THE "NEW" CUBAN ECONOMIC MODEL (OR SOCIALISM WITH CUBAN CHARACTERISTICS)[1]

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"The 'two-track' approach ('governing the market'), as for instance pursued in China, seems to be more effective policy than moving directly from one extreme (central planning) to the other (a capitalist market economy)."

"In more general terms it looks as if the present transition—the one leap "big bang" transition—is too abrupt and too extreme. Eastern Europe should look East rather than West, i.e., should study the East Asian model rather than the OECD model of the 1980's."

"It is difficult, if not impossible, to reach the two objectives of political democracy and economic efficiency simultaneously. If the two can only be reached in sequence, then it would seem that economic restructuring, development and efficiency should come first."

—Louis Emmerij, *Eastern Europe in a Development Perspective*, 1995, pp. 31-32.

INTRODUCTION

Cuba has passed the first half of the 1990's with a wave of economic and political change, social tension, disillusionment and threatening conflicts. It faces a convergence of moral, social, economic and political crises that derive mainly from the failure of its economic and political systems and also as a result of external pressures: the tightening of the U.S. embargo and the end of the annual US$500 per capita Soviet subsidies. The existing socioeconomic system and, above all, the values on which it is based have lost the support and confidence of most Cubans, especially the young. [3] While, this period is about the terrifying collapse of the existing order, it also presents yet undefined and not fully understood opportunities that can lead Cuba to a new, more dynamic, progressive, participatory and democratic order, both economically and politically. Cuba has *much* to gain

1. It is beyond the scope of this paper to analyze political reform in Cuba or whether political reforms should precede or follow economic reforms. As we have indicated elsewhere, we believe that a path of negotiated, gradual and simultaneous political and economic reforms is best for Cuba. A political and economic path of systemic and comprehensive reforms cannot be accomplished quickly, but instead as a result of a gradual process, because of the lack of democratic and market institutions and because the development of these institutions takes years. Cuba urgently needs a strong accord for a steady, peaceful and integral transformation from a dictatorial command organizational structure to a democratic market-oriented society.

2. The views expressed herein are those of the authors and in no way represent the official views of the Inter-American Development Bank. The authors thank Mr. Jorge Pérez-López for his comments and suggestions.

3. An alternative view is held by Tad Szulc: "Castro's pilgrimage marks the successful completion of the latest phase in the history of the revolution he had launched in Cuba on Jan. 1, 1959, when his guerrillas defeated the forces of Fulgencio Batista, the old-style dictator. It was the phase in which Cuba made the painful and perilous transition from the nearly total dependence on the Soviet Union, which ended with the Soviet collapse, to today's relative self-reliance—at low living standards—and the beginning of efforts to attract foreign support for the strange Chinese-style 'socialist market economy' that Castro is striving to introduce." (*Washington Post,* October 22, 1995, p. C4).

from the emerging system, and *much* to lose if it fails to act decisively to put it in place.

Young Cubans, discontent with the present and worried about the future, feel that they are the last generation of an old system and the first generation of a new one. At the end of 1995, traditional communists are seen as remote, uninspiring, "conservative rightists," a reactionary group led by tired elderly men imbued with a failed and irrelevant nineteenth-century theology, and who have already seen their best days. Reformers are viewed as radicals, "leftists" trying to provide for a brighter future. In the recent past, especially in 1968 and in 1986, the politically powerful state sector had marginalized or wiped out small entrepreneurs in agriculture, services and handicrafts, and own-account workers. It is clear that poor domestic policies (misallocation of resources, inefficient investment, discrimination against exports) rather than external pressures have been the main cause of present failures. These failures have ignited a process of deep soul-searching among Cuban intellectuals.

There is a widening gap between dynamic change taking place in the world, generalized modernization, globalization of the economy with increasing competition—e.g., the creation of free trade areas such as the NAFTA and the liberalization of trade of the WTO—and the slow change of the present Cuban politics and government. While there are extensive changes in the world and more intensive, deep and complex links among countries, in Cuba there is an ineffective status-quo, immobilized by the application inappropriate economic principles and obsolete institutions and policies. The Cuban Communist Party's selfishness and self-centeredness organize rear-guard actions against market mechanisms and true decentralization and empowerment of citizens, about which it knows less and less. It still considers itself entitled to a monopoly on solving problems and helping Cuba make structural reforms, although cosmetically, timidly and slowly, instead of the required major substantive and systemic transformations and modernization truly based and centered on the people *that are inevitable*.

Cuba's level of national income is unusually low for the level of education and health of its people. [4] Cuban policymakers should begin to look strategically thirty years ahead, about the kind of nation they would like Cuba to be and the path the nation should take during the first quarter century of the new millennium to use its full potential, even if it is engaged in very difficult immediate tactical problems.[5] Cuba's failure to think about the long run also risks missteps and tragedy. The new economic model should avoid preserving a generally unworkable present as well as restoring an outmoded and remote past. The new system should be based on new and fresh ideas, values, institutions and structures that yield economic results based on individual responsibility and flexibility. This is very important because the swift pace of events and high-speed economic and political change in the region (a generalized free trade area for the Western Hemisphere by the year 2005) and in the world at large (e.g., the newly created WTO) and its acceleration will affect all countries, including Cuba.

It is the prospect that Cubans could be drawn into a reform process by default rather than design in this period of epochal change and sharp challenges that has stirred renewed interest on the part of the Cuban leadership and intelligentsia ("official" NGOs) in devising a strategy for the transition. Indeed the time has come for a more comprehensive reform and transformation. Not everything in the past was mistaken and not all in the present is hopeless. The jeopardy argument of reforms simply cannot be applied to a country where it is impossible to endanger previ-

4. Although it ranks very high in most social indicators, Cuba's per capita GDP was so undeniably low by 1990 that its "Human Development Index" was 12th in Latin America and the Caribbean. See United Nations Human Development Programme, *Human Development Report 1993* (New York: Oxford University Press, 1993), Table 1, p. 135-137. In 1995 its ranking is far lower due to the plummeting GDP.

5. For example, Malaysia started its vision for the year 2020 in 1993, establishing guidelines to reach Switzerland's standard of living by that year. It is time for Cuba to look forward to define its vision of the future, and define the strategy for getting there.

ous and recent progress as such progress was not based on solid grounds. The task for our generation is to ensure that the Cuban economy works; today it does not.

After five years of major economic decline and implosion, facing the brink of financial insolvency and international trade barriers, burdened by administrative inefficiencies and excessive defense spending, the Cuban authorities started some stabilization and structural reform measures, if only in a narrow field and without a clear framework or general success. In our view, the government squeezed the economy when it was contracting. The overall economic prospects remain grim. We consider the recent reforms irreversible, a historic watershed from which retreat is all but impossible. Others consider them only a mirage and a dangerous one. More open markets and foreign investment have barely reached the bottom dwellers, by some measures as destitute as ever. Still no transformation so recent can be called sustainable, particularly with Castro long accustomed to broad swings and abrupt economic-policy reversals as the ones in 1968, 1975, 1986 and 1993. Thus there is potential yet again for bitter disappointment. Uncertainties surrounding the transition to a new generation of leaders to succeed Castro also affect decisions. His likely successors are reluctant to assert themselves while he is still alive.

Cuba is at a crossroads. The wrong turn may indeed have a serious impact on its social and political makeup. The legitimacy of the system is increasingly questioned as the government continues to postpone measures and reforms to satisfy the needs of the large masses of its citizens who are deprived of productive employment and find difficult to cover their most basic needs. Unevenness in sharing the benefits of the recent incipient recovery, high unemployment, abolition of workers' basic rights, scant housing, and deteriorating education, health and sanitation are leading to a stressful social situation. It is likely that many countries will rightly resist allowing Cuba to enter the regional integration agreements without further political and market-based economic reform.

In this paper we analyze the recent proposal for the restructuring of the Cuban economy advanced by Cuban economists Carranza, Gutiérrez and Monreal's (CGM) [Carranza, Gutiérrez and Monreal, 1995]. This proposal has been greeted with a mixture of uneasiness and misgivings because it is a marked metamorphosis of their previous position, it is still characterized by some unyielding features, and because the authors do not apparently share our convictions in a market economy, unlimited civil liberties, pluralistic political system, open government and limitation of police powers. [6] Although we have some important, and often deep, differences of opinion with them, they have advanced the most significant departure from the Stalinist model of society from within Cuba, as well as the most complete and ambitious attempt inside Cuba from quasi official sources to analyze current government failures and present the first coherent proposal for transition to a more market-oriented economy. They are willing to admit with candor policy errors and the infeasibility of the current system. They vigorously address some structural problems in the economy and the need to dismantle the pervasive disincentives and distortions of extreme statism, though at times in fumbling fashion. They rightly assert that without real economic growth, there is nothing Cuba can do to improve the well-being of its people. They have raised the toughest questions about the design of the current policies and institutions and present a convincing case for substantial and comprehensive market-based reforms that could bring at least some of the changes the Cuban people want. The CGM proposal entails Cuba continuing to open the economy internally and to

6. We envision a political system for Cuba based on the free competition of ideas, freedom of speech, freedom of the press, freedom of assembly and freedom of association. The role of the state must be reduced, with the government authorities subject to control by the law, a legislature and mass media. These freedoms and regulations contain in themselves the abolition of the one-party system, freedom for alternative parties to organize and free elections for the legislative and executive branches of government. In general we consider that the state should not decide for the individual.

the outside world in line with requirements for entry to such arrangements as NAFTA and the WTO.

The CGM proposal represents a very significant step towards a more market-oriented, people-based and open economy but it is still far from the Chinese and Vietnamese model or the Asian market socialism model (AMSM) that Castro promised to follow in his "prepared" speech of July 26, 1995 and after his visit to China and Vietnam in December 1995. After analyzing and submitting the proposed "new" model and framework for change and reform to rigorous and skeptical questioning, we offer some counter-proposals to kick off the intellectual debate called for CGM that must occur, i.e., we hope that the CGM proposal is the beginning of the reform debate rather than the end of it. A new strategy is needed to return Cuba to a path of modernization and sustained, long-term economic and social development. Once the CGM model and framework is fully understood, it is evident that additional and deeper steps are needed to handle some of their omissions and commissions. A much more systematic and complete approach is required to make the imperative and decisive breakthrough to shape the future that lies ahead, to direct it, rather than to let the Cuban nation be victimized by it. Both Cuban academicians and émigrés can best serve the Cuban cause by discarding the narrow and parochial bounds of ideology. Our goal in this paper is not to settle the issues, but rather to raise some unconventional thoughts.

In the second section we present the main elements and characteristics, as well as some important omissions, of the CGM proposal or "new" Cuban economic model and will analyze the principal differences and similarities between the AMSM and the new Cuban model, both for the main microeconomic reforms, institutions and strategies and for the macroeconomic policies, institutions and strategies. In the third section the likely outcomes in relation to growth and equity from the application of the new Cuban model are diagnosed. The next section includes five recommendations for a more effective model for self-sustaining and lasting growth with social equity and effective participation. In the fifth section the main conclusions are summarized and some final reflections are presented. The main features of the AMSM are analyzed in Appendix I, showing that it is feasible to introduce markets in a centrally-planned Stalinist economy in a gradual way.

THE "NEW" CUBAN ECONOMIC MODEL AND THE AMSM: SIMILARITIES AND DIFFERENCES

> "The disasters that have happened in the countries of the Soviet Union ... compared to the impressive successes of China and Vietnam, clearly indicate what can and what cannot be done if one wants to save the revolution and socialism."
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> — Fidel Castro, July 26, 1995 as quoted by the *Financial Times*, November 27, 1995, p. 4.

> "The real difficulty in changing the course of any enterprise lies not in developing new ideas but in escaping from old ones."
>
> — John Maynard Keynes

Principal Elements and Characteristics of the CGM Proposal

The "new" Cuban economic model has two main purposes, now that the Cold War has ended and Cuban socialism has arrived at a stage when it is unable to survive in its non-market fashion. One is to revive the Cuban economy from the deepest depression in its history. The other is to formulate a cautious medium-cum-long-term economic reform program to modify the socialist nature of the economy, reflecting the inclinations of the Cuban leadership for political continuity and social control. Until now, the authorities have been extremely vague about basic economic objectives and policies. The propelling factors for change lie in the generalized pessimism about the economy, the current stagnation trap, the fundamental strains in Cuban society and the demonstration effect of reform in market socialist economies in Asia.

The CGM proposal for restructuring the Cuban economy involves three stages:

- Stage I, reestablishment of financial equilibria and search for efficiency, has two phases: improvement of internal finances (Phase A) and initiation of economic restructuring and hard budget constraint (Phase B).

- Stage II, transition to a regulated market (decentralized marketization of state enterprises (SEs)) and
- Stage III, decentralization of the economy. The last two stages place more emphasis on structural reforms.

