

Tax law dilemmas for self-employed workers

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1. INTRODUCTION

In 2010, a series of regulations were published that allowed for the expansion of self-employment as an alternative to the rationing of employment in the state sector and for the creation of goods and services for the population. In just over four years, the number of private enterprises grew threefold, going from 144,000 in 2009 to 490,000 people by the end of February 2015. Currently, self-employed workers known as “cuentapropistas” represent 8% of employment and generate 5% of the Gross Domestic Product (GDP), according to data from Cuba’s National Office of Statistics and Information (ONEI).

These changes were accompanied by new regulations in the tax arena¹, which is the focus of this article. To understand them, it is necessary to take into consideration at least three basic elements. First, self-employed businesses are not recognized under the law as companies, even while no restrictions exist on the hiring of a labor force. This implies that all income is deemed as personal, and therefore subject to different liabilities than the profits of state or foreign companies, or cooperatives. It also means that it is not possible to apply specific deductions associated to investment, production costs, commercialization expenses or others typically associated with a company’s activities.

The second element is that the National Office of Tax Administration (ONAT) does not have the resources that would allow it to verify self-employed workers’ income and expenses case-by-case. Because of this, standardized methods are used, which is common around the world for the collection of revenue from small taxpayers.

Lastly, it is a principal objective of this special tax regime to avoid the private accumulation of property, in accordance with Guideline No. 3 of the 6th Party Congress. To put it another way, the tax system is being

¹ See Resolution No. 286/2010 of the Ministry of Finances and Prices (MFP), Act 113/2012 of the Tax System and Resolution No. 21/2013, also from MFP.

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used to discourage the growth of companies, imposing a progressive - and excessive- tax burden, as well as penalizing the hiring of more than five employees. These elements will be addressed in further detail ahead.

The structure of this article will be as follows: after the introduction, a section dedicated to a description of the special tax regime for self-employed workers follows; then, an analysis of the effects of that regime; and lastly conclusions.

2. DESCRIPTION OF TAX LIABILITIES FOR SELF-EMPLOYED WORKERS OR “CUENTAPROPISTAS”

Starting with Act 113 of 2012, the tax regime for self-employed workers was divided into two categories: the simplified regime and the general regime. (See Figure 1)

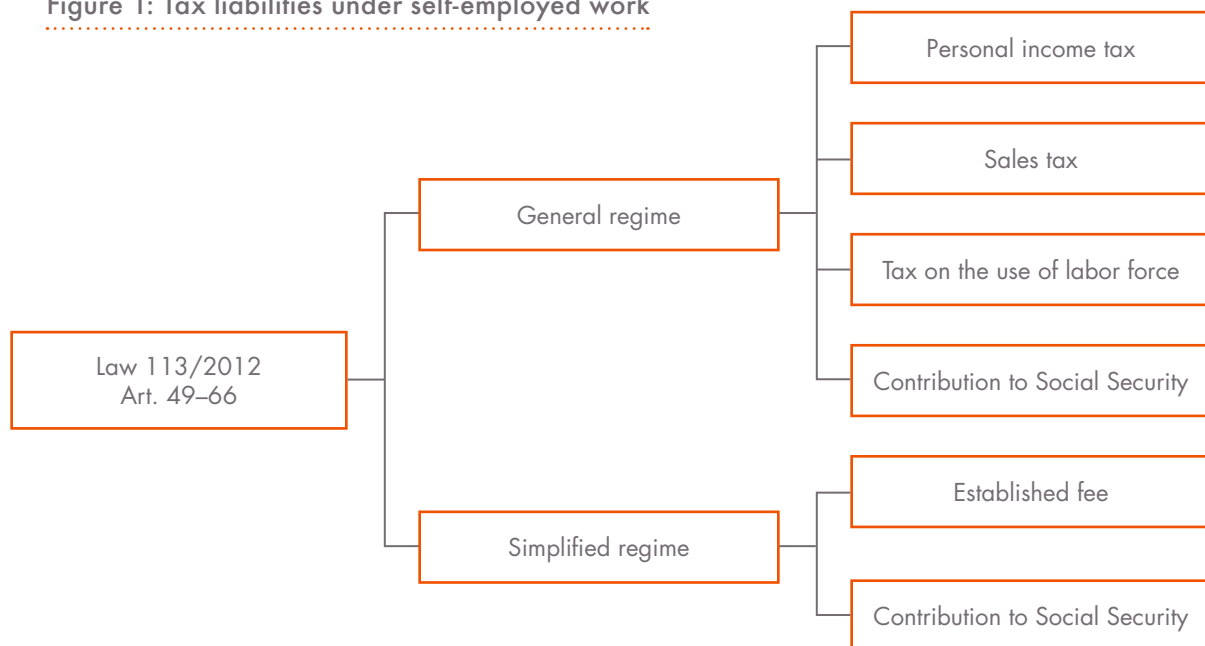
The simplified regime is applicable in ninety-three economic activities that have been designated as having lesser complexity and scale. For example, domestic personnel, messengers, gardeners, shoemakers, people dedicated to the repair of various items such as eyeglasses, umbrellas, bicycles, etc. It consists of only two liabilities: a) the payment of a monthly set fee that can vary from 20 to 150 Cuban pesos, depending on the activity; and b) contributions to social security that are paid quarterly through bank branch offices.

