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Communiqué

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Give moms and dads a tax break, urges C.D. Howe Institute study

Using Canada's tax system as a social policy tool has created unfairness in federal income tax policy, hurting Canadian families, particularly those with children, argues a study released by the C.D. Howe Institute. The authors suggest that providing a universal child deduction would be an important first step toward rectifying tax inequities between different types of families.

The study, *Giving Mom and Dad a Break: Returning Fairness to Families in Canada's Tax and Transfer System*, was written by Kenneth J. Boessenkool, a Policy Analyst at the C.D. Howe Institute, and James B. Davies, Professor of Economics at the University of Western Ontario and an Adjunct Scholar of the C.D. Howe Institute.

Boessenkool and Davies argue that, under the current tax system, couples with a single earner are taxed too heavily relative to couples with two earners, and that a system of joint filing by spouses would go far toward ensuring that the tax system treats different kinds of married couples fairly. Canada has not moved to a joint-filing system in defining taxable income — as France and the United States, for example, have done — in part because of social and economic concerns that have been raised about such a system. Canada does, however, provide social policy transfers on a family basis, thus avoiding paying cash transfers to high-income, single-earner families. Boessenkool and Davies argue that, in the absence of a joint-filing system, the status quo of taxing on an individual basis while delivering social policy on a family basis is an acceptable compromise.

The same cannot be said of the tax treatment of children. Here, Boessenkool and Davies argue, social policy concerns have squeezed out such tax policy considerations as the fair treatment of different types of families. For example, the current tax code treats the choice of middle- and upper-income families to have children the same as a consumer purchase: such couples get the same size of tax deduction for having a child as they would for buying a fancy boat — namely, none. This, the authors say, is unacceptable. Furthermore, the ever-growing deduction for child care expenses means that some middle- and upper-income families with two earners get a large tax reduction for the care of their children, while others, especially single-earner couples, get nothing.

Boessenkool and Davies suggest that Ottawa could reduce such inequities by reintroducing a universal deduction for children. A per child deduction of, say, $2,000 combined

with a reduction in the child care deduction of the same amount would not make any family worse off, while families that now claim less than the maximum child care deduction would get a tax cut. This change would cost Ottawa $3 billion. A universal child deduction, by giving a tax cut to families with modest incomes, would also allow a reduction in punishing marginal tax rates (as high as 65 percent) on many of those families that are a result of the tax code's stacking tax-back rates for child benefits on top of regular income tax and social security contributions.

Boessenkool and Davies show that if, in addition to a universal child deduction, the current refundable child benefit and the child portion of the goods and services tax credit were wrapped together to form a unified child credit that was taxed back at modest income levels at a single rate, marginal tax rates for families earning between $20,000 and $30,000 would fall by between 5 and 20 percent without making any of these families worse off.

The authors argue that, while the tax system has legitimate tax policy and social policy objectives, Canadians deserve defensible and well-designed tax policy as much as accountable and sensible social policy. Universal child deductions and lower marginal tax rates on modest-income families hold out the promise of both.

This is the first in a new series of C.D. Howe Institute Commentaries called "The Taxation Papers." The series deals with the tax policy opportunities presented by the rapidly changing Canadian fiscal environment — in particular, ways to reform personal income tax policy within a sound economic framework, rather than allowing policy to be driven by short-term political considerations. Papers in the series will seek to establish the fiscal room for tax reduction; identify specific problems with past choices about the taxes used to finance government (the tax mix); show how personal income taxes have been or should be adjusted for inflation; estimate the impact of high tax rates on people and on economic efficiency; show how taxes interact with federal and provincial social support programs; and synthesize these issues within a rational framework for tax reform and tax reduction. The series editors are Jack M. Mintz, a professor in the Faculty of Management, University of Toronto, and Finn Poschmann, a Policy Analyst at the C.D. Howe Institute.

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Accordez un allégement fiscal aux parents, soutient une étude de l'Institut C.D. Howe

L'utilisation du régime fiscal du Canada à titre d'outil de politique sociale a créé des politiques d'impôt fédéral sur le revenu iniques, qui nuisent aux ménages canadiens, particulièrement ceux qui ont des enfants, soutient une étude de l'Institut C.D. Howe. Les auteurs proposent, comme première mesure importante pour remédier aux iniquités fiscales entre les diverses catégories de familles, l'établissement d'une déduction générale pour les enfants.

L'étude, intitulée *Giving Mom and Dad a Break: Returning Fairness to Families in Canada's Tax and Transfer System (Accordez un allégement aux parents : comment rétablir l'équité du régime canadien d'impôt et de transfert envers les familles)*, est rédigée par Kenneth J. Boessenkool, un analyste de politique à l'Institut C.D. Howe et James B. Davies, professeur d'économie à l'Université de Western Ontario et attaché de recherche auprès de l'Institut C.D. Howe.

MM. Boessenkool et Davies soutiennent que, dans le cadre du régime fiscal actuel, les ménages dont un seul des conjoints travaille sont imposés trop lourdement par rapport aux ménages dont les deux conjoints travaillent. Une méthode de codéclaration d'impôt veillerait à ce que le régime fiscal traite équitablement les différents types de couples mariés. Le Canada n'a pas encore adopté de méthode permettant la codéclaration des revenus imposables — comme l'ont fait notamment la France et les États-Unis — en partie à cause des inquiétudes sociales et économiques que soulève un tel système. Le Canada prévoit cependant les transferts sociaux en fonction des ménages, évitant ainsi de verser des transferts pécuniaires aux familles à revenu élevé dont un seul des conjoints travaille. Les auteurs soutiennent qu'en l'absence d'une méthode de codéclaration, le *statu quo*, soit d'imposer les particuliers individuellement tout en appliquant les politiques sociales en fonction des familles, représente un compromis acceptable.

On ne peut en dire autant du traitement fiscal des enfants. Selon MM. Boessenkool et Davies, les préoccupations des politiques sociales ont éliminé le traitement fiscal équitable des diverses catégories de familles. Ainsi, le code fiscal traite le choix des familles à revenu moyen et élevé d'avoir des enfants au même titre qu'un achat de consommation : en effet, ces couples jouissent de la même déduction d'impôt pour leur enfant que celle qu'ils recevraient à l'achat d'un bateau de plaisance — c'est-à-dire, absolument aucune. Cette situation est inadmissible, affirment les auteurs. À ceci vient s'ajouter la déduction toujours croissante des frais de garde d'enfant, qui signifie que certaines familles à revenu moyen et élevé dont les deux conjoints tra-

vaillent reçoivent une réduction d'impôt importante des frais de garde d'enfants, tandis que d'autres familles, notamment les couples dont un seul des conjoints travaille, ne reçoivent rien.

MM. Boessenkool et Davies proposent qu'Ottawa remédie à ces inégalités en réintroduisant une déduction générale pour les enfants. Une déduction de quelque 2 000 $ par enfant assortie d'une diminution équivalente des déductions de frais de garde d'enfant ne comporterait d'inconvénients pour aucune famille, tout en faisant bénéficier d'une réduction d'impôt celles qui ne réclament pas la déduction maximale permise pour les frais de garde d'enfant. Il en coûterait trois milliards de dollars à Ottawa pour apporter ce changement. En accordant une réduction d'impôt aux familles à revenu modeste, une déduction générale pour les enfants permettrait également de diminuer les taux marginaux d'imposition excessifs (pouvant atteindre 65 %) qui découlent de l'ajout du taux de récupération des prestations fiscales pour enfants aux cotisations ordinaires de sécurité sociale et d'impôt sur le revenu.

Les auteurs démontrent qu'en plus d'une déduction générale pour enfants, si l'on intégrait le crédit d'impôt pour enfants à la part du crédit de la taxe sur les produits et services qui porte sur les enfants pour former un crédit d'impôt unifié, lequel serait assujetti à un taux de récupération fiscale unique pour les niveaux modestes de revenus, les familles qui gagnent entre 20 000 $ et 30 000 $ constateraient une réduction de 5 à 20 % de leur taux marginal d'imposition, sans subir d'inconvénients.

MM. Boessenkool et Davies reconnaissent que le régime fiscal est assorti d'objectifs de politique fiscale et de politique sociale valables, mais que les Canadiens ont droit à une politique fiscale bien conçue et justifiable, au même titre qu'à des politiques sociales responsables et raisonnables. Or, des déductions générales pour les enfants et des taux marginaux d'imposition réduits pour les familles à revenu modeste répondraient à ces deux critères.

Ce document marque le premier volet d'une nouvelle série de Commentaires de l'Institut C.D. Howe intitulée « Les cahiers de la fiscalité ». Elle traitera des possibilités de politiques fiscales qu'offre la situation fiscale en évolution rapide au Canada — et plus particulièrement, des moyens de réformer les politiques de l'impôt sur le revenu des particuliers dans un cadre économique rationnel, plutôt que de laisser des raisons politiques à court terme dicter ces politiques. Les documents qui font partie de cette série chercheront notamment à établir la marge fiscale pour une réduction d'impôt, cerner les problèmes exacts qu'ont posé les choix de taxes et d'impôt pour financer le gouvernement dans le passé (soit la composition des recettes fiscales), démontrer comment rectifier l'impôt sur le revenu des particuliers pour tenir compte de l'inflation, établir les répercussions des taux d'impôt élevés sur les particuliers et sur l'efficience économique, démontrer l'interaction des taxes et des programmes d'aide sociale provinciaux et fédéraux, et mettre en rapport tous ces problèmes dans un cadre rationnel pour la réforme fiscale et la réduction des impôts. La série est dirigée par Jack M. Mintz, professeur à la faculté de Management à l'Université de Toronto, et Finn Poschmann, un analyste de politique auprès de l'Institut C.D. Howe.

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Giving Mom and Dad a Break:

Returning Fairness to Families in Canada's Tax and Transfer System

by

Kenneth J. Boessenkool
and
James B. Davies

Canada's income tax system, unlike the systems of some other Group-of-Seven countries, requires filing by individuals, rather than couples. Yet the personal income tax is increasingly integrated with social programs that take account of family status. Does this inconsistency make sense, or should Canada switch to having couples file jointly?

Joint filing would offer some improvements in the horizontal equity afforded couples versus singles and one-earner versus two-earner families. It would also integrate tax and social policy. However, economic, administrative, and social objections to joint filing are significant. Thus, the status quo of taxing on an individual basis but delivering social policy on a family basis is defensible.

The same cannot be said of the current *Income Tax Act*'s treatment of children. Social policy concerns for them have squeezed out tax policy considerations, such as maintaining equity between single-earner and two-earner families and providing universal recognition for the nondiscretionary expenses of raising children.

The solution is a universal deduction for children. Further improvements in equity could be made without increasing anyone's tax burden if this universal deduction was accompanied by a similar-size reduction in the child care expense deduction.

