

# **“The Effects of Introducing Flat Tax in Romania on Macro and Micro Economical Level”**

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The crisis started as a financial one and then, step by step became an economical crisis. Specialists, analysts, economists have not yet reached a satisfactory answer to the question when the crisis started. Anyway, our government has set the economic crisis began on 30 September 2008 in Romania. After this date, the government had started a lot of measures in order to prevent a big crisis. We must mention that the Romanian crisis has also different causes than the USA and UE. We'll detail this in the paper. All the fiscal policy was revised in a very short period.

The paper is presenting the effects of introducing flat tax in the crisis period. We were analyzed the macro-economic effects regarding the number of firm affected all over the country and in our county by this tax. In the same time we must be very careful on the micro-economic effects. We studied the cost evolution with taxes on different firms and different ways to survive from crisis.

The paper concludes with the good and bad effects of this tax since 2009 till now. We are also proposing some measures for the good way of the Romanian economy.

**Key words:** economic crisis, flat tax, income tax, profit tax, accounting legislation, fiscal policy

## **I Introduction**

The financial crisis forced all the states to revise their fiscal policy and expenses policy. There were measures that must be taken in order to decrease the major effects of the crisis.

The duties and taxes are the means used by all the states in order to ensure a balanced financing of the economy in order to make made the expenses needed for social services, social insurance, army, education etc. As a matter of fact, the duties and taxes are essential instruments of the economic and social policies of the state which are used to stimulate the priority sectors of the economy and not only, instruments that emphasize the interventionist character of the state.

The small companies are the base of any democratic economy and the foundation of the European economy, too. They represent an essential source of jobs and new business ideas and a real support for development.

These enterprises are the most sensitive companies to changes in the business environment and legislation enforce, too. SME's are the first to be affected by the burden of bureaucratic excesses and, on the other side, they are the first to flourish from the initiatives to eliminate bureaucracy and reward success.

As a result, we must observe the special attention of the Romanian Government for the development of the small and medium sized enterprises, which led to introducing the income tax for micro-enterprises as an alternative to the profit tax.

The income tax for micro-enterprises was introduced for the first time in Romania in 2001 once the Government adopted the Ordinance no. 24/2001 on micro-enterprise taxation. This Ordinance was repealed by the Law No. 571/2003 regarding the Fiscal Code.

Regarding the fiscal point of view, a micro-enterprise is defined by the Fiscal Code as a Romanian legal entity that fulfills all of the following requirements at the 31st of December of the previous fiscal year:

- a) It has other source of income than the one obtained from consulting and management that constitutes more than 50% of the total income;
- b) It has 1 up to 9 employees;
- c) It achieved an income that did not exceed the equivalent in lei of 100.000 euro;
- d) The registered capital of the legal entity is owned by persons, others than the state, local authorities and public institutions.

The Law no. 24/2001 were not to apply to the following kind of institutions:

- banks;
- insurance and reinsurance companies,
- investment companies, investment management companies and deposit companies;
- securities mediating companies;
- companies with exclusively external trading activities.

The income tax rate for enterprises was modified as it is followed: 2% in 2007; 2.5% in 2008; 3% in 2009.

At the end of 2004, the Romanian Government introduced flat tax of 16% for the incomes of individuals and for the profit of the companies. According to the opinion of the authorities who proposed it, this measure represented the structure of a fiscal relaxation, in order to stimulate the economy.

After this fiscal measure, the potential expansion of businesses, the increase of direct investments, the reduction of the share of underground economy, a sustainable economic growth, more jobs, the increase of saving and investments, were considered ingredients of a successful program and were expecting to happen. However, many specialists showed at that time their concern regarding the timeliness of introducing the flat tax for individuals and companies.

The fiscal relaxation introduced in 2004 expected to come from the flat tax will lead to a boom of businesses, will bring to surface an important part of the “underground” businesses (estimated to be at 20% in Romanian GDP at that time, and 29,6% from GDP in 2011 – according to the European Commission Report), will attract direct foreign investments, will lead to a sustainable economic growth, more jobs, the increase of saving and investments etc. However, at that time, the specialists of the International Monetary Fund (and not only them) expressed their opinion saying that timing for introducing this fiscal measure is wrong.

