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## **NO MORE SECOND-CLASS TAXPAYERS: HOW INCOME SPLITTING CAN BRING FAIRNESS TO CANADA'S SINGLE-INCOME FAMILIES**

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### **SUMMARY**

The Canadian personal income tax system does not pay much attention to whether the amount of money an individual brings home is supplemented by the income of a spouse or not. That means that families where one spouse earns more than the other get taxed at a higher rate than families where two working partners earn the same total income split evenly between two paycheques. In fact, a family with just a single earner making \$70,000 a year pays 30 per cent more in taxes every year than a family with two partners making \$35,000 a year. A single-earner family taking in \$120,000 a year pays the same income tax as a dual-earning couple making \$141,000 between them.

The federal Conservative government has at least suggested it wants to finally level that playing field – nearly six decades after a royal commission recommended that the income tax system be changed to recognize total family household income, rather than focusing on each individual's income. Given that Canada's income tax system aims to treat people in similar circumstances as equally as possible, it is certainly time to let couples split their income so they do not face a penalty in higher tax rates than those faced by couples bringing home the same amount of total pay.

While couples with just a single earner enjoy some advantages, a dual-earning couple does not – namely the extra time the stay-at-home spouse is able to use to raise children and produce other unpaid, home-based benefits – that can be accounted for using other means. Specifically, cutting out the transferability of the unused portion of the basic personal tax exemption for couples splitting income – requiring couples splitting their income to each earn money in order to use this credit – is one way to account for the difference in unpaid benefits that single-income families do typically enjoy more than dual-income couples.

That is one mechanism; there may still be others the government might consider. But the bottom line is that there are ways to account for certain non-labour-market-related differences between single-earner families and dual-earner families.

No doubt many of these proposals would be an improvement over the current, where two different families subsisting on the same pay are taxed very differently, with one type of family penalized simply because of how their income is earned.

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## INTRODUCTION

During the last federal election, the Conservative government reopened old questions on the fair tax treatment of families. It offered to introduce a new “family tax plan” to lower the tax burden of families. Instead of drastically reforming the personal income tax system into a full joint-filing system, the Conservatives proposed “income splitting”: individuals could transfer up to \$50,000 of income between couples, provided the family had a dependent child under the age of 18. The effect of this proposal is to level the tax burden between families, even if one spouse earns more income than the other. As shown in this paper, income splitting could introduce additional fairness into the tax system, particularly for single-earner families currently bearing a higher tax burden than dual-earner families.

The progressive nature of the current personal income tax system results in couples with only one wage earner reaching higher marginal tax rates much sooner than, and suffering a significant tax penalty over, couples where both earn similar amounts. A couple with a single earner making \$70,000 will pay over \$2,000, or 30 per cent, more in taxes than a couple with two earners each making \$35,000, a difference that increases with income. Including provincial income taxes magnifies the difference in the tax burden between families.

An important principle of taxation is that the tax system should be neutral between individuals in similar circumstances, so those with equal income and equal needs should have equal tax burdens. This suggests that the joint resources of a household should be included when determining the total tax burden. Recommendations of the 1966 Royal Commission on Taxation (the Carter Report) argued that the appropriate tax unit should be the family, as the income and expenditure of two individuals are not independent when they live together. The 1978 Meade Report in the United Kingdom rationalized this tax treatment because, among other reasons, households with similar joint resources should be taxed equally, and a couple living together has lower expenses than they would if they lived separately.<sup>1</sup>

Even as the Canadian system maintains the individual as the tax unit, it has developed a transfer system based largely on equalizing tax treatment across families. Many tax exemptions and credits are based on net family income or transferable between spouses. A consequence of maintaining the individual as the unit of taxation is that families with a large amount of income disparity between spouses pay higher taxes than that paid by couples with similar total household incomes but less income disparity between spouses. This is primarily the case for employment income, as some sources of income can already be split between spouses to minimize taxes: investment income can be claimed by a spouse, families with small businesses can pay dividends to family shareholders, and payments from the Canada Pension Plan and private pension plans can be made to spousal Registered Retirement Savings Plans by a spouse earning greater income.

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<sup>1</sup> The assumption that households are comparable based solely on their joint market income and time allocation remains a value judgment. Households may still be quite heterogeneous beyond these characteristics and thus not be truly equal. For a discussion of these arguments see Jonathan Rhys Kesselman, “Income Splitting and Joint Taxation of Couples: What’s Fair?” *IRPP Choices* 14(1) (2008).

A primary argument against income splitting or joint taxation revolves around differences in time allocation between single- and dual-earner families. Families with single earners have more total implicit income, as the stay-at-home parent is able to provide more unpaid and untaxed work at home than a family with two wage earners, and thus should have a higher tax burden. Income splitting would then simply give a tax break to relatively wealthy families. However, the current tax system is not well suited to account for these differences in family structure and earnings. Taxing this additional household income is currently done only through the progressive nature of the income tax system, causing high-income families to suffer a tax penalty while lower-income families already face nearly identical tax burdens. A second critique of income splitting is that it may decrease the incentive of secondary earners to enter the labour force. By combining the income of both spouses, the secondary earner faces his spouse's higher marginal tax rate if he enters the labour market. Again, though this is true for an income-splitting system, a progressive income tax on individuals is not the ideal way to encourage increased entry into the labour market.

Though these issues should give the government pause before simply implementing a stand-alone income-splitting proposal, income splitting allows for other mechanisms to correct for these differences between families. In our opinion, introducing income splitting, along with restrictions on the transferability of the basic tax exemption, is a far better approach for personal taxation as it directly increases equality between family earnings and corrects for labour-market distortions due to home production provided by at-home spouses. We argue that couples choosing to split income should be unable to transfer the basic exemption as well. This effectively converts the basic exemption into an employment tax credit when a couple chooses to split income and accounts for the differences in family structure.

