

# C.D. Howe Institute COMMENTARY

FISCAL AND TAX COMPETITIVENESS

## Income Splitting for Two-Parent Families: Who Gains, Who Doesn't, and at What Cost?

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### **In this issue...**

While proponents say income splitting will support families raising children, all families would not be equal in reaping the benefits.

# THE STUDY IN BRIEF

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In the 2011 federal election the Conservative Party pledged to allow couples with minor children to split up to \$50,000 of their incomes each year for tax purposes. Tax savings would arise to the extent that the spouses' marginal tax rates differ. Advocates of splitting claim an inequity in tax burdens for one-earner couples versus two-earner couples and often invoke the image of the traditional family with mom at home minding the kids. This *Commentary* provides a quantitative analysis of the economic impacts of the federal income splitting proposal including the effects if the provinces adopted a similar scheme. Its findings include the following:

- Income splitting would reverse the relative position of one-earner and two-earner couples with the same money incomes; on average, the two-earner couples would now bear the heavier tax burdens.
- The gains would be highly concentrated among high-income one-earner couples: 40 percent of total benefits would go to families with incomes above \$125,000, and the maximum annual gain from federal splitting would exceed \$6,400. The maximum gains from provincial splitting would range from zero in Alberta to \$5,750 in Ontario.
- Of all households, 85 percent would gain nothing (including single parents), and even among couples with children nearly half would gain nothing or less than \$500.
- The annual revenue cost of the splitting proposal would be \$2.7 billion for the federal government and an additional \$1.7 billion for the provinces if they were to follow suit.
- Extending the splitting proposal to all couples regardless of children would more than double the revenue cost – to \$5.6 billion for the federal treasury and \$3.5 billion for all the provincial governments (with \$2.1 billion for Ontario alone), yielding a total annual cost exceeding \$9 billion.
- The splitting proposal would significantly raise marginal effective tax rates for most lower-earning spouses, thus imposing barriers for working or returning to work; this would make married women more vulnerable by reducing their work experience.

The *Commentary* concludes that income splitting would fail to achieve its ostensible horizontal equity goal. And if the objective is to provide support to families in raising children, it would distribute most benefits where they are least likely to be needed. Splitting would also be revenue costly and adverse to work incentives. We suggest changes to other parts of the tax and transfer systems that would be more effective in addressing the true needs of families and taxpayers more generally while avoiding the disadvantages of splitting.

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In the 2011 federal election the Conservative Party of Canada pledged to allow parents of minor children to split their incomes for tax purposes, with the change contingent on the federal budget's returning to balance (see Conservative Party of Canada 2011).

Under this "Family Tax Cut" proposal, up to \$50,000 of income would become transferable between spouses each year, with tax savings arising to the extent that their marginal tax rates differ. The argument for this reform is that it is unfair for two couples with the same total income to bear different total tax liability when their split of earnings differs; in particular, the case of the one-earner couple where the other spouse stays home to mind children is often invoked. The Conservatives' pledge followed a similar one in their 2005 election platform – indeed, the notion of horizontal equity embedded in the proposal was a primary basis for the much earlier advocacy of a flat-rate personal income tax by the Canadian Alliance and the Reform Party.<sup>1</sup>

The income-splitting proposal, however, would not amount to minor tinkering with the Canadian income tax system; rather, it carries considerable importance for several reasons. First, it would change a basic element of the income tax – the unit of taxation – at least for couples with children. Second, it could set a precedent for wider income splitting of couples' incomes, such as eliminating the \$50,000 annual limit or the requirement to have dependent children.<sup>2</sup> Third, the associated revenue cost of the proposal would be large – \$2.7

billion annually for the federal treasury and \$1.7 billion more for the provinces if they were to parallel the change in their tax provisions. Fourth, it would offer no tax reduction for the great majority of Canadian households, while the government revenue loss would lead to either a curtailment of public services or an increase in their tax burden to make up the shortfall. Finally, the proposal raises key issues about tax policy that the Conservatives did not mention, including incentives, efficiency, gender neutrality, and the effects on married women.

This *Commentary* examines the Conservatives' income-splitting proposal quantitatively to identify what groups would gain and by how much and the effects of the proposal on work and family formation incentives. It also briefly assesses related tax policy issues and alternative reforms that could achieve some of the same purposes but with different distributional effects and less distortion to incentives. Our computations assume that the provinces would follow any federal income tax change of this nature, as they did in 2006 when Ottawa introduced income splitting for eligible pension income of seniors. Provincial participation is not an essential feature of the reform, although the provinces (except for Quebec) might be constrained by their Tax Collection Agreements with Ottawa that require them to use a common definition of taxable income. If the provinces chose not to make such a change, the effects would be about one-third smaller than our figures, depending on the province. We further assume that splitting would be permitted for both employment/self-employment earnings and property/investment income, since the Conservatives' proposal did not distinguish between the two

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- 1 For analysis of the earlier argument that a flat tax would eliminate horizontal inequity across couples with different splits in their earnings, and the relationship to income splitting, see Kesselman (2000).
- 2 Already, the Ontario Conservative Party has made a 2011 election campaign pledge to introduce "income sharing" up to \$50,000 for all couples, with or without children (Howlett 2011). Ontario Conservative leader Tim Hudak had introduced a private member's bill on income splitting in the provincial legislature in 2008. We present cost estimates of the Ontario Conservatives' proposal later in this *Commentary*.

forms of income.<sup>3</sup> We also discuss the possible merits of permitting couples to split their property/investment income but not their labour earnings, a practice found in several other countries.

## Arguments For and Against Income Splitting

In the Canadian tax system, the primary taxable unit is the individual, who is assessed for tax principally on the basis of his or her own income. In practice, though, several features of the system recognize family relations. For instance, taxpayers can claim portions of unused child, spouse, or dependent tax credits to reduce their tax payable;<sup>4</sup> tax-based benefits to persons and families are usually determined on the basis of family income;<sup>5</sup> seniors can split their eligible pension income for tax purposes; spousal Registered Retirement Savings Plans (RRSPs) can be used to split income between spouses; and assets can be transferred from one spouse to the other, albeit constrained by income-attribution rules.<sup>6</sup> Thus, departures from use of the individual as the basic tax unit relate either to capital or pension income or to the transfer system or subsidiary aspects of the income tax. At the same time, the Canadian tax system tightly constrains the ability to split labour earnings between spouses other than through the hiring of a spouse in a family business.

The principal expressed goal of income splitting is to ensure that couples with similar total *money income* pay similar amounts of tax – an application

of the horizontal equity principle that “equals” should be taxed equally. However, critics of income splitting argue that “equals” are more appropriately gauged by broader measures of a family’s total economic resources or consumption.<sup>7</sup> That approach would include the value of home-produced services, such as cleaning, cooking, and childcare, which is larger when one spouse spends less time, or no time, in the paid labour force. Such an approach would also deduct work-related costs such as commuting, the need for appropriate work clothing, and hired childcare or daycare. In this perspective, a two-earner family is not the “equal” of a one-earner couple that has the same total *money income*, because the latter couple has more *in-kind income* from home-produced services and fewer work-related expenses.

Another goal of income splitting, implicit in the Conservatives’ scheme, is to give parents greater ability to spend time at home caring for their children. This choice could be exercised by, for example, one parent’s working part time, rather than full time, or stopping work entirely. Yet this goal and that of horizontal equity make a curious mix, for two reasons. First, if income splitting were a *prima facie* requirement for fairness among couples with varying earnings splits, then on what basis can splitting be restricted to couples with dependent children? Second, income splitting is an odd policy choice if a major objective is to help parents spend more time on child rearing. It would be of the most benefit to couples that are already the most able to reduce one spouse’s work and of the least benefit to couples with the least

3 Thus, whenever we use the term “earn” or “earner,” we are referring to the individual’s total income. However, in all numerical illustrations, we assume that all the income is in fully taxable forms such as labour and interest income, rather than of a type that is taxed at preferential rates, such as capital gains and Canadian dividends.

