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Export Processing Zones in Cuba

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Abstract

In a radical shift of policy, Cuba inaugurated in 1997 a number of export processing zones (EPZs). Despite generous tax incentives and an abundant supply of educated labour, investors have not rushed to the EPZs, except for one firm which has its eye on national rather than export markets. This paper argues that Cuba's EPZs have failed not because they face a United States trade embargo, but rather because employers must pay US $1.50 an hour for labour that receives take-home wages equivalent to only 4 US cents an hour.

Export Processing Zones in Cuba

In a bid to attract foreign investment and increase exports, the Government of Cuba inaugurated two export processing zones (EPZs) in the Havana area in May of 1997, a third at the nearby port of Mariel in November of 1997, and announced that it intends to open a fourth zone in the southern port of Cienfuegos. Although this represents a radical shift in post-1959 Cuban policy, it is a movement toward incentives long offered in the region by other governments, including that of pre-revolutionary Cuba.[1/] In some respects Cuba is a less than ideal location for export-oriented manufacturing, for the country is cut off from the United States market and lacks preferential access to markets outside of Latin America and the Caribbean. On the other hand, exporters are free to ship goods to any country other than the United States, and Cuba offers them an educated labour force, low wages and the absence of independent trade unions, so development of export processing is by no means a far-fetched idea.

1. Cuba's EPZ incentives

In June of 1996, President Fidel Castro enacted Decree Law 165, which allows EPZs to operate in Cuba. In October of that same year the Government set up a National Office of Free Zones to administer the law. The proposed Cienfuegos Free Zone and two of the free zones in the Havana area (Wajay and Mariel) are administered by Almacenes Universales S.A., a commercial venture of the Revolutionary Armed Forces that concentrated, until recently, on leasing space of in-bond warehouses to foreign producers and promoting sales of their goods. The fourth EPZ (Havana Free Zone, in the Berroa Valley west of the capital) is administered by CIMEX, a large public enterprise responsible for the wholesale and retail distribution of a wide variety of local and imported goods. CIMEX, like Almacenes Universales, leases space for storage of imports in its in-bond warehouses. Both companies are now converting existing warehouses for factory use, and plan to make additional EPZ factory space available with an ambitious programme of urbanization and construction of new buildings (see table 1).

The Cuban authorities have set aside a total of 1,250 hectares for the four free zones (see table 1). To place this statistic in perspective, it should be noted that Panama's bustling Colon Free Zone occupies less than 400 hectares of land. Prior to the inauguration of Cuba's free zones, the Colon Free Zone was the largest in the Western hemisphere both in size and in volume of shipments; it is now largest only in shipments, as both Mariel and Cienfuegos surpass it in land area.

In many respects, Cuba's EPZ legislation resembles that of other countries in the Caribbean Basin. Free zones are deemed to lie outside the customs territory, so the Government does not in any way tax or restrict the exports or imports of firms operating in the zones. Similarly, with respect to capital flows, article 38.1 of Decree Law 165 provides for the unrestricted transfer abroad of profits. Investors are allowed as a matter of course to retain full ownership of EPZ plants; this is an important concession in Cuba, where all foreign investors so far have had to form joint ventures with public enterprises, and are limited to a maximum participation of 49 per cent.[2/] Investors with plants in EPZs are also entitled to total exemption from Cuban income tax and taxes on labour utilization for 12 years, to be followed by a 50 per cent exemption for another 5 years.

In one important way, Cuba's concessions to investors in EPZs exceed those of any other country in the region. Export processing zones are designed to promote exports. In this spirit, Caribbean countries invariably prohibit EPZ sales to the domestic market: in other words, they require producers to export all their output

(Willmore, 1996). Central American governments allow limited sales to the local market, but never in competition with domestic industry, never without payment of full import duties, and never without specific permission for each sale (Willmore, 1992). In contrast, Cuba automatically allows EPZ plants, subject only to payment of duties, to sell up to 25 per cent of their output in the national market. Moreover, Cuba exempts from payment of duty that portion of a product that is national value-added, and EPZ companies can sell an unlimited amount of their output in the domestic market with approval. Products that incorporate at least fifty per cent Cuban value-added are totally exempt from payment of duty. No other country in the Caribbean Basin offers these incentives for EPZ sales to the domestic market.

2. Wage costs

Export processing plants are generally low-skilled, labour-intensive operations, so potential investors look carefully at minimum wages. The Government of Cuba has set the EPZ minimum wage at 163 pesos a month. This is more than 50 per cent higher than the minimum wage in the rest of the economy, but is still very low. Converted at the rate used by government exchange houses (*casas de cambio*) in October of 1997 for the purchase of foreign currency, it is equivalent to little more than seven US dollars a month. Assuming a 40-hour week and an average of 4.2 weeks in a month, this amounts to approximately four US cents an hour. Average wages are somewhat higher, about 200 pesos a month, which is equivalent to US $8.70 a month or somewhat more than five cents an hour. Cuban professionals, including medical doctors and university professors, seldom earn more than 400 pesos a month, so EPZ wages are relatively high by Cuban standards. Nonetheless, they are far lower than take-home pay of workers in EPZs of other countries in the region (see table 2), and lower even than wages in export processing plants located in the People's Republic of China.

