FROM DEAD ENDS AND BLIND CORNERS TO OPEN HIGHWAYS: TRAVELING DOWN THE ROAD TO CUBAN ECONOMIC LIBERALIZATION

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Much has been written about the policies that will need to be pursued when Cuba begins to re-insert itself in the global economy as it opens its markets and joins the ranks of modern democracies. In our writings, we have tended to assume that once a Cuban government bent on reform begins the process of opening up the economy, it will adopt policies in keeping with best international practices, and these policies will allocate resources productively and produce an efficient market economy, free of distortions. It has also been said, in the Cuban context and more generally, that political freedoms and economic reforms must go hand in hand if the economy is to grow on a sustained basis and for the country and its people to prosper over time.

The reality may well play out differently. Transitions are messy and dynasties fall hard. One thing is to plan for a smooth transition; quite another is to pull it off. In a transition period, especially one after half a century of oppressive communist control over the lives of the Cuban people, new players will enter the stage who will try either to establish links with elements of Cuba's nomenclature or wrest power from them. These new actors themselves will have competing interests. Some, with their resources, connections, and business know-how, will contribute enormously to growing the economy and creating productive jobs. Others will apply their energies and talent in directions that may not necessarily contribute to the welfare of the nation, or to easing political tensions. Depending on how these tensions play out in a democratic setting, the road to Cuban economic liberalization could be rough and long, or a shorter straight run.

This paper draws on the experience of transition countries in Eastern Europe, and the emerging market economies in Latin America, Asia and elsewhere, as they left behind failed development models and intrusive, growth-stymieing government controls. It is a tale of the pressures Cuban officials will have to endure as they endeavor to unshackle private initiative and embrace market freedoms. It catalogues, by no means exhaustively, bad ideas that a good, strong government will need to fend off if Cuba's is to be restored to a vibrant economy with growth that reaches everyone.

Corruption, currently rampant, will not disappear and may well worsen during the initial phase of transition, especially if controls are not dismantled quickly and the distortions that these give rise to are ripe for exploitation. An honest government will need to move quickly to stamp out corruption, avoid patronage, and implant a meritocracy in all spheres of government. That will be a tall order, but either we as-

1. The views expressed in this paper are those of the author and should not be attributed to the International Monetary Fund, its Executive Board, or its management.

pire to have a serious government that inspires respect domestically and abroad, or we have one cloaked in the robes of democracy but not much better than the one that departed. Fortunately, if the political will exists, talent abounds. There are extremely competent people in Cuba, including in the government and the military, who must know that their managerial attributes would be rewarded in terms of position and social status in a freer economy. There is also a huge pool of expertise in all aspects of running a modern economy among the Cuban diaspora.

THE PUBLIC FINANCES

The opportunity for mischief in public finances is considerable, given the present dominant role of the state in the Cuban economy, and the time it will take to pare it back. The government that will emerge from the rubble of communism hopefully will come to power with a strong popular backing. The possibility cannot be dismissed, however, that for a time, the new government will in fact be much weaker than the current one. In the absence of a power center, ministries may be allocated on the basis of power sharing, and local authorities could become irresponsive to the central authority, and start collecting their own revenue and conducting their own public policy. Under these circumstances, fiscal policy will be fragmented and policies at different levels of government likely will work at cross purposes. Patronage would swell the public payrolls, and there could be a proliferation of new taxes and tax rates. The government's financial position could not be easily discerned because ministries, government agencies, and the local authorities would keep separate bank accounts, rendering budgeting and ex-ante expenditure authorization, and ex-post auditing, virtually impossible. In sum, the balkanization of the public sector just described would be chaotic and probably less disciplined than under the present regime.

