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Tax Fairness for One-Earner and Two-Earner Families: An Examination of the Issues

by

Michael Krashinsky and Gordon Cleveland
Division of Management
University of Toronto at Scarborough

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Canadian Policy Research Networks, Inc.
250 Albert Street, Suite 600
Ottawa, Ontario K1P 6M1

Foreword

Policies for children and families cross traditional policy realms and reach into areas not usually thought of as part of the 'family policy' domain. This discussion paper examines one such policy overlap.

Professors Michael Krashinsky and Gordon Cleveland of the University of Toronto demonstrate that the current Canadian income tax system does not discriminate against stay-at-home parents in favour of parents who enter the paid labour force. Rather, the non-taxation of household production is actually a tax advantage for stay-at-home parents which oftentimes makes labour force activity less attractive. The Child Care Expense Deduction exists to partially correct for the horizontal tax inequity between families in which one parent stays at home, as compared to those in which the parent enters the labour force. This deduction permits employed parents to deduct a necessary *work-related expense* from income before tax rates are applied. This paper thus provides much needed clarity on a tax policy with an impact on families that is often misunderstood.

This discussion paper was commissioned as part of the three-year research project designed to address the multifaceted question, *What is the Best Policy Mix for Canada's Children?* The ultimate goal of the project is to help set the foundation for an overarching societal strategy for children and their families. CPRN seeks to stimulate new thinking about the kinds of interdependent and integrated programs and policies that could improve child outcomes in Canada.

To achieve this, greater understanding is required about policy and program interventions and the outcomes that these interventions produce for children. However, a concrete understanding of child outcomes alone is insufficient to enable conclusions to be drawn about what the 'best' mix of policies for children and families might be. In order to choose among options, and provide valid justification for those choices, decisions must be firmly rooted in the values held by citizens who will be affected by those decisions. Thus, the *Best Mix* project also builds upon earlier work by CPRN on Canadian values and refines this understanding by linking values to child outcomes. Other components of the *Best Mix* project include comparisons of policy practices in six Canadian provinces and in Canada and seven other countries, identification of positive outcomes for children, and a careful reading of the research on the well-being of children. CPRN's policy conclusions are presented *in A Policy Blueprint for Canada's Children*, by Jane Jenson and Sharon Stroick. A full list of publications appears at the end of this report.

I want to thank Mike Krashinsky and Gordon Cleveland, who undertook this project for CPRN as an extension of their own research in this area. I also want to thank our funders, especially the Canadian foundations that provided most of the financing for the project, along with a number of federal and provincial agencies. They are all listed at the end of this report. In addition, I want to acknowledge the contributions of the Advisory Committee members and the external reviewers whose advice and constructive criticism helped shape the entire *Best Mix* research program.

Judith Maxwell
December 1999

Executive Summary

The Canadian tax system is based on the individual as the tax unit. Therefore, the amount of tax a family pays depends on the incomes earned by each individual rather than the total amount of family income.

The current Canadian income tax system does not disadvantage one-earner families with children in favour of two-earner families with children. In fact, one-earner families have more consumable income left after taxes and work-related expenditures than do two-earner families with the same money income. On top of that, the non-taxation of household production is an important, though rarely considered, tax advantage for one-earner families.

The Child Care Expense Deduction is an important element of our current tax system, which partially corrects for this tax advantage, that is, for the horizontal tax inequity between families in which one parent stays at home and those in which parents enter paid work. This deduction permits employed parents to deduct a necessary work-related expense from income before tax rates are applied. The Child Care Expense Deduction allows us to correctly calculate the appropriate taxable income in two-earner families. One-earner families should not be eligible for this deduction because, in general, they do not have work-related child care expenses.

Reintroducing a tax exemption (or tax credit) for dependent children can be justified on the basis of horizontal equity in the tax system, but it should not be financed by any change in the Child Care Expense Deduction. Furthermore, it would not guarantee that the majority of tax savings would be spent on children.

Tax Fairness for One-Earner and Two-Earner Families: An Examination of the Issues

Professors Michael Krashinsky and Gordon Cleveland
Economists at the Division of Management
University of Toronto at Scarborough

The treatment of one-earner and two-earner families has occasioned considerable controversy over the last couple of years in Canada. Some believe that two-parent families with children who only have one parent currently employed in the paid labour force (one-earner families) are disadvantaged by the tax system.[1] They argue that tax reform in recent years has been dominated by a 'social agenda' designed to favour two-parent families in which both parents are employed (that is, two-earner families). According to this argument, the basic principles of fair and equitable taxation have been ignored, while the dictates of this 'social agenda' have dominated tax reforms.

Given this controversy, it is worth reviewing the main principles that our tax system has historically applied to this issue, and examining some evidence of fair or unfair treatment. Because this material is complex, we have structured this discussion as the answers to a set of questions about the taxation of one-earner and two-earner families.

