

How to Turn \$450 into \$9.50: A Cuban Experiment with Capitalism

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***Abstract:** Rapid development in the tourism industry has provided Cuba with a possible solution to a recent economic crisis caused by the withdrawal of Soviet aid. While the Cuban economy indicates positive signs of growth – higher GDP, a healthy supply of hard currency, and increased government revenues – actual economic development is debatable. This paper will provide a critical examination of Cuba’s tourism industry and assess the impact of tourism on economic development by examining relevant macro indicators. One of the key findings of this analysis is that Cuban tourism is marked more by **leakages** as opposed to **linkages**. This paper argues that unless Cuba reevaluates its tourism policy, it faces a grim future. This is even more important as the world recession seems to be longer than anticipated and other Caribbean destinations are eroding the Cuban advantage by offering low-priced packages.*

Introduction

Tourism in Cuba has grown considerably in the past decade. From a country on the brink of collapse to one with a thriving economy, Cuba has joined the popular trend of employing international tourism as a means of economic development. Many developing and former communist countries include international tourism as a source of national revenues, but Cuba has implemented its strategy in a different way. A definitive isolation from the rest of the Cuban economy hinders the tourism industry's growth and Cuba's development as a nation. For an industry to be a vehicle for economic development, it must be the leading generator of income and employment, create effective linkages, and have a significant multiplier effect.

This paper begins by briefly describing the historical context that has led to a focus on tourism as a means of economic development. It is followed by a discussion of the present situation of the tourism industry and its benefits for Cuba. While Cuba has experienced economic growth according to certain indicators, this paper questions Cuba's ability to transform this economic growth into long-term development. The paper continues with an analysis of the limitations of Cuba's tourism strategy. The weaknesses of economic policy and social hindrances are highlighted by the low multiplier effect. High leakages and few forward and backward linkages reduce the multiplier effect in Cuba. The paper concludes with recommendations to modify tourism policy to turn recent and rapid economic growth in one industry into sustainable economic development for the nation as a whole.

Historical context

After Fidel Castro assumed power in Cuba, the United States imposed an economic embargo in 1960. Cuba turned to the other world power – the Soviet Union – for economic and political aid. Cuba paid low prices for Soviet oil and the Soviet Union purchased Cuban sugar at inflated prices. Artificially high revenues of sugar and re-exports of oil became the base of the economy. Trade between the two nations comprised 80 percent of Cuba's international transactions. The actual amount of Soviet subsidies and its proportion of Cuba's GDP is difficult to determine because the Cuba-USSR trading agreements relied on prices disconnected from the world market.

However, it is obvious that Cuba depended on Soviet support to guarantee minimum consumption levels to Cubans and support its renowned education and health systems.

The artificial terms of trade protected an inefficient industrial sector and discouraged diversification of exports. Cuba continued to be a nation dependent on the monoproduction of sugar, a primary commodity with a continually falling price. Sugar demands substantial amounts of energy and was the main source of foreign exchange (Orro, 2000: 41). This highlights the link between oil exports and the decline in production in the early 1990s. In 1989, the Soviet Union cutback their subsidies and other concessions, a precursor to official withdrawal of support on September 12, 1991. Between 1989 and 1993, the real GDP fell 40 percent, imports fell 75 percent, exports fell 79 percent, domestic consumption fell 60 percent, and industrial and agricultural capacity fell 70 percent. Employment declined from 4.4 million to 4.1 million and real wages fell almost 40 percent in urban areas (Trumbull, 2000: 306).

The economic crisis peaked under immense foreign debt and lack of hard currency formerly received from sugar and oil exports. The fall of the USSR and subsequent economic crisis in Cuba convinced many that the Cuban regime was near its end. Castro announced a “special period in the time of peace” and rationed food and energy. These actions slightly altered the economy without sacrificing the ideals of the Revolution. However, the survival of the Cuban system eventually needed a shift in goals and a redesigning of economic institutions. In short, it necessitated an entire reconfiguration of the Cuban economy.

