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Economic Reforms in Cuba and the United States:

Sure, I CAN Invest ... but Should I?

By: Andrew C. Adair

April 25, 2015

To say that the recent developments in the U.S. – Cuba relationship will lead to more investment on the island is a dramatic understatement. Indeed, each step taken by the country's leaders represents a historic step forwards on the long march to normalization of relations and open trade. However, the slew of positive developments to this date are limited to surface level concerns that, while important changes to make, do not do enough to legitimize investment in Cuba. In this way, the positive developments resemble internal reforms in Cuba designed to attract foreign investment that put Band-Aids on gushing wounds. Absent from recent discussions, for example, are efforts to enhance government transparency, as well as structural reforms to Cuba's legal system.

For our purposes, it is important to distinguish between types of investment. Some firms want higher risk and seek out investments in developing countries to capitalize on uncertain environments and generate higher returns.¹ Mainstream investors are generally more risk averse and are unable to hedge against increased risk. Cuba is not ready for these investors yet. This paper begins by explaining the

¹ See, e.g., Tom Herzfeld, Interview: A Glimpse into the Future of the U.S. Private Investment in Cuba, Wharton: Knowledge, available online at <http://knowledge.wharton.upenn.edu/article/the-future-of-us-private-investment-in-cuba/> (Mar. 13, 2015) (“We’re looking for returns in excess of what people would make in private ventures and more plain-vanilla investments. And we want the risk. People who are investing with us are willing to take the risk. We want that risk.”).

significance of recent developments in relations between the two countries, as well as some obstacles to further developments. Part II juxtaposes internal reforms in Cuba with some of the major obstacles discouraging investment in Cuba. Part III discusses the use of risk assessments by investors, and notes that Cuba's risk is still fairly high. In sum, the positive developments during the last few years effectively make it legal for U.S. companies to invest in Cuba. But Cuba still has a long way to go to make its business climate attractive to such investment.

I. DEVELOPMENTS IN THE U.S. – CUBA RELATIONSHIP

The recent push by Barack Obama and Raul Castro to normalize relations between their two countries generated widespread attention in the financial press. The attention is warranted: these efforts paved the way for future investment in Cuba by eliminating several important barriers. This section will examine the reforms in waves, focusing first on those announced in 2009, those announced in 2014, and then the most recent reforms announced this year. The section will conclude by pointing to political hurdles that may complicate the next wave of reforms.

A. 2009 Reforms

The first 100 days of President Obama's presidency featured an aggressive shift in policy with regards to Cuba. By executive action, the President lifted travel restrictions related to family visits and certain cultural exchanges, and authorized the remittance of financial and other resources to Cuba by family members. The changes also sought to enhance telecommunications links between the two countries.² These

² See The White House: Office of the Press Secretary, Fact Sheet: Reaching Out to the Cuban People (Apr. 13, 2009), available online at

changes, while limited in scope, provided an important signal to potential investors that the U.S. was diverting from the policy of isolating Cuba and its people. It also signaled an effort to change the dynamic between the two countries after Raul Castro took leadership.

The effects of this policy are clear. In 2012, the number of U.S. tourists to visit Cuba was twice the number of visitors in 2007, and this does not count more than 350,000 Cuban-Americans permitted to visit Cuba in 2012 under the new regulations.³ Since 2012, those numbers have continued to increase at a dramatic pace. In addition, Americans have responded to Obama's allowance of remittances by sending significant sums of money to Cuban family members. Many people that we spoke with in Cuba noted that remittances from the U.S. provide a higher income than anything you can earn from the government. Those anecdotes are real. It is estimated that up to \$3 billion per year is remitted to family members in Cuba. If divided evenly among the entire Cuban population, that would amount to about \$272 per person.⁴ By comparison, the average Cuban earns around \$200 per year. This comparison is striking. Indeed, some Cubans even used the remittances to open businesses and purchase homes. By giving more Americans the chance to visit Cuba and allowing the transfer of capital from America to Cuba, President Obama's initiatives opened the door for business opportunities on the island.

https://www.whitehouse.gov/the_press_office/Fact-Sheet-Reaching-out-to-the-Cuban-people/.