The CGM proposal covers two microeconomic areas:

1. Reform of SEs and
2. Redefinition and establishment of other forms of property and economic organizations.

It also covers seven macroeconomic areas:

1. social security,
2. price and wage policies,
3. budget,
4. public investment,
5. exchange rate policies,
6. foreign trade and

banking, monetary and credit policies (see Table 1).[7] As we shall see further on, in many ways the CGM proposal is long on laying out principles and short on specific policies.

The CGM proposal shows some flexibility, albeit insufficient, and skips the nuances and subtleties of some complex issues in setting market-based policies and reforms to modify many earlier positions. Hence, it stifles efficiency and growth potentials and, if followed, will prove incapable of meeting effectively the nation's need for self-sustaining, long-term growth and equity. While in most cases the proposed reforms are steps in the right direction, they neither go far nor deep enough, especially in the microeconomic and institutional areas. They also have some unintended, though predictable, consequences and perils. If the market-based reforms are not well-designed, they will not be able to create sufficient supply expansion and could create a reaction against further reforms. Additionally, some of Cuba's longstanding obstacles to reassuming self-sustaining growth remain unaddressed. These include, inter-alia, the excessive reliance on foreign capital to propel growth; the lack of implementation of market reforms necessary to dismantle the maze of regulations and distortions accumulated during of 35-plus years of heavy statism, make the Cuban economy run more efficiently and provide it with more resilience to compete in international markets; and its omission of the fact that the physical infrastructure and the environment have deteriorated significantly while sugar has become obsolete from a technical point of view, is undercapitalized, and its comparative advantage has eroded. Notwithstanding all this, the CGM proposal could contribute to the improvement of the Cuban economy in the near future.

The proposed reforms are not temporary capitalist measures or concessions, but are presented as a true initiation of systemic transformations. CGM realize that change is inevitable and their prescriptions define the scope and the terms of some market-based reforms. However, the CGM proposal is far less fundamental than the AMSM. It has some of the institutional weaknesses of the AMSM but not some of the latter's dominant microeconomic strengths. CGM should look closer at the AMSM to gain insights. The static analysis in the CGM proposal about the role of a hyperactive state is wrong in economic terms. It fosters dependency on bureaucratic direction and inflexibility rather than on cooperation and opportunity with impersonal market forces. We see it as a serious failure of strategy. Even in a socialist market economy, the role of the state is more focused than in the CGM proposal, and the structure of incentives for the private sector is more appealing.

If Cuba is beginning the transition from a system of central planning towards one with a greater use of markets, market signals and associated incentives, it

7. We have changed the order of the macroeconomic topics in the CGM for organizational purposes.

Table 1. The Carranza-Gutiérrez-Monreal (CGM) Proposal for Restructuring the Cuban Economy[a]

	STAGE I:Reestablishment of financial equilibria and search for efficiency.		STAGE II: Transition to a regulated market (decentralized marketization for SEs).	STAGE III: Decentralization of the economy.
	Phase A: Improvement of internal finances (stabilization, 1 month).	Phase B: Initiation of economic restructuring and hard budget constraint (1 year).		
Special concerns and features	Monetary reform. Problem of financial liberalization prior to monetary reform.	Need to create dynamic of growth. Increase efficiency of state enterprises (SEs). Increase agricultural production.	Priority to administration of SEs and to budget control.	Emphasis on the diversification of property forms, not their appropriate composition.
Microeconomic Reforms				
1. Reform of public sector enterprises.		Economic incentives for SEs to improve their performance. Wage bonuses related to cost reductions and increases in production, both in quantity and in quality. More strict labor discipline. Eliminate unnecessary workers. Cooperativization of assets and SEs or privatization through sales, leases and administrative contracts.	Allow retention of profits for investments and decentralization of their accountability to local levels. Strengthening of hard budget.	Government directives concentrated in SEs. SEs will normally finance their expansion with own profits.
2. Redefinition and establishment of other forms of property and economic organizations.		True decentralization of UBPC. Small private enterprises and cooperatives, including privatization of existing assets and enterprises. Establishment of production quotas. Allow small private firms to provide services to SEs. Allow hiring of workers by private enterprises and own-account workers. Flexibilization of own-account workers, intermediaries, including professionals. Bankruptcy law for private enterprises and cooperatives.	Strengthening of private services, including professional services. Bankruptcy law for SEs.	Some sectors and activities are restricted to SEs. Partial privatization of some SEs through sale of stocks.

a. Based on: Julio Carranza Valdés, Luis Gutiérrez Urdaneta and Pedro Monreal González, Cuba: *La restructuración de la economía*, (La Habana; Centro de Estudios sobre América), unpublished draft, January 1995.

Table 1. The Carranza-Gutiérrez-Monreal (CGM) Proposal for Restructuring the Cuban Economy[a] (Continued)

	STAGE I:Reestablishment of financial equilibria and search for efficiency.		STAGE II: Transition to a regulated market (decentralized marketization for SEs).	STAGE III: Decentralization of the economy.
	Phase A: Improvement of internal finances (stabilization, 1 month).	Phase B: Initiation of economic restructuring and hard budget constraint (1 year).		
Macroeconomic Reforms				
3. Price and wage policies.	Keep ration system for necessities but with higher prices; allow parallel markets and some free markets for non essential goods.	Establish more rational prices both for outputs and inputs. Price ceiling for agriculture goods. Wage differentials and bonuses.	Gradual expansion of price liberalization. Decentralization of wage determination.	Elimination of rationing. Market-determined prices but with price ceilings.
4. Social security.	Direct income transfers to the poor and vulnerable to compensate for the retail price increase.	Labor training. Work for the unemployed in community activities. External sale of services. Promotion of assembly plants for exports.	Adjust direct income transfers to the poor and vulnerable.	Minimum wages established and adjusted.
5. Budget.	Increase retail prices to eliminate the fiscal deficit.	State restructuring. Income tax and social security payments on UBPC, cooperatives, private farms, own-account-workers and land tax on UBPC. Hard budget and elimination of subsidies for SEs. Indirect taxes on luxury items and remittances.	Emphasis on tax administration. VAT. Decentralization to local governments.	
6. Public investment.		Investments in infrastructure for exports and export activities.		
7. Exchange rate policies.	Limited convertibility; free convertibility for foreign firms and trade-oriented SEs. Dual exchange rate with preferential rate for tourism and remittances.	Limited convertibility. Dual and competitive rate adjusted periodically. Use of tariffs instead of other restrictions to control imports. Orderly opening.	Mini-devaluations or crawling peg. Partial convertibility. Some exchange controls to avoid capital flights.	Unification. Full convertibility in the current account except for a few transactions.

Table 1. The Carranza-Gutiérrez-Monreal (CGM) Proposal for Restructuring the Cuban Economy[a] (Continued)

	STAGE I:Reestablishment of financial equilibria and search for efficiency.		STAGE II: Transition to a regulated market (decentralized marketization for SEs).	STAGE III: Decentralization of the economy.
	Phase A: Improvement of internal finances (stabilization, 1 month).	Phase B: Initiation of economic restructuring and hard budget constraint (1 year).		
8. Foreign trade.		Demonopolization of foreign trade. Debt swaps. Trade accords. Orderly and gradual opening. Use of tariffs instead of other restrictions to control imports.	Gradual reduction of tariffs.	Selective protection through fiscal, monetary and trade instruments.
9. Banking; monetary and credit policies.	Monetary reform to eliminate the monetary overhang. De-dollarization and limitations on dollar circulation.	Separation of Central, commercial and developing banking. Interest rate for loans to the private sector. Individual savings accounts in dollars.	Differential interest rates.	Use of selective credit. Institutionalizatio n of "public" capital markets.

can consider seriously the experience of other countries, such as China and Vietnam. Further, Cuba can skip steps and avoid the mistakes or detours of those two trailblazers. The AMSM has shown that the transition from central planning to the market can best be accomplished by establishing an efficient incentives regime and then relying on the decentralized decision-making of households and firms based on market prices. The economy will develop more successfully if the incentives structure for domestic producers is brought more in line with that for foreign investment. In addition, the authorities should play a major role in establishing the legal, regulatory, and policy environment conductive to growth of a free and competitive market.

The CGM proposal is much more growth, outward-looking and future oriented in its basic objectives than in its means. Cuba's tradable sector, based on an outward-looking strategy in which non-sugar expansion will be the engine of economic growth and development, is central to the restoration of growth. This outward orientation is a necessity arising from the smallness of the domestic market and limited natural resources. It also requires a production system able to follow the international rhythm of technical progress, a more liberal trade regime likely to impose discipline on the domestic producers, and a reorientation toward a structure of production in line with the country's comparative advantages, in order to compete internationally. Gradual, but continuous and decisive, opening of the economy to foreign trade and competition is an intrinsic component of a robust transition to a market economy and its integration into the world economy. Consequently, a more determined trade policy and reform instruments to achieve than the one proposed are necessary to reap the benefits of specialization and modernization and to maximize efficiency and factor productivity.

Microeconomic aspects of the CGM Proposal

While the CGM proposal improves the incentives regime for state enterprises (SEs), private enterprises (PEs) and own-account work, the microeconomic part of the proposal barely makes a dent in the dominant role of the state in the Cuban economy. There remains a disturbing tendency on the part of the authorities in trying to micromanage, perform lots of tasks and make decisions. No solutions are proposed to address the need for transparency in this critical area. CGM have neither fully accepted the principle of decentralized decision-making by households and firms nor that competition is an essential market force. The proposed microeconomic reforms need significant rethinking. This is the time to change the proportions among what is permitted, what is restricted and what is banned for the private sector to do in order to develop and implement a strategic approach that is focused largely on domestic efforts to raise savings and factor productivity.

The CGM proposal is not likely to provide entrepreneurs enough space and confidence to invest in real production and jobs, essential elements for economic recovery and prosperity. Cuba will grow if it can establish a clear and efficient division of labor between the public and private sectors, as well as competition between them to improve the public sector. The public sector in the CGM proposal will still crowd the private sector out of a range of activities that the latter could well undertake and do much more efficiently than the state. The authorities need to define state activities more sharply and to give greater scope and size to the private sector as China, Vietnam and Laos PDR have done successfully. CGM define a vision that cannot transcend a false choice of what the government should do for the people instead of what people must do for themselves and for the country. Here our differences with CGM are not about gradualism in the implementation of the proposed measures as they suggest, but about intensity and comprehensiveness of the measures.

The CGM proposal also needs to include more market reforms to improve the incentives structure for saving, investment and production by households and firms through reforms of the investment and trade regimes, the financial system and the legal infrastructure. CGM calls for gaining some advantages from the market without actually relinquishing centralized control.[8] Cuba has to rebuild its institutions to the decentralized realities of cyberspace and the Information Age to promote individual initiative, entrepreneurship and opportunity. However, massive regulations generally result in a lethargic public sector, a private sector motivated by rent-seeking, corruption, and efforts to gain monopolies from government favors, income inequality and a growing underground economy. Cuba has to move from a culture of redundant economic controls and scrutiny to a culture of economic results.

Great emphasis is placed by CGM on improving the performance of SEs, eliminating poorly-performing SEs and disguised employment, and prescribing the renovation for the operational conditions of capable firms. These steps are insufficient to generate the supply response needed in the Cuban economy. The hard budget constraint, hard loans and proper taxation of SEs should improve the macroeconomic conditions but will not solve the supply problems of the Cuban economy. Even by granting SEs more autonomy, and by enforcing hard budgets, hard loans and bankruptcy, they will continue to waste resources because of political intervention, the absence of discipline, inefficient management, and the absence of clear property rights. Those who really want an enhanced role for the market, must allow more room for formal private activities, increasingly free entry and exit, individual entrepreneurship, private property and competition. Only a radical extension of the private sector creates favorable conditions for the expansion of production.

In the CGM proposal, the agricultural cooperatives —that did not work well elsewhere, especially in socialist countries—are the proposed predominant form of organization for agriculture and other economic activities. There is only limited decentralization without private ownership. This basic idea seems emotionally-inspired rather than rationally-determined. The Yugoslav cooperative experience constituted an attempt—albeit a highly imperfect one— to move socialism away from the exclusive reliance on the state and the bureaucracy and on the private

8. "The market shall be subordinated to the plan in order ′to force′ development and to guarantee the primacy of the state sector and the political power in the hands of the people" (CMG, 1995).

sector, private property and the market.[9] This proposal is unrealistic and unworkable, hence failure is inevitable because it maintains a highly restrictive organization unlikely to produce tangible dividends, has little support outside the Cuban intelligentsia and lacks a positive experience as its foundation.

