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## FISCAL FEDERALISM AND TAX AUTONOMY. DIGITAL ECONOMY CHALLENGES

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### **Abstract**

The delimitation of tax administrating powers between the state and its parts (subjects, lands, etc.) has an important role in the foundation of the tax system of any state, regardless of whether it is unitary or federal.

Digital economy is, above all, the emergence of new forms of management, which require a different procedure for the definition of the subjects and the objects of taxation, as well as the procedure for linking the relevant objects to the territories of the sources.

The challenges of digital economy are being actively discussed in relation to cross-border operations and transnational companies on an international level, such interest has become particularly relevant after the development of the OECD BEPS plan.

Nonetheless, digital economy also represents a challenge for domestic relations regarding tax management. In this article, taking as an example the Russian Fed-

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eration, we will illustrate emerging problems in this area and describe the attempts at solving them.

### **Key words**

Fiscal federalism, local taxation, tax autonomy, digital economy, tax experiment

**JEL Classification:** H20; H710; K34

### **Introduction**

Federalism cannot be identified with the form of state structure; the phenomenon of federalism must be interpreted more broadly. The concept of federalism covers the entire system of relations, in each individual state, emerging between the center (central, state power) and its territorial structural elements - regions, administrative-territorial entities, subjects. Nevertheless, federalism as a system of interdependent relations includes various aspects of the interaction of the center and the regions: organizational, legal, economic, cultural, etc.

This interaction acquires a concrete expression in the form of legal relations: administrative, or, for example, tax.

In reality, this interpretation of federalism does not contradict the understanding of federalism as established by constitutional law. Federalism as a whole is a complex system of public relations emerging in connection with the existence and vital functioning of states, not only federal, but often even unitary.

The most important aspect of federalism, which makes it possible to understand its essence as a system of relations, is the question of the delimitation of competences and powers between different levels of organization of state authority, in particular, in the sphere of tax relations. Legal and economic science operates on the concept of tax federalism developed in 1959 by Richard Musgrave.

However, it should be noted that this question is often not covered by one single term and is not strictly defined by it.

For example, the OECD and IMF acts use the term tax autonomy, which refers to the rights of the sub-central state in the area of taxation.

Additional questions also arise in connection with municipal finances.

There should be no doubt that local state should have enough own funds that can implement the tasks and functions set out in the law. The principle of financial

independence of local state suggests that it should be regulated by statute that the state should provide the municipalities with the necessary sources of own revenues sufficient to finance local authorities' expenditure commitments (Juchnicz, 2017: 34).

Tax federalism is part of the tax system. The division of tax administrating powers includes: the definition of tax policy, participation in the development of legislation on taxes and fees, the determination of rates, tax exemption, etc.

There are three broad ways of sharing of the income tax field between the central government and SNGs in federal and quasi-federal countries:

1. Full tax powers. Both levels of governments have the power to access a given tax field; they can define the base, set the rates, and collect the taxes themselves. In practice, they may choose to use the tax base already set by another level (usually the central one) and to have the tax collected on their behalf. But they must set their own rate; otherwise it defaults to zero. In other words, there must be an explicit tax decision by SNGs.

2. Optional tax powers. Both levels of governments have the power to access a given tax field. However, the subnational governments must use the tax base of the central government which also collects the tax. If they do nothing, the central government rate is the default one for their portion of any shared tax. There is no need for an explicit tax decision by SNGs.

3. No tax powers. One level of government sets the base as well as the rates and collects the taxes. Tax revenue is then shared between the two levels of governments according to a formula that may or may not give some weight to where the tax was collected. In this case, there is no possibility of explicit tax decisions by SNGs (Ruiz Almendral, Vaillancourt, 2010).

In many tax systems the approaches to the order of the division of delimitation of powers between the center and the subjects have been formulated long ago. The foundations of tax federalism often find their consolidation in constitutional principles.

The degree of decentralization varies greatly across the OECD countries. While the sub-central share of total state expenditures varies from less than 6 percent to more than 60 percent, taxes accruing to sub-central state extend between 3 and 50 percent. The constitutional background of a country, whether it is federal or unitary, says little about actual fiscal autonomy. Local state in some unitary countries

have a higher share in public spending than local and regional state together in federal countries (Blüchliger, King, 2005).