³ See Marc Frank, "Americans traveling to Cuba in record numbers," USA TODAY (Oct. 18, 2013), available online at <http://www.reuters.com/article/2013/10/18/us-cuba-usa-tourism-idUSBRE99H0J320131018>.

⁴ See Judith Miller, "Cuba on the Edge," DEPARTURES 201, 202 (May/June 2015).

B. 2014 Reforms

Following a chilling period between the two nations spurred by the imprisonment of Alan Gross, President Obama's December 2014 announcements presented sweeping changes in the relationship between the two countries. These announcements included notice that the State Department would begin the process of reestablishing diplomatic ties with Cuba, a further easing of travel restrictions, an increase to the permissible remittance levels, a loosening of the import/export rules of Cuban goods, and the allowance of authorized transactions between the U.S. and Cuba. These reforms have already had a significant effect and will continue to do so.

The increased access of Cubans to Americans and American money means increased opportunity for the private sector. A lack of available financing for private ventures limits the possibilities of the ventures, but the 400 percent increase in remittance levels means more money from the U.S. can enter Cuba to finance these ventures.⁵ Moreover, although Cuban entrepreneurs faced a lack a market for goods and services, increased tourism and relaxed rules for imports and exports will increase demand. Increased access to capital combined with increased demand for goods is a favorable recipe for development of private enterprises in Cuba.

The effort to reestablish diplomatic relations between the countries revolves around the reopening of embassies in Havana and Washington, D.C. There are very tangible benefits to turning the Interests Section in Havana into a full-fledged embassy, but the significance to investors would be mostly symbolic. A U.S. embassy in Cuba

⁵ Pavel Vidal Alejandro, "The Cuban Economy and Obama's New Policy," ONCUBA (Feb. 12, 2015), available online at <http://oncubamagazine.com/economy-business/the-cuban-economy-and-obamas-new-policy/>.

means that the change in tone between the two countries is permanent and that enhanced trade opportunities are legitimate in spite of lingering sanctions. It also will give the U.S. a platform from which to advocate for its business interests should the need arise.⁶

C. 2015 Reforms

The most significant reform so far this year was President Obama's decision to trigger the removal of Cuba from the State Department's Terrorism List.⁷ This removed a major hurdle in negotiations to the establishment of an embassy, and symbolically, creates some distance between Cuba from the three states remaining on the list: Syria, Sudan, and Iran.

The reform also makes a significant difference for U.S. financial institutions considering doing business in Cuba. Though not prohibited, engaging in transactions with countries on the terrorism list demanded costly compliance mechanisms and tolerance of significant risk.⁸ Simply put, the costs of complying with government regulations were not met by the upside of transacting in Cuba. This dramatically

⁶ Nick Miroff, "The U.S. and Cuba will soon agree to reopen their embassies. Here's what happens next." THE WASHINGTON POST (Apr. 14, 2015), available online at <http://www.washingtonpost.com/blogs/worldviews/wp/2015/04/10/the-u-s-and-cuba-will-soon-agree-to-reopen-their-embassies-heres-what-happens-next/>.

⁷ See Karen DeYoung, "Obama removes Cuba from the list of state sponsors of terrorism," THE WASHINGTON POST (Apr. 14, 2015), available online at http://www.washingtonpost.com/world/national-security/obama-removes-cuba-from-the-list-of-state-sponsors-of-terrorism/2015/04/14/8f7dbd2e-e2d9-11e4-81ea-0649268f729e_story.html. The process involves the President's recommendation to Congress, followed by a 45-day period during which Congress can pass a joint resolution opposing the move. It is unlikely that such an effort will succeed.

