

Cuba's Underground Economy

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I INTRODUCTION*

Like most countries, Cuba has an "underground economy." In the Cuban case, this economy is comparatively large and includes the activities of a significant part of the population. Much of Cuba's underground economy exists because of the unwillingness of the state to license and officially authorize activities which are permitted and legal in virtually all other countries and which are also permitted for state and mixed sectors of the Cuban economy. Official policies such as tough regulations and heavy taxation together with a negative political and media environment also block legal self-employment or "own-account work" (*Trabajo por Cuenta Propia* or "TCP") and help push it into clandestinity.

A large part of Cuba's underground economy, or that component labeled here "Legitimate Underground Economic Activities" (or "LUEAs") in fact makes a valuable contribution to the economy and society and to people's survival. With a range of policy modifications that would provide a supportive policy environment, many enterprises in the clandestine economy would "surface" into legality. They would operate like normal small enterprises in many countries. They would generate significant net benefits for Cuba and would serve as a part of the foundation for future economic and social development.

In this study, an analysis of one part of the underground economy, namely the "Legitimate Underground Economic Activities" is presented, with examinations of their character,

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evolution, structure and functioning and also their social and economic consequences. The nature of these activities, in the 2000 to 2004 period is explored, partly based on the results of a survey undertaken for this purpose. The main components of public policy that affect above ground self-employment and thence the "LUEA" sector are also analyzed. The implications of the analysis for public policy are also explored.

The next section of the essay analyses some of the relevant concepts of informality and illegality utilized in the literature on the underground economy and informal sector, with reference to the Cuban case. It includes a discussion of information problems and the approach used here for analyzing the underground economy. Section III, briefly describes the evolution of the underground economy of Cuba. In Section IV, the public policies that push economic activities underground are analyzed. The character of the "LUEAs", as revealed in a small survey of self-employment activities undertaken in early 2003, is sketched in Section V. The next section outlines the social and economic consequences of the "LUEAs". Some of the implications for future public policy in Cuba are then explored in Section VI. Finally, the results of the study are summarized and some conclusions are tendered.

II. Analysing the Underground Economy in the Cuban Context.

There are three general streams of analysis and literatures that are relevant for understanding Cuba's underground economy. These include a focus on the "informal sector" in the context of developing countries, an analysis of the "second economy" in the context of the transition or former socialist economies, and third, an examination of the underground or shadow economy often in the context of the high income countries. There are definitional and conceptual complexities within each of these three approaches as well as overlaps and similarities among them. Moreover, these streams of thought have evolved over time and there are a variety of

interpretations and concepts within each of the three approaches. This complicates the task of analyzing the particularly unique case of Cuba. While all of the three general approaches are of relevance for Cuba, no single approach is entirely satisfactory. For this reason, a hybrid and "customized" approach is used in this essay.

The "informal sector" approach, launched forcefully by the International Labour Organization in its 1972 Report on employment in Kenya and deepened steadily since then (ILO 2002), was adapted to the Latin American context by a variety of writers, notably V. Tokman at PREALC, F. De Soto, and others. The central defining characteristic of informality in these approaches is that it is "extra-legal," or outside the regulatory, taxation and supportive framework of the state, but that it is more or less tolerated by the state and, therefore, not considered as criminal in character. The relevant small enterprises in this approach produce legal goods and services though the production processes are extra-legal. The "formal economy" then includes those enterprises and activities that are within the regulatory and taxation powers of the state, though also benefiting from a wide range of supportive public policies (infrastructure, credit, subsidization of various sorts, protection versus imports, training, subsidized "R&D," etc.)

The concept of "informality" in this stream of thought does not fit Cuba closely because small enterprise is either "formalized" or captured by the state as licensed self-employment, or else it is criminalized and forced underground. On the other, hand, the basic characteristics of the informal economy identified by the ILO - low barriers to entry, use of indigenous resources, small scale, family organization, high labor intensity, skill acquisition outside the formal educational system and competitive market structures - are all characteristic of Cuba's underground economy.

The stream of thought, emerging from the analysis of the transition economies emphasizes the "second economy" in centrally planned economic systems, namely those activities that are outside the central planning system but which people conduct for private survival or gain and that

are knowingly illegal. (Pérez -López, 1995, pp. 13-16, 77). These activities would encompass legal private activities such as production in private plots and small enterprises, semi-legal and tolerated "gray area" private activities in which legal goods were produced illegally, illegal private activities within the state sector, and illegal private activities in which goods were produced and exchanged by unlicensed and hidden enterprises (Los, 1987, cited by Pérez-López, p.14). The "second economy" approach was utilized most effectively for the Cuban case by Jorge Pérez-López (1995) and is consistent with the approach used here.

In their international survey of the "shadow economy" (2002 Chapter 1), Schneider and Enste present a definition of the underground economy that includes household production, informal non-marketized but legal activities (such as neighborhood help and self-help organizations), an "irregular sector" (legal products produced illegally) and a criminal sector (illegal production of illegal goods or services). The last two are defined as the "shadow economy".

A modified set of categories of economic activities relevant for the specifics of the Cuban case is used in this essay. As illustrated in Table 1, economic activities are split into the four categories: Household Economy, Formal Economy Enterprises, the Underground Economy, and the Criminal Economy. The concepts used in this essay are a modified version of those of Schneider and Enste as well as Pérez-López. The Household Economy, Category A, similar to the ILO (2002:12) concept of "Reproductive" or "Care Economy", includes all non-marketized production and exchange of goods and services within the home and between friends and neighbors. It is probably larger in Cuba than elsewhere. Though some parts of home-based economic activities are included in the estimates of GDP of some countries, they are largely excluded in most countries and probably totally excluded in Cuba.

Table 1 TYPES OF ECONOMIC ACTIVITIES, with special reference to Cuba

Type of Activity	General Character of Activity	Examples
A. HOUSEHOLD ECONOMY Non-monetized activities within the home or among neighbors	<ul style="list-style-type: none"> - Child rearing; activities - Personal services; - "Do-it-yourself" activities 	<ul style="list-style-type: none"> - All tasks relating to support and rearing of children; All household tasks; - Home maintenance and repair,
1. Within families and households	<ul style="list-style-type: none"> - Cooperative work around the home; - Barter of legal goods and services; - Sharing of some work tasks. 	<ul style="list-style-type: none"> - Repair of plumbing etc. for a neighbour; - Baby-sitting
B. FORMAL ECONOMY Legal products produced within the regulatory framework of the state.		
1. Licensed "Self-Employment" - Non-Agricultural Enterprises - Agricultural Enterprises	<ul style="list-style-type: none"> Registered "Cuenta-Propistas" - Small Farmers 	<ul style="list-style-type: none"> - 157 registered activities; 153,000 persons (Jan. 2003) - tobacco farmers
2. Formal Enterprises: Joint Ventures, State Enterprises Formal Coop. Enterprises	<ul style="list-style-type: none"> -Tourism; Minerals; Int'n'l Marketing - Sugar sector 	<ul style="list-style-type: none"> - Melia S.A.; Sherritt; Habanos S.A - Cimex, Gaviota; Cubanacan
C. UNDERGROUND ECONOMY: Unauthorised or Illegal Methods or Enterprises;		
1. Legal Activities, "Legitimate Underground Economic Activities" Home-Based Enterprises Non-home based enterprises	<ul style="list-style-type: none"> - Unrecorded production and transactions - Construction and maintenance - Unauthorized transport; - Unauthorized street sales; 	<p>See list of specific activities in Table 7</p> <ul style="list-style-type: none"> - Appliance repair; - Plumbing electrical repair, - Home improvements; - Cigar sales, "gypsy taxis"
2. Within registered self-employment activities	<ul style="list-style-type: none"> - Unauthorized sales - Unauthorized dollar activities 	<ul style="list-style-type: none"> - bicycle repair shop selling replacement parts;- peso taxi providing service in \$US
3. Underground activities operating within State Firms	<ul style="list-style-type: none"> - Private payments to state employees above official rates - Under-the counter sales at stores; 	<ul style="list-style-type: none"> - Supplementary payments for hairdressers, tradesmen, etc. - State taxi drivers not metering their fares;
4. Unrecorded and unofficial income supplements paid by mixed enterprises or state firms or the public sector to some employees	<ul style="list-style-type: none"> - Income supplements to employees in US dollars; - Special access to foreign travel, vehicles, housing ... 	
5. Unrecorded, unofficial payments from customers to employees	<ul style="list-style-type: none"> - Unrecorded tips by tourists to state employees or the self-employed 	
6. Black Markets: Illegal exchange of goods and services at higher prices	<ul style="list-style-type: none"> - Under-the-counter sales of rationed products in state retail outlets - Sales of products outside the state monopoly retailing system 	<ul style="list-style-type: none"> - Butchers or bakers selling products outside the rationing system to favoured customers at a premium price; - Sale of fish, seafood, potatoes, or beef
D. CRIMINAL ECONOMY: Unlawful activities, carried out illicitly		
1. Within state institutions, state enterprise and joint ventures	<ul style="list-style-type: none"> - Theft of all sorts; - Use of public property for personal use or gain; 	<ul style="list-style-type: none"> - Theft of state property; - Sale of lucrative job positions; - Private use of vehicles and drivers
2. Within Self-employment enterprises	Sale of stolen goods	
3. Outside the formal economy	<ul style="list-style-type: none"> - Sale of stolen goods; Fabrication & sale of illegal substances; Lottery, Prostitution, Counterfeit 	<ul style="list-style-type: none"> - Sale of stolen cigars; - Drugs;

