

## CUBA'S ROAD TO SERFDOM

*Carlos Seiglie*

The last decade of the 20th century was marked by a profound change in the structure of the international political system and with it the foreign policy priorities of the United States. Yet, one policy that has remained unchanged for close to 40 years has been the use of a unilateral embargo on Cuba with the presumed objective of provoking a change in the behavior of a dictatorial and repressive government. That policy has continued in light of the evidence that the efficacy of unilateral economic sanctions in effectuating political change is at best inconclusive. In fact, Kaempfer and Lowenberg (1988) illustrate how domestic politics influences the design and severity of the sanctions to account for the varying interests of different constituencies (see Seiglie 1997 for an application to the case of Cuba).

### The Politics of Isolating Cuba

The political motivation for the U.S. embargo on Cuba varied over two distinct time periods. The first was formulated during the Cold War era when the Soviet Union posed a credible national security threat. During that period, the embargo on Cuba could be viewed in the broader context of a foreign policy of containment of the Soviet Union's sphere of influence. In that context, if the embargo imposed a cost on the Cuban economy, part of it would have to be borne by the Soviet Union through greater subsidies to its client state, thereby reducing the available resources posing a threat to the United States. At the same time, the policy complemented the desires of the Cuban-American community who wanted the ouster of the Castro regime.

With the end of the Cold War and the collapse of the Soviet Union, the international transfers that kept the Cuban economy afloat during the previous period and provided Cuba with no incentive to make

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Carlos Seiglie is Associate Professor of Economics at Rutgers University.

profound economic and political adjustments ended (see Perez-Lopez 1995 for a discussion of the events). Given this situation, Castro proceeded to make feeble attempts at surviving by initiating changes such as permitting foreign investments in the economy. The U.S. response has been to adjust its unilateral sanctions by passing legislation such as the Cuban Democracy Act (1992) and Helms-Burton (1996). Those bills were presumably designed to reduce the flow of investments to Cuba by international investors who felt that the returns from investing and trading with Cuba after Castro's opening were greater than those offered by other opportunities. The legislation attempted to do so by imposing a cost on those who did business with Cuba in a series of tie-in arrangements or linkages. In economic terms, the United States attempted to force the world community to internalize what it perceived as a negative externality being generated by these countries' decision to trade and invest in Cuba.

Yet, a more thoughtful analysis of the embargo during this latter period will indicate that it has continued primarily to appease domestic interests. Furthermore, it has not been designed with the objective of imposing a large enough cost on the Cuban economy to effectuate a change in Castro's behavior. In fact, the effectiveness of the embargo is negligible, imposing relatively small costs on the Cuban economy. For example, although there are restrictions on trade by U.S. firms and subsidiaries with Cuba, the policy continues to permit travel and remittances by Cuban-Americans to Cuba under the pretext of humanitarian assistance. These capital flows are much larger, more stable, and more predictable than foreign investments in Cuba. One of the first principles learned in economics is that resources are fungible—resources that flow into Cuba as direct investment from Spain are no less humanitarian than those that flow in from Miami. If the objective is to impose the greatest harm on Cuba's economy, then this loophole must first be closed.

To emphasize the size of the loopholes, in March 1999 the U.S. Department of State estimated that foreign entities had invested \$1.7 billion dollars in Cuba since 1990, or slightly more than \$188 million dollars annually. Contrast this with the fact that in the 1990s remittances to Cuba by Cuban-Americans, which are permitted by law, averaged about \$250 million dollars per year. Similarly, while U.S. citizens not of Cuban origin are not permitted to visit the island without U.S. government approval, 124,000 U.S. citizens of Cuban descent visited the island in 1999, primarily using the travel services of Cuban government-operated Havanatur. Their expenditures while visiting Cuba provide a sizable flow of international reserves that help keep the Cuban economy afloat.

Given the questionable efficacy of those sanctions (not to mention the moral authority that any government bestows upon itself to interfere in either domestic or international trade), I argue that we should not fear the consequences of eliminating the embargo, since there are many other economic policies enacted by Cuba's current regime that provide little incentive for foreigners to invest in Cuba. As illustrated below, these policies stifle the level of production and, therefore, Cuba's ability to develop economically. Furthermore, ending the embargo would also serve to eliminate the pretext that Cuba's socialist experiment would work if not for the U.S. sanctions.

### The Foreign Investment Law: Economic Mismanagement or Premeditated Exploitation?

There is currently an estimated 4,500 companies from more than 100 countries "doing business" with Cuba (U.S.–Cuba Trade and Economic Council 2000). Foreign companies operating in Cuba must hire workers directly through the state employment agency, ACOREC. Under current practice, firms pay the agency in U.S. dollars, and workers are paid a fraction of the amount in nonconvertible pesos. In the jargon of economics, the state wants to act as a monopsonist (i.e., a single buyer) in the labor market by requiring all firms to hire workers through ACOREC. In effect, the Cuban state has become a big employment agency. As economic theory suggests, this monopoly in the hiring of labor depresses wages below what would exist in a competitive labor market and reduces employment below the competitive level. In effect, the Cuban government is able to extract as an implicit tax the difference between what they receive from foreign firms and what the government pays workers. ACOREC extracts a high dollar wage from foreign firms by virtue of its market power and, in so doing, captures economic rents.