The remainder of this paper explores the impact of income splitting in terms of equity of families under the tax system. Rather than looking at who gains and who loses from being able to split income, we analyze the inefficiencies of the current personal tax system and show how income splitting can allow additional instruments to create a more equitable personal tax system. Simply allowing personal income splitting would provide a tax break for high-income individuals, as shown by Laurin and Kesselman,<sup>2</sup> but this is partly due to these taxpayers being disadvantaged by the current system, and further adjustments to the tax system, such as an modification of the transferability of the basic exemption, can be made to ensure equity for all families.

## **A BRIEF INTRODUCTION TO THE CANADIAN PERSONAL INCOME TAX SYSTEM**

To facilitate analysis, we consider the current federal income tax burden for two hypothetical families. One family is a married couple with a single earner making all of the family's market income; the other has two earners, each making, taken together, an equal market income. As a baseline, we assume neither family has any children. Canadian families run the full gamut of income shares between spouses, so this comparison causes the starkest results in terms of

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<sup>2</sup> Alexandre Laurin and Jonathan Rhys Kesselman, "Income Splitting for Two-Parent Families: Who Gains, Who Doesn't, and at What Cost?" C.D. Howe Institute Commentary, Issue 335 (2011).

family earnings disparity. The total income tax burden of these two families, excluding Employment Insurance (EI) and Canada Pension Plan (CPP) programs,<sup>3</sup> is presented in Figure 1. Due to the progressive nature of the tax system, the single-earner family's tax burden is larger than the dual-earner family's, as the former reaches tax-rate thresholds sooner.<sup>4</sup>

### **BOX 1: PAYROLL TAXES**

All of our calculations of tax burden omit Employment Insurance and Canada Pension Plan premiums, or payroll taxes. Assuming income is shifted during tax filing, the original earner is still liable for all Employment Insurance (EI) and Canada Pension Plan (CPP) payments on her income. Therefore the original earner has her earnings insured (up to the specified maximum) and her pension-plan contributions are tied to her earnings. Kesselman and Laurin include payroll taxes in most of their evaluations of tax burdens under income splitting, arguing the correlation between these payments and their benefits are not strong. But while payroll taxes are mandatory deductions from income, these programs also provide either an expected benefit, or future benefits tied to current contributions, both of which should be accounted for to determine the total tax burden. As it is difficult to adjust for the benefits of the programs across incomes, these have been omitted. However, we note that, to the extent that programs run at a deficit, they subsidize work effort.

With the Employment Insurance program, working individuals pay a premium of 1.83 per cent from their paycheque each month, up to a maximum of \$839.97 per year. This premium insures their income up to \$45,900. If an individual loses her job, she can receive up to 55 per cent of her average insurable earnings, up to a maximum of about \$485, every two weeks, to a maximum of 45 weeks, depending on the unemployment rate in her region. As this is based on individual income, a two-earner household will pay up to twice as much into employment insurance as a single-earner family, and a single-earner earning more than \$45,900 will pay less into EI than a double-earning family. However, the double-earning family will also receive twice the benefits if both earners become unemployed, and will see a less significant drop in income if only one earner becomes unemployed. Given the recent economic conditions, the Employment Insurance program has run a deficit for the last few years and is projected to run a deficit until 2014, making the current expected benefits of the program exceed total contributions.

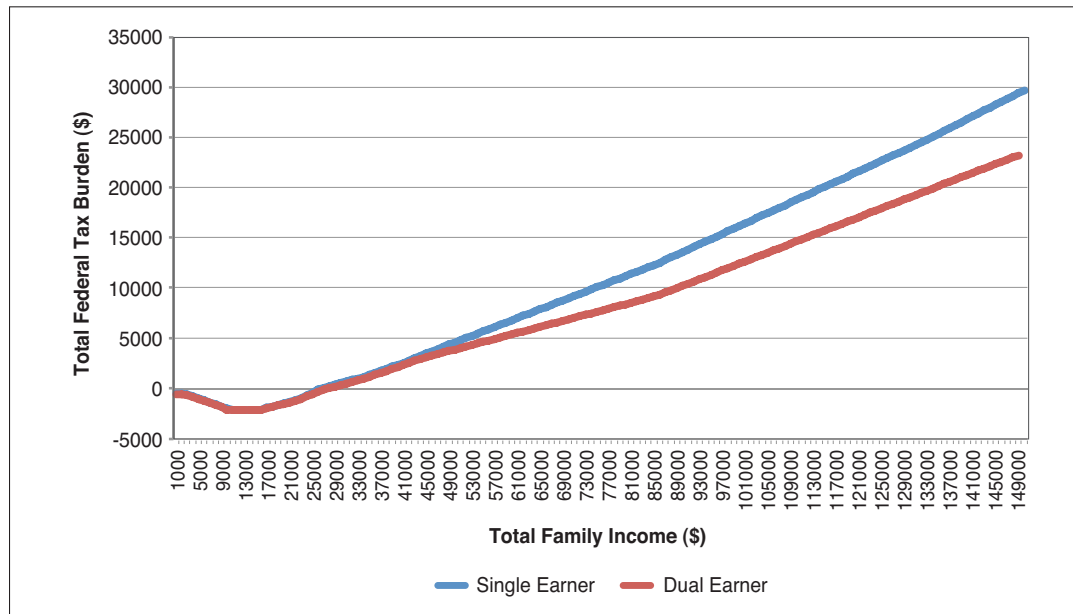
The Canada Pension Plan works in a similar manner. Individuals must pay a premium of 4.95 per cent of their earnings, an amount matched by their employer, when their income is above \$3,500, up to a maximum contribution of \$2,306.70 per year, when annual income reaches \$50,100. With dual-income couples, the total contributions to the CPP are higher, but so are the benefits. If a family only has a single earner, it is only eligible for one public pension. As the Canada Pension Plan constitutes a small level of savings, it is unlikely to be enough savings for couples to prepare for their retirement, and most couples will have a private RRSP in addition to CPP. This reduces the impact of contributions to the CPP on the savings decisions of individuals. The CPP is expected to have positive cash flow until 2020, at which point will need to fund an increasing number of retirees, but it is still expected to be sustainable until at least 2085. It would be inappropriate to estimate individual contributions to CPP without accounting for future benefits, so CPP contributions have also been excluded. Finally, the contributions to EI and CPP provide a tax credit against personal income taxes to avoid double taxation. Any benefits received from the two programs are considered taxable income, even though EI payments may fall into a low-income tax rate and CPP taxes are paid in the future. These tax credits are also excluded from the analysis.