However, the relevant question remains; what list of tax authorities can be distributed to the territories? The answer to such question depends on which functions can in a matter of principle be redistributed to the level of a subject (part of the state), for which financing it is necessary to establish tax sources of budget revenues.

There are different studies that confirm the effectiveness of a decentralized management (Suwandi, Warokka, 2013). For example, a reasonable working principle is to decentralize all functions except those for which it can be demonstrated that central provision is needed because of economies of scale, because the benefits of a particular type of service are highly public in nature, or because uniformity of provision is an important objective, for example to maintain the efficiency of the internal economic union or to achieve national equity objectives (Boadway, Roberts, Shah, 1994: 2).

Concurrently, in the example of Switzerland, it can be noted that the allotment of the cantons to establish taxes can lead to the fact that not only would types of taxes, tax rates, and tax allowances vary between cantons, but also the legal procedures for determining tax liability and calculating taxes due, and even the definitions of tax fraud and the extent of penal sanctions (Gilardiy, Kublerz, Wasserfallen, 2010).

However, the extent of decentralization of revenue-raising need not correspond exactly with that of expenditure responsibilities. Indeed, in virtually all multi-government economies, lower levels of government finance some of their expenditure responsibilities by transfers from the higher level. There are two reasons for this. The first is simply that the case for decentralizing expenditure responsibilities is stronger than that for decentralizing revenue raising. While decentralizing expenditures leads to more efficient service delivery, it is not clear that there are equivalent efficiency advantages (apart from fiscal accountability) of decentralizing revenue raising. On the contrary, decentralization of taxation can lead to significant inequities and inefficiencies in the federal economy. Thus, there are economic advantages from having more taxes collected at the higher level of government than is necessary for its own expenditures, and transferring some of them to the states, that is, for there being a fiscal gap (Boadway, Roberts, Shah, 1994: 4).

The forces shaping the evolution of SCG (sub-central government) tax revenue and tax autonomy are political, fiscal and economic in nature.

- First and probably most important are policy reforms such as a reassignment of taxes to another government level, a change in tax autonomy or a swap between local/regional taxes and intergovernmental grants. Constitutional and legislative amendments largely account for the rapid change in countries such as Belgium or Spain involved in a secular decentralization process.
- Second, fiscal reasons such as a relative change in tax rates or bases can also affect the pattern of taxing power, e.g. if one government level changes its tax rate or base while another government level does not. In many countries rates and base of local property taxes remain unchanged over long periods of time, while the bases of central government income taxes or goods and services taxes are regularly updated.
- Third, different taxes react differently to the business cycle or to structural change, and this may affect tax revenue of different government levels. A local profit tax reacts more swiftly to an economic downturn than a central government income tax, and a local sales tax on goods reacts more slowly to the rise of the service sector than a central value added tax (Blüchliger, King, 2005).

It should be noted that the need for funding is constantly increasing, more and more expenses are being decentralized and that these are systemic changes that are already occurring in many countries. The increasing territorial need for financial support aggravates the issues of division of authorities between states and its constituent subjects. This issue is particularly acute in the area of income taxation which is connected with a significant internal migration of the population to large cities, which attract them with its many opportunities.

On the one hand, in Russia hopes are being put on the digital economy to provide all territories with a unified standard of public services regardless of the degree of distance from the center, however, on the other hand it is digitalization itself that forces people to move to those regions where new types of business opportunities are available.

Digital economy poses additional challenges to the tax system. The emergence of new methods of management (virtual services and goods, new marketing methods, professional activities, etc.) forces any state to develop new approaches to taxation, as well as a revision of already well-established approaches to fiscal federalism and tax autonomy.

Our observations and studies confirm the fact that decentralization is necessary and that digital economy will in every possible way push states towards it. How-

ever, the methods, the degree and the speed of achieving decentralization, as well as tax autonomy, may be different.

So what distinguishes digital economy and what problems does it create for tax systems?