Even if the dismal picture just presented turns out to be a worst-case scenario that does not quite unfold as laid out, it would not be unheard of for a strong central authority to buckle under the influence of pressure groups or to allow political expediency to act as a policy driver. In this regard, the easiest way to destabilize the public finances is to lose control of the government payroll, either because of excessive hiring, or granting wage awards that cannot be financed other than with ad hoc, distortionary tax increases, or by imposing an inflation tax that will be paid mainly by the poorer groups in society. There will also be a tendency to avoid wage differentiation in the public sector, which will discourage innovation and efficiency. Moreover, public wages are often seen as a floor for private wage settlements, and wage increases should be commensurate with productivity gains and consistent with the inflation objectives. In this connection, to discourage corruption, government employees will need to be paid competitive wages related to their various skills, which the government will not be able to afford if the public employment is not scaled back and kept lean through a reform of the civil service. An effective civil service reform would include decompression and upgrading of the salary scales, integration of special remuneration practices, rationalization of allowances, and measures to eliminate labor redundancies.

Excessively liberal public pensions (or excessively generous severance pay) can also create imbalances in the public accounts that will crowd out resources for priority spending in social areas such as education and health care, and for rebuilding infrastructure.

Experience has shown that fiscal positions also can be destabilized if individuals or groups seek remedy through the courts or the legislature for grievances against, and suffering at the hands of, the outgoing regime. While it would not be appropriate that a new Cuban government should be held responsible for crimes and misdeeds committed over the last 50 years, courts and legislatures often find it difficult to set aside demands of aggrieved family members who lost loved ones, or suffered politically-motivated incarceration. In the debate about the cost of asset restitution to owners of expropriated properties, and its impact on the public finances, the cost of legislation of court rulings in favor of this other class of potential claimants is not well recognized. It can add, however, and it has added in the case of some Latin American countries, several percentage points of GDP to the national debt.

A far more common approach to make it appear that the fiscal position is sound is to engage in extra budgetary spending, or to by-pass fiscal rules altogether by directing state banks to extend loans to "priority" sectors or to failing public enterprises. These loans usually will need to be continuously rolled over and interest capitalized, and the extent of these transactions and their effect on the economy will not be truly recognized until the banks become insolvent and have to be restructured and recapitalized through the issuance of government debt.

There will be great political pressure from interested parties to "help" certain sectors with subsidized credits through specialized state banks. Developing countries are littered with such entities and, as noted in the previous paragraph, these banks are but adjuncts of the central government that provide financing that in many cases is not meant to be repaid. With an efficient, well supervised, well capitalized private banking system, operating in an economy that in all likelihood will be undergoing a process of rapid remonetization with plentiful loanable funds, market forces will be at work to make credit accessible to all sectors of the economy. If the society as a whole, through democratic processes, decides that there is a need to have an agricultural development bank, a mortgage bank, a savings bank, a marketing board, and the like, the government should ensure that the manner in which resources are transferred to these agencies is transparent, well understood, and the funding kept within the confines of an agreed overall budget envelope.

Taxation is an area with the potential for introducing significant distortions in the economy, particularly when holes in the budget are closed with stop-gap revenue measures. Examples of such measures abound. A popular one that typically yields between 1½- 2 percent of GDP is a tax on financial transactions, usually applied to bank debits. This tax is relatively easy to collect, can be passed easily, and provides a quick yield. The tax, however, discourages financial intermediation, and its yield diminishes quickly. A temporary surcharge on imports is another favorite measure that would be at odds with the effort to open the economy, and may have the perverse result of reducing customs receipts, if importers under-invoice their purchases to offset the tax, or pay bribes to avoid taxation altogether. A tax amnesty is sometimes used to produce a quick revenue injection. Apart from the moral hazard created by rewarding tax delinquency, this measure will negatively affect the ability of the tax authority to administer the tax system, as tax payers will figure that if they wait long enough another amnesty will follow.

It has become fashionable to devolve tax revenue collected by the central government to states and municipalities, and demands for such transfers can be expected. Provided that there is sufficient capacity to manage these funds at the local level, devolution is not necessarily a bad policy as long as spending responsibilities are also transferred, and not just revenue. Pressures will also be felt to establish revenue sharing formulas with local governments. If limited in scope, revenue sharing can be effective in developing harmonious intragovernmental relations, but if carried too far, it will introduce budget rigidities that will make it difficult to reorient spending priorities.

