

8-28-2017

“Capitalist” Cuba: the Privatization of the Cuban Economy and Its Unintended Consequences

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Christopher Palomo, *“Capitalist” Cuba: the Privatization of the Cuban Economy and Its Unintended Consequences*, 24 U. Miami Int’l & Comp. L. Rev. 195 (2017)

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"CAPITALIST" CUBA: THE PRIVATIZATION OF THE CUBAN
ECONOMY AND ITS UNINTENDED CONSEQUENCES

Christopher Palomo

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I. INTRODUCTION

In 2008, the Cuban government announced its intention to update its socialist economic model, and develop for the

first time a significant private sector.¹ These reforms were intended to alleviate a growing national debt and state-labor surplus by shifting significant overemployment in the state sector into the newly expanding private sector.² To accomplish this, the Cuban government expanded the list of private-sector business licenses (*trabajo por cuenta propia*) to 201 lines of work, while simultaneously laying off surplus state labor—allowing it to be absorbed into the private workforce.³ As of today, approximately 10% of the Cuban labor force has already been laid off from state employment, and another 21% is expected to follow.⁴ Although, the government hoped that these recently released state workers would be able to take advantage of the newly expanded

¹ Geoff Thale, *Labor Rights and Cuba's Economic Reforms*, Washington office on Latin America 2 (Dec. 2013), http://www.wola.org/sites/default/files/Labor_Rights_and_Cubas_Economic_Reforms.pdf.

² Philip Peters, *Cuba's Entrepreneurs: Foundation of a New Private Sector*, American (Jul. 2012), <http://www.american.edu/clals/upload/LexingtonCubaEntrepreneurs-1.pdf>.

³ Carmelo Mesa-Lago, *Institutional Changes of Cuba's Economic-Social Reforms*, Brookings 2 (Aug. 2014), <http://www.brookings.edu/~media/research/files/papers/2014/08/cubas-economic-social-reform-mesalago/cubaseconomicssocialreformsmesalago.pdf>.

⁴ *Id.* at 8.

entrepreneurial licenses and support themselves through self-employment, this has not yet been the case.

Although Cuba's recent reforms have expanded some entrepreneurial freedoms, entrepreneurship in Cuba still remains heavily circumscribed. Currently, both practical and legal restrictions on market access are prevalent. The legal restrictions are the result of the still heavy circumscription of entrepreneurial freedoms, and the practical restrictions are the result of the unavailability of business prerequisites such as storefront, capital, supplies, and inventory. Together these inefficiencies have caused access to the Cuban private sector to be far too restricted to support the rapid influx of state labor. This paper proposes that for the privatization of a socialist economy to occur efficiently, economic reforms must first create a legal system with sufficient entrepreneurial freedoms, secondly provide its citizens with sufficient access to business prerequisites, and finally the transition of state labor and assets into the private sector must occur gradually enough to allow these freedoms to develop. By not addressing these limitations before relocating 10-31% of the labor force into the private sector, the Cuban Government has disenfranchised these workers. Today, the Cuban private sector is far too restricted to allow Cuban entrepreneurs to be successful, and this is resulting in increases of both labor exploitation and inequality.

II. MOTIVATION FOR CHANGE: PRIVATIZATION AS A SOLUTION

The Cuban economy operates as a socialist regime.⁵ Under this system, the means of production are centrally owned and operated by the state. As a result, nearly every public service is provided by the government as opposed to private businesses. Unlike in the United States, in Cuba barbers, electricians, repairmen, vendors, etc., are all state employees. Accordingly, the Cuban government has historically been the single largest employer on the island, and is responsible for 95% of the island's gross domestic product.⁶ While some limited entrepreneurship has historically been permitted, the private sector has always been heavily circumscribed. Historically, government restrictions have limited Cuban entrepreneurs (*cuentapropistas*) to only 158 lines of work and forbid them from hiring employees.⁷ As a result, Cuba's private sector has essentially been negligible in terms of employment (4-7% of the labor force) and production (contributing only 5% to GDP).⁸

The problem which Cuba now faces is that many of its state-owned enterprises (SOE) are operating at a loss, and are relying on additional state subsidies to remain in

⁵ *Id.* at 2.

⁶ Philip Peters, *Cuba's Entrepreneurs: Foundation of a New Private Sector*, *American* 9 (Jul. 2012), <http://www.american.edu/clals/upload/LexingtonCubaEntrepreneurs-1.pdf>.

⁷ *Id.* at 5.

⁸ *Id.* at 9.

operation.⁹ Because there is no private sector to replace these inefficient SOEs, necessary public services would become unavailable without a government subsidy. As a result, the Cuban government has become trapped in a cycle of inefficient spending, which has threatened to bankrupt the nation. To resolve these inefficiencies and excessive spending, the Cuban government has turned to increased privatization as a way to reform its economic model.

In 2012, the Cuban government made a series of changes to the labor code increasing the role of private business in the economy. These changes to the labor code are meant to address this over-nationalization of the economy by shifting unprofitable state businesses into the newly expanding private sector—thereby reducing government spending. Over time, Cuba hopes to grow its private sector production from 5% to 45-50% of the island's GDP, and is prepared to lay off as many 1.8 million state workers (approximately at least 31% of the labor force) to accomplish this.¹⁰ Altogether, over 300 articles of the labor code have been proposed for

⁹ Geoff Thale, *Labor Rights and Cuba's Economic Reforms*, Washington office on Latin America 2 (Dec. 2013), http://www.wola.org/sites/default/files/Labor_Rights_and_Cubas_Economic_Reforms.pdf.