The foreign debt and lack of hard currency severely inhibited Cuba’s ability to secure financing for trade and investment activities. This restricted capital and inhibited Cuba’s ability to rebuild physical infrastructure and modernize Cuba’s factories, mines, sugar mills, hospitals, and other potential sources of hard currency. Cuba implemented drastic reforms allowing previously banned activities in the reform package of 1993. The four major components of this plan were 1) liberalization of foreign investment, 2) breakup of state farms and creation of farmers’ markets, 3) dollarization of the economy, and 4) legalization of self-employment. These reforms paved the way for investment in tourism. By 1994, the tourism industry led Cuba’s economy.

Current Trends in Cuban Tourism

The Cuban government recognized that international tourism would provide much needed hard currency and employment, but Cuba did not have the capital or expertise to open hotels that would appeal to international tourists. The government changed the investment law of 1982 and encouraged foreign capital and capitalists to develop and manage the tourism industry. The prostitution, crime, and social degradation of Cuba's former heyday concerned the government, so they allowed the industry to develop isolated from most of the Cuban economy and citizens.

Spain has the most tourism investment in Cuba; its *Grupo Sol Melia* set up the first joint venture in May of 1990 – the four star Sol Palmeras. They also opened two five star hotels in Varadero, with an investment of \$90 million, and manage another in Havana. (Trumbull, 2000: 307-308). There are over 300 joint ventures in the tourism industry, with \$1.757 billion in foreign investment and another \$4 billion committed or in discussion as of 1998 (Trumbull, 2000: 307). Most current joint venture agreements are management contracts, due to uncertainty of success in the Cuban market. Countries with investments in the Cuban tourism industry include Mexico, France, Italy, the Netherlands, Canada, and Germany.

Foreign investment increased Cuba's hotel supply from 10,000 rooms in 1988 to over 34,700 rooms in 2000 (Anuario Estadístico de Cuba, 2000). Ten thousand additional rooms are presently under serious consideration for development. This represents an average annual capacity increase of 11 percent. Figure 1 shows that the majority of rooms are in Havana and Varadero. Other areas with lower capacity include Holguin, Santiago de Cuba, and Camaguey (Anuario Estadístico de Cuba, 2000). Of the 346 hotels in 2000, nineteen of these properties are five-star hotels, sixty are four-star, sixty-six are three-star, and sixty-five are two-star. However, the ratings of hotels in Cuba are generally higher than those recognized in the rest of the world. Hotel occupancy is strong and average market occupancy overall was 74.2 percent in 2000 (Anuario Estadístico de Cuba, 2000).

Cuba is known for its beaches and investors are highlighting other types of tourism including water-based experiences and cultural tourism. Figure 2 illustrates the increase of arrivals. Visitors increased 82 percent from 1990 to 1994 and another 129

percent between 1994 and 1998. Cuba is now the fifth most popular tourist destination in the Caribbean with a market share of 9 percent (Crespo and Suddaby, 2000: 358). The government hopes to have 10 million visitors with gross revenues of \$5 billion in 2010.

Cuba's market share is impressive when one considers that its greatest potential market, the United States, is virtually untapped. Table 1 shows that almost half of Cuba's tourist arrivals are from Europe. Latin Americans and Canadians comprise the other half. This market mix improves expenditure and length of stay (Europeans generally stay longer and spend more), limits the cyclical nature of tourism by spreading recession risks among various regions of origin, and smoothes seasonality (Simon, 1995: 4). The average stay in 1999 was 7.8 days, down from just under ten in 1993 and the average expenditure was \$1,200 per visitor compared to \$1,300 in 1997 and \$1,500 in 1995 (Crespo and Suddaby, 2000: 355).

Beneficial Effects

The dramatic increase in tourism changed the Cuban economy to one reliant on a new export sector. International tourism promotes economic growth and development and is recognized as a viable economic development tool. International tourism improves the balance of payments and generates government revenues. It also enhances income by creating jobs. International tourism promotes economic growth and development by creating forward and backward linkages.

The Cuban government officially touts international tourism as the star of Cuba's economic development strategy and offers tax incentives to foreign investors. The strategy was successful, although contained and controlled. Fidel Castro was determined that capitalism would remain an island within the island to minimize socio-cultural disruptions and minimize wealth accumulation and income gaps (Simon, 1995: 2).