<sup>3</sup> Reasons for excluding Employment Insurance and Canada Pension Plan contributions are located in Box 1.

<sup>4</sup> All tax calculations were done using Kevin Milligan's Canadian Tax and Credit Simulator (CTaCS) for the 2011 tax year. See Kevin Milligan, *Canadian Tax and Credit Simulator (2012)*. Database, software and documentation, Version 2012-1.

In addition to the simple progressive income tax scale, shown in Table 1, a series of tax credits and transfers lower each individual's tax burden. Each individual is given a basic personal exemption of \$10,822 of income in 2012, to reduce the tax payable for an individual. The basic personal amount is multiplied by the lowest tax bracket, 15 per cent, for a tax credit of \$1,623.30. If an individual's income does not exceed the basic personal exemption amount, she can transfer the unused portion to her spouse. Individuals also receive a credit for their first \$1,095 in employment income, and low-income families are entitled to a GST/HST credit and Working Income Tax Benefit. The GST/HST credit is \$260 for each parent and decreases as income exceeds \$33,884 in total family income. The Working Income Tax Benefit is a refundable tax credit provided to families with income above \$3,000, which begins to be clawed back when income reaches \$15,205, hitting zero when family income is above \$26,952. Each of these credits are either transferable between spouses, or adjusted for total family income, so that the total tax burden of the two families are virtually identical until the single-earner family hits a higher tax bracket. As total family income climbs, the difference in tax payments increases substantially. At a total family income of \$70,000, the single-earner family will pay \$2,075 more in federal tax, 30 per cent more tax than the comparable two-earner family. In fact, the single-earner family pays as much tax as a dual-earner family making \$84,000. A single-earner family making \$120,000 pays as much tax as a dual-earner family making \$141,000.

**FIGURE 1: TOTAL FEDERAL TAX BURDEN FOR COUPLES WITH NO CHILDREN**



**TABLE 1: FEDERAL INCOME TAX BRACKETS AND TAX RATES BY INCOME CATEGORY FOR 2011**

Income	Tax Rate
Up to \$42,707	15%
Between \$42,707 and \$85,414	22%
Between \$85,414 and \$132,406	26%
Above \$132,406	29%

As the Conservative government's proposal for income splitting is focused on families with children, we now reconsider the tax burden of the two families above, but with the addition of each family having a young child as a dependent.<sup>5</sup> Families with children receive other tax benefits so they have more disposable income to raise their children. Many of the available credits are based on total family income, and therefore do not discriminate on the basis of earnings disparity within a family. The GST/HST credit increases by \$137 for each child in the family, but is clawed back at the same total family income as adults. There is a transferable dependent child amount of \$2,191, resulting in a tax credit of \$328.65 (15 per cent x \$2,191) to reduce the payable tax of either spouse. The Canada Child Tax Benefit (CCTB) and the National Child Benefit Supplement (NCBS) are non-taxable payments paid to families with children under the age of 18. The Canada Child Tax Benefit is a basic benefit of \$1,405 paid for each child of a family (with a supplement for families with more than two children), while the National Child Benefit Supplement is \$2,177 for the first child, and smaller benefits for each additional child. The benefits for the Canada Child Tax Benefit decrease if adjusted net family income exceeds \$42,707, and the National Child Benefit Supplement decreases above adjusted net family income of \$24,863.<sup>6</sup> As these benefits are either transferable or tied to family income, the amount received by families does not depend on the income disparity between spouses.

Two particular benefits are taxed differently based on the income disparity of couples, as both accrue to the lower-income earner. The first is the Universal Child Care Benefit (UCCB), an income supplement of \$1,200 per year, taxable at the tax rate of the lower-income earner. The benefit provides a slight advantage to families with income disparity, as the lower-income earner may not be in a tax-paying position. It only becomes a disadvantage for a dual-earner family when both earners are above the lowest income tax bracket. When an earner is in a higher tax bracket, say 22 per cent, the Universal Child Care Benefit will increase the tax burden of the dual-earner family relative to the single-earner family by the difference between the relevant tax bracket and the minimum 15 per cent bracket, or  $(22 \text{ per cent} - 15 \text{ per cent}) \times \$1,200 = \$84$ .

The second tax benefit causing a tax difference based on the earnings of spouses is the child-care expenses deduction. This deduction lowers the taxable income of the lower-income spouse. Families can claim up to \$7,000 in expenses for daycare, boarding school and day camp. Unlike the Universal Child Care Benefit, the child-care-expenses deduction is more likely to decrease the tax payable by a smaller amount in families with a large earning disparity between spouses. In the case of true single-earner families, the lower-income earner will not be in a tax-paying position and the family will not be able to claim child-care expenses. Though the child-care-expenses deduction is potentially quite large, few families are able to make use of the full deduction, and different family types will differ in their usage of the deduction. Stay-at-home spouses are able to trade off some household work or leisure to provide some additional child-care, while a dual-earner household is likely to have less ability to alter its work schedule to accommodate child-care during the day. Vincent and Woolley<sup>7</sup> look at the

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<sup>5</sup> Some tax benefits are maximized for children under six.