¹⁰ Philip Peters, *A Viewers Guide to Cuba's Economic Reforms*, American 9 (May 2012), <http://www.american.edu/clals/upload/LexingtonViewersGuide-1.pdf>.

modification.¹¹ These changes and their general goals have been outlined in a publication by the government entitled *Lineamientos de la Política Económica y Social del Partido y la Revolución*, and are discussed in detail below.¹²

III. WHAT CHANGES HAVE THE CUBAN REFORMS MADE TO THE CUBAN ECONOMY?

A. SMALL BUSINESS

The private sector has long been a negligible part of the Cuban economy, and this was no accident. Since the start of the Castro era, the Cuban government instituted numerous legislation intentionally designed to limit entrepreneurship. Such restrictions were a symptom of the socialist ideology propagated by Fidel Castro, who viewed the private sector as—at best—a necessary evil.¹³ However, the recent reforms the Cuban labor code deviate from this line of thinking.

¹¹ Carmelo Mesa-Lago, *Institutional Changes of Cuba's Economic-Social Reforms*, Brookings 2 (Aug. 2014),

<http://www.brookings.edu/~media/research/files/papers/2014/08/cubas-economic-social-reform-mesalago/cubaseconomicssocialreformsmesalago.pdf>.

¹² Geoff Thale, *Labor Rights and Cuba's Economic Reforms*, Washington office on Latin America 2 (Dec. 2013),

http://www.wola.org/sites/default/files/Labor_Rights_and_Cubas_Economic_Reforms.pdf.

¹³ Philip Peters, *A Viewers Guide to Cuba's Economic Reforms*, American 4 (May 2012),

<http://www.american.edu/clals/upload/LexingtonViewersGuide-1.pdf>.

Recently, the Cuban government has begun to recognize the need for privatization, in order to deal with the island nation's abysmal economic production.¹⁴ As a result, the government has expanded the number of available forms of private sector employment and begun to legalize what many would consider normal business practices. Some of the key legislative changes are as follows:

- The self-employed may now hire employees¹⁵
- Health and safety standards extend to the private sector¹⁶
- Non-discrimination in hiring¹⁷
- Expanded seating in restaurants from 12 to 50 persons¹⁸
- Expanded private employment to 201 lines of work¹⁹
- Government goal to increase private sector production from 5% to 45-50% of GDP

Cuba's early reforms have attempted to create a middle ground, allowing some private businesses to operate independently, while requiring others to operate as private

¹⁴ *Id.*

¹⁵ *Id.* at 12.

¹⁶ Steve Ludham, *Economic Changes in Cuba-What About the Workers?*, Morning Star (Jul. 2014), <http://www.morningstaronline.co.uk/a-3736-Economic-changes-in-Cuba-What-about-the-workers>.

¹⁷ *Id.*

¹⁸ Philip Peters, *Cuba's Entrepreneurs: Foundation of a New Private Sector*, American 11 (Jul. 2012), <http://www.american.edu/clas/upload/LexingtonCubaEntrepreneurs-1.pdf>.

¹⁹ *Id.* at 9.

sector cooperatives.²⁰ These cooperatives maintain ownership of the enterprises with the state, but cede day-to-day operations and a portion of the profits to private workers. In total, cooperatives and otherwise, Cuban citizens are now allowed to privately operate one of 201 tightly licensed businesses.²¹ Additionally, owners of these businesses are now permitted to hire employees.²² This is a distinction from past years, when the hiring of employees in the private sector was limited to only family members.

However, despite this expansion in private sector business licenses, meaningful entrepreneurship in Cuba remains heavily circumscribed. This is because the vast majority of Cuban business licenses are for menial labor such as selling fruit, repairing umbrellas, refilling lighters, and other tasks too small for government attention.²³

²⁰ Raúl J. Valdés-Fauli, *Cuba's Private Sector and the New Legal Framework*, Fox Rothschild LLP (Jul. 2015), <http://www.foxrothschild.com/publications/cuban-private-sector-and-the-new-cuba-legal-framework/>.

²¹ Jose Azel, *The New Cuba Policy: Fallacies and Implications*, World Affairs Journal, <http://www.worldaffairsjournal.org/article/new-cuba-policy-fallacies-and-implications>.

²² Philip Peters, *A Viewers Guide to Cuba's Economic Reforms*, American (May 2012), <http://www.american.edu/clals/upload/LexingtonViewersGuide-1.pdf>.

²³ Jose Azel, *The New Cuba Policy: Fallacies and Implications*, World Affairs Journal, <http://www.worldaffairsjournal.org/article/new-cuba-policy-fallacies-and-implications>.

Regardless, despite these seemingly limited freedoms, the recent reforms are the strongest endorsement of private business in the Castro era.²⁴ By gradually relieving these restrictions, the hope is that private individuals will be able to play a larger role in the nation's economy. However, for entrepreneurship in Cuba to find long-term success, it is likely that more meaningful changes will be needed.

B. INCREASES IN PROPERTY RIGHTS

For the first time since 1959, Cubans are now allowed to legally execute transfers of title to both their homes and automobiles.²⁵ Prior to this reform, transfers of title occurred under the "*Permuta*" system.²⁶ This system operated as essentially a barter between two homeowners, in which the two properties were simply traded for one another.²⁷ Moreover, the system was heavily regulated by the government.²⁸ First, the two properties in question had to be of equal value.²⁹ Second, no money could be included in the

²⁴ Philip Peters, *A Viewers Guide to Cuba's Economic Reforms*, American (May 2012), <http://www.american.edu/clals/upload/LexingtonViewersGuide-1.pdf>.

²⁵ Lina Forero, Book Note, *The Cuban Government Approves Guidelines to Reform Cuba's Economic Model and Develops an Implementation Strategy*, 17 LAW AND BUSINESS REVIEW OF THE AMERICAS, 761, 764 (2012).

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

transfer.³⁰ Finally, the government had to approve the transaction.³¹ Not only was this system a source of corruption on the island, but had also effectively strangled the transfer of real property.³²

This restriction on property transfers has contributed to the stagnation of private business.³³ Currently, the majority of private businesses are operated from the home, with 85% of businesses having no employees.³⁴ However, as significant growth in the private sector occurs, businesses will need the freedom to acquire property in which to grow. The new system addresses this by liberalizing the access to property and loosening government regulations on transfers.³⁵ All that is now required is notary approval, funding of the transaction through a state bank, and payment of a still undetermined tax.³⁶ Most crucially, the new system allows for transfers of property for money,³⁷ thereby removing the most crippling restriction of the

³⁰ *Id.*

³¹ *Id.*

³² *Id.* at 764-65.