Source: The author

The "Formal Economy" Category B in Table 1, includes state enterprises, mixed enterprises (with joint foreign multinational and state ownership) and cooperative enterprises. The formal economy also includes the licensed self-employed. Officially registered self-employment enterprises and private farm enterprises are small and might appear "informal" in character. However, they have been "captured" completely by the public policy of the Cuban State and are not "informal" in any sense except their small size and the hostility of public policy towards them. They operate within a tight framework of licensing, size limitations, health and safety regulations, employment regulations, environmental regulations in some cases, and a rigorous tax regime. However, authorized "*cuenta propistas*" sometimes have links to the underground or criminal economies if they acquire some of their inputs from illicit sources ultimately through pilferage and theft from state enterprises or institutions.

The "Criminal Economy," Category D, usually refers to those economic activities that produce illegal goods and services and do so in clandestine circumstances out of the regulatory and fiscal purview of the state. Illicit drug manufacture and sales, prostitution, trade in endangered species, gambling in some jurisdictions, the sales of some types of firearms or explosives, smuggling, theft, and the sale of stolen property are cases in point.

The "Underground Economy," Category C, includes a wide variety of phenomena. The common feature of these activities is that they involve the generation of income and the production and exchange of goods and services in unlicensed enterprises or using unauthorized methods. However, as stated earlier, the goods and services produced in these processes are legal - in contrast to the criminal economy where the goods or services themselves are illegal. The underground economy includes a variety of phenomena: "Legitimate Underground Economic Activities", underground activities operating within state firms or the public sector underground

activities operating within registered self-employment activities, unrecorded and unofficial income supplements paid by mixed enterprises or state firms or the public sector to some employees, unrecorded and unofficial payments from customers to employees, and "Black Markets" or illegal exchange of goods and services. The complexity of the underground economy is apparent from this list. For example, in some state firms, employees in effect run their own private enterprises, requiring additional payments from citizens for their services. Some employees of mixed enterprises receive additional dollar incomes "under the table." Some employees of state firms and institutions use public property for private activities and may receive particular benefits in terms of access to foreign travel and the per diems this generates, housing, transportation, holiday facilities, access to restaurants, etc. Indeed this is in part how the party patronage system works.

As noted earlier, this study focuses on "Legitimate Underground Economic Activities" (or Category C 1.) The other important components of the Underground Economy are not analyzed here, significant though they may be. These "LUEAs" involve the production and exchange of legal goods and services even though the persons producing them are outside control of the state. Though tolerated elsewhere, however, in Cuba, such unauthorized activities are considered criminal (Articles 3.1 and 3.2, Decree Law 174 1997, See Table 4 below). A significant proportion of these is carried out within the home of the producers or the clients and is conducted on a monetized basis, (rather than for reciprocal barter exchange within family or among friends as is the case with the "Household Economy"). In some cases they are conducted on an itinerant basis outside the home as is the case with retailers of cigarettes or newspapers.

As noted above, unregistered but otherwise legitimate enterprises in the underground economy are considered by the government of Cuba to be criminal in character. In this essay, however, they are considered as potentially legitimate. Most countries have some economic

activities that are undertaken clandestinely though the activities themselves are not illegal. Such clandestinity is usually designed to avoid taxation, minimum wage or other labor legislation, or health, safety and environmental legislation. In Cuba, the tax evasion motive for entering the underground economy is strong. Perhaps most important in the Cuban case, however, is that many economic activities that are normally permitted elsewhere are either prohibited entirely or else are limited directly through the refusal to grant licenses to applicants who then must remain clandestine if they are to exist at all. This amplifies the scope, diversity and magnitude of the underground economy in Cuba vis-à-vis other countries.

The difficulties of understanding the structure, functioning and size of the underground economy for any country are obvious. Enterprises operating illegally are unwilling to divulge information on their activities for fear of being detected and prosecuted. It is therefore difficult to acquire information on the underground economy in all countries. However, this has been the focus of steadily improving studies in recent years, as governments and international agencies have tried to learn more about their magnitude and functioning.

There are a variety of direct and indirect measures that can be employed to estimate the magnitude of the sector (Schneider and Enste, 2000, pp. 91-97). All of these are useful, but are of necessity imperfect and approximate in character.¹ None of these methods appears to be completely satisfactory in any country. Reliance upon such measures is especially inappropriate in Cuba at this time due to its numerous unique features together with the severe structural and monetary changes it has undergone since being orphaned from the Soviet economic system in 1988.

Some estimates of the magnitude of the shadow economies for the various regions of the world have been made by Schneider and Enste (2002B, pp. 46-53) and are summarized in Table 2.

For this table, the shadow economy is defined as including "unreported income from the production of legal goods and services, either from monetary or barter transactions - hence all economic activities that would generally be taxable were they reported to the tax authorities." (Ibid, p.4.) This definition is broad as it includes home-based economic activities, exchange among neighbors, informal types of monetary and barter transactions, and "underground" economic activities of the sort indicated in Table 1, Category C. (The estimates are also constructed using a number of different criteria). It can be seen, from Table 2, that the shadow economy is large in most countries and regions.

In the case of Cuba at present, the types of measures mentioned above all appear to be nearly impossible to construct given current publicly available information. Therefore, one must rely on direct observation to construct a picture of the sector from fragmentary information obtained from various sources.

Table 2. Size of Shadow Economies, Major Regions of the World, 1999-2000

Region and Country	Per Cent of GDP	Region and Country	Per Cent of GDP
Western Europe		Latin America	
Average	18.0	Average	41.0
Range	8.8-28.6	Range	19.8-67.1
Switzerland	8.8	Chile	19.8
Spain	22.6	Costa Rica	26.2
Italy	27.0	Cuba	Not Known
European Transformation Countries		Africa	
Average	38.0	Average	41
Range	18.9 - 67.3	Range	28.4 - 59.4
Other (2001-2002)		Asia	
USA	8.7	Average	26.0
Canada	15.8	Range	11.3 - 52.6

Source: F. Schneider, June 2002A, pp. 7-11.