4 These provisions differ from the issues raised by income splitting, since the credits are valued at flat, rather than progressive, rates; see our later discussion of the spousal credit.

5 This type of family-based income testing usually works to the disadvantage of couples with discrepant incomes, since individual-based income testing more often provides benefits to the lower earner.

6 The income-attribution rules tax the income from property transferred between spouses in the return and at the rate of the transferor rather than the transferee, unless special conditions have been met on the transfer. For a recent review of income-splitting strategies, see Jacob and Lee (2010).

7 See Kesselman (2008) for a comprehensive, critical review of the arguments and related evidence. For earlier Canadian treatment of related issues, see Boessenkool and Davies (1998) and Vincent and Woolley (2000). All these studies conclude that income splitting for couples would not be desirable policy. For one Canadian study that supports income splitting, see Mintz (2008).

ability to do so (not to mention single parents).<sup>8</sup> Our later quantitative results confirm this point.

Thus, on a principled economic basis, the argument for income splitting by couples with children faces several challenges. Moreover, relatively few countries allow general income splitting – or joint taxation more broadly – citing its creation of gender inequities, distortions of marital incentives, work disincentives for the lower-earning spouse, and other economic inefficiencies. We examine some of these issues briefly in our analysis of the federal Conservatives’ proposal. Our purpose in this *Commentary* is not to resolve these differences of perspective, but to cast light on the distributional, revenue, and other economic implications of the income-splitting proposal.

## Does Horizontal Inequity Exist?

If one accepts the “money income” basis for comparing couples and the implied higher tax burden of couples whose partners have disparate earnings, how large is this horizontal inequity? We compute the pattern of the tax burden at various total family income levels separately for different splits in spouses’ earnings. In particular, we consider the cases where the income of the lower-earning spouse is less than 15 percent and more than 35 percent of family income; each case constitutes about one-third of all two-parent families with dependent children. We take into account such provisions as the childcare expense tax deduction and income-tested credits and benefits that are linked and/or delivered via the personal income tax.<sup>9</sup> We also include employees’ payroll taxes (or “premiums”) for employment insurance (EI) and the Quebec/Canada Pension

Plan (Q/CPP), since these are part of households’ tax burden.<sup>10</sup>

Figure 1 compares the average tax burden of families with children where the two spouses earn relatively similar and relatively dissimilar total income. As expected, at most income levels, families with earnings unevenly distributed between spouses bear, on average, a heavier tax burden than those where the spouses’ incomes are relatively similar. At lower income levels, the tax burden is negative since transfer payments received from governments exceed taxes paid. From the point where the tax burden becomes positive (at around \$50,000 of family income) to about \$80,000, the average tax burden of families with unevenly distributed income exceeds that of families with similar spouses’ incomes by an amount ranging approximately between \$500 and \$1,500; the same is true for family-income levels above \$100,000.

Although such a difference in average tax burden is not trivial, at first sight the progressive nature of the tax system might suggest that families with similar spousal incomes should have a pronounced tax advantage, especially at higher income levels. In fact, the gap in the relative tax burden of the two types of families is mitigated in large part by payroll taxes. For the same total family income above middle levels, payroll charges for EI and Q/CPP are higher for dual-earner families than they are for single-earner families, reflecting the operation of annual earnings ceilings. If one ignores payroll taxes, the tax advantage enjoyed by dual-earner families rises to between \$1,500 and \$4,000.

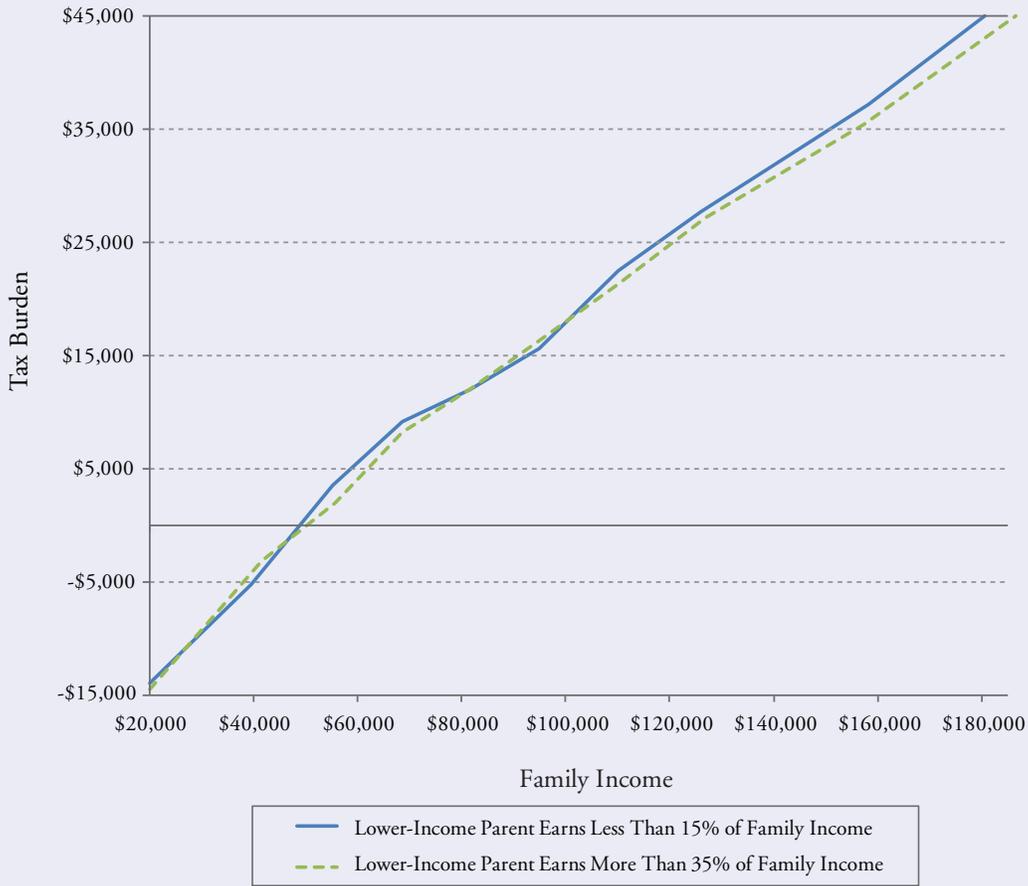
The tax treatment of childcare expenses also affects these differences. Since childcare costs are deductible by the lower-income spouse, the tax

8 Some more natural policy choices, such as enhancements to the Child Tax Credit or the Universal Child Care Benefit (both creations of the Conservative federal government), are discussed later.

9 We include the Canada Child Tax Benefit, the Working Income Tax Credit, and GST/HST credits, as well as similar provincial income-tested credits.

10 One could argue for excluding these premiums since they are linked to benefit eligibility, but for EI this linkage is very loose, and for the Q/CPP the prospective benefits are often far in the future. Additionally, about two-fifths of Q/CPP premiums are used to finance benefits for previous cohorts and are unrelated to entitlements for current contributors.