³³ *Id.*

³⁴ Geoff Thale, *Cuba's New Labor Code and Foreign Investment Law: Implications for Workers*, Washington Office on Latin America (Jul. 2014), http://www.wola.org/commentary/cuba_s_new_labor_code_and_foreign_investment_law_implications_for_workers.

³⁵ Lina Forero, Book Note, *The Cuban Government Approves Guidelines to Reform Cuba's Economic Model and Develops an Implementation Strategy*, 17 LAW AND BUSINESS REVIEW OF THE AMERICAS, 761, 765 (2012).

³⁶ *Id.* at 764.

³⁷ *Id.*

"*Permuta*" system: the need to own property in order to acquire property. While property law in Cuba remains restrictive, the new legislation is an indication of its evolution.

C. FOREIGN INVESTMENT

One of the most significant developments in Cuban legislation is the new policy toward foreign investment. This area has the potential to rapidly update the island's economic condition.³⁸ However, to be successful, it must be managed correctly. Since Raul Castro took office in 2008, Cuba has gradually broadened the criteria used for accepting foreign investment projects.³⁹ Initially, the criteria used for accepting foreign investment were principally limited to projects that would bring new capital, markets, or technology to the island. Today, Cuba has expanded these criteria to include all sectors except health care, education and the armed forces.⁴⁰ Crucially, these new policies have expanded the use of foreign investment to allow for job creation and increases to national production.⁴¹ The hope is that this expansion of foreign investment will help supplement Cuba's struggling domestic banking industry,

³⁸ Carmelo Mesa-Lago, *Can Cuba's Reforms Succeed?*, Americas Quarterly, <http://www.americasquarterly.org/content/can-cubas-economic-reforms-succeed>.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

by introducing new avenues of capital and investment.⁴² As a result, the new policies represent a significant step in making investment in Cuba more attractive. Nevertheless, despite these changes, foreign investment has yet to make a significant impact on the island's economy. Many factors still make Cuba unattractive to foreign investment, such as the low purchasing power of the Cuban public, a highly selective approval process, and numerous policies restricting management by foreign investors.⁴³

IV. SUCCESSFUL PRIVATIZATION: LEGAL AND MARKET REFORMS

By studying the privatizations of the socialist economies of China and Eastern Europe, economists have developed theories as to the reasons for their success. The conclusion of this research is that for the privatization of a socialist economy to be successful, a nation must reform both its laws and market infrastructure. This theory is based on the reasoning that both the legislation and market environment developed under a socialist system are insufficient to address the circumstances that will arise in a

⁴² Carmelo Mesa-Lago, *Institutional Changes of Cuba's Economic-Social Reforms*, Brookings 8 (Aug. 2014), <http://www.brookings.edu/~media/research/files/papers/2014/08/cubas-economic-social-reform-mesalago/cubaseconomicssocialreformsmesalago.pdf>.

⁴³ Carmelo Mesa-Lago, *Can Cuba's Reforms Succeed?*, Americas Quarterly, <http://www.americasquarterly.org/content/can-cubas-economic-reforms-succeed>.

private market.⁴⁴ This is because both of these environments work together to support the private sector. While the legal environment provides the scope of freedoms to market access, the market infrastructure provides the tools necessary for participating in private enterprise. As a result, an efficient private sector cannot develop without both of these operating efficiently.

V. REFORM OF THE LEGAL ENVIRONMENT

As shown above, a private sector cannot succeed in isolation, and requires both legal and market reforms to allow it to be successful. Legal reform is perhaps the most obvious of these changes, and is undoubtedly necessary to commence the process of privatization. However, for privatization to be successful, legal reform must do more than legalize private entrepreneurship. At a minimum, a successful private sector must promote competition and provide market actors the legal freedoms necessary to efficiently enter the market.⁴⁵ As a result, without legal reform, excessive market restriction will inevitably lead to unemployment, exploitation, and inefficient pricing.⁴⁶ While numerous changes are needed, the aspects of the legal environment most in need of reform are: contract law,

⁴⁴ Michele Balfour, *A Privatization Test: The Czech Republic, Slovakia and Poland*, 17 Fordham International L. J. 85, 85-6 (1993).

⁴⁵ *Id.*

⁴⁶ *Id.*

entrepreneurial diversity, and political stability.⁴⁷ This paper defines these elements as the country's "legal environment."

A. CONTRACTUAL FREEDOMS

Extensive contractual freedoms are essential for the private sector to function efficiently. The greater the freedoms of contract, the greater opportunity the market has to maximize the value of its assets.⁴⁸ This is because restrictive contract laws have the effect of reducing the available number of buyers and sellers. Such restrictions prevent parties from receiving the highest price available for their goods and services. Efficient prices should be determined by the market, rising and falling with supply and demand. However, for such a market to function efficiently, expansive contractual freedoms are necessary.⁴⁹

As private individuals are unlikely to finance and operate entire businesses on their own, there must be legal freedom to develop the employment and investment relationships necessary to fund privatization. Contract rights need special attention during the privatization of socialist nations, due to the fact that central planning economies are operated by the state as opposed to private actors. As a result, the legal framework in this area is at risk of being overly restrictive. In fact, in some situations certain essential contractual freedoms and relationships may be entirely

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.* at 86.

nonexistent or prohibited. Restricting the freedom of contract is symptomatic of socialist systems, and such restrictions reduce efficiency in the private sector.⁵⁰ In order to attract investment and promote efficiency, such freedoms should be liberalized.⁵¹

B. ENTREPRENEURIAL DIVERSITY

Transitioning economies lacking investment and infrastructure have attempted to mitigate these deficiencies by restricting the rate at which employment is privatized. The hope is that by restricting the number of permissible forms of self-employment, the economy will be able to avoid the inefficiencies created by its lack of capital and infrastructure. While such restrictions may be well intentioned, over restriction of the permissible forms of self-employment will also create a risk of inefficient production.

