U.S.-Cuban Trade Cooperation and Its Unraveling

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Although it is frequently forgotten in today's geopolitical climate, in the first sixty years of this century, the United States and Cuba shared a close relationship of economic and political cooperation. The cohesiveness of the relationship progressively broke down until it was abruptly ended with the Cuban Revolution of 1959. This paper seeks to understand the mechanism by which the relationship degenerated. We propose that, by viewing it as a long-term relational contract, analogous to a private contract, one can identify organizational features that unhinged the cohesiveness of the relationship. In particular, the long-term relational contract, established at the turn of the century with the incorporation of the Platt Amendment into the Cuban constitution and the U.S.-Cuban Treaty of Reciprocity, began to unravel seriously because of a fatal flaw included in its governance structure after 1934. This turning point was marked by two formal acts - the abrogation of the Platt Amendment and signing of a new treaty of reciprocity, and the passage of the Jones-Costigan Act in the United States, which founded the current quota-based U.S. sugar program. We demonstrate how the operation of the quota system created a dynamic that led to the disintegration of U.S.-Cuban cooperation.

The International Relational Contract

The usefulness in the contractual analogy lies in the well-developed body of literature that applies to private contracting agreements. Clearly, there are fundamental differences in how sovereign states reach agreements relative to private business entities. The key point of similarity is that both modern businesses and governments are complex organizations that produce decisions by an interaction between members.

The existence and stability of long-term relational agreements between organizations is one of the features that underlies modern capitalism. This is true both of private business organizations and of governments acting on behalf of their citizens to promote international commerce and legal defense of indi-

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vidual rights and property. An important distinction, though, is that whereas formal agreements between businesses may rely on third-party legal enforcement of their contracts, formal agreements between governments may not resort to effective third-party enforcement. Given the difference, one might expect a divergence in enforceability of formal agreements between states, such as treaties and other international accords, relative to private contracts.

The difference in enforceability, however, is not as severe as the formal picture would suggest. The literature has shown that legal enforcement of contracts is resorted to rarely because it is costly. Indeed, many private agreements are made and carried through without relying on the threat of third-party enforcement. Internal mechanisms, built into the agreement, and relationships founded on repeated dealings, reputation, or trust are the cornerstones of enforcement in private agreements. One might hypothesize that whenever stability in long-term relational agreements between governments is observed, it relies on the same mechanisms of enforcement. Conversely, when an established long-term relational agreement is unstable, or breaks down, it might be explained by the ineffectiveness of one of these informal enforcement mechanisms [Hart, 1989; Milgrom and Roberts, 1990].

An important precept of the contracting literature is the fundamental incompleteness of contracts. Because of informational asymmetries and transaction costs, complete contracts are impossible. Inevitably incomplete, contractual agreements must expect occasional post-contractual adjustments or renegotiations. One approach to this problem is the "relational contract," the most ready example of which is the employer-employee contract. Recognizing the unavoidable incompleteness of the relationship, the parties do not agree to the details of an exchange; rather, they agree upon a set of common terms by which they establish a relationship of exchange; but the details that govern the relationship on a year-to-year basis are left to ex post determination. This is how one might characterize the constellation of explicit treaties and implicit agreements that surrounded Cuba's acceptance of the Platt Amendment and both countries' acceptance of the Treaty of Reciprocity of 1903. The persistent cohesiveness of the relationship depended on the ex post operation and governance of the details in accordance with the ex ante terms [Williamson, 1985, pp. 164-66; Kreps, 1990].

Another parallel between the relational contract and the treaty relations is the mutual understanding regarding termination of the agreement. For example, in an employer-employee relationship, either party has the right to end the agreement unilaterally, if the terms should become disadvantageous [Alchian and Demsetz, 1972; Milgrom and Roberts, 1992, p. 131]. Likewise, in the treaty relation, both nations pragmatically had to understand that the treaty commitment could not be sustained if its maintenance unambiguously diverged from national interest.

