

Method of Defining the Rate of Dependency of Financial Stability on the Tax Level

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Abstract

Objectives: The paper substantiates the need in the improvement of the taxation of companies as a factor of economic development of the country and its regions. The aim of the research is the formation of corporate taxation mechanism that provides the maximum effect on the extension of the income base and increases in the companies' solvency. **Methods:** In order to accomplish this aim the author's used methods of theoretical and empirical studies and the system approach to the consideration of corporate taxation. The latter aided to determine the economic expediency of existing taxation system. The method of economic modeling was used for the presentation of research results. The methodology of determining the influence of the changing total tax rate and the model that includes the mutual dependence of the tax level and the taxpayer's solvency. **Findings:** Apart from existing approaches to determination of the mutual dependence between the amounts of tax and discretionary income of a taxpayer, the proposed method views the dependence of the solvency on the amount of payable tax from the point of basic tax level and the changes in the total tax rate. It allows defining the actual tax burden of the taxpayers. **Application:** The significance of the study is the fact that the authors have revealed the role of tax in financial and distributional relationships. This fact is significant for the taxation theory because the known functions of tax mentioned in economic literature do not fully uncover the categorical nature a tax.

Keywords: Discretionary Income, Income, Solvency, Taxation, Tax Rate, Tax Burden

1. Introduction

This paper studies the adjustment of the following indicators of financial and economic activities of companies producing of material and intangible values: profitability, solvency and the state budget tax burden. The regularity between these indicators is proved by the fact that the company's solvency depends on its profitability. The more is the income, the more is the profit, and the higher is the

ability to pay for the delivered goods, rendered services, and the tax liabilities for the state budget and state non-budgetary funds¹. In the setting of economically favorable development of a company this regularity becomes a factor of economic growth. However, in case of the underdeveloped economy, the regularity becomes unobservable and has an inverse effect. The higher is the company's tax burden; the lower is its income, which brings down its sol-

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veny. Thus, low profitability, poor solvency, and high tax burden emerges from underdeveloped economy. In such case, the state usually abstracts from solving the economic problems of companies to some extent. It should be noted that the state never refuses for timely budget replenishment by tax. In this case, the strengthening of the tax fiscal function occurs, which reduces the roles of its other functions like regulatory or social one. This paper studies the cause and effect relationship between such indicators of the company's activity as profitability, the level of tax burden and solvency. This relationship would lead to the establishment of optimal correlation of the taxation and solvency. It is very important for the harmonious interest's cultivation of the state and taxpayers. Existing situation in these indicators' correlation in companies (especially, in the companies of developing countries) shows that it is mostly far from being harmonious. Thus, the solution to this problem gains special significance.

2. Research Methodology

Having studied the literature issues in the Russian Federation and abroad, it is easy to see the acuteness of the tax level correspondence to the taxpayers' capabilities. In Russian Federation, the tax system acts under the Tax Code². However, the tax system of the RF still has certain methodological and organizational challenges. The problems in the taxation are closely related to the state budget generation. Therefore, one of the current issues of the government is a chronic budget gap and lack of funds for the country's economic development³. The solution to this problem lies in the tax optimization. To accomplish this tax policy needs to compile the tax arrangements depending on the premises⁴.

The fiscal character formed in the process of the reforms of the tax system, the system's overload, the complexity of legislation had their toll on the exacerbation of transformational crisis and criminalization of economy⁵.

The transfers of the federal government are addressed to the regions as means of solving national tasks of increasing the economic efficiency and maintaining social equity⁶.

Income goes into the federal budget by federal tax collection. It affects the interregional ration of disposable income because of the distributional character of certain taxes and various existing tax bases in different regions⁷. In the Russian Federation, the tax system bears a load of distributional and redistributive financial relations. That means that tax system can normalize economic and social situations in Russia by vertical and horizontal leveling of regional development and apply different taxation methods (including advanced income taxation method for citizens and organizations)⁸.

It is clear that the efforts of the RF entities in the establishment of a solid financial base for the regional economic development and the solution of pressing social problems do not have a system-based character⁹. The problem of tax burden depends not only on the tax level but also on the level of profitability. It turns; it is affected by the decline (increase) in the tax rate and tax deferral (installments). All this may increase (reduce) the stimuli of attracting real investments¹⁰.