Main Findings of the Commentary

- The "take" portion of Canada's tax system (the revenue-raising part) assesses tax on a individual basis, while the "give" portion (the many spending programs associated with the *Income Tax Act*) calculates benefits on a family basis.
- Is this inconsistency defensible? A switch to joint filing by couples, which would be generally equivalent to using the family as the basis of taxation, would repair some inequities in the current system, such as the fact that dual-earner couples with high incomes pay less tax than single-earner couples at the same income level. It would also tend to increase redistribution to lower- and middle-income single-earner couples, encourage more rational splitting of capital incomes, and clear up the inconsistency of subjecting low-income single-earner couples to tax while simultaneously providing social benefits. Nevertheless, these advantages of joint taxation would be outweighed by various economic and social disadvantages.
- The case is stronger for continuing to base social benefits on the family, which is the only way they can be targeted to those who are truly poor.
- Social policy concerns have, however, squeezed out tax policy concerns in the *Income Tax* Act in the treatment of families with children.
- Current Canadian tax policy affords no universal recognition of children. In effect, it treats children in middle- and high-income families like consumer spending, as if parents had no legal or moral obligation to spend money on their care.
- This treatment is indefensible. Some of any family's spending on children is nondiscretionary and should be omitted from the tax base. The amount omitted should be the same for all taxpayers, a goal that can be accomplished only by a deduction from taxable income, not a tax credit.
- The obvious way to achieve this goal is to reinstate a universal deduction for dependent children. Only in this way can the tax system ensure horizontal equity between families with and without children at all income levels.
- A universal child deduction would also make more palatable to other taxpayers the deduction dual-earner parents and working single parents can now take for child care.
- A universal deduction of $2,000 per child would cost Ottawa about $3 billion. A small reduction in this cost and a further improvement in horizontal equity between single- and dual-earner families could be achieved by lowering the child care expense deduction by an equal amount. This policy would have no impact on dual-earner families that currently claim the maximum child care deduction (they would obtain the same amount from the new child deduction), and families that do not now claim the maximum would receive a tax cut.
- That tax cut would create some room to lower the taxback thresholds and taxback rates now imposed on modest-income families who receive social benefits. Specifically, we suggest combining the current Canada Child Tax Benefit and the child portion of the goods and services tax credit and imposing a modest taxback for family incomes over a low threshold.

Thirty-two years ago, the Royal Commission on Taxation (known as the Carter Commission, after its chairman, Kenneth Carter) made its recommendations on reform to the Canadian tax system. One was that the basic unit of taxation be the family rather than the individual. The commission's rationale — indeed, its entire tone on the topic — is summarized in the following:

> We believe firmly that the family is today, as it has been for many centuries, the basic economic unit in society. Although few marriages are entered into for purely financial reasons, as soon as a marriage is contracted it is the continued income and financial position of the family which is ordinarily of primary concern, not the income and financial position of the individual members. (Canada 1966, 123.)

The Carter Commission's recommendations regarding the unit of taxation were not heeded. Even today, the Canadian tax system continues to treat the individual as the basic unit for tax purposes. Further, support for taxation on the basis of family is often derided as a quaint idea whose time is now past.

That judgment may be too simplistic. The principles of joint taxation of spouses provide a useful benchmark to evaluate the current treatment of different types of families and individuals. Moreover, although the part of the tax system that raises revenues (the "take" portion) assesses tax on an individual basis, the many spending programs associated with the *Income Tax Act* (the "give" portion) calculate payouts on a family basis.

The purpose of this *Commentary* is to ask whether the inconsistency between the "take" and "give" parts of the tax system is defensible. Does it make sense to have rate schedules, deductions, and credits that, for the most part, ignore the family status of taxpayers, while programs such as the Canada Child Tax Benefit (CCTB), the goods and services tax (GST) credit, and the guaranteed income supplement (GIS) take full account of family status? (Other programs, such as employment insurance and the Canada and Quebec Pension Plans, have features based on the family. We omit them from the discussion here primarily because of their more tenuous link with the tax system.)

The study is divided into four parts. The first considers the tax treatment of married couples, describing theoretical alternatives, and briefly outlining Canada's current policy environment as well as what other Group-of-Seven (G-7) countries do. In the second part, we evaluate the alternatives, and provide recommendations for future tax policy.

We then follow a similar pattern for considering the role of children in the tax system. The third part examines theoretical alternatives as well as current policies in Canada and elsewhere. Then we evaluate the alternatives and make some proposals for change.

We conclude that, although joint filing has some attractions on equity grounds and provides a useful benchmark in evaluating any tax system, it has drawbacks. The advantages of moving from individual to joint filing in the "take" part of the tax system would be outweighed by its disadvantages, not least of which is the fact that there are more pressing priorities. The "give" portion, however, should continue to use the family as its basic unit.

One pressing priority is the tax treatment of children, in which the status quo is less defensible. Briefly, the lack of universal recognition of children in the tax system produces important inequities. Canada's tax system treats "the costs of raising children [as] simply consumer outlays" (Kesselman 1993, 117). We therefore recommend the reintroduction of universal tax deductions for dependent children.

The Treatment of Married Couples

A fundamental choice in designing a personal tax system is the basic unit subject to taxation.

An important consideration is maintaining, as far as possible, both horizontal equity (that equally situated persons be taxed equally) and vertical equity (that persons with differing ability to pay be taxed in a way that society deems fair).

The Carter Commission's development of its argument for joint filing by spouses begins with the desirability of allocating taxes "in proportion to the 'discretionary economic power' of tax units," and defines that power as the portion of a tax unit's command over goods and services that is not required to "maintain the members of the unit" (1966, 5).

Arriving at the appropriate tax burden for families and individuals requires two steps, according to the commission. The first step is defining the tax base — properly specifying discretionary income or, conversely, ensuring that nondiscretionary income is not subject to taxation.[1]

The second step is determining the progressivity of the tax system — ensuring that those with greater discretionary income pay an appropriate proportion of their income in tax. Both of these considerations come into play when deciding on the best unit for taxation.

Alternatives

The two viable ways of defining the basic unit subject to tax are the individual and the family. Because the analysis in this section ignores, as much as possible, the presence of children (the focus of the second part of the *Commentary*), we here substitute "married couple" for "family" and ask what is the appropriate treatment of individuals and married couples within the tax system.

Individual Filing

If the ability to pay does not vary according to marital status, the appropriate unit of taxation is the individual, and the sharing of expenses or income between individuals (whether married or single) is irrelevant to the determin-ation of tax.

For individual filing, a primary consideration with respect to the tax base is the amount of income to be excluded under the heading of nondiscretionary expenditures. One such category is expenses incurred in earning income. The second is personal nondiscretionary expenditures, which tax systems usually handle by excluding some basic personal amount in addition to other specified nondiscretionary expenses, most commonly those related to healthcare and disability. Exclusions for a child (but not a spouse) could be included in such a system.

With respect to progressivity, the most important consideration is the setting of a rate structure. A system of individual filing requires only one structure, often with a stepped series of rates, and all taxpayers apply it against their discretionary income.

Another progressivity consideration is whether to use deductions (excluding determined amounts of income from total income before applying the tax rate) or credits (subtracting determined amounts from tax payable after applying the tax rate to taxable income). The relationship between the choice of credits or deductions and the rate structure is important. In a tax system with a single rate, it makes no difference whether credits or deductions are used.[2] As a tax structure becomes progressive, however, a system of credits worsens departures from horizontal equity (see Box 1). Moving from deductions to credits increases the progressivity of the tax system for a given rate structure. Alternatively, under a system of deductions the authorities can increase progressivity without sacrificing horizontal equity simply by changing the rate structure (Sayeed 1985; Cloutier and Fortin 1989).

Joint Filing

If married couples share their incomes and expenses within the marriage, this fact affects

Box 1: *Deductions vs Credits: Progressivity and Horizontal Equity*

In a tax system with a progressive rate structure, the choice between deductions and credits affects the level of progressivity and the presence of horizontal equity.[a] Consider, for example, a tax structure with two rates: 25 percent for taxable income below $30,000, and 50 percent for taxable income above that level. Now imagine four taxpayers: Allison who earns $60,000; Brent, who earns $50,000; Darren who earns $30,000; and Carol, who earns $20,000. Allison and Darren both have disabilities that require $10,000 in annual nondiscretionary expenditures.

Thus, Allison and Brent have the same level of discretionary income, and if the tax system is horizontally equitable, they should pay the same amount of tax. The same holds for Carol and Darren. Vertical equity requires that Allison and Brent each pay more tax than Carol or Darren.

If the tax system contains both a personal and a disability deduction, and the latter is large enough to include all $10,000 of Allison's and Darren's disability-related nondiscretionary expenditures, then both horizontal and vertical equity result (see panel A of the table). Allison and Brent each pay in tax the same proportion of their discretionary income (30 percent), and Carol and Darren, who have lower incomes, pay a lesser proportion (25 percent).

If, instead, the tax system uses credits based on converting deductions to credits at the lower tax rate (which is how Revenue Canada converted most deductions to credits 1988), two things happen (see the table, panel B). First, the progressivity of the system increases: the proportion of income that Brent and Allison pay increases, while that for Carol and Darren stays the same. Second, horizontal equity is violated — Allison and Brent no longer pay the same amount of tax.

What if the deductions were converted at the higher rate, as is done with Canada's charitable credit (panel C of the table)? Again, the tax system becomes more progressive; this time, Carol and Darren pay lower proportion of their discretionary income in tax. Horizontal equity is violated for them, though it is restored for Allison and Brent.

Deductions versus Credits under a Progressive Tax System: An Example

	Allison	Brent	Darren	Carol
	(dollars)			
	A. With Deductions			
Total income	60,000	50,000	30,000	20,000
Personal deduction	10,000	10,000	10,000	10,000
Disability deduction	10,000	0	10,000	0
Taxable income	40,000	40,000	10,000	10,000
Tax paid[a]	12,500	12,500	2,500	2,500
	B. With Credits Based on Bottom Rate			
Total income	60,000	50,000	30,000	20,000
Tax before credits[a]	22,500	17,500	7,500	5,000
Personal credit[b]	2,500	2,500	2,500	2,500
Disability credit[b]	2,500	0	2,500	0
Tax paid	17,500	15,000	2,500	2,500
	C. With Credits Based on Top Rate			
Total income	60,000	50,000	30,000	20,000
Tax before credits[a]	22,500	17,500	7,500	5,000
Personal credit[c]	5,000	5,000	5,000	5,000
Disability credit[c]	5,000	0	5,000	0
Tax paid	12,500	12,500	2,500	0

a 25 percent of $30,000 or less and 50 percent of any amount over $30,000.

b 25 percent of deduction amount ($10,000).

c 50 percent of deduction amount ($10,000).

Neither of these credit schemes would raise the same amount of revenue as the deduction scheme; the first would raise more revenue, and the second less. To raise the same revenues, the tax authorities would have to adjust other parameters. If they acted judiciously, they might be able to retain the same level of progressivity (by adjusting tax rates, for example), but no adjustments would exclude the same amount of discretionary income from tax for those paying different marginal rates of tax.[b] A system of credits must sacrifice some horizontal equity.

a Thanks to William B.P. Robson for motivating this discussion; an adapted version appears in Boessenkool (forthcoming). See also Cloutier and Fortin (1989).

b This is true even when credits exist that bear no relation to the existing rate structure, as is the case with the federal political donations credit.

their ability to pay and should, in principle, be reflected in a tax system that is based on the couple, rather than the individual.

