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**IMPACT OF LUMP-SUM TAX IN ROMANIA**

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**Abstract**

*Any enterprise is willing to get a higher profit and when taxation is low and when this is higher. As a manager, you do not justify your presence in the top, if you do not want to maximize your business opportunities, and get as much as possible. Therefore, the new lump-sum tax introduced by means of the Government Emergency Ordinance no. 34/2009, from our point of view, it directly acts over the firms' financing.*

*The Government Emergency Ordinance no.34/ 2009 concerning the introduction of the lump-sum tax in Romania, the measures that restrict and remove costs that can be deductible in a firm's accounting, as well as those related to the rise of the tax to be paid by microenterprises caused strong debates in the business environment, especially within small businessmen.*

*Financiers could not mention how long the firms would pay the lump-sum tax, because according to economic forecasts, many of them will not succeed to outrun the crisis and forecast a gloomy period for Romania, especially when, according to deadlines in the ordinance, many measures will be maintained up to the end of the next year, that obviously indicates the date when the state authorities expect a modification of the situation.*

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**JEL Classification:** H21, H25

**1. Some advantages of presumptive taxation**

Legal presumptive taxation, id est that case when occurrence of at least a legal condition (practically) of the requirement as regards this system of taxation, may have some important and relevant positive effects. Some of the most important ones are shown as follows:

a. restriction, reduction and, avoidance of tax evasion, at the limit. It relates to the situation wherein eligibility of deductible costs is imitated (there is illegally, for instance, the costs that are not or cannot be functionally related to income), or the situation wherein some income is not registered, in both situations reducing the taxation basis (taxation profit);

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b. reduction of tax management costs, as a result of reducing the necessary „amount” of tax control. It relates to the fact that lump-sum taxed economic activity should not be transparent for the governmental inspector;

c. stimulation of development concerning economic activity. It relates to the requirement of tax payers that are subject to presumptive taxation to ensure economic substance in order to pay the lump-sum tax (getting a net profit at least at the level of lump-sum tax), that has a positive impact over other indirect “conventional” taxes;

d. rising of security of coincidence between the encashed public income and scheduled public income. This drives the rise of macroeconomic financial constancy;

e. economic selection of viable companies. Companies that do not get, continuously, a minimum economic profit (id est equal with the monetary value of the lump-sum tax) will have to leave the market, that is an extremely useful and effective economic drainage system; as regards the requirements of the present paper, by means of economic profit we understand that accounting profit associated with available assets related to the treasury of the company concerned, id est that accounting profit associated with the company’s capability to effectively pay the related budget liability.

## **2. Some disadvantages of presumptive taxation**

As regards the tax philosophy, the blind system of taxation cannot be the system of taxation prevailing in a national economy. The reasons of this statement are the following:

### a) theoretical reasons

- quasi-generality of presumptive taxation would have the significance of taking over the economic calculation from the „charge” of the free market to that of governmental bureaucracy, that is impossible (possibility of centralized economic calculation has been infirmed both in theory and social practice);

### b) empirical reasons

- inflexibility of tax taking by presumptive taxation drives permanent losses of tax income, though these are not scheduled in the public budget. We relate to the fact that rising of the taxation base has no positive effect on the fiscal income, as the level of income is set independently by the variation of the taxation basis;

- there is an important adverse effect for tax payers that are ranged, for instance with the presumptive taxation criterium –, turnover –, below the breakeven that would allow their continuity on the market, leading to the quick and possibly, final removal of sources of taking the lump-sum tax itself.

Introduction of legal presumptive taxation, i.e. the case when at least one of the legal requirements occurs (again, here, practically) concerning the requirement of this system of taxation, however, may create, some vulnerabilities in the economic system concerned. The main vulnerabilities can be:

1. impairment of early economic activities concerning firms that do not register economic profit; it is about firms whose economic activities are, in the main,

efficient, but that are at the beginning of entering the market (i.d. under the impact of economic barriers at entrance). These firms activity will be discouraged and, according to the place occupied horizontally and vertically in the national economic activity, their discouragement will be able to generate negative chain effects, with a negative end on the total tax income of the public budget;