The primary economic benefit from tourism is the generation of hard currency and revenues to finance both foreign and domestic deficits. This also seems to be the main motivation behind Cuba's tourism policy. The government benefits from capital investment and revenues including aircraft landing fees, airport departure taxes, hotel occupancy taxes, sales taxes paid by tourists, import duties on the goods and services demanded by tourists, corporate taxes and profit repatriation taxes, as well as other

licenses and fees (Espino, 2000: 369). This direct injection of foreign currency into the government may be the primary benefit to Cuba. Indicators of Cuba's benefits are strong – GDP has increased between 0.7 percent and 6.2 percent every year since 1994. The peso stabilized at the unofficial exchange rate of 23 pesos per dollar and the fiscal deficit is near 2.2 percent of Gross Domestic Product. Real per capita income also grew each year since 1995 as did the standard of living (Mesa-Lago, 1998: 43). Tourism employed 64,000 Cubans in 1996, 70,900 in 1997, and 81,000 in 1998 (Espino, 2000: 370). Gross revenue from tourism comprised 66 percent of Cuba's service exports in 1998, making it the leading export sector (Espino, 2000: 368).

These positive indicators stem from the high amount of foreign investment in tourism and a select few other areas (nickel, petroleum). While investment is increasing in tourism, operating difficulties due to infrastructure deficiencies and supply shortages trouble the industry. There are definite gains from tourism but existing and potential problems reduce Cuba's economic benefits and general tourism expansion. Cuba has made considerable tax concessions and allows unregulated repatriation of profits to attract capital. These concessions reduce the direct financial benefits to the government. Further, Cuban law restricts foreign firms to less than 50 percent ownership, another impediment to potential investors. Investment is limited to large multinationals that can maneuver through these obstacles. Difficulties in operating conditions in terms of labor and especially supply reduce profits for foreign investors.

For years, economists have delineated the difference between economic growth and economic development. While Cuba indicates positive signs of economic growth – higher GDP, a healthy supply of hard currency, and increased government revenues – actual economic development is debatable. Two ways to measure potential economic development from the tourism industry are to analyze the impact of leakages and linkages on the multiplier effect.

Multiplier Effect

The multiplier concept is that demand stimulates supply, therefore encouraging local production. Revenues that enter an economy stimulate investment, spending, and employment. They circulate through the economy and promote future incomes. The

value of the multiplier reflects leakages, the portion of income that leaks out of the local economy at each round of circulation. Growth experienced is the excess of injections into the economy over leakages out of the economy.

International tourism is the most vibrant and dynamic industry in Cuba and leads the export sector. Foreign visitors spend money in hotels and restaurants, as well as on transportation, entertainment, souvenirs, and other incidentals. In the case of Cuban tourism, capital enters the economy through investment and tourist expenditures. The degree of the multiplier effect depends on two main variables: 1) the amount of leakages in the form of savings, taxes paid to the government, repatriated profits, and imports necessary to provide services to tourists, and 2) the strength of forward and backward linkages between tourism and other industries in Cuba.

The larger and more diversified an economy, the lower the leakages and the higher the value of the multiplier. While Cuba is the largest Caribbean country, its economy is not diverse. The enclave structure imposed on the tourism industry drives the multiplier value lower than most Caribbean nations. The income multiplier for Cuba has been estimated between 0.74 and 0.84. Other Caribbean countries have estimated income multipliers ranging from 0.58 in the British Virgin Islands to 1.58 in Jamaica (Espino, 2000: 370).

The lack of reliable, detailed data for Cuban imports and tourism in general make measuring the exact multiplier effect for the Cuban tourism industry difficult. In order to illustrate the relatively low value of the multiplier, this paper will next discuss the manners leakages are most likely occurring. An evaluation of weak forward and backward linkages will further highlight factors contributing to the low value of the multiplier.

Leakages

One of the greatest impediments to income multiplication in Cuba is the government. Great amounts of tourism-generated revenues leak out of the economy as the government absorbs them in the form of taxes and payroll controls. Although government revenues are perhaps the primary benefit to the Cuban economy, these leakages hinder the potential multiplier effect and long-term economic growth. The

Cuban government collects taxes on everything from hotel occupancy to imports. In 1999, tax receipts grew by 13.9 percent. This includes a 17.8 percent increase in taxes generated by services, which encompasses hotels, restaurants, and other activities related to tourism. (ECLAC, 1999: 190) The government also collects revenues through licenses and fees charged to foreign enterprises, a few privately held Cuban companies, and taxes paid directly by foreign tourists.