Most casual observers or visitors to Cuba are introduced quickly to the underground economy by the ubiquitous vendors of cigars, who volunteer to obtain the major cigar brands for

the visitor at cut-rate prices, and unlicensed taxi-drivers. The underground economy is so obvious in Cuba that it has been observed and explored by journalists that have visited Cuba, even for short periods of time. Ken Gray of the Ottawa Citizen (2004) referred to flourishing black markets, illegal intermediaries and “finders fees”. Vanessa Bauza of the Houston Chronicle (2001) described an illegal video rental enterprise of the sort that exists all over Cuba. Gary Marx of the Chicago Tribune (2003) unearthed information on the illegal lottery that flourishes in Cuba. Mark Frank of the Financial Times (2004B) observed the underground economy in rural Cuba.

For this study, a small survey of self-employment in legal enterprises and also in underground enterprises was undertaken in various municipalities of Havana from late February to April 2003. The survey methodology and its results are discussed in Section V below.

III. The Evolution of the Underground Economy in Cuba

In 1960-1961, most legal economic activity was collectivized and a central planning system was installed to replace the market mechanism as the main means of resource allocation. A small legal private sector continued to exist in agriculture and non-agricultural activities, however. The March 1968 “Revolutionary Offensive” eliminated most of what remained of the legal micro-enterprise and small-scale enterprise sectors. Some small enterprises were converted to state ownership, but many, including street vending, vegetable stands, bars and auto repair, were shut down, with the entrepreneurs driven underground.

The central planning system itself inadvertently promoted the underground economy both through the rationing system and through the imperatives of improvising solutions to the shortcomings of the planning system. The rationing system, implemented initially in 1961, 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. This was to be achieved by replacing individual (or family) choice, expressed through markets, with an allotment of basic goods available at prices that were low relative to the average monthly income. Because everyone received essentially the same rations, many people would sell the rationed items they did not want or trade them for other products they did want. In this way, the rationing system converted virtually everyone into a mini-capitalist, searching for opportunities to sell and to buy.²

Continuing suppressed inflation arising from increases in the money supply while prices remained fixed, created a situation of excess demand and generalized shortage. This meant that anyone with privileged access to a product at an official price could resell it at a higher market-determined price. This created a strong incentive for “rent-seeking” or making a profit from arbitrage between the fixed price state sector and the market determined prices.

The weaknesses of the central planning system also promoted clandestine economic activities. In a perfectly functioning central 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 context of economic turbulence with major disruptions in flows of supplies, enterprise managers often must take initiatives in resolving unforeseen problems through improvisation outside the formal central planning system. To obtain required inputs they often must negotiate 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*” as well as monetary payments have been central, resulting in highly politicized economic management. This also promoted the illegal and extra-legal exchange of goods.

In the 1970-1993 period, there was a large underground economy consisting of self-employed persons with assistance from family members and perhaps friends. There was also a legal non-agricultural sector after 1978, when Decree-Law 14 of July 1978 formally permitted some 48 categories of self-employment (Pérez-López, p. 95-96). These micro-enterprises were mainly home-based, and many were part-time activities. The number of officially registered non-agricultural self-employed workers of this sort was placed at 25,200 in 1989 (*ibid*, p. 113). Various unregistered but otherwise legal activities were undoubtedly carried out as well. The existence of these activities operating in the “underground economy” is a main reason why the legal micro-enterprise sector was able to spring to life quickly after its legalization in 1993.

It is difficult to acquire an idea of the magnitude of the underground economy and accurate measurement is impossible at this time. However, occasionally a glimpse of the size of sector is obtained. For example, one report indicated that in three of the 15 Municipalities in Havana, police and customs officials raided 150 clandestine cigar-making operations, which were then shut down. 11,935 boxes of cigars were confiscated (www.Cubanet.org 6/1/04). If there were 150 illicit cigar operations in three of the 15 Havana Municipalities, it is likely that there are thousands across the country, because of the wide knowledge of cigar making, the low barriers to entry into the activity, and its remunerativeness.

Another indication of the size of the underground economy is the “messenger” activity. Although only two are included in this survey, there actually are innumerable "messengers" who make the purchases from the rationed-product market for other citizens. There may be at least one or more for every block in the more densely populated areas of Havana, for example. Likewise, there are innumerable clothes washers who wash clothes for their neighbors for a fee.

IV. Public Policy and the Underground Economy

General studies of the underground economy have found that a variety of factors promote its expansion. Among the factors analysed by Schneider and Enste (2000 and 2003) in their definitive survey and analysis of the underground economy internationally are:

1. The burden of tax and social security contributions: the heavier the burden, the greater the incentive to go underground.
2. The intensity or density of regulations; the stricter, more detailed, more complex and capricious the regulatory regime, the greater the incentive to go underground.
3. Social transfers (e.g. unemployment insurance or welfare payments) that permit individuals to work unofficially, plus a high (usually 100%) tax on such transfers should the individuals graduate into the formal economy. This induces people to remain in the underground economy while receiving the benefits.
4. Forced reduction of official working hours permitting people to hold additional unofficial jobs;
5. Earlier retirement permitting people to work "below ground."
6. High unemployment rates pushing people into the underground economy.
7. Factors of a psychological or sociological character may also be significant. If the regulatory and tax regimes are considered to be inequitable, people would have less compunction about going underground.

All of the above factors with the exception of number 6 are operative in the Cuban case.

The onerous tax and regulatory regimes promote clandestinity. Early retirement ages, reduced hours of work on the job, relatively generous social transfers and the "psychological factor" are all relevant for the Cuban case. However, open unemployment has not been high in the last few years, so that this has not promoted the underground economy. But in Cuba, there are additional factors that help to push otherwise legitimate enterprises into the underground economy, namely the general political environment, the licensing system and competition from the state sector.

A. General Political Environment

Cuba's political leadership has been continually critical of the micro-enterprise sector. By early 1997 it was beginning to state that the sector was necessary for a while but that in time a policy reversal would be desirable (Castro, 1997). The micro-enterprise sector has been criticized

for a number of reasons. First, it ostensibly promotes a mentality that is incompatible with “socialism”, whereas the purpose of the reforms was in fact to save “socialism” not to start a transition to anything else.³ It has also been blamed for the increase in income inequalities (*ibid*) though this is due mainly to the monetary/structural/institutional (Ritter, 2002).

The official de-emphasis of the sector is apparent in the United Nations CEPAL document authored largely by analysts in the *Instituto Nacional de Investigación Económica*, a Cuban Government research institute *on "Social Policy and Structural Reforms: Cuba at the Beginning of the 21st Century"* (April 2004, p.177). In this document, the self-employment sector receives less than one page out of a total of 293, reflecting the official neglect of the sector as of mid-2004.

The coverage of the micro-enterprise sector in the press also has been generally critical, with attention focused on alleged illegalities and income inequalities.

Small-scale entrepreneurs also lack a political voice. Article 3.14 of Decree Law 174 prohibits the organization of producer cooperatives or associations unless officially authorized. Any type of independent association on the part of the "*cuenta propistas*" has been ruled out according to the Minister of Economy, J.L. Rodriguez (1997).

Finally, basic security for the private sector entrepreneurs is lacking. Old memories persist of the confiscations of the early 1960s and in 1968. Policy reversals such as the elimination of the farmers' markets in 1986 are remembered. The 2004 decision to cease issuing new licenses for some 40 types of micro-enterprise activities undoubtedly reinforced the perception that there can be no fundamental and enduring security for these activities under current political circumstances.

