



**Cuba Transition
Project**

**FOREIGN DIRECT INVESTMENT
IN POST-CASTRO CUBA:
PROBLEMS, OPPORTUNITIES AND
RECOMMENDATIONS**

By

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Cuba Transition Project – CTP

The Cuba Transition Project, at the Institute for Cuban and Cuban-American Studies (ICCAS), University of Miami, is an important and timely project to study and make recommendations for the reconstruction of Cuba once the post-Castro transition begins in earnest. The transitions in Central and Eastern Europe, Nicaragua, and Spain are being analyzed and lessons drawn for the future of Cuba. The project began in January 2002 and is funded by a grant from the U.S. Agency for International Development.

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Executive Summary

The history of economic transition since the collapse of communism in the late 1980s and early 1990s offers many lessons for what Cuba may expect when it eventually embarks on its transition path. The path of transition has been more difficult than was conceived immediately following the collapse of communism. The nearly exclusive policy focus on economic liberalization and privatization of public enterprises did not lead to the sustained inflows of foreign capital and the rapid economic growth and development once promised for these economies. Current transition strategies have increasingly recognized the importance of well-functioning social institutions (“good governance”) as the necessary foundation of a well-functioning market economy. Building the institutional infrastructure required by a market economy and necessary for long-term success in attracting FDI has proven, however, to be a difficult and slow process.

Foreign direct investment is accepted as one of the key supportive components of an economic transition strategy, but some of the key determinants of FDI are also ones that characterize an effective institutional infrastructure of a market economy. Additional factors related to *systematic* or *market risk* are also important determinants of FDI. A basic understanding of these determinants can aid future policy makers.

This paper examines Cuba’s recent experience in attracting FDI, summarizes some of the empirical work that has been done regarding the link between well-functioning social institutions and FDI and draws lessons for a future Cuban government pursuing transition to a market economy. General policy recommendations are also developed.

The key elements necessary to promote FDI overlap with the foundations of successful long-term economic development. These elements may be summarized as: macroeconomic stability; minimum corruption in the public and private sectors of the economy; a rational commercial legal and regulatory code consistent with the basic requirements of market economies; good governance structures and civil society; a strong physical and human capital infrastructure; and a strong export sector that pro-

vides an adequate inflow of foreign exchange earnings. A brief outline of our recommendation appears in the table below.

Recommendations that call for U.S. financial support for economic assistance to Cuba during transition are based on the premise that a successful economic development path in Cuba is in the vital interests of the U.S. The U.S. should, however, resist pressures to adopt special fiscal incentives (tax breaks or subsidies) for U.S. companies investing in Cuba that artificially create competitive advantages and are difficult to dismantle at a later date. The U.S. should limit its economic role to facilitating technical assistance in the area of economic policy and creating structures of governance and civil society, providing financial assistance necessary to attain macroeconomic stability, and leading a multinational effort to provide the financing needed to rebuild physical infrastructure in ways that promote economic development across the island.

Summary of Policy Recommendations

Priorities:

- *Establish macroeconomic stability – low inflation and stable exchange rates.*
- *Develop market-compatible social institutions that support long-term economic growth.*
- *Limit corruption as much as possible.*
- *Promote the rapid growth of export-oriented private business enterprises.*
- *Rebuild economy's physical infrastructure.*
- *Facilitate the development of business management skills necessary for success in a globally integrated market economy.*

Macroeconomic Stability:

- *Introduction of a new currency establishing a rational and sustainable foreign exchange rate.*
- *Credible policy commitment to fiscal and monetary discipline.*
- *Establish foreign exchange reserves necessary to avoid short-term speculative pressures on the currency. (This is likely to require foreign assistance directly from the U.S. but preferably from the IMF.)*
- *Establish an efficient tax system that can raise sufficient revenues without excessive tax burdens or excessive distortions to market-driven relative prices.*

Market-Compatible Social Institutions:

- *Create a well-functioning banking system and domestic capital markets characterized by a decentralized, competitive private sector banking system that includes participation of international banks.*
- *Establish mechanisms and structures that ensure credit is available to small and medium size enterprises and provides an ample supply of credit for home ownership.*
- *Create the equivalent of the U.S. Small Business Administration.*
- *Draw from U.S. and international technical expertise in developing Cuba's banking and credit institutions.*
- *Adopt strict ethical standards, with adequate enforcement resources, governing financial information and transactions that prevent investor fraud.*

Limiting Corruption:

- *Develop a legal/regulatory system that complements economic development including an independent and professional judiciary to interpret laws and regulations and settle disputes.*
- *Establish a respect for the rule of law.*
- *Create a business culture that neither encourages nor tolerates corrupt behavior by either management or employees.*

Summary of Policy Recommendations, Continued

Export Oriented Business Enterprises:

- *Replace Decree Law 77 that governs foreign investment in Cuba.*
- *Privatize state-owned enterprises that engage in production for export or that monopolizes essential goods or services.*
- *Restructure existing export zones for offshore manufacturing platforms following “best practices” found in other developing countries.*
- *Given the likely importance of tourism revenues in generating the foreign exchange critically needed in the initial period of transition, Cuba should apply the export- zone concept to its tourism sector and provide duty-free access to the imported goods required by this sector.*

Rebuilding Physical Infrastructure:

- The U.S. should create a low or zero-interest loan fund to finance public infrastructure development for building new, or repairing existing, airports, seaports, and major elements of the ground transportation network.
- Introduce elements of market competition into the operations of airports and seaports through privatization of these facilities as part of the strategy for attracting FDI financing for rebuilding the nation’s infrastructure.
- Encourage FDI in developing electricity production and telecommunications infrastructure through financial guarantees against expropriation and regulatory actions that effectively represent a public taking of private property.

Business Management Education:

- Establish joint programs and cooperative agreements that create partnerships between U.S. and Cuban post-secondary educational institutions to deliver high quality instruction in business management practices, business ethics and international commerce.
- The U.S. should allocate ample scholarship funds that encourage private sector participation through matching grant mechanisms in order to fund higher education in Cuba.

