

# Robbing Peter to Pay Paul

## *Cuba's Fifty Years of Failed Socialism*

Korok Ray

For the fifty years of its existence, the Republic of Cuba has held a position on the world stage out of proportion to its 11 million people and \$145 billion GDP.<sup>1</sup> This is because Cuba is the last bastion of pure communism in the Western hemisphere, one extreme on the continuum of economic systems where a single party plans all economic activity, silences political opposition, and seeks to provide a broad social safety net. Although the U.S. trade embargo on Cuba is often the focal point of popular debate, the main problem with Cuba is not the trade embargo, but rather the failed socialist policies of the Castro administration. These policies provide a vivid illustration of central planning gone awry in Cuba's labor, housing, and agricultural markets. Fifty years after the revolution, Cuba is still poor and, despite their pure motives, the economic policies of socialism and forced income redistribution are squarely to blame.

**The Fusion of State and Market.** In Cuba, the state controls a vast majority of economic activity. With the small exception of private restaurants and joint ventures with a handful of companies, there is effectively no private sector. The government is the largest employer, landlord,

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and provider of social services on the island. The government also sets almost all wages and prices in the economy, ranging from the salary of a physician to the price of cigars to the rent for an apartment.

Consider the structural differences between a capitalist and socialist economy. In a capitalist economy, the corporation employs the individual, captures the worker's output, and pays him wages. The corporation is an especially important entity in a capitalist economy, as it is a legal creature that is born, lives, and may die. In Cuba, the corporation has no official existence, nor do any of the markets (equity,

effectively two currencies in circulation in Cuba. The first is the Cuban peso. The government pays its citizens in pesos, and, aside from in tourist areas, Cubans use pesos for their daily transactions. The other currency is the Cuban Convertible Peso, or CUC, which is pegged to the U.S. dollar. For years, the circulation of dollars was illegal on the island, even though dollars crept in through the informal market. After the fall of the Soviet Union, Fidel Castro opened up the island to tourism, which became Cuba's major industry, and this brought more dollars. The shift to an emphasis on tourism is evident in Cuba's economic data, which show that

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debt, venture capital) that surround the corporation. Thus, ownership in Cuba is limited, and more dispersed. It is impossible to own shares of private enterprises because such enterprises are illegal. Instead, by virtue of passing their output to the government, all individuals effectively own a small share of the entire society. The relevant notion in Cuba is public, not private property. Aside from the few private enterprises that exist, individuals do not have any claim to ownership of their output and are not exposed to taxation. This blending of public and private interests defines Cuba's economy.

**The Double Economy.** There are

total expenditures on tourism in 2003 reached almost \$2 billion.<sup>2</sup> In 2003, the hotel and restaurant contribution to Cuba's GDP reached 28.8 percent.<sup>3</sup>

Raul Castro, Fidel's younger brother and the current head of state, has said the double economy is hurting Cuba. This is true for two reasons. First, the peso is weak relative to the dollar: the exchange rate is twenty-three pesos to a single dollar. Second, Cuban citizens have uneven access to the dollar economy. Those whose goods and services are consumed by tourists have a disproportionate economic advantage since they will earn their living in a more valuable currency. This can distort incentives to invest in human capital over the long

term and therefore shift the allocation of capital and labor away from what is socially optimal. A Cuban taxi driver can earn as much from tips in a single cab ride as he could in a month from his salary paid by the Cuban government. While this makes the cab driver better off, it also provides incentives for young men and women to become cab drivers rather than doctors and lawyers, who have less exposure to the dollar economy. In most economies, skilled labor earns a higher return than unskilled labor because it is more productive to society. In Cuba, unskilled labor (the taxi driver) can earn more than skilled labor (the doctor) due to this uneven access to the dollar economy.

Problems in the Cuban labor market also originate from the fact that the government sets the wages of all its workers and, guided by the egalitarian principles of socialism, it sets them close together. For example, monthly wages range from approximately four hundred pesos for unskilled labor, such as factory work, to seven hundred pesos for doctors.<sup>4</sup> Though it is admittedly difficult to measure productivity in Cuba because the individual is not the residual claimant to his income and passes all of his output to the government, the income distribution is nonetheless far less variable than the distribution in productivity.

There are adverse economic consequences from compressing income distribution. While the policy of underpaying doctors and overpaying plumbers may have the benefit of creating a more equal society, it has the side effect of distorting the efficient allocation of labor. Like all forms of investment,

human capital investment is sensitive to its rate of return; the higher the eventual returns tomorrow, the greater the incentives to invest today. Lowering the return on high productivity work and raising it on low productivity work dampens incentives for tomorrow's generation of workers to invest in extensive education to take those skilled labor jobs. Also, if skilled workers can earn higher wages in market economies elsewhere, this gives them an incentive to leave the country, which is exactly what Cuban doctors have done over the last several years.<sup>5</sup> While this form of global trade in labor is efficient because labor moves to its place of highest productivity, losing such skilled labor is detrimental to Cuban society. The government has dealt with this by placing severe restrictions on immigration rather than increasing wages for skilled labor nearer the market rate.

