State Capitalism in Cuba: The Lessons of the Literature on State Owned Enterprises and Market Liberalization

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STATE CAPITALISM IN CUBA: THE LESSONS OF THE LITERATURE ON STATE OWNED ENTERPRISES AND MARKET LIBERALIZATION

D. Daniel Sokol

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The basic theory of market liberalization is a simple one—create proper incentives based on property rights, contractual enforcement, competition, well-functioning financial markets, effective corporate

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2. See generally HERNANDO DE SOTO, THE OTHER PATH: THE INVISIBLE REVOLUTION IN THE THIRD WORLD (1989). See also Gillian K. Hadfield, The Many Legal Institutions that Support Contractual Commitments, in HANDBOOK OF NEW INSTITUTIONAL ECONOMICS 175, 17576 (Claude Menard & Mary M. Shirley eds., 2005) (surveying the literature); DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 54 (1990) (“[T]he inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment in the Third World.”).


governance, investor protection, trade openness, and rule of law/legal institutions. These ingredients plus the effective organization of the institutions of government and the markets lead to economic growth. Yet, creating such change is not easy nor does it occur without economic and social disruption and without pushback from entrenched interests. Thus, the promise of market liberalization has not always delivered.

In this context of liberalization and privatization, Cuba is charting a path that many countries have already transitioned to over the past 25 years. However, Cuba has a potential late-mover advantage as it transitions to a market economy. In addition to a rich theoretical literature in economics on how best to establish market mechanisms, there is also significant empirical literature describing both what worked and what are the shortcomings in the implementation of market liberalization and privatization of state owned enterprises (SOEs). This literature also speaks specifically to the Latin American experience. Overall, Latin America, with a history of statist intervention extending into the 1990s (and in some cases due to popular resurgence, more recently as well), lagged behind US, European, and East Asian development. Since the

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7. See generally Rafael La Porta et al., Investor Protection and Corporate Valuation, 57 J. FIN. 1147 (2002).
11. William Megginson, Privatization and Finance, 2 ANN. REV. FIN. ECON. 145, 146 (2010) (“Well over 100 empirical studies have examined the economic and financial performance of privatized companies or industries, either on a case-by-case basis or using multinational or multicompany datasets.”).
1990s, Latin America’s growing pains in introducing liberalization have been significant. As such, Cuba can learn from the mistakes made in prior Latin American (and other) market liberalizations to create a more effective strategy to bring economic prosperity to its people.

The reason why SOEs and liberalization matter so much for Cuba is that Cuba lacks capital to improve its infrastructure, modernize its existing SOEs, and invest in growth. Liberalization can help transform Cuba and promote the well-being of its citizens. Part of this liberalization will occur by reforming Cuba’s SOEs (including privatization). Changes to SOE structure to liberalize SOEs can have profound changes on the Cuban economy. If a country improved the efficiency of SOEs by a mere 5%, the World Bank estimates that in that country, this efficiency gain could free up approximately 1–5% of a country’s GDP. Greater privatization and market liberalization, if managed properly with an effective competition policy framework, can create dynamic growth that can help navigate Cuba out of a potential middle income trap (once the initial growth/catch up phase has subsided).

Part of the complexity of Cuban economic liberalization is that both the future and pace of its transition are unclear. Though Cuba has slowly begun liberalization, whether the current pace of gradual change and the desire to maintain that change within a socialist system will continue remains unknown.

Cuba has gone through phases of liberalization, including most importantly the Lineamientos de la política económica y social del

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Competition – the rivalry between firms – benefits countries and people through various channels. First, a solid competition framework provides a catalyst to increase productivity as it generates the right incentives to attract the most efficient firms. Second, a strong competition policy can be an effective tool to promote social inclusion and reduce inequalities as it tends to open up more affordable options for consumers, acting as an automatic stabiliser for prices. Third, competition promotes innovation as firms facing competitive rivals innovate more than monopolies. Competition mechanisms can even help deliver on other strategic objectives, such as environmental or health benefits.