A couple and two individuals with the same amount of income do not necessarily enjoy the same standard of living. (Some economists prefer the term “welfare.” We use “standard of living” to emphasize that the utility parents get from having children does not enter into the comparison. Parents voluntarily have children, so presumably their welfare rises when they do so. However, with more individuals sharing the same total income, the real consumption level — the “standard of living” — of each family member must go down.)

Families, of course, come in different sizes. How, then, can the tax authorities (or anyone else) make equitable comparisons of the ability to pay? One way to do so is to use adult-equivalent scales. If, for example, it costs twice as much for two people to enjoy the same standard of living as it costs a single person, the adult equivalent for a couple is 2. If, however, living together offers economies of scale, as is usually assumed, the adult equivalent for a couple is less than 2. In brief, an appropriate measure of a family’s standard of living seems to be its income per adult equivalent: that is, its income divided by its number of members converted to an adult equivalent.

Adul-tequivalent scales are easy to understand and much used in a variety of analyses and program applications. They are, for example, implicit in Statistics Canada’s low-income cut-offs (LICOs), which give the amounts of income needed for families of various sizes to have comparable standards of living, and in provincial welfare rates, which aim to provide basic income for family units of various sizes.

Despite the frequent use of adult-equivalent scales, analysts disagree about how to estimate them and the range of alternative results is wide (Browning 1992). Consequently, a variety of scales is in practical use. Statistics Canada uses a value of 1.36 for a couple (a two-adult family) in its current LICOs, while the average for provincial welfare programs is closer to 2.00. The adult equivalent for a couple in US census poverty lines is as low as 1.25, but the income distribution studies of the Organisation for Economic Co-operation and Development (OECD) use 1.70. (See the appendix to this paper for more on the variety of adult-equivalent scales.)

Clearly, subjective judgment is inescapable in erecting a reasonably fair scale for policy use. Nevertheless, the difficulties of the task should not be exaggerated. Tax systems necessarily make implicit assumptions about adult equivalents in their treatment of units of different size. Take, for example, a decision to tax people entirely on an individual basis. The implicit choice is an adult equivalent of 2 for all couples. In other words, in examining the implicit adult equivalents, one makes explicit and systematic judgments that might otherwise be hidden, weak, or inconsistent. Adult equivalents can thus help to provide useful benchmarks for evaluating any tax system.

Adult Equivalents in Tax Design. Using the adult-equivalent approach in designing a tax system is simple. The first step is to set up the personal deductions, tax brackets, and marginal tax rates considered appropriate for a single individual. The next step is to take one takes an adult-equivalent scale for families of different size and multiply the deductions and thresholds between tax brackets by the applicable adult equivalent.

Figure 1 illustrates the results of applying this procedure in the cases of a single individual and a married couple in a system that has marginal tax rates of zero on the first $10,000 of income, 25 percent on $10,000 to $60,000, and of 50 percent above that point. The adult equivalent for the single person is, of course, 1. For the

Box 2: ***Algorithm for an Adult-Equivalent Tax System***

Assuming that the standards of living of families of different sizes at all income levels can be adequately compared through the use of a single adult-equivalent scale, the following algorithm would ensure that the tax system appropriately accounts for ability to pay:

1. Denote income as Y and the adult equivalent number of family members as A. The family's income per adult equivalent is thus $Y^A = Y/A$.
2. Set the amount of tax payable by an unattached individual as a function of Y^A: specifically, $T(Y^A)$.
3. Charge the family a tax equal to $T(Y^A) \times A$.

This procedure ensures that the family's tax payment, per adult equivalent, is the same as that of an unattached individual with income Y^A. Conversely, the payment of taxes reduces each family member's standard of living by the same amount as that lost by a single individual with an income equal to Y^A.

sake of comparison, we assigned the couple two different adult equivalents: 1.5 and 2.0.

For the couple, the thresholds of the tax brackets are simply multiplied by the value of the adult equivalent. Thus, when the adult equivalent is 1.5, the couple begins to pay tax when its income reaches $15,000 (1.5 × $10,000), and it hits the top tax bracket at an income of $90,000 (1.5 × $60,000).

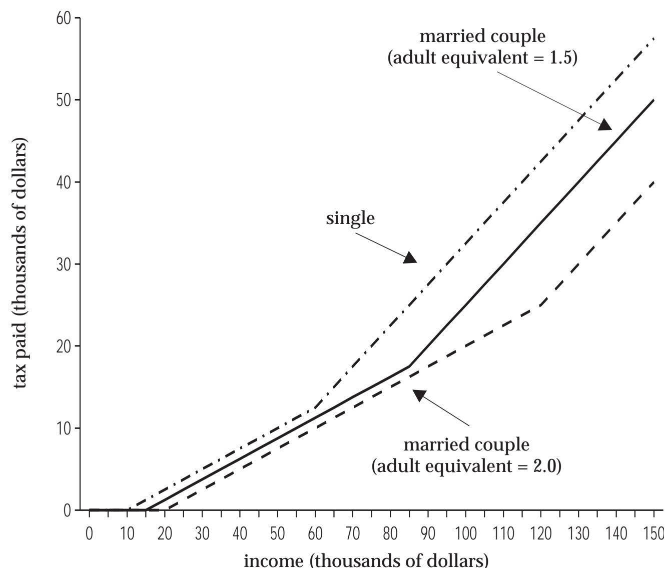
Adult Equivalents in Tax Implementation. The adult-equivalent approach to taxation can be implemented in three ways. One is to publish a single tax schedule and have all families make the following computation when completing their returns:

1. divide the family's income by its adult equivalent to get its income per adult equivalent;
2. consult the tax schedule to see how much a single person with the corresponding income would pay; and
3. multiply the amount in step 2 by the adult equivalent to get the family's tax burden.

This method, which is expressed as an algorithm in Box 2, corresponds to the French system, described later.

A second way to implement the adult-equivalent approach is for the authorities to compute the implied tax schedules for families of all different sizes. Although this method requires a number of published tables, it simplifies completing the tax return, since the tax-payer has only to look up the family's income level in the appropriate tax table in order to compute the tax payment. The Carter Commission followed this approach when it proposed that families be subject to a rate schedule separate from individuals, but it set-

Figure 1: ***Adult-Equivalent Tax Burdens***



Note: See text for assumptions about tax brackets and rates.

tled on two rate schedules (as is done in the Unied States), mostly to keep the tax returns simple.

A third way to implement joint filing, although one that is inflexible in terms of adult equivalents, is to allow income sharing within a system of individual filing. Formally, this approach implements the adult-equivalent approach already sketched but uses an implied adult equivalent of 2 for married couples. In other words, it denies that the economies of scale from living together should be taken into account in setting tax burdens. Two people living together and sharing $100,000 in income pay exactly the same tax as two unrelated single individuals each earning $50,000.

What Canada Does

Canada's tax system operates on both an individual and a family basis. The reason for this dual approach is that the system functions as more than merely a tool for raising revenue to fund government expenditures. For social policy reasons, it also redistributes revenue via transfer payments, many of which are fully intertwined with the tax system itself. But the goals of tax policy and social policy differ in important ways, and using the tax system to achieve disparate goals raises a number of difficulties.

Tax Policy

The "take" part of the tax system uses the individual as the basic unit of taxation. Each individual files his or her own tax return, and only a few explicit provisions exist for income sharing by couples — two exceptions being a credit for non-income-earning spouses and provisions for spousal registered retirement savings plans (RRSPs). Individuals apply a single rate schedule to their taxable incomes without much interaction with spouses or other partners.

One can benchmark the Canadian tax system using adult equivalents. As a married couple's taxable income rises, each of the two goes through a series of taxable income brackets with cutoffs of $29,590 and $59,180 — the same width as those for single individuals.[3] Under the adult-equivalent procedure, a married couple would have wider tax brackets. If, for example, the tax system used an adult equivalent of 1.36 (the value implied by the LICOs), the spouses would not reach the top bracket until their combined income was $80,485.

Consider two kinds of couples: those with one earner and those with two. The basic amount of nontaxable income for a single person in 1997 was $6,456 (the basic personal amount); for a single-earner couple, it was $11,836 (the earner's basic personal amount plus the deduction for a non-earning spouse of $5,380); and for a dual-earner couple, it was $12,912 (two basic personal amounts). The implied adult equivalent for a single-earner couple just on the margin of having to pay tax is, therefore, 1.83 ($11,836/$6,456); for a dual-earner couple, it is 2.00. The full range of the implied adult equivalents is set out in Table 1.

These calculations suggest that, under Canada's individual-based system compared to an adult-equivalent approach, high-income single-earner couples pay too much tax (or low-income single-earner couples pay too little). Further, because dual-earner couples are taxed as if the adult equivalent were 2, single-earner couples pay more tax at all income levels, with the discrepancy rising as income rises. Relative to the implied LICO adult equivalent of 1.36, the scale for single-earner couples implied by the tax system is quite low by the time family income reaches $40,000.

These two results flow just from the structure of credits and rates in Canada. Another important difference between single- and dual-earner couples arises from the value of the additional home time of a non-earning spouse. In some cases, this home time is, of course, in-

Table 1: *Implied Adult Equivalents for Single- and Dual-Earner Couples, Canada, 1997*

Single-Earner Couple			Dual-Earner Couple		
Total Income	Equivalent Single's Income[a]	Equivalent Single's Income[a]	*Total Income*[b]	Equivalent Single's Income[a]	Implied Adult Equivalents
(dollars)		*(value)*	*(dollars)*		*(value)*
11,836	6,456	1.83	12,912	6,456	2.00
20,000	10,900	1.83	20,000	10,000	2.00
30,000	16,700	1.80	30,000	15,000	2.00
40,000	32,200	1.24	40,000	20,000	2.00
60,000	48,500	1.24	60,000	30,000	2.00
100,000	85,800	1.17	100,000	50,000	2.00

[a] The income at which the tax paid by the single, when multiplied by the adult equivalent, equals the tax paid by the couple.

[b] Each spouse earns half of total family income.

Source: CCH 1996.

voluntary and not highly valued, but in other cases, the value of the extra home production and leisure time it generates may be considerable. From the viewpoint of the economist, home production in principle should be taxed in order to achieve horizontal equity. Although dual-earner couples also engage in home production and non-earners often do considerable volunteer work (which one might consider in lieu of tax), the fact that home production is not taxed offsets to some degree the heavier taxation of the cash income of single-earner couples, shown in Table 1.

Finally, we note that, although the adult-equivalent calculations generally hold in Canada for labor income because the system effectively prevents couples from splitting that income for tax purposes, the results may not always hold for capital income.

The use of an individual tax unit requires extensive and difficult-to-enforce provisions to prevent couples from shifting their capital incomes so as to minimize their total tax burden. In Canada, these provisions include attribution rules and the tracking of transfers and loans between partners. But well-advised married partners with substantial financial assets can usually find ways around the spirit of these rules by using, for example, interspousal loans and transfers. At the very least, they can engage in the simple practice of having the lower-income spouse do all the saving and the higher-income spouse pay the household expenses, with net assets accruing over time to the spouse with the lower lifetime labor earnings. Because the individual is the tax unit, capital income can, therefore, be taxed at the lower rate usually applicable to the spouse with the lower income. Thus, for families with the requisite resources or management skills, the taxation of capital income is often effectively joint taxation.