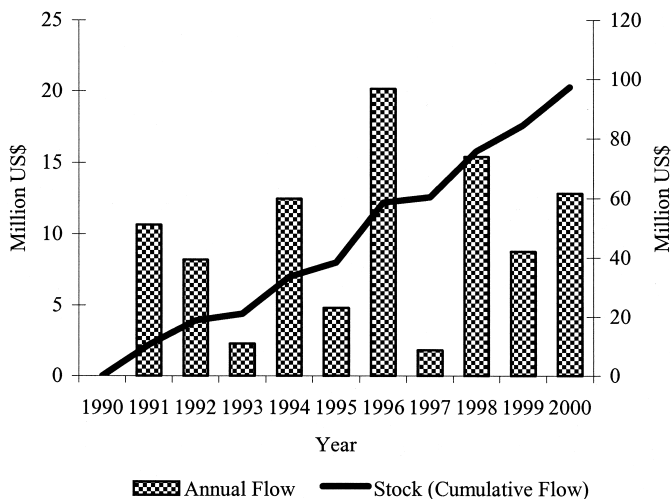
Introduction

One of the challenges faced by economies in transition from socialist, centrally planned systems to market capitalist systems is mobilizing the aggregate savings necessary to realize the expansion of capital needed to sustain rapid economic growth. Nations must often turn to external sources of financing in order to fill the gap between domestic savings and the requisite public and private capital investment. The role of foreign direct investment in meeting the external financing needs of developing countries and economies in transition has increased significantly since the early 1980s when external debt financing became more difficult to obtain.

After the collapse of socialism in the former Soviet Union, Cuba realized that its access to foreign lending was significantly limited, and its government reluctantly recognized that some form of foreign direct investment would be required. This led to the policy of allowing *Economic Associations with Foreign Capital* or joint ventures with foreign partners. Although these ventures have been reported with much fanfare, the actual dollar values of foreign investment flows (and stocks) have been very modest in comparative terms. According to U.N. statistics, Cuba's stock of foreign investment reached \$97 million in 2000 and from 1998 to 2000 the annual inflow of FDI ranged from \$9 million a year to \$15 million.¹ If the rate of annual inflow held up during the last two years, then Cuba's stock of FDI will reach between \$115 million and \$127 million by the end of 2002. The international financial climate, however, turned markedly worse in 2001 and in the first half of this year. The flow of FDI to Latin America as a whole declined in 2001 according to the U.N. Economic Commission for Latin America and the Caribbean, and it is, therefore, unlikely that Cuba was able to match the average annual inflows experienced from 1998 to 2000.

A comparison of FDI in Cuba to other Caribbean and Central American nations reveals that Cuba ranks at the bottom in terms of the absolute U.S. dollar volume of investment and in per capita terms. According to UNCTAD, Cuba's stock of FDI is considerably smaller than that of other, smaller Caribbean nations. For example, Cuba's stock of FDI in 2000 was less than one half of Haiti's stock of FDI, and one-third the size of Barbados's FDI. (See Table 1.) Even if one were to use the much higher levels of FDI reported by the Cuban government, Cuba's FDI stock would still be far behind countries like Panama, the Dominican Republic, Costa Rica and Jamaica.

Annual Flow (Left) and Stock (Right) of FDI in Cuba



The consensus among development economists is that FDI yields positive benefits to recipient economies, although the extent and dynamic nature of those benefits depends on the strategy and policies recipient countries use to attract foreign capital.² Countries that seek to attract FDI through generous tax preferences, direct and indirect subsidies or by relaxing labor and environmental standards run the risk of transferring the social benefits of FDI to foreign investors, cutting net benefits to zero or even negative values.

An alternate strategy is to expand and modernize the nation's physical infrastructure, improve the quality and effectiveness of social institutions, and raise the quality and productivity of its labor force. Pursuing the latter strategy not only serves to attract FDI, but also provides a foundation for creating competitive domestic firms. This strategy is less likely to result in the emergence of two separate classes of firms during a period of transition: 1) a profitable and dynamic coterie of foreign owned firms, and 2) a marginal and stagnant horde of domestic firms.

Citing the empirical work of Stein and Daude (2001), the Inter-American Development Bank reports that a number of indicators amenable to public policy actions appear to be important determinants of FDI in developing countries.³ High tax rates have a deleterious effect on FDI. The quality of the labor force (as measured by the proportion of the population older than 25 that have some tertiary education) and a quality index of infrastructure may have a positive influence on FDI, but their

impact appears to be small and not conclusive. There does, however, appear to be statistically conclusive evidence that the quality of social institutions (as reflected in measures of corruption, the rule of law, regulatory quality, government effectiveness, political stability, and political voice and accountability) has a direct effect on FDI.⁴

Cuba ranks among the bottom of nations in terms of the quality of its social institutions.⁵ Cuba ranked below the median index value in five of the six indexes of quality of governance compiled by Kaufmann, Kraay and Zoido-Lobaton (2002) – only in the index of political stability did Cuba score above the median.⁶ Cuba scored in the lowest quintile with respect to both political voice and accountability, and regulatory quality. The latter appears as the single most important governance characteristic in Stein and Daude's empirical study of the determinants of FDI. If one computes a composite quality of institutions index as a weighted average of the six governance indicators (with the weights determined by their estimated relative importance in determining FDI), then one finds that Cuba's overall quality of institutions index ranks in the 31st percentile.

While there is no doubt that FDI through joint ventures has been very important in expanding Cuba's capacity to earn much needed foreign exchange, the employment and income effects have been very limited.⁷ According to Villanueva (2002), only 19,800 persons were employed in domestic/foreign joint venture firms (less than 0.5 percent of the workforce), although the average wage including benefits in joint venture firms seems to exceed the national average. FDI has yet to yield the economic success that many had expected or hoped for, and has actually been a failure on two basic fronts. First, Cuba's strategy and regulatory policies governing FDI have failed to produce investment flows necessary to leave a clear, positive imprint on the economy, and, second, FDI has failed to produce either widespread economic benefits through inter-industry linkages or dynamic impetus for economic growth through sustained increases in productivity.

The obstacles that prevent the economic success of FDI in Cuba at present are also not likely to simply disappear by embarking on a path of transition to a market economy, unless a transition government abandons the strategy of targeting industries for FDI priority and its preference for case-by-case negotiations with potential foreign investors. The focus of strategy should be on laying the institutional and regulatory foundation that facilitates FDI in general. When formulating FDI policies and pro-

grams a new government would do well to focus on the factors that drive financial management decisions in market economies.

The following section of this paper illustrates that recognizing the FDI decision as a “capital budgeting” problem in corporate finance yields insights useful for identifying the basic determinants of FDI. In subsequent sections we offer some general recommendations for U.S. and Cuban government policies directly affecting FDI in a Cuban transition economy.

