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The US and Cuba: incrementalism, reversal risk and the Dictator's Dilemma

Cardiff Garcia Author alerts Mar 21 20:49 Comment

To analogise the ongoing diplomatic maneuvering between the US and Cuba to a scenario of mutual hostage-taking doesn't sound charitable, but it might be the best framework for understanding a relationship long defined by its baffling surrealism.

And it's a useful lens through which to see not only President Obama's visit to the island, the first by a sitting US president in almost nine decades, but also the specific actions taken by each side in the time since the intent to normalise relations was first announced on 17 December 2014.

Last week John Kavulich, president of the US-Cuba Trade and Economic Council, described this idea to a roomful of lawyers at the US-Cuba Corporate Counsel Summit in New York.

On the US side, Obama clearly wants to make the rapproachement an enduring foreign-policy legacy of his administration, and the Cuban government knows this. It can afford to test Obama on how far it needs to go in the direction of economic and political liberalisation before satisfying American requirements to continue deepening the relationship.

But Cuba's efforts to modernise its economy also depend heavily on the country's relatonship with other countries and with foreign (non-US) companies, and specifically on the potential source of foreign investment they can provide. Except these firms and countries are hesitant to provide much investment while the US embargo is in place and Cuba is locked out of most multilateral institutions.

In other words, Cuba needs the momentum towards diplomatic restoration and the end of the US embargo to continue beyond the end of Obama's time in office. To ensure this happens, the Cuban government will have to take meaningful and credibly permanent steps towards providing greater economic and political freedoms.

The liberalisations on both sides have been made incrementally to this point. The gradual pace was partly for logistical reasons, but I'm sure it was also the result of suspicions inside of both countries about the intentions of the other side.

As depicted in wonderful detail by William LeoGrande and Peter Kornbluh in *Back Channel to Cuba*, diplomacy between the US and Cuba since the Cuban Revolution in 1959 has endured a long sequence of avoidable misunderstandings and betrayals by both parties. Maybe the best argument against the embargo is simply that the enormous expenditure of US diplomatic resources it has required to enforce — all to deal with an immiserated island of 11 million people that long ago ceased to pose a threat to national security — is impossible to continue justifying.

Cuban realities

American diplomats might reasonably worry that they'll be made to look naive, fearing the Cuban government will reverse its modest steps to loosen its authoritarian grip over the economy and society *after* the US has already made more of its enormous market available to Cuban trade.

Indeed the Cuban government has historically done exactly that: briefly allowed certain private-sector activity to enliven a flagging economy and then reversed course abruptly. The Cuban regime has long been subject to a macroeconomic variant of the Dictator's Dilemma, an informal concept which says that embracing information technology is necessary for an autocratic ruler to maintain a prosperous state, and yet this also requires accepting the risk that such technologies will exert democratising pressures.*

It helps to know a few things about the realities of life in Cuba to better understand why the dilemma applies more broadly to the Cuban economy and society.

The Cuban state still directly controls most of the economy and employs the majority of the population: between about 60-75 per cent of the workforce, depending on how you account for off-the-books second jobs and participation in the limited private sector.

State salaries are abysmally low, roughly the equivalent of $25 USD per month by official figures. In real terms, wages have never recovered from their collapse when Soviet subsidies to Cuba ended *more than twenty-five years ago*.** Pensioners such as my 89-year-old great aunt Juana receive the equivalent of $8 USD a month and a few supplemental items from what is left of the "libreta", or ration book.

Billions of dollars in remittances from relatives in Florida and elsewhere remain crucial to the economy. Healthcare and education are free but under-resourced, offering little meaningful choice. The country's ossified economy and terrible demographic trends — a consequence both of very weak fertility for a developing country and emigration — long ago started pressuring the government's ability to fund them.

Impressive renovation is underway in Old Havana and along parts of the *Malecón* boardwalk. But many of the crumbling buildings that tourists like to gawk at are dangerous: collapses are especially frequent during heavy rains. Even in parts of Havana with its heavily touristed areas the sanitation is inadequate, leading to periodic outbreaks of dengue like the one last summer.