1. What are the key features of the taxation of individuals and families in Canada now?

The Canadian income tax system, as it stands now, uses the individual as the unit of taxation. What this means is that in general, two individuals with the same income will pay the same amounts of tax, independent of their family situation. This is in contrast with Canada's social welfare system, which generally considers family income (i.e., the sum of the incomes of all individuals in the family) as the appropriate basis for determining welfare payments and other transfers.

Of course, like any other generalization, this one is not strictly true. Various measures in the tax code do consider family circumstances that go beyond the characteristics of the individual taxpayer. For example, parents are allowed to claim tuition payments as deductions when their children do not require those deductions to reduce their taxable income to zero (although the children must agree to transfer these deductions). Either spouse may claim charitable contributions made by the other spouse. One taxpayer may claim medical expenditures made by all members of the immediate family. The Canada Child Tax Benefit is based on family income.

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[1] Boessenkool, Kenneth J. 1999. "Putting Tax Policy in Its Place: How Social Policy Took Over the Tax Treatment of the Family." In Allen, Douglas W., and John Richards (eds.). *It Takes Two: The Family in Law and Finance*. Policy Study 33; and Boessenkool, Kenneth J., and James B. Davies. 1998. "Giving Mom and Dad a Break: Returning Fairness to Families in Canada's Tax and Transfer System." C. D. Howe Institute *Commentary* 117 (November).

There are also two other specific provisions which consider family circumstances that are particularly relevant to this paper. If one spouse earns very little income, the spouse with higher earnings may claim a tax credit against federal and provincial taxes worth about $1,400 to the family. On the other hand, if both spouses are employed and use paid child care, then the child care expense deduction is available to the parent with the lower earned income.

While these parts of the tax code are not trivial, it would be fair to say that most members of a family pay taxes as if they were individuals, rather than part of that family. In other words, a change in the income of your spouse does not, in general, change the taxes that you are obligated to pay. In addition, again in general, a change in the number of people in the family also does not change your tax obligations. If you get married or if you have children, your taxes will not change (other than through the spousal credit, the Canada Child Tax Benefit, and the child care expense deduction as noted above).

All of this is in marked contrast with the system in some other countries, specifically the United States. In the United States and a few other countries, the family is the unit of taxation. In the United States, when two workers get married, their total taxes will generally change. When families have children, their total taxes generally fall, because there is a tax deduction for dependent children.

2. What are the key principles of equity and efficiency in taxation that should guide decisions about the tax system?

The concept of *horizontal equity* is a central one for tax theory. It states that people in essentially the same economic circumstances (with the same level of well-being) should, in fact, pay the same taxes. Ideally, this means that two people who start off with the same set of economic opportunities should pay the same taxes even if they make different decisions about how to live their lives (e.g., decide to engage in full-time paid employment versus decide to engage in full-time home work).

Another key concept is that of *economic efficiency*. This states that the tax system should not alter people's behaviour, that is, their behaviour as it would be in the absence of taxation. Strictly speaking, economists define economic efficiency in a slightly more complicated manner. Taxation should not alter behaviour from what it would be in the presence of purely 'lump sum' taxes.

The two concepts are actually closely related. If two people in the same initial position end up paying the same taxes regardless of the economic decisions that they make, then they are unlikely to have much incentive to alter their decisions (that is, to behave as if they were the other person) because of taxation. Thus, in many cases, horizontal equity promotes economic efficiency.

Vertical equity is also a major principle which tax systems strive to meet. Vertical equity implies that a tax system should be progressive. In other words, people with a greater ability to pay should pay a higher fraction of their incomes in tax.

3. Why don't we tax families instead of individuals? Wouldn't that be fairer?

When two workers marry and form a household, each of them is economically better off. They share living quarters and expenses so their well-being rises. Because of this, it might seem only natural that they should pay more taxes. On the other hand, if an individual marries someone with no income, the earner's well-being generally falls because, unfortunately, 'two do not live as cheaply as one.' In this case, an allowance for the extra costs of living would seem to be justified. All this would seem to argue for taxing families as a unit (i.e., taxes based on family income) rather than beginning with the taxation of individuals and then adding on modifications to deal with spouses and children.

Unfortunately, this logic creates another problem. If we tax families as a unit, the tax system will end up either taxing or subsidizing the formation of families (i.e., marriage or a common-law arrangement). Clearly, we want a tax system which is fair for both families and for unattached individuals and which neither penalizes nor unduly rewards family formation. However, it is a well-known proposition in public finance theory that an income tax system cannot meet all of the following three criteria: (1) equal treatment of all families with the same total household income (i.e., horizontal equity), (2) progressive taxation so that taxpayers with higher incomes pay a higher percent of income in taxes (i.e., vertical equity), and (3) the absence of an incentive or penalty for family formation (i.e., a subsidy or penalty for living as a couple).