B. The Licensing Process for Self- Employment Activities

Official authorization of self-employment or micro-enterprise is based on licensing at the municipal level. However, potential entrepreneurs often are denied a license to practice their

particular activity. Although publicly available information on the licensing process is limited, some information is presented in Table 3 for the Municipalities of Havana for the 1996 to 2001 period. This table indicates that licenses granted for self-employment activities over this period, declined by almost 39%. Meanwhile, over the same period, requests for licenses increased by over 111%, despite the obvious discouragement effect that ever increasing “failure rates” would generate. Licenses granted as a percentage of total applications for licenses declined from 83.3% in 1996 to about 24% in 2001. This reduction in the granting of licenses for self-employment in Havana was likely followed in other parts of the country. The declining success rate in obtaining licenses for self-employment undoubtedly led the unsuccessful to find other venues for their survival strategies and entrepreneurial energies. Many of these activities likely entered the underground economy.

Table 3 The Self-Employment Licensing Process, Havana, 1996-2001

Application Process Categories	Number of Applications per year					
	1996	1997	1998	1999	2000	2001
Total Applications for Licenses	46,268	69,407	84,456	91,398	94,827	97,687
Applications in Process	n.a.	n.a.	n.a.	n.a.	n.a.	499
Licenses Granted	38,057	34,984	31,587	28,380	24,719	23,351
Licences Granted as Percentage of Total Applications	82.3%	50.4%	37.4%	31.1%	26.1%	23.9%
Applications Refused	8,211	34,423	52,889	63,018	70,108	74,337
- Requests Denied	n.a.	n.a.	n.a.	n.a.	n.a.	1,878
- Withdrawn during Application	n.a.	n.a.	n.a.	n.a.	n.a.	11,332
- Failed Application process	1,791	24,990	41,002	50,015	56,809	60,627

Source: Dirección Provincial de Trabajo y Seguridad Social, 2001, p.1 and 5.

In 2004, all new licenses for some activities were halted. Resolution 11/2004 of the Ministry of Labor established that from October 1, 2004 onwards, no new licenses were to be issued for 40 different trades. Those already with licenses could continue their activities, but transfers of licenses to other individuals or relatives were prohibited. Among the 40 activities no longer licensed were used book vendors, masseuses, jewelers, restaurateurs, magicians, metal

workers, food venders and auto mechanics. The other 118 legal activities could continue with the possible issuing of new licenses. (*BBC Mundo*, 28 Abril 2004, cited in Cubasource, April 28). The limitation on the issuing of new licenses in such activities as auto mechanics or masseuses will encourage many to undertake their activities in clandestinity.

C. The Regulatory Environment

The self-employed in Cuba's officially authorized activities operate in a tough regulatory framework. Formal or officially recognized enterprises in most countries must operate within a framework of laws and regulations regarding labor standards, health and safety, and the environment. In Cuba, however, the regulatory environment is stringent and is 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.

Part of the legislative framework within which Cuban micro-enterprises must operate, together with the punishments for contraventions of the regulations, is summarized in Table 4. This list of possible contraventions, extracted from Decree Law 174 of 1997, provides a useful summary of the regulatory environment for self-employment activities. The first limitation on the micro-enterprise sector is the restriction of the range of authorized activities (Article 3:1). While by early 2003, 157 activities were authorized, employing (officially) 153,000 persons, all other activities were prohibited (*Naciones Unidas, CEPAL*, 2004 p.177)⁴. Locating a micro-enterprise anywhere except one's home is also prohibited (Article 3:4). Decree Law 174 also mentions a variety of limitations on the size and diversity of micro-enterprises, including the well-known restrictions on paladares and food vending.

Other types of restrictions deny micro-enterprises access to a variety of key production inputs. They are prohibited from hiring labor, though family members can work in the micro-

enterprise. They also lack access to foreign exchange and imported inputs. Large scale state firms and mixed enterprises can use their peso earnings to acquire foreign exchange at the official exchange rate of \$U.S. 1.00 = 1.00 Convertible Peso (CVP) = 1 Cuban Peso, and are able to obtain the required bureaucratic permission to import needed material inputs or machinery and equipment at this exchange rate. Micro-enterprises cannot do this. They can purchase items at the dollar stores, but only what is available there, only at the going prices, which included a 140% mark-up, and only having obtained their U.S. dollars at the quasi-official rate that is relevant for Cuban citizens, namely \$U.S. 1.00 = 1.00 CVP = 27 Cuban Pesos in mid-2004, or with U.S. dollars or Convertible Pesos earned directly.

Micro-enterprises have no access to credit from the formal banking system so that their investment must be financed from savings, informal loans from friends, and retained earnings. The absence of credit to the micro-enterprise sector helps to stunt its development. A further limitation on the micro-enterprise sector is that its access to markets is restricted. Only sales to individual consumers are permitted. Sales to state enterprises, the public service, mixed enterprises, or formal organizations (for example quasi-NGOs) are prohibited. The objectives of this restriction are to limit the expansion of the private sector and to protect the state enterprises from competition. Micro-enterprises are also prohibited from advertising their products or services through the media or through advertising "flyers," news-sheets or handouts.

A final restriction on the micro-enterprise sector is the prohibition of the use of "intermediaries" (Articles 3:5, 3:6, and 3.13.) This requires that self-employed producers must sell their own output. Specialized vendors can not resell the products of a number of producers. This prohibition of the most fundamental degree of specialization condemns many self-employed

**TABLE 4. DECREE LAW 174: MICRO ENTERPRISE RULES,
CONTRAVENTIONS, FINES, AND PUNISHMENTS**

CONTRAVENTION	FINES (1) (Pesos)	Seizure of Equipment or Products	Withdrawal of License (2)
Article 3 Contravention of Micro Enterprise Regulations			
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		2 years* min.
(b) Sale of fish, seafood or beef in a private restaurant;	500-1,500	Yes	2 years* min.
(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		2 years* min.
(g) Inadequate receipts for legal purchase of inputs;	250-750	Yes	2 years* min.
(h) Use of family labor without licenses;	400-1,200		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	Yes	1 years* min.
4. Use of ones 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 others products	400-1,200		2 years* min.
7. Non-payment 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		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 specifically authorized	500-1,500	Yes	permanent
16. Resale of industrial products purchase in state sector	400-1,200	Yes	2 years* min.
17. Use of prohibited materials or inputs	250-750	Yes	
18. Operation in other provinces from that authorized	250-750	Yes	
19. Failure to update information provided to <i>Registros de Trabajadores de Cuenta Propia</i>	150-500		.
Article 4 . Contravention of Sanitary Regulations			
Article 5. Contravention of Tax Provisions			
Article 7. Unintentional Contraventions			
Article 8. Multiple Contraventions of multiple character			
Article 9. Repeat Offenders			

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

Notes:

- 1) The 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 offences.
- 2) Some micro entrepreneurs state that the minimum
- 3) Two-year license suspension may really mean a permanent suspension.

persons to continuing low productivity and low incomes. It thereby contributes to societal loss due to the general wastage of resources and human energies.

To enforce these regulations, a small army of "inspectors" is employed. Such inspectors wield arbitrary power and can levy large fines for infractions on the part of *cuenta propistas* and *paladores* (almost eight times the average monthly income.) They also constitute an additional corruptible layer in the system. Anecdotal evidence suggests that the taking of bribes of various sorts for overlooking infractions of the regulations is commonplace.

This regulatory environment makes much legal self-employment difficult if not impossible. As a result, those micro-enterprises that can survive more easily operating illegally do so. The restrictions also have the effect of promoting a generalized culture of illegality.

D. **The Micro-enterprise Taxation System**

In principle, it is reasonable and necessary that all types of business enterprise in any country be taxed equitably in order to pay their fair shares of the cost of the provision of public goods and services. However, the level of taxation in the micro-enterprise sector in Cuba escalated rapidly, from low levels in September 1993 to levels that were exceedingly high by 2004.

