system, opening it up to foreign investment. Many countries over the past decade have privatized their telephone systems, allowing foreign investors to take large shares in the new companies. This has happened in Argentina, Australia, Chile, Mexico, Puerto Rico, and Venezuela.

**Tourism.** Prior to Castro's takeover, tourism was one of Cuba's most important industries. Today, the Caribbean region draws an estimated \$8.8 billion annual in tourist business, an amount that is expected to increase nearly 40 percent by the end of the decade. In 1990, Cuba earned only a paltry \$80 million from an estimated 250,000 tourists.<sup>2</sup> A post-Castro Cuba will provide investment opportunities for foreign entrepreneurs in hotels and resorts which need to be modernized and rebuilt.

1 "A Million Cubans May Want to Emigrate," *National Journal*, November 23, 1991, p. 2854.

2 *Cuba Business* Vol. 6, No.1 (February 1992), p. 9; German Suarez and Ely Gracia, "Tourism in a New Cuba," Blue Ribbon Commission on the Economic Reconstruction of Cuba, Report No. 7 (Washington, D.C.: Cuban American National Foundation, November 23, 1991).

By removing restrictions on foreign investment, Cuba could receive as much as \$3 billion in foreign investment from Cubans now in exile, an infusion of capital not available to most other ex-communist countries. A post-Castro Cuban government should make it easy for foreign investors to make their investments, with minimal central government involvement and oversight. An especially promising source of foreign capital might be for Cuban enterprises to engage in joint ventures and strategic alliances. These alliances allow foreign companies jointly to manufacture products with private Cuban companies. In such arrangements, both partners gain by sharing the costs and information needed to produce an end product.<sup>8</sup> As a result, newly privatized Cuban companies could greatly expand their access to new technologies, management techniques, distribution channels, and capital. To make joint ventures attractive, Cuba thus should avoid strict antitrust laws that discourage such alliances.<sup>9</sup>

## A MEDIUM-TO-LONG-TERM STRATEGY FOR ECONOMIC GROWTH

A new Cuba understandably will focus first on reforms to get the economy moving at once. Then it must plan for the medium to long term and embrace policies that prompt economic growth. These would include:

- ✗ **Promote rapid development of competitive and efficient financial institutions, including stock and bond markets.**

The World Bank's 1989 World Development Report states correctly that "to obtain all the benefits of greater reliance on voluntary, market-based decision making, [less developed countries] need efficient financial institutions."<sup>10</sup> Financial institutions such as banks and stock exchanges are vital for a functioning free market, directing funds to productive enterprises.

Banks accept deposits, for which they pay interest, and lend out money to individuals or businesses, for which they receive interest, the "rent" they charge on money. Banks also purchase large blocks of stocks which they then market to other investors. Banks also help finance exports and imports.

A new Cuban government thus should move quickly to establish a free banking system. In doing so, it should take a lesson from America on what not to do. America separates investment banking from savings and loan banking. This makes banks less diversified and therefore often less able to deal with economic hard times that might reduce profits for one banking activity but not for another. Thus, a new Cuban government should allow its banks to engage in all forms of banking activities.

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<sup>8</sup> See Jordan D. Lewis, "Partnerships for Profit: Structuring and Managing Strategic Alliances (New York: The Free Press, 1990).

<sup>9</sup> See Bryan T. Johnson, "Increasing American Competitiveness Through Strategic Alliances," Heritage Foundation *Background* No. 857, September 26, 1991; and "Forging Alliances to Bust Into the Japanese Market," Heritage Foundation, *Background* No. 876, January 31, 1992.

<sup>10</sup> *World Development Report: 1989* (Washington, D.C.: The World Bank, 1989), p. 1.

**Fostering Small Banks.** A new Cuban government should pay special attention to the need for cooperative banks, operated on a small scale by local people, lending mainly to one another. In less developed countries especially, new goods, services, and jobs are generated by small entrepreneurs. Larger banks often have limited capacity to evaluate the needs and credit-worthiness of such small businessmen and-women. In many less developed countries, where strict banking laws favor large banks but hinder or bar the creation of smaller ones, the poorest people suffer.

By contrast, where small banking is allowed, as it is in Bangladesh, the poor prove quite capable of making sound lending decisions. In Cuba, with most large industries in ruins, a new government should take care to assure that individuals in small communities or rural areas as well as large investors, could engage in banking activities.

A new government of Cuba should avoid America's banking insurance mistakes. Currently the U.S. government insures banking deposits and charges the same rate whether a bank pursues reckless lending policies or sound ones. By banning market pricing of insurance for banking, the U.S. government has removed the market incentive of high insurance rates that would discourage irresponsible or risky lending. This is a major cause of the current savings and loan crisis. To avoid this problem, a new Cuban government at minimum should charge market rates to banks for insurance. Better still in the long term might be to allow the private sector to insure banks.