The zany dual-currency system distorts Cuba's macroeconomic statistics to the point of uselessness. More importantly, it also acts as a massive tax on Cuba's exporting sectors, including tourism, and as a correspondingly massive subsidy to its inefficient state-led importing sectors.*** Yet consolidating the two currencies would require Cuba to formally recognise that its state-run enterprises are insolvent without the subsidy, thus requiring a big fiscal boost to cushion the losses and resulting unemployment. That's one of the many reasons that more foreign investment is needed.

As mandated in the Cuban constitution, the state has a complete monopoloy on imports and exports, shutting out the private sector from global markets except through informal channels. The government doesn't release much data about its balance of payments situation, and even after agreeing a debt reduction with the Paris Club, nobody knows how much external debt Cuba has.

The Cuban government furthermore maintains a list of private-sector occupations that are allowed, though the ones that really matter are related to tourism: restaurants, bed & breakfasts, and taxi driving.

Needless to say, these are not traditionally known as dynamic economic sectors. Far more sensible would be to publish a list of occupations that are *not* allowed and to permit any job not on that list.

Those Cubans who work in the touristic sectors that do price their services in convertible pesos make *much* more money than workers on government salaries. This creates an odd situation where highly trained and well-educated workers in occupations mainly provided by the state — engineers, say, academics or even doctors — are incentivised to take jobs as waiters and taxi drivers. And because the state controls all imports, private restaurants with an abundance of the stronger currency compete against regular Cubans for the same limited food supplies, keeping food prices high.

To invest in Cuba, a foreign company historically has had to partner with a Cuban state-run enterprise — with the Cuban partner taking the majority stake. Decisions about hiring and firing employees, and even decisions about paying them, are also restricted and typically overseen by a government ministry.

For the time being, Internet access remains forbidden in homes without an exemption from the government, few of which are granted except to connected elites. Internet access has loosened and become cheaper in the last year, but it is still too expensive for many Cubans without remittances. Startup entrepreneurs have good ideas but lack financing options, and their legal status is constantly in doubt.

There is only a limited free press, mostly consisting of online writers whose articles are more likely to be read abroad than domestically, though their ranks have grown in recent years. Dissidents, activists, and independent journalists are still routinely detained and harassed, especially when important dignitaries visit, though there are fewer of the arbitrary and brutally long prison sentences of the 2000s.

The dilemma

As for how these realities, and in particular the interaction between the fledgling private sector and the dominant government sectors, pertain to the Cuban variant of the Dictator's Dillema, a lucid explanation is found in multiple passages from *Entrepreneurial Cuba*, by Archibald Ritter and Ted Henken, probably the best available book on the evolution of the modern Cuban economy:

> The existence of a flexible second economy (providing employment and efficient production) within the official planned economy provides state socialism with a very convenient, short-term subsidy, even if its long-term impact can be quite corrosive.
>
> Furthermore, this subsidy is provided through the active self-exploitation of a large part of the workforce (working in a state job as an air-traffic controller by day, while moonlighting as a clandestine airport cabbie by night, for example).
>
> …
>
> The outright prohibition of activities the government prefers to keep under state monopoly (such as the import-export business and most professions) allows it to exercise symbolic control over the population and impose an apparent order over Cuban citizens and society.
>
> However, this control comes at the cost of pushing all targeted economic activity (along with potential tax revenue) back into the black market—where much of it lived prior to 2010 as evidenced by the high proportion of [cuentapropistas, or private businesses] who are found in government surveys to have been "laboralmente desvinculado" (unconnected to the state sector) prior to becoming legally self-employed.
>
> On the other hand, the inclusion and regulation of the many private activities dreamed up and market-tested by Cuba's always inventive entrepreneurial sector would create more legal employment opportunities, a higher quality and variety of goods and services at lower prices, while also increasing tax revenue to target inequality and fund social programs.
>
> However, these benefits come at the political cost of allowing greater citizen autonomy, wealth and property in private hands, and open competition against long-protected state monopolies (Celaya 2013a and 2013b).
>
> …
>
> Calling attention to the unique institutions of state socialism and tracing the linkages between state agents and private entrepreneurs affords us an insider's view of the corrosive effect of the second economy on state socialism.
>
> Such an approach also reveals a major historic instance of what Max Weber called "unintended consequences": the party-state's instrumental, if inadvertent role in its own demise.
>
> Therefore, Cuba along with the few other remaining outposts of state socialism face a difficult if not impossible dilemma: "[T]o survive in a world of competing states, they are

> compelled to institute and sustain market reforms. Yet the spread of markets erodes the commitment to the party and paves the way for regime change" (Nee and Lian 1994: 284).