The total amount extracted can be calculated by multiplying the number of workers who can actually find work in foreign enterprises at the higher wage rate charged by the state times the implicit tax rate. Foreign companies are currently paying the Cuban government an average of \$500 a month for each worker. The Cuban worker in turn receives 300 Cuban pesos or \$14.00 a month from the government agency at the most favorable exchange rate (average monthly wage for all Cubans was reported by the government to be 223 pesos in May 2000).<sup>1</sup> The state extracts on average a whopping \$486.00 a month per worker—a measure of the extent to which the Cuban

<sup>1</sup>The data are from the U.S.–Cuba Trade and Economic Council.

government is victimizing its own workers. In 1999, the Cuban government reported that the number of nationals receiving U.S. dollar bonuses or U.S. dollar-based bonuses was nearly 1.8 million (out of a workforce of 4.5 million). Of these, the latest estimate for the number of Cubans being hired through ACOREC by 350 foreign firms is 75,000.<sup>2</sup> If we multiply this amount times the amount extracted per worker by the Cuban government, we arrive at an estimate for the implicit tax on workers of \$36.5 million dollars a month. Annually, this amounts to \$438 million dollars or over 2.3 *times* the annual rate of foreign investment in Cuba.

### The Gains from Economic Freedom

Creating a free labor market in Cuba would benefit Cuban workers by increasing their real wages and increasing the number of jobs. The net gain to society from this change in policy would be quite large. As the government permitted workers to deal directly with foreign firms, the equilibrium wage and the level of employment would rise, which would increase production. The net gain to society is measured by the difference between this increase in output and the opportunity cost of the incremental workers hired (see Harberger 1971). Stated differently, the Cuban government's current policy of not permitting Cuban workers to deal directly with foreign firms imposes a deadweight loss on society.

The size of the deadweight loss can be estimated as follows. Suppose that the average monthly wage received by the Cuban government per worker employed in joint ventures is \$500.00 as reported. At the current exchange rate, the average Cuban worker receives approximately \$14.00 a month of this from the state. The most conservative estimate is that 75,000 workers are employed in joint enterprises. Furthermore, suppose the uncompensated wage elasticity of hours worked (elasticity of labor supply) is 0.5. Then, assuming the supply and demand for labor are linear, the loss in production is \$16 million dollars a month or \$192 million dollars a year below where it would be if the government permitted a competitive labor market to exist that resulted in Cuban wages rising to \$50 a month or to a \$600 annual salary. The deadweight loss to society is \$170 million dollars a year.

If competitive labor market conditions raised average Cuban wages to \$100 a month or to a \$1,200 annual salary, the estimates for the loss

<sup>2</sup>As reported in *El Nuevo Herald (Miami Herald)*, March 18, 1999 from Agence France Presse.

in production from failing to enact this policy rises to \$27.5 million a month or \$331 million dollars annually. This amount is *twice* the annual amount invested in Cuba by foreigners over the last decade. The social welfare losses from continuing the current policy would be \$268 million dollars annually. These estimates rise dramatically if we assume that the wage elasticity of hours worked is higher than 0.5. It is clear that Cuba is paying a high price for regressing to serfdom.

Yet, as large as this cost may be, it is only a fraction of the total cost that the government's policy imposes on society. The reason is that for the state to remain a monopsonist in the labor market and, therefore, to continue to extract the rents granted by having this privileged position, it has been essential for the state to deny Cubans the right to freedom of contract in the labor market and the right to own private property. If the government enacted the economically sound policy of massive privatization, labor markets would become competitive. The government's monopsony power would break down since each worker would have the option of either working at the government's lower wage—seeking individually or collectively to buy out some state-owned firm and become the recipient of the residual income—or instead work for some other domestic private firm that offers them higher compensation, possibly in the form of an equity stake in the enterprise. The power of the Cuban government to exploit the workers would therefore be eliminated. Finally, it should be pointed out that since the current policy reduces the level of employment, the marginal productivity of capital and return to capital (net of risk) is currently lower in Cuba than it would be if the Castro government initiated the appropriate reforms.

Cuba cannot develop economically if it continues to permit only foreigners, and not its citizens, to own private property. Granting workers the right to own property will result in an increase in saving and development of the capital markets. Equally, reforming the capital markets so that all Cubans may borrow and lend will lead to the development of small businesses which are so essential in achieving a high level of development.

## Conclusion

Official figures show that foreign investment in Cuba since 1990 has been substantially smaller than the amount sent by Cuban-Americans in the form of remittances and other assistance permitted by loopholes in U.S. sanctions. Even if the U.S. embargo were lifted, the low returns to capital resulting from the mismanagement of the economy under the Castro regime would not lead to any major capital

inflows. With so many investment opportunities available in the developed and developing world, Cuba is just one more capital-hungry country competing for funds. It is important not to lose sight of the basic fact that as compared to the cost that Cuba imposes on itself by restricting freedom of contract and private ownership, the potential effect that the U.S. embargo has on the Cuban economy is negligible. The Castro regime has only itself to blame for its predicament.

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