2. passing over the cost of trade arrears between firms to the firms that are not able to refinance their trade debts or cannot generate monetary surrogates for the debts held. It is about firms that are viable, they register accounting profit but cannot get the cash flow related to this accounting profit due to the phenomenon of trade arrears between firms. This time, the activity of firms that are in economic cruise (have exceeded the economic barriers at entering, are installed on the market and are efficiently involved in the national economic system);

3. creation of an asymmetry in economic competition, by means of normative rise as regards the firm cost of the firms subject to presumptive taxation. Indeed, if we shall consider the budget liability as a sui-generis cost (though, in the right sense of the cost term, the budget liability is not framed in the production cost), i.e. if we shall consider it as a firm's operation cost in general, then competitiveness of firms subject to presumptive tax but that do not succeed to produce the money required to pay the budget liability concerned, is negatively affected, because the eventual external financing of the payment related to the budget liability will enter the next production cost. A vicious circle occurs that, will finally earmark the firms concerned in relation to their competitors.

### **3. Introduction of presumptive taxation in Romania**

The Ministry of Public Finance has set seven collection tranches, that will be carried out quarterly by absolutely all firms, though they are established during this year.

This ordinance wherein introduction of the lump-sum tax is predicted has a sensitive point from the very beginning, because it does not mention the term of tax payer explicitly, that could suggest that money is to be collected from all those that issue invoices.

The second paragraph in article 18 in the law no. 571/ 2003 concerning the Fiscal Code has been changed by means of the Government Emergency Ordinance no. 34/2009: "Tax payers, except those mentioned at paragraph (1), article 13, letter c)-e), art. 15 and 38, in case when the profit tax is lower than the sum of minimum tax for the tranche of total suitable income, provided at paragraph (3), must pay the tax for this sum".

Excepted from paying the lump-sum tax are:

- night bars, night clubs, discotheques, casinos or sport bets, including legal entities that obtain this income based on a contract of association;

- foreign legal entities and non-resident individuals that work in Romania within an association without legal status;
- resident individuals associated with Romanian legal entities;
- foreign legal entities that generate income from/or in association with real estates located in Romania or from sale/cession of titles of participation held at a Romanian legal entity;
- Treasury and state institutions;
- Trust companies;
- Religions;
- Approved private education institutions;
- Owner associations;
- NGOs, trade unions;
- Patronizing federations etc.

The remaining firms should pay, mentioning that firms that register a profit will still pay a tax of 16%, but not less than the minimum limit related to the range of income it is framed in.

### **Lump-sum tax tranches**

Total yearly income/ yearly minimum tax

Lei 0 – 52.000	= Lei 2,200 (yearly minimum tax – approximately Eur 500)
Lei 52.001 – 215.000	= Lei 4,300 (around Eur 1,000)
Lei 215.001 – 430.000	= Lei 6,500 (around Eur 1,500)
430.001 – 4.3 million Lei	= Lei 8.600 (around Eur 2,000 )
4.3 million – 21,5 million Lei	= Lei 11,000 (Eur 2,500)
21.5 million – 129 million Lei	= Lei 22,000 ( Eur 5,000)
Over Lei 129 million	= Lei 43,000 ( Eur 10,000).

To calculate the minimum tax, total income will be taken into consideration. The total income is obtained from any source, registered on 31st of December of the previous year, of which the following is subtracted:

- a) Income from stock fluctuation;
- b) Income from production of tangible and intangible assets;
- c) Operating income, representing the quota of governmental grants and other resources to finance investments;
- d) Income from reduction or avoidance of provisions for which deduction has not been provided, according to legal regulations;
- e) Income resulted from abatement of debts and increases due to state budget, that were not deductible costs at the calculation of taxable profit, according to legal regulations;

- f) Income made from damages from insurance companies;
- g) Non-taxable income expressly mentioned in agreements and memoranda approved by means of laws.

At the calculation of yearly minimum tax for the second quarter, the profit tax due at the end of the quarter is compared with the yearly minimum tax, recalculated accordingly for 1 May 2008 – 30 June 2009, dividing the tax by 12 months and multiplying with the number of months related to the period concerned.