Taxes participation in controlling the economic processes is constant, same as in the manufacturing process and acquisition of income (the state budget subsequently pays a part of it), and in the creating conditions for the manufacturing process¹¹. One need to keep in mind those efficient measures in taxation optimization taken by the state may face counteractions in the form of lobbying from the interested parties in the government authorities¹². Moreover, these measures lack differentiated approach to the fixation of the tax rate. It is important for matching the tax rate with the taxation base, because the income may appear to be hidden depending on its earning¹³.

The RF policy of increase in the tax level adversely affects the state of the economy and the financial Capabilities of the country. Disposition and reallocation of funds are the same processes because they use the same funds - the taxes that enter the budget¹⁴. In order to assure the equilibrium in taxation one needs the conditions to shift the tax burden from the manufacturer to the consumer. It would allow developing the production and to increase the demand for the domestic goods¹⁵.

3. Methods

Tax remissions to the state budget are obligatory for any company registered in Russia. This duty should confirm the company's capabilities that determine its solvency. The tax burden of a company and its solvency should be harmoniously tied in an optimum relationship. Present ability of tax payment is a main, but not the only one economic condition for such ties. There is another key condition for the tax payment and assuring the company's solvency. It is the mechanism for the flow of funds from the payer to the state budget. The authors reveal the subject matter of these conditions by watching the flow of funds, which turn from income into taxes and from taxes to finance. Tax revenues are accumulated in the state budget system and state non-budgetary social funds¹⁶. That is, taxes enter these funds as a part of payer companies' finances. This process may be shown in a scheme of flow of funds sequence $(I \rightarrow T \rightarrow F)$ where I - taxpayer's income, T - tax, F - finance.

This sequence of the flow of funds (being fixed in taxation) starts with the disposition of funds earned by an economic entity $(I \rightarrow T)$. That is the moment when the sum to be paid as a tax to the budget is being determined. The further flow of funds consists in their transfer as a tax to the budget. This process ends with the fund's concentration in the state budget (the main budget of the country) and non-budgetary state funds. The money is also accumulated in the municipal budgets by the local tax payments.

The flow of company's funds develops by the taxation of their income and payable tax payments to the state budget. This justifies the distribution function of taxes along with other functions mentioned in the economic literature. The essence of this function is that taxes accomplish their social function by means of tax disposition of monetary funds and the formation of funds having socio-economical, political and other significance (same as the state budget). This is achieved by the essential progress of the assessed amount of tax to the budget. The scheme of the flow of funds it is shown as $(T \rightarrow F)$. That is, the money entering the budget as tax acquires qualitatively

new form and turn into finance. Apart from the money, finance has a designated purpose. This fact is the intention of budgetary and non-budgetary funds.

The socio-economic purpose of these funds varies, so the funds may be social, budgetary and non-budgetary¹⁷. The question about the amount of money for the establishment of monetary funds and their coverage of the state expenses for the solution of political, economical and social tasks remains fundamental along with socio-economic and political significance of such funds.

To address this problem, one needs to study the financial and economical states of the taxpayers consisting of individuals and legal entities. If consider this question in the context of the flow of funds, one will find the solution in studying the flow of funds at the stage of payers' money turning into tax, i.e. at the stage of the financial resources disposition.

This stage $(I \rightarrow T)$ has a key significance in the study of the role of tax in economic processes.

It is necessary to determine the economic basis of the flow of funds in this part of the general process in order to reveal this particular stage of the flow of funds.

If the flow of funds at stage $(T \rightarrow F)$ satisfies the needs of the state in monetary funds, then at stage occurs a disposal (money transfer from a person to the ownership of another person) of taxpayer's funds to the state for its services.

Thus, the state budget is a subject of demand of funds, while the taxpayers are the subjects of the supply of these funds. On the scheme of the flow of funds in the tax payment to the budget the $(T \rightarrow F)$ stands for the demand and $(I \rightarrow T)$ stands for the supply. In the study of the flow of funds from the taxpayers to the state budget, let us assume that the condition for the demand and supply equilibrium is necessary. However, in reality the state demand for tax funds exceeds the taxpayers' supply. Therefore it is important that empirical estimate of elasticity from the corporate tax base affected by the changes in corporate tax rate have significant information for the estimation of income and wellness of the corporations¹⁸.