There are no differences in social security payments between a simplified or general regime. In both, the worker selects the contribution level (between 350 and 2,000 pesos), pays 25% of it and receives 60% when retiring. This way, if the person decides to select the base of 2000 pesos, then he/she must make monthly payments equal to 500 pesos (25%), for which they will receive a retirement of 1,200 pesos per month (60%) in exchange.

A worker can convert from a simplified to a general regime, if they have more than one license at a time and/or if they hire more than one employee.

Under the general regime, self-employed workers have four essential liabilities: personal income tax, sales tax, tax on the use of a labor force, and contributing to social security. (See Figure 1)

Figure 1: Tax liabilities under self-employed work



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The sales tax requires a monthly payment. In the case of self-employed workers, the rate approved for retail sales is applied, which is 10% of the total gross sales income². Standardized methods are not applicable, therefore the taxable base is subject to what taxpayers freely report.

The tax on the use of labor force is also paid monthly. In 2015 the rate is 12%, but there is a schedule in place for its reduction, so that in 2016 the rate would be 10%, and then 5% starting in 2017. The base for this tax is the payroll, however, it is not left to the taxpayer to freely declare that, rather the average wage of the province where the business is registered is used as a reference.

The complexities of this tax come from the need to establish mechanisms to discourage the growth of micro-enterprises. In the interest of achieving such an objective, a progressive tax base has been implemented, such that more taxes are paid as more workers are hired. This way, when a business has five or less employees, it does not pay the tax; starting with the sixth worker and until the tenth, the payments equal to 150% of the district's average wage as a base; between eleven and fifteen workers as the base result in 200% of the average wage of the province; and starting with the sixteenth worker, 300% is taken. Table No.1 details this, taking the average wage of the province of La Habana in 2013 (484 Cuban pesos) and a tax rate of 12%. Consider that:

(1) Tax Base = (Average wage of the province) X (progressive factor) X (amount of workers)

(2) Tax = (Tax Base) X (Tax Rate)

Table No. 1 Tax on the use of labor force

Number of Workers	Tax Base	Tax	Total to Pay per Month
0 - 5	Exempt	Exempt	Exempt
6 - 10	$484 \times 150\% \times 5 = 3.630$ pesos	436 pesos	436 pesos
11 - 15	$484 \times 200\% \times 5 = 4.840$ pesos	581 pesos	1,017 pesos
16 +	$484 \times 300\% = 1.452$ pesos for each additional worker	174 pesos for each additional worker	More than 1,191 pesos

Source: prepared by the author

The personal income tax has been the most controversial, due to the high tax burden that it imposes. In Table No. 2 the basic elements of this framework are evident. The tax base is calculated from the total of gross sales income, from which it is possible to deduct: a) 10,000 pesos tax-exempt of a general character; b) other taxes paid, such as sales taxes, tax on the use of labor force, contributions to social security, publicity taxes, among others; c) rent expenses paid to state companies; and d) a standardized percentage of expenses, which varies according to the type of activity, going from 10% (in the case of computer programming) to 50% (in the case of “paladares” or privately-owned restaurants and cafeterias).

² From a general standpoint, the sales tax is 2% on wholesale trade and 10% on retail trade. There is also a special tax for products, applicable to alcoholic beverages, tobacco, hydrocarbons, luxury items and the transmission of electric energy.

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As previously mentioned, it is not possible to deduct expenses or investments outside of these standardized percentages, even when the taxpayer has the capacity to prove them. Expenses or special deductions associated to a family's situation, such as the number of children, having some disability, disease or others are also not considered. The tax returns are carried out personally and joint returns for marriage or family are not permitted.

The applied tax is progressive and ranges from 15% to 50%. The maximum scale is reached at 50,000 Cuban pesos annually, in net terms. (See Table No. 2)

Table No. 2 Personal Income Tax

Gross Incomes

- (-) 10,000 Cuban pesos (CUP) tax-exempt
- (-) other paid taxes (sales, labor force, others)
- (-) rent expenses for STATE owned movable and immovable property
- (-) Standardized percentage of expenses according to activities (10-50%)

Annual Net Income (Tax Base)

Annual Net Income (CUP)	Tax Rate (%)
Up to 10,000.00	15
Over 10,000.00 up to 20,000.00	20
Over 20,000.00 up to 30,000.00	30
Over 30,000.00 up to 50,000.00	40
Over 50,000.00	50

Source: prepared by the author

Payments are made using two fundamental methods. The first is through monthly fixed fees, which are mandatory and standardized according to the type of activity. These vary from 700 pesos to 30 pesos, in the case of “paladares” (restaurants) and passenger transport using boats or motorboats, respectively. After the fiscal year has ended, a signed tax return must be submitted according to the terms detailed in Table No.2. If the sum of the monthly fixed fees is less than the amount of the tax that must be paid according to the return, the taxpayer must pay the difference. On the other hand, if the person has paid more than they were liable for through the fixed monthly fees, they will not receive any refund.