The expansionist economic policies of the Authorities under the conditions of an already “superheated” economy will cause a price increase of more than 5% (the inflation target forecasted by the National Bank for 2006). By the way, the inflation targeting strategy was introduced in Romania in 2005, two years before our adhering to the European Union.

In this context, there were a lot of factors which pressing on the growth of inflation above the forecasted level, like:

- the growth rate of the deficit of current account (about 12% of GDP in 2006);
- the budgetary “holes” created after the introducing the flat tax (around 1% of the GDP also in 2006);
- the increasing of public expenses;
- the liberalization of the capital current account;
- the inefficient and insufficient restructuring;
- the increase of the expenses for the adhering to the European Union and also for the adhering to NATO (annually, in average, 3% of GDP).

In conclusion, we may say that at the point of introducing the flat tax for companies (1<sup>st</sup> of May 2009) there existing two kinds of tax:

- income tax (1,5% in 2001, when it was introduced) for the micro enterprises defined by the Fiscal Code;
- profit tax (16%) applied to turnover for the rest of the companies (and 16% flat tax for the incomes of individuals).

### **Flat Tax Impact on Macro Economical Level**

In the context, because of the financial crisis which was felt very well in Romania starting with 2009, the Government must take some measures in order to decrease to effects of the financial crisis. So, legal modifications of the profit tax and income tax for companies starting with 1<sup>st</sup> of May 2009. The law was given for a determined period of time, a period considered enough by the Government to clear up the not functioned companies and to force the companies to pay a minimum tax for their activity (1<sup>st</sup> of May 2009 – 31<sup>st</sup> of December 2010).

The Romania’s Government must take into consideration also the recommendations of the European Union and other international financial institutions to reduce budget expenses. In fact, the Romania’s Government adopts the Emergency Ordinance no. 34/2009 on budget rectification for the year 2009 and introduce some fiscal and financial measures that brings in chapter V important modifications concerning the profit tax, the income tax and the enterprise income tax, the value added tax and the Fiscal Procedure Code.

**Table no. 1. The minimum tax to be paid divided on income tranches**

<b>Turnover -lei-</b>	<b>Turnover -euro-</b>	<b>Annual minimum tax -lei-</b>	<b>Annual minimum tax -euro-</b>
0 - 52.000	0 – 13.000	2.200	550
52.001 - 215.000	13.001 – 53.750	4.300	1075
215.001 - 430.000	53.751 – 107.500	6.500	1625
430.001 – 4.3 million (mil.)	107.501 – 10,75 mil.	8.600	2150
4.3 mil. - 21.5 mil.	10,75 mil. – 5,375 mil.	11.000	2750
21.5 mil. - 129 mil.	5,375 mil. – 32,25 mil.	22.000	5500
> 129 million	> 32,25 mil.	43.000	10750

We considered 1 euro = 4 lei (the official course of National Bank at the 31<sup>st</sup> of December 2008 was 1 euro = 3,9852)

According to this table, the companies will pay at list the minimum tax specified according to their turnover in the last year.

By the way, starting with the second month of the 2nd trimester of 2009 (1<sup>st</sup> of May) all trading companies that pay the profit tax (except nonprofit organizations, owner associations, educational establishments and religious institutions) or the income tax must pay a minimum

tax calculated based on the total income obtained in the previous year (according to the last balance account from December 2008).

As the law said, the profit tax (16%) or income tax (3%) to be paid for each trimester is compared with the annual minimum tax for the trimester and the higher value is paid. The annual minimum tax for the trimester is determined by dividing the minimum tax to 12 months and multiplying the result with the number of months for the corresponding period of time (2 months for the 2<sup>nd</sup> trimester of 2009, 3 months for the 3<sup>rd</sup> and 4<sup>th</sup> trimester of 2009 and so on for 2010 year).