#### **4. Reasons to introduce lump-sum tax**

From analyses carried out by the Ministry of Public Finance it results that, in 2007, from the 617,525 tax payers (legal entities), 2,000 provides more than 85% of public income. Representatives of the Ministry of Finance showed that across the country, the number of companies that stated losses in 2007 was 242,106 (39.2% from the total number of registered companies), as the turnover of these enterprises amounts to Lei 134 billion.

According to officials of the Ministry of Public Finance, almost 70% of the 242,106 firms that reported losses in 2007 is ranked in the first two categories of yearly minimum tax. It has also been showed that the total number of firms that recorded losses 109,617, 46% respectively, had income up to 100 million old lei (10,000 new lei), while approximately 75,000 firms registered income ranged between 100 and 500 million old lei (Lei 50,000).

The patronizing federations put forth that over 40,000 small firms will be affected. However, many companies criticised the measure of the Ministry of Public Finance and showed that it would dynamyte economy, following to have domino effects, because it will result in reduction of activity or even the closure of some firms, lay offs, unemployment and, implicitly, minimum budget collections. Furthermore, according to data sent to the Romanian Patronizing Federation, it is said that introduction of the lump-sum tax will affect over 40,000 existing small firms in Romania and a lot of family businesses, with 3-10 employees, these firms running in tourism, supply of services, trade or belonging to small handicraftsmen.

According to small entrepreneurs, but also to those that has established a business this year, the measure will result in either closing the firm, or finding other solutions to state an as low as possible income. They mentioned that is is impossible for a firm with a “0” turnover should pay Eur 500 to the state.

The ordinance has also modified the taxation quote on microenterprises' income, this being set to 3% in 2009, compared to 2.5% - last year. Also, the law states that “in case when the tax due to microenterprises is lower than the yearly minimum tax, they must pay the tax at the level of this sum”.

The representatives of the Ministry of Public Finance mentioned that for the year 2009 the following rules will be taken into consideration in order to apply the provisions:

- For the second quarter, the microenterprises' income tax due at the end of the quarter is compared with the yearly minimum tax, recalculated accordingly for 1 May – 30 June 2009, by dividing the yearly minimum tax to 12 months and multiplication with the number of months related to the period concerned.

- For the third and the fourth quarters, the microenterprises' income tax due at the end of each quarter is compared with the yearly minimum tax, recalculated accordingly.

In case of downturn, the European Commission recommends the adoption of measures in order to help small enterprises, that create most jobs in the European Union. As you can see, they are sustained to liquidate in Romania.

According to the situation specific to each state, the following types of measures can be taken into consideration: deduction of taxes and social contributions: lower social contributions paid by employers can have a positive impact over the maintenance and creation of jobs while the lower taxation of income can sustain the buying power, especially for those with a low income; temporary reductions of the standard VAT quote: they can be introduced rapidly and can generate a fiscal stimulation to sustain consumption.

Thus, the Government Emergency Ordinance no. 34/2009 comes in conflict with the recommendations of the European Community and the International Monetary Fund:

- it breaches the Article 3 in the Fiscal Code related to the principles of taxation “efficiency of taxing by securing long term constancy of provisions within the Fiscal Code, so as these provisions not lead to unfavourable retroactive effects”;

- it breaches Article 4 in the Fiscal Code “Any modification or completion to the present code becomes effective starting from the first day of the next year to that wherein it has been adopted by law “;

- it breaches the Treaty of the European Community that provides removal of discriminations in approaching the suppliers of services, or implementation of a similar approach to tax payers that are in different situations (a tax payer having a loss and another one obtaining profit can pay the same lump-sum tax) is discriminatory;

- such kind of antiabuse measures restrict the basic liberties and are forbidden by the Treaty of the European Union;

- the International Monetary Fund's specialists were against application of a minimum profit tax, calculated at the level of the gross income, as it is unfair and skews the economic activity.

We, do not cling to the rise of short term taxation and perceived reluctantly this lump-sum tax. We understood the extraordinary need of the government to get additional resources, as long as most effort to keep under control the budgetary deficit comes to cutting of costs that diminished considerably.