Social Policy

For the most part, the "give" part of the tax system uses the family as the unit of taxation. For example, the GST credit and the GIS for seniors are clawed back through the tax system on the basis of family income. (An exception is Old Age Security; as a result of the cancellation of the proposed family-based seniors benefit, its

transfers will continue to be taxed back on an individual basis.)

The primary goal of such social policy instruments is to redistribute income according to need, which is usually measured by family income. One can view these transfer programs as supplements to, or replacements of, provincial welfare programs that are available to all Canadians.[4]

What Others Do

The number of ways to design a tax system is effectively endless. A brief overview of how G-7 countries treat married couples in their tax systems is indicative of the variety that exists.[5]

France

In France, income tax is levied on fiscal households. Couples are jointly liable for the payment of the tax assessed on the total income of the family unit, which comprises husband, wife, and dependent children but may be made up of only one person who is single, divorced, or widowed.

The French system is based on adult equivalents. The husband and wife count for one adult equivalent each, so all couples have an adult equivalent value of 2. Taxable income is divided by the adult equivalent corresponding to family size and composition to arrive at an amount of income per adult equivalent. Income tax is computed on this income per adult, and the result is multiplied by the appropriate adult equivalent to obtain tax payable.

The French coefficient system effectively limits the effect of the progression of tax rates (look back at Figure 1).

Germany

Under German tax law, a husband and wife may file a joint assessment, which reduces rate progression. Tax assessment is based on 50 percent of the couple's total taxable income, with the resulting value multiplied by two to arrive at tax payable. A married couple may, however, elect to be assessed separately, in which case each must file his or her own income tax return.

Each taxpayer has a personal allowance, which is doubled when married couples file jointly. The result is that a married taxpayer filing jointly pays no income tax unless the couple's income is more than four times the minimum for a single person. Except for this doubling of the personal allowance, the German system applies the adult-equivalent system, with couples' having a value of 2.

Italy

The family unit is not used in Italian tax law. Each spouse has a distinct and separate tax obligation. Instead of personal allowances or deductions, Italy offers amounts that can be credited against the gross tax due. The credit for a dependent spouse is eight times as large as the credit for each dependent child. Tax credits for dependants are available only if the persons to whom they refer have no income above a fairly low level.

Japan

In Japan, tax is assessed on individuals, and married persons are taxed separately on all types of income. A basic allowance is available for a dependent spouse where the taxable income of the dependent spouse does not exceed a specified limit. The spousal allowance is the same size as the allowance for each dependent child. There is also a special allowance for low-income taxpayers; it declines as the income of the dependent spouse increases.

The United Kingdom

The UK income tax system uses the individual as the basic unit of taxation. There is a personal

allowance as well as a tax credit for married couples. A number of rules apply to a husband and wife living together. First, the two can share the personal and married couple allowances in various ways. Second, the income from jointly owned property can be split 50–50, or according to some other ratio, in perpetuity, if a special declaration is made. Finally, tax relief for interest paid on home mortgages can be split among spouses.

The United States

The United States has four distinct categories of taxpayers based on family status: married filing jointly; head of household; single individual; and married filing separately. A head of household is a single individual who cares for dependent children without a spouse. Married individuals can choose between joint or separate filing.

Each group has its own tax schedule, and all schedules have five rates (15, 28, 31, 36, and 39.6 percent). The family status designation determines the income levels at which these rates apply; for example, the income cutoffs for married taxpayers filing separately are half of those for married taxpayers filing jointly.

A couple may face what is referred to as a "marriage penalty": if spouses earn roughly equal taxable incomes, they pay more tax on their joint income than the combined tax that they would pay if they filed their own returns based on the tax rates applicable to single individuals. However, if the spouses' incomes are quite different; or if only one spouse receives taxable income, the couple usually pays less tax by using the married filing jointly rates.

CCH Standard Federal Tax Reporter gives the following example:

> Joe and Jane each receive $100,000 in wages in 1997. The tax on $200,000 using the joint return rates is $56,068.50. If they were unmarried and, therefore, qualified to file as single individuals, each would pay $26,003 tax on $100,000 of wages for a total of $52,006. On the other hand, if Joe earned $200,000 in wages and Jane did not work, the tax using joint return rates would remain $56,068.50. However, if Joe was not married, his tax on $200,000 would be $60,770.50 using the single rates. (1996, para. 12, 606.)

The US system applies something close to the adult-equivalent approach in its treatment of married and single taxpayers. Each individual, including a dependent child or student, qualifies for a personal exemption equal to $2,650 in 1997. In addition, couples can claim a standard deduction of $6,900, and singles $4,150. Thus, the effective zero rate bracket for an individual extends to $6,800, and that for a childless couple to $12,200 or 1.8 times as much.

Aside from the generosity of providing equal personal exemptions for both members of a couple, the US system implies an adult equivalent of 1.67 for married couples up to an income of $151,750, an amount that covers most US families (Table 2). Above this income level, the implied adult-equivalent values decline.

The Alternatives

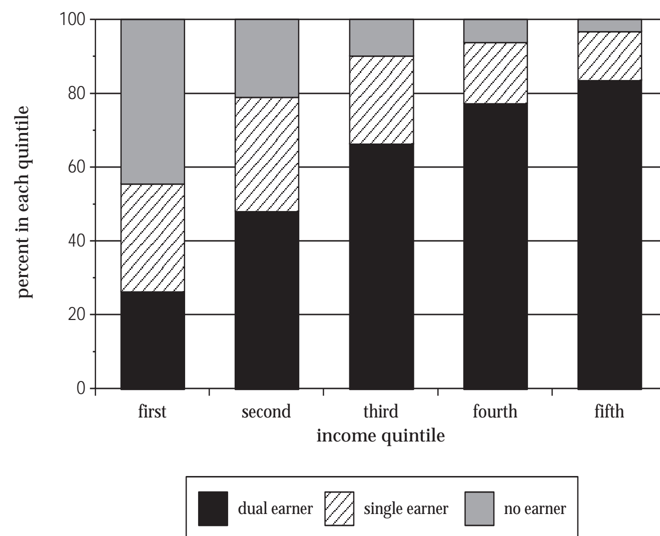
We started by pointing out the two tax system alternatives for handling couples: joint filing (effectively, the family as the unit of taxation) or individual filing.

The Carter Commission argued forcefully in favor of moving to a system that used the family as the basic unit of taxation in Canada. In addition, three of the G-7 nations (France, Germany, and the United States) have tax systems that, in one way or another, have adopted the family as the basic unit of taxation. Is there still a case to be made for Canada's moving toward a joint system?

The Case for Joint Filing

We consider five major points on the positive side of the joint-filing ledger. Notice that some refer to possibilities for reducing the progressivity of Canadian income taxation at middle incomes and raising it at higher incomes. We do not have a philosophical predisposition toward increased progressivity at the upper end, but we do feel that middle-income earners bear too much tax at present.

Figure 2: ***Couples by Income Quintiles, Canada, 1995***



Source: Statistics Canada, cat. 13-215-XPB.

Equity

Against the adult-equivalent benchmark, the Canadian tax system has a number of weaknesses in terms of how it treats married couples. At higher income levels, for example, single-earner couples pay too much compared with individuals, a situation that implies a problem of horizontal inequity.

As shown in Table 1, dual-earner couples are taxed essentially as individuals — that is, they are taxed with an implied adult equivalent of 2. The implied adult equivalents for single-earner couples, however, are less than 2 and fall as income rises. Figure 1 shows, as a rough approximation, how dual-earner couples, single-earner couples and singles are taxed. If the acceptable adult equivalent for couples is less that 2, the current system produces horizontal inequity between single- and dual-earner couples, as well as between couples and singles. Further, there is a vertical equity problem since marginal rates rise much more slowly for dual-earner couples than for their single-earner counterparts.

To put matters simply, if the adult-equivalent procedure is the benchmark, dual-earner couples pay too little tax and higher-income single-earner couples too much compared with single individuals.

Distributional Impact

Some people think that only high-income families can afford a stay-at-home wife and that the penalty the Canadian tax system applies to single-earner families is, therefore, of little concern. This idea is based on a great misconception. About half of all couples in the lowest income quintile (the lowest 20 percent of all couples ordered by income) that have any earnings have a single earner and, in general, single-earner families are much more common at the lower income levels (see Figure 2). In contrast, about 85 percent of couples in the top quintile have two earners.

Since joint filing would benefit single-earner couples relative to dual-earner couples, it would tend to redistribute toward lower- and middle-income families.

Income Splitting

As we have already pointed out, Canada's income tax system approaches a fully individual basis of taxation only for earned income.

Despite the best efforts of tax law, it is possible for couples with any substantial amount of capital income to find ways to shift the resulting tax burden between spouses. Thus, in addition to the obvious horizontal equity issue, treating capital income on a family basis would remove the vertical inequities that result from the ability of high-capital-earning households to share their capital incomes.

Integration of "Take" and "Give"

A different argument in favor of joint filing has to do with integrating the "give" and "take" portions of the tax and transfer system. Doing so would clear up some important inconsistencies in the *Income Tax Act*, such as subjecting single-earner, low-income families to positive tax while simultaneously providing support in the form of GST credits and/or GIS payments, both of which use family, rather than individual, income as the basis for benefits.

To make this argument, one must assume, of course, that there are good reasons for basing social policy on the family, rather than on the individual. We see many such reasons, not the least of which is avoiding the payment of substantial benefits to middle-income families in which one spouse specializes in home production. Another reason is there is much broader agreement on the applicability of adult-equivalent scales, such as the LICO, at lower income levels than at higher ones.

Middle-Income Tax Cut

Canadians today are revealing considerable support of relief for middle-income taxpayers. Under the current regime of individual filing, such a tax cut would tend to increase the system's progressivity at the upper end and raise inequities between single- and dual-earner couples. A dual-earner couple with each spouse at the middle- or higher-income level would benefit twice from such a tax cut, but a single-earner couple only once. If joint filing were in place, however, such an inequity would not occur.

Objections to Joint Filing

The continuing use of individual taxation suggests that Canadian policymakers feel that joint filing has drawbacks. Although some of the possible disadvantages are uncertain or can be questioned, the total list is quite long. Below we canvas eight drawbacks.