The employment conditions of Cuban nationals are an example of the government's limits on the tourism industry. The average monthly salary is 217 pesos (\$9.50). For each Cuban employee, foreign companies pay \$450 a month to the state agency, Acorec, which pays the workers in worthless pesos. Employees that receive tips must exchange their dollars for pesos at the official exchange rate of one dollar for every peso. These policies lower profitability by raising labor costs and they also limit the income of Cuban nationals. While the government greatly benefits from these practices, it limits the income effect on the nation's economy.

A second way tourism revenues leak out of the Cuban economy is through imports. The Cuban economy cannot supply the tourism industry with the inputs necessary for operations and thus relies heavily on imported goods such as construction materials, equipment, furnishings, and basic supplies. One report states that Cuban hotels imported 50-60 percent of their supplies in 1995 (Simon, 1995: 2). ECLAC reported that imported products accounted for 49 percent of supplies to the tourist industry in 1999 (1999: 194). This raises costs and limits the effect of tourism on the rest of the Cuban economy since local products are not consumed. Reducing the import component of tourism is an explicit policy goal in Cuba, but little progress is being made.

Repatriation of foreign earnings is a third form of leakages from tourism-generated revenues. Most direct profits flowing into foreign-owned operations leave the local economy in the form of repatriations. Cuba imposes few restrictions on the amount of earnings from the tourism sector that may leave the country. Table 2 shows that repatriated earnings have grown steadily since 1990 with the largest increase occurring in 1993, when Cuba began to seriously focus its efforts on recruiting foreign companies to enter its tourism industry. A fourth form of leakages is domestic savings. Since savings in Cuba are almost nonexistent, it has little impact on the multiplier effect.

Linkages

Another factor that determines the value of the multiplier is linkages. Forward and backward linkages are formed by an industry's demand for inputs and its supply to consumers and other industries. In this manner, revenues circulate through various sectors in the economy. This has an extensive impact, far beyond that of the initial capital injection into the economy. For sustainable economic development to occur, it is vital for export industries to establish linkages with the rest of the economy.

In the Cuban economy, the tourism industry operates as an enclave, effectively separated from the rest of the economy. With an enclave situation, Cuba receives an inflow of hard currency and the creation of jobs within the industry. The lack of linkages to other sectors adversely affects the income multiplier effect for Cuban tourism. The government has put up barriers to keep this capitalist enclave separated from the rest of the socialist economy. The imposition of the enclave mode hinders the tourism industry and the rest of the Cuban economy. Continuing government policies designed to keep the tourism sector separate curtail the multiplier effect through limited local supply connections and distorted wages. The total impact of tourist expenditures is probably not much larger than the direct income and employment created (Espino, 2000: 370).

A second impediment to maximum income multiplier benefits is the capacity of the Cuban labor force. While it is true that Cubans are generally well-educated, often well beyond the required skills for the tourism-related jobs, most of the positions offered to Cubans are low-skill, low-paying, entry level positions. In addition, Cubans are not well trained for the service industry. Another factor is the numerous restrictions on self-employment that could complement the foreign owned hotels and services. Many small businesses, such as restaurants and small shops, provide services to tourists. Most qualified Cubans are unable to enter the market as wage earners due to heavy regulation and taxation.

A third factor necessary to establish linkages is internal demand. Without internal demand, no forward linkages can be formed. The Cuban economy has a complete absence of internal demand because the tourism industry focuses entirely on foreign visitors. While Cubans may enjoy a portion of the revenues spent by international

tourists in their country, they are not able to provide supplies to support the industry, nor are they able to participate as tourists themselves in the majority of resorts. This leaves most Cubans completely out of the supply chain—they are not suppliers to the tourist industry, nor is the tourist industry supplying services to them. Internal demand does almost nothing to stimulate supply. In terms of backward linkages, Cuban industry is largely incapable of providing the supplies necessary to operate resorts that cater to international tourists. As mentioned earlier, the import component is extremely high.