The Cuban government's approach has historically been to vascillate between a closed and a slightly less-closed fist. Thus the fear that any current loosening will be temporary. To roll out the new measures incrementally, whether intentional or not, has been a useful way to gauge Cuba's willingness to change.

And for its part, the Cuban government has a simple and paranoid but nonetheless powerful worry: that each US gesture of friendship is really a calculated move to sow hostility within Cuba and eventually unseat the current regime.

Cuban officials would prefer doing business with more distant countries that don't challenge its longstanding narrative of enmity with the US, and that also don't have a long pre-Revolutionary history of imposing their wills on Cuban institutions from abroad. And ordinary Cubans, for all their frustrations with their government, do share with it a deep sense of nationalism. I didn't understand just how strong the sentiment was until I spent significant time in Cuba last year.

In the wake of the decison to normalise relations, quite a lot of sensitivity was therefore to be expected.

But change is definitely happening

And yet despite the history of miscommunication and hostilities, progress — often halting and frustratingly slow, but progress nonetheless — has been made by both sides in the time since December 2014.

The Obama administration has proved willing to claw away at the prohibitions of the embargo to the extent that the executive branch is permitted to maneuver around it. Trade in most sectors is still prohibited, but large new exemptions have been made for US companies in telecommunications, transportation and finance in particular, among many other changes.

The travel restrictions on American visitors to Cuba have been eviscerated. Earlier this week the government announced that Americans could now travel by themselves to Cuba for "person-to-person educational" reasons under a general licence, which means that pre-approval from the government is not necessary. Previously visistors under this category needed to go with an approved tour group.

I can't exaggerate the extent to which this new measure essentially guts what was left of the travel ban. Tourism by Americans to Cuba technically continues to be forbidden, but the trips now allowed are tourism in all but name.

Though not all have provided details of the deals, several American companies have just announced new plans for business in Cuba — Western Union, Starwood Hotels, Marriott, Verizon — and Obama said in an interview that Google was nearing a deal to help increase connectivity on the island.

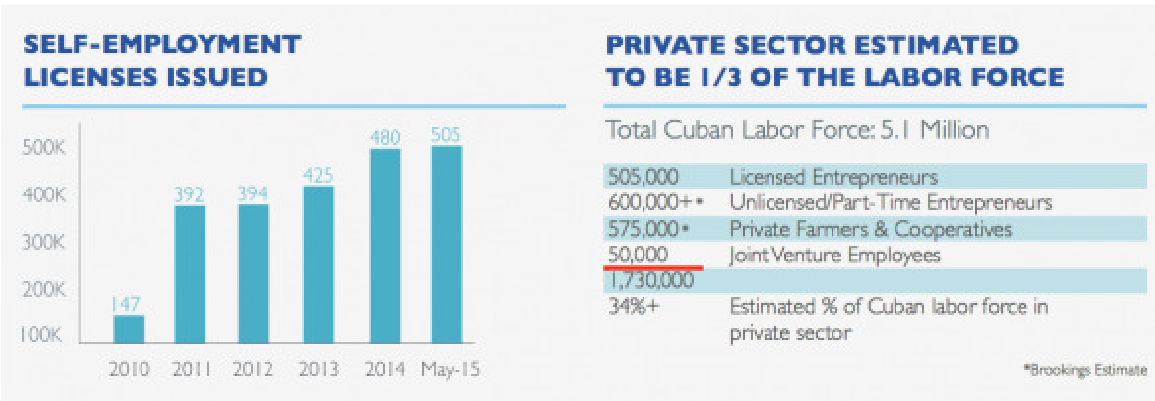
Although any comparison is imperfect given the subjective measures involved, the American side has gone faster and farther than the Cuban side, whose steps have been too limited for optimistic observors both in the US and in Cuba (and for me!).