For an economy to be competitive, it must allow actors to efficiently enter the market.⁵² Limitations on the lines of work permitted to operate in the private sector are the most direct restriction on market access.⁵³ Without sufficient entrepreneurial diversity, there is a significant risk of unemployment.⁵⁴ This is because if there are insufficient jobs available to accommodate the size of the private

⁵⁰ *Id.*

⁵¹ *Id.* at 85.

⁵² *Id.* at 89.

⁵³ *Id.* at 89-90.

⁵⁴ *Id.*

workforce, production in these segments will suffer from surplus labor. Essentially, as the supply of workers rises past the demand for their services, prices for such services will drop until excess workers can no longer afford to operate and leave the market. Accordingly, a sufficient amount of entrepreneurial diversity is necessary to allow these workers the opportunity to find new employment. While it is not necessary for a nation to privatize its entire economic production, it must privatize a sufficient portion of its economy to accommodate the private workforce.

C. POLITICAL STABILITY

A successful economic transition will not occur overnight. Therefore, for privatization to be successful, it must be consistently supported by the government. Political stability is essential to ensure that the long-term goals of the transition are met and supported by the following regimes.⁵⁵ An economic reform is no small feat, and requires the full and consistent support of the government.⁵⁶ A stable government lends credibility to the hope that the reforms are not merely temporary efforts that will be overturned by the next regime.⁵⁷ Such credibility is necessary to attract sufficient long-term investment.

⁵⁵ *Id.* at 91

⁵⁶ *Id.*

⁵⁷ *Id.*

VI. REFORM OF MARKET INFRASTRUCTURE

In addition to these legal reforms, for a privatization to be successful it is necessary to reform a nation's market infrastructure.⁵⁸ This is a practical reform and largely concerns the logistics necessary for privatization. For a market to function efficiently, workers must have access to the market prerequisites necessary for enjoying the newly-created entrepreneurial freedoms.⁵⁹ Without an efficient market infrastructure, market actors will not have the resources necessary for entering the private market, despite the legal freedom to do so. These resources include access to capital/financing, access to supplies and inventory, and access to property/storefront.⁶⁰ This paper defines these elements as the country's "market infrastructure."

A. PROPERTY

Efficient access to property is essential to encourage investment.⁶¹ As a legislature grants a private market the legal freedom to develop, it must provide it with the room to do so. Real property, particularly storefront, is essentially the garden in which a private sector is destined to grow. As a result, the unavailability of real property can indirectly place a ceiling on private sector development. Ultimately, restrictions on access to real property inhibit the ability of

⁵⁸ *Id.* at 90.

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.* at 87.

individuals to enter the market. These restrictions may result from overly strict regulations on the transfer of real property, dilapidated infrastructure, or real property shortages. Regardless of the form, either will indirectly inhibit the ability of individuals to enter the market.⁶² Accordingly, it is essential for the privatizing nation to not only make efforts to liberalize the transfer of property, but also to rebuild and revitalize dilapidated infrastructure in order to ensure that there is sufficient access to property for individuals to enter the market.

B. SUPPLIES AND INVENTORY

As an economy transitions to incorporate private enterprise, a nation must also ensure that its supply chain adapts as well. An infrastructure developed under a socialist system must be adapted to provide private workers access to a stream of supplies and inventory. Not only is a newly developing private business sensitive to shortages of business necessities, but unlike state-owned enterprises, a private business cannot rely on government subsidies and taxes to remain in operation. As a result, to promote the growth of private business, a transitioning economy must monitor the condition of its market infrastructure in order to prevent such shortages from occurring. In the early years of privatization, private wholesale markets, delivery companies, and suppliers are not likely to develop. As a result, state infrastructure should be adapted to supplement

⁶² Michele Balfour, *A Privatization Test: The Czech Republic, Slovakia and Poland*, 17 *FORDHAM INTERNATIONAL L. J.* 85, 88 (1993).

private sector growth.⁶³ Accordingly, as with access to property, without sufficient access to supplies and inventory, private enterprise will fail to develop, despite the legislative freedom to do so.

C. CAPITAL MARKETS AND FINANCIAL INTERMEDIARIES

Finally, the government must ensure that there is a banking system adequate to support privatization.⁶⁴ Banking and capital are the lifeblood of economic reform, and without them, a private sector cannot develop. Access to financing is necessary not only to supplement personal savings and investment, but also to prevent inequality. Without equal access to financing, entrance to the market will be unequally skewed by access to personal wealth. Such circumstances not only restricts access to the market, but also reduces competition and production by preventing successful business models from entering the market. As a result, access to banking, financial intermediaries, and foreign investment is essential to allow all market actors an opportunity to enter the market, as opposed to only the wealthy.⁶⁵

VII. THE PACE OF PRIVATIZATION

While the necessary reforms to the legal and market environment are discussed above, left undiscussed is the manner and pace at which such reforms should be

⁶³ *Id.* at 89.

⁶⁴ *Id.* at 92-93.

⁶⁵ *Id.* at 93.

implemented. An effective pace of privatization is not only dependent on the speed at which state labor and assets are transitioned into the private sector, but it is also dependent on the legal and market reforms that proceed and prepare for privatization.⁶⁶ The legal and market infrastructure developed in a socialist economy are not adequate to address the controversies that arise in private markets.⁶⁷ As a result, it is essential to reform these environments prior to commencing privatization.⁶⁸ If state-labor and assets are transitioned into the private sector before these reforms have been implemented, inefficiencies in the private market will develop.⁶⁹

China presents an excellent example of a successful transition, as nearly 20 years of various piecemeal reforms preceded large-scale privatization of state labor and assets.⁷⁰ These reforms began by utilizing private cooperatives to increase the autonomy and independence of state-owned

⁶⁶ Jie Gan, *Privatization in China: Experiences and Lessons*, Hong Kong University of Science and Technology, 2-4, (2008), http://english.ckgsb.edu.cn/sites/default/files/privatization_in_china.pdf.