### **Example 1**

A trading company had a turnover of 350.000 lei in 2008 (about 87.500 euro) and it is registered like profit tax payer. According to the Emergency Ordinance no. 34/2009 (see table no.1), the minimum tax to be paid for this turnover is 6.500 lei per year (1.625 euro).

During the 1st trimester of 2009 the company registered losses and did not have to pay a profit tax. We suppose that the profit tax for the 2nd trimester of 2009 is 1.000 lei (about 250 euro).

The minimum tax for the same period was calculated like this:

$6.500 \text{ lei} / 12 \text{ months} \times 2 \text{ months (period: 2}^{\text{nd}} \text{ month of 2}^{\text{nd}} \text{ semester} - 30^{\text{th}} \text{ of June)} = 1.083 \text{ lei (270,75 euro)}$ .

In our case, because the profit tax resulted is lower than the flat tax, the company must pay the higher value, which is the flat tax, meaning 1.083 lei (about 270,75 euro).

During the 3rd trimester, the same company has a resulting profit tax of 1.700 lei (425 euro).

The minimum tax for the same period of time is:

$6.500 \text{ lei} / 12 \text{ months} \times 3 \text{ months (period 1}^{\text{st}} \text{ of July} - 30^{\text{th}} \text{ of September)} = 1.625 \text{ lei (406,25 euro)}$ .

Because this amount is smaller than the calculated profit tax, the company has to pay for the 3rd trimester 1.700 lei (425 euro). It is important to mention that the same calculation principle will be applied for the 4th trimester of 2009 and the whole year 2010.

According to this modification of the Fiscal Code, no legal entity can make an exception when it comes to pay a tax for their incomes or profit gains. Regarding of its economic status, whether it registers losses, obtains a minimum profit or doesn't have any income at all the company must pay a tax to the state.

### **Example 2**

A company is founded on the 1<sup>st</sup> of January 2009. According to the Emergency Ordinance, the newly founded taxpayers will profit tax.

In the first trimester, the new company registered losses and in the second trimester, too. According to profit tax it had no tax to pay and according to flat tax legislation it will pay profit tax which means 0 lei.

So, the newly companies founded in 2009 will be advantaged by the flat tax law.

Starting with the 1<sup>st</sup> of May 2009, for the profit tax payers, a lot of expenses became restrictly deductible and other, nondeductible. So, the category of limited deductible expenses includes the functioning, maintenance and repair expenses, excluding the ones for fuel, the expenses related to cars used by persons occupying leading and management positions of the legal entity, are limited to deducting no more than one car for each such person.

Starting with the same date, the nondeductible expenses for calculate the profit tax include any fuel expenses for road motor vehicles that are destined exclusively for person transportation with a maximum weight of no more than 3.500 kilograms and that don't have more than 9 passenger seats, including the seat of the driver, owned or used by the taxpayer.

As the Emergency Government Ordinance specify, the fuel expenses can be deducted only for the following:

1. Vehicles used exclusively for: intervention, repairs, security and protection, courier, worker transportation to and from the place of activity, vehicles specially adapted to be used as broadcast vans, vehicles used by the sales agents and the agents of human resources;
2. The vehicles that are used for paid person transportation, including taxis;
3. Vehicles used for renting by other persons, including training activities in driving schools.

This measure regarding the deductible and nondeductible expenses became in order to modify, meaning to increase the base for calculating the profit tax. We must mention that a lot of companies abuses of these kinds of expenses regarding especially fuel for any car owned by the firm.

### **III. Flat Tax Effects on Micro Economical Level**

This flat tax introduced on the 1<sup>st</sup> of May 2009 affects especially the little business men, who tried to make a legal business, with a small capital (the minimum capital for this kind of firm is 200 lei - around 44 euro) and with the hope in the future to expend their business by some employees.

On micro economical level, each enterprise thinks to optimize its budget and, implicitly, its incomes. A lot of firms could not increase their incomes in order to can cover the flat tax, so that their owners think how to decrease the expenses.

