



REGULATORY AND FISCAL CAPACITY OF INCOME TAXES IN UKRAINE: THE BEHAVIORAL ASPECT

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- A** The article is devoted to the problems of implementation of fiscal and regulatory capacity of income taxation. Reasons of insufficient realization of fiscal and regulatory capacity of income taxation are defined. The relationship between taxpayers' and government's behavior and fiscal and regulatory capacity of income taxation are identified. The ways of improvement of income taxation are justified.
- B** Corporate income tax, personal income tax, single tax, taxpayer's behavior.

РЕГУЛЯТОРНИЙ ТА ФІСКАЛЬНИЙ ПОТЕНЦІАЛ ПОДАТКІВ НА ДОХОДИ В УКРАЇНІ: ПОВЕДІНКОВИЙ АСПЕКТ

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- A** Стаття присвячена проблемам реалізації фіскального і регуляторного потенціалу податків на доходи. Знайдено причини недостатньої реалізації фіскального та регуляторного потенціалу податків на доходи. Виявлено взаємозв'язки поведінки платників податків і держави та фіскального і регуляторного потенціалу податків на доходи. Обґрунтовано напрями вдосконалення податків на доходи.
- B** Податок на доходи фізичних осіб, податок на прибуток, єдиний податок, поведінка платника податку.

РЕГУЛЯТОРНЫЙ И ФИСКАЛЬНЫЙ ПОТЕНЦИАЛ НАЛОГОВ НА ДОХОДЫ В УКРАИНЕ: ПОВЕДЕНЧЕСКИЙ АСПЕКТ

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- A** Статья посвящена проблемам реализации фискального и регуляторного потенциала налогов на доходы. Выявлены причины недостаточной реализации фискального и регуляторного потенциала налогов на доходы. Определены взаимосвязи поведения плательщиков налогов и государства с фискальным и регуляторным потенциалом налогов на доходы. Обоснованы направления усовершенствования налогов на доходы.
- B** Налог на прибыль, налог на доходы физических лиц, единый налог, поведение налогоплательщика.

Statement of the problem

Taxes on income in most developed countries of the world have both fiscal and regulatory capacity. While the fiscal and regulatory effects of income taxes are basically balanced, income taxes in Ukraine have long been considered only in the case of reaching of their fiscal capacity. This practice has led not only to a loss of regulatory capacity of income taxation, but to a gradual reduction in the tax base. It has affected the fiscal capacity of income taxation badly. Nowadays the government is stating a need to improve the country's tax system, and I agree with this idea. However, such improvements should not simply copy the successful experience of foreign countries. The government must take into account the economic and psychological backgrounds of tax reform. Only in this case there is a chance that the reforms will work to the benefit of the society.

Analyses of recent researches and publications

Taxes on income are the subject of scholarly debate, both in Ukraine and abroad. However, the object of these discussions is significantly different. A. Slavkova focuses attention on the problems of personal income tax administration. She believes that the low efficiency of administration negatively affects revenue. Among the main causes of the low efficiency of administration, she names the low level of tax culture and the high level of shadow economy [9, p. 221-222]. I. Tsybalyuk explores the problems of the fiscal efficiency of increasing income taxes [10]. Debatable aspects of the harmonization of income taxation are presented in the article by I. Legkostup and K. Katsuba [6]. The regulatory effects of income tax have been researched by R. Van [13]. The behavioral aspects of the impact of income taxation are explored by M. Dragota, V. Dragota, L. Tatu, D. Tatu [11].

Recent studies by Ukrainian scientists focus on the problems of implementing fiscal capacity of income taxation. Western researchers often focus on the regulatory capabilities of income taxation. Also, it should be noted that many scientists abroad focus on the behavioral aspects during the solving the problem of taxation. This problem is relevant for Ukraine as well. Ignoring the behavioral effects of tax reforms, in my view, is one of the key reasons for their failure. Therefore, **the goal of this article** is to assess the influence of behavioral factor on the implementation of fiscal and regulatory capacity of income taxation in Ukraine.