Conclusions and Assessment

Cuba's short run economic indicators show that the country has improved its situation dramatically since the fall of the Soviet Union. The emphasis on international tourism in the export portfolio caused a substantial portion of this economic growth. Although tourism is performing well presently, the long-term performance and benefits of the tourism industry are still in question. Political risk, bureaucratic and legal barriers, and economic conditions limit potential investors to large multinationals that can maneuver the obstacles. The appeal of economic incentives (tax breaks, etc) and market potential rival the operating difficulties caused by a severely deteriorated economy and continued political uncertainty (Simon, 1995: 11). If the government accelerates and integrates recent market reforms into a sincere, full-fledged transition program, investor confidence would increase.

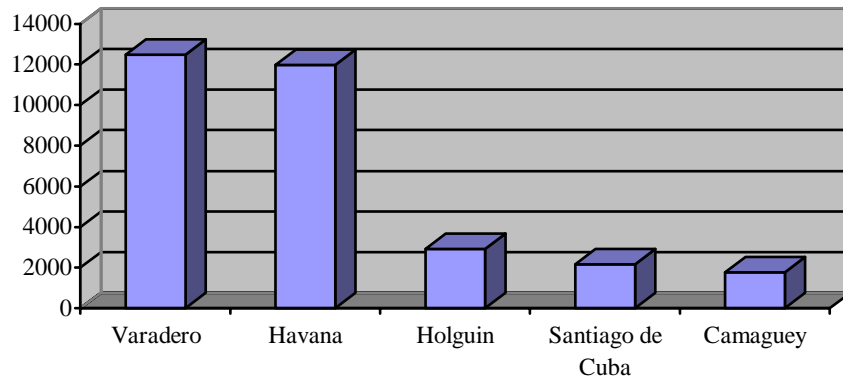
The Cuban government must keep in mind that tourism is a highly competitive business where switching costs are relatively low for tourism operators and practically nonexistent for the tourists themselves (De Holan, 1997: 778). If price continues to be Cuba's advantage, the tourist market could quickly disappear. For a tourism strategy to be successful in the long-term, the country must have a sustainable competitive advantage. The government and investors must look to differentiate, segment, and specialize the market. The development of a competitive advantage other than price is even more important in light of the recent world-wide recession lasting longer than anticipated. Cuba has a low current repeat rate and targets sheer volume to solve the country's immediate financial problems (Simon, 1995: 9). A preliminary ECLAC report for 2001 describes the Cuban reaction to the decrease in demand since September. Cuba

seems to be taking steps to build a competitive advantage other than price by imposing restrictions on imports and temporarily closing some facilities. During this time, they are remodeling and repairing rooms as well as retraining the labor force (68-69). This demonstrates new focus on quality rather than low price and high volume. The September 11 terrorist attacks crippled the industry and the recent changes cannot salvage the economy. Arrivals for the first quarter were down 14% from last year. To make travel to Cuba more attractive to Europeans, Cuba recently announced that the Euro would circulate beside the dollar (De Cordoba).

Further development in the industry is impossible without additional reforms. The changes of 1993 brought the country out of an economic crisis. While they appeared to move Cuba towards a more market-based economy, it is now clear that they maintained socialism rather than served as the first steps of a transition to a market-oriented economy (Trumbull, 2000: 307). Castro still denounces the evils of capitalism and insists on Cuba remaining socialist. Rivera describes the new policies as “tentative, opportunistic, and tactical in nature”, which he finds consistent with other market experiments (2000: 102). The reforms and subsequent economic policy are not true reforms that are best for the economy, but necessary reforms that maintain the political situation of state control. The government made only a few concessions and now heavily taxes and regulates the private sector that emerged. With the government unwilling to undergo legal and institutional changes regarding property relations and contracts, entrepreneurial investments are stunted.