4. Results

4.1 Justification of Regularity between the Level of Tax Burden and Solvency

Is the theory of demand and supply related to taxation? If it is true, then this relation is indirect because the state sets the values of its demand in tax income and the limits of corporate taxation in advance due to budget acceptance for the next fiscal year. In such manner, the principle of legislative tax setting should be followed. The use of the theory of demand and supply in this research of the mutual dependence of the income and solvency may be the basis for the scientific substantiation of this dependence and may help to define the optimum relationship of the profitability, solvency and the level of the tax burden.

Hence, the taxpayers pay the predetermined amount of tax to the state budget, while the state budget for the next fiscal year includes this amount. It should be kept in mind that individual taxpayers pay at existing tax rates, and the total sum of tax funds paid should correspond to the sum of predesigned tax income for the following fiscal year.

However, in practice, these values not always coincide. Normally actual receipt of tax funds is lower than the predesigned one. It is due to the fact that the tax burden is higher than the real taxable capacity.

Moreover, the income base has always depended on the taxpayer's economic and financial states. These states in turn, depend not only on economic and organizational factors of production but also on some external factors, such as the state of market competition, foreign economic conditions, etc.

Therefore, the high tax burden is a reason for the decline in the company's financial state, which results in further reduction of its solvency. In this regard, the solution to the problem of adjusting the level of tax burden to the level of solvency of a company becomes especially relevant. The higher is the tax burden, the lower is the company's solvency, and vice versa, the lower is the tax

burden, the higher is the solvency. These indicators are exactly the opposite of each other.

Figure 1 shows that the tax burden and solvency are opposite indicators that explain the reverse effect on each other. In certain conditions their values may be at the equilibrium point (K) that has its coordinates ($X = 2.5$, $Y = 2.5$). This correlation of the studies indicators in the setting of Russian economy is a rare phenomenon and has generally a theoretical character.

Due to the fact that in reality the correlation in the (K) point on the Figure 1 is difficult to accomplish, practically the value of this correlation seeking equilibrium has different coordinates. As a rule, the values of the tax burden is higher than the values of the taxpayer's solvency.

The Figure 1 takes the change in the taxation (change in tax rate, reduction or increase in tax privileges, etc.) as a factor leading to variation in the relationship of the tax level and the solvency of a company. Practically the tax level and the state of solvency are affected by other factors that lead to changes in the relationship between tax

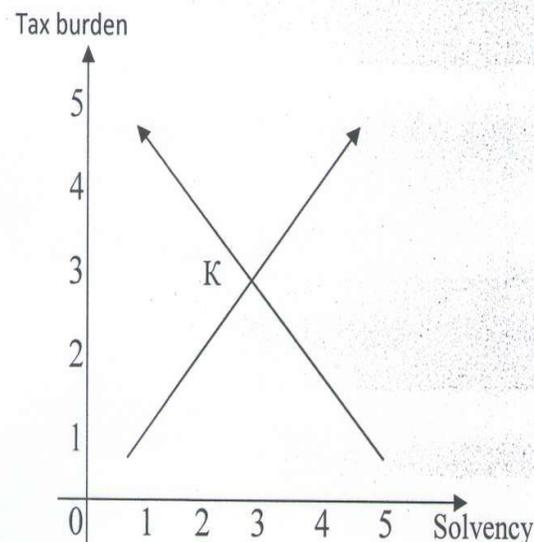


Figure 1. Mutual dependence of the tax burden and the solvency of a company.

level and solvency that stand beyond the taxation process. Such factors may include:

- Change in price for goods and services; development of inflation; fall in production output;
- Penal sanctions for the violation of civil, budget, tax or other legislation;
- Foreign sanctions. The result of these factors is the runoff of profitability.

Variation of the taxpayer's solvency is a direct factor of the reduction of its taxable capacity and decline in its solvency.

