

Chapter 7

Cuba's *Apertura* to Small Enterprise

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Introduction

When defining the features that ought to characterize the building of a new society, the classics of Marxist-Leninism—particularly Lenin—stated, among other things, that the State, on behalf of all the people, should keep the ownership over all the basic production means. We turned this precept into an absolute principle and almost all the country's economic activity started to be run by the State. The steps we have been taking and shall take towards broadening and relaxing self-employment are the result of profound meditations and analysis and we can assure you this time there will be no going back.

President Raul Castro, 2011

Almost from the beginning of the Cuban Revolution until 2010, official policy towards small enterprise first was to eliminate most of it in a variety of policy moves culminating in the “Revolutionary Offensive” of 1968 and from 1993 until 2010 to permit a limited but contained opening to the sector. Despite this negative policy environment, Cuba incidentally generated a significant reservoir of entrepreneurship that constitutes a valuable resource for the on-going and future emergence of the small enterprise sector.

In October 2010, a variety of liberalization measures were introduced, as a means of stimulating small enterprise enough to absorb large numbers of state sector workers that were considered redundant and were to be laid off. The new supportive approach to small enterprise was then ratified by the VI Congress of the Communist Party of Cuba in April, 2011. Because the small enterprise sector did not expand rapidly enough, further liberalizing steps were initiated in May 2011. The policy changes from 2010 to 2012 represent a major shift in Cuba's development trajectory. Already by 2012 the expansion of the sector has been dramatic—even if below the expected or planned levels.

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There now can be little or no doubt that this new expansionary course will be maintained in view of the failures of past policy approaches to the sector, the obvious benefits of the new policy approach and the demonstrated pragmatism of the Government of President Raul Castro. However, if Cuba is to obtain optimum benefits from small enterprise sector, a range of further reformist measures as well as some tax reforms are still necessary.

The objective of this essay is assess the policy environment in which the small enterprise sector operated as of mid-2012 and to explore some alternate policies and approaches towards the sector for the future. By way of introduction, however, the policy approach to the sector from roughly 1960 to 2010 as well as the impact of this policy environment on the shaping of entrepreneurship is outlined briefly.

Entrepreneurship: Cuba's Previously Suppressed Resource

During the 30 years from around 1963 to 1993 in which the exercise of entrepreneurship in a market-oriented setting was largely prohibited, Cuba in fact created a nation of entrepreneurs. Although the intention was to convert Cuba into a "school for socialism," the reality is that Cuba has also been, in part, a school for market-oriented entrepreneurship. This is one of the more surprising paradoxes of the Cuban Revolution.

The nature of Cuba's planned economy itself inadvertently promoted widespread entrepreneurial values, attitudes, behavior, and *savoir-faire* as citizens of necessity had to buy and sell, truck and barter, hustle and "network" in order to improvise solutions to their personal economic problems. One important phenomenon in this process was the rationing system, implemented initially in 1961. This system was designed to provide everyone with a basic supply of foodstuffs, clothing, and household consumables, in order to achieve a minimum level of equality of consumption and real income. It provided every individual (or household for some products) with fixed monthly quotas of foodstuffs, cigarettes, or household consumables and with annual quotas for clothing and footwear. Everyone received the same allocations of products at controlled and generally low prices (in relation to average monthly incomes).¹ Because everyone received essentially the same rations, many people would receive some items that they did not want or which were of lower priority than other items. In the context of generalized shortage and excess demand which existed with varying intensities since 1962, especially after 1989, everyone had an incentive to sell the rationed items they did not want or to trade them for other products they did want. For example, nonsmokers would purchase their cigarettes and cigars through the rationing system and would then give them to other family members or friends, resell them on unofficial markets, or trade them for other products. Thus, the rationing system itself converted many people, regardless of their levels of ideological enthusiasm, into mini-capitalists, searching for opportunities to sell and to buy.

¹Children and those with special health problems such as diabetics were treated differently and provided with special food rations.

The situation of excess demand and generalized shortage, especially after about 1988 when the cessation of subsidization from the Soviet Union began to make itself felt, also meant that anyone with privileged access to a product at an official price could resell it at a higher free-market price or in the dollar economy. There was therefore a strong incentive for "rent-seeking" or making a profit from buying and selling or exchanging many types of product between the fixed-price official sources and the unofficial or "black market" determined price. Related to the above phenomenon was "*amiguismo*" or "*sociolismo*" or "partner-ism," that is, the reciprocal exchange of favors. While such reciprocity probably occurs in all countries and in many different contexts, it took on some important additional forms in Cuba. Basically, any person with control over resources could exchange access to those resources for some current or future personal material benefit. Cultivating friends or associates in this way was vital for assuring oneself and one's family access to the goods and services necessary for basic material well-being. Complex networks of reciprocal obligations thus became an important part of the functioning of the economy. Daily life involved continuing endeavors in maintaining the personal relationships necessary to ensure access to necessary goods and services through the underground economy, or through the official channels via reciprocal services or "tips."

In short, citizens in their everyday material lives had to behave in an entrepreneurial manner. At the level of the individual or more often the family, people had to explore continuously and evaluate new economic opportunities, to acquire the consumer goods they and their families needed, to sell some consumer goods (or in some cases outputs of goods and services), to bear uncertainty, face risk and take ultimate responsibility, and to invest in the maintenance of their supply and market networks, all under hard and unforgiving budget constraints.