Calculation of the foreign exchange equivalent of local wages is complicated by the fact that three currencies circulate side-by-side in Cuba: ordinary pesos (which fluctuate in value), convertible pesos (pegged to the US dollar) and US dollars. All three currencies are legal means of payment at least for some transactions, but wages are paid in ordinary pesos, while many goods and services can be purchased only with convertible pesos or dollars.

Residents and tourists alike can buy and sell currency at commercial banks or at any of the many small exchange houses (*casas de cambio*) operated by the Cuban Government in Havana and throughout the island. In October of 1997 these houses purchased convertible pesos and US dollars at the rate of 23 pesos and sold convertible pesos at the rate of 25 pesos. Customers could purchase ordinary pesos without limit. The exchange houses did not sell US dollars, but many did sell convertible pesos, subject to a limit of 400 convertible pesos per purchaser per day. Convertible pesos are accepted in Cuban shops and restaurants on par with the US dollar but they have no value abroad. The illegal black market price of US dollars in October of 1997 was close to the Government's buying rate of 23 pesos, which indicates there was little or no excess demand for dollars.

Cuban workers are able to survive despite their low wages because they receive free health care and education from the Government, and they pay no more than 10% of their income for housing. In addition, all Cubans are entitled to a subsidized monthly food ration. The rationed goods are limited, however, and do not cover all basic needs. Workers are free to shop at farmers' markets and in dollar stores where goods are not rationed, but prices in the open market are high for anyone who depends on a Cuban salary. Each adult is allowed, for example, to purchase each month, at very low prices, 6 pounds (2.7 kilograms) of rice and 20 ounces (570 grams) of beans. Rice and beans are basic to the Cuban diet; rice sold on the open market in October of 1997 for about 20 US cents a pound (44 cents per kilogram) and beans sold for 39 cents a pound (86 cents per kilogram). These are the prices Cubans must pay to supplement their monthly allotment of subsidized food.

Luxuries excluded from the ration card are also available on the open market, at a price. Fresh pork, for example, in October of 1997 sold for the equivalent of US $1.09 a pound (US $2.39 a kilo), local ham for twice that price, and beer for 75 US cents per 12 ounce can or bottle. Large avocados could be purchased for the equivalent of 34 US cents each, and oranges and limes for 2 US cents each. For the average worker, a single avocado represents nearly a day's wages, and a pound of fresh pork almost all of three days' wages.

3. Non-wage costs and investor response

Despite the availability of a large supply of educated workers at low wages, investors are not rushing to Cuba's new EPZs. In May of 1997, the first EPZ plant began operations: Euro Latina in the Wajay Free Zone near Havana International Airport. At the beginning of 1998 no other EPZ plant was even in the planning stage of operation, although dozens of foreign companies are said to have made inquiries. Euro Latina is a Jamaican-owned company that employs a Chilean manager and about 40 Cuban nationals (all high school or university graduates) to mix and package powders that are dissolved in water in the home to make beverages. Euro Latina uses Argentine equipment and imports all packaging material, chemicals and flavours from Argentina, but there is considerable backward linkage with the Cuban economy because sugar is a major ingredient in their soluble beverage powders. The plant has yet to export any of its product. The Government has granted Euro Latina permission to sell all its output in the national market for a period of two years, after which it is supposed to begin to export to foreign markets.

It is not too early to assess Cuba's current EPZ policy, for EPZ plants are notoriously footloose, and move in and out of countries in a matter of weeks. Such investments thrive in uncertain political environments that are too hostile for less reversible ventures. Haiti, for example, by 1990 was host to 145 export processing plants that employed approximately 140,000 workers. The owners of these plants quickly relocated production to the Dominican Republic and other countries following the 1991 military *coup d'etat*. Haiti's civilian President was restored to power in October 1994; by the end of 1995, 40 of the EPZ plants had returned to the country, despite the continued existence of political unrest and uncertainty. These 40 plants generated about 12,000 jobs in Haiti, attracted by an abundant supply of labour and a minimum wage that was equivalent to only 30 US cents an hour (United Nations, 1996, p. 205). With the right incentives, it can be expected that EPZ producers would similarly move at least some of their operations quickly to Cuba.

One might argue that Cuba's failure to attract foreign investment to its EPZs is a consequence of the Cuban Liberty and Democratic Solidarity (Helms-Burton) Act signed into law by US President Clinton in March of 1996; but this is not likely. The Helms-Burton Act targets only foreign firms that traffic in properties confiscated from United States companies or from anyone who is currently a United States citizen. EPZ investors do not make use of any confiscated property, so are not affected by provisions of the Helms-Burton Act.

Cuba's EPZ strategy has failed and will continue to fail not because of the external embargo, but rather because of Cuba's own internal policies, which (i) do not allow foreign companies to hire workers directly and, most importantly, (ii) impose a high implicit tax on wages.