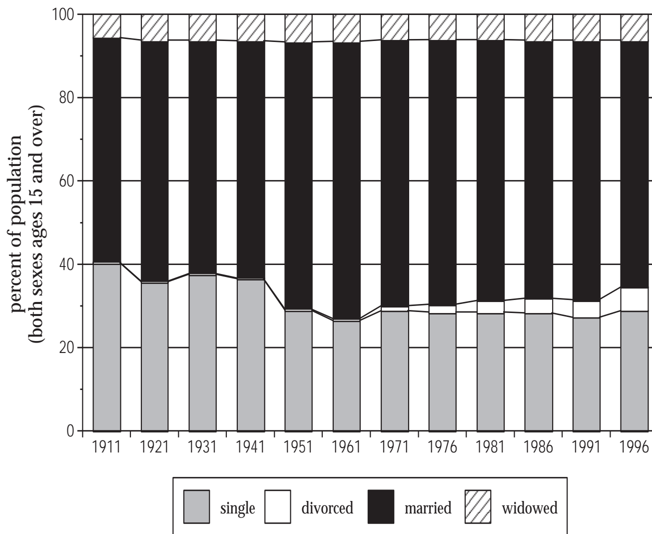
Spouses' Privacy Concerns

Objections to wives' being forced to file joint tax returns with their husbands have a long history (see Brooks 1992). One root is the feeling that the state should respect the independence of married women. An offshoot is that it is unfair to expect spouses to necessarily share all information about their incomes, assets, and other tax-relevant items. As the Ontario Fair Tax Commission says:

> We cannot ignore the damage that would result from masking the individual economic contributions made by women and sublimating rather than encouraging their economic individuality within the family unit. Taxation should respect, support, and encourage a woman's economic autonomy. (1993, 266.)

This viewpoint seems to have become increasingly widespread. If it has become the majority view, then Canadians may be willing to tolerate some degree of horizontal inequity in the treatment of single individuals versus couples and of single-earner versus dual-earner couples in order to protect the economic independence and privacy of married women.

Figure 3: *Marital Status in Canada, 1911–96*



Note: As late as 1961, divorced Canadians made up less than 0.4 percent of the population, ages 15 and over, a proportion almost too small to show up on this graph.

Social Changes

Some of the objections to joint filing take strength from changes in the institutions of marriage, the family, child rearing, and women's work that have occurred in Canada in the past several decades. An overview of these recent social changes serves as a preamble to the discussion of these objections.

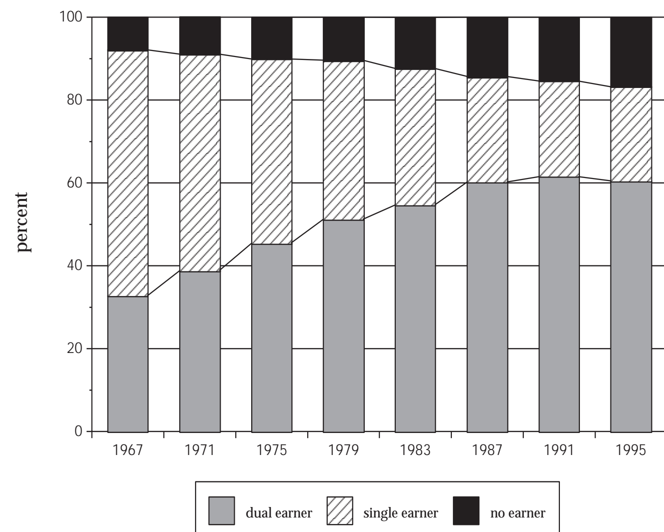
Looking at marital status of the population over age 15 makes it hard to argue that marriage is an institution coming to an end (Figure 3). Indeed, the proportion of those who are married is greater now than it was in the first 40 years of the century. The biggest shift, other than the increased percentage of married individuals after 1941, is the growing number of divorced individuals. As Allen (forthcoming) and others have documented, the divorce rate has doubled over the past 30 years. This rise in divorce has been a contributing factor in the increase in single parenthood, from 8 percent in the 1970s to 14 percent in the 1990s (Dooley 1995).

Yet some significant shifts have occurred in the married category. First, the proportions of single- and dual-earner couples have shifted drastically (see Figure 4). In the late 1960s, 60 percent of married couples had a single income earner. By 1995, this figure had fallen to just over 20 percent. Dual-earner families made up most of the difference, rising from just over 30 percent to just over 60 percent of couples.

Not surprisingly, these dual-earner couples are a large proportion of high-income families (see Figure 2). In 1995, dual-earner couples made up more than three-quarters of the top two income quintiles. By contrast, single-earner couples were nearly one-third of those in the bottom two quintiles. (Couples who have no earned income — but may have capital income — make up the largest part of the lowest quintile and smaller shares of higher quintiles.)

The second significant shift has been a movement away from formal marriage toward common-law unions and single parenthood. In the 1981 census, common-law families (which are

Figure 4: *Couples by Source of Income, Canada, 1967–95*



Source: Statistics Canada, cat. 13-215-XPB.

included in the married category in Figures 2 through 4) made up 7 percent of all couples, a doubling of the value from the 1971 census (Romaniuc 1984). These trends have continued (see Table 2). By 1996, single-parent families were more than 14.5 percent of all families, and common-law couples nearly 12 percent, while married couples were less than 74 percent.

The increase in single parenthood suggests an increase in individualist sentiments, such as those already quoted from the Ontario Fair Tax Commission. If the greater risk of divorce (or other social factors) leads husbands and wives to act more as individuals than as family units, the theoretical arguments for joint filing are weakened.

Table 2: *Canadian Families by Marital Status, 1991 and 1996*

	1991	1996
	(percent)	
Married-couple families	77.3	73.7
With children	48.1	45.1
Without children	29.2	28.6
Common-law families	9.8	11.7
With children	4.0	5.5
Without children	5.8	6.2
Lone-parent families	13.0	14.5

Source: Statistics Canada 1997.

Effects on Marriage

As discussed earlier, joint filing would create a "marriage penalty" for dual-earner couples in which the spouses earn similar amounts. Conversely, a "marriage subsidy" would arise for single-earner couples or for dual-earner couples in which one spouse's earnings were much larger than the other's. One implication is possible effects on the propensity of couples to get married and on the rate at which marriages break down.

Careful empirical work reveals that, in the United States, such effects, although statistically significant, are quantitatively very small (see, for example, Alm and Whittington 1995; Whittington and Alm 1997.) In Canada, however, there is a general impression that marriage is weakening as an institution, and one province (Quebec) has a very high rate of cohabitation outside marriage. If joint filing were introduced, the impact the tax system has on marriage might increase.

Defining and Identifying Couples

Determining who can or must file jointly is an administrative issue that complicates a joint-filing tax system. The shift away from traditional marriage toward common-law unions and single-parent families would make the identification problem more acute.

The current Canadian tax system has provisions that require heterosexual couples to declare that they are living in a common-law relationship, but such rules are difficult to enforce because there is no obvious way in which the government can monitor whether individuals are actually in compliance.

As the determination of "married" becomes less clear, people find increased opportunities to "game" the system by revealing relations only when the net tax benefits of doing so outweigh the disadvantages. Because joint filing would reduce total taxes for some couples and increase it for others, such as those in which both spouses have significant earnings, some — perhaps many — common-law couples might prefer not to file jointly.

These potential difficulties are magnified by the possibility that the definition of *spouse* may be expanded beyond individuals of opposite sexes.[6] As the types of relationships thought deserving of treatment similar to marriage expand, the difficulties of enforcement and compliance under a joint-filing system will increase.

Married Women's Labor Supply

Unfortunately, most forms of taxation distort the supply of labor. Taxes on married women's

earnings may be particularly damaging. Marginal rates of taxation affect individuals' labor supply (decisions about work and leisure). Within a marriage, the secondary earner's decision to work may be particularly influenced.

Under a joint-filing system, husband and wife would face the same marginal tax rate (as they would in the absence of any tax), a situation that might seem to level the playing field. There is, however, more to the matter.

Taxation can create two separate distortions in a couple's labor supply responses. One is *between* spouses. If their marginal tax rates differ, there will be a tendency to shift the family's labor supply mix away from the spouse with the higher marginal rate; thus, that spouse will spend relatively more time in home production and the spouse with the lower marginal rate relatively less. Joint filing would eliminate this kind of distortion.

The second potential distortion is usually regarded as more important (see, for example, Boskin and Sheshinski 1983).[7] This is between the use of time in the home and in the labor market. Distortion exists even when spouses are taxed at the same marginal rate because *any* income tax encourages both to spend less time in the labor market and more time in the home than they would in the absence of that tax. Secondary earners shift much more readily between the home and the labor force in response to economic stimuli than do primary earners, who generally seek full-time labor force attachment until retirement (see, for example, Benjamin, Gunderson, and Riddell 1998, chap. 2). This sensitivity means that tax distortions of secondary earners' labor supply are more damaging than those of primary earners. Hence, given progressivity, a system of individual taxation has an edge because it distorts the labor supply of secondary earners less than a system of joint taxation.

In principle, the best approach for Canada would be one that balanced these competing distortions. This could be done by flattening the rate structure. If all taxpayers paid the same rate of tax, the first distortion would be eliminated and the second minimized.[8] (Thus, the past 20 years' movement away from steeply progressive tax schedules has reduced the importance of the economic distortions.)

In practice, the existence of a progressive rate structure forces a choice between individual and joint filing. Each eliminates one distortion completely. Thus, neither joint nor individual filing is ideal from the viewpoint of efficiency. However, the conventional view is that the distortion of married women's labor supply is the more serious problem, so if the choice between joint and individual filing has to be made on efficiency grounds, individual filing may be better.

Home Production

In principle, the value of home production should be included in a comprehensive measure of income for tax purposes. Nontaxation of home production favors families that have single earners and those in which the secondary worker works relatively few hours (at least to the extent that the extra home time of the at-home spouse is not offset by, for example, an increase in volunteer activity). The nontaxation of home production tends to offset the fact that dual-earner couples in which the spouses earn similar amounts pay too little under a system of individual filing.

Under joint filing, all couples would be evaluated strictly in terms of their total money incomes. There would be no offset to compensate for the lower home time of the dual-earner couple.

Income Sharing

The adult-equivalent approach, which provides the conceptual basis for joint filing, assumes that family members share all their income (or

at least share the consumption benefits that the income produces). This assumption is required in order for a tax burden placed on families with the same income to be fair no matter which member is the source of that income.

At the conceptual opposite from the presumption of equal sharing is the idea that spouses' welfare depends to some degree on their individual earnings.[9] In some dual-earner families, each spouse may have effective control over his or her own earnings. Thus, given the differences in earnings between spouses, primary earners may have significantly higher standards of living than their spouses (and perhaps any children present).

In such situations, joint filing, which imposes the same marginal rate on both spouses, seems inappropriate on equity grounds. Taxing spouses as individuals may be superior in these cases, not only on conventional tax policy criteria but from the viewpoint of bolstering the welfare and independence of the secondary earners.

One hopes that the majority of Canadian couples practice a high degree of sharing. In determining the choice of tax unit, should policymakers respond to those egalitarian couples or to those who do not exhibit equal sharing? This decision is clearly a value judgment. The more one is concerned with the inequities faced by secondary earners (and perhaps children) in families where primary earners hog more than their share and the more prevalent one believes such families are, the less will be one's tolerance for a system of joint filing.

Progressivity

A joint-filing system would treat single-earner and dual-earner couples similarly if they have equal total incomes. In contrast, the current Canadian system of individual filing provides quite different results for the two kinds of couples. At a total income level of $100,000, for example, a dual-earner family in which each spouse earns $50,000 pays total tax (ignoring surtaxes) of $18,478 but a single-earner couple pays $22,549.[10] Although this difference is certainly significant, the differential in dollars is similar at higher income levels, and thus it declines as a percentage of total income. And at lower income levels, the absolute differential is less.