Id.
Partido y la Revolución in 2011, in which the Communist Party outlined market liberalization in Cuba though the government still maintained substantial control over the economy. In some ways, Cuba’s current undertaking seems to be a similar model to the Chinese experience. China has managed its state capitalism in a gradual way across a number of areas of its governance. As Calomiris et al., describe:

China’s approach to privatization and liberalization has been piecemeal and gradual, and state dominance over economic affairs remained largely intact during the process of privatization. During the 2001 episode that we study here, when the government contemplated the sale of remaining state shares in partly privatized firms, the Chinese government’s proposed sale of its shares did not coincide with a broad economic liberalization. Thus, actual and prospective privatization in China occurred within an unusual economic and political environment, in which the government maintained substantial control over the economy.

However, the Chinese model of SOE reform and liberalization is not the only one. By improving relations with the United States, the speed of Cuban liberalization may change. Similarly, as the leaders of the Cuban revolution ages out, the next generation of leaders may have a different agenda, particularly because the regime that traditionally propped up the Cuban economy (Venezuela) is itself in significant economic turmoil and no longer capable of subsidizing Cuba. Increased tourism and trade with the United States also might lead to greater knowledge diffusion, in part through increased use of internet and mobile telephony, which may facilitate increased demand by the Cuban people for more political freedom to go hand in hand with more economic freedom. Further, because of historic ties and a large Cuban-American lobbying group,

17. ECURED, Lineamientos de la política económica y social del Partido y la Revolución, (2013), http://www.ecured.cu/Lineamientos_de_la_pol%C3%ADtica_econ%C3%B3mica_y_social_del_Partido_y_la_Revoluci%C3%B3n [https://perma.cc/A6QN-SK8T].
U.S.-based government aid and private investment might be conditioned on certain economic changes or simply may create a pressure point for the Cuban government to liberalize further in order to benefit from the potential size of U.S. investment. The future political economy of Cuba remains uncertain, but any of the above options are possible, as are many alternatives.

This Article outlines core concerns for Cuba in its market liberalization process. First, from the agency cost perspective, it explores the limitations of SOEs versus private (publicly traded) firms. Then, it examines the empirical literature on SOEs and SOE reforms and privatizations. Next, the Article offers a number of possible policies going forward that will allow Cuba to reform its state capitalism to benefit Cuba’s consumers. Such reforms include SOE corporatization, SOE privatization, and the introduction of a competition policy system to Cuba (as effective corporate governance and competition may be substitutes for each other).

I. SOEs, Incentives and Performance

SOEs differ from privately owned firms in terms of their incentives and, as a result, their corporate governance structure. First, unlike private firms, SOEs are not necessarily profit maximizers. Hence, SOEs perform worse than private firms. SOEs perform poorly because they have more severe principal agent problems than private firms do. Privatization can significantly mitigate the agency cost problem of SOEs because market mechanisms can be used with regard to managerial compensation. Nevertheless, the decision to privatize can be highly political, even when privatization itself would improve firm performance. In a traditional private firm (whether privately held or publicly traded), managers are compensated for their performance, which better aligns incentives between owners and managers to reduce agency costs.

24. Privatization can significantly mitigate the agency cost problem of SOEs because market mechanisms can be used with regard to managerial compensation. Nevertheless, the decision to privatize can be highly political, even when privatization itself would improve firm performance. I. Serdar Ding & Nandini Gupta, The Decision to Privatize: Finance and Politics, 66 J. FIN. 241, 248–50 (2011).
alignment decreases the agent’s temptation to shirk their managerial responsibility. One way in which this is done is through incentive based pay.

Paradoxically, SOEs exist in large numbers despite the theoretical and empirical justifications to move to full privatization. State capitalism survived the liberalization and privatization wave of the 1990s and 2000s worldwide, including in Latin America. Indeed, in many countries, SOEs produce 20-30% of its GDP. There are a number of reasons for this. First, SOEs and state capitalism may have cultural factors. Second, Chinese SOEs in particular make up a large number of the Fortune Global 100 in terms of revenues. Third, in some areas, larger political preferences may justify state ownership under certain circumstances, such as in the provision of public goods like education and health care.