A sound stock market also is necessary to attract domestic and foreign investment. It also can assist government privatization efforts: a functioning Cuban stock market would be an ideal place to sell off large state-owned enterprises.

**✕ Establish a tax structure that minimizes disincentives for economic activity.**

A primary mistake of ex-communist countries over the past three years has been to set high tax rates, making it difficult or impossible for entrepreneurs to acquire the capital to begin or expand operations. Poland, for example, has set business taxes at 40 percent and Czechoslovakia at 60 percent. High personal income taxes also discourage productive efforts.

Ex-communist governments claim that they need high taxes initially to raise the revenue to cover the costs of transition to a free market. But high tax rates hold down economic production, thus holding down revenues to the government and slowing the economic transition. Cuba thus would do well to hold tax rates low to avoid these problems.

**Economic Disincentives.** Governments need revenue to provide such essential services as police protection, law courts, and national defense. Yet the source of tax revenue, taking real resources away from their owners, can distort investment and spending decisions, thus increasing economic inefficiency.

The new Cuba should design a tax structure that balances the need to generate the revenue necessary to finance legitimate government operations with the disincentives inherent in any tax scheme. A good tax system should target a broad tax base to insure the lowest possible tax rates. The best approach would be a flat tax

of a set percentage to be paid by all individuals regardless of income. A flat tax avoids the disincentives to production that result from the form of tax popular in most countries, the so-called progressive tax. This latter tax takes a larger percentage of an individual's income the higher his income rises. The result: the individual is penalized for being productive.

A flat tax also brings more revenue into a country's treasury than does a progressive tax. Because the economy grows faster with a flat tax, there is more economic activity to tax and thus more government revenue.

The new Cuba, facing the huge burden of reorganizing its government and economy, will appreciate especially the fact that a flat tax is easy to administer and manage. It requires no more than a few lines on tax forms, making it easy to fill out and easy to check for accuracy.

The new government of Cuba would do well, too, to avoid a business tax altogether. A business tax in fact is increased taxation on the very productive forces that should be least burdened. Under this system, profits are taxed as business profits and then, when the remaining profits are distributed to the owners, they are taxed as income. Such a tax seriously hinders economic growth and should be avoided.

The new government of Cuba might also set a limit on the size of its budget to a share of GNP. By holding down spending, the government would help assure that taxes remain low and thus that the economy continues to expand.

- ✗ **Avoid addiction to foreign aid by establishing strict guidelines that direct all aid going to Cuba to the alleviation of immediate suffering and the establishment of free market institutions.**

A new Cuban government no doubt will have offers of foreign assistance from America's Agency for International Development (AID) and from international organizations like the Inter-American Development Bank, the International Monetary Fund (IMF), and the World Bank. The new Cuban government, faced with an economy ruined by Castro, will be tempted to accept this assistance. History suggests strongly, however, that such aid does little good, and in fact will retard economic growth.

There is no indication that foreign aid helps build prosperity. Since the mid-1950s Western countries have transferred at least \$1.6 trillion to poorer countries in Africa, Asia, and Latin America.<sup>11</sup> Little economic progress has been made there. What progress was made was due more to free market policies than to foreign assistance. Massive loans from international organizations have only mired its recipients in deep debt. Such aid is of little help to countries that have not reformed their economies sufficiently.

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11 Nicholas N. Eberstadt, "Foreign Assistance Requests for Africa," Testimony before the Subcommittee on Africa, Committee on Foreign Affairs, U.S. House of Representatives, March 9, 1989.

The Philippines, for instance, has been unable to translate about \$10 billion in aid, promised by the West after the fall of Ferdinand Marcos in 1986, into economic growth. Conditions attached to foreign aid often directly hinder economic growth. The IMF, for example, recently forced the reform-oriented government of Argentina to raise taxes. This will buy some short-term assistance from the IMF at the cost of lowering Argentines' living standards and discouraging their productive efforts.

A new Cuban government might in fact need little or no foreign aid. Cuban exiles in America could provide an estimated \$3 billion in the first year following Castro's demise for the reconstruction of Cuba. Yet if a new Cuban government feels that it needs aid, it should establish strict guidelines to guard itself against foreign aid addiction. It should accept funds only to meet emergency needs or to help establish free market institutions, prevent starvation, and meet medical needs. This aid should not be given until the post-Castro Cuba establishes guidelines for free elections and a set termination date for such aid is established.

