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ESTIMATING THE RETURN OF ADDITIONAL FEDERAL SPENDING ON BUSINESS TAX COMPLIANCE

OFFICE OF THE PARLIAMENTARY BUDGET OFFICER
BUREAU DU DIRECTEUR PARLEMENTAIRE DU BUDGET

The Parliamentary Budget Officer (PBO) supports Parliament by providing economic and financial analysis for the purposes of raising the quality of parliamentary debate and promoting greater budget transparency and accountability.

This report analyses the relationship between federal spending and additional tax revenues generated through business compliance programs since 2015-16 and estimates how changes in funding might affect future revenues.

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Executive Summary

Since Budget 2015, the federal government has announced additional funding aimed at supporting the Canada Revenue Agency's (CRA) efforts to strengthen tax compliance, with the objective of preventing underground economic activity, tax evasion and aggressive tax planning. To that effect, the Canada Revenue Agency (CRA) has been allocated close to $1.9 billion in additional funding between fiscal years 2015-16 and 2023-24. In return, the federal government expects to collect $13 billion in additional revenues over the same period.

Although compliance activities extend to both individuals and corporations, this report focuses solely on business compliance programs as defined by the CRA. It analyses the historical relationship between federal spending and additional tax revenues generated through business compliance programs and estimates how changes in funding might affect future revenues. The scope of the analysis is limited to the federal government and does not consider the effects of the increased federal spending on provincial governments.

The PBO estimates that for each additional dollar spent on business compliance programs between 2015-16 and 2018-19, the Federal government collected an average of $3.9 in additional revenues, which resulted in a fiscal impact of $5.7 when adjusted for non-cash items. The PBO expects this fiscal impact to decrease over the years to reach $4.3 by 2024-25, reflecting taxpayers' behavioural changes (Summary Table1).

Summary Table 1 Estimated return per dollar of additional federal spending on business compliance programs

	2015-16 to 2018-19 (average)	2023-24	2024-25
Revenues (cash)	$3.9	$3.3	$2.9
Non-cash items	$1.8	$1.6	$1.4
Fiscal impact	**$5.7**	**$4.9**	**$4.3**

Sources: Office of the Parliamentary Budget Officer, Budget documents (2015 to 2019), Canada Revenue Agency.

Note: Fiscal impact includes non-cash items such as tax refunds reduced, interest and penalties, and the present value of future taxes assessable.

2018-19 is the most recent fiscal year for which actual data is available from the CRA; as such, 2019-20 stands as the initial forecast year.

A portion of the assessed taxes responsible for that fiscal impact is subject to objections and/or appeals, which means the actual fiscal impact may be lower that what is indicated in Summary Table 1. The PBO estimates approximately 81.3% of the total fiscal impact will materialize based on historical data of the CRA.

The PBO also assumes additional federal spending on business compliance programs would decline gradually after 2019-20 to reach zero by 2024-25, as per announcements made since Budget 2015 (Summary Table 2). Therefore, we anticipate that additional federal spending planned between 2019-20 and 2024-25 would generate $2.4 billion in revenues over the same period, for a fiscal impact of $3.4 billion.

Summary Table2

Expected fiscal impact of additional federal spending on business compliance programs

($ millions)

	Additional federal spending	Incremental federal revenues	Federal fiscal impact
2019-20	$211	$820	$1,197
2020-21	$201	$850	$1,240
2021-22	$106	$409	$597
2022-23	$45	$161	$235
2023-24	$35	$118	$172
2024-25	-	-	-
Total	**$598**	**$2,357**	**$3,441**

Sources: Office of the Parliamentary Budget Officer, Budget documents (2015 to 2019), Canada Revenue Agency

Note: Incremental revenues represent the increase in federal revenues as a result of the additional spending on business compliance programs (approximately 60% of total additional spending).

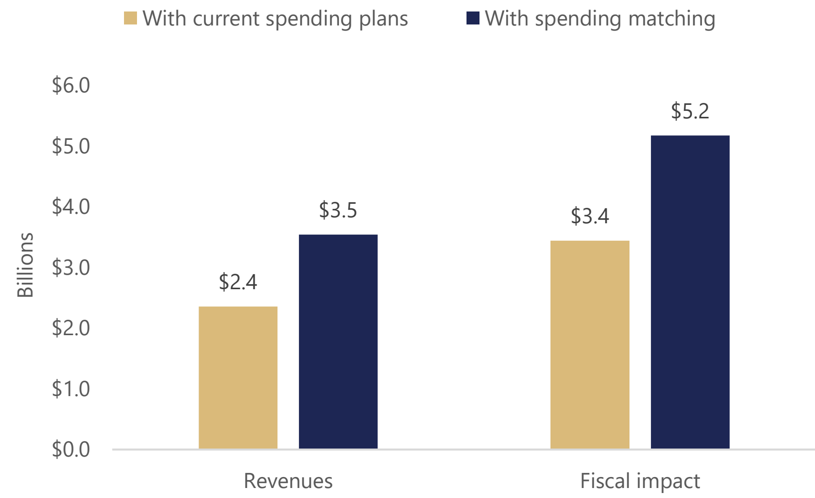
Fiscal impact includes non-cash items such as tax refunds reduced, interest and penalties, and the present value of future taxes assessable.