The micro-enterprise tax regime consists of compulsory lump-sum monthly fee paid each month to the tax authority, the *Oficina Nacional de Administración Tributaria* (ONAT) together with a yearly self-administered correction for the annual tax payment carried out by each micro-enterprise. The “*cuota fija mensual*” or “monthly fixed lump-sum payment” was imposed initially in 1993 when Cuba entered the first phase of micro-enterprise liberalization. The Ministries of Finance and Prices and of Labor and Social Security set the minimum rates, but the Administrative Councils of the Municipal governments are empowered to establish rates above these minimum levels, with the approval of the relevant Ministries. The rates can be changed

every six months, in January and July. The legislation permits the Councils to raise – but not to lower – the rates if it considers that the incomes of the micro-enterprises are "excessive." At the end of each year, micro-enterprises pay a tax on their annual revenues on the basis of a tax schedule either in pesos or dollars (or "convertible pesos after October 2004) depending on the currency they operate in. However, they can deduct the total of the monthly lump-sum "*cuota fija*" payments from the amount of tax owed according to the schedule. If the amount owing exceeds the payments already made, they must make up the difference. However, if the amount paid exceeds the amount owing at the end of the year, the state does not pay a rebate.

The most problematic feature of the tax system is that a maximum deduction of only 10% from gross income is permitted for purchased inputs in the determination of taxable income (or 20% for transportation.) In other words, *net income for tax purposes* is always considered to be 90% of gross income regardless of the real value of purchased inputs. (*Oficina Nacional de Administración Tributaria*, 1997, 6). This means that those micro-enterprises that face high costs for purchased inputs and investment are being taxed on these purchases and not on revenues after the deduction of costs. The effective tax rate on value added by the firm on its actual net revenues can therefore be very high and, in theory, can exceed 100% (Ritter, 2002). Many enterprises such as food vending, shoemaking, arts and crafts and used booksellers, have costs that far exceed the 10% allowable, and in consequence may pay extraordinarily high taxes on their net incomes.

In contrast to the regime for micro-enterprise, mixed enterprises involving foreign multinational firms face a tax regime that is reasonable in comparative international terms, allowing for the deduction of investment costs and costs of production from gross income in determining the taxable income base. The more favorable treatment for the mixed enterprises vis-à-vis domestically owned micro-enterprises is clear from the information in Table 5.

Table 5. Comparison of the Tax Regimes for Cuban Microenterprise and Foreign Enterprise Operating in Joint Ventures

	Micro-Enterprise Sector	Joint Ventures
Effective Tax Rates	May Exceed 100% of Net Income	30% of Net Income [50% for mining and petroleum]
Effective Tax Base	90% of Gross Income; [Maximum of 10% allowable deduction for production costs.]	Net Income after Deduction of Total Production Costs
Deductibility of Investment	Not Deductible from Taxable Income	Fully Deductible from Taxable Income
Lump-Sum Taxation	Up-Front “Cuota Fija” Tax Payments Necessary	None
Rebates for Tax Overpayment	No Rebates for Tax Overpayment	Not Applicable
Tax “Holidays”	No	Yes
Profit Expatriation	No	Yes

Source: The Author

E. Predatory State Sector Competition.

The government also engaged in predatory competition with some types of micro-enterprise.

An example of this was the campaign of some of the state enterprises against the *merienderos* or vendors of snacks, soft drinks, and various types of food in the streets to a modest clientele and in the peso economy. In early 1997, state firms used fleets of bicycle-carts to sell similar snacks in the same locations where the micro-enterprises tend to locate. This could be fair competition except for the discrimination in input costs and taxation levels favoring the state firms. The state firms, for example, are able to purchase their inputs through the state controlled sector and at state controlled prices. These prices are a small fraction of the prices at the dollar stores where the micro-enterprises must purchase their inputs⁵.

V. The Underground Economy in the 1993 to 2004

In order to begin a systematic analysis of the underground economy in Cuba, a survey of self-employment activities – above and below ground – was undertaken. This essay, however,

focuses on the legitimate or otherwise legal economic activities carried out in clandestinity. The analyst who undertook this survey, a Cuban citizen who wishes to remain anonymous, conversed with a total of 189 individuals who were operating what has been labeled here "LUEAs". Some of the interviewees were known to the analyst; others were contacted through referrals from acquaintances and through knowledgeable observation of economic life in Havana. The interviews were of necessity informal conversations rather than formal interviews. The surveyor engaged the person in general discussion and in the course of the conversation, the questions were covered. Some, but often not all, of the questions were answered. The interviewer recorded the responses after the conversation. One interviewee was engaged in a patently illegal activity, namely the selling of goods admittedly stolen. This case is omitted in this study. Two of the interviewees were engaged as "runners" in the "numbers racket" or lottery, "*apuntadores de numeros*" – illegal in Cuba, but legal in some other countries. This activity is included here.

The Questionnaire guiding the interviews is presented in Appendix I.

The interviewer sought out wide varieties of "LUEAs", so that the proportions of activities or enterprises cannot be taken as a representative sample. A listing of the interviews, grouped by economic sector is shown in Table 6. One striking feature revealed in this table, is the diversity of the underground economic activities. Some sophisticated types of economic activity were practiced, including the manufacture of rum, beer, soft drinks, plumbing parts, mattresses, adornments for cars and spare parts for cars,. Many of the activities were "low tech" in character and involved limited economies of scale, allowing reasonable efficiency at a low volume of output and with one or a few workers. Some types of underground activities were not caught in this survey such as some types of business services, the fabrication of various types of furniture, and a wide range of handicraft workers who produce items for the registered "*cuenta-propista*" artisans.

There are a number of interesting findings of the survey that are summarized here. The major proportion of the illegal enterprises operated out of the homes of the entrepreneurs or those of the clients, though some operated "in the streets". Licensed self-employment activities, on the other hand, tend to operate openly on the street or in public. One of the unlicensed activities, newspaper reselling, did take place openly, but this activity seems to be tolerated by the authorities, perhaps on humanitarian grounds, as most of the vendors were pensioners trying to supplement their pensions. Some unauthorized activities took place within authorized self-employment enterprises, for example, the illegal vending of bicycle parts by licensed bicycle repair enterprises. Not surprisingly, almost all of the illegal entrepreneurs reported that they thought that the incomes that they earned exceeded that which they could earn in the state sector. Some 65 respondents of the 189 also reported that they considered that their incomes were "comfortable". A few respondents mentioned their monthly earnings, though the majority did not. Daily earnings ranged from 20 pesos per day to a high of 80 in one case. Most were grouped in the 20 to 60 pesos per day area. In comparison with the state sector, these levels are reasonably high, the average monthly income in Cuba being 240 pesos in 2002 in the official peso economy. (However, some employees in the state sector also are able to supplement their peso incomes through access to some products provided as bonuses, together with opportunities for pilferage or theft as well as the fruits of "*amiguismo*").