Table 1. Stock of Foreign Direct Investment (Million US\$)

COUNTRY/GROUP	1993	1997	2000	Rank Out of 22 in 2000
Developing countries: America	159,738	293,125	574,981	
Other America	79,188	117,169	189,076	
Antigua and Barbuda	380	481	564	14
Aruba	NA	482	732	13
Bahamas	587	1,014	1,564	9
Barbados	201	254	300	17
Belize	120	181	283	18
Costa Rica	2,097	3,568	5,196	5
Cuba	22	60	97	21
Dominica	121	236	276	19
Dominican Republic	1,085	2,223	5,214	4
El Salvador	255	480	2,001	8
Grenada	126	224	357	16
Guatemala	2,061	2,363	3,419	6
Haiti	158	162	216	20
Honduras	535	863	1,482	10
Jamaica	1,227	1,891	3,240	7
Montserrat	57	64	77	22
Netherlands Antilles	262	4,157	6,227	3
Nicaragua	239	624	1,373	11
Panama	2,585	4,957	7,108	1
Saint Lucia	449	580	831	12
St Vincent and Grenadines	104	315	524	15
Trinidad and Tobago	2,819	4,987	7,028	2

Source: United Nations Conference on Trade and Development, *World Investment Report 2001*.

Note: Stock of FDI is defined as the value of the share of capital and reserves (including retained profits) attributable to the parent enterprise, plus the net indebtedness of affiliates to the parent enterprises.

Principles of Corporate Finance and the Determinants of FDI

Corporate management must consider many of the same factors that are important in creating wealth from capital investments in their domestic markets when evaluating a potential investment opportunity located outside the firm's home country. FDI, however, presents special challenges including less familiarity with a foreign location's economic and regulatory environment, and greater uncertainty over future currency convertibility. A potential foreign investment creates additional wealth when the net present discounted value of its anticipated future cash flows is positive, and this depends on anticipated market demand conditions, costs and productivity trends, and consideration of risk arising from unpredictable market and regulatory events.

The explicit calculus of an investment's net asset value reveals that factors such as effective corporate income tax rates, the anticipated rate of depreciation (or appreciation) in the host country's currency, the degree of general market risk associated with operating in the host country, the effective cost of credit, and all of the factors that determine before tax operating profit margins, are all important determinants of foreign direct investment.

The value of a specific foreign direct investment project is inversely related to corporate income tax rates. The higher these are the smaller the asset value of FDI and, hence, the smaller the wealth created by a foreign investment project that is being considered. If the tax rate is too high, then the value of a potential FDI project may well be negative, indicating that the project will destroy value rather than create it. The project will, of course, not be attractive to management and shareholders in this instance. High tax rates that cannot be offset through higher output prices and/or lower unit costs will discourage FDI.

Taxes can be explicit or implicit. For example, when a government collects special fees on foreign exchange or banking transactions, these fees act in much the same way as taxes on gross revenues or profits. In the case of Cuba, where the government is a partner in virtually all FDI projects and where its "investment" in a project generally represents in-kind contributions of negotiated value, the government's negotiated share of operating income is effectively a tax.

The anticipation of a depreciation in the value of the local currency will similarly reduce the anticipated value of an FDI project, unless prices

and/or unit costs adjust to offset the effect of a currency depreciation on US\$ value of cash flows.⁸ The experience of countries characterized by significant periods of instability suggests that such offsetting movements in local currency prices or costs are unlikely during a period of macroeconomic instability. On the contrary, history suggests that wide differences in movements in exchange rates, prices and costs accompany periods of macroeconomic instability.

Economies characterized by chronic instability represent a more risky environment in which to operate and higher risks are reflected in a higher cost of financial capital. The cost of capital is a weighted average of the interest rate charged on borrowed funds, and the rate of return required by investors.⁹ The required rate of return to equity is directly related to the perceived risk of the investment. An increase in the cost of capital reduces the present value of anticipated positive cash flows. When the perceived risk associated with operating at a foreign location increases, it is more difficult to find investment projects that create value for foreign investors (i.e., have positive net asset values). When investors require a higher rate of return to equity, the cost of capital increases, increasing the likelihood that management will reject a specific investment project. When perceived risk drives up the cost of capital, foreign investors prefer investment projects that have short “payback periods.” That is, they prefer projects with high net cash flows in the immediate future, allowing them to recover their capital investment sooner rather than later. Short payback periods are more likely to occur in the export sector, than in the domestic sector of a transition economy.¹⁰

The cost of borrowing also directly affects the cost of capital, and, hence, low interest rates promote FDI while high interest rates discourage it. Foreign investors, in general, attempt to borrow funds denominated in the currency of the host country as they seek to leverage their equity investment. The host country’s government is unlikely to be able to assist the foreign investor with access to low interest debt financing when the FDI project requires the purchase of imported capital goods and the host country has poor access to international credit or faces prohibitive interest rates in the global capital markets. Cuba at present is certainly not in a position to assist foreign investors in this capacity, and unlikely to be in a much better position during the early stages of an economic transition to a market economy.

It is also clear that before-tax operating cash flows (the difference

between revenues and direct operating costs) are important parameters in the *ex ante* assessment of any FDI opportunity. Certainly this difference between revenues and costs depends upon the strength of demand in the market for the investment project's particular products/services, and also on average productivity. The levels of human capital embodied in the labor force are an important determinant of productivity and average costs. The same, of course, is true of public infrastructure that facilitates transportation and communication and lowers their costs. Average costs, however, include not only typical production costs, but also *institutional overhead* costs that may be a significant component of total costs. The latter include legal costs, the costs associated with maneuvering through the regulatory environment (including any "corruption tax"), and the cost of shaping regulations and economic policy. When the regulatory approvals, operating constraints, and applicable taxes and/or fees needed to implement an FDI project have to be negotiated on a case-by-case basis, these institutional costs increase operating costs and/or capital investment costs and, therefore, increase the likelihood that management will not find the FDI project financially attractive.

It is not surprising that levels of FDI in Cuba since 1993 have been sub par when compared to the flows of FDI that accrued to the region and to many Caribbean and Central American countries during the last decade. Considering the elements that comprise a financial assessment of FDI projects, it is likely that the comparatively poor performance in attracting FDI has been due to the high risks associated with investing in a fairly unpredictable environment as well as the high investment costs associated with negotiating the regulatory bureaucracy. Maneuvering through the regulatory maze has become so difficult that the European Union issued a report outlining investors' complaints and suggesting changes to the Cuban government.¹¹ Foreign investors complain of arbitrary and haphazard regulatory requirements that change constantly, prohibitively high government charges (disguised taxes) for banking and customs services, excessive overhead and unnecessary difficulties.