2018-19 is the most recent fiscal year for which actual data is available from the CRA; as such, 2019-20 stands as the initial forecast year.

If the additional spending planned over the medium-term instead matches historical levels, the PBO forecasts the federal government could increase its business compliance revenues by $1.2 billion by 2024-25. This would bring additional business compliance revenues to $3.5 billion between 2020-21 and 2024-25, which represents a fiscal impact of $5.2 billion (Summary Figure 1).

Summary Figure 1

Changes in business compliance revenues if future spending matches historical levels (2019-20 to 2024-25)



Sources: Office of the Parliamentary Budget Officer, Budget documents (2015 to 2019), Canada Revenue Agency.

Note: Fiscal impact includes non-cash items such as tax refunds reduced, interest and penalties, and the present value of future taxes assessable.

The "current spending plans" scenario assumes additional spending gradually declines to reach zero by 2024-25. The "spending matching" scenario assumes total additional spending planned between 2020-21 and 2024-25 matches total additional spending identified between 2015-16 and 2019-20.

1. Introduction

As a part of its mandate, the CRA is responsible for ensuring that taxpayers comply with the requirements laid out in the Income Tax Act. The CRA therefore operates compliance programs to identify which taxpayers are more likely to breach those requirements.

Since Budget 2015, the federal government has announced additional funding aimed at supporting the Canada Revenue Agency's (CRA) efforts to strengthen tax compliance, with the objective of preventing underground economic activity, tax evasion and aggressive tax planning.

The Canada Revenue Agency (CRA) has been allocated close to $1.9 billion in additional funding between 2015-16 and 2023-24. In return, the federal government expects to collect $13 billion in additional revenues over the same period.[1]

Although compliance activities extend to both individuals and corporations, this report focuses solely on business compliance programs as defined by the CRA. It also examines the historical relationship between federal spending and additional tax revenues generated through business compliance programs to estimate their future fiscal impact.

The scope of the analysis is limited to the federal government. Therefore, it does not consider the effects of the increased federal spending on tax compliance programs on provincial governments' fiscal positions.

2. CRA's business compliance programs

The CRA administers five business compliance programs:[2]

- Small and Medium Enterprises (SME)
- International and Large Business
- High-Net-Worth Compliance[3]
- Scientific Research and Experimental Development
- Goods and Services Tax (GST)/Harmonized Sales Tax (HST)

In general, audits are the most common tool used for ensuring compliance, although less intrusive methods or soft interventions are preferred in certain circumstances. Soft interventions would include initiatives such as educational and communications campaigns. Below is a brief description of each of the business compliance programs under consideration in this report.

SME compliance program

The SME program collects information relating to the business and/or personal affairs of taxpayers in order to determine the correct amount of taxes payable, generally through audits. The outcome of these audits can also affect other taxpayers or GST/HST registrants which, in turn, could result in additional audits (Canada Revenue Agency, 2017).

The CRA's strategy for the SME population focuses on identifying the least intrusive and most economical way to promote compliance, hence the use of soft interventions when these are deemed more effective.

International and Large Businesses compliance program

This program collects information about the business affairs of taxpayers to determine if they are complying with the Income Tax Act. Most cases will involve only administrative consequences, that is audits resulting in more tax owing and possibly civil penalties. The outcome of these audits can also affect other taxpayers or GST/HST registrants which, in turn, could result in additional audits (Canada Revenue Agency, 2017). This program covers the following types of income tax audits:

- **Large business**: For income tax compliance of the largest and most complex business entities;
- **International tax**: For reporting of world income and proper payment of taxes by non-residents working or carrying on business

in Canada; international cross-border transactions between related parties; transfer pricing; foreign accrual property income; foreign affiliate rules; and other international tax issues;

- **Offshore compliance**: For international transactions of unreported foreign income and undisclosed assets; and
- **Aggressive tax planning**: This includes the identification of emerging tax avoidance issues and arrangements, the review of tax shelters and promoters, and the application of the general anti-avoidance rule.