4.2 Implementation of Mutual Dependence of Tax Burden and Solvency of a Company into Practice

Let us give an illustrative example of putting into practice the theorems given in the paragraph 4.1. Suppose that the income of a company is 100 units. The total tax rate is set within the optimum limits determined by economics in the range of 30 to 33% of total income. A group of scientists' leads by Professor A. Laffer concluded their study of tax level optimization with a fact that the value of total

corporate tax rate should be within 30 to 35%¹⁹ of total income of the company. Professor A. M. Abdulgaliimov calculated the optimal level in the range of 30 to 33%²⁰. Every time the rate increases the tax amount grows. Yet it will lead to the reduction in the amount of income at the taxpayer's disposal.

Taking into the account the conditions of this example (change in total tax rate) it is possible to determine the change in the taxpayer's amount of income. It leads to a reduction of the payable tax and the worsening of the taxpayer's solvency. In the tax rate of 30% the amount of tax is 30 units. In the tax rate of 40% the amount of tax is 40 units. In the tax rate of 50% the amount of tax is 50 units. In the tax rate of 60% (i.e. doubled) the amount of tax is 60 units. Variation of the parameters of income and tax under the influence of increasing total tax rate is shown at the Table 1.

There are imputed figures for the variation of the total tax rate to the upside. This being said, the growth of the tax rate is shown on the assumption that in modern Russian tax system the tax burden usually increases. The prerequisite for this example is fixed amount of income.

* Here the income is the difference between the gross income and the expenses made for the purposes of this income.

Resource: authors. Variation of tax rate leads to changes in the amount of payable tax, and for further

Table 1. Effect of the total tax rate variation on the amountsof the taxpayer's payable tax and income after their payment

Variation of total tax rate	Variation of the amounts of payable tax and income left after the tax payment in case of fixed amount of income from production activity		
	Amount of income in units*	Amount of tax in units	Amount of income after tax payment (gr2-gr3)
Basic rate is 30%	100	30	70
Tax rate is 30%+10%	100	30+10	70 - 10=60
Tax rate is 30%+20%	100	30+20	70 - 20=50
Tax rate is 30%+30%	100	30+30	70 - 30=40

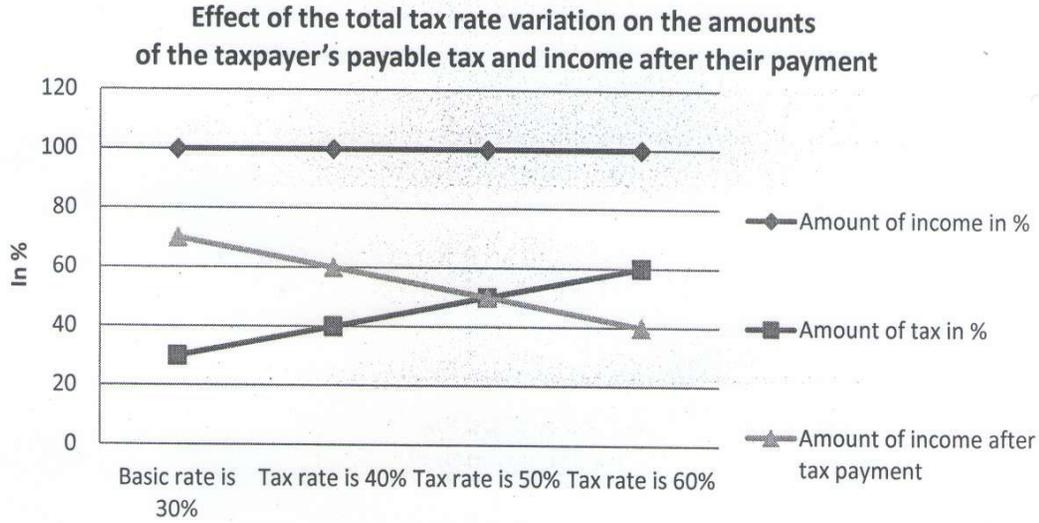


Figure 2. The amounts of the company's income, payable tax and remaining income after the tax payment.

change in the amount of income at the taxpayer's disposal. If the amount of received income remains the same, the variation of the income in taxpayer's disposal occurs proportionate to the variation of the tax rate and the amount of payable tax. This information is shown in the graphs 3 and 4 of the Table 1.