<sup>6</sup> Adjusted net family income is total family income excluding the Universal Child Care Benefit, which is discussed in the next section.

<sup>7</sup> Carole Vincent and Francis Woolley, "Taxing Canadian Families: What's Fair, What's Not", *IRPP Choices* 6(5) (2000): 1-44.

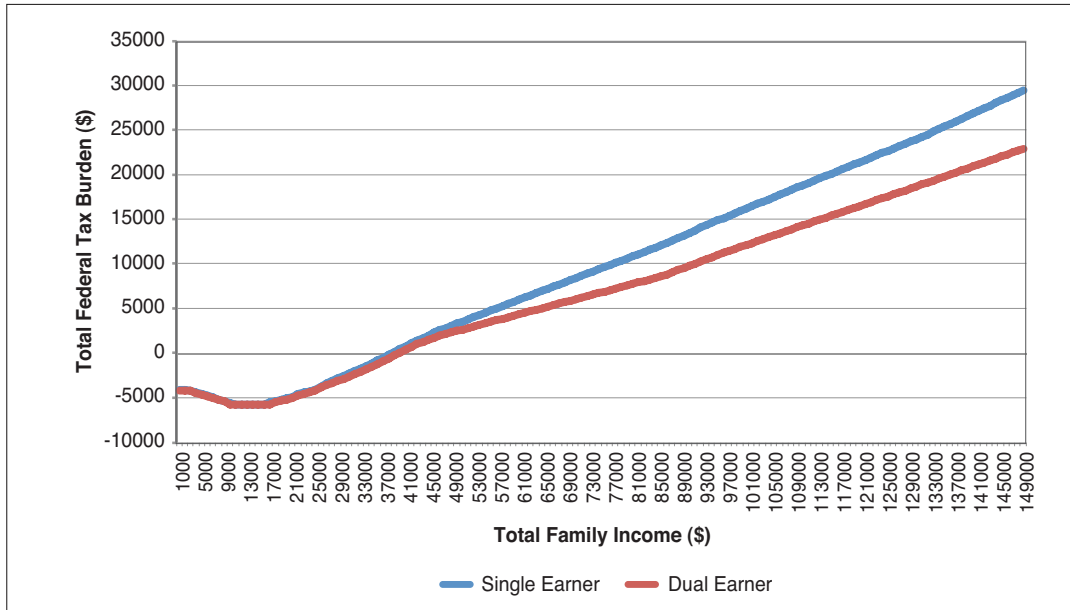
distribution of child-care expenses by family income and earner type. They find that few families claim the full amount of the expense deduction, with the average expense claim being \$1,620 per child. Dual-earner families also claim an overwhelming proportion of total child-care expenses. Dual-earner couples comprise 59.4 per cent of all families with children, but claim 83.5 per cent of all child-care expenses. Single-earner couples represent 20.8 per cent of the total families with children, and claim only three per cent of the total child-care expenses. With average full-day child-care costs exceeding \$600 a month across Canada,<sup>8</sup> it is apparent many families do not claim their full eligible expenses. To adjust for differences in child-care expenses, we use data from Statistics Canada's Social Policy Simulation Database and Model (SPSD/M) to estimate the average claimed child-care costs for each family type. The SPSD/M takes survey data from the Survey of Household Spending and matches families to T1 tax filings to provide a representative sample of Canadian households. To get acceptable data observations on child-care costs, we treat two-parent families where the lower-income earner makes less than 15 per cent of the household total income as single-earner households, and families where the lower-income earner made more than 40 per cent of the family income as dual-earner households. Observations of families with child-care and non-zero child-care expenses were binned into \$20,000 income brackets. The median per-child child-care costs and median total family income for adjacent bins were then taken and scaled by income to plot the estimated child-care costs for the full income distribution. Child-care costs rise with income, and dual-earner families always claim higher expenses for each income level.

The tax burden of the two family types including these additional child tax benefits is shown in Figure 2. The child-related tax benefits decrease the tax burden of both families by a substantial amount. At \$70,000, the tax burden of a single-earner family decreases by \$890, though the tax-burden difference between the single- and dual-earner families increases by a couple of hundred dollars to \$2,190. At a family income of \$120,000, the tax burden of the single-earner family is higher than a dual-earner family by \$4,800. Due to the increased tax-deductible expenses on child-care incurred by the dual-earner households, this is not surprising. A single-earner family may supply much of its child-care through at-home child-care, which is unpaid, and therefore untaxed, work. An equitable tax structure should account for the differences in expenses and unpaid work of both families, a discussion that is saved until after we take a look at how income splitting would affect the tax burden of families.

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<sup>8</sup> Gordon Cleveland, Barry Forer, Douglas Hyatt, Christa Japel, and Michael Krashinsky, "New Evidence About Child Care in Canada: User Patterns, Affordability and Quality," *IRPP Choices* 14(12) (2008): 1–30.