An understanding of the components that make up the financial evaluation of an FDI project can guide policymakers in developing and prioritizing strategies to promote foreign investment once the Cuban economy embarks on a transition path and international relations are normalized with the U.S. Abandoning Cuban-style socialism and normalizing commercial relations with the U.S. will undoubtedly expand interest in

FDI in Cuba. A transition to market capitalism implies that domestic and foreign firms will be free to enter into contracts with one another, and firms will be able to enter into employment contracts directly with workers and independent unions. It is also clear that a quick resolution to the issue of properties confiscated or nationalized by the present Cuban government is a pre-requisite to a significant inflow of FDI.

Recommended Strategies for Promoting FDI in a Transitional Cuban Economy

Setting Priorities

Quick and decisive action regarding economic policy will be necessary to lay the groundwork for a successful economic transition and attract high levels of FDI. Creating a stable macroeconomic environment, building market-compatible social institutions, limiting corruption, promoting the rapid expansion of export-oriented industries, rebuilding physical infrastructure, and expanding the management skill-base of the workforce should all be given high priority by the government of a Cuba in transition.

Establishing Macroeconomic Stability

One difficult challenge that Cuba should anticipate during transition is the maintenance of macroeconomic stability, which in turn reduces investment risk and the cost of capital, and encourages FDI. As difficult as this challenge may be, an unwavering commitment to macroeconomic stability is essential for promoting economic growth, as well as FDI over the longer term. Stability requires low rates of price inflation, low interest rates and avoidance of sudden and large variations in exchange rates (especially currency depreciations). There are no simple formulas for maintaining macroeconomic stability, but history suggests that there are some general guiding principles – control of the domestic money supply, fiscal discipline that avoids uncontrollable public sector deficits, eco-

nommic policy credibility, and barriers against excessive, speculative capital flows.

One of the first steps in creating a stable macroeconomic environment will be the introduction of a new unit of currency that establishes a rational and sustainable foreign exchange rate.¹² Cuba will need to quickly establish an abundant reserve of hard currency (U.S. dollars) in order to establish confidence in its new currency and defend it against sudden speculative pressures that may emerge during the early period of transition. The government should not try to rigidly adhere to a fixed exchange rate, but rather allow the currency's value to fluctuate within a reasonable band. U.S. and IMF financial assistance, preferably with the direct participation of Canada and Mexico, would be very valuable in establishing Cuba's reserves of hard currency. Perhaps as important as financial assistance, will be the willingness of the U.S. to send a strong message to the international financial community that it is committed to assist Cuba in a successful economic transition. The latter would enhance the credibility of a future Cuban government and its economic policies.

Macroeconomic stability imposes certain responsibilities on the Cuban government as well. The government will need to maintain fiscal discipline limiting the size of any fiscal deficits to reasonable proportions of GDP, while devoting a significant share of its expenditures to building physical infrastructure and human capital (education). The government will need to establish an efficient tax system that minimizes opportunities for tax evasion and keeps tax rates compatible with those of similar countries. Excessively high tax rates reduce global competitiveness and discourage FDI. A future government must be viewed as politically stable in order to establish the credibility of its economic policies, especially when those policies result in short term economic hardships and dislocations.

Building Market-Compatible Institutions

Many of the strategies and policies that support economic development in general are also supportive of FDI. Developing a well-functioning banking system and domestic capital markets are important for both economic growth in general and FDI. A regulatory structure that facilitates the development of a decentralized, private sector banking system

will be necessary as Cuba pursues a transition to a market economy. International banks should also be allowed to play a useful role in developing Cuba's future banking system.

Public sector financial institutions should complement a private banking sector to ensure that credit is also available to borrowers whose needs are unlikely to be met by the private sector. Public financial institutions, for example, can play an essential role in providing adequate credit to facilitate home ownership for a broad segment of the population. A pent-up demand exists for new housing and repairs to existing housing in Cuba. Home ownership financing is necessary for converting pent-up demand into effective demand and would give a boost to the construction industry. The latter would encourage Cuban exiles that have developed successful construction and land development firms in South Florida to invest in Cuba.

The equivalent of a U.S. Small Business Administration would not only yield significant benefits to economic development in general, but also play a significant role in encouraging FDI from Cuban expatriates. Many of these expatriates have already established successful small business enterprises in the U.S. and an SBA type of agency could provide the access to credit that would entice them to develop Cuban businesses. These enterprises would be atypical of most FDI in that they may be more likely to be oriented to serving the needs of the Cuban consumer market rather than exporting. The U.S. could not only provide Cuba with technical expertise in this area, but also provide funding to initiate the program. Programs of this type are designed to be self-financing, and, therefore, initial U.S. financial assistance would not be expected to become a long-term drain on U.S. public finances.

As noted earlier, financing FDI often involves tapping host country credit sources, as well as access to international banking services, since the bulk of FDI traditionally involves export-oriented activities. As Cuba embarks on a path of transition to a market economy it will need the technical expertise required for the development of a private enterprise banking system. Constructing a new Cuban banking system requires expertise in banking systems and practices in developed market economies, as well as knowledge of the difficulties encountered in developing a banking system in other transition economies and knowledge of the unique aspects of Cuba's economy and society. The diversity of experience and knowledge-

base needed to design a new banking system for Cuba could be realized by assembling a broad team of advisors including private and public banking officials representing the U.S., a cross section of other economies of the Western Hemisphere, multilateral economic development agencies and officials from countries with the direct experience of creating a banking system during a transition period.

Similar advisory councils would be useful in other key areas such as taxation, accounting standards, labor law, private and public pension systems, financial market regulation¹³ and environmental regulation. These advisory councils would provide a broad spectrum of experiences to Cuban policymakers that would assist them in developing their own institutions, and should include professionals with balanced training in the theory and practice of economic policy for small open economies. Policymakers would be well served by an awareness of the policy mistakes made by countries in transition, and from those made in Latin America's emerging markets.

FDI is influenced by many of the same institutional conditions that are now recognized as essential foundation for attaining long-term economic development objectives.¹⁴ A well functioning civil society – the characteristics associated with good governance practices – provides this essential foundation. Although a variety of indicators may be used to measure “good governance,” there appears a very clear direct correlation between good governance and development goals such as reducing poverty and infant mortality, and increasing human capital and per capita income.¹⁵ The accountability of government to society is a key aspect of governance and strengthening civil society not only improves accountability, but Stein's and Daude's (2001) empirical work suggests that it has a positive impact on FDI as well. Multilateral organizations and other international development aid institutions recognize that a broad network of NGOs working with external financial support and serving a broad range of public interests is an effective way to help strengthen civil society. Multilateral institutions should facilitate the development of independent NGOs in Cuba that are focused on strengthening political voice and accountability.