## **AMERICA'S ROLE IN A FREE CUBA**

Although much of the responsibility for transforming a post-Castro Cuba from an impoverished economy into a growing free market obviously rests on the new Cuban government and the Cuban people, there are ways that America can ease the new Cuban government's burden of transition. The U.S. should:

- ☛ **Restore Cuba's most favored nation trade status, and, as soon as possible, negotiate a free trade area with Cuba.**

Cuba was one of the original signatories of the General Agreement on Tariffs and Trade. Yet since Castro's takeover, Cuba has ignored many GATT principles. Further, in 1962, the U.S. revoked Cuba's most favored nation status, which provides each GATT member with equal trade treatment. The status was revoked because of Castro's increasing anti-Americanism. And in February 1962, the U.S. imposed a trade embargo against Cuba, which, for the most part, remains today.

When Castro is gone, and immediately following free elections in Cuba, the U.S. should restore most favored nation status to Cuba and eliminate the trade embargo, but not before. American businesses should be given an opportunity to trade and invest in Cuba as quickly as possible.

Ending the U.S. trade embargo and restoring most favored nation status will help Cuba in the short run. But then, as Cuba overcomes the initial difficulties of reorganizing its ruined economy, the U.S. should be prepared to start negotiating a free trade area (FTA) agreement with Cuba. Such an agreement would remove barriers, all tariffs, and most non-tariff barriers to trade between the two countries. In the long term, the U.S. should bring Cuba into the North American Free Trade Area (NAFTA), currently being negotiated by the U.S. with Canada and Mexico and into the U.S.-sponsored Enterprise for the Americas Initiative. This Initiative seeks to link the Western Hemisphere into one common economic market.

**Framework Agreements.** U.S. trade negotiators first should work with a free Cuba to establish the framework agreements necessary to bring Cuba into NAFTA.

These framework agreements, already existing for most Western Hemisphere countries, establish the basis for which free trade negotiations will take place. Framework agreements often set out target dates for negotiations, topics of discussion, and the objectives of such discussions. The U.S. then should negotiate an FTA quickly, bilaterally with Cuba. This would avoid the delays that would result if the U.S. tried to bring Canada and Mexico into the agreement immediately.

If Cuba cannot quickly negotiate an FTA bilaterally with the U.S., then Cuba could be brought into NAFTA as part of the U.S.-Caribbean Community (Caricom), formed in 1991.<sup>12</sup> Caricom was established to facilitate the free trade agreement process. Instead of negotiating with each country separately, the U.S. would negotiate with entire regions at the same time.<sup>13</sup>

A post-Castro Cuba will likely become America's most important trading partner in the region, as well as an important country for American investors. And with 2 million Cuban exiles now in Florida, it might be all but impossible to stop free trade and investment from developing spontaneously. Therefore, it would greatly benefit both the U.S. and Cuba if an FTA were established soon after democratic elections are announced. If a U.S.-Cuba FTA is delayed because Cuba is grouped with Caricom, or must await Canadian and Mexican approval, then Cuba's chances of quick economic recovery soon after Castro's fall are seriously diminished.

☛ **Restore to near its 1958 level, Cuba's share of U.S. sugar quotas.**

Sugar production accounted for 80 percent of Cuba's exports between 1920 and 1959. Today, sugar is still its largest export, making up about 82 percent of total exports. But Cuba's total sugar production has grown from only 5.9 million metric tons in 1960 to about 7.2 million tons in 1987. This is an annual growth rate of less than 1 percent. By contrast, production in Brazil, another major sugar exporter, increased from 2.8 million metric tons in 1958 to more than 8.5 million metric tons in 1987, an average growth rate of over 10 percent per year.<sup>14</sup>

U.S. sugar growers have enjoyed trade protection almost continuously since 1816. In 1934, the U.S. government established a quota system that restricts imports from each sugar exporting country. Cuba's quota in 1958 was 3.2 million metric tons. The U.S. embargo has barred Cuban sugar exports to the American market. Since then, the U.S. government has reduced the amount of imported sugar, substituting domestic sugar production. Today, America's sugar producers enjoy the highest amount of government protection ever.

To give Cuba an immediate market for its main crop, the U.S. should restore a substantial portion of Cuba's 1958 3.2 million ton annual sugar quota after Castro falls. In the long term, Cuba must diversify its economy and increase foreign ex-

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12 Currently, Caricom consists of Antigua, Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Lucia, St. Kitts and Nevis, St. Vincent and the Grenadines, and Trinidad and Tobago.

13 "U.S., Caribbean Nations Sign Trade Agreement," *Washington Post*, July 2, 1991.

14 U.S. Central Intelligence Agency, "The Cuban Economy: A Statistical Review," ALA 89-10009 (April 1989), pp. 7-9; U.S. Department of Commerce, "U.S. Relations with Cuba: A Statistical Survey," HF 3075.U49 (August 1975).

change earnings in tourism, manufacturing and numerous agricultural goods. Yet access to the U.S. sugar market would allow Cuba quickly to gain much needed hard currency earnings.