### **1. Understanding the concept of digital economy and the formulation of the problems that it poses for tax systems**

Digital economy means that part of economic output derived solely or primarily from digital technologies with a business model based on digital goods or services (Bukht, Heeks, 2018: 1).

The OECD proposes a set of eight “vectors of digital transformation”, listed below under three headings:

- 1) scale, scope and speed;
- 2) ownership, assets and economic value;
- 3) relationships, markets and ecosystems.

These “vectors” are suggested to improve the understanding of the digital transformation and related policy implications (OECD, 2017).

Nonetheless, the very definition of digital economy is not explicitly given, and its concepts were modified under the influence of time and circumstances. Everything gets complicated by the fact that digital economy is increasingly intertwined with traditional economy, and that therefore the boundaries between the two are almost no longer felt (Bukht, Heeks, 2017).

The first major issue concerning the taxation in digital economy has to do with the mobile and intangible nature of digital goods and services. Over the last century, traditional economy and the existing tax policies attached to it have been rooted in clear-cut jurisdictional barriers. This is directly linked to the assumption that brick-and-mortar physical locations where goods and services are produced could signify physical presence (also known as a permanent establishment), and they could be used to determine where tax must be paid. In digital economy, the same thought process cannot be applied. Almost all commerce along the supply chain is done virtually without a significant physical presence in one or any jurisdiction, although a company may still have physical stores, factories, or warehouses. The very nature of digital economy means that a fixed place of residence

within a national boundary is no longer required to generate income, especially for new business models based on subscription, access or advertisement, and new technologies such as 3D printing. Yet, global tax policy is still lagging behind this innovation (Juswanto, Simms, 2017).

Obviously, we can recognize that digital economy has a positive impact on the development of states.

It is also necessary to mention separately the possibilities of tax control in connection with the emergence of social networks, digitalization of information, big data, etc., which also contribute to the reform of tax control approaches, forms and methods of its implementation.

We have previously noted that for the Russian Federation the development and maintenance of digital economy is very important.

The key factor in the production of the economy of the XXI century is the electronic data. Various industries of the production and consumption, science and education undergo digital transformation. The main objectives of these directions are the creation of the information society in Russia, the formation of digital economy and the strengthening of the role of the Russian Federation in the world arena.

The program “The digital economy of the Russian Federation” approved by the Russian President defines goals and objectives within the 5 basic directions of development of digital economy of the Russian Federation for the period up to 2024. They include normative regulation; personnel and education; formation of the research competencies and technical achievements; information infrastructure; information security.

Any coin has two sides. In this case, it is vital to remember that the increasing development of digital economy leads to serious risks and threats, whose likelihood of development, scale and consequences we still have to learn.

However, now we can already predict that the tax systems of states will no longer be able to remain the same as they used to be.

For example, the OECD notes that the tax challenges arising from the digitalization of the economy were identified as one of the main areas of focus of the Base Erosion and Profit Shifting (BEPS) Action Plan, leading to the 2015 BEPS Action 1 Report on Addressing the Tax Challenges of the Digital Economy (the Action 1 Report). The Action 1 Report recognized that digitalization and some of the

business models that it facilitates present important challenges for international taxation (OECD, 2019).

Nevertheless, in the long run this change affects not only issues of international taxation and international cooperation of states in this area but it also already has an impact on tax autonomy in federal states.

For example, in May 2019, a referendum was held in Switzerland on the reform of the Swiss corporate tax, in which almost 65% voted in support of the document proposed by the Parliament.

Previously, the current system was very attractive for multinational corporations, however this simply could not keep on going.

Due to this changing international tax environment and the OECD/G20 BEPS project, the Swiss government initiated a process to reform its tax system in line with the latest international standards and with the purpose of strengthening the attractiveness of Switzerland as a business location.

The reform includes several different changes. In addition, the reform raises the cantons' share of direct federal tax revenue to 21.2 percent (previously 17 percent). This will give the cantons fiscal policy leeway to reduce their profit taxes if necessary and thus remain competitive (Anghileri, 2019).