We still believe it will be very difficult for the government to stay close to the deficit scheduled for this year. It remains to be seen if the impact will be that predicted. In reality, it is possible that estimated income not to be seen.

It is an additional burden for small firms, that should finance by own sources, in order to pay their lump-sum tax. Those firms that do not get anything are threatened by extinction. The Government bet is related not to those firms that do not want to set up a business and see hampered any possibility to try running, the government bet seems to be related to those that have not paid anything to the tax authorities for years.

Moreover, in a period of downturn that is increasing, the fight is for survival. If the firms would be let more, instead of 16% you would take them 10%, it does not mean that collections to the state budget would rise. At present, the firms are trying to survive. Perhaps in some enterprises, some people have brilliant ideas and are trying to capitalize the crisis period, but most enterprises is obsessed to survive.

From our point of view, by implementing the lump-sum tax abnormal situations can occur for some tax payers, wherein the lump-sum tax can exceed the value of total income. It will have negative effects over economy and the level of budget collections: increase of underground economy, the firms will prefer making collections without invoice in order to reduce their turnover, and as a result, the budget income will drop; many firms will collapse, that will result in multistage effects (rise of number of unemployed people, rise of budget expenses with unemployment aids, reduction of budget collections from taxes and wage taxes: social security contributions, the unemployed, health, wage tax etc.); reduction of VAT collections; reduction of budget collections from profit tax, coworkers' income tax; a smaller part of firms will change into Individual or Family Business in order to get rid of lump-sum tax payment.

## 5. Conclusion

Writing this paper, in the margin of presumptive taxation, it occurred the freak idea that presumptive taxation would tax the loss. Certainly, within the aforementioned issues, when we approached possible vulnerabilities that presumptive taxation can create, we also referred to the risk that some firms could be affected both in their activity sustainability and in their competitiveness.

Actually, the idea that presumptive taxation taxes loss seems to us excessive and, in fact, not sustainable (if it were so, then any internalization of negative externalities should be disapproved). We shall reason our position starting from the general understanding of taxation (id est of compulsory taking, from associations that form the state, of some legal contributions to sustain the public sector). Under the circumstances, we consider there are four separate reasons to justify (rationalization) the tax (any tax):

1. The philosophy reason (contract cost reason): based on the social contract, the state should secure public goods (public goods are goods exclusively created by the state, are distributed outside the market, id est non-competitively, free of charge, and their consumption is public – regardless how much the public goods are

consumed, the available amount of those public goods does not reduce, for instance, national defense); by definition public goods are available to all the members of society, therefore, all members of society should contribute to their production (this is made by means of tax payment);

2. Economic reason (economic cost reason): those getting economic excesses from profitable activities (profitable activities are those activities that bring profit, id est surplus of income compared to costs or, more exactly, surplus of collections compared to payments) of any kind, they succeed getting these surplus amounts both as a result of own merits (investments in money, work, risk, imagination etc.) and as a result of economic, social, institutional conditions etc. already existing; these conditions have been created by the state, based on taxes paid by the previous generations (or by the next generations, if these conditions have been created by public indebtedness); generically, it can be said the state has “shares” in any private enterprise – thus, due taxes represent only „dividends” payable to the public shareholder for the entire general infrastructure secured to the economic environment.

3. Social reason (social cost reason): economic activities generate both individual costs (recovered by their introduction in the individual price, by the economic subject concerned) and social costs (so-called negative externalities, for instance pollution, unemployment, criminality). Neutralization of negative externalities is carried out by the state (also based on the social contract). Financing this neutralization is carried out by tax payment by companies that, by means of things, creates negative externalities (either explicit, or implicit);

4. Moral reason (moral cost reason): human nature encourages the free rider behaviour (free rider behaviour is that behaviour aiming to get the benefit without accessing the payment of that benefit price (it is also called the paradigm of train jumper); the free rider behaviour creates informal social injustice; avoidance of this behaviour can be only made by norming the constraint to pay the value of advantages that every company has, as a result of its membership to the society (to the state, widely).

We consider the economic and moral grounds for taxation can be totally and righteously applied to presumptive taxation. The other reasons should be approached under the circumstances wherein the issue of vulnerabilities generated by this system of taxation has been discussed.

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