Some may feel that these discrepancies are tolerable in view of the various other disadvantages of joint filing. On the other hand, if the federal government decided to significantly increase the progressivity of the personal income tax system — as it did in its 1998 budget by reducing the 3 percent surtax only for those below a threshold level of earnings and by some other measures (see Poschmann 1998) — these discrepancies would increase, and so would the equity case for joint filing.

Conclusion

Both joint filing and individual filing have significant advantages. Joint filing is attractive on both horizontal and vertical equity grounds. The adult-equivalent approach provides a useful benchmark for Canada's current tax system of individual filing. Applying that marker suggests that the inequities created in the taxation of different family types by a system of individual filing are not trivial.

Another consideration in favor of joint filing is the fact that more single-earner couples than dual earner couples earn lower incomes. Thus, a move to joint filing would benefit Canadians at the middle and bottom of the income distribution more than those at the top. Also, joint filing would remove the necessity for complex provisions regulating income splitting (mostly capital income splitting), which would be attractive on both efficiency and vertical equity grounds. Joint filing would put the "take" portion of the tax system on the same basis as the "give" portion.

Finally, if policymakers want to increase progressivity through, for example, a middle-income tax cut, having joint filing would avoid the increased inequity between single- and dual-earner couples that such a cut would create in the current system.

Despite these attractions, joint filing also presents a substantial list of drawbacks. The sentiment in favor of the separate treatment of husbands and wives is strong; so is the belief that tax provisions should encourage the independence and economic autonomy of married women. Individual filing gives dual-earner families a tax break that evens up their treatment relative to single-earner families from the viewpoint of those concerned about the untaxed extra home time enjoyed by the latter. Individual filing also reduces the disincentive effects of taxes on the labor supply of married women.

Social and other changes in recent decades have also weakened the case for joint filing. In order to implement such a system fairly, the tax authorities must be able to define a couple readily and defensibly and to monitor taxpayers' status in this regard. The emergence of an increasing number of unconventional families makes this ability problematic.

Also, the gradual flattening of the income tax structure that has occurred in recent decades has reduced the inequities caused by having individual rather than joint filing. If Canada ever moved further in the direction of a flat tax, then the argument for joint filing would become even weaker.

To our minds, the list of objections outweighs the advantages of a wholesale movement to a system of joint filing. In particular, the administrative difficulties of doing so cannot be overlooked. A final consideration, as we explain shortly, is that the Canadian tax system has more important problems that need fixing.

Nevertheless, we believe that the serious inequities arising from the system's using the individual as the tax unit, rather than taking into account the implications of family size for ability to pay, deserve attention. Canada's system of individual filing would be amenable to provisions that reduced some of the inequities we have outlined. First, although the tax system is much less progressive today than it was in the past inequities between single- and dual-earner families have been reduced, these inequities still exist and provide a ready defense for moving to (or keeping) certain parts of the tax system on a family basis. Two examples of existing policies are spousal RRSPs, which encourage wealth creation in the hands of those who choose to specialize in home production, and the spousal allowance, which reflects the reduced level of discretionary money income in the hands of single-earner married couples. Treating capital income as joint income would also lessen some of the inequities, particularly for Canadians with relatively low levels of capital assets.

The case is even stronger for basing social policy on the family. Indeed, there is really no alternative in a world where the goal of social policy is increasingly taken as the provision of transfers targeted to those who are truly poor. Providing the same assistance to a family in which each of two spouses earns $20,000 and to a single-earner family making $20,000 would be a frivolous waste of money. Further, basing social policy measures on the family avoids the payment of benefits to middle- and high-income single-earner families where one spouse specializes in home production. Finally, research exists on adult equivalents at low incomes (Statistics Canada's LICOs and the implications of provincial welfare rates); thus, devising appropriate transfer schedules at low-income levels based on family size would not be insurmountably difficult.

We conclude that the current tax treatment of couples is an acceptable compromise. Unfortunately, the same cannot be said about the tax treatment of children.

The Tax Treatment of Children

Unlike the tax treatment of married couples, which has seen few changes over the past 30 years, the tax treatment of children has undergone a revolution in Canada (see Boessen-kool forthcoming). From universal social policy expenditures (family allowances) and generous tax exemptions, the country has shifted to social policy expenditures targeted to low-income families. Middle- and high-income families no longer receive tax-related recognition for the presence of children. In this second half of the paper, we ask whether this treatment of children is defensible.

Children Are Not Fancy Boats

"Revealed preference" is an economic tool that looks at an entity's expenditures and infers the underlying preferences that give rise to the observed spending pattern. In the tax treatment of children in Canada, the revealed preference of government shows that the value it puts on children decreases with the income of the family in which those children reside. As Kesselman argues, Ottawa treats the choice of middle- to high-income families to have children as a consumer outlay no different from "the purchase of a fancy boat" (1993, 117).

A possible "children as fancy boats" argument might go as follows. Parents have children voluntarily and enjoy higher utility as a result; therefore, they should not receive subsidies or tax recognition for these children any more than they do for any other voluntary activity that results in higher utility.

This argument ignores the fact that parents have a moral and legal obligation to care for their children. Parents must share their income with their children, in part because children are unable to earn income on their own. Thus, a portion of the family income can be regarded as belonging to the child. From an equity standpoint, this income should not be taxed on the same basis as it was before the presence of a child. Rather, it should be taxed on the basis of some adult equivalent, since this is what determines a child's standard of living. The implication is a lower tax rate or some other recognition of children within the tax system.

Three other problems with the "children as boats" argument can be noted. First, some families may have once had adequate resources to raise their children but have now fallen on hard luck. Some negative shocks are privately insurable (death, disability), but others are not (involuntary unemployment, business failure, divorce). If a business goes bust, the owner can sell his fancy boat, but he still has a legal and moral obligation to take care of his children.

Second, families may have accidentally had more children than desired. There are few recorded cases of the accidential acquisition of fancy boats.

Third, consider the efficiency-based arguments. Families (including the children themselves) do not capture all of the benefits of the human capital investments represented by raising children.[11] Society in general benefits, not least from their future tax payments, which are not negligible in Canada. From a social policy viewpoint, the implication is that, without a subsidy, the fertility rate will be too low.

Excluding a portion of a family's income due to the presence of children is ultimately a question of selecting an appropriate tax base. A certain amount of the family's spending on children should be considered nondiscretionary and thus omitted from taxable income.

Alternatives

The preceding arguments lead to what appears to be a widely held view — namely, that tax liability should decline with the number of children. The rate at which this liability should decline and whether and how this rate should differ across income levels remain matters of dispute.

The Adult-Equivalent Approach

One way of adjusting tax liabilities for the presence of children is through an adult-equivalent approach. Conceptually, it can be applied to either individual or joint taxation. In the former case, an individual's income is adjusted by an adult-equivalent value for each dependent child; after that, the rate structure applies. A special difficulty with adult equivalents under an individual-based tax structure is the need for some rule to determine which spouse's income is the basis for the adult-equivalent calculation.

In a system with joint taxation, the adult-equivalent approach for children would be a straightforward application of the procedure described for married couples. Family income could be divided (as in France) by an adult-equivalent value that included additional amounts for each child. A single rate structure would be applied to the resulting income level, and the tax amount grossed up by the adult-equivalent value. As the family's adult-equivalent size increases, the thresholds for various marginal rate brackets would rise in proportion.

Deductions and Credits

Another option is granting a deduction or credit for each child. The amount could be uniform for each child or vary with the number of children (for example, so much for the first child and half as much for each subsequent child). Would a deduction or a credit be preferable? If the purpose is to ensure horizontal equity between families with and without children (so as to reflect nondiscretionary income), a deduction would be superior to a credit for the reasons elaborated in Box 1.

An additional reason for our preferring a deduction is that we are speaking of children. In our view, expenses for children are nondiscretionary, and providing relief for the family is ultimately a question of finding the correct tax base. Thus, nondiscretionary income excluded for children ought to be the same for all taxpayers and such income removed from the tax base. Credits merely offset tax liabilities, rather than excluding a portion of income from tax.

Note that, for families above the first positive tax bracket — for single-earner Canadian families, those with taxable income of more than $29,590 — deductions for children provide less relief than the adult-equivalent approach because the thresholds between subsequent tax brackets are not increased. This apparent bias can be excused, at least to some extent, if one believes that the relevant adult-equivalent scale for higher-income taxpayers reflects greater economies of scale.

Social Policy Expenditures

Another way in which government can recognize children is by providing cash payments to families or subsidizing goods or services that parents would otherwise purchase for them (perhaps in smaller quantities). An example of the former is the refundable tax credit, which is often confused with a tax credit but operates more like an expenditure program. Because a refundable credit provides payments to citizens whether or not they have any tax liability, it is a redistributional tool that provides cash to those with no or low income and, at the same time, offsets tax liabilities for those with higher taxable incomes. Refundable tax credits take many forms with various kinds of phase-in and phase-out provisions (Richards 1998). Refundable credits or *demogrants* (cash payments to all citizens in a demographic class) do not exclude a similar level of taxable income for all taxpayers. They cannot be used to define the tax base because they effectively exclude different amounts of income for taxpayers at different income levels.

Examples of goods and services for parents include subsidized child care and primary and secondary education. These subsidies take a va-

riety of forms and can be geared to income. For the most part, these programs (unlike refundable tax credits) do not interact with the tax code, although it is conceptually possible that they could; two examples are income-contingent loan schemes and education vouchers geared to income (Finnie and Schwartz 1996).

What Canada Does

Canada recognizes children through the "take" and the "give" sides of its tax system. Both have seen significant changes in recent years, simplifying the system, at least in terms of the number of programs available.

The country does not, however, provide universal recognition for children, especially those in two-parent families, as it used to through a tax deduction for each dependent child and the family allowance program.

Tax Policy

The "take" portion of the system recognizes children in two ways. The first is the Child Care Expense Deduction (CCED), available to cover the cost of child care, up to a specified limit, for both secondary earners and single parents.

Second, single parents can apply the spousal equivalent credit against taxable income for their first child. This credit does not disappear as income rises.[12]

Social Policy

The "give" portion of the Canadian system includes several programs that affect families with children. The first is a refundable child tax credit, which has been in place since 1978; after various incarnations, it has been recently renamed the Canada Child Tax Benefit (CCTB). It works as a negative income tax for children. When a family has income below about $21,000, it receives the full benefit per child. Above this level of family income, the benefit is clawed back, initially on the basis of the number of children (at rates between 12.0 and 27.0 percent) and then at a uniform rate (2.5 percent for one child, 5.0 percent for more than one child) above selected thresholds (usually about $26,000).

Second, the GST credit has a supplement geared to the number of children, and the taxback range overlaps with that of the CCTB. While programmatically distinct from the CCTB, the child supplement portion of the GST credit can be conceptually viewed as part of one refundable child tax credit that combines the two elements.