But the SOEs of today bear little resemblance to the SOEs of the 1980s: today’s SOEs may be publicly traded as an SOE hybrid of mixed ownership (with both minority and majority owned by the state); or may be modeled on a corporatized form. This holds true for both OECD countries and emerging markets. Thus, many SOEs have moved to a profile in which metrics of profitability are more important than they once were, which has led to the restructuring and reformation of SOEs. Consequently, the view of a monolithic SOE that relies on central planning is a relic of the past in most countries other than Cuba.

The limits of SOEs encompass a broad literature but I provide some basic points herein. A traditional SOE does not align incentives—whether a manager performs well or poorly they are paid the same. As

29. Id. at 407.
33. Id. at 2.
such, SOE managers do not have effective mechanisms of accountability to the SOE and its owners.\textsuperscript{35} Privatizing ownership and creating pay incentives through bonuses and stock ownership alleviates this agency cost problem.\textsuperscript{36} Further, SOEs may have multiple objectives that conflict: profit maximizing may not align with other goals such as employment\textsuperscript{37} or social goals.\textsuperscript{38} Both of these factors play some role in reducing SOE efficiency and in limiting the success of SOEs relative to private corporations.\textsuperscript{39}

Empirical work on stock and bond markets and SOEs supports the prior theoretical scholarship. With regard to equity markets, Chen, Firth, and Xu find that a change in control over to private hands leads to better financial performance.\textsuperscript{40} Ben-Nasr, Boubakri, and Cosset analyze the political determinants of the cost of equity with a data set of 236 firms that were privatized between 1987 and 2006 in 38 countries.\textsuperscript{41} They find that the cost of equity increased with government ownership.\textsuperscript{42}

New research on debt markets also sheds light on SOE performance. There should be a risk premium associated with borrowing money for an SOE. Banks should lend at a higher rate of interest to SOEs since SOEs are more likely to be poorly managed relative to private firms. However, because the government either explicitly or tacitly guarantees SOE debt (which it does not do for most private firms),\textsuperscript{43} SOEs have an advantage over their private competitors. Recent work by Borisova et al., examine bond credit spreads to find that SOEs are generally associated with higher cost of debt but have lower cost of debt during a financial crisis.\textsuperscript{44}

The picture of SOEs and debt is clearer based on the amount of state ownership. Borisova and Meggison find that as firms privatize they

\begin{footnotesize}
\begin{itemize}
\item[37.] Maxim Boycko et al., A Theory of Privatisation, 106 Econ. J. 309, 309 (1996).
\item[39.] Musacchio & Lazzarani identify these two problems as Type I (corporate governance and Type II (fiscal governance) problems of SOEs. Musacchio & Lazzarani, supra note 28, at 10.
\item[40.] Gongmeng Chen et al., Control Transfers, Privatization, and Corporate Performance: Efficiency Gains in China’s Listed Companies, 43 J. Fin. & Quantitative Analysis 161, 188 (2008).
\item[41.] Hamdi Ben Nasr et al., The Political Determinants of the Cost of Equity: Evidence from Newly Privatized Firms, 50 J. Acct. Res. 605, 608 (2012).
\item[42.] Id. at 639.
\item[43.] Giuliano Iannotta et al., The Impact of Government Ownership on Bank Risk, 22 J. Fin. Intermediation 152, 154 (2012).
\end{itemize}
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confront a higher cost of debt as the amount of state ownership diminishes. However, after completing privatization, companies that fully privatized have lower credit spreads than firms that only partially privatized. These findings suggest that investors are more concerned with partial privatization than full privatization because the role of the state in a partially privatized firm is murky and creates investment risk.

Industrial policy also plays a role within a broader SOE and state capitalism agenda. Government has an interest in ensuring that its SOEs succeed. As such, the government as regulator may restrict competition by providing various benefits to SOEs that it does not offer to other firms. Though this might result in direct preferences to SOEs, it may also create indirect preferences, such as implicit loan guarantees for favorable lending, regulatory preferences such as the creation of a large monopoly position in related industries, limitations on foreign ownership, or hidden subsidies through either no taxation or more lax corporate governance requirements vis-à-vis private firms. Other studies provide initial analysis of sovereign wealth funds and their level of independence from government control (and political objectives), of Chinese SOEs and their governance both home and abroad, and of state ownership and industrial policy in antitrust/industrial organizations that distort competition. These issues will confront Cuba as well, depending on the industries and companies that Cuba views to be “strategic.”