⁶⁷ *Id.*

⁶⁸ Surijit S. Sidhu, *Privatization and Deregulation: Needed Policy Reforms for Agribusiness Development*, 72 (1999).

⁶⁹ Uner Kirdar, *A World Fit for People*, 90 (1994).

⁷⁰ Jie Gan, *Privatization in China: Experiences and Lessons*, Hong Kong University of Science and Technology, 2-4, (2008), http://english.ckgsb.edu.cn/sites/default/files/privatization_in_china.pdf.

enterprises.⁷¹ Such cooperatives maintained ownership of the enterprise with the state, while distributing control and a portion of the profits to private individuals. It was not until after the proliferation of these cooperatives that subsequent reforms allowed private individuals to enter the market for themselves.⁷² This gradual pace allowed China the opportunity to experiment and determine which legislation worked best to develop an effective private sector. As a result, by the time large-scale privatization of state labor and assets began in the 1990s, both the Chinese legal environment and market infrastructure were adequately prepared to deal with the needs of the market.⁷³

That being said, deficiencies in the economic production and profitability of state-owned enterprises may present temptation to rush privatization. For example, after large-scale privatization began in the 1990s, nearly half of Chinese state-owned enterprises reported zero or negative equity, and the others were significantly less productive than similar privately-owned businesses.⁷⁴ This result is consistent with the economic theory that private individuals are more efficient owners of assets than the state.⁷⁵ This is due in part to the fact that state-owned enterprises suffer from reduced incentives to improve their operating

⁷¹ *Id.* at 2-3.

⁷² *Id.*

⁷³ *Id.* at 12-13.

⁷⁴ *Id.*

⁷⁵ Marko Simoneti, *Efficiency of mass privatization vs. gradual privatization: Owner and seller effects on performance of companies in Slovenia*, cerge-ei, https://www.cerge-ei.cz/pdf/gdn/rrc/RRCII_15_paper_01.pdf.

efficiencies, social responsibilities, and pricing models.⁷⁶ As a result of these reduced incentives, there is temptation to transfer state labor and assets to the private sector as quickly as possible. However, such temptation must be controlled.

As stated above, an effective privatization is not only dependent on the speed at which state labor and assets are transitioned into the private sector, but it is also dependent on the legal and market reforms that proceed and prepare for privatization.⁷⁷ As a result, while economic production may benefit from private ownership, the privatization of state labor and assets should be restricted until both the legal and market infrastructure have been sufficiently adapted to support the transition. Without these reforms, private business will not have the legal and infrastructural prerequisites necessary to function efficiently, effectively making the economic advantages of private ownership unobtainable.

VIII. THE CUBAN PRIVATE SECTOR

A. INEFFICIENCIES OF CUBA'S LEGAL ENVIRONMENT

As of now, the legal environment in Cuba is too restrictive to support a successful private sector. Cuban legislation not only limits the number of permissible forms of self-employment, but also directly restricts the growth of private business by limiting both investment and the

⁷⁶ *Id.*

⁷⁷ Jie Gan, *Privatization in China: Experiences and Lessons*, Hong Kong University of Science and Technology, 2-4, (2008), http://english.ckgsb.edu.cn/sites/default/files/privatization_in_china.pdf.

acquisition of real property. As discussed above, for a private sector to be successful, a socialist nation must reform its legal environment prior to expanding the private workforce. However, the Cuban government has failed to do this. Despite identifying over 300 articles of the legislative code in need of reform to support privatization, as of 2013 the Cuban government has implemented only 46 of them.⁷⁸ Despite these minimal legislative reforms, Cuba has proceeded to rapidly transition both state labor and assets into the private sector. As of today, approximately 10% of Cuban state labor has already been transitioned into the private market, and another 21% is expected to follow.⁷⁹ Ultimately, both Cuba's legal and market environment are not prepared to support this large influx of labor.

Currently, Cuban workers are limited to 201 types of entrepreneurial licenses, the majority of which are for menial activities such as wrapping buttons, shining shoes, cleaning spark plugs, peeling fruit, selling fruit, and repairing umbrellas.⁸⁰ As privatization and state layoffs in Cuba continue, more and more workers will be forced to enter the

⁷⁸ Carmelo Mesa-Lago, *Institutional Changes of Cuba's Economic-Social Reforms*, Brookings 2 (Aug. 2014), <http://www.brookings.edu/~media/research/files/papers/2014/08/cubas-economic-social-reform-mesalago/cubaseconomicsocialreformsmesalago.pdf>.

⁷⁹ *Id.* at 8.

⁸⁰ Jose Azel, *The Illusions of the Cuban Reforms: Castro Strikes Out*, World Affairs Journal (Aug. 2013), <http://www.worldaffairsjournal.org/article/illusion-cuban-reform-castro-strikes-out>.

private sector.⁸¹ However, as a result of Cuba's restrictive legal environment, these workers are left with no other alternative than to support themselves through menial labor. Cuba has one of the best education systems in Latin America. Limiting workers to this short list of menial tasks unfairly limits workers' earning potential by failing to make use of this investment in education. Cuba has planned to grow the private sector to sustain as many as 1.8 million Cuban workers (approximately at least 31% of the labor force).⁸² Is it truly efficient for such a large percentage of workers to work as shoe shiners and fruit vendors?

These restrictive policies not only create a ceiling on private sector production, but are also likely to lead to an increase in unemployment. This is because Cuba's lack of entrepreneurial diversity confines an ever increasing segment of the workforce into a narrow range of employment options. If not addressed, this is likely to lead to a surplus of labor in these lines of work. As stated above, labor surpluses are responsible for market inefficiencies, and will artificially lower the price of goods and services, leading

⁸¹ Geoff Thale, *Cuba's New Labor Code and Foreign Investment Law: Implications for Workers*, Washington Office on Latin America (Jul. 2014), http://www.wola.org/commentary/cuba_s_new_labor_code_and_foreign_investment_law_implications_for_workers.