Figure 1: Average Net Tax Burden, by Family Income and Earnings Split between Parents, 2012



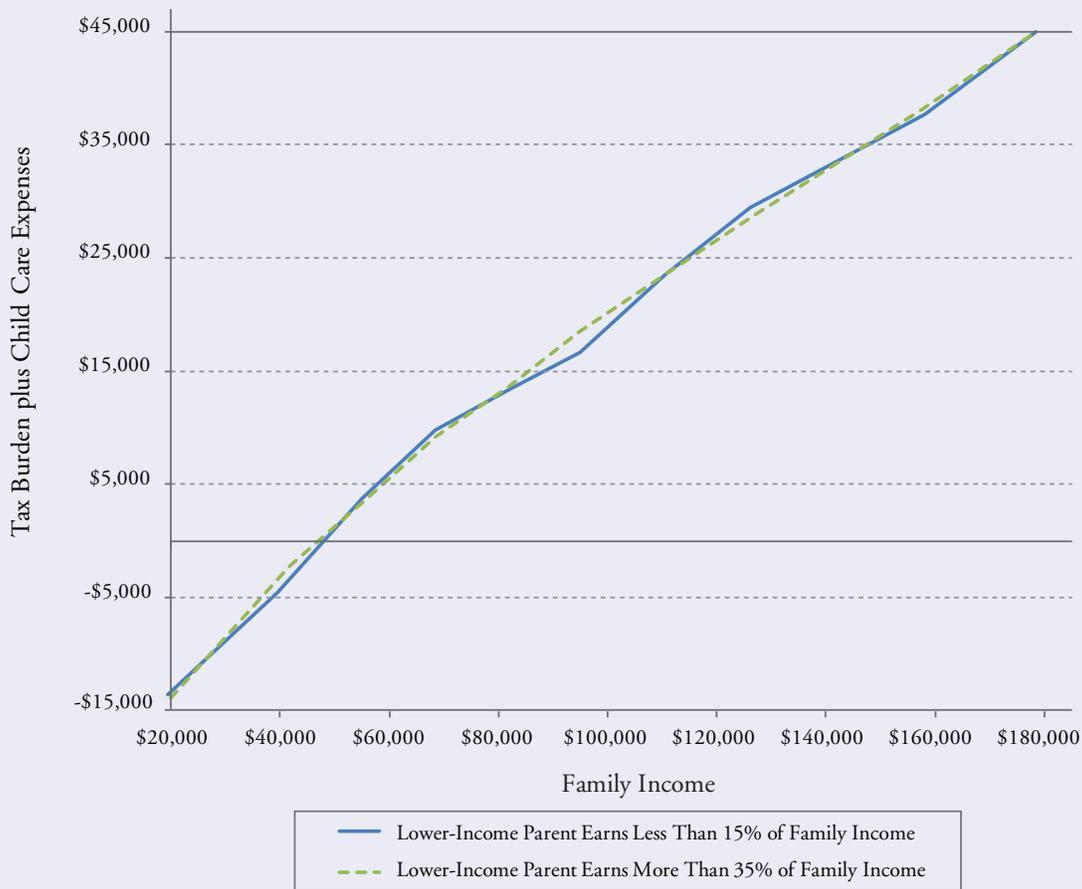
Note: The chart shows the average family net tax burden calculated for each income decile. Deciles divide the income range into ten equal parts, so that the bottom decile, for example, represents the 10 percent of families whose income is lower than the next 90 percent. Source: Authors' calculations using Statistics Canada's SPSPD/M, v.18.1.

value of the deduction is higher for families with more evenly distributed incomes. That dual-earner families spend more on childcare on average than do single-earner families compounds this advantage. Yet, a broader measure of a family's economic resources available for ordinary consumption should subtract childcare costs in comparing "equals" to assess horizontal equity, and these costs are higher for most two-earner couples with young children. Alternatively, one could measure the value of childcare provided by a parent in the home, which is larger for most single-earner couples, and add that to the money income of families. When the net-of-tax expense of childcare is added to a family's tax burden as a drain on

income, any financial advantage dual-earner families enjoy mostly disappears, as shown in Figure 2.

In summary, the current tax system imposes a heavier tax burden on families with the same total money income where the two spouses have relatively unequal incomes. The extra burden is relatively small, however, if we factor in the higher payroll tax incurred by two-earner couples. When we consider the additional outlays for childcare expense (even net of the associated tax savings), we find that dual-earner couples have net-of-tax resources available for consumption that are very similar to those single-earner couples across a wide range of total family incomes. Since childcare is just one of the additional expenses borne by the

Figure 2: Average Net Burden of Taxes and Childcare Expenses, by Family Income and Earnings Split between Parents, 2012



Source: Authors' calculations using Statistics Canada's SPSPD/M, v.18.1.

dual-earner couple, considering other work-related expenses (or, conversely, the single-earner couple's extra home-produced services beyond childcare) would only accentuate their different tax burdens – and in a way favourable to the single-earner family.

### How Income Splitting Would Work

A couple would gain from income splitting by being able to shift taxable income from the spouse in a higher tax bracket to the spouse in a lower bracket. The tax savings would equal the product of the amount shifted and the difference between

the spouses' two marginal tax rates.<sup>11</sup> If income splitting were permitted without limits, this could be accomplished simply by having eligible couples with children file a joint tax return in which all of the tax brackets are twice as wide as for other taxpayers. With the Conservatives' proposed \$50,000 limit, however, income splitting most likely would be implemented through discretion about the amount of taxable income that a higher-earning spouse could shift to the lower-earning spouse. As with current provisions for pension income splitting, the proposed family income splitting would entail notional rather than actual

11 Computing the tax saving is more complex when the shifting is not across two adjacent tax brackets, or when one spouse has partly unclaimed deduction amounts, non-transferable tax credits, or deductions that could be claimed against income taxed at a higher marginal rate.

transfers of income and would require the consent of both spouses. Including property/investment income could complicate the provision considerably, since capital gains are taxed at preferential half-rates and Canadian dividends are both grossed up and granted a non-refundable tax credit.

The progressivity of personal tax rates is crucial in determining the benefits of income splitting. In 2011, the federal taxable income brackets are: \$0–\$41,544 (15 percent), \$41,544–\$83,088 (22 percent), \$83,088–\$128,800 (26 percent), and \$128,800+ (29 percent). For couples that would be eligible under the Conservatives' proposal, tax savings would arise only if the two spouses' taxable incomes are in different brackets, and the savings would depend on the difference in the spouses' initial marginal tax rates and on the amount that could be shifted before the two rates were equalized. By equalizing marginal tax rates, we mean that the two spouses move into the same tax bracket, with one or both possibly at the upper or lower boundary of that bracket. The examples in Box 1 illustrate how splitting would operate under various scenarios. High-income couples that are constrained by the \$50,000 limit might still be in different tax brackets after splitting their incomes.

One feature of the federal personal tax system, the "spouse or common-law partner amount," might appear to be a limited form of income splitting between spouses, but in fact it operates in a very different way. This provision allows the higher-earning spouse to claim the portion of a basic personal amount that the lower-earning spouse cannot use to shield income.<sup>12</sup> In 2011, both amounts are the same, at an exemption-equivalent of \$10,527 – that is, if the lower-earning spouse had no income, the higher-earning spouse can shield an additional \$10,527 of income from tax. This additional sum escapes tax only at the

federal bottom-bracket rate of 15 percent and not at the higher-earning spouse's marginal tax rate. Thus, the spousal amount does not diminish tax progressivity in the way that income splitting does.

If the provinces (and territories) joined the federal government in introducing income splitting, then the progressivity of their rate schedules also would come into play. In most, the threshold for the top rate bracket is lower than the federal threshold of \$128,800; several provinces begin their top bracket at taxable incomes as low as \$60,000–\$70,000. Yukon and Nunavut match the federal threshold, while only Nova Scotia exceeds it, at \$150,000. Moreover, some provincial rate schedules are more steeply progressive than the federal schedule, with top bracket rates more than twice the bottom bracket rates; the ratio is less than two for the federal tax.<sup>13</sup> Given these discrepant rate schedules and boundaries, a couple might be able to gain from income splitting under the provincial tax but not under the federal tax; the converse would also be possible. With its tax at a flat 10 percent of taxable income, Alberta's eligible couples would gain almost nothing from provincial income splitting<sup>14</sup> – thus illustrating how a flat-rate tax eliminates the so-called horizontal inequity arising for couples with progressive taxation.