Let's suppose a number of 10 micro enterprises, each of them with 2 employees: the owner and the accountant. We must mention that according to Romanian law every firm must have these two employees. The owner of the company must be employee and pay taxes for social insurance, with the exception if he is already an employee for another firm and he is paying there the contributions. The accountant must be even employee, even working with a commercial contract. We took into consideration the first situation.

The minimum salary for the owner can be very different from the minimum established by the government in 2009 which was 600 lei (150 euro) per month for unqualified workers and 1200 lei (300 euro) per month for graduated persons (the minimum salary in 2012 was established at 700 lei, around 162 euro, considering the exchange rate at 1<sup>st</sup> of January 2012 which was 4,32 lei for 1 euro) for a programmer of 8 hours a day, 5 days a week. In the same time the owner may have a contract only for 2 or 4 hours a day..

The contract for the accountant salary usually is for 1 or 2 hours a day for small companies and varies from minimum 150 lei (37,5 euro) to 300 lei (75 euro) per month.

The social contributions for a contract are (the contributions percent is considered for 2009 year):

- company contributions: 26% (18,5% for social insurance + 5,2% for health insurance + 0,5% for unemployed + 1,8% different funds);
- employees taxes: 15,5% (9,5% for social insurance + 5,5% for health insurance + 0,5% for unemployed) and 16% for income tax applied to the taxable income.

We may also suppose that 2 of these companies closed their activity. In this case if the owners of the firms probably had already another job, the accountant loses a company and the state loses also some taxes, some incomes.

### **Optimistic vision**

Let's say that from that 10 companies only 2 of them closed their activity and the other 8 continue the business. In this case all the 8 companies started 1<sup>st</sup> of May 2009 should pay the flat tax. As they are small companies they will have to pay 550 lei (137,5 euro) for each trimester. In the case they registered losses and didn't pay any tax to the state starting this date the companies will have to pay at least the minimum tax.

So the expenses of each firm increase with 550 lei for trimester (137,5 euro). We should also suppose that the firm will have enough incomes in order to pay this tax.

In our optimistic vision the state will have an increase of incomes:

- 2 small firms will close their activity so they will pay each of them around 300 lei (75 euro) for taxes at the Official Registry of Commerce;
- 8 small firms will pay, each of them, 1.833 lei (458,25 euro) for the whole year 2009 for the flat tax. The sum is calculated like this:  
 $2.200 \text{ lei/year (550 euro) / 12 months} * 10 \text{ months} = 1.833 \text{ lei (458,25 euro)}$

The Romanian budget will register an increase of income with:

- $2 * 300 \text{ lei (75 euro)} = 600 \text{ lei (150 euro)}$ ;
- $8 * 1.833 \text{ lei (458,25 euro)} = 14.664 \text{ lei (3.666 euro)}$ .
- TOTAL incomes for the budget: 15.264 lei (3.816 euro).

Conclusion in this case is that the state will have also more incomes for the budget.

### **Real vision**

In our real vision will describe what really happened for the most of small business companies. The companies who closed their activity should go to the Official Registry of Commerce to announce their wish and to pay a tax around 300 lei, meaning 75 euro.

Let's take the example of a small firm with 2 employees: the owner and the accountant.

The owner salary: 600 lei per month (150 euro) for 8 hours a day.

The accountant salary: 300 lei per month (75 euro) for 2 hours a day.

The social contribution for both of them will be:

- company contributions:  $26\% * 900 \text{ lei (225 euro)} = 234 \text{ lei (58,5 euro)}$ ;
- employees taxes: -  $15,5\% * 900 \text{ lei (225 euro)} = 139,5 \text{ lei (34,9 euro)}$ ;
- income tax  $16\% * (900 - 139,5 - 250) \approx 82 \text{ lei (20,5 euro)}$ .