The Founding of the Relationship

The Cuban War of Independence of 1895-98, which terminated with U.S. intervention in 1898, was disastrous for the Cuban economy. The U.S. War Department estimated that the population of Cuba declined by twelve percent and that the wealth of the island was reduced by two-thirds [U.S. War Department, 1899, p. 41]. The sugar industry, the lifeblood of Cuba, was particularly devastated. The U.S. provisional governors, Gen. John Brooke and Gen. Leonard Wood, and Secretary of War, Elihu Root, all emphatically voiced views that Cuba's pacification and economic revival depended on U.S. support [Wright, 1931, pp. 23-24; U.S. Tariff Commission, 1929, pp. 376, 386]. They proposed generous concessions in commercial relations as the preferred policy. At a minimum, they advocated a significant reduction in the duty on imports of Cuban sugar [U.S. Tariff Commission, 1929, p. 375-76, 378].

Incorporation of the Platt Amendment into the Cuban constitution was made a condition for departure of military occupation. The Platt Amendment required that Cuba, through its own constitution, cede to the United States the right to approve all treaties with other foreign countries, and the right to intervene to preserve "independence," and protect "life, property, and individual liberty."[1] These extraordinary impositions met passionate resistance from many Cuban patriots [Smith, 1963, pp. 126-127]. The constitutional convention sent a delegation to Washington to meet with Secretary of War Root to make it clear that there was substantial opposition to the Platt Amendment and that commercial concessions by the United States would be critical if the amendment were to be incorporated into the Cuban constitution. Root assured that "once the government of Cuba was established, representatives would immediately be appointed to study and propose a treaty of commerce which should be based on mutual benefits and friendly relations" [U.S. Tariff Commission, 1929, p. 383].

The U.S. Congress took up the issue of trade reciprocity with Cuba in January 1902. The legislative battle centered on a proposed preferential treatment for Cuban sugar. The most vocal proponents and opponents were identified by special interests. Proponents included owners of Cuban sugar plantations, sugar refiners, the U.S. Export Association, the Merchants' Association of New York, and the New York Produce Exchange. Opponents were principally the U.S. cane and beet sugar interests. They bitterly objected to any policy which imposed the costs of Cuban support disproportionately on only select domestic industries, namely the sugar industry. Instead, they preferred direct aid to Cubans financed by all Americans [U.S. Tariff Commission, 1929, pp. 391, 395].

President Roosevelt's energetic support for the treaty was critical to its passage in 1903. Cuban sugar and tobacco received a 20 percent reduction from the full U.S. tariff rate. Cuba, in exchange, gave U.S. imports a 20-40 percent discount on its duties.[2] Thus began the era of cooperation.

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[1] U.S. Statutes at Large. XXI: 897-98. Cited in Smith [1963, pp. 125-26].

[2] The House passed the treaty by a vote of 335-21 and the Senate by a vote of 75-18 [U.S. Tariff Commission, 1929, p. 30; Wright, 1931, pp. 26-30].

The Years of Cooperation

The passage in both Cuba and the United States of the reciprocity treaty ushered in a new era in bilateral economic relations. Although both countries awarded preferential treatment to each other's products, there was no long-term legal commitment to low tariffs in and of themselves. That is, both nations retained the right to adjust their tariffs. Thus, the reciprocity regime was not "risk-free"—exporters in both countries faced the possibility that tariff modifications could reduce or even eliminate the benefits conveyed by the treaty.

But the political threat to the Cuban economy depended more on concern over general tariff reform than on direct actions toward sugar. Historically, the United States Congress rarely changed individual duties except in conjunction with an omnibus tariff bill. The tariff risk to Cuban sugar, therefore, varied to no small degree with the ebb and flow of recurrent debates on free trade and protectionism in the American legislature. Fortunately for Cuba the supporters of free trade held the upper hand for nearly twenty years. Thus, from 1903 to 1921 U.S.-Cuban trade relations flourished. Cuban exports with the United States grew by a factor of 5 in the next 20 years, and imports grew by a factor of 7. U.S. direct investment in Cuba, concentrated in the sugar industry, increased by 13 times (see Tables 1 and 2).[3] Figure 1 shows that Cuban exports of raw sugar to the United States, nearly their only customer, doubled from 1902 to before the First World War.[4]