But it is false to say that Cuba has done nothing throughout the thawing years of the Obama administration.

The expanded authorisations of private-sector *cuentapropistas* have led to a rapid climb in entrepreneurial activity. By some measures a full third of Cubans are in some way employed by the private sector.

The growth was further accelerated by a tourism boom last year, during which the number of visitors from the US spiked by a tremendous 77 per cent, a figure which does not include visits by Cuban-Americans like me.

From a fact sheet produced by Ted Henken and Engage Cuba:



Entrepreneurs entering these sectors and the workers they hire have enjoyed an incredible relative boost to their living standards. And it is their kind of success which raises societal expectations for what even small changes in policy can do for them.

"A surprising area of self-employment growth is in telecommunications," writes Henken. "The chronic scarcities and bottlenecks caused by the lethal combination of state socialist planning and the US embargo have resulted in the incubation of a true 'maker' culture. Highly trained but underemployed computer programmers and telecom agents have started launching innovative start-ups like AlaMesa and Conoce Cuba or designing 'lean' software and offline mobile apps for both a Cuban and international clientele. Aiming to encourage this dynamic phenomenon, new U.S. regulations issued by the Obama Administration during 2015 now allow the contracting of Cuba's private sector IT and other professionals."

Another useful list of changes was recently published by Engage Cuba, and included this entry:

> Cuba increased the number of Wi-FI hotspots from zero to 65 by the end of 2015 and cut the cost of usage by 50%. Further expansion will take place in 2016, including 80 new

> public Wi-Fi hotspots.
>
> Daily internet access averaged more than 150,000 people in 2015, more than double the 2014 statistics. One result: the number of people with email access has increased significantly.
>
> Cuba also announced pilot broadband service to homes, restaurants, bars, and cafes, with a goal of reaching 50% household penetration and 60% mobile penetration by 2020.

Cuba rewrote its foreign investment laws in 2014 and set up the Mariel economic zone, in which the rules are more amenable to companies who wish to invest on the island. Thus far it has been a disappointment. But the flurry of announcements by US companies this week shows that plenty of interest remains.

And last week Cuba signaled plans to end its punitive 10 per cent tax on exchanging US dollars into Cuban convertible pesos. The tax applied only to dollars and to no other foreign currency. Most interesting about the decision was the explicitly *quid pro quo* nature of it. According to the Cuban foreign minister Bruno Rodriguez, ending the tax was reciprocity for the US allowing Cubans to transact in US dollars in international financial markets.

The last hostages

During the brutal "Special Period" of the 1990s, when the end of Soviet subsidies had produced an economic cataclysm in Cuba that is unimaginable by modern Western standards, the government decriminalised microenterprise and self-employment activities in order to attract hard currency via tourism and exports. But when the worst of the period had ended by 1996, Fidel Castro once again restricted private-sector activity and the government continued propagandising against it to reinforce the stigma of profit-making.

Raul Castro, back then singing a different tune than today, issued the following statement on 23 March 1996: "The psychology of the private producer and the self-employed worker in general, as a result of the personal or family origin of their incomes—the private sale of the good or service they produce—generates individualism and is not a source of socialist conciencia."****

More recently, in 2013 the government arbitrarily shut down street vendors selling imported products and private movie theaters being run out of homes. The justifications offered for the crackdowns were outrageously technical and silly, and the incidents reminded Cubans that any change in their country always brings risks of a sudden setback.

So looming above the historic activity of the last year and four months is the question of whether the recent changes are permanent — for both sides.

Cubans are watching the US presidential elections this year with extreme interest. A Hillary Clinton administration clearly would continue on the path set by Obama.

But even a Republican in the White House might well not care enough about Cuba by the time he arrives to change course. Majorities of Republicans and even Cuban-Americans now favour normalised relations, with more minds shifting in that direction each day. But the future would be far less clear under a Republican president, and cetainly the rhetoric from Ted Cruz sounds quintessentially hardline-Republican.