About 37% of the 189 respondents reported that they employed others in their enterprises. Many enterprises, 38 in total, employed family members, 13% employed non-family members and a few employed both. Twenty-seven reported employing more than one additional person, these being mainly in gastronomic services and manufacturing. 18% of the respondents had other

Table 6. Underground Economic Activities Encountered in Survey
Sector, Activity and Number of Interviews

Personal Services	Cones for Ice Cream Cone Manufacture (3) Sausage Making (1) Coffee Vending (3)	Boxes for Cigars (3) Woodworking (1) Foundry (1) Soft Drinks Bottle Tops (2) <i>Pinatas</i> (1) Tailor (1)
Barbers (3)		
Hairdressers (1)		
Manicurists (3)		
Clothes washing (3)		
Knife Sharpening (2)		
Teachers (3)		
Shoe Repair (2)		
Auto Washing (1)		
Auto Parking (4)		
Film Rental (5)		
Room Rental (2)		
Eye Glass Repair (1)		
Cigarette Lighter Refillers (3)		
Mattress Repair (2)		
Upholstery Repair (1)		
Messenger (1)		
Clothing Repair (1)		
Document "Plasticizer" (1)		
Watch Repair (3)		
"Apuntadores de Numeros" (Numbers Racket) (2)		
Gastronomic Services		
Restaurants (2)		
Snack bars (3)		
Soft Drink Vending (3)		
Pizzerias (2)		
Fruit Vending (1)		
Meat Vending (1)		
Seafood Vending (1)		
Candy Vending (1)		
Rum Making (1)		
Beer Brewing (1)		
Soft Drink Making (3)		
Bread Baking (1)		
Candy Makers (3)		
Ice Cream Makers (1)		
Mechanical Services		
Gas Stove Repair (20)		
Refrigerator Air Conditioner Repair (5)		
TV and Video Repair (5)		
Water Pump Repair (1)		
Kitchen Appliance Repair (2)		
"Chapista de Lavadores" (1)		
Locksmiths (2)		
Liquid Gas Vending (1)		
Automotive Services		
Auto Mechanics (4)		
Auto Electricians (2)		
Auto Upholsterers (2)		
Auto Locksmith (2)		
Auto Body Shops (2)		
Auto Painters (4)		
Tire Repair (2)		
Spark Plug Cleaners (1)		
Spare Parts for Autos (1)		
Adornments for Autos (1)		
Manufacture		
Shoemakers (3)		
Mattress Making (1)		
Electric Motor Rewinding (3)		
"Torneros" (2)		
Furniture Upholsterers (2)		
Cigarette Making (1)		
Cigarette Package Making (1)		
Cigar Making (3)		
Construction Trades		
Carpenters (5)		
Plumbers (4)		
Electricians (2)		
Plasterers/Concrete/Brick (5)		
Glass Work (3)		
Metal Work (5)		
House Painters		
Transportation		
Taxis (2)		
Bicycle Taxies (2)		
"Carretilleros" (1)		
Retailing		
Bicycle Parts (4)		
Ice Venders (2)		
Jewelers (3)		
Plumbing Parts (1)		
Cigarettes and Newspapers (2)		
Extracts for Food Preparation (1)		
Primary Activities		
Sub-aquatic fishing (1)		
"Lenador" (Wood Vendor) (1)		
(Charcoal-maker (1)		
"Desmolachador de Palmas" (1)		

Source: The author.

Table 7. Some Information from the Survey of Underground Activities

Sector	Total Enterprises in Sectors	Retired Entrepreneurs	Those with Other Employment	Employment of Other Workers In Enterprise				Those Reporting a "Comfortable Income"
				Total	Family	Non-Family	Both	
Personal Services	46	22	6	6	6	-	-	9
Mechanical Services	17	4	6	5	1	3	1	2
Automotive Services	18	2	6	9	6	3	-	8
Construction Trades	25	2	6	12	8	4	-	12
Gastronomic Services	34	4	2	23	11	12	1	16
Retailing	13	6	1	1	-	1	-	3
Transportation	5	-	-	-	-	-	-	1
Manufacture	27	4	6	13	6	5	2	13
Primary Activities	4	-	-	-	-	-	-	1
Total	189	44	33	69	38	27	6	65
Percent of Total	100.0%	23.3%	17.5%	36.5%	20.1%	14.3%	2.1%	34.4%

Source: The author.

employment mainly in the state sector. Of these, most had jobs in the same activity in which they had their own underground activity.

Most respondents indicated that the major problem they faced was not being licensed, that is being illegal. Other difficulties were also mentioned, such as shortage of inputs, age and health issues, competition, lack of customers, and finding a place to work. Some stated that they had no difficulties. Most of the illegal enterprise also mentioned “becoming licensed”, that is being legalized, as the most significant change they would like to see for their enterprise. On the other hand, a small proportion did not perceive the absence of a license as a significant problem, In fact, they did not wish to become licensed or officially authorized.

An additional result pertained to the sources of the inputs used. These were said to come from the dollar stores, the official economy or from recycled products. Virtually no one stated that their inputs came from "other sources" meaning illicit sources.

Finally, with respect to the question regarding future plans (question 12) virtually no respondents stated that there were possibilities of expanding their economic activities, though

some stated that they had plans for the future. Most also stated that the main factor blocking the expansion of their business was their inability to obtain authorization.

VI. Social and Economic Impacts of the Cuba's Underground Economy

In most countries, the underground economy is viewed negatively by policy makers, analysts, and much of the broader society. The reasons for this are well known. The sector is involved in tax evasion. It operates outside the regulatory framework of the state so that minimum wages and labor laws, health and safety legislation and environmental laws may all be evaded. It is often linked to illicit drug production and trafficking, prostitution, and the marketing of stolen property. It is associated with "sweat shops" where minimum wages are not paid and where basic labor standards are not met. Trafficking in people or illegal immigrants is part of the general picture of the underground economy in some countries as well.

In Cuban, the underground economy has some negative consequences similar to those in other mixed market economies. Underground enterprises in Cuba also evade some taxes. They may evade environmental, labor, and health and safety standards. Some criminal activities are included in Cuba's underground economy such as drug production and sales, and prostitution. They are also often linked to the purchase of stolen inputs from the state sector.

However, Cuba's underground economy is essentially different than the underground economy almost everywhere else because the Cuban Government blocks the legalization and emergence of legitimate micro-enterprise activities through the restrictive policies outlined in Section IV above. As emphasized earlier, Cuba's underground economy includes many small businesses that would otherwise operate legally and above ground. They already generate benefits for Cuban citizens and the Nation, but these benefits are limited due to clandestinity. First, the non-criminal or legitimate part of Cuba's underground economy produces relatively

low cost goods and services that are not provided adequately by the state sector. Despite some advantages, state sector enterprises are often too cumbersome, bureaucratic and inefficient to supply the goods or services adequately. Much of the underground economy involves the production of basic products or services by low-income people for low-income people and adds to the diversity of products and services available to the public⁶. The legitimate underground sector provides productive employment for large numbers of Cubans. Reasonable incomes are earned by many permitting them to survive better than would otherwise be the case.

The legitimate underground economy also generates or saves foreign exchange for the country. Some areas of production contribute directly to foreign exchange earnings. For example, the large numbers of authorized artisans utilize the services of significant numbers of unauthorized assistants to produce the handicrafts and art that tourists buy in large quantity. Many enterprises in the underground economy also use domestic and recycled materials of various sorts, and substitute for imports in some cases⁷.

Legitimate underground economic activities may evade direct taxation by the state, but not indirect taxation. Those citizens who earned US dollars and, after November 2004, convertible pesos in their activities or who earn enough pesos to acquire convertible pesos at the 27 Peso to \$1.00 price, are taxed indirectly when they use the US dollars to make purchases at the dollar stores. The sales taxes in the dollar stores ranged from a rate of 140% on items of basic consumption, to 100% for electronic products with additional increases in May 2004 (Grogg).

Another important contribution of the sector is that it generates savings and investment. There are no sources of credit for the enterprises in the sector except for their own savings or the savings of friends or families. Enterprises in the sector are carefully managed so that they

generate surpluses for re-investment with no reliance on credits from banks, the state, or foreign sources.

A counter-intuitive contribution of the underground economy is that it subsidizes the official socialist economy. This is because the professionals and workers in the socialist peso economy do not receive sufficient incomes to survive. They rely upon their supplementary activities in the underground economy to provide the incomes that permit them to make the necessary purchases in the dollar stores, the agricultural markets or the black market. This means that the supplementary clandestine activities and incomes support the health system, the educational system, the civil service, industry, and other parts of the socialist peso economy.

While there are serious inefficiencies in the functioning of the legitimate economic activities of the underground economy, there are also some sources of efficiency. The first of these is that the capital facilities of the micro-enterprises are usually the homes of the micro-entrepreneurs. This means that the “overheads” in terms of especially dedicated factory capacity are avoided. This transfers some of the cost to the micro-entrepreneurs themselves and their families whose homes and home lives may be disrupted by such economic activities. Apprenticeship types of learning by adolescents may also be promoted by home-based economic activities.