Table 1: U.S. Direct Investment in Cuba (millions of 1926 dollars)

Year	Sugar	All Agriculture	Total
1896		65.4	97.8
1906	48.4	154.8	316.9
1911	100.1		315.8
1912		108.7	318.9
1927	628.0	675.1	1193.2
1929		604.3	965.8
1936		327.9	824.1
1943		177.6	512.1
1950		165.7	405.2
1957		148.2	469.5

Sources: 1896, 1906, 1911, 1927: Lewis (1938), pp. 615-616. 1912: U.S. Tariff Commission (1929), p. 3. 1929, 1936: U.S. Commerce Department (1956), p. 10. 1943: U.S. Treasury

[3] British investment was significant in railroads, and Spanish concerns remained important in agriculture [Pinos Santos, 1973, pp. 36-42; Jenks, 1928, pp. 160-66].

[4] The real value of Cuban exports to the United States more than tripled from 1902-1914. Authors' calculation from Zanetti Lecuona (1989), cuadro III. The United States was the destination for over eighty percent of Cuban exports during this period. Also, effective March 1914 the U.S. tariff on Cuban sugar fell from 1.348 cents per pound to 1.0048 cents per pound. See Table 3.

Department (1947), p. 70. 1950: U.S. Commerce Department (1953), p. 44. 1957: U.S. Commerce Department (1960), p. 90.

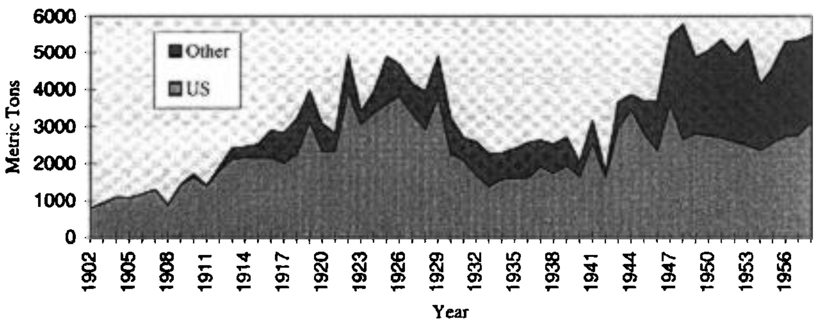
Notes: 1911 figure does not include investments in tobacco. After WWI nearly all American investment in Cuban agriculture was in the sugar industry. Separate figures for the sugar industry are therefore not available.

Table 2: Number of Sugar Mills in Cuba, and Share of Production, by Nationality of Ownership, Selected Years.

	Cuban		United States		Spanish		Other		Total
Year	No.	Prod. (%)	No.	Prod. (%)	No.	Prod. (%)	No.	Prod. (%)	No.
1902				20					
1906			30	28					
1913	67	33	39	37	41	18	25	12	172
1926	101		41	63	16		26		184
1935	50		70	62	37		22		179
1939	56	22	66	55	33	15	19	8	174
1952	113	55	41	43	6	2	1	0	161
1955	118	59	39	40	3	1	1	0	161

Sources: 1902: U.S. Tariff Commission (1929), p. 170. 1906: U.S. Tariff Commission (1929), p. 169. 1913: Dye (1998), p. 60. 1926, 1935, 1939, 1952, 1955: U.S. Commerce Department (1956), p. 37.

Figure 1: Cuban Sugar Exports, 1902-1958



Source: Grupo Cubano de Investigaciones Económicas (1963), pp. 462, 668, 670, 964.