⁸ Karl Vic, "Obama's Move to Drop Cuba From Terror List Sets Up Showdown With Congress," TIME (Apr. 14, 2015), available online at <http://time.com/3821558/obama-cuba-terror-list-congress-showdown/>.

hindered the access to capital and financial markets for Cubans, and even denied access to bank accounts for Cuban diplomats in Washington.⁹ When the change is effected and Cuba is removed from the list, U.S. financial institutions will be able to remove this risk from their assessments and will likely begin to transact more frequently in Cuba. Other benefits include more freedom for businesses to negotiate trade deals, increased access for Cubans to loans from international organizations such as the World Bank, and the ability to process credit and debit card transactions in Cuba. The USA Today aptly described that as a result of this move, the floodgates are now open.¹⁰

D. Political Opposition: what's left?

The U.S. and Cuba are on the path to normalization of relations, but thus far, every change by the U.S. government has been by executive action. Much of the opposition from Republican legislators stems from Cuba's unsatisfactory record on human rights. According to House Speaker John Boehner, the Obama Administration's efforts to normalize relations amounts to rewarding the Castro regime despite a "clear record of repression at home and exporting violence throughout the region." The Speaker further condemned the moves, explaining that "[c]ozying up to [an] oppressive

⁹ Randal C. Archibold and Julie Hirschfeld Davis, "Cuba to Be Removed From U.S. List of Nations That Sponsor Terrorism," THE NEW YORK TIMES (Apr. 14, 2015), available online at http://www.nytimes.com/2015/04/15/world/americas/obama-cuba-remove-from-state-terror-list.html?_r=0.

¹⁰ Alan Gomez, "First Take: With Cuba off terror list, floodgates open," USA TODAY (Apr. 14, 2015), available online at <http://www.usatoday.com/story/news/world/2015/04/14/first-take-cuba-obama-state-sponsors-of-terrorism/25777625/>.

regime in Cuba is a blow to all who long for liberty and dignity.”¹¹ This vociferous dissent to the President’s policy may stifle ability to take further steps.

One of those steps would be the full repeal of the embargo. Most of the reforms addressed above reflect an easing of the embargo’s restrictions. Indeed, the President has significant room to implement the various laws that constitute the embargo, including flexibility over sanctions on Cuba. However, its full repeal requires an act of Congress.

Congress may also use other tools to halt the movement toward normalization of relations with Cuba. Focusing specifically on the establishment of an embassy, Republican Senators have suggested two ways they can get in the way. The first is to prevent the appointment of an ambassador by blocking a confirmation vote in the Senate. Wary of taking steps that may perpetuate the power of the Castro regime, Senator Marco Rubio pledged to “do everything within the rules of the Senate to prevent [a nominee for Ambassador to Cuba] from ever even coming up for a vote.”¹² Senator Rubio and others have also pledged to use their power over appropriations to block funding for the U.S. Embassy, effectively denying the embassy’s ability to operate.¹³ The effectiveness of such tools is unclear, however, it is apparent that some members of Congress will strive to impede efforts to further normalize relations.

¹¹ Speaker Boehner’s Press Office, “A Blow to All Who Long for Freedom” (Apr. 14, 2015), available online at <http://www.speaker.gov/press-release/blow-all-who-long-freedom>.

¹² Alexandra Jaffe, “Rubio pledges to block vote on Cuban ambassador,” CNN (Dec. 17, 2014), available online at <http://www.cnn.com/2014/12/17/politics/marco-rubio-block-cuba-nominee/>.

¹³ *Id.* See also Rebecca Shabad, “Graham: Block funds for US embassy in Cuba,” THE HILL (Dec. 17, 2014), available online at <http://thehill.com/policy/finance/227426-gop-senator-threatens-to-block-us-funds-to-open-embassy-in-cuba>.