Confronting Corruption, The Rule of Law and the Role of the State in FDI

Confronting corruption in both the bureaucracy and in private enterprises needs to be given the highest strategic importance by a new Cuban government if economic transition is to yield significant benefits within a relatively short period. Widespread corruption is known to have a detrimental effect on economic growth and development, and empirical studies by Wei (2000) and Wei and Shleifer (2001) have shown that it has a negative impact on FDI as well. The experience with transition in the former Soviet bloc should remind us that a political battle between those who wish to build a Western-style democracy and market economy and those who wish to build personal wealth even at the expense of the new state and Cuban society.

Transitional economies have been plagued by corruption at various levels of government and in the private sector (Naím, 1995 and Pérez-López 1997). The need for a strong civil service system that supports a corps of professional public servants in transition economies is self-evident. The detrimental effect of corruption in the bureaucracy has long been recognized,¹⁶ but corruption within private sector enterprises – even “low intensity” corruption – may be equally detrimental to economic development. Reports of corruption within commercial activities in Cuba have become commonplace, and even acknowledge by the regime. The previously cited article in *The Economist* reports on a decision by a construction company to pull out of its partnership with the Cuban government after discovering “its partner was dipping into company funds and that workers were selling materials on the black market.”

While criminal and civil penalties against fraud and theft are necessary to combat corruption, it is also necessary to create a business culture that neither encourages nor tolerates corrupt behavior. No society can rely solely on criminal and civil statutes to regulate individual or corporate behavior. Corporate codes of conduct, monitoring of employee and executive behavior within enterprises, and individual internalization of a socially defined system of ethics are necessary to effectively combat corrupt business practices. Self-policing and peer pressure (the importance of reputation) can be effective and efficient mechanisms to combat low-level corruption.

In Cuba’s recent history an informal economy based on personal rela-

tionships, perk swapping, and reciprocal favors has been necessary to keep the broader economy afloat. Reliance on an informal network of “connections” has become a hallmark of consumer transactions as well as complex supply relations. Preventing the spread of informal, personalized business relations during Cuba’s transition deserves high priority. In a transition economy, these informal networks can degrade quickly into the type of crony capitalism and corruption that have plagued other transition economies (Cruz and Villamil, 2000), and can represent a serious constraint on FDI.

Cuba will need to quickly develop a legal/regulatory system that complements economic development, while ensuring market competition, preventing extreme income inequality and protecting the public health and the natural environment. The rule of law is one of the building blocks of economic development and there is a renewed appreciation among economists and other social scientists for the role of institutions in economic growth and development, and in promoting FDI.

MacLean Abaroa (1999) points to a changing role of the state with less direct intervention and a greater role in facilitating change, and a shift in focus from government to governance. The latter recognizes that governments alone are not able to deliver the necessary services and solutions required for an increasingly complex system of social relations, especially in developing countries. There will be a need to financially support objective research, public forums and education on the issue of legal reform as Cuba builds a new legal and regulatory system. Resources will be needed for the training of judges and judicial officers (including independent mediators). This will be a difficult and expensive task that may take many years to complete.

Successful transition to market economy requires a change in the role of the Cuban state from one of controlling and micro-managing economic enterprises to one of providing the legal and institutional framework within which enterprises manage their commercial relations. One clear example of where the current role of the state must change is in the regulation of FDI.

The law that at present governs FDI in Cuba¹⁷ represents an obstacle to foreign investment in a transition economy. This law strictly regulates the types of investment and operating conditions that must be adhered to by foreign companies operating either as joint ventures, within a business

alliance with Cuban partners, or on their own. This approach is incompatible with a market-based economy and must be abandoned.

Foreign companies should be free to form new companies with Cuban investors, establish business alliances or cooperative agreements, or set up their own operations in Cuba subject to little more than official registration. The same laws and regulations that apply to Cuban firms should govern foreign firms or their joint ventures. Special privileges uniquely for foreign firms should be avoided, along with special preferences or incentives for Cuban Americans or expatriates. Special privileges or exemptions from regulations often invite corruption and/or create market distortions with unintended, adverse consequences. At the same time, it would be a mistake to try to limit or block FDI in so-called “strategic” industries.

Privatization of state-owned enterprises could potentially spur a wave of FDI in the initial period of transition. Since the state currently plays a pervasive role in the production of virtually all goods and services of significant importance, privatization of state-owned enterprises (SOE) must represent a key element of Cuba’s successful transition to a market economy. Privatization will send a strong signal to market participants and potential foreign investors that Cuba is committed to establishing a free market economy. Privatization of state enterprises is likely to be a gradual process, however, if the present regime is replaced by a governing council comprised mainly of military leaders. Most of Cuba’s important industries are firmly under the control of the military, and relinquishing control of these enterprises would be against its narrow interest. Nevertheless, if the process of transition is to yield significant economic benefits for a broad segment of the population, SOE (most, if not all of them) will have to be privatized. It will then be necessary to resolve the issue of conflicting ownership claims prior to privatizing many SOE, and certainly before foreign investors take the risk of purchasing what are currently Cuban government assets.

While privatization of state-owned enterprise has been shown to stimulate an initial wave of FDI as economic transition commences, establishing the rule of law and limiting corruption will have more important long-term benefits. That is, privatization is unlikely to be a sufficient condition for creating a steady flow of FDI over the long-term, even as it is likely to be a necessary condition for creating that steady flow.

Export Promotion and FDI

FDI in developing countries is associated more often than not with exporting activities.¹⁸ FDI in export ventures are often a less risky proposition than FDI to serve the domestic market. Foreign firms looking for offshore production facilities to lower overall costs of production and increase profitability are very familiar with the market for their product (they may be producing for their own domestic market or for an established global market) and they have greater control over costs even when producing abroad. Offshore facilities may focus on a narrow aspect of the broader production chain. Revenues and costs are likely to be predictable with less uncertainty, and FDI for export purposes is likely to have lower cost of capital (other things equal). The aforementioned characteristics, of course, encourage FDI.