During World War I, global sugar markets were seriously disrupted, leaving Cuba as one of the few remaining sources of sugar for the Allied Powers. When the postwar recession hit, Cuban sugar interests that had borrowed heavily from U.S. banks to finance furious expansion from 1916-1919 went into receivership. National City Bank, in particular, came to own significant properties on the island [Cleveland and Huertas, 1985, pp. 106-112]. Other American companies - including major sugar refineries and also manufacturers such as Hershey, Hires Root Beer, and the Loft Candy Company – took the opportunity to purchase Cuban sugar assets at low prices [*Cuba Review,* "Many Changes in Ownership of Cuban Mills," (October 1920), pp. 32-33; Smith, 1960, pp. 29-30; Pinos Santos, 1973, pp. 110-119].

The crisis in Cuba during 1921 was mirrored by a deep recession in the United States that affected both agriculture and industry. The extent of this downturn and the Republican party's success in the election of 1920 led to strong support for tariff reform. In 1921, Congress passed emergency tariff legislation that called for temporary increases in the duties on many items, including sugar. In 1922, these increases were made permanent and in many cases augmented by the Fordney-McCumber Tariff Act. The result was a duty of 1.7648 cents per pound on Cuban sugar, whereas it had been 1.0048 cents per pound only two years earlier (see Table 3). In both instances, domestic beet and cane sugar interests found allies, primarily in the mainstream Republican party, who also wished to raise tariff barriers on industrial and some farm products.

Table 3: History of U.S. Tariff on Sugar

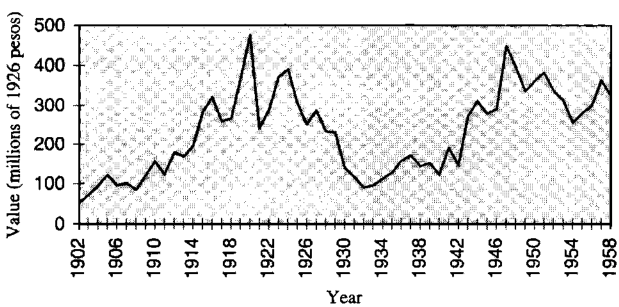
Year	Duty on Cuban Sugar (cents per pound)	Duty on Sugar (cents per pound)	Range of Ad Valorem Equivalent for Cuban Sugar
1897 - 1903	1.685	1.685	62 % - 91 %
1904 - 1914	1.348	1.685	44 % - 63 %
1914 - 1921	1.0048	1.256	9% - 37%
1921 - 1922	1.6	2	46 % - 54 %
1922 - 1930	1.7648	2.206	34 % - 118 %
1930 - 1934	2	2.5	133 % - 216 %
1934 - 1942	0.9	1.875	30 % - 61 %
1942 - 1947	0.75	0.9375	14 % - 25 %
1948 - 1951	0.5	0.6875	9 % - 10 %
1951 - 1959	0.5	0.625	8.5 % - 9 %

Source: *Willett and Gray,* various issues.

These incidents clearly showed that the U.S. Congress would favor domestic special interests over Cuban economic concerns even at a time of extreme vulnerability on the island. The tariff increases, which added to the growing discontent in Cuba over the imperialist terms of the Platt Amendment, merely foreshadowed events to come. The American election of 1928 gave the Republican party the presidency and a large majority in each house of Congress. A major plank in the party's platform was tariff reform, ostensibly to support the ailing agricultural sector. However, the political process soon resulted in across the board increases in duties for many manufactures. The duty on Cuban sugar was raised from 1.7648 to 2 cents per pound, despite the entreaties of many legislators who foresaw that such an increase would have devastating consequences in Cuba [Dye and Sicotte, 1998, p. 34].

The effect of the sugar tariff was felt immediately in Cuba. From 1930 to 1933 Cuban sugar exports, both in volume and value, plummeted (Figures 1 and 2). The Cuban sugar industry was ruined. A telling example of this is that National City Bank wrote down its investment in the General Sugar Corporation from $25 million to $1 million - a stunning 96% fall in value [Cleveland and Huertas, 1985, p. 392]. Table 1 shows that the value of U.S. direct investment in Cuban agriculture, almost all in the sugar industry, lost nearly half of its value between 1929 and 1936.[5] The economic collapse culminated in the Cuban Revolution of 1933, a turning point in twentieth-century Cuban history. In January 1934, after several months of instability, elements of the armed forces, headed by Fulgencio Batista, orchestrated a coup d'etat.