In sum, the Obama Administration has taken a number of steps to open up the opportunity for Americans to invest in Cuba. By easing travel restrictions, opening up access to capital, moving towards establishing embassies, and removing Cuba from the State Sponsors of Terrorism List, the Obama Administration effectively made investing and doing business in Cuba possible. That however does not address concerns that Cuba's climate is unripe for investment. The next section will focus on missed opportunities by Cuba to make structural reforms necessary for attracting investment.

II. INTERNAL REFORMS IN CUBA AND MISSED OPPORTUNITIES

When Raul Castro came to power in Cuba, he seemed to bring with him a desire to reform Cuba's economic system. That desire manifested itself, and Cuba's economy left communism for what appears to be a hybrid capitalist-socialist model. Chief among these reforms were sweeping changes to the opportunities available to Cuban citizens. Those changes include the opportunity to get licenses for trade and to establish privately operated businesses, such as restaurants. These small business owners are among the first Cubans to pay taxes since the revolution. Discussions with Paladar owners indicated that it is a difficult business to be in, but that being in business was better than settling for a state-provided salary. While these reforms to the Cuban system are monumental, the efforts made to attract foreign investment fall short of having such a great impact. This section first examines reforms that Cuba made and then describes the areas that it should have focused its efforts on instead.

A. Reforms that Cuba Made

In March 2014, Cuba's National Assembly enacted reforms designed to attract foreign investment in Cuba. These reforms included a delay and reduction in the profits tax for joint ventures with the Cuban government.¹⁴ The law also reduces taxes on labor costs, permits complete foreign ownership, allows investment in new sectors including real estate, recognizes intellectual property rights of investors, and more.¹⁵ These reforms also included important guarantees by the government designed to increase investment security. However, those guarantees, much like the law's other measures, were hollow. The primary reason being that they provide for the expropriation of a foreign investor's assets if it is in the public utility or social interest.¹⁶ Moreover, the tax breaks only apply to joint ventures which require the investor to take a 49 percent stake to the government's 51 percent—an implicit tax because it denies foreign investors the opportunity to control their investments.

Later last year, the Cuban government released a catalog of domestic projects that are ripe for foreign investment. The list's release was significant in that it provided expansive information for foreign investors, but it also made very clear that despite the invitation to invest, "Cuba will remain a state-driven economy dominated by large government holding companies and the authorities will dictate the direction and pace of

¹⁴ Daniel Trotta, "Cuba approves law aimed at attracting foreign investment," REUTERS (Mar. 29, 2014), available online at <http://www.reuters.com/article/2014/03/29/us-cuba-investment-idUSBREA2S0EJ20140329>.

¹⁵ "What the New Cuban Foreign Investment Law Means," LAW360 (Aug. 11, 2014), available online at <http://www.foxrothschild.com/newspubs/newspubsArticle.aspx?id=15032395156>.

¹⁶ *Id.* Even though the expropriation requires indemnification, it depends upon the actions of an unreliable government.

change.”¹⁷ Notable examples that should temper the enthusiasm that foreign investors have for recent changes abound. In the tourism sector, Cuba outlined 21 potential hotel construction projects and 33 requests for new management contracts at state-owned hotels. But the Cubans did not invite foreign investors to take leadership in the best tourism opportunities, such as for hotels in Havana.¹⁸ In the agricultural sector, the Cuban government invited investment in several commodities, but prohibited participation in the profitable cigar industry, and severely limited participation in the sugar industry.¹⁹ Cuba invited investment in its energy sector, but requires investors to sell output to the state’s distribution systems at pre-fixed prices. Cuba also established a Free Trade Zone in Mariel, but development on the port is slow due to inadequate sites and a lack of connections to utilities.²⁰ The Brookings Institute summed up the catalog by noting that firms must guarantee foreign markets, that the Cuban government will discriminate between home countries, that privatization of state-held enterprises is prohibited, and that foreign investors may not partner with private enterprise in Cuba.²¹

These two examples of incentives designed to attract foreign investment in Cuba make clear that Cuba is not going far enough. Although the Obama Administration made investment possible, the Cuban government has largely failed to create a

¹⁷ Richard Feinberg, “Cuba’s Foreign Investment Invitation: Insights into Internal Struggles,” Brookings Institute: Up Front (Nov. 21, 2014), available online at <http://www.brookings.edu/blogs/up-front/posts/2014/11/21-cuba-foreign-investment-feinberg>.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ Feinberg, “Cuba’s Foreign Investment Invitation: Insights into Internal Struggles.”

favorable business climate. Doing so requires more than tax incentives and the availability of projects: it requires structural reforms.