To see this, imagine that we have the following 4 groups of people:

Case I: Two unrelated people living separately, each earning $25,000.

Case II: Two people living together (i.e., a family), each earning $25,000.

Case III: Two unrelated people living separately, one earning $50,000, the other earning nothing.

Case IV: Two people living together (i.e., a family), one earning $50,000, the other earning nothing.

Consider the total taxes paid by each group. Equal treatment of families with the same household income implies that taxes should be the same for cases II and IV. The absence of a marriage or family formation penalty or subsidy implies that cases I and II should pay the same taxes, as should cases III and IV. Together this would imply that all four groups should pay the same taxes. But if this is true, we have violated progressivity, because the same taxes are being paid in cases I and III. Progressivity requires that the average tax rate be higher when income rises, so that a single individual earning $50,000 must pay more total taxes than two individuals living separately who each earn $25,000.

To make the issue about a penalty or subsidy for family formation clearer, look at this example from a different viewpoint. Progressivity of the tax system means that someone with an income of $50,000 must pay more than twice the taxes paid by someone with an income of $25,000. If the tax system is progressive, it must therefore be true that unattached individuals earning $25,000 each will together pay less tax than two other unattached individuals, one of whom earns $50,000 and the other of whom earns zero (cases I and III). But if each of these sets of unattached individuals should marry, if nothing else changes, the two households will have the same total incomes. If we now tax both of these new households the same amount (i.e., if we tax them on family income instead of individual income), then at least one of the households will find that its taxes changed when they got married. Hence, there is either a marriage penalty or a marriage subsidy.

From the above discussion, we can see that Canada's tax system can be seen as a saw-off, or compromise among several ideal principles which cannot all be fully realized. We make some allowances for the different situation of different families, but largely choose to tax individual income to avoid any incentive or penalty for family formation.

This stance is probably especially important given the existence of the *Charter of Rights and Freedoms*. Giving significant special treatment to families under the tax system would require us to define families exactly, and that would provide a significant incentive for groups of individuals to attempt to meet the 'family' definition. A married couple is clearly a family. A common-law couple is viewed as a family for many purposes. Homosexual couples claim family status for the purposes of qualifying for various benefits. But are two unrelated individuals sharing living quarters to save money a 'family'? What about two unrelated individuals living on the same floor of an apartment building? The difficulty of defining a family, and family income, has led many analysts to conclude that basing the Canadian tax system on family income would not produce a fairer and more efficient tax system.[2]

4. Is the current tax system in Canada unfair to stay-at-home parents?

Does the existing Canadian tax system, based on individual income, discriminate against families with a single earner? This is, in a sense, the key question. To nearly all economists, the answer is simply no. Stay-at-home parents are engaged in household production. This kind of production is, and has been, vitally important to Canadian families. Given the same family income, families with a stay-at-home parent are better

[2] For instance, see Boessenkool, Kenneth J., and James B. Davies. 1998. "Giving Mom and Dad a Break: Returning Fairness to Families in Canada's Tax and Transfer System." C. D. Howe Institute *Commentary* 117 (November).

off than families with two employed parents because of the larger amounts of time available to devote to home work and other pursuits.[3]

However, because no money officially changes hands to reward this work, it is untaxed. In contrast, all other Canadians who work for pay are taxed on the value of their productive activities at work. Thus, home work is favoured under the tax system, rather than penalized.

To see this, a simple example will help. Suppose that a family consists of a father and mother and two preschool children. Suppose that the man earns $50,000 per year. Ignoring Canada/Quebec Pension Plan and Employment Insurance payments, and also ignoring private pension plans and other deductions, the federal taxes on this $50,000 would be $9,239 (ignoring the Canada Child Tax Benefit and the spousal exemption for now). Assuming that provincial taxes are another 50 percent of federal taxes, the tax bill is now $13,859.

Suppose that the woman could earn $26,000 by working outside the home. In general, we expect her to enter the labour force only if she finds she is more productive working outside than inside the home, that is, if the $26,000 value placed on her labour by the market exceeds the loss in production inside the household. Therefore, let's look at the calculation she makes.

Suppose, for example, that the value of child care services provided by the mother in the home during the day is considered to be $12,000 because the parents feel that an adequate replacement for the mother's daytime care can be acquired only at the local day care centre, which charges $12,000 (an average amount in urban Canada for licensed child care for two preschool children).