Figure 2: Cuban Sugar Exports, 1902-1958



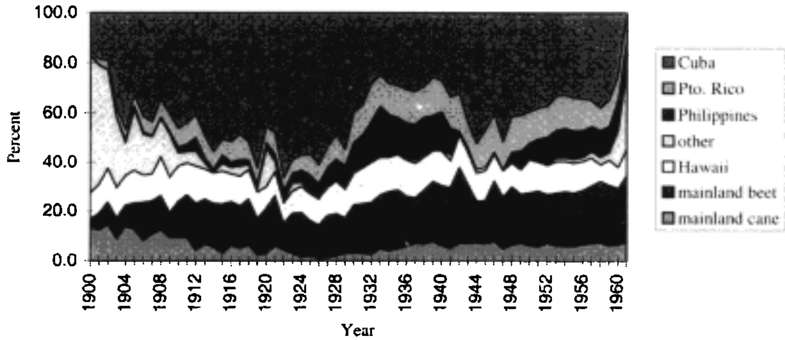
Source: Zanetti Lecuona (1989), cuadro II.

Endorsement and Demise of the New Regime

[5] Overall investment in the island declined less rapidly than that in the sugar industry, largely due to the appreciation of substantial investments electricity and telephones [U.S. Commerce Department, 1956, p. 10; Smith, 1960, p. 167].

In the eyes of many observers the revolution had been fomented by the economic collapse in Cuba, which in turn owed a great deal to the higher sugar duty contained in the Hawley-Smoot tariff law [Aguilar, 1972, p. 99; Foreign Policy Association, 1935, pp. 186, 246]. The new Roosevelt Administration was committed to improve the conditions in Cuba in order to help American investors, stabilize the island politically, and make U.S. relations with Cuba into an example of its new "Good Neighbor Policy" toward Latin America. Of course, the Administration wished to do so without directly challenging domestic sugar, which had been spared somewhat from the agricultural crisis gripping the rest of the country because it benefited from the high tariff on Cuban sugar [Smith, 1960, p. 160]. As Figure 3 shows, the beet producers increased their share of the U.S. market considerably during the early 1930s. The industry did not want any new Cuba policy that would affect them negatively.

Figure 3: Sources of U.S. Sugar Supply



Source: U.S. House of Representatives, Committee on Agriculture (1962), p. 3.

The political outcome was a new three-pronged approach to foreign policy with Cuba. First, the Platt Amendment was abrogated as a concession to Cuba and to foster greater good will on an issue that had been a source of friction between the two nations. Second, a new Reciprocity Treaty was negotiated in which the rate of duty on Cuban sugar was reduced from 2 cents per pound to 0.9 cents per pound. Lastly, the Congress passed the Sugar Act of 1934, which introduced a quota system for all major sources of supply to the U.S. market.[6] This quota regime was the single most important element of the U.S.-Cuban economic relationship until the Revolution of 1959.

[6] The U.S. Tariff Commission conducted a study of the situation and recommended a complete reworking of the American sugar market along the lines of a quota system. The Agricultural Adjustment Act had also called for a privately negotiated division of the U.S. sugar market, but the plan presented by the industry was eventually rejected [Dalton, 1937, pp. 72, 80-91].

Although the reduction in the tariff clearly worked to the advantage of Cuba, producers on the island could not gain the full potential benefits because of the existence of the quantity restrictions. The elements of this system, enacted in the spring of 1934, essentially fixed all major producing regions' shares of the U.S. market at the averages from 1931-1933. The use of these years as a base constituted a settlement with domestic producers. If any other three year period had been chosen since the origin of the reciprocity regime, Cuba would have received a larger quota (Figure 3) [Heston, 1987, pp. 106-112]. Still, at least under this system Cuba's sugar exports to the U.S. would grow with demand.