**FIGURE 2: TOTAL FEDERAL TAX BURDEN FOR COUPLES WITH A CHILD**



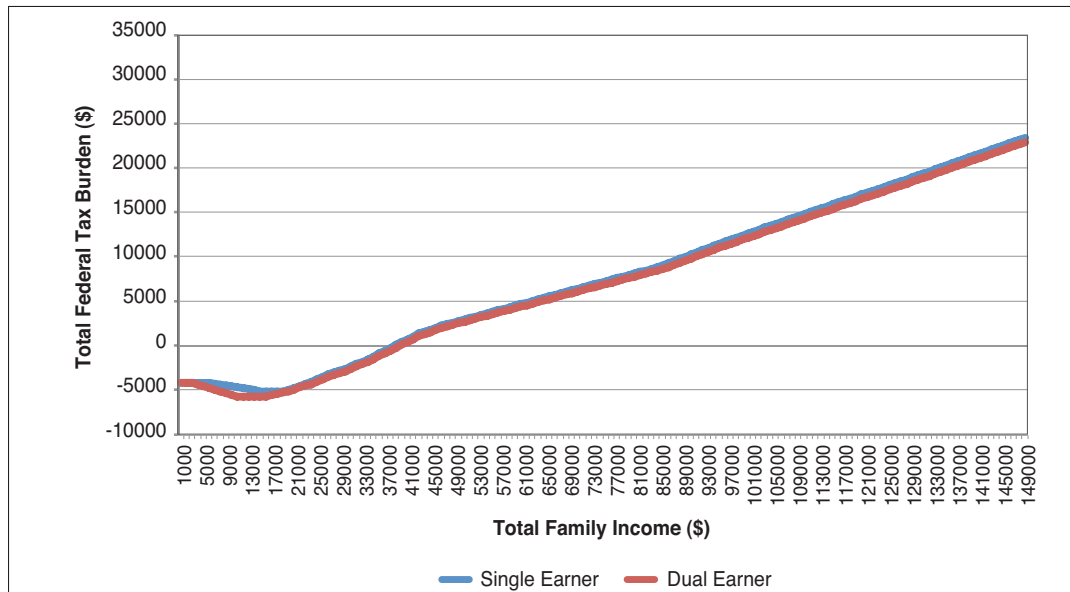
## HOW WOULD INCOME SPLITTING WORK?

In proposing its income-splitting plan, the Conservative government was not clear on the exact details. What it proposes is that families with children under the age of 18 would be able to shift up to \$50,000 of income to lower their tax burden. The Conservatives did not specify what types of income would be able to be shifted, or if there would be any other adjustments made to the tax system. As such, in order to provide estimates about the effect of such a plan, some further assumptions must be made. We assume that all types of income may be shifted and that income is shifted at the time of tax filing, making the original earner liable for all EI and CPP payments on their own income. All other taxes and credits are determined on the net income of the individual after income is split between spouses.

As all income from our hypothetical families comes from wage income, and EI and CPP are excluded, the only tax difference we will observe between a couple splitting income at the end of the tax year versus a couple making equal employment income are their differences in child-care expenses and the employment tax credit (if the lower-income spouse earns less than \$1,095, as in our extreme single-earner case). The effect of the income-splitting proposal can be seen in Figure 3. The curves only diverge when the single-earner family income exceeds \$100,000 in income, reaching the limit of income splitting, while the small differences up to this point are due to child-care expenses and the employment income tax credit.



**FIGURE 3: TOTAL FEDERAL TAX BURDEN FOR FAMILIES WITH A CHILD, UNDER INCOME SPLITTING**



## HOUSEHOLD WORK AND IMPLICIT INCOME

Under the proposed federal income-splitting policy, the tax burden of two families will be virtually identical throughout most of the income distribution, regardless of how the income earning is split between couples. An equal tax burden for these two families would appear to generate an equitable outcome — but are these families truly identical? An issue touched on previously is the difference in time-allocation between family types. The single-earner family has one worker working a single full-time job, with the other providing additional home production over what the dual-earner family provides — unless the single-income family’s sole earner is working an equivalent number of hours as the two earners in the dual-income family (i.e., the single-income earner is working two full-time jobs, or the equivalent thereof). The single-earner will have a higher wage rate, and, when there is no income-splitting for tax purposes, the home production of the stay-at-home spouse may be implicitly taxed through the rate on the single-earner’s market income.

As the difference in tax burden increases as family income increases, implicitly taxing the household production of a spouse would only be appropriate if the home production of the spouse increases along with the income of the working spouse. Instead, empirical work on time use has found home production to be uncorrelated with family income, and can be considered a lump-sum transfer to money income.<sup>9</sup> The value of this transfer will depend on the employment status of the adults in the household and whether they have children or not. Using data from the General Social Survey on time use and the Census of Population, Statistics Canada<sup>10</sup> attempted to quantify the value of home production for different individuals by measuring the replacement cost of unpaid work.<sup>11</sup> The study found the average value of unpaid

<sup>9</sup> Harley Fazis and Jay Stewart, “How Does Household Production Affect Earnings Inequality? Evidence from the American Time Use Survey,” BLS Working Paper No. 383, U.S. Bureau of Labor Statistics, 2006.

<sup>10</sup> Statistics Canada, “Households’ Unpaid Work: Measurement and Valuation,” *Studies in National Accounting*, No. 3. Catalogue No. 13-603-MPE1995003, Ottawa, 1995.