## Who Would Not Gain from Income Splitting?

Many Canadian couples and households would gain no tax savings from the Conservatives' proposed income-splitting plan. Limiting the provision to households with one or more dependent children under age 18 obviously would exclude single adults living alone, single parents

12 This spousal amount has been criticized as an unwarranted form of fiscal support for stay-at-home spouses, particularly when they have no young children; see Law Commission of Canada (2001) and Kershaw (2002).

13 That three provinces have ratios exceeding that of the federal income tax, indicating greater tax rate progressivity at the provincial level, runs counter to the idea that labour mobility supports lesser tax progressivity at the subnational than at the national level (see Kesselman 2000).

14 Although income splitting would not yield any gain through a lower statutory tax rate, the lower-income spouse could save tax through better use of non-transferable credits and deductions.

### Box 1: Illustrative Examples of the Operation of Income Splitting

Three scenarios show how income splitting would operate with respect to federal income tax (for the tax brackets in 2011). They ignore any potential interactions between the split income and other provisions of the tax and benefit systems that hinge on an individual spouse's net or taxable income. All dollar figures given in the examples pertain to taxable incomes.

**Case A:** Without splitting, Tom has income of \$25,000 (in the 15 percent bracket), while his spouse Katy has income of \$45,000 (in the 22 percent bracket). With the option to split incomes, Katy shifts \$3,456 to Tom, placing each of their taxable incomes within (Tom at \$28,456) or at the top of (Katy at \$41,544) the 15 percent tax bracket. Note that this couple does not need to equalize their taxable incomes to gain the maximum benefit from splitting; they simply need to shift income at least to the point where their marginal tax rates are equalized. Katy could shift more income to Tom, and they would still both remain in the 15 percent bracket with no additional tax savings. The couple's total tax savings from splitting are the amount shifted (\$3,456) multiplied by the differential between the two tax rates (22% – 15% = 7%), or \$242.

**Case B:** Without splitting, Susie is a stay-at-home parent with taxable income of zero, while her spouse Gerald has income of \$90,000 (in the 26 percent bracket). In paying his taxes, Gerald claims both his own \$10,527 basic personal amount plus an equal sum for the spousal amount (thus shielding \$21,054 from the bottom-bracket rate of 15 percent at which credits are computed). With the option to split incomes, Gerald shifts \$41,544 to Susie, placing each of their taxable incomes within (Gerald at \$48,456) or at the bottom of (Susie at \$41,544) the 22 percent bracket. (As in Case A, Gerald could shift more to Susie, and even equalize their taxable incomes, but this would not yield any additional tax savings.) The couple's savings from splitting are the amount shifted out of Gerald's 26 percent bracket (\$90,000 – \$83,088 = \$6,912) times the differential with the 15 percent bracket into which it is shifted, or \$760, plus the amount shifted out of Gerald's 22 percent bracket (\$41,544 – \$6,912) times the differential with the 15 percent bracket, or \$2,424, for a total of \$3,184. Gerald's loss of the spousal amount when splitting income can be ignored, because Susie acquires an equivalent basic amount when she files.

**Case C:** Without splitting, Viju has part-time earnings of \$20,000 (in the 15 percent bracket), while her spouse Ashok has income of \$150,000 (in the top rate bracket of 29 percent). With the option to split incomes, Ashok shifts the maximum allowable \$50,000 to Viju, which puts him into the 26 percent bracket and his spouse into the 22 percent bracket. The limit on splitting prevents these spouses from equalizing their marginal tax rates and also limits the amount of tax savings they can achieve from splitting incomes. In this case, their total tax savings are nevertheless a healthy \$4,144 (the computation is still more complex than in Case B).

(who have no spouse for splitting), childless couples, couples with only grown children, and other households with more than one adult (related or unrelated) but no spouse and no child under age 18. In addition, many couples with one or more dependent children would gain nothing or very little from income splitting if neither

spouse earns more than the bottom-bracket level of taxable income (\$41,544) or if both spouses have earnings that place them in the same tax bracket. Of course, even if both spouses initially were in the same bracket, allowing them to split incomes would allow one spouse to curtail work and thus potentially benefit from splitting.

Table 1: Gainers and Non-gainers from Income Splitting, Distribution by Type of Household, 2012

Household Type	% of All Households
<b>Non-gainers</b>	<b>85</b>
Single persons	45
Single parents	6
Couples with no child under 18	31
Couples with a child or children under 18	2
<b>Small gainers (<math>\leq</math> \$500), couples with child under 18</b>	<b>6</b>
<b>Large gainers (<math>&gt;</math> \$500), couples with child under 18</b>	<b>9</b>
<b>Total</b>	<b>100</b>

Note: Households are census families. Two or more census families may share the same dwelling. Income splitting is limited to \$50,000 per family with minor children and is applied in the federal and provincial taxes.

Source: Authors' calculations using Statistics Canada's SPSD/M, v.18.1; responsibility for the results and their interpretation lies with the authors.

Table 1 displays our estimates of the percentages of different types of households that would gain and not gain from income splitting. Recall that our estimates assume that both federal and provincial income taxes permit income splitting for families. We find that about 85 percent of all households would gain nothing from the proposal, and a further 6 percent would gain very little (\$500 or less per year). Only 15 percent of all households would enjoy any tax savings from income splitting, and even among couples with minor children nearly half would gain little or nothing. The proportion of households gaining would be further reduced if splitting were confined to federal taxes. In short, not only would the great majority of Canadian households gain nothing from income splitting; they could be losers on account of the scheme's revenue cost and associated curtailment of public services or compensating tax hikes.

### Who Would Gain and by How Much?

Those who potentially could gain from the income-splitting proposal are two-parent families with one or more dependent children under age 18. As Table 1 shows, nearly half of that group would obtain only modest tax savings or none at all, but some families would be able to shift the full limit of \$50,000 of taxable income from a primary earner who is in the top bracket to an at-home spouse with no earnings, saving the couple \$6,408 in federal tax.<sup>15</sup> In addition, as Table 2 shows, the couple's provincial tax savings would range from zero in Alberta to as much as \$5,748 in Ontario – where the couple would have maximum total federal plus provincial tax savings of \$12,156.

Without a limit on the amount of income that could be split, the same illustrative couple would save \$10,096 in federal taxes alone. Even with the proposed limit, however, the couple could save more than 60 percent of the potential amount from having no limit, since the amount shifted

15 For the maximum tax savings, this example also assumes that the primary earner's income is sufficiently large as to remain in the top tax bracket even after the income shifting. Our calculation further ignores the possible interaction between income splitting and the treatment of the income shifted to the lower-earning spouse via other tax provisions that hinge on the lower-earning spouse's income (such as childcare expense deduction and the taxability of the Universal Child Care Benefit, received for children under age six).

Table 2: Maximum Tax Savings from Splitting with a \$50,000 Limit, by Province, 2011

Province	Top/Bottom Rate Ratio <sup>a</sup>	Top-bracket Taxable Income Threshold <sup>b</sup>	Maximum Tax Savings
		\$	\$
<b>Alberta</b>	1.00	n/a	0
<b>New Brunswick</b>	1.57	120,796	1,537
<b>Saskatchewan</b>	1.36	116,911	1,818
<b>Newfoundland and Labrador</b>	1.73	63,807	2,044
<b>Manitoba</b>	1.61	67,000	2,930
<b>Quebec</b>	1.50	78,120	3,562
<b>Prince Edward Island</b>	1.87	98,145	3,678
<b>British Columbia</b>	2.91	100,787	4,523
<b>Nova Scotia</b>	2.39	150,000	4,957
<b>Ontario</b>	3.45	78,361	5,748
<b>Federal</b>	<b>1.93</b>	<b>128,800</b>	<b>6,408<sup>c</sup></b>

## Notes:

<sup>a</sup> Top rate includes the effect of the surtax in Ontario and Prince Edward Island.