Granting tax preferences is a frequently-used device to bypass the budgetary process. It would be incongruous to be extending exemptions on the one hand, while on the other, having a broader commitment to strengthen revenue collections by expanding the tax base. Tax incentives for foreign direct investment also should be avoided. Instead of tax incentives, this type of inflow could be encouraged through a system of accelerated depreciation and loss carry-forward, which would not create distortions. In general, the use of the tax code to steer investment would create a bias in decision making toward discretion that paradoxically would tend to discourage investment over the long run, as the country may not be seen as a serious place to invest.

Another way to bypass the budget that has become fashionable is known as public-private partnerships (PPPs). These arrangements involve the private sector supplying infrastructure assets and services that traditionally have been provided by the government. By involving private sector management and innovation, PPPs may deliver increased efficiency, better quality, and lower cost than traditional public procurement. Successful PPPs recognize that both partners have certain advantages relative to the other in performing certain tasks and managing specific risks. The objective is not to eliminate risk, but to achieve optimal risk sharing, with each risk assigned to the partner who is best equipped to manage it. However, these advantages and the financial leverage they provide to the government also entail a different kind of risk. If the government is inexperienced and enters into contracts without an adequate legal and institutional framework, it could end up with unanticipated liabilities and costly responsibilities. Governments have been known to enter into such arrangements solely to move public investment off budget and debt off the government balance sheet. Needless to say, if that were the government's principal motivation, it would run counter to its other stated objectives of providing good governance.

In sum, the next government should aim at three overarching fiscal objectives. Firstly, it should not allow its operations to create macroeconomic instability through deficit financing, or its size becoming so large that it would leave little space for private activity. Secondly, it should work at making public sector operations fully transparent and holding public officials accountable for their actions, thus reducing the possibility of corruption, and it should strive to provide public expenditure of the highest quality, with emphasis on efficient investment in human capital. Thirdly, tax policy should aim at neutrality and equity, with a simplified system with few taxes and tax rates, a broad base with very few exceptions, and a bias towards taxing consumption more than income.

THE EXCHANGE RATE SYSTEM

Important as fiscal policy can be in setting the tone and the basis for sustained economic growth, the financial crisis in Latin America and Asia of the last decade demonstrated that poor regulation of financial systems, and rigid exchange rate regimes, can exact as much economic damage as lack of fiscal discipline. The opening up of the Cuban economy will witness a surge of capital inflows that will be welcome and will help rebuild the island's infrastructure. However, they will also will need to be managed carefully to protect against credit booms, overheating and price pressures, and asset bubbles. In this setting, insisting on keeping the exchange rate fixed—and many who can take best advantage of one-way bets will so insist—will produce the so called "impossible trinity": an economy that (1) cannot control domestic liquidity, and (2) manage its exchange rate, if (3) its capital account is open (and the capital account would need to be kept open as there will be little risk of large outflows, and it would not be possible to stop inflows). If the currency is held down, foreign exchange inflows will boost money growth. The central bank can try to "sterilize" the impact of rising reserves by selling securities to mop up the excess liquidity. But, sales of government or central bank paper will tend to push up interest rates and so attract more capital imports. In addition, the quasi-fiscal costs of central bank sterilized intervention would limit the room for further international reserve accumulation.

If Cuba were to choose a hard peg or outright dollarization, it would need to be prepared to forego the option of an independent monetary policy. In this setting, if international competition from low-wage producers intensified, or if the island faced a permanent terms of trade shock, fiscal policy would need to adapt accordingly. However, because there is a limit as to how far fiscal adjustment can correct an irreversible balance of payments imbalance, the only two other levers to realign relative prices would be through wage deflation and/or a fall in employment. Of course, if the labor and product markets were sufficiently flexible, there would not be a need for a flexible exchange rate. For example, because of its peg, Hong Kong remained immune from the contagion devaluations that swept Asia in 1997–98. However, the price was paid in five years of deflation and crashing asset prices. On balance, it would appear that any attempt to peg the peso would be unfeasible until it became abundantly evident that a national consensus had emerged in favor of financial discipline. Until then, prudence would dictate that the peso ought to be allowed to float.