One of the strengths of the CGM proposal is that it refers for the first time in socialist Cuba to the need for a comprehensive legal framework for the economic system in general and for the restructuring or liquidation of insolvent SEs and PEs in particular. Policy changes to reverse the command system without an appropriate legal framework may be sufficient to initiate the transition, but are not enough for long-term development. However, still missing are fair and credible laws for real property, intellectual property, domestic investment, contracts and dispute resolution so that the incentives regime will work properly within the legal framework of a market economy. Also, a labor code for a market economy is needed to include, inter-alia, protection of employer and ***employee*** rights and obligations, microregulation of labor contracts, social insurance, the right to strike and a labor arbitration mechanism truly independent from the government. The strong distortions created by the government intermediary by hiring workers for foreign enterprises at salaries charged in dollars but paid in pesos should be eliminated. They reduce the degree of international competitiveness of the Cuban labor force and tend to stymie employment-creation.

Considerations regarding transparency and accountability in decision-making and in conducing the affairs of state—which are marked weaknesses of the AMSM—are starkly absent in the CGM proposal. The principles of good government, respect for human rights, accountability and the role of law, have value in their own right as well as relevance to the process of economic development.

It is easy to dismiss some of the microeconomic commissions and omissions of the CGM proposal as routine rhetoric, short on specifics and long on discourse. Of course there is a political rationale for them. CGM are faced with dramatic policy dichotomies and conflicting objectives of transformation needs that might undermine the interests of the Communist party hierarchy and its constituency.[10] However, problems exist on two levels. The first is in the microeconomic reform debate itself. The CGM proposal's deceptive, but crisp and contentious, rhetoric might frustrate the imperative reforms, when they ought to be within reach, by hardening positions. The larger danger of their situational microeconomic proposals, is that they tend to vindicate public cynicism of economic leadership. The CGM proposal's rationale or basis is that people do not notice untruths. But, of course, they ultimately do, and in the long run, this makes effective government harder.

Macroeconomic aspects of the CGM Proposal

It is obvious that stabilization cannot continue forever. It cannot be justified for as long a period as 1990-1995, neither on account of the need to ensure price stability, nor to create the conditions to restructure the economy. The timetable is already overstretched. The required stabilization should be accomplished, once and for all, and in the shortest possible time. A longer timetable only makes the long-term effort more difficult. One month, as suggested by CGM for eliminating the imbalances both in the flow (slashing the budget deficit and bringing it under control) and in the stock (eliminating the monetary overhang) makes sense. We also agree with their emphasis on the need for a monetary reform. There is an excessive monetary overhang as the result of several years of fiscal deficits that has to be addressed either through monetary reform or by an increase in the general price level, or both.

9. Kornai (1995) considers that however noble the motives behind this model, it lacks coherence, due to the obvious absence of separate representation for capital.

10. For many communists, a prosperous Cuba is not and never has been the real goal. What they care about far more is staying in power and keeping political and social control. The recovery of the economy is only a means to this end.

However, it should be noted that since the fiscal deficit in 1994-1995 was eliminated via a price increase, the case for another increase of prices at the retail level for fiscal reasons is weak because it could be deflationary in an already very depressed economy. Excessive macroeconomic tightness could suffocate the supply response to the liberalizing microeconomic reforms. Macroeconomic stability is easier to achieve when growth is vigorous.

The basic concept underlying the proposed tax reform in the CGM proposal is to place the tax burden on income; however, more emphasis should be placed on indirect taxes to spur entrepreneurial activity. The backbone of the system should be an across-the-board value-added tax. On the expenditures side, the CGM proposal includes important but insufficient propositions to rationalize social expenditures, such as one to supplement incomes by direct transfers to the poor, instead of maintaining blanket subsidies through low prices for some essential goods. In general redistribution by taxes and transfers is more efficient than by direct interference in markets. Absent in the CGM proposal are reforms such as rationalizing social expenditures by eliminating unnecessary administrative and bureaucratic expenditures, as well as concentrating social expenditures on the poor and avoiding universal coverage for some services. Also, the government should use cost-benefit analysis to select public investments, establish public bidding for public procurement, and use NGO's to provide social services to the poor. Choice, competition and market incentives should be gradually introduced to the public sector through innovations such as public school choice, social services vouchers, and partial payment for some health expenditures. The Chinese and Vietnamese have privatized, at least partially, university education and health services. Many doctors and nurses practice privately in those countries.

We agree with CGM that the most important objectives of exchange rate policy must be to avoid significant overvaluation of the currency and make it predictable. The actual overvaluation of the exchange rate is preposterous and determines a severe anti-export bias that discourages both the growth and diversification of exports and creates an over-dependence on foreign capital. A real exchange rate with a competitive, stable value is a very important stimulant to export-led growth by providing a favorable environment for investment and marketing decisions. The recommended crawling peg, or depreciating the exchange rate at a pace that maintains external competitiveness—through small changes at frequent intervals mainly to compensate for differences in the rates of inflation—could be very important, with periodic adjustments to reflect internal and external factors. Likewise, if the tariffs are reduced step-by-step according to a clear and pre-announced schedule, all enterprises, both SEs and PEs, will have strong incentives to impose efficiency and adjust to increasing foreign competition.

The CGM proposal considers that if U.S. the embargo is lifted the conditions for the external sector will improve. We agree with this proposition, but the lifting of the embargo is neither a necessary nor sufficient condition for the self-sustaining improvement of the external sector. Many of the difficult structural obstacles that have inhibited growth must be addressed. Expectations will improve but "objective" economic conditions also have to improve. The incompetent management and inappropriate economic policies followed over the years, because they have not been rapidly corrected, as well as the current system and economic organization, have undoubtedly played a significant role and have been a fundamental cause of the vulnerability of the external sector, not their consequence. Cuba must improve internal organization and resource allocation if it is to overcome its external fragility and fully recover. In this sense change has to come mainly and mostly from within Cuba.

The CGM proposal placed a lot of emphasis on foreign direct investment through joint ventures. However, foreign private investors expect to earn a competitive rate of return, adjusted for risk, within an environment that provides international standards of investor protection and business services, which are usually taken for granted by foreign enterprises and are not available in Cuba. If that infrastructure is incomplete or missing, foreign investors will go elsewhere unless the opportunities for rent-seeking and establishing dominant market shares are considered to be sufficient to offset the increased risk of investment. The joint ventures already in place, mainly involving small capital flows, suggest that foreign investors are keeping a foot in the door for just such a development. Foreign direct investment is a lagging, not leading, variable in the transition process.

The CGM proposal does not pay attention to external debt management nor to the normalization of relations with the international community that could make Cuba once again an appealing place for real and financial investment. Cuba's foreign debt and U.S. compensation claims on confiscations of property tend to discourage foreign private investment. Negotiation and settlement of foreign claims and debt renegotiation (debt write-down, debt restructuring, debt service reduction, and a temporary moratorium) are needed to improve the credibility of the stabilization program with private investors and contribute to exchange rate, interest rate, and fiscal adjustments by diminishing the uncertainties about future policies and to smooth the path to market-oriented reform. The remittances from émigrés could also trigger a robust expansion pulled by externally-financed consumption.

There is still a need for an overall strategy to establish a reliable private financial system; otherwise the chances of achieving sustainability are virtually nil. The financial system's tasks during the transition are to raise and efficiently allocate resources, make payments, help finance the emerging private sector, help place a hard budget constraint on SEs, and perform corporate functions, both in public and private sectors. If the financial policy is correct, monetization will occur and monetary policy must accommodate a sustained increase in monetary demand. Policies should develop a genuine two-tier banking system, increase its integrity and make it accessible to non-traditional savers. The emphasis of the CGM proposal is on a public capital market that is unlikely to work; neither are the references to a positive real interest rate to private domestic savings, and the ability to attract financial capital movements.

CGM also recommend an industrial policy, but the emphasis appears to be only on SEs rather than on a selective export push for the private sector based on the acquisition, adoption and mastery of "best practice" international technologies and production organization methods.

LIKELY OUTCOMES OF THE CGM PROPOSAL ON GROWTH AND EQUITY

The main weakness of the CGM proposal, in contrast to the AMSM, is that it does not pay sufficient attention to the vitality and dynamism of some basic microeconomic policies that are essential to expand the aggregate supply and to generate a high and self-sustaining rate of growth. These include the proper liberalization and deregulation of private economic activities, the strengthening of incentives that link material reward to economic performance for individuals and enterprises, and the stimulation of private initiative and competition. One point that needs stress is that the proposed microeconomic reforms will generate a sluggish adjustment on the supply side given the starting conditions of the economy and the vast and comprehensive structural changes that are necessary. The proposed macroeconomic policies for stimulating savings are also limited.

One of the major strengths of the CGM proposal is that the authors attempt to reestablish macroeconomic equilibrium and provide a credible macroeconomic framework and instruments to manage aggregate demand and structural adjustment in desirable directions, through proper, though limited, policies (fiscal, monetary and external sector policies). Also, the proposed policies will institutionalize macroeconomic instruments for prompt and effective response to external shocks. Though real, our differences in this area are of degree and need, except for the financial sector. What is feasible and desirable macroeconomically depends, nevertheless, upon achievements in the microeconomic area. Unless the low efficiency at the micro level is improved, the macro unbalance will continue. The problem is just not of balancing aggregates but turning the aggregate supply around.

The reform recommendations by CGM may well trigger some immediate output expansion and put Cuba on a higher growth path than the current status quo allows. However, it is unlikely that Cuba will be able to achieve growth and social development with the new system of incentives and institutions, because it is clear that Cuban exports are not competitive. The point is that even some recovery will only reach a level that is far below what most consider Cuba could achieve. In this sense we consider that the CGM's recommendations constitute a transformation trap—or an unnecessary long detour—for high, self-sustaining and lasting growth with equity.[11]

The CGM proposal is comprehensive in the sense that it covers some of the main policy variables but it is not complete because it lacks the consideration, both in depth and breadth, of some key microeconomic institutions and macroeconomic variables. Yet it is full of paradoxes in relation to consistency. Internally the proposal is articulated because the effects of its measures are mutually supportive, but there are inconsistencies and discrepancies between extensive objectives and confined instruments; hence likely outcomes are based on hope rather than on design. The proposed new model of reformed socialism for growth and prosperity is partially based on market-oriented policies, international trade, foreign private investment and a smaller private sector, but lacks a sense of priority because of still too comprehensive and asphyxiating state sector. The proposal lacks a true vision for the country because it effectively disregards the situation and trends imposed by today's world markets. In the final analysis, CGM have yet to recognize that the world has changed profoundly and irrevocably.

The limitations on proper incentives and required institutions and the excessive role of the public sector, both directly and through regulatory mechanisms—with excessive and tight prohibitions, often contradictory microregulations and cumbersome and redundant controls—will harass and irritate private firms. Simplifying regulations is particularly important for investment promotion, both domestic and foreign. Unless higher rates of growth are achieved, the coverage and quality of social services that Cubans became accustomed to in the 1980's will not continue.[12]

Finally, we consider that the CGM proposal can be improved both on growth and equity grounds. There are severe conceptual problems with the proposal even if its initial premises were correct. That is why, in the following section, we make five recommendations to spark more robust economic growth.

RECOMMENDATIONS FOR "UNMAKING THE CUBAN QUAGMIRE"

> "It takes all the running you can do to keep in the same place. If you want to go somewhere else, you must run at least twice as fast as that."
>
> —Carroll, *Through the Looking Glass*

> "In the life cycle of growth and relative decline, the experiences of different countries show somewhat different features, as one factor in growth substitutes for another. But it is the vitality and flexibility giving way to rigidity that determines the pattern."
>
> —Kindleberger (1995, p. 36)

It is obvious that Cuban stalinist socialism based on central planning and public property is dying and state-generated development is in retreat. Economic stagnation exists alongside political fragility. There is increasing tension between the internationalism required by global economics and the radical nationalism and chimera of isolationism and autarky that the island´s communist leaders believe fosters internal political cohesion.

The core of the debate between CGM and us is not about the need to rebuild the shattered Cuban economy. The notion that many aspects of the economy must be overhauled in a number of different dimensions is mutually accepted. We also agree that Cuba requires a carefully considered, systematic and clear set of transition policies. There is, however, much less consensus in relation to the role and limits of the private and public sectors in the economy and about the speed, intensity, comprehensiveness, sequencing and sectoralism with which an orderly transition

11. In Kornai's words "...whichever of the grave problems it tries to resolve, it may exacerbate the others" (Kornai 1995, p. 217).

12. At the time annual transfers from the Soviet Union were approximately US$500 per capita.

strategy can be implemented realistically, and about microeconomic and institutional matters.

We consider that the basic economic goals of the Cuban people are to: (1) create an expanding economy that generates high levels of income and employment opportunities for the well-educated population; (2) maintain social coverage of basic public services (education and health) and a relatively even distribution of income; (3) create a truly decentralized economic system that allows for widespread participation and initiatives of the population; (4) reinsert Cuba into the world economy; and (5) have a smaller but effective and proactive state that orients and guides the transformation and modernization processes. These basic goals can be summarized as decentralized growth with social equity guiding the transition and transformation processes. The main reforms and policy measures should be constrained by them. Therefore, we are critical of extreme recipes, from both the "left"—those that consider all other alternatives neoliberalism—and the "right" that consider all other alternatives to be statism. We find this debate as gravitational pull away from center-based economics, anguished and polarizing and not in the best interest of Cuba. Both extremes are faulty in four fundamental ways: (a) they unnecessarily induce economic stagnation; (b) they incur in large and unnecessary social costs; (c) they weaken, instead of strengthening, civil society in general, and democratic institutions and organizations in particular; and (d) they confuse means and ends about the role and limits of the state and the objectives of privatization.