<sup>b</sup> Tabulated threshold includes the effective threshold for the top surtax for Ontario and Prince Edward Island.

<sup>c</sup> Because of special fiscal arrangements, for Quebec the maximum federal tax savings from splitting would be \$5,351.

Source: Authors' calculations from statutory rate schedules.

would fill up the non-earning spouse's bottom tax bracket, where the tax savings are greatest. In practice, then, the proposed dollar limit would constrain few of the couples that would benefit from income splitting.

Table 3 displays the percentage distribution of total tax savings from income splitting, with eligible families classified into three groups hinging on the earnings disparity of the two spouses. For couples with the greatest disparity (where the lower-income spouse earns 0–15 percent of family income), the tax savings cluster around the larger tabulated figures of more than \$1,000 per year. About half of these single (or nearly single) earners would garner annual tax savings exceeding \$2,000, while more than 20 percent of this group would gain more than \$5,000. For couples with the least disparity (where the lower-income spouse earns 35–50 percent of family income), the tax savings cluster around the smaller tabulated figures of less

than \$300 per year. Couples with an intermediate degree of disparity (where the lower-income spouse earns 15–35 percent of family income) cluster in the mid- to upper range of the distribution of tax savings. Fully 48 percent of all eligible families would garner savings of \$500 or less per year.

Table 4 displays average tax relief in dollars by income groups and parents' income disparity. In the upper panel of the table, each cell represents about 8 percent of all families: about 25 percent of families are in each income group, and about a third of families are in each family group defined by earnings disparity. The average tax relief for families earning more than \$125,000 would reach \$6,443 when the parents earn very unequal incomes, but only \$351 when their incomes are more evenly split. Tax relief would diminish sharply for lower levels of family income, reflecting the progressivity of the income tax system and the much more limited scope of these households to

Table 3: Percentage Distribution of Families, by Amount of Tax Savings from Income Splitting and Earnings Splits, 2012

Amount of Family Tax Savings	Families Where the Lower-Income Parent Earns...			
	from 0% to 15% of family income	from 15% to 35% of family income	from 35% to 50% of family income	All
(\$)	(percent)			
<b>nil</b>	15	6	15	12
<b>1–100</b>	4	9	33	16
<b>101–300</b>	6	9	22	13
<b>301–500</b>	4	6	10	7
<b>500–1,000</b>	8	18	13	13
<b>1,001–2,000</b>	11	27	6	14
<b>2,001–5,000</b>	31	24	1	18
<b>5,000 and over</b>	21	2	0	8
<b>All</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

Notes: Families are dual-parent families with minor children and up to \$50,000 per family may be split between parents. Tax savings are federal plus provincial and assume that the provinces adopt the same splitting scheme.

Source: Authors' calculations using Statistics Canada's SPSPD/M, v.18.1.

shift income. The average tax relief for families earning no more than \$55,000 per year would be less than one-fifth that for families earning over \$125,000.

The lower panel of Table 4 displays how the total tax relief from income splitting is distributed across the income quartiles for two-parent families with children. Clearly, the relief would be skewed toward the upper quartiles: the top 25 percent of families by family income would receive 41 percent of the total relief (federal plus provincial). In contrast, the bottom quartile would receive just 7 percent of the total. Moreover, 23 percent of all relief (or more than \$1 billion) would go to the 8 percent of two-parent families in the top quartile and in which the lower-earning spouse earns less than 15 percent of the family's income. As the table shows, the relief from income splitting would be skewed somewhat more toward the upper quartiles at the federal level than would be the case at the provincial tax level. This difference likely reflects the narrower tax brackets and lower

income thresholds for the top bracket in most provincial tax schedules relative to the federal tax (as well as the fact that Alberta's flat tax would yield almost no relief from income splitting).

## The Effects of Income Splitting

### *The Revenue Cost*

Table 5 shows our estimates of the annual revenue cost of the Conservatives' income splitting proposal at \$2.7 billion for the federal government and \$1.7 billion for the provinces if they were to follow suit. As far as the distribution of the revenue cost (and tax relief) is concerned, it is no surprise that families where the spouses earn dissimilar incomes would be the major beneficiaries of this policy. Families where the lower-income spouse earns less than 15 percent of the family's total income would receive more than 60 percent of the total benefits of the provision, and they

Table 4: Average Family Tax Relief as a Result of Income Splitting, by Income Group and Earnings Splits within the Family, 2012

Families Where the Lower-Income Parent Earns...	Proportion of All Families	Family Income				
		\$55,000 or less	\$55,001–\$88,000	\$88,001–\$125,000	\$125,001 and over	All
	(%)	(\$)				
from 0% to 15% of family income	32	592	2,652	4,664	6,443	2,791
from 15% to 35% of family income	32	266	1,035	1,677	2,325	1,439
from 35% to 50% of family income	36	115	302	351	351	303
All	100	409	1,290	1,780	2,364	1,469
Proportion of all families (%)	–	25	25	25	25	100
Proportion of federal relief (%)	–	6	21	32	41	100
Proportion of provincial relief (%)	–	8	24	26	42	100
Proportion of total relief (%)	–	7	22	30	41	100

Notes: Households are census families. Income splitting is limited to \$50,000 per family with minor children. Tax savings are federal plus provincial and assume that the provinces adopt the same splitting scheme.

Source: Authors' calculations using Statistics Canada's SPSD/M, v.18.1.

would see their disposable income jump by 3.4 percent on average. In sharp contrast, families where the spouses have much more similar earnings would receive just 7 percent of total savings, and their disposable incomes would rise by just 0.4 percent. The intermediate group of families by earnings disparity would receive 31 percent of the total benefits and enjoy a 1.6 percent increase in disposable income.

In Table 6, we break down the revenue cost by province and show the cost of income splitting

separately for federal and provincial income taxes, again assuming that provinces follow the federal initiative's limit and scope. In part because of its large population, Ontario accounts for the largest revenue cost for both federal and provincial splitting. However, the steep progressivity of Ontario income tax rates accentuates the revenue cost for provincial tax splitting. The revenue cost for Ontario if restricted to splitting with children is \$1.14 billion, nearly equal to the \$1.16 billion federal revenue cost in that province.<sup>16</sup>

16 If Ontario were to adopt the provincial Conservative Party's proposal to extend splitting to all couples, regardless of the presence of dependent children, the provincial revenue cost would rise to \$2,100 million. This high figure also reflects the province's relatively high degree of progressivity in its income tax.

Table 5: Cost to Governments and Distribution by Earnings Splits within the Family, 2012

Families Where the Lower-Income Parent Earns...	Provincial Fiscal Cost	Federal Fiscal Cost	Proportion of Total Fiscal Cost	Proportion of Families
	(\$ millions)		(%)	
<b>from 0% to 15% of family income</b>	1,040	1,690	61	32
<b>from 15% to 35% of family income</b>	550	850	31	32
<b>from 35% to 50% of family income</b>	140	190	7	36
<b>All Families</b>	<b>1,720</b>	<b>2,730</b>	<b>100</b>	<b>100</b>

Notes: Families are dual-parent families with minor children. Provincial and federal fiscal costs represent reduction of government revenues as a result of income splitting of up to a maximum of \$50,000 per family.

Source: Authors' calculations using Statistics Canada's SPSD/M, v.18.1.

Table 6 additionally reports our estimates for the proportion of the federal and provincial revenue costs – and thus tax savings – attributable to families with incomes above \$125,000 in each province. Quebec is a big outlier on this measure, with 61 percent of provincial tax savings in that province going to high-income families versus an average of 42 percent for all provinces. This pattern reflects the operation of Quebec's relatively flat rate structure combined with a non-refundable tax credit rate equal to that of the second-highest income tax bracket. Concentration of the tax savings from federal income splitting in higher-income families averages 41 percent nationally, but it is distinctly higher in Alberta at 55 percent and in Newfoundland and Labrador at 53 percent. Since taxpayers in all the provinces face the same federal income tax rate schedule, these outliers must reflect solely the differences in the distribution of family incomes in those provinces.