II. SOLUTIONS

A. Privatization

The economic impact of privatization of SOEs has been tremendous. As Megginson notes, “[s]ince 1977, governments around the world have raised almost $2.0 trillion by selling SOEs to private investors and corporations.” He adds that success occurred because “privatization has proven influential because of the industrial and financial importance of

46. Id.
48. Megginson, supra note 11, at 147.
the companies selected for divestment because the largest sales were executed through [share issue privatization] that massively impacted national stock market capitalizations and liquidity.”

Cuba may want to follow some kind of sequencing of privatization. Even partial (non-majority) privatization has reduced traditional SOE problems, at least in the case of Indian SOEs that were partially privatized. Further, according to work that examines privatizations from 1990 to 2001 and includes 25 countries, sequencing privatizations gradually (rather than all at once privatizations) leads to more effective outcomes. Work by Vaaler and Schrage provides additional understanding on how best to stage privatization. A non-controlling (minority) stake for partially privatizing SOEs signals state support for the enterprise in countries where the possibility of investment policy reversal is high, but that such policy has limited time duration effectiveness. Empirically, financial returns are abnormal for the first one to two years after privatization when partial state ownership ranges from 15–30%. Related work by James and Vaaler finds that minority state ownership (particularly in countries with low state stability) reduces the risk of low policy stability and that when the state owns 21–30% of a project’s equity, the risk decreasing effect of minority state ownership maximizes.

Research has not yet answered a question on sequencing and effects post privatization. We do not know if privatization would be more effective if the stock were listed in a local market versus in the U.S., U.K., or dual listed markets. That is, does the bonding hypothesis (where higher quality standards in U.S. and U.K. markets bonding firms to better corporate governance) hold for partially private (but still SOE controlled) firms? There is evidence that cross listing leads to better corporate governance for Brazilian, Korean, and Indian firms. The evidence, however, does not clarify whether this results from a self-selection effect

49. Id.
53. Id. at 635–36.
in which the cross listing itself indicates the existing quality of corporate governance; or whether the very process of cross listing improves corporate governance. In the case of Chinese SOEs, foreign listings may also serve the private interests of SOE managers rather than those of shareholders.\textsuperscript{56} One study finds that non-politically connected firms do better in foreign stock listings in terms of greater profitability, but that politically connected firms provide more benefits for managers (with poorer performance)—such politically connected SOE managers were more likely to receive media attention and promotion to a senior government position within a five year period after the foreign stock listing.\textsuperscript{57}

When governments choose partial privatization, they retain some ownership, either as the majority or minority shareholder. These firms perform better than 100\% government owned SOEs but less well than 100\% privately owned firms.\textsuperscript{58} How well these firms perform relies in part on how much government interferes with the profit-making mission that a purely private firm would have.\textsuperscript{59}

\textbf{B. Corporatization}

Through increased corporatization SOEs have tried to mimic private firm governance. In the Chinese setting, increased corporatization has led to improved performance because of better monitoring and a reduction of agency costs.\textsuperscript{60} This only partially fixes the issue as private ownership still leads to greater returns than does government ownership.\textsuperscript{61} Where the gains of privatization have been limited, it may be because even after an IPO, a controlling stake of the SOE remains in government hands.\textsuperscript{62} In such settings, incentives within the firm may not fully align to reduce agency costs.\textsuperscript{63}