The Sugar Act of 1934 fell under the jurisdiction of the House Ways and Means Committee. When the bill came up for renewal in 1937, a personal deal was struck between the chairs of Ways and Means and Agriculture committees in the House by which the quota bill was passed to the jurisdiction of the latter [Price, 1971, pp. 222-3]. The change of jurisdiction was of great significance to the governance of the quota system. The Ways and Means Committee was accustomed to dealing with legislation, such as tariffs, that involved foreign policy considerations. The Committee on Agriculture consisted disproportionately of representatives from rural states who favored domestic farm interests. The governance of the quota system passed from being determined largely by revenues and customs policy to being determined by domestic farm policy.

The first piece of evidence in this dramatic shift in governance policy is that, during the renewal process, the House Agriculture Committee attempted to improve the lot of the domestic sugar industry at Cuba's expense. It advocated fixing Cuba's quota at 1.82 million tons, rather than using the flexible percentage it received under the 1934 act. The State Department applied pressure and blocked this initiative on the part of the House Agriculture Committee, and the 1937 act guaranteed Cuba a continued 28.6 percent of the U.S. market, which it had enjoyed under the previous law [Heston, 1987, pp. 393-4].

This episode signaled to the Cubans that they would be especially vulnerable so long as the Agriculture Committee possessed jurisdiction over the quota renewal process. This was because of the committee's domestic farm orientation, and its strong ties to the Department of Agriculture, the original sponsor of the domestic beet sugar industry. The Sugar Act of 1937 would expire at the end of 1940, and the Cubans would have to conduct another lobbying offensive in Washington to oppose the efforts of domestic sugar interests, well-represented by members of the House Agriculture Committee and the U.S.DA. Other legislators, more likely to be sensitive to Cuba's economic distress, would defer to the Agriculture Committee's jurisdictional authority under the current regime. Because sugar was now a stand-alone issue, there was no need for other legislators to get involved.

The Second World War interrupted this policy, and the quota system was suspended from 1942 to 1947. During that time, Cuba greatly expanded its exports of sugar [Bernhardt, 1948, pp. 257-285]. The change in fortune brought an economic boom to Cuba.

After the war, the quota system was resumed. Cuba faced periodic political trials due to the nature of the renewal process. In 1948, 1951, and 1956 the quota system was altered. The House Agriculture Committee continued to press for the reduction of Cuban quotas and their reallocation to domestic producers. The State Department took on the role of defender of Cuban economic interests before Congress. In 1947 Secretary of State Marshall noted that a quota system harmful to the island's sugar industry "might also bring on economic and political chaos in Cuba, necessitating expensive American intervention" [Heston, 1987, p. 400]. Following the Moncada assault of 1953, in the 1955 hearings held before the House Agriculture Committee, Assistant Secretary of State Holland cautioned that reducing Cuba's quota allotment would "strengthen the hand of 25,000 active communists" [Heston, 1987, pp. 413-4].

Despite the exhortations of the State Department, Cuba's share of the sugar market in the United States was reduced by the quota revisions of 1951 and 1956. Figures 2 and 3 illustrate the island's declining export earnings through the early 1950s and its slight decline in market share within the U.S. The effects on the sugar industry were predictable. When the Department of Commerce reviewed investment opportunities in Cuba in 1956, it opined that "investment in sugar has reached an apparent saturation point" [U.S. Commerce Department, 1956, p. 11]. Indeed, since the debacle of the 1930s, U.S. interests had divested considerable quantities.[7] Table 2 indicates that U.S. corporations owned 23 fewer mills in 1952 than they had in 1939, although their share of production had not decreased proportionally. Cuban ownership had picked up as foreign interests exited the sugar industry. In the postwar years, U.S. capital was the only foreign capital of note on the island. Yet, in real terms, it was lower than it had been at any time since before the First World War (Table 1). The largest U.S. investments were now clearly in the realm of utilities. Moreover, U.S. investors were increasing capital flows elsewhere in Latin America at a much higher rate than they were in Cuba [U.S. Commerce Department, 1957, p. 112].