We should note that our estimates are based on a Statistics Canada model that does not account for behavioural responses to policy changes. Given the incentives income splitting would pose, the likely revenue costs in reality could be significantly higher. As we discuss in more detail below, income splitting would induce some married spouses – mostly women – to reduce their hours of work, others to withdraw from the labour force, and still

others to choose not to re-enter the labour force after withdrawing to mind infants or young children. All of these responses would reduce that spouse's taxable earnings and taxes paid. Moreover, their partner's tax liabilities also could decline, because their gains from splitting would increase in response to the spouse's decreased earnings.

#### *The Effects on Families' Relative Tax Positions*

When we compare the tax burdens of families with the income-splitting proposal, a complete reversal of the trend observed in Figure 1 emerges. At almost all levels of family income, the average tax burden of dual-earner families where the lower-earning parent contributes more than 35 percent of the family's income would exceed that of single-earner families where one parent earns less than 15 percent of family income, as shown in Figure 3. For families with income above about \$65,000, in particular, the tax burden would be lower in the uneven-earner families than in dual-earner families by \$3,000-\$4,500 on average. Thus, instead of being overtaxed relative to dual-earning couples with the same total money incomes, single-earning couples would now be undertaxed.

Table 6: Distribution of Federal and Provincial Costs of Income Splitting, by Province, 2012

Province	Provincial Splitting Cost	Federal Splitting Cost	% of Provincial Benefits to \$125,000+	% of Federal Benefits to \$125,000+
	(\$ millions)		(%)	
<b>Alberta</b>	negligible	490	n/a	55
<b>British Columbia</b>	180	300	44	34
<b>Manitoba</b>	50	90	34	28
<b>New Brunswick</b>	20	50	21	39
<b>Newfoundland and Labrador</b>	20	50	33	53
<b>Nova Scotia</b>	60	70	27	37
<b>Ontario</b>	1,140	1,160	40	39
<b>Prince Edward Island</b>	5	10	24	29
<b>Quebec</b>	200	440	61	39
<b>Saskatchewan</b>	20	80	35	40
<b>Total/average</b>	1,720	2,730	42	41

Notes: For Ontario the provincial revenue cost if splitting were extended to all couples irrespective of whether they have children is computed as \$2.1 billion.

Source: Authors' calculations using Statistics Canada's SPSD/M, v,18.1.

As noted previously, payroll taxes account for much of this difference. While removing payroll taxes from consideration would lower the tax-burden advantage enjoyed by single-earner families, it would still be, on average, about \$1,000-\$2,500. One reason for the tax differentials favouring uneven-earner families is the childcare expense deduction, which is more valuable to uneven-earner couples after splitting than before. There are also deduction amounts and non-transferable tax credits for which lower-income spouses may not have enough taxable income to be able to claim before splitting, but which become claimable after splitting. If we consider the burden of additional childcare and other expenses borne by dual-earner couples, the disadvantage of income splitting to dual-earner couples with the

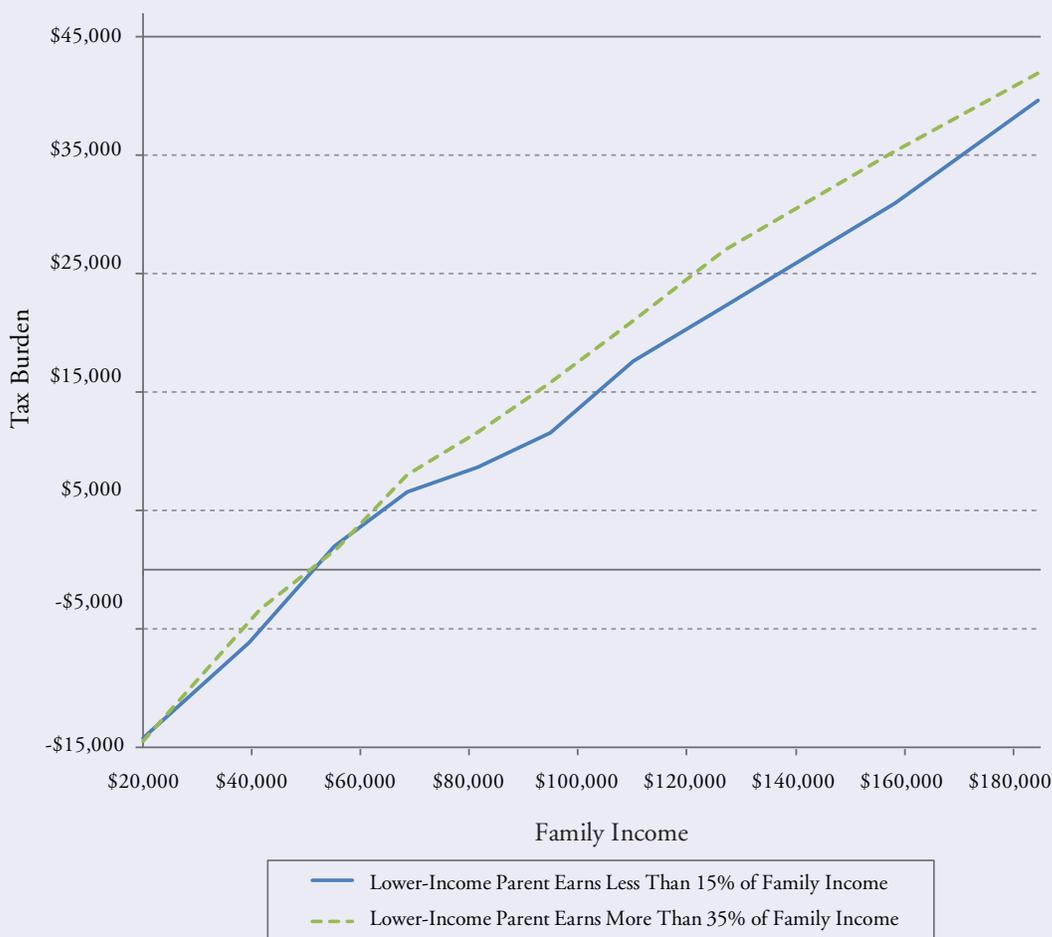
same level of real resources as single-earner couples would become even larger.

### *The Effects on Work Incentives*

Income splitting would affect work incentives for eligible couples. The research literature on this topic has addressed both the impact on the marginal effective tax rate (METR) of each partner and the tax "hurdle" the lower-earning spouse faces in choosing whether to re-enter the labour force – likely after taking time out to mind infants or young children.<sup>17</sup> One finding is that income splitting can raise the METR on the earnings of the lower-earning spouse and/or decrease it on those of the higher-earning spouse. Since the lower-earning spouse is typically the

<sup>17</sup> Kesselman (2008) provides an extensive review of the theoretical and empirical economic research on the labour supply effects of income splitting and the associated efficiency costs. Increased METRs can also affect various other behaviours, such as savings and tax avoidance, that have both efficiency and revenue costs; see Canada (2010) and references cited therein.

Figure 3: Average Net Tax Burden after Income Splitting, by Family Income and Earnings Split between Parents, 2012



Source: Authors' calculations using Statistics Canada's SPSPD/M, v.18.1.

mother, and married women are much more responsive in their work choices to variations in tax rates than are married men, the overall effect would be a decrease in total paid work hours and an increased cost to economic efficiency. Moreover, in many situations, income splitting would raise the hurdle to re-entering the labour force, carrying adverse implications for women in terms of their work experience and potential long-term earnings.