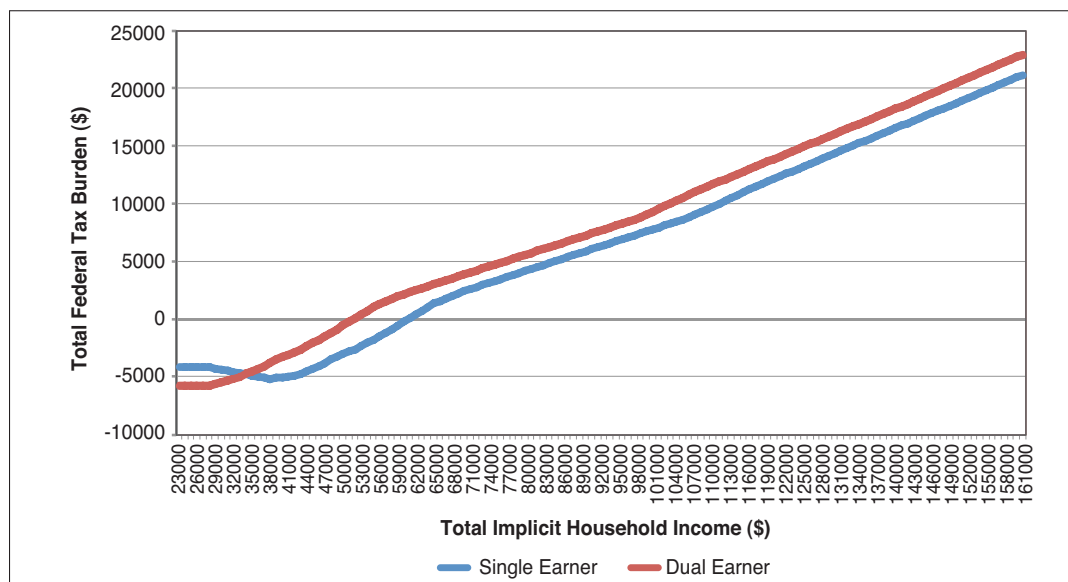
<sup>11</sup> Another approach is calculating the opportunity cost of a stay-at-home spouse, which is less precise as it is difficult to determine market alternatives for stay-at-home parents.

work of a stay-at-home wife without children is \$25,836, a premium over an employed wife of \$11,012.<sup>12</sup> Stay-at-home wives also provide more unpaid child care than employed wives, and employed husbands with children provide more household work than those without children.

Accounting for the total income of the two families with children requires some consideration to avoid double counting income or misrepresenting shifts in time allocation. Single-earner couples do not claim as much in child-care expenses as dual earner-couples do, and claimed child-care spending is not a reflection of the total costs of raising children. Both parents, in both households, will provide at-home child care, adding to the unpaid work done in the household. To account for the change in income from raising a child, we subtract both paid child-care expenses and the difference in home production between parents with a child and those without, as this home production comes at a cost to the additional leisure time or other household work. This is, in a sense, the motivation behind the child-care-expenses deduction: as household child-care is tax-free, so too are the daycare expenses of working couples. We further assume that all other costs of raising a child, such as food, shelter, and clothing, are equal across family types.

Including this implicit income allows for a comparison in the total household after-tax income and child-care costs of both families. A comparison of the total taxes paid based on implicit income is shown in the figure below. Without any further adjustments, income splitting would provide a substantial tax break for single-earner families. Yet, income splitting results in a remarkable change in the difference in tax burden: above what is a market income of \$52,000 the difference in tax burdens is relatively stable at around \$1,700. A majority of this difference is due to the transferability of the basic exemption (or the spousal allowance). A single-earner family is able to claim two basic exemptions, meant to account for the fact that even though a stay-at-home spouse provides additional production, it does not result in additional disposable income.

**FIGURE 4: TOTAL FEDERAL TAX BURDEN FOR FAMILIES WITH A CHILD, UNDER INCOME SPLITTING (IMPLICIT INCOME)**



<sup>12</sup> All values are converted into 2011 dollars. This does not account for changes in hours worked from 1992 to 2011, nor does it account for changes in wages in excess of inflation to 2011. It is not possible to determine the amount of household work provided by an individual given whether his or her spouse stays at home or not. It is also split only between employed and unemployed and is not adjusted for the hours worked by an employed spouse. Replacement cost is uniform for all income levels. The stay-at-home spouse was chosen to be a woman to maximize home production and match data more closely.

Though the tax burden swings in favour of single-earner families under an income-splitting system, it is simpler to adjust for this difference using other policy instruments. To compensate dual-earner families for the lack of implicit household income, the tax system should allow a greater benefit to those families in a simple way: eliminating the transferability of the spousal allowance for couples choosing to split income and requiring it to be used to reduce employment income instead. This would require each spouse to earn income to use the full basic exemption, converting the exemption into an employment tax credit only for those couples splitting income. Coupled with income splitting, this shift would cover most of the difference in implicit household income between family types. As the main difference in tax burden is due to single-earner families being able to produce more untaxed work at home, conversion to an employment tax credit would allow for more untaxed labour-market income from secondary earners.

The ability to use this tax exemption would optimally be tied to the amount of hours worked in the labour market, not the market income of the individual. Since the household production of an individual depends mainly on the time allotment, and not the employment income, of the family, only individuals who have worked significant hours in the labour force should be eligible to claim this exemption. This would be to prevent an individual from working a very high wage for a short period of time, claiming the full credit, and then retreating home to provide additional household production. Although the personal income tax is applied on the total annual income of individuals instead of the hourly wages, implementation could follow in a similar manner to the way insurable working hours are used to define employment insurance benefits. Implementing a tax credit on the annual income of an individual could be used for tax avoidance, but this is likely to be confined to groups that are already able to shift income through non-wage income, such as dividends.