Presentation of the basic material. Income taxes worldwide are generally divided into current income tax and tax on accumulated income (property taxes, wealth, inheritance). In Ukraine, taxing accumulated income is in a developmental stage, that is why to assess their fiscal and regulatory impact is quite difficult. In this article we will focus on the current income tax situation. Three taxes on current income are levied in Ukraine: corporate income tax, personal income tax and a single tax.

Corporate income tax. The fiscal capacity of corporate income tax is sufficient for Ukraine at present. Its share of revenue was about 20% in 2002, but gradually it decreased to 16% in 2010, and was down to 10% in 2014. The decline in the share of corporate income tax can be measured in two ways. On the one hand, the reduction of fiscal role of corporate income tax is the evidence of a reduction of capital available to a business, which should contribute to its development. That is, an increase in corporate income tax regulatory effects should be expected. Is this really easy in Ukraine actually?

The high tax burden on the profits of companies over a long period of time has become one of the key motifs of income tax evasion. This is evidenced by the large share of unprofitable enterprises in the economy of Ukraine. Additionally, the share of unprofitable enterprises and the shadow economy are closely linked (fig. 1).

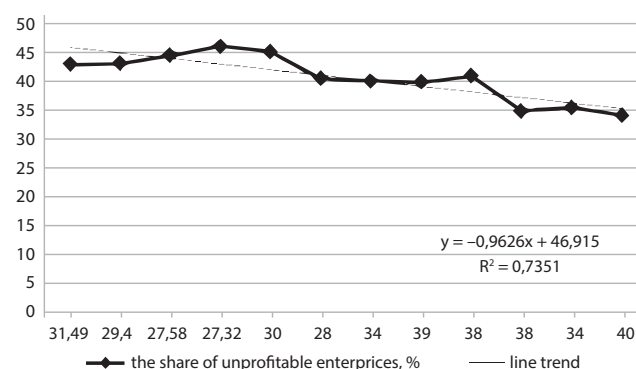


Fig.1. RELATIONSHIP BETWEEN THE SHARE OF UNPROFITABLE ENTERPRISES AND AN INTEGRAL INDEX OF SHADOW ECONOMY
 Source: constructed by the author on the basis of information from the State Statistics Service of Ukraine and the Ministry of Economic Development and Trade of Ukraine

Charts show that the studied variables are closely linked. The increase in the shadow economy contributes to the growth in the share of unprofitable enterprises. The share of the shadow economy is estimated by the Ministry of Economic Development and Trade to be 40-45% (2014 – 42%); the World Bank estimates that the share of the shadow economy reaches 60%. In such circumstances, the implementation of corporate income tax regulations is impossible because the lack of response to change by taxpayers will be extremely low. Moreover, in the long term, this situation adversely affects the fiscal capacity of corporate income tax. The business get-away into the shadows is a reason for the reduction of the tax base, and at the same time, it is a cause of the decrease in tax revenue.

The Laffer curve, which is widely known [12], shows that with an income tax rate increasing the budget revenue will grow only to a certain optimum point, and then it will fall. However, this does not mean that by reducing the tax rate the reverse effect can be achieved. Therefore, attempts to reduce the tax burden of corporate income tax by applying the benefits or reducing tax rates have not yielded the expected results. Taxpayers are used to working in the shadows. Moreover, Ukrainian business even cannot be called 100% shadow. This is a hybrid phenomenon taking place, when officially registered enterprises concurrently operate in both the formal sector of the economy and in the shadow sector. These working conditions are so familiar and comfortable to taxpayers that the way out of the shadows, in fact, is contrary to the taxpayers' interests. Therefore, a reduction of tax rates or the introduction of additional benefits will not affect taxpayers' behavior. They will enjoy a reduced tax rate on the profits calculated officially, and will still continue to conduct business in the shadows as well. This is the situation when fiscal and regulatory capacities of corporate income tax were blocked by the negative effects of the shadow economy.