Generally, taxes and contributions to social security are paid in Cuban pesos (CUP), regardless of the currency the self-employed worker operates with. To calculate their taxes, income and expenses in convertible pesos (CUC) must be converted into Cuban pesos (CUP) using the current exchange rate under CADECA (currently 1 CUC = 24 CUP).

On the other hand, to support start-up businesses, a 3 month grace period is granted during which the self-employed worker must only make payments of contributions to social security. Those that rejoin the workforce will be able to enjoy this benefit, provided that 36 months have passed since the date they stopped being taxpayers in that sector.

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3. SOME IMPLICATIONS OF THE TAX REGIME FOR SELF-EMPLOYED WORKERS

One of the effects of the current tax regime for self-employed workers is pressure toward price increases produced as a result of the sales tax and the personal income tax.

In the case of sales, it is not possible to discount the tax already paid on the price of purchases at the end of the tax period. For this reason, the final price that the consumer is faced with includes, through production costs, the taxes paid on the purchase of materials plus more than 10% of the sale of the new product. That situation is exacerbated due to the absence of a wholesale market the self-employed workers can access.

From the perspective of personal incomes, the standardization of expenses imposes a priori profit margins equal to or greater than 50%. In Table No. 3, it is shown what happens when a self-employed worker has profit margins lower than what the law supposes, or in other words, real expenses greater than the standardized ones.

In this case we consider a cafeteria with an annual gross income equal to 600,000 pesos; with less than five workers, for which no taxes are paid on the labor force; and a contribution to social security equal to 1,050 pesos (it is not included in the table due to its small size). This cafeteria is authorized to lawfully deduct 50% of the gross incomes from sales, however, its actual expenses represent 80% of those incomes. As becomes evident, one of the risks that businesses face in that situation is that tax liabilities can exceed the net profit.

Table No. 3 Situation of a self-employed business when the actual expenses exceed the standardized ones

Liabilities under Law (CUP)		Actual situation (CUP)	
Annual Gross Incomes	600,000	Annual Gross Incomes	600,000
(-) Exempt minimum	10,000	(-) Exempt minimum	10,000
(-) Payment of Sales Taxes	60,000	(-) Payment of Sale Taxes	60,000
(-) Standardized expenses per Law (50%)	300,000	(-) Actual Expenses (80%)	480,000
Net Incomes per Law (INL)	230,000	Actual Net Incomes (INR)	50,000
Tax to pay (T)	104,500	Tax to pay (T)	104,500
Average Tax Rate (T/INL)	45%	Actual Average Tax Rate (T/INL)	209%

Source: prepared by the author

The foregoing sets self-employed workers up with a serious dilemma, since there is pressure from the tax side to increase prices, while from the demand side, no changes have been produced that allow people to assume those higher prices.

Another option to reduce the tax burden is evasion. In 2014, 60% of audited taxpayers turned out to have underpaid, which combines with a peculiar fact, that only 7% of all tax returns resulted in additional payments over monthly minimum fees. For this to be possible, for example, most of the “Paladares” had to declare monthly gross incomes lower than 200 CUC or 4,800 CUP, which hardly seems credible given the current level of prices.

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Surveys have verified that a significant portion of self-employed workers consider it necessary to evade taxes, even though they recognize that it is a felony for which they could be severely penalized. That attitude is reinforced by the fact that tax authorities still lack mechanisms to know the actual income of taxpayers. Alternatively, there are institutional variables that do not incentivize submitting a higher return, such as the deterioration of engagement mechanisms and popular control of public administration.

Meanwhile, the progressive nature of the tax on the use of a labor force further incentivizes informality and evasion, whether by not declaring the entire number of personnel hired, or by holding several licenses for the same business.

4. CONCLUSIONS

Analysis of the tax regime for self-employed workers shows that one of the fundamental objectives of the system is to control the size of companies, preventing a concentration of property in private hands. Many of the problems generated by this regime, and among them that tax evasion has become the rule stands out, stem from the design of the tax system itself, which corresponds to policies meant to restrict growth.

This presents several dilemmas, of course. First, it is contradictory to establish a system that penalizes a greater hiring of a labor force at a time in which the self-employed sector is expected to serve as an alternative to the rationing of employment in the state sector. Secondly, imposing greater restrictions to growth also implies limiting the possibilities of collecting revenue, with important long-term effects. And lastly, the effects on prices have damaging consequences, not only for self-employed workers, but for the population as a whole.

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