Our approach consists of putting more emphasis on five elements. **First**, the entire reform package must be designed by nurturing entrepreneurship and initiative based on individual rights and freedoms, market and competitive deepening, and institutional development with a view toward smooth path of recovery and resumed high, self-sustaining and lasting growth. **Second**, social policy must be redesigned and put in place to minimize the social costs of stabilization, liberalization and deregulation. **Third**, reform programs should be formulated and implemented as a result of the political interplay of representative organizations within the framework of increasing initiatives and participation of all members of society. **Fourth**, Cuba must joint international financial institutions (the World Bank, IMF and IDB) in order to sustain the reform and to mobilize external resources as a precondition to effective mobilization of private foreign capital. **Fifth**, a leaner but strong state should orient the entire transformation and modernization processes.[13]

For the analysis that follows, it will be assumed that a satisfactory solution to the external debt problem—consisting not merely of postponing payments, but of a significant and permanent reduction of the debt burden—can be found. This is also a precondition for finding new strategies that could return the country to a path of high and sustained economic and social progress. In addition to being assigned a lower priority, Cuba now suffers the consequences of its debt moratoria and a very poor credit rating. It must reach agreements with commercial and official creditors on debt relief and reduction, simultaneous with, and not following the required adjustment, and should include a lower level of servicing and improved terms for interest and principal payments that must be made, compatible with adopted targets.

The dimension of the task ahead is daunting and goes well beyond the realm of economics. We strongly support reforms aimed at stabilization, considered mainly as a reduction of the fiscal crisis and the elimination of the monetary overhang with all their attendant consequences. As opposed to CGM, we place stronger emphasis on an in-depth and immediate liberalization and deregulation of the main markets, as Vietnam did in 1989, especially for new PEs, or an increased reliance on national and international markets to allocate scarce resources to increase efficiency in an economy that is stagnant, monopolistic, overregulated and overprotected. Moreover, the settling of property rights and compensation for confiscation should not become a symbol of unresolved social

13. See Rolando H. Castañeda and George P. Montalván, *Cuba in Transition—Vol. 3.*

conflicts, and expanding privatization should be motivated by efficiency and by the proper long-term distribution of wealth and property rather than by the need to improve the short-term financial position of the state or to restore the pre-1959 distribution of wealth.

We envision an initial acceleration of price increases after a process of price decontrol with a slow and protracted process of low inflation that may take several years; a moderate decline in output and in employment in the short run and a strong recovery in the medium term; a rapid privatization of services, retail trade and small and medium agricultural and manufacturing activities coexisting with a slow and complex process of privatization of medium- and large-scale SEs in industry, public utilities and state-owned banks while there is a continued improvement in their operation; an induced improvement in the current account of the balance of payments and a reduction of the fiscal deficit in the short run and then a slow deterioration of both in the medium term to the extent there is a strong recovery.

Catalysts for growth

Development depends on growth and therefore market-based policies and reforms must be adopted based on export-led growth and internal competitive markets which will encourage initiative, entrepreneurial drive, savings and investment to make a real and lasting breakthrough. The net effect will be a stronger Cuban economy and higher incomes all around, which should be stabilizing. Two missing elements in the CGM proposal are a more effective incentives system to create strong growth performance and a more appropriate price structure to guide efficient resource allocation.

It is not necessary to make Cuban society wait to achieve absolute stability and structural transformation (liberalization and deregulation of internal and external markets) of its economy before launching into a strategy for sustained economic growth. The economy has been stagnant and there has been a steady increase in the gap with other regional developing countries in technical development, innovation and product quality. Economic growth is indispensable for social and political reasons and cannot be delayed much longer. Sustained growth will depend primarily on Cuba's ability to generate private savings to finance investment. A good program of comprehensive and enhanced incentives for entrepreneurship and modernization and clear rules of the game are required in order for government policies to inspire credibility about long-term sustainability. Once investors and savers begin to benefit from new opportunities and the potential financial payback for them is clear, there will be little trouble raising the necessary capital. This is a precondition for debt renegotiation and mobilization of external resources from international financial institutions.

There are three key and related reasons why strong economic growth is critical and cannot be postponed any longer: (1) the existence of unsatisfied social services (especially housing and restoring the quality of health and education that more seriously affect the poor and disadvantaged, since they are unable to secure private services; (2) the unemployment compensation and other social safeguards; and (3) the capability to maintain a pattern of distribution of income and wealth without great disparities would otherwise be quite limited to assure long-term social peace and order in Cuba. Vigorous rates of broad-based growth are also needed to strengthen political democracy because of the social and political pressures that the movement toward democracy entails. Economic reforms will only survive politically if they show some benefits early on and if those benefits expand gradually encompass, larger and larger segments of society.

The main dilemma in the current situation is that substantial and sustained economic growth is needed, but the reforms and policies being presently pursued, or the better ones proposed by CGM, are not conducive to vigorous and sustained growth, assuring rather that it will not be forthcoming. Cuba has to put a new system in place capable of achieving a level of growth near the economy's potential through long-term capital accumulation. Economic theory and practical experience teach us that the combination of a skilled labor force, low real wages, proximity to a large and growing market, and the availability of financial resources should lead to growth.

Accepting the urgent need for a higher rate of economic growth, the question is how best to achieve it under the present circumstances, i.e., to create an attractive environment in Cuba for all individuals and enterprises, whether domestic or foreign. The proper incentives to work harder, save more and invest are needed, such as the ones established in China, Vietnam and Eastern Europe. We are especially concerned with the supply side, and seek to enlarge productive capacity by increasing mobility, adaptability, flexibility and efficiency in the utilization and allocation of resources among competitive uses. We consider that Cuba should seek to eliminate distortions in incentives, enhance the role of market forces, and improve microeconomic efficiency. The advantage of marketization lies not only in its allocative efficiency and factor productivity, but also in its facilitation of innovative and creative activity (technological change).

To boost the rate of economic growth, significant expansion of productive capacity through physical investment must be one of the primary objectives of the reform process. But equally important is the mobilization of adequate savings to ensure the realization of required investment and to make it more accessible to non-traditional investors. Institutional and legal changes are necessary to mobilize domestic and foreign savings and ensure a better allocation of it. A proper positive real interest rate policy can be critical in influencing not only short-run changes in spending, inflation, and external financing, but also in affecting longer-term accumulation of financial assets and the level, composition and productivity of investment. Two distinct supply-side forces should be freed by the market-based reforms: a rapid accumulation of capital stock and technology catch-up and, second, a powerful adjustment in the structure of saving incentives and in the variety of instruments. A set of attractive and secure savings instruments needs to be developed, such as bonds and stocks, pension funds, and mutual funds.

It will also take the concerted effort of government, individuals and businesses. Creating wealth demands cooperation. We have in mind that private foreign investment usually lags rather than leads growth. It enters when growth has already gained momentum and then tends to accelerate it. Increasingly entry into activities, internal competition, international trade based on outward growth orientation and application of up-dated technologies and organization can contribute substantially to improving both the allocation of resources and their productivity and, consequently, the international competitiveness of Cuba's exports. The state must play the strategic role of devising the policies and implementing the mechanisms to make the best use of these factors. There is need for continued absorption of up-dated and improved technologies and organization in the more traditional activities that still represent the backbone of production and exports (agriculture and tourism).

Social policy targeted to the poor

The adverse social effects of the stabilization and adjustment policy should be offset by the rationalization of the social expenditures and carefully focusing relief on the vulnerable and in investing in human capital to maintain the social safety net. A social policy designed to protect the vulnerable from the most distressing effects of economic restructuring and to distribute the fruits of progress evenly must be an intrinsic part of any reform strategy that seeks continued political support under increasingly democratic and participatory conditions. The degree of social and political support will determine the scale of reforms that can be sustained without derailing the entire transformation and modernization program. The recent experiences of Eastern Europe and Latin America suggest that the increase in social programs not only constitutes good economics but also makes political sense. If this is not done, there is a real danger that the reforms will stall and even that voters will once again favor the old order.

Reduction of waste, focalization and efficiency gains provide the most likely and immediate means for improvements in the public provision of social services in a hypertrophied welfare state. Greater reliance should be placed on private provision of some of these services or through NGO's.

We believe that a combination of high economic growth with a relatively even distribution of income, and not at its expense, is highly possible and desirable for Cuba. It tends to insure dignity to all citizens and prevents private concentrations of economic power from dictating economic policy. East Asian market economies have made a conscious effort to achieve "shared growth," that is, growth whose effects would be felt by as wide a segment of society as possible and they have achieved very successful results.

Democratization for true and effective participation

Institutions necessary for effective involvement, participation and democratic decision making should be put in place to breed cooperation, self-confidence and accord; they are important elements in maintaining support in favor of reforms and are most important for much wider reasons than narrow economic ones. Honest differences of opinions and wide participation "from below" in the introduction of the new policies are required to elicit and encourage the attitudinal changes and to address political corruption, a fixture of Cuban political life since independence, without which no reform can succeed. It should empower Cuban citizens to use the energies of their good education and health that are available waiting to be unleashed. We consider that if only fast and abrupt top-down changes are implemented, they are likely to prove counterproductive and unfeasible. There are strong pressures in Cuba today to evolve in the direction of individual rights, participation and pluralism, in order that political choices are voiced and made in a transparent, predictable, reliable, and comparatively inexpensive manner. It is crucial that a broad set of people—not just a few bureaucrats—participate in the debate about how important changes should be shaped, as well as in the design, administration and supervision of the programs. Then these will gain broader acceptance and become a reality.

Feedback and participation to define a sense of common purpose and shared burdens, is crucial for success, especially in a country where effective de-facto taxation is so high. People will serve the cause only by devising undertakings that command participation and can be sustained over time. Current domestic realities permit no other choice than to obtain clear and unambiguous backing. One of the most strategic choices that the government faces is whether to give some control and decentralize decision-making based on superior understanding of appropriate circumstances in return for a faster pace of development. Instead of trying to control most decisions, the government should concentrate on establishing an incentives regime that promotes efficient decision and true participation by households and enterprises both in economics and politics.

By establishing strategic alliances and partnerships with non-governmental and business sectors, the public institutions will be able to pursue a broader concept of governance. A strong and vibrant non-governmental participation is needed. This should include, inter-alia, new independent non-governmental and community-based organizations, professional and business groups and associations that will allow professionals and entrepreneurs in Cuba to stay in touch with advancements being made in their disciplines and enterprises. Open debate regarding economic policies should be allowed. For example, the government should encourage labor participation in enterprise reform.

Cuba and the international financial community

Cuba's active participation in international financial institutions—the IMF, World Bank and IDB—is an area that was not covered by CGM, but that in our opinion could play a significant role in making possible decentralized and sustainable economic growth with equity. It would facilitate reflection and could be decisive in the analysis of alternative proposals for systemic and structural market-based reforms and developing microeconomic policies to remove impediments to economic growth. Furthermore, international financial organizations can offer loans for economic development, possibly under advantageous (concessional) conditions, given Cuba's precarious situation, as well as facilitate technical cooperation and renegotiation of debt.

Foreign assistance could also stimulate the growth of private investment and provide the necessary assurance that the transition program will succeed. Cuban policymakers could then look ahead several years and consider how inflows of official development assistance and direct investment might contribute to development, within a context of sound and well-managed macroeconomic policies.

Role of the state during the transition

In contrast to the CGM proposal, we support a subsidiary role for the state in productive activities, getting out of activities that the private sector can perform in a more efficient way, shrinkage of government and demystification of the state. The continuing dominance of SEs in industry, foreign trade, banking and other sectors by CGM is a major impediment to competitiveness and capital accumulation necessary for the sound development of the economy.

Having so stated, we understand that boosting Cuba from stagnation to steady economic growth requires an important initial role for the state. Many of the transformations will not take place spontaneously. Rather, they will require a proactive state, particularly during the earlier phases of the transition. The goals of the transition can be best achieved by purposeful improvement and guidance of the market rather than by unfettered market forces. There is a need for reform of the state to address the downsizing of numerous ministries that are supposed to deal with economic issues in a command fashion.

The strong empirical evidence from the experience of East Asian market economies shows that the public sector has played a forceful and aggressive role in defining the growth strategy and implementing it, by fostering and stimulating entrepreneurship, ensuring a strong competitive framework and guidelines, and factor allocation in preestablished directions. This is based on the presence of externalities arising from large, coordinated investments in infrastructure and productive capacity, as well as the risks involved in substantial investment with long gestation periods. No local entrepreneurial groups, alone or in conjunction with foreign investors, foresaw the full potential of these sectors or appropriately discounted the future costs and benefits. However, the state did not intervene in the direct production of goods and services that the private sector is more efficient in producing nor did it interfere with the private sector´s ability to do so. Market remedies should generally be used to treat and correct market distortions.