It doesn't mean that corporate income tax payment mechanism should continue unchanged. Also, I don't approve of the idea of raising the tax rate on profits. Further reform of the corporate income tax should be implemented in the case of tax harmonization with the European Union. The government has to take steps that would enable a business to exit the shadow sector of the economy. Economists in recent years have made popular certain ideas about the need for guaranteeing property rights, the development of partnerships between the fiscal service and taxpayers, etc. I support these ideas too. However, this won't reduce the amount of shadow profit which is not taxed. The force of habit is too large and taxpayers have absolutely no motivation for stopping shadow activities. In fact, the government has to find a way to motivate taxpayers to think not in the usual

short-term frame of mind, but long-term. This means that government has to put them in a situation known as the prisoner’s dilemma [4, p. 34]. This is not the classic zero sum game, where one player is winning and the other is losing. In this case, it is necessary to achieve a win for both parties (the government and taxpayers) or avoid loss.

The win for both parties in this case is the exit of the taxpayer from the shadow economy, the full payment of income tax by taxpayers, and the effective use of the funds received by the government, which will benefit the entire society.

As an option, the government can offer taxpayers a tax amnesty. According to its conditions the taxpayer receives preferences from the government if it moves out of the shadow sector of economy and declares its hidden profit. The rewards could be tax or non-tax. The success of such ideas is almost entirely dependent on the government. It should provide information about such opportunity, ensure the implementation of its obligations, to guarantee the preservation of property rights. However, the most important thing is to ensure that the rules of the game will not change in the long run.

Is this possible in Ukraine? Yes, if the formal rules of taxation would not be blocked by informal rules. At the beginning, the government has to renounce the practice

of requesting informal advance payments, that is when taxpayers pay artificial income taxes upfront to avoid a threatened tax audit.

Personal income tax. This is a very important tax for the government. Its share of tax revenue is 20% on average. This figure is consistent with international practice. However, there are a number of problems that the government has been trying to solve for more than a decade. One of these challenges is how to increase the fiscal capacity personal income tax. Statistics shows that positive changes in economic dynamics are not conducive to an equivalent growth in personal income tax revenue. Replacement of progressive taxation with a flat tax, and then a subsequent return to a progressive scale have not seen a growth in the tax base. In fact, reducing the tax burden on individuals was equal to reducing tax revenues. At the same time regulatory incentives, such as social benefit taxes and tax credits, were increased, there was practically no effect on the tax base.

As in the case of corporate income tax, the main reason is the high share of shadow incomes declared by individuals. Using the monetary method, the minimum volume of shadow income and budget loss of personal income tax (PIT), based on a rate of 15%, has been calculated (table 1).

SHADOW INCOME AND BUDGET LOSSES OF PIT IN UKRAINE BETWEEN 2002-2014

Table 1

YEAR	SHADOW INCOMES, BLN UAH	BUDGET REVENUE LOSSES OF PIT, BLN UAH
2002	51.26	7.69
2003	34.93	4.54
2004	5.49	0.82
2005	68.65	9.85
2006	18.88	2.83
2007	87.26	13.09
2008	84.56	12.68
2009	8.94	1.34
2010	108.13	16.22
2011	36.15	5.42
2012	42.21	6.33
2013	56.18	8.43
2014	78.91	11.84

Source: calculated by the author using the monetary method based on information of the State Statistics Service of Ukraine and the National Bank of Ukraine.

As can be seen from table 1, the volume of shadow income has no overall single trend during the study period. A trend towards rapid growth is visible in the example of the last three years. In this situation, using the regulatory capacity of PIT is impossible. Because any attempt to manipulate tax rates will increase budget losses. However, the PIT has a significant fiscal capacity through the legalization of shadow income.