The Committee of Experts on International Cooperation in Tax Matters as constituted in 2017 formed a Subcommittee on Tax Challenges Related to the Digitalization of the Economy (the "UN Subcommittee") to address the tax challenges of the digitalization of the economy. The Subcommittee decided that it should propose guidance on:

- (1) Tax treaty issues;
- (2) Domestic law issues;
- (3) VAT issues, with subgroups being formed as appropriate to address aspects of this work.

At the international level, issues of national law are mostly limited to reviewing the feasibility of development of special taxes for subjects of specific sectors of digital economy, such as Hungary's tax on digital advertising and Italy's levy on digital transactions.

Furthermore, when calculating the amount of tax revenue of each SCG, the problem of determining the source of income arises.



This is particularly true in cases in which SCGs have the right to establish taxes in their own territories. These situations require some type of harmonization.

Additionally, questions about tax collection also arise. These are questions regarding qualifying actions for tax purposes. For example, whether workers of an online taxi, car transportation, or food delivery mobile app, in which drivers use their own cars, are considered employees or self-employed independent contractors. How tax officials should treat these workers is unclear (Juswanto, Simms, 2017).

As demonstrated, digital economy raises questions for states both at the international and national levels.

## **2. Properties of tax federalism and tax autonomy in the Russian Federation**

The Constitution of the Russian Federation was adopted in 1993. In it, tax issues deal with the joint power between the management of the Russian Federation and the Russian Federation itself. Nevertheless, it does not define the specific principles or conditions for such distinction between the aforementioned management.

Constitutional principles represent the basis of the division of authority in the tax field, which, therefore, is in this part subject to federal jurisdiction (Constitutional Court of Russian Federation: 5-P/1997). The fundamental constitutional principles that are aimed at clarifying the limits of this joint power are: unity of economic space, equality of subjects in the relations between the federation and themselves, equality of rights and freedoms of men and citizens, and prohibition of any form of discrimination. Other constitutional guarantees are additionally involved into clarifying this principle.

At the initial stage, the constituent entities of the Russian Federation had broad authorities to establish taxes in their territory. This often led to disputes, whose resolution was impossible without the intervention of the Constitutional Court of the Russian Federation. By 1998, an extensive proceeding was gathered, thanks to which the principles of the tax system were formulated, which were consolidated in the codification of the legislation regarding taxes and fees.

The properties of tax federalism in Russia can be exemplified by the following legal position of the Constitutional Court of the Russian Federation: “The right to establish taxes is possible only by taking into account the fundamental rights of a person and of a citizen, consolidated in Articles 34 and 35 of the Constitution of the Russian Federation, as well as the constitutional principle of unity of the

economic space. Given the need to achieve a balance between the mentioned constitutional values, tax policy aims at unifying tax exemptions. This goal is served by such a general principle of taxations and fees, as the exhaustive list of regional taxes which can be established by the state authorities of the constituent entities of the Russian Federation, and the resulting restrictions on the introduction of additional taxes and mandatory deductions, and as well as on raising tax rates and tax payments” (Constitutional Court of the Russian Federation: 5-P/1997).

The constituent entities of the Russian Federation and municipalities do not have tax sovereignty, since the source of their power is not in the multinational people of the Russian Federation, but in federal legislation. In this regard, their powers in the field of taxation have a concretizing nature and are shown in the possibility of clarifying certain elements of taxation (Krasnyukov, 2018: 41).

There have been some attempts at introducing taxes at a regional (local) level that were not prescribed by the Russian Tax Code (or other federal laws). For example, in Khabarovsk a fee was introduced for using land plots without title documents, moreover it was qualified by the Court as a type of taxation not prescribed by the federal legislation (Supreme Court of the Russian Federation no. 58-APG12-5 (2012)).

In the Russian Federation there are three different levels of the tax system: federal taxes, regional taxes, and local taxes.

Furthermore, the Budget Code of Russia determines the budgets to which the corresponding taxes are credited. So, such taxes as corporate income tax and personal income tax, are in fact federal taxes, however if the former is partially attributed to the budget of the federation, the latter is attributed only to the budgets of the constituent entities and the municipalities.