Government and the private sector are partners; they should not be adversaries locked in combat. They are supposed to be working toward the same goal: economic development.[14] Cuba needs critical macroeconomic balances, microeconomic guidance and institution-building in the transformation and modernization process, it should avoid market failures and support the development of small and medium enterprises, especially by improving access to capital, training, the transfer of technology and marketing. Additionally, effective state intervention is needed to establish and preserve competition, to regulate monopolies, to mobilize concessional resources and negotiate debt rescheduling and forgiveness, promote education, guide infrastructure, enforce laws, and for the protection of health, safety, the environment and overall natural resource management. The pursuit of self-interest unrestrained by suitable institutions carries no guarantee of anything except chaos and uncertainty, especially in financial markets where prudent regulation and supervision is needed. We support the public presence in economic activities that are regulatory in nature. We strongly reject a "do-nothing" position on the ground that competent state bureaucracies do not simply exist to administer such a role. That is precisely why Cuba should avoid government failures through unnecessary interventions in the production of goods and services, as well as problematic enforcement, rent-seeking activities and bureaucratic expansion.

What is needed is a professional, independent, and disciplined civil service that is prohibited from being active in politics, selected on merit through an examination system, protected from undue influence of business groups, operating on the basis of clear rules and written records and with promotion based on performance and merit. Bureaucrats should be pre-

14. "When markets and governments have worked in harness, the results have been spectacular, but when they have worked in opposition the results have been disastrous" (World Bank, 1991, p. 2).

vented from entering business or politics while in service. Political appointments and civil service positions should be clearly distinguished by law.

Dismantling the production of goods and services out of the public sector will facilitate the state's streamlining and strengthening, leading to a greater ability to administer the workings of the economy, to control and regulate economic activity where required without stifling private initiative, to provide basic income and social services for all instances in which the economy fails to provide for the most vulnerable, to make highly selective government intervention and work together and in close collaboration with the private sector, as partners in the development process.

FINAL REFLECTIONS AND CONCLUSIONS

At the beginning of 1995 it was widely known in U.S. academic circles that CGM had prepared a new development strategy for Cuba based on the AMSM. It was also assumed that the Cuban leadership was going to announce additional structural reforms to those enacted in 1993 and 1994 for the strengthening of the incipient recovery of the Cuban economy and its reinsertion into international markets based on the framework and guidelines of the CGM proposal. On July 26, 1995 Castro declared that Cuba would follow a strategy inspired on the AMSM and adopt "unquestionable elements of capitalism." In September 1995, with a remarkable coincidence of timing, the CGM proposal was finally published in Cuba. At the end of November, the Finance Minister announced an income tax on hard currency earnings, tax on boats and road tolls for two highways. However, as of February 1996, significant structural reforms proposed by CGM are yet to be disclosed and implemented in Cuba, as well as the initial trigger mechanism to effectively start the process for the needed recovery of the economy and its international reinsertion.

In Appendix I of this paper we analyze the AMSM and reach the conclusion that China was able to introduce gradual and piecemeal market-based reforms starting with a minimum bang in 1978 due to its unique initial macroeconomic stability-cum-moderate economic growth, but that Vietnam had to follow a faster and deeper approach, based on an initial "radical surgery" to stabilization and gradual structural reforms in 1989, because of its much more severe internal and external problems.

We are not able to assert confidently that the AMSM is the appropriate model for transition, but we consider that it holds very significant lessons for Cuba. Given the current difficulties in Cuba and the progress achieved by China and Vietnam, there is a strong case for the initiation of a Cuban version of the AMSM, similar to the faster and deeper approach that the Vietnamese started in 1989. Both China and Vietnam have allowed substantial private enterprise, starting with agriculture, small manufacturing, handicrafts, services and own-account work, that has extended across the whole economy even though they have reserved several activities (heavy industry, public utilities and natural resources) for the public sector or for joint enterprises with foreign participation. Both countries have adopted deregulating and liberalizing microeconomic reforms within a stable macroeconomic management framework that have encouraged investment, savings and productivity increases. They have been able to achieve high rates of economic growth, relatively low inflation, have maintained social expenditures and have induced massive foreign investment from émigrés. We hope Cuba can encourage the imagination and initiative of its people and combine a gradual but decisive economic opening with serious advances and modernization of political institutions.

The CGM proposal is a first, but still far distant, approximation to the AMSM. It does not support a more complete liberalization and deregulation of agricultural activities nor the increasing entry and competition into many economic activities as the Chinese and Vietnamese did when they started their market-based reforms. The CGM proposal does not have some of the most important microeconomic strengths of the AMSM, but it has most of its weaknesses, both economically and politically. Its likelihood of survival in the long run in its present form is a matter of serious doubt. It should be bolder and more daring in proposing genuine solutions sooner. This is not simply right. It is also necessary for the survival and prosperity of Cuba. The more similar feature of the new Cuban model and AMSM is on its political aims: there are neither proposals for significant political reforms, civil liberties and freedoms, nor political parties and pluralism. This silence was predictable.

CGM have presented a vision of Cuban society to which the transition process should be moving and have drawn a program of action which is coherent in its components parts and can serve as a stepping-stone for building the required accord for change. However, the economic reform prescriptions they have presented are still driven more by calculations of political convenience and effective social control than by the genuine requirements of economic need and growth. The effort to overregulate and control a broad range of private activities stems from a distrust of markets and competition and will determine a weak microeconomic setting vulnerable to external shocks. The economic reform process that they recommend will prove insufficient to produce any real prospect of self-sustaining and lasting recovery in living standards or new sources of growth and employment. It will not end the binding constraint on long-term growth of the economy; hence it is a transformation trap or an unnecessary long detour for high and sustainable growth with equity. However, the CGM proposal—even with all its limitations and contradictions—has established a basic framework which can subsequently be built upon. If their recommendations were implemented, it would constitute a remarkable, albeit inadequate and incomplete, accomplishment.

APPENDIX I
THE ASIAN MARKET SOCIALISM MODEL (AMSM)

"Our revolution is still in its first day. We have no real private property, no de-monopolization. We still have the same Soviet communist leaders in power... I want Russia to have not simply a market economy but an effective market economy, not simply an anti-totalitarian regime but a working democracy. I want to liberate the people from the previous system and from the quasi-democratic system we have today."

— Grigory Yavlinsky, *The Washington Post*, December 3, 1995, p. C3.

"What the Chinese have done to their economy is phenomenal. In 15 years, China has come from a poverty-stricken nowhere to the economic front. Real income has quadrupled, putting it on the course to become the world's largest economy..."

— Mortimer B. Zuckerman, "America's China Syndrome", in *U.S. News & World Report*, October 30, 1995, p. 110.

"More disturbing is the tendency to dismiss the Chinese experience as irrelevant or somehow phony. Indeed, this dismissal verges on a kind of physiological denial when carried out by individuals who have themselves been involved in policymaking in European socialist countries with rather mixed results. Thus, one commonly hears a wide range of far-fetched and mutually contradictory reasons why China's experience is irrelevant to other socialist countries."

— Barry Naughton, "China's Economic Success: Effective Reforms Policies or Unique Conditions?" in *The Evolutionary Transition to Capitalism*, Kazimiers Z. Poznanki, ed. (1995), p. 132.

TWO APPROACHES TO A MARKET-BASED ECONOMIC SYSTEM: "BIG BANG" VIS-A-VIS GRADUALISM

There are two principal approaches, in terms of the nature and pace of transition, from a centrally-planned to a decentralized, predominant market economy. One is the so-called "big bang" or "generalized shock therapy" (Lipton and Sachs, 1990, especially p. 99).[15] It advocates swift and comprehensive policy reform, some kind of an "all or nothing" or "quick-fix" approach, including simultaneous economic stabilization, liberalization of domestic and external markets, top-down privatization and institution building as necessary components of market-based reforms. It implies that unless the preconditions are created at once, the road to a market economy can never open up. This approach encourages initiating and completing all these measures within a relatively short period of time. In this approach, sequencing of reforms is practically irrelevant. It offers simple prescriptions, has no patience for the diversity, complexity and complications of dismantling the socialist system, and scarcely focuses on detailed microeconomic reforms that are necessary to eliminate the frictions and barriers of imperfect and segmentated markets. It implicitly assumes a strong and rapid market adjustment toward new equilibrium based on an extreme form of market clearing, that unemployment is a voluntary phenomena and that the role of economic policy in general is distorting and irrelevant as established by the new classical macroeconomic theory. It ignores that increased uncertainty in prices and employment reduces the market efficiency due to the lack of a proper coordination/communication mechanism. The market-based reforms undertaken in Eastern Europe and the former Soviet Union in the first half of the 1990's are prime examples of this strategy.

The big bang is expected to generate a "J-curve" effect on growth, i.e., that GDP will initially decline for a kind of creative destruction and to accelerate

15. Technically, shock therapy is a treatment propelling electric current through the body with the goal of stimulating nerve cells, thus altering the chemistry of the brain, to resume more normal functions. Following the convulsion, the cure is likely to become evident only gradually, if at all, over a protracted period of time. It is applied as a last resort to patients suffering from certain types of severe mental depression and catatonic schizophrenia by psychiatry departments in hospitals and related mental institutions. The effectiveness of the treatment is a matter of considerable controversy in the medical profession.

the natural selection, but soon be followed by a strong and robust recovery as a result of better economic policy, improved overall management and increased efficiency. It has been judged to be theoretically sound, rigorous and feasible in practice by the mainstream of the economics profession and the international financial institutions (the World Bank and the IMF). It is an interesting theory but not a proven method. It is the conventional wisdom or the economists' consensus of the moment which has so far overshadowed the design of alternative transitional agendas.[16] It is a leap of faith, rather than a conclusion based on hard evidence, because the idea that it will generate a growth takeoff represents a hope rather than a well-founded expectation. It has generated a sort of speculative bubble or a temporarily self-fulfilling prophecy, creating an initial mood of euphoria. However, typically a "reality check" comes and the bubble bursts, because of its high transition costs and because the technical design is not a good as its myth. In reality, the behavior of output followed, at least initially, an "L"-shaped pattern instead of a "J-shaped" one and the supply side has been so weak that the reduction in output in Eastern Europe in 1989-1993 "was on a massive scale and unprecedented since the Great Depression of 1929-1933." (UN/ECE, 1995, p. 10).[17]

In some cases, the radical change was carried out explicitly to shatter the former economic system, take the old guard out, and make the transition process irreversible, but it has also stopped further reforms, generating a very strong adverse reaction.[18] It has been more harmful than necessary. The sacrifice ratio of disinflation and the Okun's misery index (unemployment and inflation rates) have been very high. There has been a significant increase in poverty, unemployment, inequality and a decrease in human welfare in general (Emmerij, 1994, pp. 19-21) evidenced by rising numbers of people below national poverty lines and serious deterioration in standards of health and mortality rates. Ordinary people face rising economic insecurity. The jobless rate in most East European countries is well over 10 percent of the labor force and has remained high, despite the emerging recovery of output. There has been only a small reduction in "excess employment" as indicated by the difference or similarity between the cumulative contraction in GDP and the cumulative compression in employment between 1989 and 1994. As more people remain without a job for a long time they will tend to drop out of the active labor force permanently because of a loss of skills. One especially worrisome fact is that there are more young people and school leavers among the unemployed.

There has been an institutional vacuum and generalized administrative weakness due to the problem of missing, weak or inappropriate state institutions or, at best to the transaction costs of making the change from one set of institutions to another. There has been a marked rise of organized crime that some authors consider is providing a service to economic development because it is "the only force interposed between the new economic boyars and the defenseless consumers and entrepreneurs of Russia."[19] Foreign direct investments have been rather modest, probably linked to systemic factors such as the uncertain legal, political and institutional environment.

The contrasting approach is the "gradual," "incremental," "evolutionary" or "organic" approach (Kor-

16. Summers, 1992, p. 112.

17. "by far the most helpful circumstance for the rapid propagation of a new revolutionary theory is the existence of an established orthodoxy which is clearly inconsistent with the most salient facts of reality." (Johnson, 1971).

18. Also, the advances in democracy and of a truly independent judicial system have several limitations, as the Josef Olesksy affair has shown in Poland. "In a little less than in two years, Poland has been transformed from a country headed by pro-Western leaders who risked their lives and well-being for democratic values into nation headed by leaders who collaborated with and had strong personal friendships with officials of a foreign power that dominated their country for half a century." (Article by Adrian Karensky, President of Freedom House, *The Wall Street Journal,* January 22, 1996, p. A12).