Indeed, even from the standpoint of SOE managers, responding to a

\begin{itemize}
  \item \textsuperscript{56} Mingyi Hung et al., \textit{Political Considerations in the Decision of Chinese SOEs to List in Hong Kong}, 53 J. ACCT. & ECON. 435, 436 (2012).
  \item \textsuperscript{57} \textit{Id.} at 448.
  \item \textsuperscript{58} Gupta, \textit{supra} note 50, at 1011.
  \item \textsuperscript{59} Other forms of state ownership include state owned holding companies (to control a number of SOEs), state development banks, and sovereign wealth funds. However, these variations of state capitalism are beyond the scope of this Article.
  \item \textsuperscript{60} Varouj A. Aivazian et al., \textit{Can Corporatization Improve the Performance of State-Owned Enterprises Even Without Privatization?}, 11 J. CORP. FIN. 791 (2005).
  \item \textsuperscript{62} Chen et al., \textit{supra} note 40, at 161–62.
  \item \textsuperscript{63} Gongmeng Chen et al., \textit{Have China's Enterprise Reforms Led to Improved Efficiency and Profitability?}, 7 EMERGING MKTS. REV. 82 (2006) (providing evidence of more limited value of Chinese privatizations in which the state retains a controlling interest.).
\end{itemize}
desire to increase firm performance creates problems since SOE managers “will bear many of the costs (i.e., angry workers, disgruntled suppliers) . . . Thus managers of SOEs have no incentive to improve efficiency or develop innovative and new products.”

Yet, the same managers from SOEs perform better under private ownership. This suggests that the incentive alignment problem can be solved long term. In the near term, increased corporatization may on the margins improve SOE profitability and also serve as a first step to eventual privatization.

C. Performance Contracts

Regulation provides one way to address the principal-agent problem when the regulator is the principal and the agent is the regulated firm. This solution is effective in some industry settings (although within private firms). Performance contracts create a mechanism to reduce monitoring costs by decreasing information asymmetries and allowing for benchmarking of performance of SOE managers. Overall, however, high powered incentives may limit this approach because it may create opportunities for capture of the regulator.

D. Introduce Competition Policy

Cuba needs to introduce competition. This includes both reducing barriers to entry as well as introducing a competition law. Competition law and policy play an important role to ensure that the gains of market liberalization accrue to consumers rather than to monopolists. As privatization begins, private monopoly should not replace public monopoly. Further, favored firms may lobby government to create restraints against new entrants under the guise of public interest that

68. The potential of capture in such settings presents a role for competition advocacy. For an overview of such advocacy, see Allan Fels & Wendy Ng, Rethinking Competition Advocacy in Developing Countries, in COMPETITION LAW AND DEVELOPMENT (D. Daniel Sokol, Thomas K. Cheng, & Ioannis Lianos eds., 2014); Dae-Sik Hong, Competition Advocacy of the Korean Competition Authority, in COMPETITION AND THE STATE (Thomas K. Cheng, Ioannis Lianos, & D. Daniel Sokol eds., 2015).
instead may hurt consumers.\footnote{71} Instead, the Cuban economy must be liberalized as part of a broader competition policy to reduce barriers of entry for new businesses and to allow new businesses to innovate.\footnote{72} Cuban companies have thus far been shielded from competition. As with other monopolists, this means that Cuban firms innovate less than firms in other countries that face competition.

Competition also protects against collusion.\footnote{73} When firms illegally raise levels above the competitive price, it has negative repercussions across the entire Cuban distribution chain and victimizes consumers. The introduction of anti-cartel law also protects against bid rigging in public procurement tenders.\footnote{74}

Domestic cartels may not be impacted by the benefits of international trade because such cartels may arise in the non-tradable sectors of the economy.\footnote{75} The lack of a competition culture also needs to change in Cuba. Promoting a competition culture creates social sanctions for cheating the people of lower prices for private gain.

**III. Conclusion**

There are a number of possible ways forward for Cuba and its introduction of greater economic liberalization, privatization and competition. These strategies are not mutually exclusive and different strategies may be taken for different SOEs depending on the


\footnote{75} D. Daniel Sokol & Andreas Stephan, *Prioritizing Cartel Enforcement in Developing World Competition Agencies*, in *COMPETITION LAW AND DEVELOPMENT*, supra note 68 at 141.
particularized facts of the SOE and its industry. Managing liberalization and privatization allows Cuban consumers to enjoy the economic benefits that the market can provide in terms of greater growth and innovation.
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