High-Net-Worth Compliance program

This program involves the audits of high-net-worth individuals, families and their related parties through their corporate holdings. High-net-worth individuals are defined as those whose net worth is $50 million or more, or those who control or exercise significant influence over more than 30 related entities (RSW Accounting and Consulting, 2011).

Activities under this compliance program address situations where the tax authorities feel that there is a substantial discrepancy between a taxpayer's apparent living standard and their reported income. As part of the audit, CRA assesses holdings in private corporations, trusts, partnerships, joint ventures, foundations, foreign entities, and investment holdings (both domestic and foreign), in addition to investments and transactions conducted through registered accounts, such as Registered Retirement Savings Plans.

Scientific Research and Experimental Development (SRED) compliance program

The CRA administers the SRED tax credit, which is a federal tax incentive program destined to encourage SRED in Canada (Canada Revenue Agency, 2019). The tax incentives come in three forms: an income deduction, an investment tax credit, and, in certain circumstances, a refund. The program provides more than $3 billion in tax incentives to over 19,000 claimants every year.

The SRED compliance program collects information to decide the overall risk of not complying with the Income Tax Act. Penalties are charged when certain required information is incomplete, inaccurate or missing.

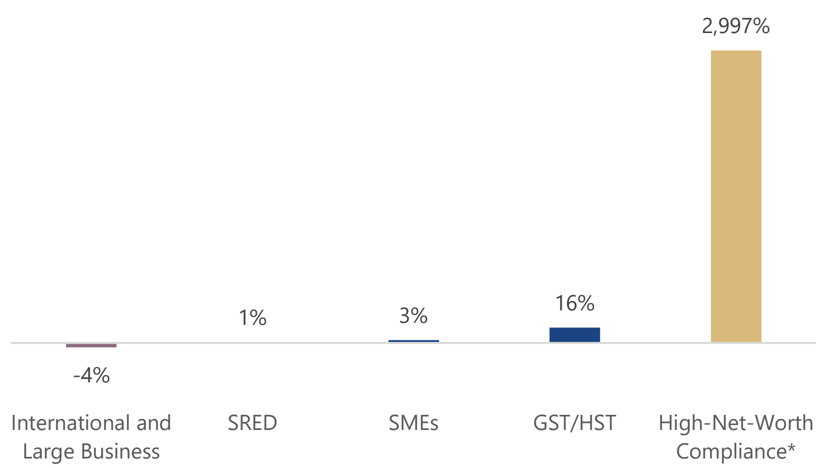
GST/HST compliance program

This program includes reviews, examinations and audits at the domestic and international level to determine the correct amount of excise taxes, other levies, GST/HST, and air travellers' security charges owing on an account and to prevent the issuance of unwarranted refunds and rebates (Canada Revenue Agency, 2017).

3. Spending on business compliance programs since 2015-16

Since Budget 2015, spending increased for all business compliance programs, except for the International and Large Business stream, which recorded a 4% decline between 2015-16 and 2018-19 (Figure 3-1). However, spending growth was unevenly distributed across the remaining four programs, ranging from 1% for the SRED program to almost 3,000% for the High-Net-Worth program.

Figure 3-1 Spending growth was unevenly distributed across programs between 2015-16 and 2018-19



Sources: Canada Revenue Agency, Office of the Parliamentary Budget Officer.

Note: 2018-19 is the most recent fiscal year for which actual data is available from the CRA. *Growth percentage not up to scale.

The dramatic spending growth exhibited by the High-Net-Worth program was largely due to a significant increase in the number of employees engaged in the compliance program. This was responsible for 97% of the spending growth for that program between 2015-16 and 2018-19. The remaining share of the growth was attributable to an increase in travel (1.6%), special fees and services (0.7%), training and education services (0.2%).

A similar pattern with regards to the increase in the number of employees was observed for the GST/HST compliance program, which explained 98% of the total spending increase.

4. Return of additional federal spending on business compliance programs

This section analyses the return of additional federal spending on business compliance programs since 2015-16 and builds on historical data to estimate the future fiscal impact of planned spending through to 2024-25. The PBO also analyzes how changes in federal spending could affect future compliance revenues.

4.1. What is the return of the additional federal spending on business compliance programs?

The return of additional federal spending on business compliance is calculated using historical spending data obtained from the budget documents and revenue data from the CRA.[4]

Using the budget documents, the PBO has identified $872 million in additional federal spending for compliance programs (personal and business) between 2015-16 and 2018-19.[5] However, since the scope of the analysis is limited to business compliance programs, it is important to identify the portion of the additional spending on those programs.