Over the past two years, different ideas about the legalization of income has been offered. Basically these ideas share a common approach in establishing a complete control over costs. Total control would be quite expensive to implement, but the fiscal effect would be questionable. The behavioral aspect of the taxpayer has to be taken

into account. Taxpayers earning an unofficial income generally work quite hard. The question is, will the taxpayer work as hard if all the taxes have to be paid? Most likely he will compare the utility from working hard and receiving an official income and working less hard and not paying taxes. From this point of view, the idea of total control may have a negative impact on the overall dynamics of economic development. It should be borne in mind that it is impossible to completely eradicate a shadow economy and this is not necessary. It exists in all countries, but the extent of it is much less outside of Ukraine. So when making decisions regarding regulation of incomes and PIT, it is necessary to take into account the potential effect of taxpayers' behavior. I do not maintain that it is necessary to leave everything as it is. On the contrary, the taxation of citizens needs to be changed, but when making changes in the mechanism of calculation and payment of PIT, first and foremost, government needs to think about what motivates taxpayers to evade taxes. After studying economic publications it is possible to observe several main reasons for this behavior.

1. High tax burden on the wages generated by payment of single social contribution (SSC). Many economists say it is one reason why wages are paid illegally. This is partly true, but, as in the case of income tax, simply lowering the SSC will not lead to the introduction of wages out of the shadow sector of the economy. Taxpayers have already worked out schemes for withdrawing a part of their wages in the shade, and they need significant reasons in order to change. There are two main motives. The first is the process of paying wages unofficially should become unprofitable. That means the cost of punishment should exceed the benefit of evasion. The second is the process of receiving an official salary is supposed to gain more for the taxpayer. The government makes efforts to implement the second motive, but there is no positive result. The appeals to get an official salary in order to receive government social guarantees seem unconvincing. Government social guarantees are so small and their quality is so poor that receiving them cannot be a motive for the refusal of informal income. Also, the size of the potential pension and its timing were the impetus for not declaring income. It may sound pathetic, but without a revival of confidence in the government, any reforms of PIT is doomed to failure.

2. Direct taxpayer fails to understand how much he pays to the government. Historically, the PIT is paid by the employer. That is, the person who pays the income, in most cases, must keep and pay PIT to the government. The taxpayer gets the amount of income after paying PIT. On the one hand, such a scheme is very convenient, but on the other it is completely opaque to the taxpayer. The taxpayer has to understand how much he

pays to the government for its claim for public benefits to be substantiated. Partly the problem could be solved by changing the tax mechanism, namely the shift to the payment of tax on the declaration. However, before this idea could be implemented the overall level of tax culture has to be raised. At the initial stage the tax calculator should be placed on the website of the State Fiscal Service for easy use by anyone. This idea has long been implemented in many countries of the European Union. The next step is a gradual transfer of taxpayers to a declarative way of paying PIT.

3. The third reason, encouraging taxpayers do not pay PIT lies in the mechanism of PIT payment. There is an idea of a non-taxable minimum income in the Ukrainian tax code. Practically it doesn't work in its full meaning. This means that, even receiving wages at a subsistence level, the person still has to pay a PIT. It turns out that the working person may not always succeed even in earning a living wage. The sheer size of the subsistence minimum is also a subject of controversy, because its value is far from reality to ensure that minimum requirements can be met even for an ascetic lifestyle.

Single tax. Single tax is a hybrid of income tax and sales tax. It is paid by taxpayers who chose an alternative ordinary (simplified) system of taxation, instead of paying income tax. The rest of its attributes characterize this tax as sales (turnover) tax. The single tax was introduced into domestic business practice in 1999. The basic idea was inspiring small business development and employment. However, in addition to the regulatory effect, a fiscal effect was achieved too. At the beginning of the simplified system of taxation implementation, tax service officers strongly "encouraged" loss-making enterprises to go on a single tax payment mode. As a result, the share of unprofitability in the years 1999-2000 was decreased. At the initial stage of the introduction of the simplified system of taxation, it had a significant positive impact on the development of small businesses and the economy as a whole. However, in the long run period, such a tax regime cannot be effective. A few years later, a simplified tax system became one of the most common tools for building tax evasion schemes. The government actually had not taken any significant steps over ten years to change this mode of tax payment. That is why the idea of reform in 2010 sparked mass protests. Relatively large-scale reform of the single tax was implemented by the government only in 2011. In fact, the simplified tax system has already exhausted its regulatory capacity, but never implemented a fiscal, primarily because of its use in tax minimization schemes.