Table 7 shows the effects of income splitting on the METR of both the lower- and higher-earning spouse. We simulated these figures for two-parent families with income falling in the tabulated income intervals for each of the two spouses. This reason and the interactions with income-tested tax

and transfer benefits at lower incomes mean that a few of the tabulated figures differ from the expected signs. Moreover, all the figures on the diagonal of the table (shaded cells) would be zero if both spouses started with exactly the same income, so the non-zero (but mostly small) figures result from variability of incomes within the intervals.

Apart from the cited items, the tabulated results confirm the expected signs: income splitting would typically raise the METR for the lower-earning spouse and decrease it for the higher-earning spouse. Some of the effects are large – on the order of a ten-percentage-point hike for a low-earning spouse when the other spouse earns over \$100,000. These results confirm the heightened

Table 7: Change in METR for Incremental Earnings as a Result of Income Splitting

		Income of Lower-Earning Spouse								
		(\$)								
		0 – 5,000	5,001– 15,000	15,001– 25,000	25,001– 40,000	40,001– 55,000	55,001– 75,000	75,001– 100,000	100,001– 125,000	125,001– 250,000
		<i>(percentage change)</i>								
Income of Higher-Earning Spouse (\$)	15,001– 25,000	-3.0 <i>-3.1</i>	-1.3 <i>-1.7</i>	-5.7 <i>-1.1</i>						
	25,001– 40,000	0.9 <i>-3.6</i>	-6.6 <i>-1.7</i>	1.4 <i>-2.4</i>	0.6 <i>1.8</i>					
	40,001– 55,000	2.6 <i>-8.2</i>	-1.5 <i>-6.7</i>	1.4 <i>-7.5</i>	1.8 <i>-4.7</i>	1.2 <i>-1.5</i>				
	55,001– 75,000	-1.0 <i>-8.8</i>	2.8 <i>-7.9</i>	-3.5 <i>-7.0</i>	6.0 <i>-1.7</i>	1.4 <i>-1.4</i>	-0.8 <i>-0.4</i>			
	75,001– 100,000	0.1 <i>-8.8</i>	5.4 <i>-5.8</i>	8.9 <i>-4.6</i>	9.5 <i>-3.5</i>	4.1 <i>-3.9</i>	1.0 <i>-3.0</i>	1.1 <i>-0.8</i>		
	100,001– 125,000	0.8 <i>-7.8</i>	10.1 <i>-8.9</i>	9.8 <i>-8.2</i>	11.0 <i>-6.3</i>	3.6 <i>-7.1</i>	4.0 <i>-4.1</i>	3.8 <i>-1.1</i>	2.8 <i>-5.8</i>	
	125,001– 250,000	0.2 <i>-4.1</i>	4.4 <i>-4.4</i>	11.5 <i>-3.6</i>	12.4 <i>-3.7</i>	9.7 <i>-3.5</i>	6.0 <i>-2.0</i>	5.5 <i>-1.3</i>	1.6 <i>-0.3</i>	0.5 <i>-0.4</i>

Notes: Figures in the table are for the initial earnings level of each spouse. The top figure in each cell = change (in percentage points) in the METR on incremental earnings (for a \$100 increase) by the lower-earning spouse. The bottom figure (italic) = change (in percentage points) in the METR on incremental earnings (for a \$100 increase) by the higher-earning spouse.  
 Source: Authors' calculations using Statistics Canada's SPSD/M, v.18.1.

tax hurdles for mothers in re-entering the labour force. Overall, roughly 20 percent of lower-earning spouses would see their METR raised by more than 9 percentage points, and 5 percent would face a more than 20 percentage point METR hike. On the other hand, about 15 and 5 percent of higher-earning spouses would see their METR lowered by, respectively, more than 8 and 15 percentage points.

*The Effects on Equity and Marital Incentives*

Income splitting raises issues of horizontal equity in the taxation of single persons and couples with equal-earning partners.<sup>18</sup> A couple enjoys significant scale economies in housing and other living costs and thus can live more cheaply together than apart. If we consider these economies in gauging consumption levels, equity dictates

18 For a review of the literature on equity comparisons between couples and singles and the effects of splitting on marital incentives, see Kesselman (2008). The United States, in particular, has a long, contentious history of tax changes that alternately increased and decreased marriage penalties and bonuses.

that the couple's combined tax burden should be heavier than that for two identical single persons. For this reason, some countries' systems of joint taxation – a variant of income splitting – carry a “marriage penalty” for couples where the partners' earnings are not too dissimilar; the US federal tax code contained such an approach until recently. The “penalty” is implemented by having a separate tax schedule for the combined income of the two spouses where the brackets are less than twice as wide as for single, unrelated taxpayers. While this issue might not seem imminent in the context of the federal Conservatives' proposal, income splitting's high revenue cost and perceived unfairness toward singles could become contentious in future.

If income splitting does not recognize the scale economies that couples enjoy, then “marriage bonuses,” in the form of joint tax savings, can occur. These bonuses are largest when the partners' earnings diverge widely and at higher family incomes. Evidence from the United States suggests that this advantage has little effect on the decision to marry, but more on the timing of weddings to obtain the tax benefits of being married prior to year-end. In Canada, however, these results would not apply since both marital and common-law relationships (and both opposite-sex and same-sex partners) qualify equally for all tax provisions, including income splitting, so long as they had dependent children. Still, even under the Conservatives' proposal, a “marriage bonus” could occur when a non-cohabiting single person with a child chooses to cohabit or marry.

## Policy Alternatives to Income Splitting

### *Tax and Transfer Benefits Targeted at Children*

If a major objective of income splitting is to permit parents to spend more time child rearing,

then it is a poor choice of policy instrument. Splitting would provide no fiscal support for single parents – those in greatest need of such help – and little or none for lower-earning couples with children. Instead, those who would benefit most from income splitting would be the highest-earning couples, many of whom will already have chosen to have one parent curtail or cease paid employment to mind children. For those couples, who are the most able financially to choose at-home parenting over paid work, the benefits of income splitting would be a pure windfall. In short, income splitting would provide support in a pattern completely the reverse of what families at various income levels need to spend more time caring for their children.

The proposal to restrict income splitting to couples with children under age 18 also seems hard to justify. The period when children derive the greatest benefit from having an at-home parent, or from spending more time from a parent, is during infancy and the pre-school years. Thus, if only families with very young children were eligible for income splitting, the provision's revenue costs could be reduced and its assistance more effectively targeted. At the same time, placing a cap of 18 years on the age of a dependent child to be eligible for splitting ignores families' increased financial burden when their children move on to higher education.

Much better policy vehicles already exist to help families spend more time caring for their children. Prime candidates include the Child Tax Credit; the Universal Child Care Benefit (if support is meant to be universal, payable for all children under age six); the Canada Child Tax Benefit (provided clawback rates are not increased much at low- to middle-income levels<sup>19</sup>); and the EI provision for parental leave (contingent on the parent's qualification through work history, and if support is aimed at the first year of the child's life). All these programs are open equally to single- and two-parent families, and any could be amended

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19 See Laurin and Poschmann (2011) for evidence on the high METRs already imposed on lower- and moderate-income households.

or expanded as needed. Indeed, the \$2.7 billion federal revenue cost of income splitting would go a long way if the money were spent instead on helping families with very young children.

### *Across-the-Board Personal Income Tax Cuts*

If the intention of the income-splitting proposal is to provide tax relief with a tilt favouring higher earners, this could be achieved more effectively by just cutting tax rates in the relevant brackets. This would not target assistance at families with children, but it would avoid the work and familial distortions of income splitting and address equity concerns about the exclusion of single parents and childless couples and singles. Rate cuts for personal tax would also pay dividends by increasing the revenue base, since varied behavioural responses – including tax avoidance and work, saving, and investment decisions – are affected by marginal tax rates. For example, a 10 percent cut in personal METRs has been estimated to raise taxable income by 2 to 7 percent (Canada 2010). Responsiveness is greatest at the highest incomes, so personal tax cuts stressing the upper brackets would be partially self-financing.