A second area where entrepreneurial action was necessary was, paradoxically, in the central planning system itself. In a perfectly functioning planning system, enterprise managers would have little to do besides obeying and implementing orders. But because the planning system could not and cannot work perfectly especially in the face of continuing disruptions and uncertainty, enterprise managers often had to take initiatives in resolving unforeseen problems. Frequently, solutions to such problems were to be found outside the normal channels of the planning system and required improvised responses by the enterprise managers. This often involved enterprise managers obtaining the required inputs through negotiations with other enterprises, with superior officials, or with superiors or inferiors in other sectors or Ministries. In these negotiation processes, political argumentation, political or Party "*amiguismo*" or "*sociolismo*" (i.e., the exchange of favors within the Party for political and material benefit) as well as economic criteria were central, and economic management was therefore highly political. Managers throughout the Cuban economy had to invest large amounts of time and energy in resolving such input-supply problems. Indeed, their performance depended upon their entrepreneurial success in operating "outside the plan."

While entrepreneurial talents have been developed broadly among the population, their exercise until 1993 was for the most part restricted to the important but low-level everyday tasks of sustenance and survival, often carried out in the

underground economy or in “black markets.” But when the space available for entrepreneurial activity was increased with the liberalization of microenterprise beginning in September 1993, the expansion and diversification of micro-entrepreneurial activity was impressive.

For example, when the production and sale of arts and crafts products mainly for a tourist market was liberalized, the production of such items sprang to life. Before this, the souvenirs and craft products available for purchase by tourists or Cuban citizens were of low quality and minimal diversity, coming as they did from a number of state workshops. However, by 1994, the Cathedral Square, Avenue “G” between 23rd Street and Linea, and La Rampa between “N” and “O” Streets were filled with vendors providing a rapidly widening range of crafts and arts. Very soon there were too many vendors for these locales and they were relocated to the Malecon, and the park between Avenida del Puerto and the Cathedral as well as La Rampa. In 2011, the Government provided a major new facility in a renovated port warehouse. Most tourists to Havana buy some mementos or souvenirs or in some cases major pieces of art generating significant amounts of foreign exchange for Cuba.

Similarly, the quasi-private restaurants in the Barrio Chino enjoyed a cultural exemption from the controls placed on normal “*paladares*” or restaurants facing no 12 chair limitation on their size. They emerged some time ago as dynamic, large, diverse, and efficient restaurants—among the best in Havana. They also have been a living example of what many sectors of the Cuban economy could become with softened regulations and more reasonable tax levels.

Public Policy and the Evolution of Micro-enterprise 1961 to 2010

In the early years of the Government of President Fidel Castro, culminating in the Revolutionary Offensive of March 1968, most of the non-farm economy was expropriated and placed under the control of relevant Ministries and ultimately *Junta Central de Planificacion (Juceplan)*. By 1970, the number of officially recognized self-employed had fallen to around 30,000 or 1.2 % of the labor force (see Fig. 7.1) The official rationale for the nationalizations was to eliminate capitalism and the “chaos of the market” as much as was possible and replace these with the “rationality” of central planning.

The consequences of the nationalizations of small enterprise became quickly apparent. The state sector—controlled by bureaucracies in Havana office towers—was unable to replace small scale entrepreneurial efforts adequately so that quality, quantity and the diversity of production declined. The underground economy expanded, theft from the state sector increased in part to feed underground enterprises, and material standards of living were impaired. The urban landscape became commercially dead—in contrast to the bustle of other Latin American cities. The economy entered a long period of sclerosis, typified by the existence of the many of the same state-owned restaurants on *La Rampa* in 2011 as in 1970.

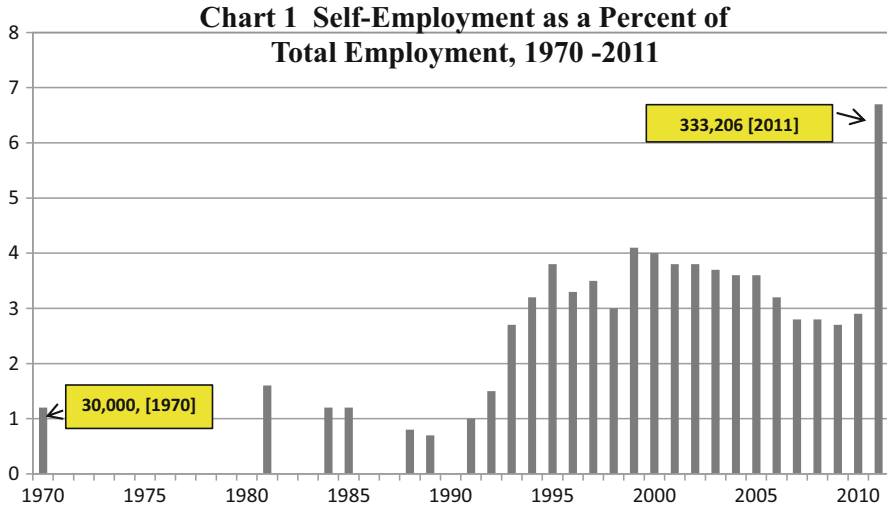


Fig. 7.1 Self-employment as a percent of total employment, 1970–2011. *Source:* ONE *Anuario Estadístico de Cuba*, various issues, and Vidal Alejandro and Perez Villanueva 2012, p. 47

In response to the 1990–1993 economic melt-down arising from the cessation of Soviet subsidization, in October 1994 the government ratified what people were already doing as part of their survival strategies and legalized many new areas of self employment. As a result, self-employment expanded rapidly as enterprises sprang up from the underground economy and as new enterprises commenced. By 1995, there were some 138,000 registered micro-enterprises. This process led to major improvements in the quality, quantity and diversity of goods and services, to increased productive employment and income generation, to increased foreign exchange earnings and savings, to increased tax revenues, to renewed commercial vigor in urban areas and to a general improvement in the quality of people's lives. On the downside, because no provision made for the legal sale of inputs to the sector, a main source of inputs came to be theft from the state.