Taking the data from the Table 1 as a basis, it is possible to plot graphs showing the changes in the amount of payable tax and the discretionary income. These graphs are shown in Figure 2.

The graphs show that in case of the growth of tax rate with the fixed value of corporate profit the values of the payable tax and discretionary income have a reverse vector of dynamics.

Effect of the total tax rate variation on the amount of payable tax may be expressed in terms of this formula:

$$T = I - (I - (I \times R)), \text{ where}$$

T - Amount of total corporate tax;
 I - amount of basic income;
 R - Total tax rate.

Having inserted the data from the Table 1, the authors obtained the following simultaneous equations:

$$30 = 100 - (100 - 100 \times 30:100);$$

$$40 = 100 - (100 - 100 \times 40:100);$$

$$50 = 100 - (100 - 100 \times 50:100);$$

$$60 = 100 - (100 - 100 \times 60:100).$$

Effect of the total tax rate variation on the amount of the taxpayer's income may be expressed in terms of this formula:

$$T_{disc} = I - (I - (I \times R)), \text{ where}$$

T_{disc} is a discretionary income of a taxpayer.

Having inserted the data from the Table 1, the authors obtained the following simultaneous equations:

$$70 = 100 - (100 \times 30: 100);$$

$$60 = 100 - (100 \times 40: 100);$$

$$50 = 100 - (100 \times 50: 100);$$

$$40 = 100 - (100 \times 60: 100).$$

The economic literature calls this income discretionary and describes it as a part the of net income of a consumer left after necessary expenses, tax, and costs

Table 2. Effect of the total tax rate variation on the amounts of the taxpayer’s profitability and solvency

Variation of the total tax rate	Variation of the amounts of company’s income, total tax and discretionary income		
	Amount of income in units	Amount of tax in units	Amount of income after tax payment (gr2–gr3)
Basic rate is 30%	100	30	70
Tax rate is 40%	100 – 10 = 90	36	54
Tax rate is 50%	100 – 20 = 80	40	40
Tax rate is 60%	100 – 30 = 70	42	28

of satisfying the survival needs. The economic state of a company depends on the discretionary income. So does the level of the company’s profitability. Therefore, the higher is the tax; the lower is the company’s income. The Table 2 shows the variation of profitability and solvency of a taxpayer under the influence of growing total tax rate.

The information from the graphs 2 and 4 of the Table 2 indicates the variation of total income and income at the taxpayer’s disposal (discretionary income) minus

total tax listed in the budget for the current accounting period. Graph 2 defined the income as a difference between gross income and the full cost of goods, works or services. Graph 4 shows the income which is the difference between the income from the graph 2 and the amount of total tax paid to the budget after the taxation of income from the graph 2. Figure 3 shows the graphs of the variation of the company’s amounts of income, total tax and discretionary income in case of growing tax rate.

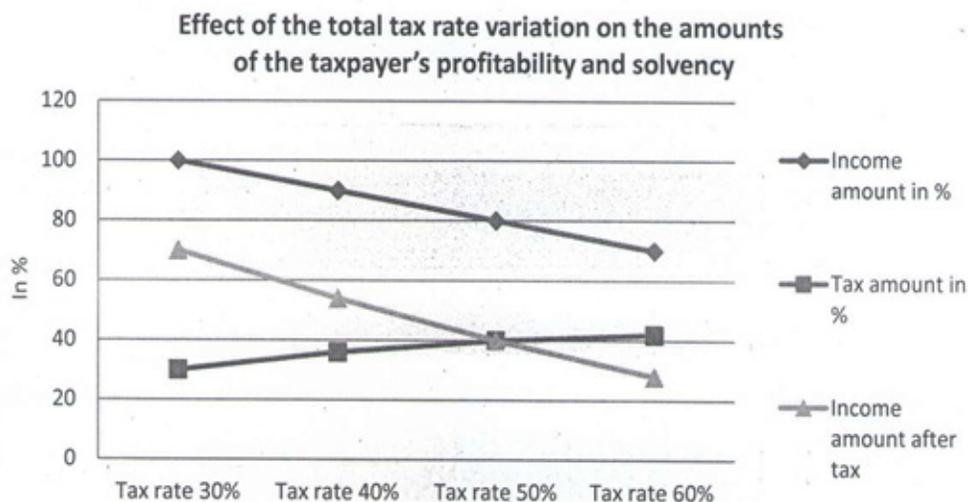


Figure 3. The amounts of the company’s income, payable tax and remaining income after the tax payment in case of changing amount of company’s earned income.