Based on CRA data, the PBO calculated that an average of 60% of the additional federal spending was directed to business compliance programs. That share was used to determine the portion of the additional federal spending allocated to business compliance programs. This brings the amount of additional federal spending on business compliance programs to $523 million over a four-year period between 2015-16 to 2018-19 (Table 4-1).

Table 4-1 Additional federal spending on business compliance programs

($ millions)

	Spending on business compliance programs	Spending on individuals' compliance programs	Total spending
2015-16	$24	$16	$40
2016-17	$120	$80	$200
2017-18	$183	$121	$304
2018-19	$196	$131	$327
Total	$523	$349	$872

Source: Office of the Parliamentary Budget Officer, Budget documents (2015 to 2019), Canada Revenue Agency's 2018-19 Departmental results report.

Note: It is assumed 60% of additional federal spending is directed towards business compliance programs.

Combining the data from Table 4-1 with CRA revenue data, the PBO estimates that for each additional dollar spent on business compliance programs between 2015-16 and 2018-19, the Federal government collected $3.9 in additional revenues.

It is important to keep in mind that this is not the fiscal impact of business compliance programs. Fiscal impact includes tax refunds reduced, interest and penalties, and the present value of future taxes assessable. Adjusting for those items based on CRA data, the PBO estimates each additional dollar spent on business compliance programs between 2015-16 and 2018-19 resulted in a fiscal impact of $5.7.[6]

Table 4-2 Average return per dollar of additional federal spending on business compliance programs

	2015-16 to 2018-19
Revenues (cash)	$3.9
Non-cash items	$1.8
Fiscal impact	**$5.7**

Sources: Office of the Parliamentary Budget Officer, Budget documents (2015 to 2019), Canada Revenue Agency.

Note: Fiscal impact includes non-cash items such as tax refunds reduced, interest and penalties, and the present value of future taxes assessable.

2018-19 is the most recent fiscal year for which actual data is available from the CRA; as such, 2019-20 stands as the initial forecast year.

Fiscal impact is likely to decrease over the future years, partly due to behavioural changes as taxpayers adopt new tax avoidance mechanisms. For instance, the PBO estimates the fiscal impact of business compliance programs will decline to $4.3 per dollar of additional federal spending by 2024-25 as a result of behavioural changes. In addition, the CRA may experience diminishing returns as it reaches the peak in terms of audit productivity.

It is also important to note that a portion of the assessed taxes responsible for the estimated fiscal impact is subject to objections and/or appeals, which means the actual fiscal impact may be lower than estimated. Using CRA data on the outcomes of objections decisions (Office of the Auditor General of Canada, n.d.), the PBO estimates approximately 81.3% of the total fiscal impact would materialize.[7]

4.2. How much revenues could the federal government expect over the medium-term given current spending plans?

Relying on the budget announcements since 2015, as well as the approach used to estimate the portion of federal spending destined to business compliance programs, the PBO has identified $598 million in additional federal spending on business compliance programs between 2019-20 and 2024-25 (Table 4-3). The PBO estimates that additional spending, according to current plans, would generate $2.4 billion in federal revenues, which would translate into a fiscal impact of $3.4 billion over the forecast horizon.[8]

Table 4-3 Expected fiscal impact of additional federal spending on business compliance programs

($ millions)

	Total spending on compliance programs	Spending on business compliance programs	Incremental federal revenues	Federal fiscal impact
2019-20	$351	$211	$820	$1,197
2020-21	$334	$201	$850	$1,240
2021-22	$177	$106	$409	$597
2022-23	$75	$45	$161	$235
2023-24	$59	$35	$118	$172
2024-25	-	-	-	-
Total	**$997**	**$598**	**$2,357**	**$3,441**

Source: Office of the Parliamentary Budget Officer, Budget documents (2015 to 2019), Canada Revenue Agency

Note: Incremental revenues represent the increase in federal revenues as a result of the additional spending on business compliance programs (approximately 60% of total additional spending).

Fiscal impact includes non-cash items such as tax refunds reduced, interest and penalties, and the present value of future taxes assessable.

2018-19 is the most recent fiscal year for which actual data is available from the CRA; as such, 2019-20 stands as the initial forecast year.