19. Edward M. Luttwak, "Russia's Pro-Capitalist" in *The Washington Post,* February 4, 1996, p. C2.

nai, 1990 and McKinnon, 1991).[20] It is partial, incremental, sequential, induced, often experimental and bottom-up. It characterizes the reform process that China started in 1978 and that Vietnam and Laos PDR initiated in 1986. However, countries differ with regard to its intensity. China has progressively introduced market forces, decentralized economic decision-making and strengthened material incentives and competition, often on an experimental basis, since 1978. It has shown the feasibility of gradually reforming a socialist economy, because with a quarter of the world's population, China has managed to record a growth rate of nearly 10 percent per annum since it started the market reforms—by far the fastest growth rate among major economies.

The gradual approach typically does not pursue privatization, especially large-scale privatization, but an increase in the free entry of PEs, improvements in the performance of SEs and competition, both among SEs and between SEs and PEs. Heavy industry, public utilities and natural resources have remained firmly the responsibility of the central government or of joint enterprises with foreign investment. Recent developments in these countries indicate that partial privatization of SEs is beginning to take place and is likely to expand soon.

Gradualism proceeds slowly, relying on the organic development of the private sector "from below" through free entry, and transition from centralized controls over prices and output to a more decentralized market economy. Privatization of SEs in China has become less important, as SEs weigh less and less heavily in the overall economy. The gradual approach implies market-based reforms over a fairly protracted period of time. Major disruptions to the economy are avoided, as well as social unrest and conflicts that could derail the reform process. Pragmatism is much more of a driving force. It has sought to reform the existing institutional and organizational structures in a deliberate manner, rather than to dismantle them and build them from scratch, because the requisite institution-building is not a goal that can be reached overnight. It tries to avoid the propagation effects of major and rapid changes. In many aspects institutional and organizational reforms lag behind policy reforms.

As a method of liberalization, it is generally regarded as groundless social engineering and self-defeating by the mainstream of the economics profession, based on the failures of partial and half-hearted liberalization in Eastern Europe (i.e., the "Hungarian economic mechanism") and the Soviet Union ("perestroika") during the 1980's, and in Rumania during the 1990's. We agree with Pérez-López (1995) who implicitly distinguishes between "perestroika," a poor, limited and faulty decentralization based on

20. McKinnon (1991) had the ability to translate his vision into gradual measures to approach the transformation goals in stages. Kornai (1995), defends an "initial radical surgery" for some areas of economic policy and supports gradual measures in several areas. "For my part, I agreed with those who stress that a profound transformation of society in the area of coordination mechanisms and property forms cannot be brought about at a stroke, by aggressive state measures, that they necessarily take place as an integral development by evolutionary means." (Ibid, p. 214). "...this is an evolutionary process that wise government measures can speed up and stupid measures or indifference can slow down. Whatever the case, it will take several years to run its course." (Ibid, p. 72). Kornai strongly rejects market socialism. He considers that something is doomed to failure when countries mix elements of planned and market economies because of irreconcilable differences, contradictions and tensions. "...undivided communist political power and a capitalist economy cannot coexist within a single robust, stable system in a permanent way, over a long historical period." (Ibid, pp. 19) It is "...a blind alley." (Ibid, viii.). Kornai also advocates "a general and comprehensive price reform which places the entire system on a market basis in a relatively short time" (Kornai, 1990, p 51).

improving SEs, and the AMSM as an adequate and increasing decentralization based on *expanding* PEs.[21] "Mainstream" economists also stress that Czechoslovakia and Poland which introduced faster and more comprehensive stabilization and price liberalization packages—have fared better than Hungary. "Gradualists" are portrayed as backsliding, lacking commitment to market reforms, aiming to restore the previous status quo, or preferring a more relaxed collectivism.[22] In contrast, gradualists consider that the "big bang" is not dictated by initial conditions but simply constitutes errors in policy and causes the interconnected socialist system to collapse. All market-based reforms are crammed into a tight time frame, so there are bound to be critical dislocations and malfunctions and a generalized chaos in economies with a virtual absence of factor markets and with low price elasticities of supply by SEs.

Unfortunately the debate between advocates of the "big bang" and "gradual" approaches has taken on an increasingly ideological and philosophical tone, along with escalation in rhetoric, each side suggesting rather demagogically that there is only one alternative, instead of analyzing whether one will get farther along the desired road by moving quickly or gradually in certain areas. We disagree with this sole dualistic choice; the question, rather, is which policies should be carried out gradually and which swiftly. Most economists will agree that certain reforms should be done more rapidly because of the effects of global distortions and the need for an initial "minimum bang" or an initial "radical surgery" to start a dynamic and sustainable growth process. Other reforms cannot or should not be done quickly. As a late developer Cuba can learn from the experiences of the trailblazers and should adopt successful policies to the extent feasible. In most democratic societies gradualism is the rule and the "big bang", shock or "cold turkey" policies the rare exceptions. Indeed, one of the major arts of democratic politics is to seek gradual solutions to conflicts of interest. Claims that bold liberalization is generally more sustainable than gradual programs are questionable given the considerable diversity of national experiences.

We believe that stressing exclusive reliance on one position or the other will ultimately be detrimental to the original transformation objectives and will not take advantage of lessons gained through experience. Transformation is an issue of political economy of normative economics, rather than simply a technical one. There is usually more than one way of carrying out reforms to attain a particular set of objectives in a specific set of historical, cultural, institutional and political circumstances.

Stabilization policies must be implemented quickly with great intensity, comprehensively and without sequencing or sectoralism, as Vietnam did in 1989. Also, fostering savings, productivity and private initiative in establishing new small and medium PEs—

21. There are three common characteristics in the AMSM and in perestroika: (1) maintenance of the ruling role of the Communist party, but with some mitigation of the repression and allowing a degree of freedom for alternative views; (2) the extensive role of state control and the subordination of the economy to the public sector; and (3) the importance of state ownership and lack of privatization of large SEs. However, there are marked differences between the AMSM and perestroika in two significant aspects: (1) an increasing role for the private sector and competition; and (2) using the market as the main integrator and coordinating mechanism of the economy which embraces decentralization, a degree of autonomy and partial liberalization of prices for SEs, and opening to trade and foreign investment. The way perestroika worked was an immediate and disorderly decentralization of SEs by giving more autonomy to enterprise managers with emphasis on soft-budgets for SEs and a limited role for the private sector. Perestroika got unconvincing and bad economic results because it did not create good fundamentals, in terms of bringing about a change that increasingly depended on the private sector and automatically reducing the inefficiencies of public sector. The initial expectation of the Soviet reformers was that, once the administrative system was decentralized, there would a momentary vacuum which would then be filled by the market mechanism, but they had no method for coordinating inputs and outputs and the result was chaos.

22. The experiences of Eastern Europe, the former URSS and Asian countries in 1989-1995 suggest the possibility that countries that retain the nomenklatura in political control may in fact move just faster by orderly progress to a market-based system than those attempting transition immediately and simultaneously on both the political and economic fronts. Political reformers who courageously struggled for rapid political and economic change (i.e., Lech Walesa in Poland) are often elbowed out in the process by the nomenklatura. The main beneficiary from rapid privatization is the nomenklatura.

which is possible in conjunction with small-scale privatization—and mobilizing these resources for carrying out the transformation process must be implemented as rapidly as circumstances permit, and it can lay the groundwork for vast improvements in allocation efficiency and factor productivity as well as for political support by spreading ownership broadly. However, the arguments frequently invoked by shockers that trade and financial liberalization cannot be introduced gradually are simply not true.[23] Neither history nor logic yield hard evidence to that effect. Even a casual reading of postwar history of Western Europe and of the recent East Asian and Chilean experiences demonstrates the lack of rigor of these arguments. Additionally, there are some reforms that are difficult and time consuming, among them large-scale privatization,[24] restructuring of SEs or the institutionalization of a healthy market economy, e.g., constructing an appropriate tax system.

Some authors (Gelb, et. al., 1993) suggest that the weakness of certain states precludes a gradual reform process because only strong states can maintain for a long time a large, relatively inefficient public sector with a small but dynamic and expanding private sector. On the other hand, a big bang reform will require, as a condition of success, a strong state. Weaker states should therefore restrict the scale and depth of changes and should therefore not risk an immediate erosion of their power base by allowing steps that estrange political allies. The need is for simultaneous sustainability and completion of the reforms rather than a simultaneous start of the transition. It is also important to consider that although a minimal state might be the *goal* at the end of the transformation process, an activist state should be the *means* during the transition.

When the generalized shock treatment was adopted in Eastern Europe and the former Soviet Union in the first half of the 1990's, its abrupt and radical changes resulted in demolishing the bureaucracy and laying the opportunity to adopt a market economy in its place. However, an unexpectedly deep, widespread and persistent decline of GDP (called the "transformational recession" by Kornai, 1995) took place with at least persistent moderate inflation rates, but sometimes extraordinarily high and explosive ones, with all their speculation effects. Persistent moderate inflation seems to be caused chiefly by inflationary expectations, hystheresis and inertial mechanisms, such as indexation schemes for wages, pensions, foreign exchange, and periodic key commodity prices (mostly food and energy) adjustments.

This situation has unraveled in some countries, producing a spiral of self-reinforcing destructive responses and slowing down reform, lowering the propensity of SEs to restructure, to significant lay-offs of workers, and generating unsettling political and social conflicts.[25] SEs prefer to raise prices, protect employment and lobby heavily for government support and

23. "It is now generally agreed that resolving the fiscal imbalance and attaining some degree of macroeconomic reform should be a priority in implementing a structural reform. Most analysts also agree that trade liberalization should precede liberalization of the capital account and that financial reform should only be implemented once a modern and efficient supervisory authority is in place" (Edwards, 1995, p. 122).

24. Hasty large-scale privatization could become an unfair give-away of the country's wealth to a small group of privileged insiders or well-connected people, as happened in Russia and in some countries in Latin America, or a "quasi" privatization where the assets are transferred but there are no improvements in management or in the financial situation of the enterprise. A growing number of Russians refers to it as "grabitization." The speed in privatizing state assets has enabled many insiders from the old regime, bureaucrats and managers, to obtain capital assets very cheaply and thereby trade their power base in the party hierarchy for economic power in the emerging market economy. "Chubais had been roundly criticized for having conceived what is viewed here as a deeply flawed privatization program. It has been variously skewered as a giveaway of precious state resources and sweetheart deals for former managers of Soviet industries and other insiders who have grabbed valuable assets for a fraction of their real value." (The Washington Post, January 17, 1996, p. A21) However, a strong case can be made for restructuring to be carried out by individuals who are able to run enterprises, rather than by the bureaucrats who made the mess to start with.

25. A contrasting view is held by Sachs (1994, p. 145): "There is simply no evidence of a sharp drop in living standards in Eastern Europe...In fact, living standards may well have increased, when we consider the elimination of queues and the increased variety and quality of consumer goods."

assistance. In some countries there are attempts to reverse the changes made thus far. The general popular mood is one of "reform" fatigue, disillusionment and anger over rising unemployment, inflation, decreasing real wages, shrinking welfare arrangements, collapse of social services, loss of job security, deteriorating standards of living, and soaring crime. This mood has been reflected in election results favoring former communists in many countries, which has been generally interpreted as signifying opposition to further *rapid* market reforms or at least in favor of marketization with a "human face."

In contrast, in China in 1978-1995, even in the aftermath of the Tiananmen Square tragedy and the subsequent political repression, and in Vietnam with its *doi moi* policy[26] and in Laos PDR in 1986-1995, the shift from central planning toward a market economy has produced strong production growth combined with remarkable stability. They have been outstandingly successful, at least in the narrow economic sense, with respect to improvements in the general standard of living, reduction of absolute poverty, and increase in foreign trade. The difference in macroeconomic performance with Eastern Europe and the former Soviet Union is so enormous that it is now impossible to disregard. Chinese, Vietnamese and Laotian experiences illustrate that prolonged drops of GDP and employment with their associated high social costs and political resistance are not an inevitable consequence of the transition towards a decentralized market economy. In the 1990's China and Vietnam have defined their own system as "market socialism," or a combination of communist politics and market economics, and have placed more emphasis on accelerating the integration of their economies to the world economy. One could argue that the process followed in these Asian countries better equips the people for freedom.

Clearly one of the most impressive achievements has been a reduction of inflation rates to levels that are among the lowest in transitional economies together with the maintenance of positive real interest rates. These three Asian countries have avoided the financial disintermediation seen in those transition economies in Eastern Europe. Furthermore, the three significant social and distributional benefits of socialist economies relative to market economies of a comparable income level have been retained: (a) high levels of education and health; (b) a relatively high degree of income security; and (c) low incidence of income aspects of extreme poverty. However, there has also been an absence of significant political reforms and a lack of civil liberties.