Much has been made of alleged high incomes in the micro-enterprise sector. Indeed, restaurants and bed and breakfast operations did generate high incomes for a while at least, and when there was a huge monetary overhang and excess money in circulation, prices and incomes were pushed to high levels. When the excess money in circulation was eliminated, prices in the microenterprise sector declined and incomes fell. Most of the sector involved and still involves low-income people providing goods and services for other low income people, so that in consequence, the micro-enterprise sector is a less significant source of income inequality.

Shortly after the legalization of self-employment, the government began to contain it with various limitations, controls, prohibitions, and onerous taxes. In most countries, formal or officially recognized micro-enterprises operate within a set of laws and regulations regarding labor standards, health and safety, product quality and the environment. Through their taxes, they bear a share of financing the

Table 7.1 The self-employment licensing process, Havana, 1996–2001

Application process categories	Number of applications per year							
	1994	1995	1996	1997	1998	1999	2000	2001
Total applications for Licenses	248,552	390,759	46,268	69,407	84,456	91,398	94,827	97,687
Applications in process	4,193	21,963	n.a.	n.a.	n.a.	n.a.	n.a.	499
Licenses granted	169,098	208,786	38,057	34,984	31,587	28,380	24,719	23,351
Licenses granted as percentage of total applications	68.0 %	53.4 %	82.3 %	50.4 %	37.4 %	31.1 %	26.1 %	23.9 %
Applications refused	10,675	11,519	8,211	34,423	52,889	63,018	70,10	74,337
Withdrawn during application	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	11,332
Failed application process	64,586	148,491	1,791	24,990	41,002	50,015	56,809	60,627

Source: *Ministerio de Trabajo y Seguridad Social*, CEPAL (1997), and *Dirección Provincial de Trabajo y Seguridad Social*, 2001, p. 1 and 5

functioning of communities and public goods. In Cuba, however, the tax and regulatory environment was stringent and was designed to limit the incomes that can be earned in the sector, to restrict the size of the individual micro-enterprises, and to reduce the size of the self-employment sector in general.

The most powerful mechanism for limiting the size of the micro-enterprise sector was the license granting process—and the simple expedient of refusing to grant licenses to petitioners. Table 7.1 provides an idea of the limited licensing that was accepted for micro-enterprise in the latter 1990s. The acceptance rate for license applications for self-employment in Havana declined steadily in the first 8 years of legalization, reaching a low of 24 % in 2001.

Part of the legislative framework, extracted from Decree Law 174 passed in 1997, within which Cuban micro-enterprises had to operate together with the punishments for contraventions of the regulations is summarized in Table 7.2. The restrictiveness of the regime is readily apparent. Articles 3 and 5 in particular provide an idea of the flavor of the regulatory environment for self-employment activities. The punishments for infractions, determined by a large corps of inspectors were serious and involved termination of the relevant activity and confiscation of equipment as well as fines.

There was also an onerous tax regime against self-employed Cuban citizens. Of particular note was the 10 % limit on production costs that could be deducted from gross income in calculating net taxable income. Moreover, investment expenditures were not deductible from taxable income.

As a result of this containment approach, the sector ceased to expand and in fact diminished as a proportion of total employment after 1995 as illustrated in Fig. 7.1.

By 2006, when Raul Castro became Acting President following the illness of Fidel Castro, the inadequacies of the state sector in providing the basic goods and services for the population had become starkly apparent. This was manifested in the

Table 7.2 Decree-law 174: Self-employment contraventions and punishments

Contravention	Fines ^a (Pesos)	Seizure of equipment	Withdrawal of License ^b
<i>Article 3 Contravention of Micro-enterprise Regulations</i>			
1. Exercise of unauthorized activity	500–1,500	Yes	Not relevant
2. Exercise of legal activity by unauthorized person	400–1,200	Yes	Not relevant
3. Violations of regulations in a legal activity			
(a) More than 12 places (seats) in a private restaurant	500–1,500	Yes	2 years minimum
(b) Sale of fish, seafood or beef in a private restaurant	500–1,500		
(c) Sales in \$US when not authorized	500–1,500		2 years* min
(d) Sale of alcohol without accompanying food sales	400–1,200		2 years* min
(e) Use of seats, benches or tables in street vending	500–1,500		2 years* min
(f) Use of other location than one's home	250–750	Yes	2 years* min
(g) Inadequate receipts for legal purchase of inputs	250–750		2 years* min
(h) Use of family labor without licenses	400–1,200	Yes	2 years* min
(i) Exhibiting unauthorized films in video rooms	400–1,200	Yes	2 years* min
(j) Sale or use of protected flora or fauna	400–1,200		1 years* min
4. Use of one's home for someone else's micro-enterprise	250–750		
5. Use of intermediaries or specialized sellers	400–1,200		1 years* min
6. Acting as an intermediary for other's products	400–1,200		2 years* min
7. Nonpayment of rental fee for market space	150–500		
8. Sales to state entity without specific permission	400–1,200		
9. Safety violations	400–1,200		
10. Hiding or falsifying information from authorities	400–1,200		
11. Failure to show registration documents at any time	400–1,200		
12. Employment of persons under 17 years	500–1,500	Yes	2 years* min
13. Acting as a wholesaler to other micro-enterprises	500–1,500	Yes	1 years* min
14. Sales or exhibition of legal products by sellers of other products	500–1,500	Yes	Permanent
15. Organization of producer coops or associations unless authorized	500–1,500		Permanent
16. Resale of industrial products purchased in state sector	400–1,200	Yes	
17. Use of prohibited materials or inputs	250–750	Yes	2 years* min
18. Operation in other provinces from that authorized	250–750	Yes	
19. Failure to update information provided to <i>Registros de TCP</i>	150–500		
<i>Article 4. Contravention of Micro-enterprise Sanitary Regulations</i>			
1. Noncompliance with Hygiene-sanitary Rules	500–1,500	Yes	
2. Inappropriate waste disposal	400–1,200		1 years* min