⁸² Carmelo Mesa-Lago, *Institutional Changes of Cuba's Economic-Social Reforms*, Brookings 8 (Aug. 2014), <http://www.brookings.edu/~media/research/files/papers/2014/08/cubas-economic-social-reform-mesalago/cubaseconomic-social-reformsmesalago.pdf>.

to unemployment. As a result, a sufficient amount of entrepreneurial diversity is necessary not only to allow these workers the opportunity to find a job, but instead to find employment that will allow Cuba to maximize its production.

Unfortunately, this lack of entrepreneurial diversity is indicative of Cuba's desire to limit private sector production. This reasoning is supported by the fact that there is Cuban legislation limiting the ability of private business owners to contract with employees and foreign investors. As of today, private businesses in Cuba are taxed so as to make hiring of any employees prohibitive.⁸³ In fact, as a result of such restrictions, as many as 85% of workers in the Cuban private sector are self-employed.⁸⁴ Additionally, the government has restricted private sector production by limiting access to foreign investment, forcing Cuban entrepreneurs to rely on an already struggling domestic financing industry. Despite the expansion of allowable foreign investment to include criteria such as job creation and increases in national production, foreign investment in Cuba has failed to make a

⁸³ Philip Peters, *Cuba's Entrepreneurs: Foundation of a New Private Sector*, American 11 (Jul. 2012), <http://www.american.edu/clals/upload/LexingtonCubaEntrepreneurs-1.pdf>.

⁸⁴ Geoff Thale, *Cuba's New Labor Code and Foreign Investment Law: Implications for Workers*, Washington Office on Latin America (Jul. 2014), http://www.wola.org/commentary/cuba_s_new_labor_code_and_foreign_investment_law_implications_for_workers.

significant contribution to the island's economy.⁸⁵ This failure is due in part to restrictive government selection criteria and numerous policies disfavoring foreign ownership.⁸⁶ While restrictions such as these are likely inspired by Cuba's history of socialism, by reforming its legal environment in this manner, the Cuban government has effectively limited the private sector's development.

IX. INSUFFICIENCIES OF CUBA'S MARKET INFRASTRUCTURE

In addition to its legal restrictions, Cuba's market infrastructure also indirectly restricts worker access to the market by obstructing access to business necessities such as storefront (real property), capital, supplies, and inventory. Finding funding and capital are often any entrepreneur's first obstacle to entering the private market, and entrepreneurs in Cuba are no different. Despite the largely menial nature of private employment currently permitted, the need for storefront, capital, supplies, and inventory is still a prerequisite for business. Accordingly, the current scarcity of these business inputs acts as a major obstacle to entering the Cuban market.

⁸⁵ Carmelo Mesa-Lago, *Can Cuba's Reforms Succeed?*, *Americas Quarterly*, <http://www.americasquarterly.org/content/can-cubas-economic-reforms-succeed>.

⁸⁶ *Id.*

A. CAPITAL

Currently, access to financing in Cuba is grossly insufficient to support widespread private enterprise. From 2011 to 2013, as little as 218,400 loans were granted by the Central Bank of Cuba, each averaging a mere \$141.⁸⁷ Additionally, only 0.2% (4368 loans) of these loans went to self-employed workers.⁸⁸ Capital is the life blood of the market, and without sufficient access to credit, businesses will fail to enter or remain in the market. As a result, many Cuban workers have been forced to rely on personal savings to supplement this lack of capital. Unfortunately, Cuban workers suffer from chronically low wages, with the average Cuban citizen earning roughly \$20 per month.⁸⁹ Yet, depending on the enterprise, starting a small business in Cuba could require an initial investment of \$220 to \$6,000 (excluding property rental expenses).⁹⁰ Accordingly, it could

⁸⁷ Carmelo Mesa-Lago, *Institutional Changes of Cuba's Economic-Social Reforms*, Brookings 8 (Aug. 2014), <http://www.brookings.edu/~media/research/files/papers/2014/08/cubas-economic-social-reform-mesalago/cubaseconomicsocialreformsmesalago.pdf>.

⁸⁸ *Id.*

⁸⁹ **Geoff Thale**, *Labor Rights and Cuba's Economic Reforms*, Washington office on Latin America 2 (Dec. 2013), http://www.wola.org/sites/default/files/Labor_Rights_and_Cubas_Economic_Reforms.pdf.

⁹⁰ Ricardo Amack, *Suppling Growth: Purchasing Challenges and Opportunities for Cuban Entrepreneurs*, The Cuban Study Group (Jul. 2015),

take some workers as much as 25 years worth of salary (\$6000) to begin a private business, based on savings alone.

Some workers have been able to partially circumvent this problem by receiving funding from abroad. This funding is in the form of remittances from family members in other countries—commonly from the United States. As a result, workers fortunate enough to receive remittances have access to a limited form of financing that is unavailable to other citizens. Accordingly, they can utilize these subsidies to fund their businesses. This access to foreign capital provides these workers with a tremendous competitive advantage, and is partly responsible for increases in income inequality. However, regulations limiting the amount and size of remittances prohibit these subsidies from becoming a genuine solution to significant capital needs, leaving even some of these foreign-subsidized entrepreneurs in need of additional financing.

B. STOREFRONT

For those workers who are able to obtain access to capital, the expense and unavailability of storefront may still prevent them from entering the market. In Cuba, access to storefront is restricted by overbearing regulations on the transfer of real property. For years in Cuba it was not possible to sell real property at all, transfers of real property could only occur by essentially trading two properties of

equal value (the Permuta system).⁹¹ While reforms have alleviated this restriction—allowing regulated sales of real property for the first time—Cuban property law remains restrictive.