Requiring sufficient employment hours as a condition for using the credit would also limit a potential negative effect of income splitting with regard to second-earner labour force participation. The benefit of income splitting is to decrease the marginal tax rate of the higher-income earner. A consequence of lowering the marginal tax rate on a higher-income earner is to increase the marginal tax rate of the lower-income earner. This has two counteracting effects. Lowering the higher-income earner's marginal tax rate increases their incentive to work more, as they are able to keep a larger portion of their earnings. However, a downside is that it lowers the incentive for the lower-income earner to work longer hours, or may dissuade them from entering the labour force entirely. Empirical work has found that primary earners are not very responsive to tax changes in their labour hours due to mandated working weeks. But secondary earners, particularly women, are far more responsive to changes in tax rates in their choice of labour hours and their choice whether to enter the labour market.<sup>13</sup> This effect would be an argument in favour of a lower tax rate on the second earner to encourage them to enter the labour force — not a higher tax rate, as income splitting would impose. In fact, recent literature on the optimal income taxation of couples finds that the optimal taxation of couples should feature a quality called “negative jointness,” where the tax rate on the secondary earner actually decreases as the income of the primary earner increases.<sup>14</sup>

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<sup>13</sup> See Michael P. Keane, “Labor Supply and Taxes: A Survey,” *Journal of Economic Literature*, Vol. 49(4) (2011): 961-1075.

<sup>14</sup> In this model, secondary earners make a discrete choice between working or not. The decision to work acts as a signal of low work-costs, suggesting that a positive tax rate on secondary earners is optimal to facilitate some redistribution. As the contribution of the secondary earner to total household welfare decreases as the income of the primary earner increases, the value of redistributing from dual-earner households to single-earner households also decreases. See Henrik J. Kleven, Claus T. Kreiner and Emmanuel Saez, “The Optimal Income Taxation of Couples,” *Econometrica*, 77 (2009): 537-560.

Current tax systems with means and family-tested income transfers, along with individual taxation, satisfy this “negative jointness” characteristic. Immervoll et al.<sup>15</sup> find that the potential efficiency gains from lowering the tax rate on secondary earners even further would result in large potential welfare improvements in 15 European countries. Moving to a full family taxation system would instead be a move towards “positive jointness” as the marginal tax rate on the secondary earner changes to equal to the marginal tax rate of the primary earner.

However, the current tax credit system has already made a sizeable distortion in the labour-market decisions of earners and has already made their labour decisions “joint.” This is another issue of a couple being eligible to claim two basic deductions regardless of how their income is earned. If both parents work, then they each claim the basic deduction; but if only one works, or is unable to claim the full deduction, this amount is already transferred to the other spouse. Thus, if the primary earner makes more than double the basic amount, or \$21,644, the marginal tax rate on the secondary spouse is zero only on their first \$1,095 of income, and 15 per cent on any income above this level. Removing transferability on income-splitting couples will allow individuals to work tax-free for their first hours, and lower the average tax rate of individuals entering the labour market, increasing their incentive to work.

An argument against means-tested transfers and joint taxation has centred on the decisions of marriages and the presence of tax “penalties” and “subsidies” applied to marriage or cohabitation between individuals. An individual-based tax system would not affect the tax burden of two individuals, regardless of whether they live together or not, but for equity reasons no tax system fully uses this principle in reality. With family-income-tested transfers present in Canada and much of the world, combining the income of two individuals often lowers the amount of eligible tax credits available for lower-income households, and results in a higher tax burden than if the partners filed separately; this is known as the “marriage penalty.”

In Europe, the “marriage penalty” can be significant. Immervoll et al. also calculate the change in after-tax income of couples at different income percentiles. Though Germany, Italy and Spain’s tax systems respond relatively neutrally to marriage, the after-tax income of couples can decrease by 20,780 euros (C\$28,096) for high-earning couples with high income disparity in the United Kingdom, and can even be over 14,000 euros (C\$18,928) for couples with a sole earner making the average national income in Sweden. In virtually all cases, the decrease in income is greater for couples with high income disparity than for those with even incomes. Canada’s use of family-means-tested transfers results in a similar marriage penalty, but not to the degree seen in parts of Europe. We estimate the marriage penalty for a dual-earner family making the median family income to be slightly above \$4,000, and less for couples with higher income disparity.

Couples with income disparity receive an income-splitting benefit from marriage, lowering this marriage penalty. With our adjustments to the use of the basic exemption, the effect of income splitting makes the tax system relatively neutral to marriage decisions, but high-income couples with a large income disparity will begin to receive more benefit than non-cohabitated couples.

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<sup>15</sup> Herwig Immervoll, Henrik J. Kleven, Claus T. Kreiner and Nicolaj Verdelin, “An Evaluation of the Tax-Transfer Treatment of Married Couples in European Countries,” OECD Social, Employment and Migration Working Papers No.76, OECD Publishing, 2009.

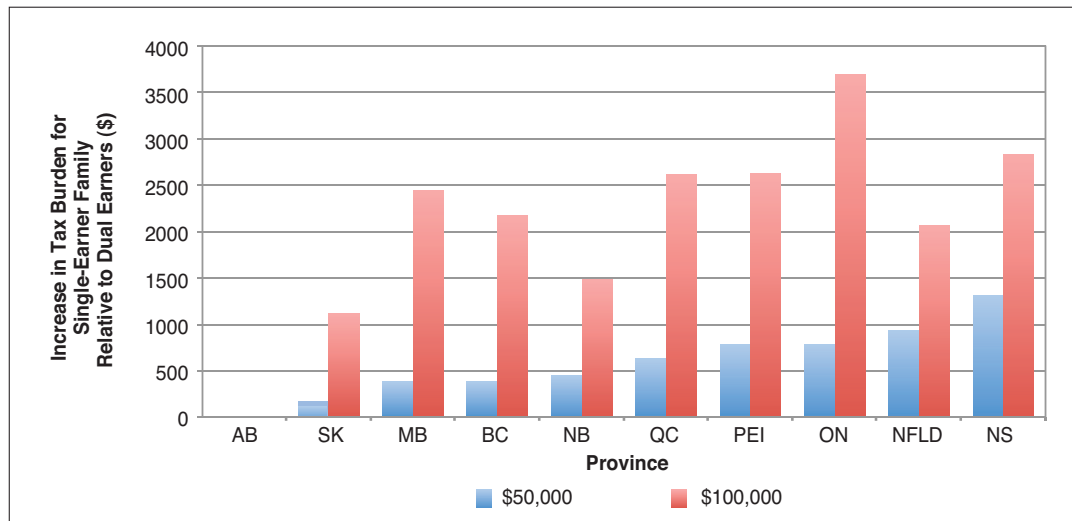
Finally, the ability to split income would lower the tax burden of couples living together, which could affect equity between family types. Currently, the tax burden of a single parent with a child is similar to a couple with a stay-at-home spouse and a child. A single parent is able to claim the equivalent-to-spouse allowance on their dependent child, which is equal to the regular spousal allowance at the federal level and in almost all provinces. A single parent will always be able to claim child-care expenses against their taxes by being the lowest income earner by default. They do, of course, have to pay taxes on the Universal Child Care Benefit at the higher rate as well. Combining these benefits together makes the difference between a single-earner family with two heads of household, and a single-parent family, negligible, though this overlooks important unpaid work at home. Allowing income splitting for couples without also extending this ability to a single parent would be unfair. Extending income splitting to any equivalent-to-spouse would provide single parents more disposable income and maintain tax equity between these family types.