To resolve this problem, the government has decided gradually to oblige single tax payers to use cash

registers. This will make it possible to control the circulation of cash and reduce the possibility of using single tax payers in tax evasion schemes. Such a decision is generally consistent with the norms of civilized society, especially according to the declaration of European values support (countries of the European Union lacking cash registers is an exception, all calculations are executed with clients are documented even if a cash register is absent). In general the adoption of such a decision by the government is an example of group thinking. When members of the group agree on most issues, it produces a strong tendency to suppress any dissent. This group initially focuses on harmony, then it waits for it and anticipates it. If all agree and meet, nobody wants to hear a contrary view. This psychological effect can cause great harm, because team members refuse to listen to all points of view, which are often made unilaterally, and the result is illconsidered decisions [5, p. 50]. However, once it is time to apply that rule in practice, mass protests start. It should be noted that the single taxpayers knew about that rule 6 months before its implementation, but did not take any steps. On the one hand, this can be explained by the expectation that the government would change its decision. Such expectations can be justified, because the government sometimes changes its decisions retroactively. But in this case, the government decided not to cancel anything. As a result, on the eve of the introduction of cash registers for single taxpayers, protests were started. As a result of that, the government agreed not to allow using cash registers by those taxpayers who have income of less than 1 million UAH per year. This reaction can be explained as a desire by the government to lessen social tension in the society. On the other hand, this is a classic example of group polarization.

This phenomenon occurs when during the group discussion, the members of the group, by themselves, are beginning to lean towards very opposite viewpoints; outside a group this phenomenon is impossible. For example, at the beginning of the discussion, some people are quite sluggish speaking out against any decision, but by the end of the discussion, all strongly and unequivocally disagree with each other on this issue, and opposition reaches a critical point. In order to limit the destructive effect of a group polarization one should avoid homogeneity in the group that makes decisions [5, p. 50]. In the field of taxation, the effect of polarization is dangerous. It is an indication that the government is not concerned with development priorities. This is a

sign of government orientation in the short run, which undermines public confidence in its work.

Regardless of the type, whether working group, sports team, band or group of friends, all groups are characterized by similar psychological processes, and they all obey certain rules. Therefore, taxpayers and the government should be seen as groups who live by certain rules.

In any group, there are certain rules and regulations which are held in compliance by all members. These rules can change human behavior, forcing one to go against his beliefs, which may be even more reasonable and correct [5, c. 52]. On this basis, if the government decides to change tax payment mechanisms, it is necessary for it to consider how these changes affect the behavior of taxpayers. It makes no sense to consider taxpayer behavior separate from government interaction. Their behavior is always closely connected with the conduct of the government. If there is a risk of opportunistic behavior by the government, the taxpayer will not comply fully with the rules of income tax payments. Income taxes in this case are a good example, because their value is directly dependent on the income of the taxpayer. The process of paying taxes on the income is associated with the knowledge that a portion of earned income is transferred to the government. Therefore, the payer expects government, which receives part of the income of the payer, will contribute to their well-being.

Conclusions. Thus, further reforms in the field of taxation should take into account the following aspects:

1. The continued growth of income taxes fiscal capacity should not be at the expense of increasing the tax burden, and due to the growth of the tax base.
2. Growth in the tax base should occur at the expense of the shadow sector of economy decrease and the growth of business activity.
3. A reduction in the shadow sector of the economy should take place through a combination of administrative and economic methods. Economic methods should prevail. The purpose of their use is to make work in the informal sector less profitable.
4. Improving the efficiency of income tax regulatory capacity can be achieved on condition that the behavioral aspects of taxation are considered. First of all, the government must change its behavior from short-term to a long-term orientation. This will allow a regaining of taxpayer trust and making their behavior more predictable.

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