The activity of regional authorities in regulating regional taxes is fundamental only for the transport tax (for organizations) and for the property tax of organizations, since the deadlines for the payment of these taxes do not follow from the Russian Tax Code. The remaining regional taxes have a considerable set of elements precisely in the Russian Tax Code. Local authorities are generally allowed to pass normative legal acts on local taxes, and without their rule-making activity local taxes will be levied in the territory under their jurisdiction. The indicated changes in the legislation allow tracing the progressive movement of the Russian legal system from a formal federalism to an actual unitary system (Tyutin, 2017).

Concurrently, particular tax regimes that relate to federal taxes of the tax system (although not attributed to the federal budget), on the contrary indicate all signs of tax autonomy, since they imply the will of the constituent entities of the federation on their implementation into the territory, which additionally implies the establishment in the law of the constituent entity and the mandatory elements of such tax.

Similar features of such establishment are also provided for the trading fees. This payment concerns local fees. However, it was only introduced in the territory of the city of Moscow, which is a constituent entity of the Russian Federation.

In 2016, a group of deputies appealed to the Russian Constitutional Court in connection with the implementation of this fee, however, the Court found no violation of the Constitution neither by the procedure of its establishment and implementation, nor in the very procedure of the levy (Constitutional Court of Russian Federation no. 2152-O/2016).

Nonetheless, it is this payment that raises questions around the resident status in the constituent entity, since in the practice of its application there is a discrimination against entrepreneurs registered in other constituent entities but carrying out activities subject to Moscow's taxation.

It is interesting to note that if an online store does not own a pick-up point and it does not trade from a warehouse, but instead only delivers the goods, then it will not be obliged to pay this fee.

This way, consciously or not, this payment stimulates an online trade in the city of Moscow.

The sufficiency of own resources for the constituent entities of the Russian Federation and of the municipalities is a massive problem, which is increasingly aggravated by a major level of tax evasion.

No one likes to pay taxes. Some dislike it more than others. Most of us pay taxes because we recognize that to get what we want from state we need to help pay for it. There is a kind of moral or social responsibility to pay our taxes, even if it hurts. But of course, not everyone feels this way. Many will do whatever they can to avoid taxes even though this means that others will have to pay more just to make up what they have avoided. To willingly pay taxes requires a "leap of faith." We have to believe that we will get something in return for the money we shell out and that other people will share the burden (Steinmo, 2018).

It is generally accepted that the superiority of the decentralized provision of public services can be more clearly established if some basic premises are satisfied, namely: (i) A substantial share of public spending is funded through taxes, (ii) Citizens are aware of the level of government to which they are paying taxes, and (iii) Sub-national government have real tax autonomy, i.e. they are able to take decisions that affect the level and composition of taxes (Solé-Ollé, 2013)

It could be argued that such a massive evasion is a consequence of taxpayers' distrust of the tax system, and that many taxpayers see nothing wrong with not paying taxes as they do not feel that the state understands their needs or that it aims to create the most comfortable living conditions. The tax on private income is closely linked to the territory of the employer's location. Thus, the gap between the requirements of the place of residence and the contribution to the financing of expenditures is in an even greater separation. Mass evasion also contributes to the loss of confidence in joint and collective participation in the financing of state expenditures.

The possibilities of the internet allow to quickly provide oneself with income and not to pay taxes.

Based on the abovementioned experience, gradual decentralization could be a positive shift into this direction, however it is simply impossible without financial resources. We have previously stressed positive importance of decentralization precisely from the point of view of improving tax discipline. This experience would also be very useful for the Russian Federation.

Nowadays tax experiments are required to ensure the reception of taxes.

Despite the fact that the experiments are regulated by federal legislation, they act as their own type of exception to the principle of unity of the economic space, creating opportunities for a gradual decentralization and possible tax autonomy.

### **3. Experiments**

In 2001, flat income taxation was introduced in Russia, which led to an increase in tax revenues in the short term, due to an increase in the level of voluntary declaration. However, now the level of shadow employment in Russia has become a serious problem and a mere flat tax has unfortunately become insufficient.