### *Splitting for Investment and Property Incomes<sup>20</sup>*

The Canadian tax system already contains many methods by which astute, well-advised couples can legally split their investment and property incomes. A key question for horizontal equity is whether fairness would be improved by removing the income-attribution rules or by providing all

couples simple provisions for splitting their combined investment income. Such reforms would improve equity for couples who are not well informed or well advised in tax and financial matters. They could also bring other benefits: lower costs for the tax authorities in policing the system; reduced private expenditures on financial, tax, and legal advisory services; and a sharper focus by couples on maximizing investment returns, rather than on strategies to minimize their joint taxes. Insofar as these changes would improve the efficiency of capital markets, benefits would also arise for society at large. However, an important factor in assessing reforms of this kind is whether they would apply to notional shifting or require an actual transfer of legal and beneficial title to the property or income.<sup>21</sup> Actual transfer of title is needed to promote gender equity, as many studies have found that a spouse's access to income conveys power over spending and in the relationship more generally.<sup>22</sup>

The Conservatives' proposal would allow couples to split their income from capital and property sources, but without any requirement that ownership of the asset be transferred. The more radical part of the proposal would allow the splitting of labour income, since investment income can already be split to a substantial degree by a variety of methods as previously noted. Several countries have chosen to prohibit splitting of labour income while providing ways for couples to split investment income easily.<sup>23</sup> Splitting investment income does not elicit the problems of labour market distortions and barriers to married women re-entering the labour force that arise with splitting labour income. Thus, proposals for income

20 This section draws heavily on Kesselman (2008, 22-25).

21 Examples of inter-spousal transfers of property and the associated income currently permitted by the tax system include pension income splitting (notional transfers suffice) and spousal contributions to RRSPs and TFSPAs (both entailing transfer of legal title).

22 See, for example, Kornhauser (1993) as well as other studies cited in Kesselman (2008) finding that most couples do not fully share their individual incomes, with clear implications for income splitting that is based on purely notional shifts of the income between spouses.

23 Some examples include the unrestricted division of investment income between spouses by allowing asset transfers (United Kingdom); the taxation of all investment income at a flat rate independent of the progressive rates applied to labour income (Finland, Norway, Sweden); and the division of a couple's total investment income equally between the two spouses (Belgium). See Kesselman (2008: 23).

splitting limited to investment and property income are worthy of closer examination particularly if they attend to the issue of gender equity.<sup>24</sup>

## Concluding Remarks

Canada's income tax system already recognizes close relationships through its benefits-related provisions and in allowing the transfer of unused tax credits within families. Income splitting is otherwise limited to pension incomes and the various means by which couples can transfer investment and property income. The federal Conservatives' proposal to allow income splitting for two-parent families with dependent children under age 18 would add a new dimension to the tax recognition of personal relationships by allowing transfers of labour earnings. It bears emphasis that these are notional transfers for tax purposes and do not require the actual shift of income from the higher-earning spouse to the lower-earning spouse. Our quantitative estimates find that the consequences, in terms of both revenue and distributional effects, would be large.

We find that, even without income splitting, the tax differentials between single- and dual-earner families with the same total money incomes are smaller than anticipated, particularly when payroll taxes are included. When the costs of childcare are factored into the net resources of comparative families, the differentials essentially disappear. Thus, any broader measure of economic resources that includes the additional costs borne by dual-earner couples (or, alternatively, the additional value of home-produced services by single-earner couples) belies the claim that the current system poses widespread inequity in the treatment of

couples with different earnings splits. Money income alone is insufficient to gauge which couples have equal resources and thus equal taxpaying capacities.

The income-splitting proposal, in fact, would lead to a complete turnaround: single-earner families would go from bearing, on average, a somewhat larger tax burden than dual-earner families to having a lower burden. This reversal of fortunes would prevail even if one disregarded payroll levies, which are disproportionately shouldered by dual-income families. If the policy objective is to equalize the tax burden faced by families with the same money incomes, irrespective of how family income is divided between the parents, then income splitting would miss even that circumscribed target. And that objective would not justify restricting splitting to couples with dependent children.

The proposed income-splitting scheme with a \$50,000 limit and restricted to couples with children would cost the federal treasury \$2.7 billion per year. If the provinces were to follow suit, it would cost their treasuries another \$1.7 billion, though their costs would diverge widely. Alberta's cost would be minimal on account of that province's flat-rate tax schedule; in contrast, Ontario's relatively steep rate progressivity would make its revenue cost nearly as large as the federal cost for that province. Making income splitting available to all couples, with or without children, would raise the federal revenue cost to \$5.6 billion per year and the total provincial cost to \$3.5 billion, for a total cost exceeding \$9 billion.<sup>25</sup>

Income splitting would disproportionately benefit single-earner families over dual-earner families, with the former garnering almost 60 percent of the total gains at both the federal and

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24 See Philipps (2011) for a gender-based assessment favourable to income splitting of property and investment incomes to the extent that it would facilitate actual equalization of wealth between spouses without entailing the work disincentives of labour income splitting.

25 Ontario's revenue cost would rise to \$2.1 billion under the provincial Conservatives' pledge to allow splitting for all couples with or without children versus the \$1.14 billion when restricted to families with children. Moreover, unlike the federal Conservatives' pledge, the provincial party's pledge is not contingent on eliminating the jurisdiction's deficit. Thus, the Ontario Conservatives' pledge is portentous for the future of tax splitting policies in the rest of Canada.

provincial levels. Average gains would range from more than \$6,000 for higher-income, single-earner families to about \$100 for lower-income, dual-earner families. Moreover, the gains would be highly concentrated: 23 percent of all relief (more than \$1 billion) would go to the 8 percent of two-parent families with income over \$125,000 in which the lower-earning spouse contributes less than 15 percent of that income. All two-parent families with income over \$125,000 would receive more than 40 percent of the total relief at both the federal and provincial levels.

In contrast to the families that would gain from splitting, 85 percent of all households would gain nothing because they lack either a spouse (individuals and single parents) or a child under age 18. Even among two-parent families that would be eligible for splitting, almost half would gain little (\$500 or less) or nothing. Moreover, those who would gain only little or nothing would almost certainly lose in a broader sense, since the substantial revenue cost of income splitting would necessitate reduced public benefits and services or increases in other taxes. One can envisage alternative policies – such as tax deductions or credits for children – that would render a more equitable distribution of benefits among affected families.

Beyond equity considerations and distributional impacts, the proposal would also affect work incentives. Many families that would benefit from income splitting would forgo some of their tax savings whenever the lower-income spouse chose to work more. The METRs of many lower-earning

spouses would rise by ten percentage points or more, which would induce some to reduce their hours of paid work. Increased METRs would also discourage some spouses, particularly mothers, from re-entering the workforce after leaving to care for young children, thus impairing their work experience and depressing their lifetime earnings. True, higher-earning spouses would often enjoy a lower METR on earnings, but these usually are men, who are much less likely to respond by changing their work hours than are women. Nevertheless, the net result would be a decline in total work hours, with adverse effects on economic efficiency.

In short, the Conservatives' proposal to permit income splitting for two-parent families with minor children would fail to achieve its particular notion of horizontal equity, likely by overtaxing dual-earner couples. It would also distribute gains disproportionately to a small share of all households (mostly at the highest incomes), fail to assist families that most need help to spend more time with their children, and create new distortions to work incentives. At the same time, the income-splitting proposal would cost participating governments substantial tax revenues, which could grow further with the expected behavioural responses. Other policy instruments could be better targeted for families most needing support, or the funds could be used for general tax reduction, without the adverse effects of splitting.

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