(continued)

Table 7.2 (continued)

Contravention	Fines ^a (Pesos)	Seizure of equipment	Withdrawal of License ^b
3. Failure to show authorities the sanitary license	400–1,200		Perhaps 2 years* min
<i>Article 5. Contravention of Tax Provisions</i>			
1. Failure to make monthly or annual payments on time	50 % of taxes due		
2. Failure to register or provide new information	150–500		
3. Failure to show documentation of any time	150–500		
4. Failure to keep revenue and cost information for 1 year	250–750		
5. Failure to provide information in the required form	500–1,500		
6. Failure to permit free access to designated inspectors	400–1,200		
<i>Article 7. Unintentional Contraventions</i>			
Contraventions which are unintentional or made by those with favorable conduct	Fine partly or fully reduced		
<i>Article 8. Multiple Contraventions of multiple character</i>			
	Fines doubled		
<i>Article 9. Repeat Offenders</i>			
Offenders who repeat contravention twice in a 2 year period	Imposition of highest fine		2 years* min.

Source: Decreto-Ley No. 174, De las Contravenciones Personales de las Regulaciones del Trabajo por Cuenta Propia, Gaceta Oficial, Numero 22, 30 de Junio de 1997. pp. 337–352

^aThe average monthly income in Cuba was 214 pesos in 1996. The fines thus range from 70 to 700 % of the average monthly income, and higher for multiple offenses

^bSome micro-entrepreneurs state that the minimum two-year suspension may really mean a permanent suspension

very limited amount of goods and services available through the ration book. Volumes of production of manufactured goods in 2006 had not recovered from the 1990–1993 melt-down and were only 43.6 % of the 1989 level (ONE 2010, Cuadro 11.1). Few products manufactured in Cuba were available in the “*moneda nacional*” economy. Instead only imported manufactures of many sorts including clothing, footwear, and household gadgetry were available and had to be purchased for “convertible pesos” in the “*Tiendas por la Recaudacion de Divisas*” (formerly the dollar stores). And the underground economy for wide ranges of goods and services was flourishing as never before.

After Raul Castro succeeded his brother, a number of policy innovations and experiments were introduced that seemed to suggest that major policy changes were being contemplated and analyzed within the Cuban government. These policy changes included

In 2006:

- Permission for Cuban citizens to enter and use hotel facilities.
- Relaxation of rules re purchase of electronic items.

In 2008:

- The elimination of the cigarette ration.

In 2009:

- Long-term leases (10 years) of unused state agricultural land by small farmers.

In 2010:

- Privatization of urban parking arrangements: parking attendants now paid a rental fee to the state for the right to allocate parking places on designated sections of streets, charge those parking their cars and retain a profit.
- Relaxation of some restrictions on private taxis.
- Experimentation with cooperative hair dressing salons and barber shops.
- Establishment of markets for inputs for small farmers aside from state input allocation.
- Permission for bus drivers to rent small city busses and operate them on a “for-profit” basis.

These were interesting if minor innovations. They were of a suggestive, tentative and experimental character rather than definitive.

President Raul Castro's Small Enterprise Policy Reforms, October 2010

In October 2010, Raul Castro's Government introduced a broad set of policy reforms for small enterprise that was part of a broader reform package designed to shrink the state sector ultimately by firing 500,000 redundant workers by March 31, 2011 and ultimately 1.8 million workers in total by 2015 (Granma, 13 de Septiembre de 2010). These workers released from the downsizing of the state sector were to be reabsorbed into the non-state sector, including small enterprises and cooperatives. This was an amazing and ironic reversal of fortune for Cuba's private sector. Small enterprises had been almost eliminated in the 1960s, then liberalized from 1993 to 1995 and then were stigmatized and contained by onerous regulations and taxation. Now they were supposed to save the economy, generating jobs, higher productivity and higher living standards than was possible under the old system. Fidel Castro's 50-year attempt to construct his own varieties of “socialism” was being repudiated and abandoned by his own brother.

Firing 1.8 million state sector workers looked risky and brutal. Hoping that they would somehow be absorbed in the non-state enterprise sector looked like wishful thinking. In other contexts this approach would be labeled “neo-liberal” structural adjustment of the most draconian sort. Would the laid-off workers have the abilities

and aptitudes necessary to start their own businesses? But the biggest question was whether the small enterprise sector could create 500,000 jobs by March 30 2011 and ultimately 1.8 million new jobs.