It has been shown that when countries open up their economies and introduce growth-enhancing reforms, the exchange rate tends to appreciate, reflecting increased productivity. Limited intervention would slow the appreciation and help to rebuild international reserves. As the central bank builds reserve buffers against an adverse turn in the external environment, pressure will build to use the liquidity to monetize bigger fiscal deficits. The country will be well served with an independent central bank able to resist such pressures. Once the reserve position reaches a level deemed adequate, intervention should be limited to smoothing out lumpy transactions, and/or attenuating speculative pressures. If appreciation ensues, pressures will build for further intervention. The central authorities must stand firm in resisting such pressures; instead efficiency-enhancing structural reforms and flexible labor markets should suffice to maintain external competitiveness.

THE FINANCIAL SYSTEM

With the opening of the economy, financial market liberalization, and abundant loanable funds, bank credit to the private sector is likely to grow at a fast pace. Banks are likely to borrow from abroad in U.S. dollars to lend in pesos, benefiting from a larger spread than if their operations were funded only domestically. Bank supervisors will need to keep a watchful eye for opened unhedged positions, and prudential regulations may need to be reinforced to cover this risk. Strong financial sector supervision and adequate prudential measures will be required to guard against a deterioration in the quality of banks' loan portfolios. Prudential requirements, in particular, bear a cost since funds have to be set aside. Bankers do not like to carry idle funds on their books and, therefore, there will be calls for easing these requirements. A few cases of forbearance of prudential requirements will be sufficient to raise questions about the adequacy of the structures of penalties for noncompliance and the independence of the regulatory authorities, especially if the banks involved are state-owned. If credit expands too rapidly, capital-adequacy risk weights may need to be increased even above Basel II guidelines. This too will be strongly resisted by the banking industry.

In view of the globalized nature of financial services, the regulatory setup will require cooperative arrangements between insurance supervisors and supervisory bodies of banks and other financial institutions. In particular, in order to monitor the health of the entire financial system, nonbank regulations must be woven with those of banks. It will be important to carefully consider eliminating the traditional firewall between banking and the insurance industry in order to promote financial innovation and keep up with global trends.

State-owned banks are notoriously inefficient and should be privatized, but many vested interests will stand in the way of such a move. Typically, these banks employ redundant labor, are slow to adapt to new technology and financial innovation, and do not assess risk well. They are often a source of financing to the government in ways that are not fully transparent. State banks' inefficiency adversely affects the entire economy in other important ways. Because of their high administrative cost, these banks must operate with wide interest spreads to remain profitable. Private banks, therefore, perceive no incentive in competing on prices to narrow the spreads, resulting in high lending rates that tend to discourage financial intermediation, and reduce access to credit to riskier borrowers.

LABOR AND PRODUCT MARKETS

To keep the Cuban economy competitive and boost growth and employment will require well-functioning labor markets and a liberal trade regime. Care must be taken that labor market regulation and practice do not impinge on job creation, and that labor arbitration show no bias toward business or unions. Collective bargaining at industry level should be discouraged, as it would give an unfair advantage to the most inefficient firms in the industry. In facing demands for minimum wage hikes, it will be crucial to take into account their potential effect on employment and competitiveness. Backward-looking cost of living adjustments will tend to ratchet up inflation and should be avoided. It will also be essential to ensure that formal employment is not discouraged because of high taxes on wages. Efforts to stem informal ways of doing business in general will pay off in promoting fair competition. It will be key to keep in mind that the government's constituency is larger than the unions; it includes the unemployed.

When Cuba opens its doors to the World and new investment pours into the island, it will be imperative that the government not be swayed by tired protectionist arguments. Free trade and relatively unrestricted commerce will encourage competition and allow the highly developed Cuban entrepreneurial spirit to engage in activities that will move production and exports up the technology chain generating profits and good paying jobs.

CONCLUSION

Governments are known for engaging in three sorts of distorting activities: picking winners; investing in what should be private sector projects; and backing favorites. When these strands come together, economic efficiency suffers and growth loses momentum. It would be highly ironic if, after suffering for half a century under a communist dictatorship, a democratically elected government fails to travel a straight road to economic liberalization. How to make sure that ordinary citizens get to share the fruits of Cuba's surge, once a market economy and democratic values are restored, will be the biggest challenge facing future governments.