The situation in Cuba is more complex.

Regarding the Internet, the expanded access zones and the announcement that Google will add more connectivity suggest that the Cuban government has capitulated to the idea that there is no longer any going back.

For one thing, Cubans have concocted some clever workarounds to get information. But the more salient issue is that the rest of the world has digitised to such a degree that a country with such weak connectivity will struggle to attract the foreign investment it has admitted is needed. To reverse course now would be futile.

My sense — and it really is just a sense — is that the Cuban government will try to pursue the Chinese approach to the Internet and censorship. As highlighted by Emily Parker and Clay Shirky in our recent podcast chat, the Chinese government is less troubled by complaints about state inefficiency and corruption than by attempts at collective action (eg calls to organise and protest). Although the Chinese government has embraced the proliferation of modern technologies, it also monitors the Interent aggressively enough that Chinese citizens even begin to self-censor — watched by the "anaconda in the chandelier", not striking at you but always there, vigilant.

As for the Cuban private sector, the vast majority of changes from the past half-decade seem too deeply entrenched to be reversed — and both US policymakers and foreign investors will also be watching closely for signs of a volte-face.

More likely is that the government, still desiring to retain as much political control as possible, will liberalise other sectors of the economy only gradually. Perhaps it will use taxation to prevent too much capital from accumulating in any one business or sector, the way it still does now. As for sudden crackdowns, they will always tempt an autocracy overseeing a mostly planned economy if a perceived threat to its control emerges. It's impossible to say with confidence that there will be no more.

Still, the trend is more hopeful than it has been in a long time. If the Cuban government does keep loosening its grip on the economy, the possibility remains that it will stop to tighten now and again, but it probably can no longer close its fist entirely.

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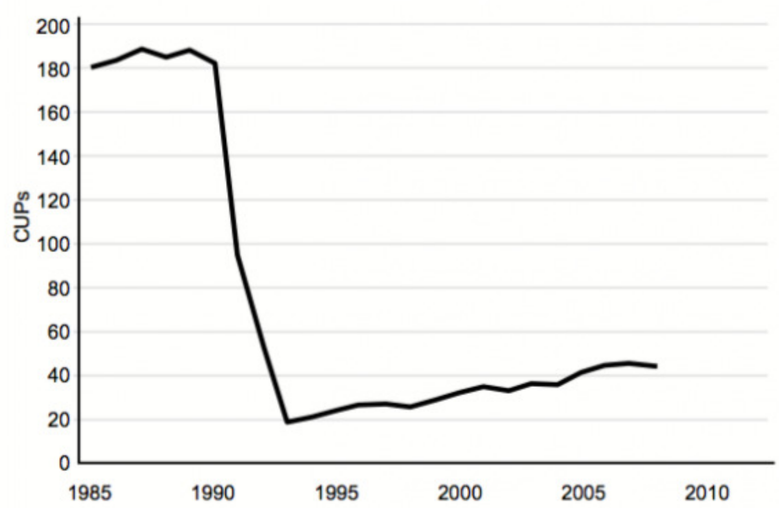
FOOTNOTES:

* I was actually introduced to the concept of the Dicator's Dilemma by the Cuban writers and

Internet activists Norges Rodrigues and Taylor Torres, whom I befriended during my sabbatical on the island at the end of last year. And they sent me to Larry Press, an invaluable source of information about Internet access and technological trends in Cuba.