For example, Cuban real property law limits the amount of property a citizen may own, prohibits real estate lawyers from operating on the island, prohibits foreigners from purchasing real property, and requires notary approval prior to any sale.⁹² Additionally, even when these hurdles can be overcome and a transaction is feasible, the majority of Cuba's property is in disrepair. A 2013 survey studying the condition of structures in Havana estimated that 58% of the city's structures were in poor or critical condition.⁹³ The additional expense of repairs, as well as government taxes, fees, and restrictions on construction, make useable storefront harder to acquire. As a result, despite the apparent efforts of the Cuban legislature to expand the private sector, meaningful entrepreneurship is forced to try to flourish from homes and street carts.

⁹¹ Lina Forero, Book Note, *The Cuban Government Approves Guidelines to Reform Cuba's Economic Model and Develops an Implementation Strategy*, 17 *LAW AND BUSINESS REVIEW OF THE AMERICAS*, 761, 764 (2012).

⁹² John Arlidge, *Cuba, Home of the World's Oddest Property Market*, *Financial Times* (2013), <http://www.ft.com/cms/s/2/95d3017e-d364-11e2-b3ff-00144feab7de.html#slide0>.

⁹³ Carmelo Mesa-Lago, *Institutional Changes of Cuba's Economic-Social Reforms*, *Brookings* 14 (Aug. 2014), <http://www.brookings.edu/~media/research/files/papers/2014/08/cubas-economic-social-reform-mesalago/cubaseconomicsocialreformsmesalago.pdf>.

C. SUPPLIES AND INVENTORY

Finally, even if an aspiring private worker is able to obtain access to capital and acquire a storefront, their access to the private market is still restricted by the unavailability of supplies and inventory. According to Cuban entrepreneurs, “the most significant problem facing small business on the island is the cost and availability of supplies.”⁹⁴ The lack of access to wholesale markets, dismal domestic production, and high import duties make acquiring necessary business inputs costly and difficult. In fact, one study found that the most affordable way to acquire necessary business prerequisites, is for workers to purchase their supplies at state-run dollar stores.⁹⁵ However, the lack of product variety and quality at these stores often causes Cuban workers to struggle to acquire the supplies they need—forcing them to look outside the island for necessities. As a result, despite the expansion of entrepreneurial freedoms, the unavailability of necessary business inputs restricts worker access to the market.

⁹⁴ Ricardo Amack, *Suppling Growth: Purchasing Challenges and Opportunities for Cuban Entrepreneurs*, The Cuban Study Group 2 (Jul. 2015), http://www.cubastudygroup.org/index.cfm/files/serve?File_id=37d8e2c5-96bc-4b33-8312-963189f8a4df.

⁹⁵ *Id.* at 3.

X. THE SPEED OF THE REFORMS AND ITS IMMEDIATE IMPACTS

Regardless of what the recent legislation means for the future of Cuba's economic ideology, the reality is that these reforms have created various challenges for Cubans living on the island today. These challenges have been caused by Cuba's inability to synchronize the growth of the private labor force with the pace of legislation. Despite extensive restrictions to market access, the number of workers entering the private workforce has been increasing. As stated above, since 2013, over half a million state workers have been laid off (10% of the labor force) and over a million more are scheduled to follow (21% of the labor force).⁹⁶ This inability to liberalize the legal and market environment prior to transitioning state labor into the private sector has placed large numbers of Cuban workers in a private sector lacking sufficient legal development. Essentially, this has created a blind spot of Cuban workers with needs left unaddressed by the gradual pace of reform.

Due to the lack of a developed private sector in Cuba, there are insufficient private businesses waiting to hire discharged workers. As a result, these workers are left with no other recourse to find work than to apply for one of the 201 entrepreneurial licenses—and start their own

⁹⁶ Carmelo Mesa-Lago, *Institutional Changes of Cuba's Economic-Social Reforms*, Brookings 8 (Aug. 2014), <http://www.brookings.edu/~media/research/files/papers/2014/08/cubas-economic-social-reform-mesalago/cubaseconomicsocialreformsmesalago.pdf>.

businesses.⁹⁷ This rapid growth in entrepreneurship ignores the realities of Cuba's poor infrastructure, lack of investment capital, and lack of entrepreneurial diversity, all of which are necessary for private enterprise. As a result, critics argue that Cuban legislation has left workers in danger of exploitation and increased income inequality.⁹⁸

Income inequality in Cuba has been rising since the implementation of the reforms in 2010.⁹⁹ This rise in income inequality has been connected to unequal access to business prerequisites such as capital, supplies, and storefront. Citizens fortunate enough to receive remittances and supplies from family abroad have potentially insurmountable advantages over their competitors.¹⁰⁰ Not only do these remittances and care packages serve as a form of financing that is unavailable to other citizens, but each US dollar they receive is worth nearly 25 times more than the Cuban peso.¹⁰¹ As a result, inequalities in access to financing have led to inequality in access to business inputs, and ultimately, to inequality in access to the private market. Despite the fact that Cuba has attempted to initiate reforms

⁹⁷ Jose Azel, *The New Cuba Policy: Fallacies and Implications*, World Affairs Journal (2015), <http://www.worldaffairsjournal.org/article/new-cuba-policy-fallacies-and-implications>.

⁹⁸ Geoff Thale, *Labor Rights and Cuba's Economic Reforms*, Washington office on Latin America (Dec. 2013), http://www.wola.org/sites/default/files/Labor_Rights_and_Cubas_Economic_Reforms.pdf.

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

in micro credit, bank accounts, and wholesale markets to alleviate these issues, these reforms have been grossly insufficient.¹⁰² As more workers are forced to trade state employment for private entrepreneurship, the price and competition for these already dwindling business resources will continue to increase. Potentially, this can create a circumstance where private sector success would be more dependent on whether or not a business can receive support from abroad, than on the merits of its own goods and services.