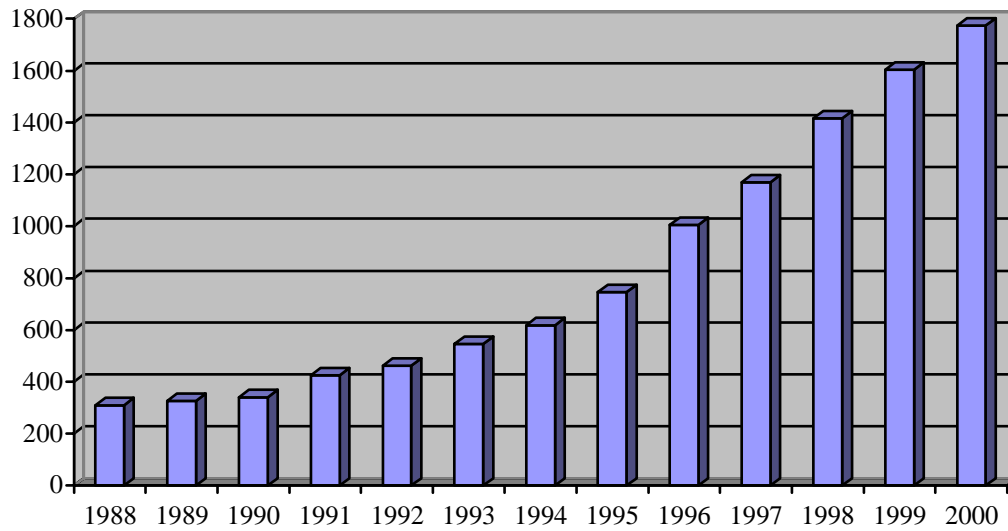
A process of authentic economic reforms is unlikely as long as Castro and socialism govern the island of Cuba. The reforms made thus far clash ideologically with socialism but are not structurally consistent with capitalism. Economic policies and fear of capitalist tendencies have cost the Cuban economy billions of dollars annually in lost investment, jobs, and real income. If the economy continues as is, subordinated to the political interests of the Cuban government, economic benefits will soon diminish. To gain the full benefits of international tourism, Cuba must reduce their leakages and improve the multiplier. In the opinion of the authors, policy changes to maximize development from tourism can only be accomplished in a unified economy where the industry is allowed to develop forward and backward linkages.

Figure 1: Hotel Rooms by Region



Source: Anuario Estadístico de Cuba, 2000

Figure 2: International Tourist Arrivals (In Thousands)



Source: Anuario Estadístico de Cuba, 2000

Table 1: Visitors to Cuba by Selected Countries							
	1994	1995	1996	1997	1998	1999	2000
Total	619,218	745,495	1,004,336	1,170,083	1,415,832	1,602,781	1,773,986
Canada	109,731	143,541	162,766	169,686	215,644	276,346	307,725
Germany	60,598	57,487	80,185	86,509	148,987	182,159	203,403
Italy	66,367	114,767	192,297	200,238	186,688	160,843	175,667
Spain	62,179	89,501	117,957	116,606	140,435	146,978	153,197
France	33,910	34,332	67,742	93,897	101,604	123,607	132,089
England	25,425	19,614	28,077	46,215	64,272	85,829	90,972
Mexico	49,096	32,069	37,229	52,712	61,589	70,983	86,540
United States	17,937	20,672	27,113	34,956	46,778	62,345	76,898
Argentina	36,414	32,583	31,331	41,511	47,579	42,612	54,185
Portugal	4,309	10,585	14,467	13,350	18,625	25,474	28,981
Switzerland	6,959	6,011	10,149	14,042	21,082	26,111	28,462
Holland	15,094	12,648	13,964	12,432	17,329	22,365	24,916
Belgium	4,296	4,369	5,981	10,674	18,061	20,092	21,594
Austria	7,272	5,803	5,404	6,050	11,979	16,119	21,056
Colombia	7,310	21,035	25,251	28,745	20,702	15,585	16,388
Russia	9,038	8,263	9,116	11,406	11,711	11,200	14,429
Chile	6,814	13,747	12,416	13,607	12,925	11,986	13,718
Venezuela	9,026	8,621	8,270	8,558	9,986	12,723	12,481
Brazil	6,263	7,825	8,513	12,993	12,697	4,387	9,249

Source: Anuario Estadístico de Cuba, 2000

Table 2: Repatriated Earnings by Foreign Companies											
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Repatriated Earnings (millions of US\$)	16	20	44	253	450	617	709	749	770	756	797

Source: EIU

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