Finally, the "LUEAs" constitute valuable "schools of entrepreneurship". Paradoxically, although the intention was to convert Cuba into a “school for socialism” during the years in which the legal exercise of entrepreneurship in a market-oriented setting was largely prohibited (or tightly restricted), Cuba actually created a nation of entrepreneurs. The nature of Cuba's planned economy itself has inadvertently promoted widespread entrepreneurial values, attitudes, behavior, and *savoir-faire* as citizens have had to buy and sell, hustle and “network” in order to

improvise solutions to their personal economic problems. The legitimate underground economy is one central manifestation of this entrepreneurship. If and when a change in the Cuba's "economic model" occurs, those entrepreneurs who have been toiling in the underground enterprises will be ready to redirect their talents to more productive pursuits. This will be a major resource for Cuba in the future.

There are negative aspects of the functioning of the legitimate underground economy that result from the policy environment that represses and eliminates "above-ground" small enterprise. At the level of the individual underground micro-enterprise, clandestinity generates severe inefficiencies. Such enterprises must remain excessively small so that economies of larger scale production cannot be reaped. They must also engage in many sorts of "attention avoidance" activities in order to remain clandestine. This creates additional costs, for example in the transportation of outputs or inputs in small batches so as to avoid detection. Clandestinity probably lowers the quality of the goods and services. Illegality, plus the various restrictions that apply to self-employment, prevent or impede the employment of additional workers, deny access to credit, deny access to foreign exchange, and prevent active advertising and marketing. For all of these reasons, entrepreneurs in legitimate underground enterprises often waste their energies on low level and relatively unproductive but necessary activities. This adds up to an immense loss for Cuba in general.

From the standpoint of the micro-enterprise sector, official policy towards self-employment results in a variety of inefficiencies. The avoidance of direct taxation by "LUEAs" is unfair for the rest of the economy and other above ground micro-enterprises that have to pay taxes. This constitutes an unfair advantage for the underground enterprises. Clandestinity could limit the numbers of enterprises in some areas, especially those with higher visibility that cannot

operate easily within the home. High levels of uncertainty and risk serve as a barrier keeping out potential participants. Therefore, there may be less legal competition, higher prices, and lower volumes of production than if these barriers to entry were lower.

There are also disadvantages at a societal level. There are tax losses, already noted. A major societal loss is the waste of human energies and entrepreneurship arising from all the implications of clandestinity and small size. The impairment of the quality of the goods and services produced is a disadvantage for society. The "LUEAs" may divert resources from valuable uses in the state sector, or even from export as well, though if they were licensed they would presumably use similar or greater quantities and varieties of resource inputs.

Capital accumulation by "LUEAs" is damaged. If the future is uncertain due to clandestinity, then there is a reduced incentive to undertake longer-term planning and investment. Instead, the micro entrepreneur has an incentive to make as much money as possible in the short run. In consequence, prices may be higher than necessary. Savings, investment and enterprise development may be sacrificed. In consequence, the micro-entrepreneurs themselves lose in the longer term; Cuban citizens as consumers lose in the short and longer term; Cuba as a nation loses through the waste of its entrepreneurial, human and material resources.

Finally, the result of the character of the tax and regulatory systems and the non-compliance they engender is that these systems lack credibility and respect. The government seems to be viewed by many micro-entrepreneurs as a hostile force whose actions are arbitrary and whose long-term vision for Cuba excludes them. Rather than leading to the gradual development of a "tax culture" in which people willingly and honestly pay their taxes, the system has provoked the habit of cheating. To some extent this has been part of people's survival strategies in the difficult circumstances of 1993 to 2004. The nature of the tax and regulatory

regimes leads some people to think that tax evasion and clandestinity are not unethical even if they are illegal. In the long term, it may be difficult to change the current "culture of tax evasion" to one of compliance.

There are a number of factors that explain why the Government of Cuba persists in implementing policies towards legal micro-enterprise that are destructive from both economic and social perspectives. The first reason is that private economic activity in general is considered to be "capitalistic" and contrary to the tenets of socialism and the type of society that Cuba is trying to construct. However, to my knowledge, it has not been explicitly demonstrated that the current policy environment actually generates social values, attitudes and behavior that are in any sense "better" than those of a mixed market system. It is doubtful that squeezing legitimate economic activity into criminality and producing a "culture of illegality" could be beneficial either for the construction of socialism or for the functioning of a fair and honest society.

Second, the political leadership at the highest levels may be unaware of the extent of the underground economy and of the consequences of repressing legal micro-enterprise for Cuba's economic and social development. While this might appear surprising, Cuba's one party system promotes "yes-men" and penalizes dissenting views. The media also perform a cheer-leading function in Cuba's political system rather than one of independent newsgathering, expression, analysis and evaluation.

Perhaps most important, permitting the growth and flourishing of a private sector, even one based on low level self-employment would generate political costs for the leadership. The emergence of a private sector would permit the development of a strata in society that was independent and not controlled directly by the government and the Communist Party by means of its control of employment and remuneration. The Government has been unwilling to permit

its control in Cuban society to be weakened in this way. However, it is useful to note that some of those in the underground economy are already independent of some of the controls exercised by the Government and the Party, as their incomes are beyond the control of the government.

A final reason is that the incomes earned in such activities are considered to be excessively and unfairly high. While there has been some truth to this, there are other explanatory factors as well. If incomes are relatively high in some self-employment activities, this is due in part to the limitations on the numbers of such enterprises that reduce competition and therefore cause prices and incomes to increase. The dual monetary and exchange rate systems also permit those in the dollar economy to earn relatively high returns, as noted earlier.

VII. Implications for Public Policy

The “legitimate underground economic activities” owe their existence largely to the restrictive public policies outlined in Section IV above. As argued in Section VI, the social and economic results of these policies are largely negative for Cuba and its citizens. A pragmatic policy environment that would normalize the "LUEAs" by bringing them “above ground” would be of benefit to Cuba and its citizens. Such an approach could increase tax revenues, improve the quality, quantity and diversity of the goods and services, intensify competition and thereby lower prices and incomes in these activities vis-à-vis the state sector, reduce the inefficiencies that accompany clandestinity, utilize Cuba's human resources more effectively, strengthen the ability of the state to maintain health, safety, labor and environmental standards, and promote a culture of tax compliance and respect for regulations rather than a culture of illegality. In sum, a pragmatic approach would help improve standards of living and economic and social development generally over the long term.

There are a variety of policy measures that would change the situation significantly and quickly. The first such measure is to liberalize the licensing process. The current approach, whereby very few applicants are authorized and no new licenses are issued for some activities, is probably the most restrictive of all the policies affecting legal micro-enterprise. Instead, the government could authorize any and all applicants for self-employment. It is likely that there would be a rapid surfacing of underground economic activities if they could receive authorization. This assertion is supported, by the “rush to legality” in 1994 when self employment was liberalized, by the large numbers of respondents in the survey who stated that they wanted to be authorized, as well as by the numbers of applicants who are refused licenses.

A second measure would be to modify the tax regime to reduce its harmful impacts. A few modifications would not be complicated and could be implemented quickly. The first change might be to establish net income rather than gross income as the tax base. This means abolishing the “10% Rule,” which limits the allowable deduction from taxable income to a maximum of 10% of gross income. This would improve the equity of the system and end the discrimination against those micro-enterprises with purchased inputs exceeding 10% of gross income. The elimination of the monthly *cuota fija* payments would have a variety of positive results. It would remove a barrier to the entry of new enterprises thereby increasing numbers of firms, intensifying competition, increasing output, and reducing prices in the sector. This would also, in time, lead to an increase not a decrease in tax revenues. A tax arrangement that ended the discrimination against domestic micro-enterprise in favor of foreign/state mixed enterprise and placed them on a similar basis would also be reasonable. At present, the tax regime is perceived to be unfair and unreasonable so that cheating and non-compliance seem to be morally acceptable as well as necessary for survival. Any other policies that would help to build the

credibility of the tax system would be desirable. Some such changes could include refunding of tax over-payments to the micro-entrepreneur and reasonable financial penalties for non-compliance.