Regulatory Reforms

The central features of the regulatory and tax reforms have been to liberalize the framework within which small enterprises operate and to accommodate the expansion of the sector, whereas the earlier regulatory and tax regimes from 1995 to 2010 were designed to contain its growth, to keep enterprises tiny, and to limit the incomes of the self-employed. The central features of the regulatory reforms can be summarized as follows:

- Licensing was broadened.
- Rental of facilities from citizens or the state became easier.
- Sales to state entities were now possible.
- Use of banking facilities and bank credit were slated to be introduced.
- Permitted activities were increased to a total of 181.
- Some regulations were eased, e.g., the 12 seat limit on the size of restaurants was raised to 20.
- Punishments for infractions of the regulations were eased. The seizure of equipment and the retraction of licenses have been dropped as punishments, but virtually all of the old infractions continue to be punished by the same fines as before.
- Imported inputs were slated to become accessible for small enterprise at wholesale prices.
- The activities of the small enterprise sector began to be “de-stigmatized.”

Of these, the liberalization of licensing was especially significant. Restrictions on the issue of permissions to establish micro-enterprises had placed a severe limit on the expansion of the sector. Reversing this policy then led to a rapid increase in the numbers of small enterprises.

However, some tight limitations on small enterprise remained. For example, professional activities continued to be prohibited. Intermediaries were still prohibited and each producer was supposed to be the seller of his or her output. Various petty restrictions such as the 20 chair rule continued. Tight limits continued on the hiring of employees. Advertising continued to be prohibited.

Tax Reforms

As part of the policy reforms designed to absorb the redundant state sector workers into the private sector, the Government of Cuba modified the micro-enterprise tax regimen. Some of the modifications were positive in the sense that they reduced the heavy tax burden on small enterprise. However, the changes were modest, and the tax system continues to limit job-creation and the expansion of micro-enterprise.

The new taxation system, presented in the *Republica de Cuba Gaceta Oficial, Número 11*, and *Gaceta Oficial, Número 12* on October 1 and 8, 2010, has four components: a Sales Tax; a tax on the hiring of workers; an income tax and social security or social insurance payments. Taxes generally are payable in *Moneda Nacional* or “old” pesos. For revenues or costs in convertible pesos (CUCs) they are to be translated into *Moneda Nacional* at the going quasi-official rate (around 22 to 26 “old” pesos per convertible peso, over the 2001–2010 period) for purposes of tax payment. There also is a special regimen for bed-and-breakfast operations that is not considered here.

First was a sales tax, a 10 % tax levied on the value of sales and payable by all micro-enterprises that do not qualify for the Simplified Tax Regime (See below.) While this tax in principle is certainly reasonable and is used in most countries, the administrative cost of monitoring the value of sales and collecting the tax for the many of the smaller self-employed activities will be high.

Second is a tax on the “Utilization of Labor.” This tax on the hiring of employees is set at “25 % of 150 %” (that is, 37.5 %) of the average national wage which was 429 pesos per month in 2009 (ONE, AEC 2010, Table 7.4). The tax would thus be about 161 pesos per month per employee or 1,932 pesos per year. A “Minimum” requirement for the hiring of employees for tax determination purposes was set at two employees for *paladares* and one for other food vendors and a few other activities. There appears to be no exception or adjustment of the tax for part-time employees. (Some 74 self-employment activities were prohibited from hiring employees and another seven could hire one employee only.)

Third, there are two income tax regimes: a simplified regime for smaller self-employment activities and a more complex regime for larger activities. The “Simplified Tax Regime” applies to some 91 activities. In place of the income tax and sales tax, they instead pay a consolidated tax, constituted by the monthly licensing fee which ranges from 40 to 150 pesos per month, payable in the first 10 days of each month. (It is unclear whether overpayments would be refunded—they were not under the previous system.)

Other enterprises fall under the general tax regime, and pay all of the individual taxes discussed here. These activities pay the up-front monthly tax/license ranging from 40 to 700 pesos per month. For the determination of the income tax payment, the “tax base” is defined as total revenue less a fixed amount for deductible expenses. The maximum amounts allowed for deductible expenses range from 10 % for 10 activities, 20 % for room rental operations, 25 % for 40 activities, 30 % for 10 activities and 40 % for 6 food and transport activities. (Bed and breakfast operations have their own specific regimen.) The tax rates rise progressively from 0 % for the first 5,000 pesos, through 25 % for additional income between 5,000 and 10,000, 30 % for income increments from 10,000 to 20,000, 30 % for 20,000 to 30,000, 40 % for 30,000 to 50,000 and 50 % for additional income exceeding 50,000.00 pesos. These rates are high but not unreasonable in international comparison.

Fourth are Social Security Payments destined ultimately for old age support, maternity leave, disability and death in the family. These are determined according to a scale that the self-employed worker selects, and may range from 25 % of 350 to 2,000 pesos per month depending on the choice of the self-employed person. This is a social insurance scheme though the payments are similar to taxes.

This new tax regime represents an improvement over the previous regime. The main improvement is that it permits the deduction as costs of production of more than a maximum of 10 % of total revenues as was the case previously. This is a reasonable adjustment to the tax base as most of the self-employed activities generate costs that are higher than the maximum allowable 10 % of total revenues. This is especially beneficial for activities such as gastronomic, transport and handy-craft or artisan activities for which input costs are far beyond 10 % of total revenues. The progressive structuring of the income tax regime is reasonable though stiff.