Regarding the first point, foreign firms operating in Cuba are required to hire all labour through an "employing entity" designated by the Government. In practice, for plants located in an EPZ, this entity is the administrator of the free zone (Almacenes Universales or CIMEX) which, technically, employs all workers in the zone. Both the 1996 Free Zone Law and the 1995 Foreign Investment Law (section five) specifically forbid foreign companies to hire workers directly. This preserves the role of the Cuban state as sole employer and facilitates control of political dissidents, but it limits the freedom of firms to choose their own workers.

Even though the minimum wage in Cuban EPZs is only about seven dollars a month (4 US cents per hour), the cost to employers is US $250 a month (US $1.50 per hour). Non-wage labour costs exceed 97% of total labour costs, which means that labour in Cuba is actually quite dear compared to nearby countries (see table 2). Most of the non-wage costs result from exchange rate losses: owners of EPZ plants are forced to purchase pesos at the official exchange rate, so it costs US $163 to pay a worker 163 pesos that are worth only seven dollars at the market rate of exchange.[3/] The worker gains nothing from this implicit payroll tax, and would prefer to receive the $163 US dollars rather than 163 pesos. In addition, there are a number of legally mandated fringe benefits that add to labour costs. These employee benefits include a 14% contribution to social security, 2 weeks' paid vacation, 6 paid holidays, and a US $2.60 daily lunch supplied by the administrator of the EPZ to each worker, but paid for by his or her employer in US dollars. Take-home pay is low, so, to motivate workers, foreign-owned companies operating in Cuba find they must provide bonuses, such as monthly bags of toiletries, or hard currency under the table, increasing labour costs even more.

4. The future of EPZs in Cuba

What is the future for export processing in Cuba? With labour costs in excess of US $1.50 an hour, Cuba is not likely to attract export-oriented investment. Import substitution is a different story, for the free zones are an attractive option for companies that want to enter the domestic market. Advantages of locating in rather than outside an EPZ include the possibility of retaining full ownership of a firm and exemption from numerous duties and taxes, including an 11 per cent labour utilization tax that joint ventures pay in US dollars on top of the hard-currency payments they make to the Cuban state employing entity.

EPZ firms may well be willing to export some of their output at a loss, in order to obtain preferential access to the domestic market. However, unless there is a drastic change in policy, it is access to the domestic market, not the possibility of exporting, that might attract manufacturing activity to Cuba's free zones. Most likely, the free zones will continue to function primarily as bonded warehouses for goods in transit to the domestic economy, with no transformation other than simple assembly, and few exports to the rest of the world. In short, they will continue to be export processing zones in concept, but not in fact.

Table 1. Cuba: Export processing zones, 1997

	Land Area (hs)		Construction (m2)		Planned Expansion, 1997-2001	
	Total	Urbanized	Office	Warehouse	Urbanization (hs)	Buildings (m2)
Wajay Free Zone	21	13	1,100	13,000	3.5	5,000
Havana Free Zone	244	45	4,200	41,616	45.0	233,829
Mariel Free Zone	553	...	540	7,000	6.0	12,500
Cienfuegos FZ	432	...	9,800	11,800	3.7	13,000
Total	1,250	…	15,640	73,416	58.2	264,329

Note: Land area is in hectares (one hectare equals 2.47 acres) and construction is in square meters (one square meter equals 10.76 square feet). Three dots (...) indicate data are not available.

Source: Business Tips on Cuba (July 1997), published by the National Office of Technological Information Promotion System in Cuba, available at that time on the internet at http://www.tips.cu.

Table 2. Export Processing Plants in selected Caribbean and Central American countries: Minimum and average wages for sewing machine operators (US dollars per hour, 1990s)

	Employee Take-Home Pay		Employer Cost	
	Minimum	Average	Minimum	Average
Caribbean:				
Cuba */	0.04	0.05	1.50	1.75
Dominican Republic	0.42	0.71	0.55	0.94
Jamaica	0.32	1.08	0.40	1.34
Saint Lucia	0.75	1.20	0.87	1.41
Trinidad	0.38	1.00	0.38	1.00
Central America:				
Costa Rica	0.65		1.02	
El Salvador	0.41		0.56	
Guatemala	0.33		0.46	
Honduras	0.41		0.57	
Nicaragua	0.21		0.60	

* 1997 wage data for Euro Latina, a plant that mixes and packages beverage powders, since no garment factory operated in any of Cuba's Export Processing Zones in that year.

Source: Author's field research in Cuba in October of 1997, Willmore (1996) for other Caribbean countries and Willmore (1992) for Central America.

Endnotes

1. For an analysis of EPZs in other countries of the Caribbean Basin, see Kaplinsky (1993, 1995) and Willmore (1992, 1995, 1996). For a brief description of EPZs in pre-revolutionary Cuba, see Rodriguez (1997).

2. The 1995 Foreign Investment Law does contemplate wholly foreign-owned companies, but no approval has been given to date, and it is unlikely to be given for firms operating outside the EPZs. See Werlau (1997).

3. The Dominican Republic prior to 1985 used this same mechanism of a dual exchange rate to tax EPZ labour, but the implicit tax at its height was only 38.4% [100*(125-77)/125] in the Dominican Republic compared to 95.6% [100*(163-7)/163] in Cuba. See Willmore (1995, p. 529).

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