**The U.S. Embargo.** The United States imposed its trade embargo on Cuba in 1962 and has maintained it, in some form or other, ever since.<sup>6</sup> At its basic level, the embargo prohibits trade between the United States and Cuba. President George H. W. Bush signed the Torricelli Act before he left office, which prevents subsidiaries of U.S. corporations in foreign countries from trading with Cuba.<sup>7</sup> President Clinton was allegedly planning on loosening the embargo, but backlash from the anti-Castro community in Miami led Clinton to sign the Helms-Burton Act of 1997, which allows American citizens to sue foreign corporations that benefited from Cuba's expropriation of U.S. assets immediately after the revolution.<sup>8</sup> President Bush added

additional restrictions on visits between Cuban Americans and their relatives in Cuba,<sup>9</sup> which President Obama reversed in April 2009.<sup>10</sup>

The embargo is a form of economic warfare with its origins in the wave of anti-communist sentiment that pervaded the United States in the 1960s and 1970s. It is designed to block trade, starve the Cuban economy, and thereby incite the Cuban people to revolt and overthrow the Castro government. As both the Castro family and the embargo have been in place for fifty years now, the embargo clearly has not achieved its objectives. In fact, Castro has been able to use the embargo as a scapegoat for all of Cuba's economic problems. Thus, rather than fomenting sedition among the Cuban people, the embargo creates hostility towards the United States.

Yet despite Castro's claims, the embargo is not the primary source of Cuba's economic failure. While the embargo prohibits trade with the United States, it does not isolate Cuba from the rest of the global marketplace. Cuba's main export partners are China and Canada, which together account for 60 percent of Cuba's total exports. Cuba's main import partners are Venezuela and China, which account for 29.6 percent and 13.4 percent of total imports, respectively. Additionally, Cuba has exports of \$2.4 billion, ranking 114 out of 226 world countries.<sup>11</sup> Thus, Cuba does have access to a significant amount of global trade to stimulate economic growth, even though it cannot access the U.S. market.

**The Housing Market.** Like many markets, the government also dominates the housing market. One peculiar

fact is that there is no housing foreclosure in Cuba. Because the government serves as both landlord and employer, if an individual does not pay rent, the government can simply confiscate future earnings. Considering the extent of the housing crisis that currently plagues the United States, this is a benefit. But a major downside of government management of the housing sector is the inability to quickly respond to changing demand. In a market system, an increase in home demand causes prices to rise. Over time, these high prices induce more construction until this increases the supply of homes, eventually causes prices to fall. Government-controlled housing, on the other hand, cannot make these adjustments if government officials are not monitoring demand on a daily basis. In Havana, an increase in population has increased demand for housing, yet the government has been slow to increase supply. In 2004, there was an estimated shortage of 1.6 million dwellings in Cuba.<sup>12</sup> Multiple families live in single-family homes, waiting their turn for the government to eventually build them new houses. Families are also forced to live in outdated homes. According to a United Nations program in historic Old Havana, the area experiences almost two partial collapses every three days.<sup>13</sup>

**Agricultural Markets.** Agriculture remains a mainstay in the Cuban economy, comprising 4.6 percent of GDP and employing 21.2 percent of the country's labor force.<sup>14</sup> However, the structure of the Cuban economy ensures that even this sector is not immune from inefficiencies. For some

products, the government is the primary producer, and therefore the primary buyer, of a farmer's output. For example, the government produces the infamous Cuban cigar, and to do so it buys 70 percent of the output of the country's tobacco farmers.

For other goods, farmers sell their output directly on one of two separate agricultural markets, which means that food effectively has two prices on the island. The first market is called the "free market," where farmers sell their output to distributors, who then sell the food according to market prices. This is similar to farmers' markets elsewhere, in which farmers or suppliers quote prices and consumers are free to choose the quantities to buy based on those prices. The government, however, has deemed the equilibrium market price too high, and therefore it has established a second market where the government enforces rigid price control. In this second type of market, the government caps the price of food below the equilibrium market price, so Cubans can have their choice in purchasing their groceries at two different prices.

These twin agricultural markets, of course, exhibit the classic symptoms of government price control. Because prices for farmers are higher in the free market, fewer of them enter the cheaper, second market. Consumers, on the other hand, rush to the cheaper market, so demand outpaces supply and shelves are soon left bare. The free market also attracts better produce that farmers know will fetch a better price. Any visitor to Cuba will notice the empty cupboards or long lines at the government market and the higher quality of produce in the free market.

The only way the government could eliminate the excess demand created through a price ceiling would be through an agricultural subsidy in which the government buys food from farmers at above market prices and sells that food to consumers at below market prices, thus taking a loss on every transaction and forcing it to make up for this loss elsewhere in the economy. Even capitalist economies like the United States routinely subsidize their agricultural markets, but the critical point is that Cuba must pay for this subsidy by raising taxes elsewhere. Thus, Cuba needs to decide which of its markets are most competitive internationally and tax those in the strongest position to subsidize the weakest. While this form of income transfers between sectors of the economy is not without its own problems, it does lay bare the harsh truth that Cuba, like any nation, cannot prop up all its sectors at once.