One of the fastest and most effective ways for Cuba to attract significant amounts of foreign investment is, therefore, likely to come from the restructuring of existing special export zones for offshore manufacturing facilities. Duty free import of components for manufacturing, assembly and/or further processing and then ultimately exporting would give an immediate boost to employment, even while the nation designs and builds a new regulatory structure for commerce and a new tax system. The development of new export zones to encourage regional decentralization of economic development may be necessary to maintain FDI momentum. The establishment of special economic zones can offer the benefit of concentrating public investment resources and efforts at developing effective institutions in small geographic areas where results are more quickly and easily achieved. Cuba is likely to become an attractive export platform for offshore manufacturing facilities serving the U.S. domestic market. Cuba should adopt those practices used in other developing countries that have been shown to yield the highest benefits for both foreign companies and their host countries.

In the case of tourism, U.S. firms operating in the leisure industry have the market experience and distribution channels to serve North American tourists very effectively. These firms could profitably leverage Cuba's natural resources to satisfy the U.S. tourism demand for warm climate, beaches and outdoor recreation activities. One of the attractive features of the tourism industry is the relatively labor intensive nature of pro-

duction. Since high unemployment often accompanies economic transition, the expansion of the tourism sector would help the nation fill the anticipated employment gap.

The *special-export-zone* concept can also be applied to tourism. Providing duty free access to imported supplies may encourage FDI in hotels and resorts that cater mainly to foreigners. Duty free access to imports, however, should be phased-out over time in order to encourage supply linkages between tourism and domestic industries.

Rebuilding Cuba's Physical Capital Infrastructure

The collapse of the Soviet Union and the end of the Soviet's massive subsidization of Cuba's economy marked the beginning of a precipitous deterioration in the nation's physical capital infrastructure. Highway networks, basic roads, port facilities have all fallen into major disrepair, while the telecommunications network has become antiquated and inadequate for the needs of a modern, globally integrated economy. The quantity and quality of an economy's capital infrastructure encourages private capital investment by reducing cost of production and increasing profitability.¹⁹

The levels of investment associated with infrastructure projects are usually very large in comparison to other types of FDI, and represent a special degree of risk even for large transnational companies – particularly in areas such as electricity production and telecommunications. The latter are two areas of capital infrastructure that deserve special priority given their importance to the total productive capacity of the economy, and the potential to represent economic growth bottlenecks.

A transition government should, therefore, consider providing special assurances against expropriations or regulatory actions that effectively result in the taking of private property from foreign investors. These assurances could take the form of legally enforceable agreements to surrender Cuban government owned assets held in foreign countries in the event of expropriations without fair compensation. Actions like these would have the added benefit of sending a signal to other foreign investors that future expropriations without compensation would be highly unlikely in a future Cuban government, and help to build confidence

that economic reforms are irreversible.

FDI that is oriented towards export activities is particularly sensitive to the condition of an economy's infrastructure. Ports, major highways, and telecommunications networks are essential for moving goods to market and establishing effective communication links between buyers and sellers. Airports and seaports will be critical to the development of Cuba's tourism sector. The public investment required to bring public infrastructure to levels that can promote significant amounts of FDI and support rapid economic development, however, are likely to exceed the Cuban government's capacity to self-finance those projects.

The U.S. could accelerate the development process in Cuba by creating a public capital infrastructure development fund, financed by the U.S., providing long-term (low interest) loans to Cuba for building or repairing highways, bridges, public buildings, airports and seaports. These funds could be structured to provide incentives for the selection of U.S. companies in the awarding of construction and engineering contracts – thereby strengthening commercial ties between the two countries. In addition, interest payments and even principal repayments could be partially forgiven according to the achievement of certain milestones regarding the creation and strengthening of democratic institutions. The use of such incentives may be a politically sensitive subject, but similar types of reward mechanisms have been used with respect to the achievement of environmental goals.²⁰ Democracy in Cuba has *public goods* characteristics and *positive externalities* like environmental conservation and environmental quality.

The U.S. could, of course, also strongly support multilateral lending programs that provide financing for infrastructure development through traditional multilateral development financing programs. These programs would not provide the commercial preferences for U.S. companies and unlikely to have any financial incentives for the development of democratic institutions.²¹

Rebuilding Cuba's infrastructure also presents an opportunity to attract FDI. Air and seaports are large infrastructure facilities that provide a variety of services – some or all of which can be operated by private companies. Port facilities can be fully privatized – where a private company builds and operates the facility, secures the financing and is responsible for the liabilities – or partially privatized with only some of

the services delivered under private ownership. Alternatively, concessions may be granted so that even infrastructure built with private funds ultimately return to public ownership. For example, government may provide a long-term lease for the land and private businesses build and own the structures, which convert to public ownership upon the expiration of the lease.

In the initial period of transition, it may be easier for large transnational firms to raise the capital necessary to build new ports or modernize existing ports than for the Cuban government. Hence, privatized airports and seaports may represent an option for developing much-needed infrastructure within a short time frame. It will be necessary in these cases, however, to ensure that port charges and user fees do not result in excessive economic rents that restrict economic growth. A regulatory structure that balances private and public interests is necessary in the case of privately owned and operated infrastructure.

Management Education for a Globally Integrated Market Economy

It also clear that higher productivity (reflected in lower costs per unit of output, or average costs) encourages FDI. Rebuilding Cuba's physical infrastructure (transport and communications) is a key element in raising productivity, and international assistance – both financial and technical – will undoubtedly be necessary given the apparently dismal conditions on the island. Building the knowledge- and skill-base of the workforce is, however, no less important in lowering average costs. Scientific and technical knowledge are important, but managerial and entrepreneurial skills are also essential for growth and development in a market economy.

Joint programs between educational institutions in Cuba and institutions in the U.S., as well as other nations of the Hemisphere can be effective in educating a new public sector bureaucracy and private sector managers in the workings of a market economy. General management programs that involve leadership training, managing change and business ethics are also critically important. Cooperative business education programs are already in place, but need to be expanded to include more U.S. institutions.²² Education and training can be provided in traditional degree formats (such as bachelors, masters, and Ph.D. programs) or more targeted, non-degree programs (such as executive seminars and work-

shops). It is in the interests of the U.S. to provide management training to as many of Cuba's managers and government civil servants as possible, and U.S. scholarships for this purpose are likely to both facilitate economic transition and encourage FDI during a transition period. U.S. underwriting of business management training and incentives for private sector matching funds represents a good investment in solidifying the transition to a market economy and democracy.