This striking difference in performance would suggest that China, Vietnam and Laos PDR have gotten some of their economic policies right while not others. While it is somewhat early to tell, it could be that their overall gradualism has been the proper choice, while the overall radicalism of Eastern European and Russian reforms might have been an excess coupled with some conceptual mistakes. It is likely that there are significant spillover and hysteresis effects on growth associated with what is done well or badly, including of prolonged periods of instability, in opening and liberalizing a highly centralized system. China, Vietnam and Laos PDR have had increasing microeconomic efficiency within a framework of macroeconomic stability.

It should be stressed that the initial conditions in China in 1978 did not show the severe internal and external macroeconomic imbalances that afflicted many other post-communist transition economies. China neither had marked inflationary pressures, a monetary overhang nor foreign debt; indeed, international reserves exceeded the foreign debt. Most of its foreign trade was conducted with market economies due to the Sino-Soviet split of the early 1960's. The economy was decentralized in the sense that local governments had a great deal of discretion. This decentralization made it possible to introduce piecemeal market-based reforms and allow experimentation without disrupting the whole economy. The authorities did not have a detailed blueprint for market-based reforms, but they did have a marked commit-

26. Renovation or reform policy; literally, new change or new road.

ment to modernize China and to integrate its economy to international markets.

In contrast, Vietnam accelerated its path towards a socialist market economy and outward-oriented development in 1989 because of the end of Soviet aid, by strengthening and deepening its commitment to *doi moi*[27] with widespread price decontrol, liberalization of the exchange rate and interest rate reform, coupled with cutting drastically the deficits of SEs (see Table 2). Vietnam was able to achieve some notable and quick successes despite a lack of international support. Uncertainty over where the economic policies were leading brought about an articulate policy more clearly and more consistent in the methods used.

Unlike the populations of many other transition economies undergoing market-friendly reforms, the majority of the Chinese and Vietnamese people benefitted immediately from the decollectivization of, and price liberalization in, agricultural activities. Also, China and Vietnam faced a more elastic supply of labor than other transition economies, where a larger percentage of workers were in heavily subsidized jobs in industry and hence had little desire to seek other employment.

The initial efforts at gradual reform have unleashed forces that 17 years later have brought China to the brink of a market economy. Socio-politically, the dynamics of the system have led to the emergence of new internal economic forces, powerful informal interest groups, and the tremendously powerful social force of consumerism. Individual freedom of choice has increased as a consequence of reform. The participation of tens of thousands of enterprises and millions of administrators, managers, owners and workers in decisions over the years of reforms has built a solid constituency and important countervailing pressures for market-directed change that appears stronger than any official announcement could in theory have produced. There is a nascent and awakening civil society (professional, business and information associations) that is making its voice heard. In Vietnam, the private sector now dominates the economy, and its share is likely to grow in the future. However, at present the private sector remains largely a household one, and few large private enterprises exist.

Most of the Eastern European countries and Russia faced major internal and external imbalances at the beginning of the 1990's, were highly centralized and received a major trade shock from the elimination of the CMEA arrangements in 1991. Most of their reformers have a sort of religious faith in a nineteenth century liberalism or considered, as do CMG, that China was a unique case determined by its very special initial conditions. Brada (1995) considers that the conditions under reforms which have taken place in China seemed so much more favorable than those found in Eastern Europe or the former Soviet Union, that the model of gradual change is not feasible for other economies. However, Brada does not consider the successful experiences of Vietnam and Laos PDR in his analysis. He does not consider that what is needed is an adjustment to the Chinese model, as Vietnam and other socialist countries has done successfully in Asia, rather than to discard it completely.

THE MAIN FEATURES OF THE AMSM APPROACH

> "We have already taken the most difficult and complicated policy decisions related to the shift towards a more market-oriented and open economy. In the coming years economic reforms will be more focused, and will be combined closely with public administration reform, and necessary improvements in the legal framework and institutional development."

27. The doi moi development process seems a coherent and consistent strategy based on two basic principles. A more people-centered approach of incentive environment designed to encourage people to realize their potential and use their own creativity, drive and imagination to improve their lives, which in turn benefits their communities and country or that "development is the result of the efforts by the people for the people;" and the open policy toward investment and trade as the basis for more dynamic and efficient development with a clear realization that to remain isolated from the global economy would retard rapid economic growth and social progress. These two principles, together with other reforms, are developing an economy which is more people-led than state-driven.

Table 2. Main Economic Reforms Approved in China and Vietnam and the CGM Proposal

Reforms	China	Vietnam	Cuba (CGM proposal)
Microeconomic Reforms			
Price reforms	Dual system enacted in 1986. Partial market determination enacted in 1986. Increasing deregulation. 70% of retail prices and 85% of output prices of SEs are market determined.	Dual system until 1989, when almost total deregulation occurred.	Price adjustment proposed for Stage I, Phase 1. Limited price liberalization proposed for Stage I, Phase 2.
Agricultural reforms	Started in 1978 with responsibility system. By the end of the 1980's basically back to household agriculture. Market determined in most agricultural products except grain, edible oils and cotton. Long term land leases. Transfers of land-use legalized in 1988. Use of public stocks to avoid wide fluctuations in a few important crops.	Started in 1986. By the end of the 1980's basically back to household agriculture. Long term land leases.	Proposed for Stage I, Phase 1. Basically it consists of the consolidation of UBPC.
Industrial reform	Started in 1979 with guidance prices for above quota output and access to material inputs thorough the market. In 1984 TVEs authorized. In 1987 contract responsibility adopted.		
Corporate governance	Started in 1978. Intensified after 1984. Expanding hard budgets. Firms retain a progressively growing proportion of the profits over which the managers are given discretion. The salaries and bonuses of the managers are linked to firm performance. The proportion of the workers' income paid in the form of bonuses has been increased.	Started in 1987. Intensified after 1989. Expanding hard budgets.	Proposed for Stage I, Phase 2.
Promotion of non-SEs. Free entry to activities.	Started in the early 1980's. Licenses are easier to obtain.	Started in the early 1980's. Intensified after 1989	
Privatization of small SEs	Indirectly through leases.		Proposed for Stage I, Phase 2.
Reforms of legal property rights		Enacted in 1989	Proposed for Stage I, Phase 2.
Bankruptcy and liquidation law	Enacted in 1987.		Proposed for Stage I, Phase 2.

Table 2. Main Economic Reforms Approved in China and Vietnam and the CGM Proposal

Reforms	China	Vietnam	Cuba (CGM proposal)
Anti-monopoly law			Proposed for Stage I, Phase 1.
Foreign investment law	Enacted in 1979. Opening of first special zones.	Enacted in 1987 and revised in 1989.	Enacted in September 1995.
Macroeconomic Reforms			
Fiscal reforms			
Tax reform	Direct and indirect taxes approved. Weak tax administration.	Direct and indirect taxes approved in 1990. Weak tax administration.	
Expenditure reform	Subsidies partly reduced.	Subsidies reduced considerably.	Proposed for Stage I, Phase 2.
Monetary reforms			
Interest rate liberalization	Not liberalized. Positive real interest most of the times.	Administered rates have been increased but not liberalized.	
Two-tier banking system	Enacted in 1985	Enacted in 1988	
Financial market development	Stock markets established in two cities.	Non-formal institutions.	
External sector reforms			
Exchange rate	Unification in 1984. Dual market reappeared later on. Competitive real exchange rate.	Unification in 1989. Deviation between official and parallel rate is small. Competitive real exchange rate.	Dual exchange rate proposed for Stage I, Phase 1. Movement toward unification starting in Stage I, Phase 2.
Controls over imports and exports	Controls of trade management greatly reduced.	Restrictions on trade have been reduced to some extent.	
Mobilization of resources from émigrés	Active promotion.	Active promotion.	Proposed for Stage I, Phase 1.
International Organizations	China returned to the World Bank and the IMF in 1978. China applied to GATT in 1991.		

— Socialist Republic of Vietnam, "*Report of the Government of the Socialist Republic of Vietnam to the Consultative Group Meeting*," Hanoi, October 1994, p. 8.

In both the shock therapy and gradual approaches, the dynamism of the economy is driven by: (1) the swift entry of new, small and medium non-state enterprises to less regulated activities that induces the shift of resources from sectors of low productivity to more productive ones and provide employee incentives; (2) the correct price signals from relatively liberalized markets; and (3) the outward orientation of the economy.

Although it may account for a relatively small share of production, this plays a major role in improving supply and introducing property relations that conform to the market economy. The initial response of the economy to the entry of PEs permits large increases in output based on only minor investments. In the gradual approach, the older planned allocation system and the distorted macro-policy environment are not immediately disrupted, but gradually become unsustainable and are slowly relaxed in the face of challenges from non-state enterprises as well as from the autonomous or decentralized SEs. In China, the local governments or communities that established the town and village enterprises (TVEs) are moved by the goals of developing their areas and extending non-agricultural employment, and depend on the TVEs for a large share of their revenues. The TVEs have been a powerful engine of growth and are market-driven and outside the web of official price and output controls that still circumscribe the activity of the SEs. They receive bureaucratic support, as well as assistance in obtaining bank credit on commercial terms, etc. The interactions and linkages between the TVEs and the SEs have determined development patterns in the medium and long term. It would be incorrect to conclude that the SEs have crowded out the TVEs or the PEs.

The three key elements of the Chinese supply-side strategy that characterize it and clearly differentiate it from other reform strategies (i.e. perestroika or the big bang) are: (1) the *gradual* but continual and cumulative introduction of market prices and competition over a broad range of the economy; (2) the *gradual* openness to the new entry of firms into sectors previously reserved to state monopoly control; and (3) the *gradual* openness to foreign trade and investment, the so-called "open door" policy. The strategy was also intended to retain the main elements of the planning and institutional apparatus and try to restructure SEs under this system. The opening began with the abandonment of the commune system in agriculture, own-account work and services, and later foreign trade and manufacturing.

The collective system, including cooperatives, was dismantled and agriculture was returned to the household production system to develop the initiative, enthusiasm, energy and dynamism of farm households. The state made appropriate investments to develop rural infrastructure, with active participation of local communities and institutions. Farms previously in traditional agricultural communes were broken up into small farms for lease, the so-called "household" or "contract responsibility system." State marketing agencies gradually raised procurement prices of agricultural products toward world-market levels, private plots were enlarged, diversification and specialization of agricultural production was encouraged and restrictions on prices, rural markets and non-agricultural activities were relaxed, as well as increasingly deregulated and less encumbered by red tape, all of which raised farm productivity. Land was deemed public rather than land being privatized or given to the former owners, the communal land within each village was more or less equally divided among the peasant households, but individuals could buy, sell and transfer long-term agricultural leases. Farmers received land leases initially for a limited period and later for up to 15 years, with permission for the transfer and inheritance of rights.

A major concomitant of market-oriented reforms has been the progressive decentralization of economic decision-making and expanding market incentives. The central driving force is intense competition between SEs, TVEs and PEs which, by eroding the profits of SEs, spurs them to reduce costs and innovate. Moreover, since profits constitute a key element of the tax base, reducing profits lowers tax revenue, thereby hardening the government budget constraint. The government has responded by reducing subsidies to SEs, forcing them to maintain the momentum of innovation and cost reductions.

These elements have been capable of dealing at the same time with the legacy of central planning and gearing the engine of economic growth. Thus, the emphasis is not so much on immediate improvement of static efficiency, both productive and allocative, but on determining and gradually strengthening and deepening the dynamic process of ingenious supply expansion, technological innovation and application, as well as permanent restructuring in response to changes in relative scarcities.

China and Vietnam have increasingly used a dual pricing system by which most of the goods have both a market price and an administered or official price as well. Under this scheme the role of state-controlled prices diminishes over time and that of market determined price increases. Additionally, the former would gradually be brought in line with the latter. By allowing above-plan production to be sold at market prices typically higher that those allowed for delivery commitments, the government created incentives to expand production. Dual pricing also forces SEs to compete and improve quality to please their customers. This linking of effort and rewards has resulted in a spectacular increase in production. The fact that the price received from the market is higher merely means that the firm is facing the equivalent of a lump-sum tax for production up to the level of compulsory quotas.

Price and wage reforms have consisted of gradual but cumulative adjustments to administered prices and wages as well as expanding price and wage liberalization. Government price and wage controls have become less effective as market forces and the private sector have grown in importance. The expanding private sector has been exerting positive influence on the state through filling spaces that the state was staying away from, but also by applying competitive pressures when their areas have overlapped. Also, the presence of a viable and vigorous private sector has allowed the planners to improve monitoring of SEs and to make them responsible for their profits and losses. Apparently, these strategic mechanisms have been sufficient to kick off a virtuous cycle of powerful economic growth and dynamic flexibility for the entire economy.

In China, microeconomic reforms (price reform, agricultural reform, industrial enterprise reform except privatization and reforms of the legal framework under which enterprises operate) were adopted earlier than macroeconomic reforms (fiscal, monetary and foreign trade) but within a relatively stable macroeconomic environment. China has attained quick supply responses and developed increasingly efficient markets.