Graphs from the Figure 3 indicate that in case of growing tax rate the profitability reduces the total amount of payable tax cuts, and the level of income left after the tax payment lowers.

It should be noted that the production income and the discretionary income go down in the same manner regardless of the fact that the income left after the tax payment has greater dynamics.

If compare the tax revenues, it is clear that in case of changing profitability of a company the total payable tax is reduced. Thus, the information from the Tables 1 and 2 indicates the presence of linkage between the tax burden, total production income, and discretionary income. It should also be noted that growing tax rate reduces all indicators including the amounts of payable tax, due to the fact that reduction in discretionary income is an objective reason for the reduction in total earned income.

4.3 Simulation of the State of Regularity between the Level of the Company's Tax Burden and Solvency

The effect of total tax rate variation on the taxpayer's profitability with the use of the information from the Table 2 may be expressed in the following formulae:

$$I = (I \times R) + (I - (I \times R))$$

Here the total income of a taxpayer is liable to basic rate (30%). The value of the basic rate corresponds to the optimal tax level recommended by many researchers.

Inserting the information from the table 2 in this formula, the authors get the following equation: $100 = (100 \times 30 : 100) + (100 - (100 \times 30 : 100)) = 30$ (the amount of tax) + 70 (the amount of company's discretionary income);

$$I^1 = I - (I - (I \times R)) + (I - (I \times R)) - (I \times R^1).$$

Here the total income of a taxpayer is liable to the rate of 40%, i.e. according to the setting of the given example the basic rate grows on $10\% = (40\% - 30\%)$.

Inserting the corresponding information from the table 2 the following equation is obtained:

$$90 = 100 - (100 - (100 \times 30 : 100)) + [(100 - (100 \times 30 : 100)) - (100 \times 10 : 100)];$$

$$I^2 = I - (I - (I \times R)) + (I - (I \times R)) - (I \times R^2).$$

Here the taxpayer's total income is liable to the rate of 50%, which indicated the significant increase in the tax level. It results in the reduction of the production level and the shortage.

Inserting the corresponding information from the Table 2 the following equation is obtained:

$$80 = 100 - (100 - (100 \times 30 : 100)) - [(100 - (100 \times 30 : 100)) - (100 \times 20 : 100)];$$

$$I^3 = I - (I - (I \times R)) - (I - (I \times R)) - (I \times R^3).$$

Here the total income of a taxpayer is liable to the rate of 66%, which shows the doubled tax level. In practice, this case is exceptional for the economy and society, though it exists in theory. Inserting the information from the Table 2 in this formula the following equation is obtained:

$$70 = 100 - (100 - (100 \times 30 : 100)) - [(100 - (100 \times 30 : 100)) - (100 \times 30 : 100)].$$

A solution of these simultaneous equations finds the impact of the change in tax rate as a result of the state tax policy on the profitability of a taxpayer and his accomplishment of tax liabilities.

The conducted research on the interaction of given indicators in the form of equations solution may be presented as a method of parameters definition for the tax burden and solvency under the influence of total income tax rate variation. By means of an element-wise account of all factors of this interaction, this method presents the full range of economic relations between the state and the taxpayer in the process of income distribution in the setting of changing the fiscal policy of the state.

The proposed method of determining the influence of changing total tax rate (irrespective of whether the rate increases or decreases) on the amounts of tax and discretionary income gives an opportunity to reduce the values of the given equations for the certain case of increase in total tax rate to the combined equation expressing their subject matter. This equation may serve as a model considering the dependence of the indicators of a company's economic state (particularly, the income and solvency) on the changes in taxation of this company. The combined equation looks like

$$I = (I \times R^{(1...n)}) + I - (I \times R^{(1...n)})$$

Where $C^{(1...n)}$ is a total tax rate from 1% to n%.