The U.S. Government's Role in Cuba's FDI

The appropriate U.S. role during an economic transition is not to promote FDI in Cuba *per se*, but rather to help establish the foundation for a successful and rapid transition to a market economy and representative democracy. Market forces will direct FDI to Cuba as a result of the transition, the establishment of a stable democracy, and the inherent long-term strengths of the Cuban economy. With such a foundation in place, Cuba will attract a significant share of the region's flow of FDI as the *risk adjusted* rates of return to FDI in Cuba are likely to be markedly higher than in other parts of the region during the short- and medium-run following the start of transition. Investment flows attracted solely or primarily by U.S. financial incentives without developing the foundation for long-term growth will have only transitory effects and be unsustainable in the longer run. Nonetheless, there are U.S. policy actions that can facilitate economic transition and help to ensure its success and durability.

If a transition to democracy occurs quickly, then Cuba will need almost immediate access to the expertise and information required to take appropriate economic policy actions. The U.S. should be ready to assist Cuba during such a period by compiling a library of professional studies, academic articles, literature surveys, news articles and interviews directly related to the challenges of economic transition and public policy.

The U.S. should also assist in the creation of a directory of experts in the various fields of economic transition and development (for example: macroeconomic policy, international trade policy, financial and commercial institution building, legal system and judiciary, privatization, small business development, and civil society). This directory of experts could be used to assemble a team of advisors in key policy areas. These actions would build a knowledge base that a Cuban government could easily

access during the early phase of economic transition.

Under the appropriate business and regulatory environment, Cuba can expect a flood of new U.S. tourists drawn away from other Caribbean destinations (and away from Florida's coastal destinations as well), and re-routing of cruise-ship itineraries. Similarly the growth and development of export zones in a Cuba embarked on economic transition may very well lead to a shift in FDI from Caribbean nations. These developments may have significant detrimental effects on the economy of some of the U.S.'s Caribbean trading partners (and perhaps, Southeast Florida as well). The U.S. should be ready to mitigate these negative economic impacts in the short- and medium run.

It would be a mistake for the U.S. to adopt special fiscal incentives (tax breaks or subsidies) for U.S. companies that invest in Cuba, as this would lead to an artificial competitive advantage that may later be difficult to dismantle. Instead, the U.S. should assist Cuba in ways that strengthen the foundation of a market economy. As earlier suggested, the primary focus of U.S. policy toward Cuba during a transition to democracy and a market economy should be: 1) facilitate technical assistance in the area of economic policy, and in strengthening structures of governance and civil society; 2) provide financial assistance necessary to attain macroeconomic stability; and 3) lead a multilateral effort to provide the financing needed to rebuild physical infrastructure in ways that promote economic development that is spread across the island.

Conclusion and Summary of Policy Recommendations

The history of transition has offered many lessons since the collapse of communism in the late 1980s and early 1990s. Public policies directed toward building a market system must be adjusted to fit the unique cultural and historical contexts of each nation, and the path of economic transition has been more difficult than was conceived in the years immediately following the collapse of communism. The economic transition guru's of that early period focused on a basic formula – privatization and liberalization – to unleash the growth potential of capitalism. But mainstream economic thinking during that period under-appreciated the role played by social institutions in the market economy and failed to give the

difficulty of building market-compatible social institutions its due consideration.²³ Well-functioning social institutions (“good governance”) are widely recognized today as the necessary foundation of a well-functioning market economy, and building the institutional infrastructure that is required of market systems has proven to be a difficult and slow process – and too often the casualty of interest group political warfare.

The key elements necessary to promote FDI include: macroeconomic stability; minimum corruption in the public and private sectors of the economy; a rational commercial legal and regulatory code consistent with the basic requirements of market economies; good governance structures and civil society; a strong physical and human capital infrastructure; and a strong export sector that provides an adequate inflow of foreign exchange earnings. We have outlined a series of recommended strategies consistent with these fundamental elements, and these are summarized in the table below.

The institutional infrastructure necessary to provide a foundation that supports steady inflows of FDI is the same as that which fosters long-term economic growth and development in general. Much of the institution building efforts and public policy strategies needed to lay a solid foundation for Cuba’s economic growth and development will require significant amounts of technical assistance in a variety of areas. The logistics of institution building seem overwhelming, and E. Betancourt (2000) has compiled an extensive list of areas where technical assistance will be necessary from meeting basic humanitarian needs during the initial period of transition to framing a new legal system and developing a professional civil service.

One question that arises immediately when considering the future of FDI in Cuba during a transition to a market economy is what should be the role of U.S. policy. The U.S. should resist pressures to adopt special fiscal incentives (tax breaks or subsidies) for U.S. companies that invest in Cuba, as this would lead to an artificial competitive advantage that is likely to be difficult to dismantle at a later date.

The U.S. should, instead, assist Cuba in ways that: 1) strengthen the foundation of a market economy by facilitating technical assistance in the area of economic policy and strengthening structures of governance and civil society; 2) provide financial assistance necessary to attain macroeconomic stability; and 3) provide direct financing and lead a multilateral development financing effort to rebuild the nation’s physical capital infrastructure.

Summary of Policy Recommendations

Priorities:

- *Establish macroeconomic stability – low inflation and stable exchange rates.*
- *Develop market-compatible social institutions that support long-term economic growth.*
- *Limit corruption as much as possible.*
- *Promote the rapid growth of export-oriented private business enterprises. Rebuild economy's physical infrastructure.*
- *Facilitate the development of business management skills necessary for success in a globally integrated market economy*

Macroeconomic Stability:

- *Introduction of a new currency establishing a rational and sustainable foreign exchange rate.*
- *Credible policy commitment to fiscal and monetary discipline.*
- *Establish foreign exchange reserves necessary to avoid short-term speculative pressures on the currency. (This is likely to require foreign assistance directly from the U.S. but preferably from the IMF.)*
- *Establish an efficient tax system that can raise sufficient revenues without excessive tax burdens or excessive distortions to market-driven relative prices.*

Market-Compatible Social Institutions:

- *Create a well-functioning banking system and domestic capital markets characterized by a decentralized, competitive private sector banking system that includes participation of international banks.*
- *Establish mechanisms and structures that ensure credit is available to small and medium size enterprises and provides an ample supply of credit for home ownership.*
- *Create the equivalent of the U.S. Small Business Administration.*
- *Draw from U.S. and international technical expertise in developing Cuba's banking and credit institutions.*
- *Adopt strict ethical standards, with adequate enforcement resources, governing financial information and transactions that prevent investor fraud.*

Limiting Corruption:

- *Develop a legal/regulatory system that complements economic development including an independent and professional judiciary to interpret laws and regulations and settle disputes.*
- *Establish a respect for the rule of law.*
- *Create a business culture that neither encourages nor tolerates corrupt behavior by either management or employees.*

Summary of Policy Recommendations, Continued

Export Oriented Business Enterprises:

- *Replace Decree Law 77 that governs foreign investment in Cuba.*
- *Privatize state-owned enterprises that engage in production for export or that monopolizes essential goods or services.*
- *Restructure existing export zones for offshore manufacturing platforms following “best practices” found in other developing countries.*
- *Given the likely importance of tourism revenues in generating the foreign exchange critically needed in the initial period of transition, Cuba should apply the export- zone concept to its tourism sector and provide duty-free access to the imported goods required by this sector.*

Rebuilding Physical Infrastructure:

- The U.S. should create a low or zero-interest loan fund to finance public infrastructure development for building new, or repairing existing, airports, seaports, and major elements of the ground transportation network.
- Introduce elements of market competition into the operations of airports and seaports through privatization of these facilities as part of the strategy for attracting FDI financing for rebuilding the nation’s infrastructure.
- Encourage FDI in developing electricity production and telecommunications infrastructure through financial guarantees against expropriation and regulatory actions that effectively represent a public taking of private property.

Business Management Education:

- Establish joint programs and cooperative agreements that create partnerships between U.S. and Cuban post-secondary educational institutions to deliver high quality instruction in business management practices, business ethics and international commerce.
- The U.S. should allocate ample scholarship funds that encourage private sector participation through matching grant mechanisms in order to fund higher education in Cuba.

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NOTES

¹ *World Investment Report 2001: Promoting Linkages*, U.N. Conference on Trade and Development (Geneva: UNCTAD, 2001). Private organizations that promote U.S.–Cuba trade and the Cuban government cite much higher levels of foreign investment. The U.S. Cuba Trade and Economic Council, for example, cites US\$ 1.7 billion in investment in 1999, while Perez Villanueva (2001) cites Cuban Central Bank figures of \$1.6 billion. The UN Economic Commission for Latin America and the Caribbean reports that \$60 million in FDI flowed into Cuba from 1995 to 2000 (*La Inversion Extranjera en America Latina y El Caribe: 2001*). Jorge Perez-Lopez (2000) and Emily Morris (2000) have pointed out the difficulties in confirming and interpreting Cuba's official balance of payments statistics, raising doubt as to their accuracy. The components of the capital account (which includes FDI) are especially troublesome according to Morris, noting the presence of large and unexplained capital outflows reported as "other capital." It is also worth noting that Cuban authorities include much more than investments of hard currency in calculating the total value of foreign direct investment. They include the value (certified by Cuban authorities) of machinery and equipment, intangible property (copyrights, patents...) and "other goods and rights."

² Inter-American Development Bank, *Competitiveness: The Business of Growth* (2001), p. 252.

³ E. Stein and C. Daude, "Institutions, Integration and the Location of Foreign Direct Investment," paper presented at 2001 Annual Meeting of the Inter-American Development Bank, Santiago, 2001.

⁴ Inter-American Development Bank, *Competitiveness: The Business of Growth* (2001), Table 18.1 p. 262.

⁵ These measures of governance were developed by Kaufmann, Kraay and Zoido-Lobaton, "Governance Matters II: Updated Indicators for 2000/01," World Bank Working Papers, January 2002.

⁶ The means by which political stability is obtained is not considered by this index, although it may be indirectly and partly captured in the index of "political voice."

⁷ Omar E. Perez Villanueva, "Cuba: An Overview of Foreign Direct Investment," working paper, Economics Department, Carleton University, Ottawa Canada, February 2002. Dr. Perez Villanueva is a researcher with the Center for the Study of the Cuban Economy at the University of Havana.

⁸ Anticipated appreciation of the currency increases the expected value of an FDI project.

⁹ The proportion of capital costs financed with debt and with equity, respectively, determines the weight of each type of financing.

¹⁰ A government investment partner can, of course, structure the receipts of its

share of profits so that they actually occur further out into the future, allowing the private sector partner to recover their equity investment much sooner than otherwise. This arrangement is not likely to be attractive, however, to a foreign exchange starved government partner.

¹¹ *The Economist*, “The Americas: The Disaster is Now Irrevocable – Cuba’s Economy,” London. July 6, 2002.

¹² Cuba policymakers should resist the temptation of formally “dollarizing” the economy, as this strategy has not been the magic cure for the macroeconomic challenges that periodically afflict developing economies. The conversion rate between the current Cuban peso and the new currency must be consistent with a real exchange rate that can be sustained over the short and medium term.

¹³ Recent experience has highlighted the importance of ethical standards and adequate government oversight over the practice of providing financial information to investors, and Cuba would do well to establish strict financial reporting standards and provide sufficient enforcement mechanisms.

¹⁴ As noted earlier, the empirical work of E. Stein and C. Daude (2001) lends support to this view.

¹⁵ M. Gonzalez de Asis and J. Acuña-Alfaro, “Civil participation in national governance.” World Bank Working Papers, May 2002 (draft version).

¹⁶ See Chapter 2 in *Anticorruption in Transition: A Contribution to the Policy Debate*. World Bank Report, 2000.

¹⁷ Decree Law 77, *Foreign Investment Act*, 5th of September 1995.

¹⁸ In 2000, approximately 44% of the value of Latin America’s exports originated foreign firms, according to ECLAC (*La Inversión Extranjera en la América Latina, 2001*).

¹⁹ Inadequate and unreliable infrastructure in developing countries typically require manufacturing firms to hold higher inventories than the same type of enterprise typically requires in developed countries. These excessive inventories, combined with high real rates of interest, result in higher cost of production and loss of global competitiveness (J. L. Gausch and J. Kogan (2003)).

²⁰ For example, debt relief has been provided in exchange for protection of the rainforest or other ecologically sensitive areas.

²¹ Rebuilding Cuba’s public capital infrastructure should be compatible with the goal of achieving geographically dispersed development across the island and avoid an unequal geographic distribution of economic development.

²² Expansion of cooperative business education programs (which include a period of U.S. residency) should be considered even prior to the beginning of transition.

²³ The term refers to the social institutions necessary to exercise power in the management of a country’s economic and social resources to achieve development.

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Robert David Cruz received his Ph.D. in Economics from the University of Pennsylvania (Philadelphia) in 1985. His Bachelor of Arts degree, awarded in 1978, is from Georgetown University (Washington, D.C.). Dr. Cruz has held the position of Associate Professor of Economics and International Business in the Andreas School of Business of Barry University (Miami Shores, Florida) since 1993. Dr. Cruz also serves as senior consulting economist with The Washington Economics Group, Inc., a Coral Gables-based economics consulting firm.

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