## **PROVINCIAL AND TERRITORIAL CONSIDERATIONS**

With the federal government collecting income taxes for the provincial government under the tax collection agreements, most Canadian provinces maintain an identical definition of personal income to that of federal government. Though it is possible that the provinces will not enact legislation to mimic the federal Conservative government's income-splitting proposal, it is worth looking at the effect this policy would have across provinces. Figure 5 shows the difference in the provincial tax burden between single- and dual-earner families at different family income levels, excluding child-care expenses. Most of the differences in tax burdens hinge on the progressivity of the provincial tax schedules. The effect of an income-splitting proposal will have the smallest effect in Alberta, which has a flat personal income tax rate of 10 per cent. The Atlantic provinces have higher personal tax rates, so the effect of income splitting is large for modest levels of income. But the greatest impact from income splitting would happen in Ontario, which has the most progressive system due to additional surtaxes.

A number of provinces and territories have similar child tax-credit systems to those of the federal government. Saskatchewan and Yukon have similar dependent-child tax credits matching the \$2,000 basic child amount, which amounts to \$623 in Saskatchewan and \$154 in Yukon. Prince Edward Island, Nova Scotia and the Northwest Territories have child credits for children under the age of six. Each of these is available only to the lower-income-earning spouse and are non-transferable except for the Northwest Territories credit. Quebec has a child-care expense credit of its own, which has a maximum of \$9,000 for young children, and is applied at a decreased credit rate based on total family income. Quebec also offers a subsidy for daycare and at-home care, at \$7 a day per child.

FIGURE 5: PROVINCIAL TAX DIFFERENCES BY INCOME LEVEL



## HOW DOES CANADA COMPARE?

In a CESifo DICE report,<sup>16</sup> the tax burden of couples with different income disparities is calculated for each OECD country. The report calculates the percentage difference of net transfer to the government (net taxes after transfers) for couples with even dual income, and couples with a single earner, for couples making 133 per cent of the average family income for each country. Canada is slightly above the OECD mean, with a 24 per cent difference between the two types of couples.<sup>17</sup> Italy is the only G7 country with a larger gap between couples, at 27 per cent, and the United Kingdom's gap is slightly smaller than Canada's, at 20.8 per cent. Three of the other G7 countries — Germany, France and the United States — have joint taxation for either married couples or families, and have either no benefit to dual earners, or a marginal benefit to single-earner families. Yet the DICE report argues that this difference in tax treatment is desirable, as a large tax difference implies the second earner has a greater incentive to enter the labour force. This ratio shows the tax bill between couples, and the overall progressivity of the tax system, but does not help in determining the incentives facing the secondary worker. A higher tax rate on the primary earner would be an indirect and certainly inefficient method to encourage stay-at-home spouses to enter the labour force. A better approach would be to provide an incentive directly targeting the choice to work, and not through the use of higher taxes on the primary earner.

<sup>16</sup> CESifo, "Neutrality of Tax Systems", CESifo DICE Report Vol.9(1) (2011): 49-50.

<sup>17</sup> This value is very similar to the estimates in this paper. The estimates presented in the introduction show how much more a single-earner family has to pay in tax, while the CESifo paper shows how much less a dual-earner family will pay.

## CONCLUSIONS

Higher-income families pay more taxes, and so, given an income-splitting policy, will receive a larger tax break. This is only because, under the current system, single-earner families have a higher tax burden than dual-income couples with the same household income. Income splitting should not be considered a targeted tax break for high-income families, but, rather, a readjustment of the tax burden between families of higher incomes. The current tax system is unable to provide a level tax burden for similar families with similar means, with the tax burden for single-earner families being higher than a dual-earner family with the same market income.

Current child tax benefits do little to close this gap, causing more of a downward shift in the federal tax burden without accounting for changes in household work with the addition of at-home child-care. Allowing families to split income will even the tax burden between spouses, a mechanism already available for income other than wage earnings. However, simply allowing income splitting will do little for middle-income families, and equalizing the after-tax market income between single- and dual-earner families would ignore differences in time allocation between families. Income splitting would, however, level the tax burden between differently earning family types, allowing for other tax instruments to adjust for differences in implicit income from unpaid home production. Requiring couples splitting income to each earn income in order to use the basic exemption would serve to account for differences in the non-market means of single-earner families throughout the income distribution, and would correct for labour-market distortions that income splitting may impose. Minor changes alongside an income-splitting proposal would make the personal income tax system far more equitable for all families.

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