** Here's an amazing graph from the book by Ritter and Henken:

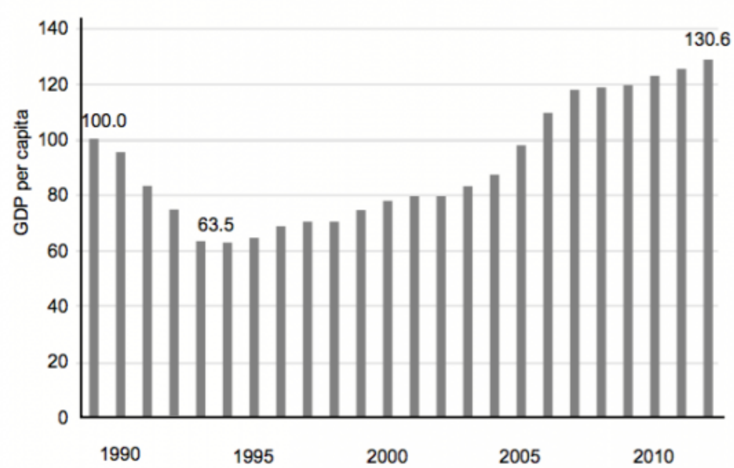
Figure 5.2: Cuba: Real Inflation-Adjusted Wages, 1989–2009 (CUPs)



Sources: Vidal Alejandro Pavel, "Politica Monetaria y Doble Moneda," in Omar Everleny Pérez et. al., *Miradas a la Economia Cubana*, La Habana: Editorial Caminos, 2009.

Wages have climbed since 2009 but not nearly back to the pre-1990s levels. Interestingly, estimates of Cuban GDP-per-capita have recovered, though these are of course plagued by the problem of data opacity:

Figure 5.1: GDP per Capita, 1989–2012 (1989 = 100)



Sources: Oficina Nacional de Estadísticas (ONE). *Anuario Estadístico de Cuba* (AEC), various years.

Note: A new GDP measurement system was adopted in 2004 increasing the value of government services in health and education by 67% (Mesa-Lago and Pérez-López 2006).

In the book (and in an earlier blog post by Ritter), the authors offer the following possible reasons for why wages diverged so aggressively from GDP-per-head:

> Despite this apparent economic growth, the real value of wages in the peso economy

> remained exceedingly low at around 25 percent of the 1989 level (see Figure 5.2).
>
> This was due to the reduced availability of goods and services at the fixed—and very low—prices of goods and services available with the ration book or directly from the public sector (e.g. medical services), together with the high costs of products in the dollar stores (at the exchange rate of around 26 pesos for $1.00 of imported products plus a high sales tax of 140%), in the farmers markets, self-employment sector, and in the under- ground economy.
>
> How could the economy recover so fully while real wages were still only at about 22 to 25% of the 1989 level? This is a puzzle indeed. Citizens of Cuba observed the contradiction for some years, as suggested by the oft-repeated observation: "Where's the economic recovery? We don't see it."
>
> Part of the explanation is that the value of GDP was increased arbitrarily as noted above, but this did not increase the supply of goods and services or the standard of living for citizens. A second explanation for the gap between overall economic performance levels and wage levels is that substantial portions of the goods and services produced in the state sector of the economy were pilfered and distributed through the ubiquitous underground economy so that revenues seldom seemed to permit higher wages. Probably a good deal more was actually produced in the state sector, but leaked out of official circuits (and statistics) through ubiquitous pilferage.
>
> There are undoubtedly other factors explaining this situation as well, such as remittances—both declared and undeclared.
>
> How did Cuban citizens manage to survive in the late 2000s with real incomes still at just 22–25% of their late-1980s levels? This has been possible because many Cubans have been able to generate incomes higher than the official wages and salaries by relying on "in kind" transfers from the state, on remittances from abroad, and/or work in the second economy.

*** The details are complicated, but under the dual-currency system, the *convertible* peso can be exchanged for foreign currencies and is pegged to the US dollar at 1-to-1. The *national* peso is not convertible to foreign currencies and is pegged at 24:1 to the convertible kind.

But the state-owned enterprises are allowed to book their revenues, generated in national pesos, as if they were also convertible at 1-to-1 with the convertible peso, not the 24-to-1 rate that the general population is charged. Furthermore, these companies can request foreign currency from the central bank in exchange for the national peso at the subsidised 1-to-1 ratio, to pay for import. But there is no guarantee that they will receive the FX, as the central bank doesn't actually have sufficient reserves to suport the subsidy. You can see how this is a nightmare for the economists who want to study the Cuban economy.

**** Source: Ritter and Henken, *Entrepreneurial Cuba*

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