However there are a number of flaws in the taxation regimen which will continue to stunt the development of small enterprise and will prevent the absorption of the redundant workers being displaced from the public sector. First, the tax on employment adds to the employer's cost of hiring a worker so that it will limit hiring and job creation. Alternately, employment will be "under the table," unrecorded, and out of sight of officialdom. Second, the overall tax level is punitive. The sum of the income tax and employee hiring tax is high—and can help create effective tax rates exceeding 100 %, as is explained below.

The most serious shortcoming of the income tax regime involves the tax base which still is not "net revenues" after the deduction of input costs, but an arbitrary proportion of total revenues. The maximum for input costs deductible from total revenues is limited to 10–40 % depending on the type of enterprise involved. When the actual micro-enterprise input costs exceed the maximum allowable, the tax rate on true net income can become very high. In the example below, the effective tax rate (defined as the taxes payable as a percentage of true net income) can exceed 100 %. If this were to be implemented in such a case, it would kill the enterprise. In general, this provision will promote cheating and noncompliance. It will discourage underground economic activities from becoming legal and block the establishment of new enterprises.

Fourth, the reforms of the micro-enterprise tax regime do little to reduce the fiscal discrimination favoring foreign enterprise. The main difference is the determination of the effective tax base which is total revenues minus all costs of production for foreign firms. In contrast, for micro-enterprise the tax base is gross revenue minus arbitrary and limited allowable levels of input costs ranging from 10 to 40 % depending on the activity. The result of this is that the effective tax rates for foreign enterprises are reasonable. But for Cuban microenterprises the effective tax rate can be unreasonable and could reach and exceed 100 %. Moreover, investment costs are deductible from future income streams for foreign firms this being the normal international convention. But for Cuban micro-enterprise, investment costs are deductible only within the 10–40 % allowable cost deduction levels (Table 7.3).

Example: Three Taxation Cases for a Paladar or Restaurant

To illustrate the character of the tax regime, a case of a "Paladar" is examined below, with the calculations summarized in Table 7.4. In this example, it is assumed

Table 7.3 Comparison of the new tax regimes for Cuban micro-enterprise and foreign enterprise operating in joint ventures

	Micro-enterprise sector	Joint ventures
Nominal tax rates	25 % rising to 50 % of gross income	30 % of net income [50 % for mining and petroleum]
Effective tax base	60–90 % of gross income; [Maximum of 10–40 % allowable deduction for input costs, depending on activity]	Net income after deduction of total production costs
Effective tax rates	May exceed 100 % of net income	30 % of net income [50 % for mining and petroleum]
Deductibility of investment	Deductible from taxable income only within the 10–40 % allowable deduction limits	Fully deductible from taxable income
Employee hiring tax	Tax of 37.5 % of average national wage for each employee hired	None
Social security payments	Yes	Yes
Lump-sum taxation	Up-front “Cuota Fija” tax payments necessary	None
Profit expatriation	No	Yes

Source: the author

Table 7.4 Example: taxation calculation for restaurant, three cases (*Moneda Nacional* or CUP)

	Case A	Case B	Case C
Gross income	100,000	100,000	100,000
Actual input cost: percent of gross income	40 %	60 %	80 %
Peso value	40,000	60,000	80,000
Allowable costs deductible from gross income: %	40 %	40 %	40 %
Peso value	40,000	40,000	40,000
Actual net income before taxes (1–3)	60,000	40,000	20,000
Tax base: (1–6)	60,000	60,000	60,000
Income tax payable: (based on gross revenues less peso value of allowable costs deductible (1–5))	19,750	19,750	19,750
Minimum employee hiring tax: 2 employees at 37.5 % of average national wage per year	3,864	3,864	3,864
Total tax payment (8+9)	23,614	23,614	23,614
Real average tax rate: (10/6)	39.4 %	59.1 %	118.1 %

Assumptions:

Annual Gross Revenues: 100,000.00 CUP (280 CUP or about \$US 10.50 per day)

Actual Costs of Inputs (labor, rental, overheads, food purchases, investment etc.)

Case A: (40 % of total revenues) = 40,000 CUP

Case B: (60 % of total revenues) = 60,000 CUP

Case C: (80 % of total revenues) = 80,000 CUP

Source: The author, based on *Republica de Cuba Gaceta Oficial, número 11*, and *Gaceta Oficial, número 12* on October 1 and 8, 2010

that the total revenues or gross earnings of the *Paladar* are 100,000 pesos per year (Row 1) or a modest 280 CUP or about \$US 10.50 per day. It is imagined then that there are three costs of production cases: Case A, B and C where costs of production are 40 %, 60 and 80 % of total revenues respectively. A situation where input costs for a *Paladar* are 80 % of total revenues is reasonable, given the required purchases of food, labor, capital expenses, rent, public utilities, etc. On the other hand, the 40 % maximum is unreasonably low for many types of small enterprise.

The differing true input cost situations (Rows 2 and 3) generate different true net income (Row 6). The tax base however is determined by the legal maximum allowable of 40,000 (Row 4 and 5) and is 60,000 pesos in all three cases (Row 7). The income tax payable is determined by the progressively cascading scale noted above and is 19,750 in all three cases (Row 8, based on calculations not shown here). The tax on hiring the legal minimum two employees is 25 % of 150 % (that is, 37.5 %) of the average national wage which was 429 pesos per month or 161 pesos for 12 months for two employees or 3,864 pesos per year (Row 9). The total taxes then are the sum of Rows 8 and 9, or 23,614 per year (Row 10).