**Policies for the Future.** The U.S. embargo against Cuba is controversial both because it has levied a steep penalty on the Cuban people and because it has not moved the island any closer to democracy over the last fifty years. On top of this, the embargo gives the Castro brothers a scapegoat for Cuba's problems. Therefore, the United States should drop the embargo and allow trade with the island. That way, the Cuban people can see for themselves how much of their economic condition depends on trading with a single partner. Most likely, dropping the embargo will have a small economic effect on Cuba, but a large political effect. With the embargo gone, the Castro brothers would have no one to blame for eco-

conomic mismanagement but themselves.

The big gorilla in the room is not the embargo, as Fidel would insist, but rather the extreme socialist policies of the Castro administration. A good first step toward liberalization would be for Cuba to relinquish its socialist agenda by relaxing many of its arcane and unnecessary laws on all manner of political and economic behavior. This includes

ernment could effectively offer tax credits to farmers who supply food at low prices. This way, the farmer can keep a larger share of his output because he faces a smaller tax burden. In exchange, he can provide food at a lower price to consumers. There will be heterogeneity among the farmers, and the better farmers who are able to supply provisions at a lower price will benefit the

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laws that restrict mobility between town and country, laws that suffocate private enterprise, and laws that control prices and wages in various markets.

But this may be too large a step. To his credit, Raul Castro has moved the economy toward free markets. For example, he has encouraged the reformation and revitalization of joint ventures between foreign companies and the Cuban government, which are the dominant mode of financing for the major international hotels that now populate parts of the island. Moreover, in his various speeches, Raul has encouraged farmers to produce more and urged Cuban citizens to work harder. While this focus on domestic production is a step in the right direction, he needs to take more aggressive steps than mere political rhetoric. Cuban citizens, like all individuals, react to incentives, and therefore the Cuban government needs to consider individual incentives at the core of any adjustment to their economic policy.

In the agricultural market, the gov-

most from this tax credit, forcing the inefficient farmers to exit the industry. On immigration, if the government still wishes to restrict mobility between town and country, and between Cuba and other countries, it should at least allow citizens to buy their way out of the regulation. Immigration laws that restrict mobility are most onerous on the high productivity workers who cannot realize their economic gains. For example, the social cost of retaining a doctor in Cuba exceeds that of retaining a plumber. But if the best doctors could buy their way out of regulation, at least the government would earn revenue that it could allocate elsewhere. This is superior to erecting rigid immigration rules that restrict mobility and keep people on the island by fiat.

In the labor market, the government should either get the market to determine the wages of Cuban citizens or, failing that, at least set wages that more closely approximate productivity. In the current system, Cubans lack incentive to work and produce, which is the heart

of economic growth. At least pegging these wages to their market equivalents in capitalist economies may be one way to approximate productivity measures.

The enduring paradox of socialism is the beauty of its idealistic objectives and the ugly reality of the society it creates. The key problem is that socialism neglects that unavoidable and essential feature of human nature, individual self-interest. While socialism's vision of an equal and fair society is seductive, its neglect of the basic truths of human

nature dooms the resulting society to economic failure. After fifty years, Cuba is a shining example of why socialism does not work, and serves as a sobering warning to governments around the world of implementing a system that seeks to institutionalize idealistic egalitarianism without acknowledging the inevitable role of self-interest.

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#### NOTES

1 Central Intelligence Agency, "Cuba," *The World Factbook*, Internet, <https://www.cia.gov/library/publications/the-world-factbook/geos/cu.html>. The listed figure is at purchasing power parity. Cuba's GDP is \$55.18 billion at official exchange rates.

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4 "Economía," Granma Internacional, Internet, <http://www.granma.cu/espanol/2009/economia1.html>.

5 "Cuban Doctors Seek Path to U.S." *National Public Radio*, 20 February 2007, Internet, <http://www.npr.org/templates/story/story.php?storyId=7492240>.

6 Miguel A. Faria, *Cuba in Revolution—Escape From a Lost Paradise* (Macon: Hacienda Publishing, Inc., 2002).

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8 H. R. 927, Sec. 3, "To seek international sanctions against the Castro government in Cuba, to plan for support of a transition government leading to a democratically elected government in Cuba, and for other purposes."

9 John-thor Dahlburg, "Cuban Americans Rush to Visit Kin While They Can," *LA Times*, 30 June 2004.

10 Anthony Broadle, "Obama to Abolish Limits on U.S.-Cuba Family Ties," *Reuters*, Internet, <http://www.reuters.com/article/topNews/idUSTRE5326HV20090404?feedType=RSS&feedName=topNews>.

11 Central Intelligence Agency, "Cuba."

12 Eric Driggs, "Deteriorating Living Conditions in Cuba," *Focus on Cuba* 59 (2004), Internet, [http://ctp.iccas.miami.edu/FOCUS\\_Web/Issue59.htm](http://ctp.iccas.miami.edu/FOCUS_Web/Issue59.htm).

13 Ibid.

14 Central Intelligence Agency, "Cuba."