Attempts by tax authorities to take advantage of the easy access to publicly available information did not always achieve the goal of leading the taxpayer to pay

the tax. In the tax control over private individuals, no particular progress has been observed recently, since individuals do not advertise their relationships with each other, however even what the tax authorities were able to find out was not enough with the accepted standard of evidence or with the accountability procedure.

The seriousness of this problem underlines the fact that in all seriousness Russia was considering the prospects of introducing a tax on parasitism.

A solution was found. At first glance, it seemed to be quite simple and very effective.

From 1 January 2019, the simplest taxation regime for private individuals was introduced in 4 regions of the Russian Federation. Any communication with the tax authority was done through a program on the phone, from the selection of a special regime to the fulfillment of tax obligation.

Such “exclusive regulation” stirred up problems of resident status in the constituent entity and in linking income to a source in the constituent entity, since residents of the regions that did not participate in this experiment also expressed the desire in taking advantage of such regime.

Previously, a resort fee was introduced as an experiment, which was also applied to a limited list of territories.

Even before that, an experiment was conducted with the property tax of organizations.

Still, this experiment should not be confused with transitional provisions. Transitional provisions act as a bridge between the coast of past regulation and the coast of the new but already defined regulation. An experiment is like a boat that goes with the flow without a clear intention to land on a specific shore.

Thus, an experiment is a response to constantly changing economic conditions, which is carried out on a limited set of territories, determining possible relevance of a regulation throughout the country.

The experiment is one of the most likely directions of decentralization, since the effectiveness of its implementation depends largely on the constituent entities of the federation.

Perhaps, following the laws of philosophy, after numerous experiments, qualitative changes in the tax system will eventually take place, changes that will also contribute to the decentralization of public administration and the improvement of tax autonomy.

#### 4. Conclusion

A self-sustaining system must, on the one hand, be sufficiently decentralized to promote competition among jurisdictions and to limit the capacity of the center to undermine the efficient operation of markets. At the same time, however, the central government must be strong enough to resist credibly moves by decentralized agents to raid the commons (Oates, 2006).

The international experience displays the natural character and the objective necessity of decentralization of state administration, which is used by public (state) government.

The objective nature of such changes is confirmed by the transition of the whole economic system of the state from a post-industrial formation to a digital one.

Digital economy is in itself a decentralized economy, in which the principles and mechanisms of the ordinary (traditional) tax federalism, which were laid down in the middle of the 20th century, do not work properly.

Even so, we can talk about a positive impact of digital economy on the development of the state, as well as the challenges that are associated with it in the economic, cultural and other areas.

The new is also a challenge for the tax system, the success of which entirely depends on how quickly, adequately and effectively it will react to this new, without violating the established principles and guarantees.

The experience of the Russian Federation shows that the issues of fiscal federalism and tax autonomy in an era of the primacy of digital economy have an acute effect on the state and are painfully felt by its citizens.

If the state has no division of powers between the state and the constituent entities, since all power, the solutions to the problems and the financial resources are found inside the state, and they do not share with the constituent entities and the municipalities, then solving the indicated problems quickly becomes more difficult and it becomes necessary to “experiment”.

The authorities of states that have declared their intention to move to the formation of digital economy must look for alternative ways to provide legal regulation of relations in the area of tax federalism. One of such non-standard solutions is a tax experiment, which, from different points of view, became a way out of the difficult situation associated with the internal contradiction between the principles

characteristic of traditional tax federalism (previously established in constitutional norms or decisions of constitutional justice bodies) and the actual challenges of digital economy.

Regardless, the main task of the state becomes that of ensuring the compliance of the implemented alternative methods with the fundamental constitutional principles, to ensure a non-discrimination of both individual regions and their population.

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### **Legal acts:**

1. Act no. 422-FZ /2018, On conducting an experiment to establish a special tax regime “Tax on professional income” in the federal city of Moscow, in Moscow and Kaluga regions, as well as in the Republic of Tatarstan (Tatarstan), as amended.
2. Constitutional Court of the Russian Federation: 2152-O/2016.
3. Constitutional Court of the Russian Federation: 5-P/1997.
4. Supreme Court of the Russian Federation no. 58-APG12-5/2012.