B. Reforms that Cuba Needs

Cuba clearly recognizes the need for an influx in foreign capital, but appears to want to bring more foreign investment to the island without changing the way it operates. Changing dynamics between Cuba and the U.S. will certainly make a difference, however, companies in many countries have been able to invest in Cuba for years and have generally not done so. Indeed, the hesitation to invest reflects a lack of confidence in the Cuban legal system and government transparency. Therefore, enhancing the rule of law and government transparency would go along way towards attracting investment to Cuba.

A number of studies have concluded that judicial strength and the rule of law are critical for attracting foreign investment, including studies focused specifically on Latin America.²² This is not surprising: investment depends on the ability to assess risk, but investors cannot properly assess the risk that they face unless can predict the challenges. A stable legal system guided by the rule of law means that investors can predict where the hurdles will be and how they can overcome them. At its core, the legitimate rule of law means that an investor's rights are protected and that it can seek remedies for wrongs. Stories of government interference in business interests, imprisonment of agents of foreign investors, and uncertain access to the legal system diminish the credibility of Cuba's incentives to foreign investors. To increase capital

²² See Joseph L. Staats and Glen Biglaiser, "Foreign Direct Investment in Latin America: The Importance of Judicial Strength and Rule of Law," 56 Int'l Studies Qtly 193, 193 (Mar. 2012).

destined for Cuba, the government should make establishment of rule of law a top priority.

A lack of government transparency likewise contributes to the hesitation to invest in Cuba. According to the World Trade Organization, “transparency in economic policy-making and in the activities of the government institutions is vital in attracting foreign investment.”²³ The organization pointed to a number of reasons why a lack of transparency hinders foreign investment: increased costs, difficulty accessing information for cross-border transactions, unsatisfactory protection of property rights, negative effect on business attitudes, and an inability to generate favorable conditions for capital inflows.²⁴

Transparency International measures transparency in countries across the world, but it does not feature a measurement for Cuba.²⁵ This suggests such a lack of transparency that it cannot even be measured. Personal interactions and observations in Cuba likewise made painfully clear that transparency does not exist in Cuba. The first sign of the lack of transparency was the refusal to allow us to meet with government officials while in Havana. Consistent requests were rebuffed. University professors bragged about the quality of the education system, but requests to see an exam were likewise rebuffed. Lectures focused on the operation of the Cuban legal system in theory, but requests for descriptions of how it worked in practice were

²³ Economic Research and Analytics Division, “The Impact of Transparency on Foreign Direct Investment,” Working Paper, World Trade Organization 3 (Nov. 2001), available online at https://www.wto.org/english/res_e/reser_e/erad-99-02.doc.

²⁴ *Id.* at 4-6.

²⁵ *See* Transparency International: Corruption by Country/Territory, available online at <http://www.transparency.org/country#CUB>.

rebuffed. The lack of transparency also showed in conversations with U.S. diplomats in Cuba, who protested that the Cuban government refused to share information regarding how it calculated key economic indicators such as Gross Domestic Product. But these denials of transparency to foreigners pale in comparison to that faced by Cuban citizens.

In a conversation with a political dissident,²⁶ I learned that Cuba has two police systems: the ordinary police and the secret police, which is guided by the Castro-led Communist Party. Alex's story of imprisonment was illustrative. After being arrested, Alex asked the police why they were arrested. The police said they did not know and that they did not want to arrest Alex, but that the secret police told them they had to do it. Alex was not permitted to see a lawyer nor a judge, and did not have visitors until he was released a few days later. This story matched suspicions related to us by many Cubans who thought that the secret police was monitoring their movements and conversations.