The effective tax rate is then calculated as the Tax Payment as a percentage of Actual Net Income (Row 10 divided by Row 6). For the Case “C,” where true costs of production are 80 % of total revenues, the effective tax rate turns out to be 118.1 %. Again, this is because the maximum allowable for costs in determining taxable income is fixed at 40 % of total revenues while the true costs of production were 80 % of total revenues.

The chief result of this example is that effective tax rates can be much higher than the nominal tax rates for all the activities where true input costs exceed the defined maximum. In some cases, taxes owed could easily exceed authentic net income—assuming full tax compliance. This situation likely occurs for all activities not covered by the simplified tax regime. Such high effective rates of taxation could destroy the relevant microenterprise and block the emergence of new enterprises which was the objective of policy prior to 2006. However, the objective of the new policy approach is to foster micro-enterprise and to create jobs.

Further Steps in the Liberalization of the Regulatory and Tax Regimes for Small Enterprise, 2011–2012

On May 27, 2011, Granma, the newspaper of the Central Committee of the Communist Party of Cuba, announced a number of additional measures that would reduce the restrictions on small enterprise. The objective of the policy changes was to facilitate the expansion of employment in the small enterprise, creating new jobs to absorb workers to be declared redundant in the state sector. The main policy modifications were as follows:

1. The hiring of up to five workers was extended to all self-employment activities. This is a significant change as it will encourage informally contracted assistants to be incorporated formally into many small enterprises.

2. Loss-making state enterprises such as state restaurants were to be offered for rental to self-employed individuals and operated as “*cuenta-propistas*.” This also may be a significant measure as it provides a mechanism for employment creation to take place at the same time as state sector workers might be declared redundant. In some cases, the same employees may end up working as a small enterprise or a perhaps as a co-operative.
3. *Paladares* or small restaurants were permitted to expand their capacity from 20 to 50 chairs—up from 12 before October 2010.
4. The “minimum employment requirement” whereby for purposes of paying a tax on each employee a minimum number of employees were required, was dropped.
5. An exemption on paying the tax on each employee was granted for the rest of 2011. This was a measure designed to provide start-up support for new enterprises.
6. Eleven new activities were designated for self-employment for a total of 181.
7. The payment of monthly taxes was waived for taxi and bed and breakfast operators for up to 3 months while they closed for repairs of their vehicles or rental facilities.
8. The monthly up-front payment for bed-and breakfast operators was reduced for the rest of 2011 from 200 to 150 pesos or convertible pesos (depending on whether they rented to Cubans in *Moneda Nacional* or foreigners in Convertible Pesos.) This also was an attempt to “jump-start” the formation of new enterprises, accelerating the establishment of new micro-enterprises and to provide a tax break while they commenced their operations.
9. The provision of micro-credits to the private sector from the banking system began in 2012. But only around 10 % of the credits went to small enterprise with the rest going to home repair (Vidal Alejandro 2012).

These changes are all reasonable. The government stated that it is “learning from experience” (“*rectificar en el camino*”). Pragmatism seems to be the growing vogue in economic management and that can only be positive.

By mid-2012, a number of additional policy innovations were under discussion or had begun to be implemented. Of special significance was the proposal to permit the establishment of employee-owned and operated cooperative enterprises to replace state enterprises in a large number of activities. This was to be implemented gradually. With experience gleaned from on-going pilot projects, a General Law of Cooperatives is to be introduced to provide the relevant legal framework. The conversion of a wide range of state enterprises in services and light manufacturing could turn out to be highly significant—or it may not, depending on the framework itself and how the law is implemented. Under such a framework, it is possible that professional services such as architects, accountancy, consulting of various sorts and computer services also could be organized—as many types of these services can operate in relatively small groupings.

One policy introduced in 2012 will have a negative impact on small enterprise. In the absence of wholesale markets for domestic and imported goods, some small-scale entrepreneurs came to rely on periodic imports of inputs brought to Cuba by

travelers by air from other countries.² The imposition of high rates of taxation on such imports will hurt many small enterprises. One hopes that provision will be made quickly for the establishment of wholesale markets for inputs.

Evaluation of the Policy Modifications

Can the micro-enterprise sector generate about 1.8 new jobs million by the end of 2015? On the positive side, there have been some important measures:

1. The political and media stigmatization has been reversed.
2. The liberalization of licensing has opened small enterprise to all possible entrants. This measure will increase competition and push prices downwards and therefore incomes in the sector towards average levels. The increased competition also will be beneficial in terms of product quality, diversity and price.
3. There has been a small increase in permitted activities.
4. Some regulations have been relaxed.
5. The increase in employment to a maximum of five workers for any micro-enterprise will reduce the miniaturization of enterprises in the sector and permit greater economies of scale.
6. The increase in the deductibility of costs from gross revenues for taxes for some activities is beneficial.
7. Future access to micro-credits, to banking facilities and to the purchase of both domestic and imported inputs at wholesale prices are all promising though as of September 2012 not yet fully in operation.
8. The rental of state facilities to small entrepreneurs for their undertakings may stimulate the abandonment of small scale service activities and manufacturing activities by the state, leaving these to the social control exercised by competition under the market mechanism.
9. The elimination of the harshest punishments for infractions, namely revocation of license and confiscation of equipment is also an valuable measure even though almost all of the original infractions still exist and are punishable by the original fines.