5. Discussion

This study shows that increase in the tax rate has its limit predetermined by the parameters of increasing the rate of economic growth. The most significant parameter is the income left after the compensation for expenses – the full cost of goods or services and the tax payment to the budget. As arranged, this income is called discretionary. Discretionary income shows the financial capability of a taxpayer to perform the business activity. Its sufficient amount allows the entrepreneur or a company to provide an economic growth besides the extended reproduction. The innovation-based economic growth definitely requires the policy of innovative economic growth besides the sufficient amount of discretionary income. However, increasing the total tax rate is not so threatening if the profitability is not reduced. If the tax level increases, the taxpayer's profitability is reduced and his solvency also decreases. It is the most unwanted thing for companies.

The graphs from the Figure 3 show that in case of increasing tax rate the amount of tax also grows, but the rate of growth of the amount of tax is significantly lower than the growth of tax rate. What is for the income and net profit (discretionary income) left at the taxpayer's disposal, their values do not grow (as the amount of

income) but decrease/ Moreover, the rate of reduction of discretionary income is higher than one of the total income.

The taxation practice in the Russian Federation testifies that the state fiscal policy has not changed significantly in recent years. It can be said that for ten last years the total tax level has been increasing. Moreover, the rate of inflation was over the limit, which marks the financial imbalance of Russian companies (not to mention the gargantuan monopolies in oil and gas business). Thus, the solvency of Russian companies together with the tax level is maintained by the state by budget appropriations and the use of emergency funds formed by the sales proceeds from the export of raw hydrocarbons.

The method specification of the impact of changes in the total tax rate on solvency may serve as a solution of a methodological problem on increasing the efficiency of the taxation system.

The paper makes an attempt to balance the correlation of the tax level and solvency with the theory of corresponding demand and supply in economics. Here the authors state the fact that it is possible to study the optimization of the correlation of the tax level and solvency in the framework of the theory of demand and supply. Therefore, it is necessary to consider this problem as a subject of the following scientific paper.

6. Conclusion

The conducted study justifies the need for setting the optimum relationship between the tax level and the solvency which confers the economic growth.

It is stated that in the setting of developing economy it is impossible to keep the balance between these indicators, which usually results in the adverse effect. The higher is the company's tax burden; the lower is its income, which brings down its solvency.

The study of the cause and effect relationship between the tax burden and solvency showed that in developing countries the ratio of these indicators was far from being balanced. Thus, the solution to this problem gains special significance. It is stated that present ability of tax

payment is a main, but not the single economic condition for such ties. The authors justified the fact that the crucial significance of the tax payment and assuring the solvency was the presence of the corresponding mechanism providing the flow of funds from the taxpayer to the state budget. The authors analyzed the flow of funds of the companies developing by means of taxation of the income and ending with the disposition of these funds from the state budget. Thus, it is justified that the tax has distributive function and the social function - as it comes from the fact tax distributes the monetary funds of economic entities and forms the financial funds. The problem of sufficient financial assets in these funds becomes especially acute because they are related to the accomplishment of political, economic and social tasks.

The authors substantiate the relevance of the theory of equilibrium between demand and supply in the study of the company's tax level correspondence to its solvency. It is stated that this theory may be indirectly applied to the corporate taxation because the tax is codified, while the solvency depends on the economic state of the company. The solution to the problem of adjusting the level of tax burden to the level of solvency of a company is updated. The authors took the following fact to solve this problem: the optimal limit of the corporate taxation should be between 30 and 33%, which is justified by the economists that deal with increasing the tax level in developing economies. The study shows that there is a strong linkage between the level of the tax burden, total production income and discretionary income left after tax payment. It is stated that growing tax rate reduces all indicators including the amounts of payable tax, due to the fact that reduction in discretionary income is an objective reason for the reduction in total earned income. On the basis of setting the dependence of the corporate income on the tax rate by solving the simultaneous equations, the authors composed a method for determination of the parameters of taxpayer's tax burden and solvency under the influence of changing total income tax rate. By means of wise element-wise account of all factors of this interaction,

this method presents the full range of economic relations between the state and the taxpayer in the process of the taxpayer's income distribution in the setting of changing the fiscal policy of the state. This method is a basis of the proposed model that accounts the dependence of the indicators of the company's economic state (income and solvency) on the changes in the taxation of this company.

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