The mere fact that Cuba has a police force labeled "secret" demonstrates an aversion to transparency. That aversion translates to business decisions made by the government. It is unclear how contracts are awarded and what limits government agencies face when it comes to the imposition of permit requirements. Discussions with a small business owner in Havana also suggested an excessive and unexpected regulatory burden that includes multiple layers of tax payments, inspections, and social security payments. In order to foster a business climate ripe for foreign investment, Cuba must address this lack of transparency. It also must enhance the rule of law.

²⁶ To protect this person from political retribution, I'll refer to them as Alex.

These two changes would be a strong signal to the international community and likely lead to a dramatic increase in capital entering the island.

III. RISK ASSESSMENTS

Investing in a foreign jurisdiction raises a number of questions that a domestic investment does not. For example, profit from foreign investment depends on the ability to remove capital from that country. Capital transfer depends on the government mechanisms governing capital flows. Investment in another country also means submitting your investment to that country's judicial system. A country incapable of enforcing judgments in your favor subjects you to risk that contractors and other parties will take advantage of you. To help investors account for these risks, as well as political risks such as regime change, many sophisticated parties produce risk assessments. Risk assessments are tools to evaluate factors that may interfere with the return on investment in a foreign country.

There are a variety of publicly available risk assessments for Cuba. Michigan State University's Broad College of Business gave Cuba and its business climate a D. The country rating suggests a "high-risk political and economic environment [and that] corporate default probability is very high."²⁷ The business climate rating suggests a very difficult business climate, in part due to unpredictable debt collection.²⁸ Another risk assessment gave Cuba the riskiest rating for short, medium, and long-term political risk, special transactions, commercial risk, and transfer risk. Cuba also

²⁷ Cuba: Risk Assessment, Global Edge, available online at <http://globaledge.msu.edu/countries/cuba/risk> (last visited Apr. 24, 2015).

²⁸ *Id.*

received a high rating for expropriation risk.²⁹ In fact, the transfer risk is so great that the rater “is reluctant to insure” it. It is also worth noting that none of the factors mentioned above have been addressed by economic reforms in Cuba. This reinforces the idea that Cuba’s attractiveness as a place to invest will not increase until the country addresses the core structural issues that were presented in Part II.

* * *

Recent developments in relations between Cuba and the United States suggest that Cuba’s climate is opening to foreign investment. American investors should be encouraged by the easing of blockade-related restrictions, such as travel bans, prohibitions on remittance, and Cuba’s place on the State Sponsors of Terrorism List. Internal reforms in Cuba are also encouraging, however, they do not go far enough to address the structural concerns of investors. Indeed, these concerns are reflected in risk assessments conducted to evaluate the likelihood of securing return on investment in Cuba.

This brings us back to the question posed in this paper’s title: I know that I CAN invest in Cuba, but should I? The answer to that question depends on your risk tolerance. But for most investors, the answer is not yet. Cuba has taken several steps in the right direction by publishing economic data, lowering the tax burden, and establishing free trade zones. More reform is necessary to dramatically alter the unfavorable business climate. That said, it is likely that those reforms will come in time. Part of the changes to U.S. policy focused on increasing access to information for

²⁹ Country Risks, Delcredere/Ducroire, available online at <http://www.delcredere Ducroire.be/en/country-risks/#focusCountry=CU&focusContinent=&filter=TransferRisk&min=0&max=7&tab=1> (last visited Apr. 24, 2015).

Cubans, encouraging travel between the two countries, establishment of NGOs, and enhancement of political society for Cubans. These reforms could lead to internal pressure for greater political reform, which could dramatically encourage foreign investment by strengthening rule of law and increasing transparency.