*Note: 250 lei (62,5 euro) represents the personal deduction for the base place of work. We suppose that the owner have a single place of work in its firm, but the accountant have many businesses to administrate. So we'll apply the personal deduction for one time.*

Total expenses with the 2 employees: 455,5 lei ( $\approx$ 114 euro) per month. In one year this means 5.466 lei (1366,5 euro).

Also we consider that the company will have no profit tax to pay.

Once introduced the flat tax the firm will have to pay at least 1.833 lei (458,25 euro).

Total expenses with the flat tax:  $5.466 \text{ lei (1366,5 euro)} + 1.833 \text{ lei (458,25 euro)} = 7.299 \text{ lei (1.824,75 euro)}$ .

Many companies tried to maintain the value of the taxes to the state of the same value because they have no resources to increase their incomes. That is why they take some measure in this way, like the decrease of the salary: for the owner from 600 lei (150 euro) per month to 300 lei (75 euro) per month and for the accountant from 300 lei (75 euro) per month to 150 lei per month (37,5 euro).

In this vision, the contribution will be:

- company contributions:  $26\% * 450 \text{ lei (112,5 euro)} = 117 \text{ lei (29,25 euro)}$ ;
- employees taxes: -  $15,5\% * 450 \text{ lei (112,5 euro)} = 69,75 \text{ lei } (\approx 17 \text{ euro})$ ;
- income tax  $16\% * (450 - 69,75 - 250) \approx 21 \text{ lei (5,25 euro)}$ .

Total expenses with the 2 employees: 207,75 lei ( $\approx 52$  euro) per month. In one year this means 2.493 lei (623,25 euro).

Total expenses with the flat tax: 2.493 lei (623,25 euro) + 1.833 lei (458,25 euro) = 4.326 lei (1.081,5 euro).

In our opinion this was the solution applied by many small companies to may survive and not to close their activity. In this way, the incomes for the budget of the country were the one expected from the flat tax, but the ones from social contribution registered a decrease.

#### **IV. Conclusion**

In this problem, the flat tax for companies the state declares that the major role of the law was for at least 2 reasons:

- to force the companies of any dimension regarding capital, assets, employees to pay a tax for their activity and
- to force the companies with no activity to closed officially their firm at the Official Registry of Commerce.

And the 3<sup>rd</sup> important reason was to collect from all the companies a minimum tax for their activity even if they declare profit or loss in the balance sheet.

By the way the state didn't take into consideration a lot of other aspects, especially in a crisis period, like:

1. Because the tranches for the flat tax started from 0 lei turnover, the owners of the firms with no activity had 2 solutions:

- the bad one to start paying a tax without having any activity;
- the less bad one to go the Official Registry of Commerce and to suspend their activity. Here we must mention that they can suspend the activity made for a maximum of 3 years. In this time the companies will still have to make some declaration to the Finance, but have no flat tax to pay. This year, in 2012, most of them must decide what will have done with their companies.

2. A lot of firm will prefer to decrease the salaries of the employees and in this way the social contributions to be paid in order to may pay the flat tax.

3. It is true that maybe the companies will try not to pay any profit tax to the state, but at least they paid the contributions for their employees so the state will still have some incomes.

4. The underground economy increase a little with the firms which preferred to pay their employees without declares the real salary on the state.

5. The underground economy increase also with the company declared with no activity and making activity without paying any taxes.
6. The state announce big incomes from flat tax in 2009 and 2010, but no information about how has been modify the incomes from social contributions regarding the salaries.
7. The law couldn't be applied till 31<sup>st</sup> of December 2010 and be repealed starting with 1<sup>st</sup> of October 2010.
8. The changes in fiscal policy for a short term, without any announcements before made an insecure business environment for our country.

In some politicians opinion this flat tax was a measure for cleaning the businesses environment.

In our opinion the measure doesn't have the success expected by the government. A minimum tax is not a bad idea for our business environment. The way of implementation without any prediction before was not so good. Because of the hurry of introducing this flat tax in order to get more incomes to the budget many businesses go to bankruptcy because they didn't have enough time to restructuring their company.

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