The overlapping of social policy taxbacks with the tax system creates severe marginal tax rate problems. The CCTB provides a poignant example. As social policy, the program is designed to provide income transfers to low-income individuals. However, presumably because of the absence of tax recognition for families, Ottawa pays a declining benefit over a broad range of income. The result is a stacking of rates. For example, between $21,000 and $26,000 of family income, child benefit taxbacks are stacked on top of a 17 percent federal rate, which becomes 26 percent with the addition of the average provincial tax rate, as well as employee contribution rates for employment insurance (EI) and the CPP/QPP, which add up to 5.9 percent (the employer plus employee contribution rates are 13.0 percent for EI and the CPP/QPP together). With various other taxbacks, surtaxes, and so on added in, a single-earner family with two children at this income level pays a marginal rate near 65 percent — at least ten percentage points higher than *all* families who earn at a higher level (Boessenkool forthcoming).

A number of smaller measures tied to the *Tax Act* are geared to providing assistance for postsecondary education. Some of the more recently announced measures combine shel-

tered income growth with direct subsidies for parents who put away money for their children's education, while others give direct tax savings for those attending postsecondary institutions. We ignore these programs in our subsequent analysis because they are relatively minor and primarily geared to youngsters who are or will be continuing their education past the secondary level, as opposed to children generally.

What Others Countries Do

As with the treatment of marriage, the international arena provides examples of the different ways of accommodating children within a tax code. Since our focus is on the tax system, we ignore some cash payments to families that are not integrated with that system.

France

The French tax system provides relief for children under age 18. It is similar to the algorithm given in Box 2. The first two children are assigned half a share each, with subsequent children each assigned a full share each. A single parent with one child is allocated two shares.

The French system is generous to couples and children. The fact that the third and subsequent children receive an adult equivalent of 1 suggests that the French may believe that economies of scale decrease with more than two children (for example, the family may require a larger house and a bigger car).

Germany

Before 1996, Germany gave families a choice between a child tax exemption (doubled for parents filing jointly, as well as for single parents) and a child benefit. After 1996, the monthly child benefit exceeded the tax savings for the exemption at all income levels.

The benefit is the same amount for the first two children, rises for the third and again for the fourth and subsequent children. It is paid in respect of children under age 18 or under those age 27 who are full-time students or on military or community service or, under certain conditions unemployed.

Italy

The Italian tax system provides a modest credit for each dependent child. It is doubled if the taxpayer is a widowed or single parent or has dependent spouse.

Japan

Japan's basic allowance for dependants under age 16 is the same size as the spousal allowance; it rises by more than 40 percent for children between age 16 and 22.

The United Kingdom

In the United Kingdom, the 1998 budget announced a new refundable tax credit that includes a family amount, additional amounts for each child, and an amount for child care for qualifying couples. This working family tax credit is available to families in which the primary earner works more than 16 hours per week, and there is an additional amount for families whose primary earner works more than 30 hours per week. Above a threshold level, the benefit is taxed back at a rate of 55 percent. Married couples can choose which spouse receives the credit. It is paid through the wage package, rather than through independent cheques from the government.

The United States

The US tax system provides a dependant's deduction for each child. The amount is reduced

once income passes a threshold, but this point is so high that the provision affects only a small minority of taxpayers. In all cases, family income must exceed $200,000 before the deduction is completely phased out.

The United States also provides an earned income supplement similar to Britain's new working family tax credit. The rather generous benefit is phased in, providing a growing payment as income rises from zero. It is also taxed back once income surpasses a target level.

What Should Canada Do?

Canada and the United Kingdom are alone among G-7 nations in their lack of universal support for children — the national forum on health raises this as a concern with respect to the health of children (Determinants of Health Working Group 1997). Canada's *Income Tax Act* provides liberal social policy transfers to low-income families with children, but has no provision in the calculation of taxable income for recognizing the nondiscretionary costs of raising children. And with a lack of indexing in the tax code, the value of even these transfers has been steadily eroding over the past 15 years, as has the real income level at which they have been taxed back.

In this section, we examine the arguments in favor of a universal deduction for children and take a closer look at the CCED. Both discussions are background to arguing for the re--introduction of universal recognition for children, for which we present a few options.

A Universal Deduction

The case for universal acknowledgment of children in the tax system can be made by first considering the tax-base issues and then the progressivity issues.

The base issues are straightforward and related to the "children are not fancy boats" argument made above. This argument, plus the ability-to-pay principle, suggests that all families be allowed to exempt from taxable income an amount that ensures that nondiscretionary income is not taxed. Only in this way can the tax system ensure horizontal equity between families with and without children at all income levels.

The progressivity issues are two. The first is the degree of progressivity of the positive portion of the tax code. For a given rate structure, progressivity could be enhanced by choosing a child credit rather than a child deduction (look back at Box 1). The price, however, would be less horizontal equity. If deductions were used, a change in the rate structure would be a cleaner way to enhance progressivity without jeopardizing horizontal equity.

The second progressivity issue is whether any deduction or credit should be refundable. This question is one of social policy, and it should be considered on its own merits, independent of the tax policy goals of horizontal and vertical equity.

In other words, the strong argument that the tax system should return to universal per child deductions to ensure horizontal equity is a tax-base question and should be kept separate from the question of whether Canada should provide refundable tax credits. We do not mean to suggest that policy tradeoffs and budget constraints do not exist. However, Ottawa has been too willing over the past decade to trade off horizontal and vertical equity in the tax system in order to construct social policy transfers such the CCTB.

The Child Care Expense Deduction

The deduction for child care has both critics and supporters. Critics of the CCED suggest that, since all parents pay the cost of caring for children, certain types of care should not receive preferential treatment. Supporters of the CCED argue that day care is a cost of earning

income and, therefore, ought to be a deductible expense. Within the context of the current tax treatment of children, both of these arguments are problematic.

Critics of the CCED ignore the fact that parents who provide child care themselves, instead of purchasing it in the market, in effect already enjoy a child care deduction. The value of their child care services, which is a form of in-kind income, is not taxed. Allowing for a deduction when these expenses are paid out of earned income is thus a simple requirement of horizontal equity.

Supporters of the CCED are on firmer conceptual ground, but ignore several realities. First, few of the costs of earning employment income are deductible and the range has narrowed in recent years, while the CCED has been consistently increased — for each child under age 7, from $500 per child in 1972 to $7,000 in the 1998 budget plan (see Boessen-kool forthcoming).

Yet, it is difficult to find a rationale for the CCED in the desire to achieve greater equity in the treatment of dual-earner versus single-earner couples, since families that care for their own children have lost all tax recognition for their children (even in the absence of children, single-earner families pay too much tax relative to dual-earner couples, as discussed earlier in this *Commentary*). Finally, the CCED allows, perhaps unintentionally, the deduction of cash expenses that single-earner couples cannot deduct, such as meals provided in child care and summer day camps.

Overall, one cannot escape the fact that enhancing the CCED has redistributed after-tax income away from people who care for their children themselves and toward families with children in other-provided care.

If the main reason for criticizing the CCED stems from the harshness of current tax policy toward parents generally and toward parents who care for their children at home specifically, the solution suggests itself. A universal deduction for children would make more palatable the presence of the child care deduction, which recognizes the special burdens of dual-earner parents and working single parents.

Problems and Solutions

Before we lay out some options for the Canadian tax system, it is worth summarizing briefly the problems that any solutions should address. From a tax policy perspective, at least two equity issues need to be addressed. First, the current system does not recognize that the cost of raising children is a nondiscretionary expense that should be exempt from the tax code. Second, the current treatment of dual- and single-earner families is inequitable for the latter, in terms of both marriage and the CCED.

A third consideration that any reform must take into account is the high marginal tax rates that arise at very modest levels of income. These punishing rates result from the failure to distinguish between social and tax policy in program design.

Solving these three problems without making any taxpayers worse off would be prohibitively expensive, not to mention politically difficult. Nonetheless, we lay out some no--budgetary-or-political-holds-barred proposals, if only to provide a target that more realistic suggestions can aim for. Tinkering should always, after all, be done with an ultimate target firmly in mind.

Proposals 1 and 2 are, therefore, truly no-holds-barred ideas. Proposals 3 and 4 are less radical attempts at moving tax and social policy in a direction more sensible than that of Canada's current system.

Proposal 1:
Provide Universal Child Benefits

Rowe and Woolley (forthcoming) argue for universalizing the CCTB. They propose eliminating all the taxbacks, making the program a

demogrant for all Canadians with children. Doing so would improve horizontal equity between couples with and without children; since single-earner couples would receive recognition for their children, the change would also weaken the argument that the child care deduction discriminates in favor of dual-earner families with children.

The cost of such a demogrant would be between $6 billion and $10 billion (depending on whether the refundable GST credit was also made universal). Beyond this cost, universalizing social policy benefits would have additional weaknesses. First, demogrants are social policy tools. Paying them to all families makes it difficult to increase payments to those least well off without enormous budgetary expense. Do Canadians really want to make cash payments to families that are making $50,000 or more? Doing so appears to be bad social policy.

Second, since these payments would be made on a family basis, they would not mix well with a tax system based on individuals. Third, payments made to families would be an incomplete way of bringing horizontal equity into the tax system, as they would operate like credits for individuals whose tax burdens are greater than the benefit payments.

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Proposal 2: Offer Generous Personal, Spousal, and Child Deductions

Providing generous personal, spousal, and child deductions would be a better system than making cash payments to middle- and high-income families. If the deductions were sufficiently generous, federal and provincial social policy would have tax-free room in which to operate without interacting with the tax system.

Such a course would restore horizontal equity between couples with and without children, as well as some balance between single-earner and dual-earner couples. It would eliminate the stacking of refundable credit taxback with tax rates. Finally, it would make a clean break between social and tax policy. Transfers directed to those at low incomes would operate within the range of income created by the deductions.

Generous personal, spousal, and child deductions would also be consistent with our argument that income going to nondiscretionary expenses should be excluded from tax. In essence, we are saying that the Canadian tax base has not been properly defined and that only by using deductions can the system arrive at a base that is acceptable.

The difficulty with this proposal is one of affordability, which results from the current size of social policy transfers to modest-income families. CCTB payments are now larger than

combined federal and provincial taxes for a two-child family with a single earner bringing in up to $20,000 or with dual earners making $25,000 (Canadian Tax Foundation 1997, tables 3.19 and 3.20). The difference between the single- and dual-earner families is the result of basing the CCTB taxback on net income, which is after the child care deduction for dual earners.

Thus, in order to avoid making anyone worse off, personal and child deductions for a family of four would have to total at least $25,000. Clearly, this method of ensuring no overlap between social and tax policy would be very expensive. (Alternatively, social transfers could be made less generous at income levels between, say, $15,000 and $25,000, but that route would likely produce significant political resistance.)

Nevertheless, this second no-holds-barred approach would be more in line with the analysis of the paper. It would allow the separation of tax and social policy and define the tax base for individuals and families in a way that exempted nondiscretionary expenses for dependent children and spouses. It would also eliminate the stacking of taxback rates on top of income and payroll tax rates.

If generous personal and spousal deductions are the goal, the challenge is finding more modest and hence realistic reforms that would move in this direction.

Proposal 3: Grant a Per Child Deduction

The first problem identified under "Problems and Solutions" is the lack of universal recognition for children, and a first step in solving it would be a per child deduction. It would introduce a measure of horizontal equity between couples with and without children, ending the tax system's treatment of children as consumer expenditures. A deduction of, say, $2,000 per child would cost the federal government about $3 billion.