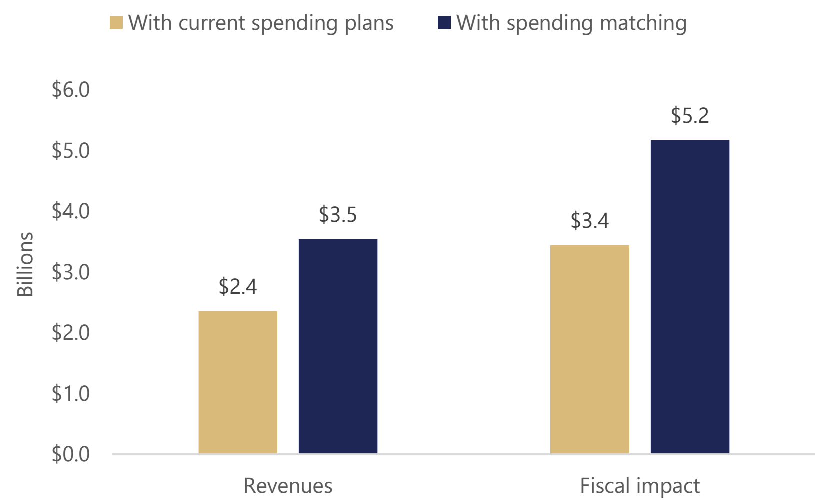
The PBO's forecast incorporates the effects of taxpayers' behavioural changes as a result of compliance activities. This effect is otherwise referred to as attrition and represents the anticipated decrease in revenues that would occur over time, as target taxpayer population discover new ways to avoid taxes.[9]

4.3. How much additional revenues could be generated over the medium-term if future spending matches historical levels?

As seen in Table 4-3, federal spending on business compliance programs starts to decrease after 2019-20, before reaching zero by 2024-25. In fact, spending identified between 2020-21 and 2024-25 ($387 million) is expected, under current plans, to be almost half of what it was between 2015-16 and 2019-20 ($734 million).

If the additional spending between 2020-21 and 2024-25 matches historical levels observed between 2015-16 and 2019-20, the PBO estimates the federal government could raise $1.2 billion more revenues from its business compliance program by 2024-25.[10] This would bring additional business compliance revenues to $3.4 billion between 2019-20 and 2024-25, which would amounts to a fiscal impact of $5.2 billion (Figure 4-1).

Figure 4-1 Expected changes in business compliance revenues (2019-20 to 2024-25) if future spending matches historical levels



Sources: Office of the Parliamentary Budget Officer, Budget documents (2015 to 2019), Canada Revenue Agency

Note: Fiscal impact includes non-cash items such as tax refunds reduced, interest and penalties, and the present value of future taxes assessable.

The "current spending plans" scenario assumes additional spending gradually declines to reach zero by 2024-25. The "spending matching" scenario assumes total additional spending between 2020-21 and 2024-25 matches total additional spending identified between 2015-16 and 2019-20.

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Notes

1. These figures were calculated by summing up the various announcements for tax compliance in Budget documents between 2015 and 2019.
2. This information was obtained through an Information Request (reference: IR0440) and was deemed confidential by the CRA. Therefore, it cannot be published.
3. Although this program is concerned with individuals net-worth; it examines their corporate holdings and not their personal income, which is why the program is considered part of business compliance programs.
4. While the PBO was involved in discussions with the CRA regarding data on incremental revenues resulting from the additional federal spending on business compliance programs, we have not undertaken any analysis to validate the data received in the context of our Information Request (see Endnote 2).
5. Additional spending identified using budget documents were equally distributed throughout the horizon over which they were announced. Although this might not be the case in practice, this approach was followed whenever a breakdown of annual spending was not available.
6. Our analysis of the most recent CRA data on audit yield (Canada Revenue Agency, 2020) indicates collectible cash represented an average of 68.5% of the gross fiscal impact for income tax and GST/HST audit programs. The fiscal impact discussed does nor account for objections, appeals and write-offs.
7. This information was combined with data on objections and appeals received from the CRA as part of their response to the PBO's information request (see Note 2 above). For the purpose of our calculations, objections and appeals are treated in a similar manner.
8. The PBO used a three-year uniform moving average of the annual return ratios to predict the path of the annual return ratios between 2019-20 and 2024-25. The forecasted ratios were then adjusted for attrition (Reference (Office of Budget Responsibility, 2014, pp. 30-31)), then multiplied with the annual federal spending identified to calculate future revenues and fiscal impact.
9. See reference (Office of Budget Responsibility, 2014, pp. 30-31) for more information about the guidelines published by the Office of Budget Responsibility regarding attrition rates. PBO's forecast assumes 21% of the yield is lost by 2023-24, and 30% by 2024-25.
10. Since the 2019-20 fiscal year is closed, we assume that eventual spending changes will only occur starting in 2020-21.