Higher sugar imports will lower prices for American consumers for American enterprises that use sugar in their products. In 1988 the Commerce Department estimated that U.S. sugar quotas cost American consumers \$3 billion a year in higher prices.<sup>15</sup> Since there are some 11,000 sugar farmers in the U.S., this means the consumer pays \$272,700 in higher prices for each farmer. The quotas caused U.S. sugar prices to soar so high that the 1986 *Economic Report of the President* observed: "Entrepreneurs were importing high-sugar content products, such as iced-tea mix, and then sifting their sugar content from them and selling the sugar at the high domestic price."<sup>16</sup> With this disastrous record, America should open its sugar market to help Americans. The emergence of post-Castro Cuba would give U.S. policy makers an ideal opportunity to begin to scrap its sugar quota system.

- ☛ **Provide only emergency economic assistance, with a set termination date, or assistance for establishing a free market, while resisting the creation of a "Caribbean Bank for Reconstruction and Development."**

Cuba might well be the one country that emerges from communism without even a plausible pretense for foreign aid. The two million Cubans living in exile in the U.S. who are expected to provide as much as \$3 billion a year in investments and assistance to a free Cuba belie the need for aid to that island from foreign governments. And the failure of the U.S. Agency for International Development (AID) over three decades to bring prosperity to less developed countries suggests that little good can be expected from bilateral foreign aid. In Eastern Europe today, AID is criticized for being too slow and not providing the sort of assistance needed to establish growing market economies.

The new Cuban government might be tempted to take as much foreign aid as is offered, ostensibly to pay for the costs of a transition to a market economy. The U.S. should not hold out such a temptation. Rather, after a post-Castro Cuba has established guidelines for democratic elections, the U.S. should offer assistance only for emergency food or medical help, or to help establish directly free market institutions. By using aid in this way, the U.S. is assured that its efforts truly help Cuba and do not get it addicted to aid.

**Disastrous Development Banks.** When Eastern European countries gained their freedom, the U.S. joined the rush to create the European Bank for Reconstruction and Development. Yet this bank's principal project so far has been to plan an expensive headquarters and hire international bureaucrats. Much of its funds probably will help Western businesses make profits in Eastern Europe rather than help Eastern Europeans to help themselves.

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15 U.S. Department of Commerce, "United States Sugar Policy—An Analysis" (Washington, D.C.: U.S. Government Printing Office, 1988), p. v.

16 *Economic Report of the President, 1986* (Washington, D.C., Government Printing Office, 1986), p. 137.



The Inter-American Development Bank, based in Washington, D.C., has been notorious for its corruption and as a way to channel money to powerful politicians and interest groups in Latin America at the expense of the people. There is no evidence that "development banks" help substantially to transform the Eastern European economies. The U.S. should resist the temptation to create a regional development bank for the Caribbean. This likely would only slow economic development.

## CONCLUSION

The Cuban people have suffered 33 years of economic hardship, human rights abuses and political repression under Castro's communist dictatorship. But with the collapse of communism in Eastern Europe and the Soviet Union, and the cutoff of economic aid to Cuba by the new Russian Republic, Cuba now faces an economic collapse that Castro is unlikely to survive.

Freedom-loving Cubans both in exile and in Cuba soon will be called on to reconstruct a society and an economy out of the ashes. But the size and prosperity of the exile community give Cuba hope for a quicker return to the road to prosperity for Cuba than might be possible for other ex-communist countries. But these Cubans and their American supporters must move quickly once Castro falls to open economic opportunities for all Cubans and to transfer productive assets from the hands of communist bureaucrats to the people themselves. The new Cuban government would do well to follow the free market principles that have proved so successful in other parts of the world.

The U.S. government and the American people understandably will want to aid the Cuban people in their hour of greatest need and greatest hope. Voluntary humanitarian assistance from the American people will no doubt help meet the basic needs of Cuba after Castro's fall. But the U.S. government must take great care not to inflict, under the guise of assistance, the same counterproductive aid policies on Cuba that have harmed other less-developed countries.

**Offering Opportunity.** What the U.S. government can offer Cuba is the opportunity to sell its goods in an open U.S. market. After the fall of Cuban communism, the U.S. should lift its economic embargo and restore most favored nation status. And when the new Cuban government stabilizes its economy, the U.S. should begin negotiations for a free trade area to make Cuba truly a part of the Western Hemisphere community of politically and economically free nations.

Most Cuban exiles in America lost businesses, homes, property, and savings when they fled Castro's dictatorship three decades ago. But in America they found freedom and rebuilt prosperous lives. There is no doubt that the Cubans left on the island will do the same when they find freedom again after Castro's demise.

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