Proposal 4: Provide a Child Deduction, Lower CCED, and a New CCTB Clawback

More could be done to improve equity between single- and dual-earner families — the second problem identified above. For example, the child care deduction could be lowered by the amount of the new deduction. This policy would have no impact on dual-earner families that currently claim the maximum CCED as they would receive the per child deduction in its place. Families that do not claim the maximum amounts for the child care deduction would receive a tax cut.

The combination of introducing a per child deduction and in effect lowering the child care deduction would not, *per se*, reduce the prohibitive marginal tax rates for families earning between $20,000 and $25,000 — the third problem we identified. Progress on reducing these rates would be possible, however, since a per child deduction would deliver a tax cut to all families with earnings above $15,000, creating some room to lower the taxback thresholds and the punishing taxback rates without reducing the current level of benefits to families at modest income levels.

To make the point concrete, consider the following set of changes:

- introduce a $2,000 per child deduction;
- reduce the maximum CCED by $2,000;
- eliminate the GST credit;
- create a unified credit composed of the current CCTB and the current child portion of the GST credit; and
- tax back the new credit at a rate of 7.5 percent above an income threshold of $15,000.

Without the new child deduction and changes to the CCED, this new clawback structure would be budget neutral: it would not cost Ottawa anything (though there would be winners and losers among families). When com-

Table 3: *Proposal 4: Average Change in Federal Transfers less Taxes*

Family Income Group	Single Parent	Couple with Children	
		Single Earner	Dual Earner
(dollars)	*(percentage of income)*		
0–15,000	0.1	–0.3	0.1
15,000–25,000	0.9	1.0	1.0
25,000–35,000	0.5	2.4	2.0
35,000–45,000	1.5	3.0	1.8
45,000–55,000	1.0	2.4	1.4
55,000–70,000	1.2	2.0	1.1
70,000–100,000	0.9	1.8	1.0
>100,000	0.7	0.8	0.6
All	0.7	1.8	1.0

Note: The values shown are for all families in the relevant income group, regardless of the number of children they have.

Source: Statistics Canada, Social Policy Simulation Database and Model, release 6.1; modeling by by Finn Poschmann.

bined with the new per child deduction and changes to the CCED, however, the unified credit would cost slightly more than the existing child and GST credits since the new deduction would lower the net income against which the taxback is applied. (The higher payments under the unified credit would almost exactly offset the cost savings from the lower CCED.)

The entire combination of proposals would cost just under $3 billion. Modeling[13] (see Table 3) reveals that it would have a negligible impact on families earning less than $25,000 (which receive the maximum amount of benefits under the current system) but deliver a modest tax cut to families above that level. The biggest benefit would be for families with incomes of $25,000 to $45,000, which, on average, would enjoy a combination of increased benefits and lower taxes of 2.2 percent of income.

Two negative aspects of this proposal are that it would increase (by 2.5 percentage points) marginal tax rates on family incomes between about $30,000 and the point at which benefits would be phased out, and it would eliminate the non-child portion of the GST credit for low-earning families and singles. On the positive side, for incomes between $26,000 and about $30,000, it would replace the combined GST credit and CCTB clawbacks of 5.0 percent each. It would also reduce by 4.6, 12.7 and 19.3 percent the tax rates for families with, respectively, one, two, and three or more children at earnings between $20,000 and $26,000.

Notice in Table 3 that the distributional results from the scheme would be skewed in favor of single-earner families with incomes between $25,000 and $55,000. Although some low-income earners would experience a net loss resulting from the elimination of the non-child portion of the GST credit, this loss should be set against the more substantial increases in the CCTB that these families have received over the past two years. In general, for each family type, the largest tax cut would go to middle-income families. This is because most of the benefit would go to two-parent families that have a single income or have dual earners but are not now claiming the full child care deduction.

Conclusion

When we separate the "take" (tax policy) and "give" (social policy) aspects of the *Income Tax Act*, the analysis reveals an important anomaly in the treatment of families with children. Bluntly put, the current act treats children as consumer purchases. This approach is unacceptable, but it could be rectified by reintroducing universal deductions for children. Aside from returning horizontal equity to the tax code, such a change would reduce the redistribution away from families that care for their children themselves to families with children in other-provided care. Even if the CCED was reduced by the entire amount of the new deduction, no family would pay more in tax,

and families that currently claim less than the maximum would get a tax cut. If combined with changes to refundable child benefits, these reforms would allow Ottawa to lower by five to twenty percentage points the prohibitive tax rates faced by families earning between $21,000 and $26,000.

Summing Up

Canada's *Income Tax Act* is no longer only about tax policy. Social policy has become an increasingly integral part. Whatever the merits of that side of the *act* (and the purpose of this paper is not to call them into question), social policy considerations have crowded out legitimate tax policy objectives.

In terms of the treatment of married couples, we point out that joint filing has much to recommend itself on horizontal equity grounds. It provides a useful benchmark for the evaluation of important aspects of tax system. However, the list of significant objections to joint filing is long and reflects both social and economic concerns. On the other hand, basing the "give" portion of the tax system on family income is certainly appropriate. We thus find that the status quo of taxing on an individual basis while delivering social policy on a family basis is defensible.

The same cannot be said of the *Income Tax Act's* treatment of children. Social policy concerns, evidenced by the increased size and popularity of the CCTB, have squeezed out tax policy considerations, such as maintaining horizontal equity between different types of families. This inequity could be rectified by reintroducing a universal deduction for children. Such a deduction would also permit progress on lightening for modest-income families the punishing marginal tax rates that are produced by adding clawbacks of the CCTB and GST refundable tax credits to other taxes.

Both tax and social policy are legitimate objectives of Canada's tax system. However, Canadians deserve defensible and well-designed tax policy as much as they deserve accountable and sensible social policy. Universal child deductions and lower marginal tax rates on modest-income families hold out the promise that Canadians can have both.

Appendix: Adult-Equivalent Scales

As noted in the main text, a wide range of adult-equivalent scales is used, and an inescapable element of judgment must come into play in arriving at a scale for any particular application.

In its income distribution studies, the OECD has used an adult-equivalent scale in which the first adult has a weight of 1.0, any subsequent adult a weight of 0.7, and each child a weight of 0.5. This scale is interesting in that, although it recognizes that two can live more cheaply together than apart and that children are less costly to maintain than adults, it denies that the addition of a third adult or more children offers further economies of scale. In contrast, most of the alternative estimates from the economics literature, such the Statistics Canada scale described below, indicate that each additional family member imposes successively lower incremental costs.

The adult-equivalent scales implicit in Statistics Canada's LICOs are based on observing the point at which families of different sizes spend 56.2 percent of their gross income on food, shelter, and clothing (Browning 1992). The implied adult equivalents are considerably lower than those of the OECD scale, as illustrated in Table A-1.

Many other scales that have been used in practical applications fall between the LICO and the OECD scales. The US census, for example, uses an adult-equivalent value of 1.25 for a married couple and of 1.89 for a couple with two children (Jorgenson 1998, 85).

The welfare rates set in various provinces imply a variety of adult equivalents. In Ontario in 1996, for example, the basic social assistance level for a single employable individual was $6,240, while a couple with two children received $14,568 (National Council of Welfare 1998). Thus, the adult-equivalent implied by these values is 2.33 ($14,568/$6,240) for the couple with two children. That ratio was the lowest among the provinces in 1996. The highest value for a couple with two children was in New Brunswick, at 4.02, and the cross-country average was 2.99.

Does the size of the adult equivalents implied by welfare payments — higher than that of the LICOs and, in many cases, above even the OECD scale — exaggerate the costs of achieving a given standard of living for families compared with singles? The answer may well be yes. Policy reasons may well be involved. The LICO and OECD scales are explicitly intended to reflect equal standards of living, while the amounts allowed single individuals under provincial welfare systems may be set purposely low in order to reduce work disincentive effects for single people. Lowering the allowance for singles inflates the derived adult-equivalent amount for a family with children.

For a review of the economic theory underlying adult-equivalent scales and of the results of econometric studies based on budget studies, see Browning (1992). Phipps (1998) provides an application of some of the most recent methods to Canada.

Table A-1: *Sample Adult-Equivalent Scales*

Family Size	Scales	
	LICO	**OECD**
	(percentage of income)	
1	1.00	1.00
2	1.36	1.70
3	1.72	2.20
4	1.98	2.70
5	2.17	3.20
6	2.35	3.70
7+	2.53	4.20+

Source: Calculated from National Council of Welfare 1998, 5, table 1.

Notes

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1 Another base consideration is what to tax. We refer to discretionary income, but everything we say here would apply equally well to a personal consumption tax.

2 Assuming, of course, that the credit was determined using the tax rate.

3 The three income brackets are taxed at federal marginal tax rates of 17, 26, and 29 percent, respectively. Adding in average provincial taxes gives total marginal rates of about 26, 40, and 45 percent (ignoring surtaxes and the myriad of other factors that affect true marginal rates).

4 This is the implicit view of the National Council of Welfare, which includes these payments in its accounting of welfare income (National Council of Welfare, various years).

5 The information in this section borrows heavily and liberally from the following sources. International Bureau of Fiscal Documentation, 1991–1997a, for France, Germany, Italy, and the United Kingdom; idem,1991-1997b, for Japan; and CCH Incorporated, 1996, for the United States. We also referenced the Ernst and Young International website (www.eyi.com) on April 8, 1998, for France and Germany and on May 25, 1998, for Italy, Japan, the United Kingdom, and the United States.

Some of our reviewers point out that some of these countries also make demogrant payments to families. If these payments occur outside the tax system, we ignore them, as we do various welfare programs.

6 Consider the recent decision not to appeal the Ontario Court of Appeal decision known as the *Rosenberg* case, which struck down the federal *Income Tax Act*'s restriction of survivor benefits from pension plans to opposite-sex spouses.

7 By relaxing Boskin and Sheshinski's theoretical assumption, Apps and Rees (1988) demonstrate that this view depends on particular assumptions about the utility functions of husband and wife. Piggott and Whalley (1996) show computationally that under not-implausible conditions, Boskin and Sheshinski's conclusion is wrong. Nevertheless this view has wide support.

8 For any positive rate of tax, a bias in favor of home production would still exist on the part of both spouses.

9 There has been much recent modeling of economic decisionmaking within the family, some of which is done in a bargaining context. In some "divorce threat" models, a spouse's bargaining strength increases with the attractiveness of his or her outside option. In other models, spouses threaten to retreat to traditional gender roles, rather than to seek divorce. (See Lundberg and Pollak 1993; and Phipps and Burton 1996.)

10 These are the values underlying Table 1, in which, for computational ease, we did not include surtaxes. If we had included them, the difference would widen from $4,071 ($22,549–$18,478) to $4,396.

11 This argument is similar to those made for investments in primary and secondary education by comparing the public and private returns to such expenditures (see, for example, Constantatos and West 1991).

12 Until earlier in the decade, if each partner in a common-law arrangement had a child, each could claim the spousal equivalent amount for that child. This loophole was closed in 1992, and common-law couples must now declare themselves married after a certain period of cohabitation.

13 We thank Finn Poschmann for providing the SPSD/M modeling of this and other options.

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