A further set of changes concerns the large number of rules and regulations mentioned in Section IV. This policy environment provides an incentive for micro-enterprises to remain underground, with a variety of harmful consequences as discussed earlier. The solution, however, is not to impose more regulations. Instead, it would be wiser to lower the barriers to entry into the legal micro-enterprise sector. This would involve reducing many of the restrictions on micro-enterprises. Reducing the density of constrictive regulations would also change the structure of incentives, which at this time encourages micro-enterprises to remain in the underground economy or out of business. By lowering the barriers to entry and changing the incentive structure so as not to penalize legality, the number of micro-enterprises will increase. With increased competition in the sector, production will increase and prices will decline. The average income level of the micro-entrepreneurs will approach the national average. Employment in the sector should increase but should decrease in the underground economy. The tax revenues actually collected by the tax system would also increase.

A final policy modification would be to make inputs available to the micro-enterprises in a reasonable manner and on an even footing with state and mixed enterprises. In some cases, the micro-enterprises are now required to purchase their inputs in the dollar stores where the prices are often up to 150 times greater than the prices on the rationed peso market (See Footnote 7.) However, to establish a reasonable market for inputs for the micro-enterprise sector as well as the state sector requires the unification of the current dual exchange rate and monetary systems.

VIII. Summary and Conclusion

Like other countries, Cuba has an underground economy. Unlike other countries, however, it includes large numbers of economic activities that would be legal if they were to be officially licensed by the Cuban Government. These enterprises produce legal goods and services. These "legitimate underground economic activities" are the focus of this study rather than truly criminal activities. These enterprises exist in part because of the nature of the public policy environment in which they operate. The government refuses to authorize all but a small proportion of applicants for these activities. Once they are authorized, licensed self-employment micro-enterprises face onerous taxation, a dense regulatory environment, political hostility, a continuously critical media, and long-term insecurity. As a result, such economic activities often enter the underground economy.

Despite some negative consequences, these clandestine economic activities generate important net benefits for Cuba and its citizens. The benefits include: low-cost goods and services that are vital for meeting the basic needs of the population, productive employment and incomes, domestic savings and investment, some foreign exchange earnings and savings, and continuous training in "entrepreneurship." But the clandestine operation of these activities, promoted by public policy, also generates losses for Cuba. These include the waste of human, capital and natural resources due to excessively small size of operation, waste of the entrepreneurial talents in low level activities, losses due to "attention avoidance," unnecessarily high prices due to reduced volumes of output, and the development of a "culture of illegality."

The social and economic benefits of the legitimate underground economic activities would be more significant if they were authorized and operated formally "above ground". This could be achieved by liberalizing the licensing for any and all applicants; establishing a

reasonable tax regime for micro-enterprise, reducing the dense regulatory burden, providing reasonable sources for inputs, and providing long term security.

Such measures are unlikely to occur in the current stage of high ideology, but will likely be implemented at some time in the future.

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Appendix I. Questionnaire on Underground Economic Activities in Cuba

1. Location: _____
2. Activity: _____
3. Registered or Licensed "*Cuenta Propista*":
3a. Yes: _____ 3b. No: _____
3c. If not, why not?
4. Workers:
4a. How many workers: _____
Family _____ Other: _____
4b. How many hours per week do you work in this activity: _____
4c. How many hours per week do others in your activity work: _____
4d. Do you have other employment as well: _____;
What sort of employment? _____
4e. Are you retired? _____
5. Income:
5a. Do you earn more than a state employee: _____
5b. Do you make a comfortable income _____
5c. How much are your employees paid per month. _____
6. Market:
6a. Where do you market your product? _____
6b. Is the market demand good? _____
6c. What is your main competition:
From other cuenta propistas? _____
From state enterprises? _____
7. Inputs:
7a. Where do you get your inputs?
Dollar Stores: _____ Recycling of used materials: _____
The Peso economy: _____ Other: _____
8. Difficulties: 8a: What are the main difficulties you face in the development and functioning of your enterprise?
9. Taxes:
9a: How much taxes do you pay? _____
9b: Can you pay them easily? _____
10. Support from Government:
Do you get any support from the government? _____
What? _____
11. Regulations: Which of the regulations are most serious for the development or functioning of your enterprise?
12. The Future:
12a Do you have plans for the development of your activity in future?
12b Are there possibilities now for expanding or improving your activity?
12c What changes would permit the expansion of your activity? If it were possible, what would you like to do with your business?

¹ Among these measures are the following:

- Sample surveys, though weakened by the unreliability of responses and unwillingness to cooperate.
- Tax auditing, also weakened by unwillingness to respond.
- The gap between the income measure of GDP and National Income; this gap includes numerous other errors and omissions and is therefore unreliable.
- The "currency demand approach" in which a disproportionately increasing demand for currency reflects an increase in the shadow economy; this also reflects numerous other phenomena that may be affecting the demand for currency as well as changes in the velocity of circulation of the money supply.
- The physical input or electricity consumption method. This attributes the growth of the shadow economy to the difference between the growth of GDP and electricity consumption. But there is little reason to suspect that this difference is due only to the shadow economy and not to other factors such as technical progress or increases or decreases in other energy uses.
- Declining labor force participation rates may reflect a switch to underground activities, but this may not necessarily be the case.

² Related to the above phenomenon was “*amiguismo*” or “*sociolismo*,” that is “friend-ism” or “partner-ism”. These terms refer to the reciprocal exchange of favors by individuals. Any person with control over resources could exchange access to those resources for some current or future personal material benefit. Complex networks of reciprocal obligations thus became an important part of the functioning of the economy. Daily life involved maintaining the personal relationships necessary to ensure access to necessary goods and services, through unofficial channels or through the official channels unofficially. This continued into the mid-2000s.

³ In the words of Vice-President Raul Castro, when reading the “*Informe*” of the Central Committee of the Party on March 23, 1996:

“The psychology of the private producer and the self-employed worker in general, as a result of the personal or family origin of their incomes - the private sale of the good or service they produce - generates individualism and is not a source of socialist '*conciencia*' ”.

⁴ Among those excluded were professional and business activities such as engineering consulting, management consulting, accounting, architecture, interior decorating, landscape architecture, computer and informatics, real estate agents, advertising agencies, employment agencies, and environmental consultants.

⁵. For example, the price of one pound of refined sugar in the state controlled sector was 0.08 pesos or \$US 0.0036 at the quasi-official exchange rate of mid-1997. The black market price was 2.5 pesos or \$US 0.011, while the price in the dollar stores was about \$US 1.50. If the micro-enterprises were forced to purchase sugar, which is a major ingredient for most Cuban snacks and drinks, from the dollar stores while the state vendors purchased it at the controlled price, the micro-enterprises could not compete with the state firms.

⁶ The goods and services provided in this part of the economy are of obvious importance for Cuba. For example, the custom fabrication of spare parts for autos keeps them functioning. The enterprises providing repair services for refrigerators and stoves are of immense value for meeting the basic needs of the population. Similarly, wood vendors and charcoal makers/vendors assist in feeding Cuban citizens.

⁷ For example, the small underground *cafeterias* and snack bars serve Cuban content foods in locales that are almost totally domestic content. In contrast, the state sector restaurant chains such as “*Burgui*” serve imported food in restaurants supplied with foreign made furniture, trays, plates etc.