However there are still some limits to the policy modifications that will not facilitate job creation.

1. The high level of taxes generally will limit enterprise creation and legalization and will continue to encourage the underground economy.
2. The tax on the hiring of employees will discourage the absorption of labor into micro-enterprise activity.

²The author knows of one micro-enterprise the owner of which undertook a marriage of convenience with a foreigner which permitted frequent travel to that country, the main purpose of which was to purchase inputs needed for the fabrication of the products sold in the micro-enterprise.

3. Micro-enterprises will remain stunted by the high effective tax rates that are incurred when costs of production exceed the minimum deductible for tax determination purposes.
4. The tax discrimination favoring foreign firms in joint ventures over domestic micro-enterprises continues.
5. Narrow definition of legal activities will limit enterprise and job creation.
6. Exclusion of high-tech and professional activities blocks the development of knowledge-intensive enterprises and wastes the training of the Cuba's highly educated population; Innovation throughout the economy blocked.
7. Some restrictions and prohibitions remain.
8. Wholesale markets, access to imported inputs and to banking facilities had not yet been commenced as of September 2012.
9. Restrictions on hiring workers remain, albeit at a higher level than previously.

By mid-2012, the number of people in micro-enterprises appears to have reached 390,000 (Oxford Analytica, August 17, 2012) up from 333,206 in September 2011 (Vidal Alejandro and Perez Villanueva 2012). This was a major increase though well below the target. Of particular note, of the 17 % of micro-enterprises workers in mid-2011 or about 55,500 were from the state sector. Some 16 % were retirees. Another 67 % had not been in the labor force, but presumably were housewives, in the underground economy, students entering the job market for the first time, or perhaps out of the labor force on disability pensions. The relatively small number of micro-enterprises formed by former state sector workers suggests that absorbing redundant state sector workers into micro-enterprise will not be easy, though the movement towards cooperatives will be helpful.³

Conclusion

While the task of modifying the policy framework for the micro-enterprise sector is incomplete, major improvements have been instituted so far and more are in the process of implementation. In the summary presented in Table 7.5, it can be seen that major advances have been made in a number of areas, notably licensing and “de-stigmatizing.” Progress has been made or promised in a number of areas. There has been no action in a couple of areas that are relevant for the Cuban case. In still other areas, some reforms have been introduced but further action is desirable.

There are always disadvantages as well as advantages in economics and in the evaluation of public policy. I have trouble finding any disadvantages or costs in a liberalized policy environment for small enterprise. However, there are three concerns that should be addressed.

³By economic activity, some 16 % people in the small enterprise sector were in transportation, 20 % were in gastronomic services (restaurants and street vendors,) 5 % rented rooms, and some 10 % were employees working in the small enterprises (Vidal and Perez Villanueva 2012, p. 47).

Table 7.5 Major public policy areas for micro-enterprises

Policy area	Status
Liberalize licensing: let anyone and everyone open a small enterprise	Done
Permit all types of self-employment, including professional and high-tech	Not yet
Taxation regime	Needs work
Raise the limit on employees to 10 or 20	In process
Provide wholesale markets inputs	In process
Permit access to imported inputs (outside TRDs and at the exchange rate available for the state sector)	In process
Eliminate silly and vexatious restrictions	Work needed
Establish Micro-credit Institutions	In process
Legalize “intermediaries” (permitting specialization between producers and venders)	Not yet
Permit advertising	Not yet
Legalize markets for housing, automobiles, and durables	In process
Cease the media and political campaigns against small enterprise	Done
Establish a “Ministry for Small Enterprise”	Not yet
Build the Credibility of Public Policy	In process

Source: the author

First, would such an *apertura* worsen income distribution? In the early stages, as some small enterprises increased in size, this would perhaps occur. But Cuba already has an income tax and an effective administrative system for taxing small enterprise so that this effect could be managed. Opening self-employment and small enterprise to all possible entrants would also increase competition in the sector and would push prices and thence incomes downwards towards average levels.

Second, would an *apertura* encourage pilferage of inputs from the state sector—as has happened in the past? This is a possibility that has to be managed. It can be managed by establishing a market for inputs for the sector that is reasonable and fair. In the past it was difficult for small enterprises to obtain their necessary domestically produced or imported inputs—except at the *Tiendas para la recaudacion de Divisas* (TRDs)—leading to purchases of inputs that were pilfered from the state sector. A reasonable market for the provision of inputs to the sector is thus vital.

Third, would an *apertura* lead to an expansion of “infractions” and illegalities as small enterprises tried to evade rules and taxes? This could indeed occur if regulations remained unreasonable and if tax burdens were impossible. If an *apertura* for small enterprise were accompanied by the dropping of vexatious regulations and if the tax regime was made reasonable, it is likely that compliance would improve. But building a culture of respect for regulations and taxes will also take time as the self-employed have come to view government as an enemy force imposing regulations that are aimed not just at their containment but also their elimination.

The economic reform process as it concerns the *apertura* towards small enterprise has been launched. It is in its early stages. It will likely continue under the more pragmatic leadership of President Raúl Castro who insisted (2011) that “there will be no going back.” It will proceed far beyond the “Lineamientos” under new generations of Cuban citizens in economic spheres generally.

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