The AMSM approach has not disrupted production in the state sector. It achieved similar or better effects than the "big bang" approach in the non-state sector, but was able to avoid its economic costs on SEs and its major social and political costs to society. The efficiency of SEs has improved as they become more autonomous and begin moving toward more realistic relative prices, facing competition from the non-state sector and financial constraints ("hard budget constraints").

Because the reform process has been gradual, the people have had sufficient time to make adjustments to the new market structures and institutions. The AMSM approach acknowledges that new institutions require time and understanding, especially the behavioral parts—ethical standards of behavior, habits, attitudes—which will inevitably evolve slowly, through the learning-by-doing process and are constrained by local idiosyncracies. The majority benefits from the market-based reforms because the economy maintains strong growth throughout the whole process. This has played a central role in supporting the momentum of piecemeal but expanding market-based reforms. The gradual approach in China, Vietnam and Laos PDR has followed a path which has induced virtuous institutional innovations and turned increasingly free national markets into places of profitable learning.

Jefferson and Rawski (1994) see the dynamics of partial reform in China's industry as a succession of responses to imbalance by both enterprises and government in a similar fashion to Hirschman's response to disequilibria in *Strategy of Development* (1958). Hirschman argued that imbalances induce not only vibrant market reactions but also government action. The dynamics that transform partial and gradual reform into improved performance is self-sustaining, simple and direct:[28]

1. Partial reform measures have reduced the entry barriers, lowered the cost of many types of transactions and eroded market segmentation, thereby reducing barriers to new technologies and resource flows.

2. Reform intensifies competition in markets for industrial products. Small and medium enterprises particularly have appeared flexible enough and have reacted rapidly to the new market conditions.

3. Stronger competition erodes profits and curtails the growth of wages and fiscal revenues. Reduced profitability limits the growth of wages and bonuses for some firms and throws others into a position of financial loss. The erosion of profits limits the growth of revenues accruing to the local, provincial and central governments.

4. Enterprises react to market pressures by searching for financial gain through modernization, increasing factor productivity and cost reduction, realized through the acquisition and application of technology improvements.

5. On balance, government policy increases industry autonomy and market exposure and hardens budget constraints.

6. Feedback mechanisms amplify and extend the reform process through technical development, economizing efforts and incremental reform. Piecemeal reforms generate a momentum of their own. The basic approach to reforms has been remarkably consistent. China's decision to create a market-based economic system ("market socialism") is an endogenous outcome of the successful partial reform process that generated forces which led to further reform, a process that is continuing to the present.

McKinnon (1994) has pointed out that China was able to avoid the inflation tax by liberalizing agriculture, self-employment and services in 1978 and imposing hard budget constraints and maintaining price controls (to avoid monopolistic price rises) on the increasingly liberalized SEs. The price controls are also necessary to peg price levels in order to provide a nominal anchor among SEs with soft budgets. To start the evolutionary search for efficient organization and a fitting mix of the public and private sectors, an initial "minimum bang" was made toward establishing a new institutional and organizational dynamics and order. By 1984, the focus of rapid economic growth had shifted to rural light industry, which began to absorb much of the labor released by productivity improvements in agriculture. The first important decision was to permit rural communities to keep the bulk of their incomes as savings and invest them in non-agricultural activities. Mobilizing increased domestic resources added to the development momentum and spread development throughout the country. This stimulated a new class of entrepreneurs operating in the countryside. China at the same time retained price controls, restrained financial support for traditional soft-budget SEs, and set positive interest rates for savings deposits thereby creating incentives to households and enterprises to build up their financial assets and soaking up potentially excess household purchasing power. SEs have become major lenders to the state itself. High capital formation rates in China have been a response to abundant economic opportunities (high real rates of return) and looser economic controls.

28. In Vietnam the government introduced an initial set of measures to harden budget constraints of public firms, including the elimination of budgetary subsidies and interest rate reforms, that reduced implicit subsidies through the banking system, and the principle of equal taxation of state and private firms. These policies led to a rationalization of the sector, and several thousand loss-making enterprises were liquidated.

Other prominent features of the Chinese model are:

1. Liberalization of self-employment activities and of small and medium enterprises in trade, together with other services reforms took place early and quickly, generating a surge of services, entrepreneurial energy and savings.[29] These reforms placed greater emphasis on material incentives and allowed a larger role for the market.

2. There was strong commitment to a stable macroeconomic environment and management. Macroeconomic adjustment (stabilization and liberalization) was initiated under the "old" administrative system. Stringent fiscal and monetary policies were implemented. There was little bank credit to the newly liberalized sectors in agriculture, services or industry, and constrained financial support to traditional soft-budget SEs. The enormous growth in savings and stocks of financial assets allowed the liberalized sector to finance itself.[30] The exchange rate has been periodically adjusted to maintain a competitive real exchange rate. The state has also occasionally used large external balances at its disposal to cool down the economy with imports.

3. Controls and monitoring of SEs have continued, although increasingly focused on profitability rather than plan fulfillment. The size of the central plan is fixed in absolute terms, but the SEs are allowed to exceed planned goals. The bonus system stimulates workers and management to increase their production targets, prodding them to ensure firms operate efficiently. Profit and depreciation allowance retentions are permitted. Greater financial and decision-making autonomy was provided to enterprises to enable them to become more efficient and respond dynamically to changing market opportunities.

4. A liberal foreign investment policy was implemented. China provided generous incentives to foreign investors and did not establish any discrimination against Chinese émigré investors. The restrictions on foreign investment were eased not only in the special trade zones but also in the rest of the country. The émigré communities have played a crucial role in the export-led growth and in the large inflow of direct investment, technological catch-up, technical assistance, human capital and trade infrastructure, thereby enhancing the performance of the supply side of the economy. They have provided the quickest source of equity for private entrepreneurs and, given the shortage of working capital, this flow was essential for private sector development, the largest source of state-of-the-art foreign investment and technology, a major conduit for Chinese exports, and an invaluable source of commercial know-how for exporting to industrial market economies. There has been an incentive to domestic entrepreneurs to invent fictitious foreign partners or to work thorough foreign fronts. Special trade zones were established to eliminate or reduce the burdensome and slow internal administrative procedures to foreign investors. The distinction between "special economic zones" and the rest of the economy has gradually eroded. The resulting capital widening and deepening, especially improvements in the quality of the capital stock, have increased labor productivity and income at a faster rate than would have been possible otherwise.

5. There has been a gradual and step-by-step opening to foreign trade but with a clear outward growth orientation. Instead of close integration to the world economy, China has sought a strategic integration to the extent that it is conducive improving its economic growth and upgrading its industrial development. China has provided high margins of effective protection and has discouraged consumption of "non-essential and

29. In Vietnam national savings increased from 3.2 percent of GDP in 1989 to 16.3 percent in 1992. This was associated with the stabilization of the economy, strengthening of property rights, and improvements in the banking system.

30. One of the most positive features of Vietnam´s financial sector reform has been the entry of new banks, mostly private, both domestic and foreign.

luxury imports." Not only were exports promoted strongly but imports were controlled, giving preference to importing the technology and capital goods that obsolete production facilities required. The government allocated directly a great deal of foreign exchange and preferential treatment was given to imports which are thought to best for China's industrialization drive. The Chinese approach to freeing foreign trade has been gradualist. Instead of a "big bang" that suddenly opened up the whole economy to international competition, world prices and capital movements, special trade zones somewhat outside the control of the traditional state trading monopolies were started in the provinces of Guangdong and Fujian in connection with the Hong Kong trade. Then these special zones were expanded to other areas within the Southern Coast region (Zhejiang and Jiangsu provinces) and became progressively more numerous and broader in scope. Inside such zones, exporters could retain all of their foreign exchange earnings while having freer access to imported materials, foreign capital, trading services and in general having far fewer regulations and restrictions. By the end of the 1980's, exports had become China's new engine of economic growth and the distinction between special trade zones and the rest of the economy had eroded as had the domestic economy's insulation from the world market. There are still many controls on imports and on capital movements.

6. External borrowing has remained low and predominantly medium and long-term from official sources. A substantial proportion of it has been on concessional terms.

7. The legal and institutional frameworks have not kept pace with economic progress and are still deficient and limited, especially in relation to ill-defined ownership property rights. China does not have a rule of law and the judicial system is not independent, but the authorities have kept and fulfilled their simple and clear economic promises and have continued and expanded the reform program. However, in the case of Vietnam it was very important to define and establish the rights of the local entrepreneurs to encourage foreign investment. Vietnam has introduced several laws since 1989 to implement market socialism and create an enabling environment for the private sector to formally engage in business in many areas. However, a deficient legal framework made up of cumbersome regulatory laws and uncertain substantive laws is perceived by the private sector as one of the most serious obstacles to its expansion.

The main strength of the AMSM is that it has been able to generate high and sustainable rates of economic growth through an expanding private sector based on a framework of microeconomic liberalization and deregulation of economic activities and on a relative stable macroeconomic management. The levels of political repression, while remaining unacceptable by international standards, have declined dramatically since the introduction of reforms in both countries. Besides the continued monopoly of the Communist Party, the lack of political reforms and pervasive official corruption, its major economic weaknesses are narrow legal and ill-defined property rights, slow or lack of privatization, and weak legal institutions for stable policies that make for uncertain economic development in the future. Undoubtedly, a more liberal economic and political system has much more flexibility.

THE IMPORTANCE OF STATE ENTERPRISE RESTRUCTURING

The "big bang" approach to SEs restructuring, which prevailed in the early transition in Eastern Europe, featured full and immediate exposure to free market forces (both internal and international) and privatization of large SEs, often heavily indebted and with tainted balance sheets and it appears to be based on some kind of public policy ineffectiveness proposition. It expected that the boost from decreasing real wages, the elimination of all subsidies, the boost of free trade and anti-monopoly legislation, would create a supply-side growth momentum, getting promising SEs in shape to compete and encouraging new PEs. The elimination of subsidies to SEs would lead to lower interest rates, less inflationary money creation, lower real wages, and very likely to a growing demand for PEs. It put more emphasis on getting the prices right than on making markets work efficiently. However, this approach was either irrelevant or injurious to the restructuring needs of SEs in light of the actual problems they were encountering. It is clear that the adjustment period should be long enough to avoid too sudden and large reduction in the economic viability of the enterprise, but not so long as to blunt the incentive to adjust.

Van Brabant (1995) considers this a de facto or disguised passive industrial policy, a thorough hands-off policy to facilitate specializing according to static comparative advantage, and that as such it has been ill-advised. Long-term problems of SEs include too-narrow product lines, weak management costs and information systems, low-quality production, outdated technologies and production methods, and obsolete capital equipment. Further, the SEs began to incur losses in a stagnant or shrinking macroeconomic environment. Generally the mainstream economic literature blames the "inertial supply" response of SEs on poor managerial motivation, politicized employee councils and general lack of discipline.

According to Amsden (1994), the task of restructuring SEs requires time—around 5 years—to upgrade the technologies by acquisition and application, along with quality improvement that are all fundamental to create competitiveness and cannot be accomplished simply by full, immediate exposure to free market forces or by "pseudo-privatization" (the transfer or "giveaway" of public assets to private owners without a real exchange of financial resources, skills and technological expertise). Amsden considers that the "supply inertia" has been due to flawed transition policies related to restructuring that hindered the SEs economic progress. Her analysis of the Polish and Hungarian "rough and tumble" experiences indicates little evidence that either worker militance or managerial myopia lay behind the "supply inertia." Instead, tight monetary policies severely weakened the financial structures of the great majority of inherently viable SEs that were unable to find private buyers. The immediate liberalization of imports tended to devastate even promising SEs in certain import-competing industries. During the restructuring, given all the adverse externalities or "prisoners' dilemmas" involved, the solution inevitably requires a more cooperative, gradual approach, involving the government, the enterprises and private agents such as banks and professional consultants, giving firms time to restructure their productive processes and resulting in lower dislocation costs in the form of unemployment and bankruptcies. Such participation, therefore, needs to be systematically planned and carefully designed, implemented, monitored, assessed and fine-tuned. Further, it is very likely that there are economies of scale in both generating production quality and in acquiring and applying new technologies and production methods.

In a study of structural adjustment in nine economies in the Pacific Basin, Patrick and Meisner (1991) found different degrees of government intervention in market-driven economic restructuring, but they did not find any evidence of restructuring by market forces alone. Highly selective interventions simply led the market.

According to Taylor (1994) the difference between shockers and gradualists is whether SEs operations stimulate or retard PEs activity and capital formation; in other words, whether "SEs crowd PEs in or out." He indicates that shockers consider that if SEs are healthy they will increase borrowing requirements and consequently generate financial disarray, while gradualists consider that if SEs are healthy they will reduce borrowing requirements thereby avoiding financial disarray. Of course, he is being disingenuous, as his conclusions contradict most of the conventional wisdom about the SEs in the transition and, as a consequence, about how to proceed with the transformation. McKinnon (1991) had already argued that rapid privatization of large SEs may cause a sharp decline in budgetary revenues.

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