In fact, there is already concern that the gradual pace of reform has been insufficient to prevent labor injustice.¹⁰³ The restrictions on market access and the increases in the private workforce have dangerously increased competition for employment. As desperation for work emerges, private workers are placed at risk of exploitation. Cuba has long been accused of numerous international labor rights violations, even before the institution of these economic reforms.¹⁰⁴ Such violations are likely to worsen as increased competition creates greater incentives for employers to

¹⁰² Carmelo Mesa-Lago, *Institutional Changes of Cuba's Economic-Social Reforms*, Brookings (Aug. 2014), <http://www.brookings.edu/~media/research/files/papers/2014/08/cubas-economic-social-reform-mesalago/cubaseconomicsocialreformsmesalago.pdf>.

¹⁰³ Geoff Thale, *Labor Rights and Cuba's Economic Reforms*, Washington office on Latin America 2-4 (Dec. 2013), http://www.wola.org/sites/default/files/Labor_Rights_and_Cubas_Economic_Reforms.pdf.

¹⁰⁴ *Id.* at 9.

exploit their workers.¹⁰⁵ While Cuba does have a national labor union to help regulate these concerns, most commentators feel it is insufficient. The *Central de Trabajadores de Cuba* (CTC),¹⁰⁶ Cuba's national labor union, primarily operates as a political instrument.¹⁰⁷ The CTC does not engage in collective bargaining over wages, hours, or terms of employment. Instead, the CTC merely reports worker grievances to the government.¹⁰⁸ As a result, critics argue that the CTC "will need to evolve in recognition of the ways in which [private] workers' interests diverge from the interests of the state."¹⁰⁹

Although the long-term goals of the Cuban reforms are yet to come, there is a need to address the immediate concerns of workers currently entering the private sector. The inability to liberalize the legal and market environment prior to transitioning state labor into the private sector has exposed Cuban workers to increased inequality and exploitation. The challenges of private enterprise, especially on an island with poor infrastructure and supplies, create substantial uncertainty about the success these new entrepreneurs will have. As more workers are forced to trade state employment for private entrepreneurship, they put at risk the modest wages sustaining them. As a result, there must be sufficient legal and market reforms to allow these workers to be successful.

¹⁰⁵ *Id.* at 4.

¹⁰⁶ *Id.* at 6-7.

¹⁰⁷ *Id.* at 7.

¹⁰⁸ *Id.* at 7-8.

¹⁰⁹ *Id.* at 9.

A. POSITIVE IMPACT OF THE REFORMS TODAY

Despite these deficiencies, the recent reforms have also had both direct and indirect benefits for the Cuban economy. Most notably, the policies have reduced the government's inflated payroll. Prior to these reforms, the Cuban government—like most other socialist states—was responsible for nearly every economic activity. As a result, prior to these reforms, the government had been forced to subsidize inefficient SOEs in order to ensure that necessary services remained available to the public. The gradual emergence of a private sector has reduced the need for government subsidies by continuing to provide public services after unprofitable SOEs are terminated.¹¹⁰ As a result, these reforms have not only saved the Cuban government money, but have also promoted efficiency by replacing, as opposed to subsidizing, inefficient SOEs.

Under the central planning of Cuba's previous model, market forces, such as competition, were severely restricted.¹¹¹ By expanding the private sector, the new model allows for the promotion of efficiency through increased competition. This rationale is based on the "invisible hand" economic theory, which states that competition will cause bad businesses to close and successful ones to succeed. Ending government subsidies, which until now had been

¹¹⁰ Philip Peters, *A Viewers Guide to Cuba's Economic Reforms*, American 16 (May 2012),

<http://www.american.edu/clas/upload/LexingtonViewersGuide-1.pdf>.

¹¹¹ *Id.* at 5.

keeping several inefficient SOEs afloat, will force inefficient firms to find ways to reduce costs and promote efficiency. Accordingly, the Cuban government has forced SOEs to either turn a profit or close their doors.¹¹² While such a measure seems harsh, it is essential for Cuba to trim the fat. By subsidizing poor business models, it is preventing progress and efficiency. Over time, Cuba should expect to benefit from the effects of increased competition in the market.¹¹³

Finally, the privatization reforms have provided the Cuban government with a new stream of taxable income—the newly licensed businesses.¹¹⁴ In 2011, the Cuban government instituted a revised tax policy that would target the *cuentapropistas* (the Cuban entrepreneurs) directly.¹¹⁵ The policy taxes entrepreneurs at roughly 35%.¹¹⁶ This number is composed of a 10% income tax and a 25% “contribution” to the social security system.¹¹⁷ Accordingly, this expansion of the private workforce has provided the Cuban government with yet another tool to reduce its deficit.

¹¹² *Id.* at 2.

¹¹³ *Id.* at 2-5.

¹¹⁴ Lina Forero, Book Note, *The Cuban Government Approves Guidelines to Reform Cuba's Economic Model and Develops an Implementation Strategy*, 17 L. AND BUSINESS REVIEW OF THE AMERICAS, 761, 763-64 (2012).

¹¹⁵ *Id.*

¹¹⁶ *Id.*

¹¹⁷ *Id.*

XI. CONCLUSION

Ultimately, creating a successful institutional environment in Cuba will take time. Up to now, Cuba's reforms have been insufficient to support the growth of a private sector. The Cuban reforms have failed to address the legal and practical concerns preventing market access. The most notable of these is the lack of entrepreneurial diversity and the unavailability of business prerequisites such as storefront (real property), capital, supplies, and inventory. Ultimately, although Cuba claims to intend to promote private sector growth, its failure to synchronize the growth of the private sector with the pace of legislation has in fact stifled its development. By shedding its excess state labor and relocating those workers to the private sector, before relieving the practical barriers to market entry, Cuba has exposed its workers to exploitation and income inequality. Ultimately, while the reforms in Cuba are a step in the right direction, for the Cuban private sector to experience long-term success, more reforms are needed. A successful private sector requires a fertile environment in which to grow and develop. Without a sufficiently liberalized legal and market infrastructure, the private market will not be able to succeed. As a result, Cuba should not only limit the continued growth of the private workforce—until greater legislative reforms have been enacted—but should also initiate legislation to address the current needs of its private workers.