The recurrent political difficulties that Cuba faced in the U.S. market led it to seek alternative markets more vigorously. In 1951 and 1952 Cuba signed agreements with Canada, West Germany, France, and the United Kingdom to sell sugar. After 1953, however, world sugar production was subject to export quotas under the International Sugar Agreement. By 1955, Cuba was selling sugar to the Soviet Union in significant quantities. The largest sale, amounting to 456,000 tons, was made at a price below that which Cuba sold to the United States. This deal in particular damaged Cuba's position during the Congressional debates over the 1956 quota revision [Heston, 1987, p. 410; Pérez-López, 1991, pp. 136-7]. To a certain extent, the Cubans may be seen as

[7] Firms from other nations also reduced their holdings in Cuba [U.S. Commerce Department, 1956, p. 11].

victims of a Catch-22. The sales of sugar to the U.S.S.R. were more urgent for the Cubans because of the quota system, yet the sales of sugar to the U.S.S.R. jeopardized Cuba's fragile support in the U.S. Congress.

Without question, the quota regime transformed Cuba's negotiating position vis-à-vis the United States from the level of an act of state to the activity of lobbying as a supplicant to Congress, with no direct representation. The success of their sugar-dependent economy had traditionally depended upon access to the American market, protected by a tariff, and therefore subject to American domestic politics. The growth opportunities for Cuba in the post-1937 regime were extremely limited. Attempts to diversify their clientele in order to reduce their exposure to the U.S. market met with the obstacles just discussed. After 1953, many Cubans felt the need to exit the current entrapment and supported the brewing revolution, which expressed hope to address growing social inequalities and an alternative plan for economic advancement. When Castro came to power in 1959, he vengefully called for a return to the allotments of 1948 and encouraged Cuban producers to double production, drive the world price down, and attempt to bankrupt U.S. beet and cane growers [Heston, 1987, p. 414].

Conclusion

The United States and Cuba entered into what might be described as a contractual relationship at the beginning of this century. This "relational contract" consisted of a nexus of treaties and implicit agreements in which both countries agreed to an astonishing level of economic and political cohesion. The fundamental asymmetry between the United States and Cuba had consequences for the terms of the original relationship, as illustrated most pointedly by the Platt Amendment. But their differences also meant that Cuba's economic welfare was tied inextricably to the economic and political milieu in the U.S.

Therefore, critical aspects of the governance of the relationship would be determined in Washington. During the first thirty years of this century, the governance structure was effectively dependent on U.S. tariff policy and the enormously complex legislative process that it entailed. In such an environment, Cuba found de facto allies among free trade advocates. As the Fordney-McCumber and Hawley-Smoot tariffs depict, this alliance could not safeguard Cuba against the protectionist fervor that swept Congress from 1921 to 1930. Still, if the benefits of this relationship for Cuba under this governance mechanism were risky, it offered some significant advantages over that which followed.

In the wake of the disastrous years 1930-1933, which tore asunder the original relational contract, the two nations renegotiated their relations and established a new constellation of policies and agreements. The enactment of the U.S. sugar quota system was intended to stabilize the market and pave the road to recovery. The fatal flaw in this approach was the governance of this plan. First, the quota system was stand alone legislation, meaning that Cuba could not rely on the allies it had found in the free trade vs. protectionism debates.

Second, critically, after 1937 the U.S. House Committee on Agriculture became the dominant political institution administering the quota. The preeminence of domestic agricultural interests in this committee put Cuba at an insurmountable political disadvantage.

The lackluster performance of the Cuban sugar industry in the post World War II years was blamed by many Cubans on the hostile reception its representatives received in Congress. These may have contributed to the eventual disintegration of U.S.-Cuban relations. When relations between the United States and Cuba thaw, whenever that might be, a new relational contract will likely emerge that also pivots around the issue of sugar. The history of the first sixty years of this century illustrates that the success of any new relation will depend upon the terms of its governance.

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