Suppose further that the value to the family of her other household production done during the day – cooking, shopping, cleaning, organizing activities and the like – is set at another $11,000. Most of this production may still have to be done if she enters the paid labour force, of course, but if the mother works at full-time employment, this home work will be done in the evening or by paid help, while the other family will have this time available for other things. In other words, $11,000 represents the extra value of the savings in time or money (or the extra quality of life or well-being) to the family with a stay-at-home parent. Finally, suppose that the woman's other work-related expenses account for $3,000 (transportation, extra clothes, and so on).

3 The recent report of the Standing Committee on Finance of the House of Commons noted that "a dual-earner couple with the same total income as a single-earner couple is not as well off as the latter. Not only are there additional employment related expenses that must be incurred with respect to the second worker, the value of unpaid work in the home, or leisure, must also be taken into account." See Standing Committee on Finance. 1999. *For the Benefit of Our Children: Improving Tax Fairness*. Ottawa: Public Works and Government Services Canada (p. 12).

This woman is right on the borderline between deciding to seek paid employment in the labour force and deciding to care full-time for her two preschool children by staying at home. She, and her family, will be equally well-off whichever decision she makes. The $26,000 she could earn by taking a job would just compensate her and her family for her extra child care costs ($12,000), the lost value of home work she could have done ($11,000) and her extra expenses related to working out of home (transportation, clothing, etc.)

But this calculation does not take tax payments into account. Looking at the taxes paid if this woman joins the paid workforce, it is easy to see that the tax code penalizes the employed mother relative to the stay-at-home mother. If the woman stays at home, her one-earner family has its federal taxes *reduced* because of the spousal tax credit, which is worth $915 in federal taxes and another $457 in provincial taxes, for a total of $1,372.

If, on the other hand, the woman takes paid employment, she will pay full taxes on her earnings. Even if the entire $12,000 of child care costs were deductible, her federal taxes would still be $1,282 and provincial taxes would be $641, for a total of $1,923. Thus, the total amount of extra taxes paid by the family that has lost the spousal credit and is now paying taxes on the woman's earnings is $3,295.

Actually, the situation is worse since Canada/Quebec Pension Plan and Employment Insurance are assessed on earned income and would amount to another approximately $1,500 lost by the employed mother. The fact that we cannot effectively tax household production (and no one is suggesting that we should try) means that the tax system tips the scales in favour of the stay-at-home mother, not against her. In the example above, the mother who went out to work cost the family an additional $3,295 in taxes relative to the mother who chose to stay at home and work in the household. It is important to emphasize that this result is not dependent on the particular numbers chosen in this example. In all cases where a mother chooses to shift from household work to a wage-paying job, family taxes will rise and horizontal equity will be violated between women working in and out of the home.

Thus it is clear that the tax system disadvantages the family with the *employed* mother relative to the family with the stay-at-home mother. Both mothers produce approximately the same amount of value for their families through work and home work. But the employed mother will pay extra taxes, while the single-earner family will get tax reductions. When the mother works outside the home, the family pays more income tax and more payroll taxes. Of course, the family receives the benefits of the mother's after-tax earnings. But it also loses the extra benefits of the household production and family well-being when the mother stays at home.

This example also illustrates the main function played by the Child Care Expense Deduction, which many recent commentators have described as an unfair advantage for two-earner families. Notice that without the Child Care Expense Deduction (CCED), the tax disadvantage faced by working mothers would be even more extreme and labour force participation would look unattractive to far more of them.

We believe that it is for this reason that the CCED has survived and even expanded in an era when most special tax provisions have been under attack. The CCED partially corrects the horizontal inequity faced by working mothers. Because these mothers pay significant taxes, and because we know that they are quite sensitive to economic incentives and signals, there is little reason for Revenue Canada to want to eliminate a provision that, overall, generates more tax revenue for governments than it costs.

5. You have shown an example where the two-earner family has higher money income than the single-earner family. What about taxation of families that have the same level of money income?

The case for arguing that one-earner families are discriminated against by the tax system is sometimes made a different way. The families that are compared have the same before-tax income. In one family, the man is employed and earns $50,000, while the woman stays at home caring for children and doing home work. In the other family, the man is employed and earns $30,000 while the woman is employed and earns $20,000. We will assume that child care in the second family costs $8,000 and is completely deductible from taxable income.

Comparing the tax treatment as we did before (and ignoring Canada/Quebec Pension Plan and Employment Insurance), we find that the one-earner family pays $12,487 in taxes ($13,859 minus the $1,372 value of the spousal credit). The two-earner family pays $6,059 on the father's earnings, and only $1,414 on the mother's earnings (because of the child care expense deduction), for a total tax bill of $7,473.

The difference in the taxation of these two families, apparently in favour of the two-earner family, is over $5,000. Of this, about $2,000 is the value of the child care expense deduction, while the other $3,000 occurs largely because when income is split between two individuals, it is taxed at a lower average rate. Again, it should be remembered that this simplification ignores payroll taxes, private pensions, as well as any child tax credits.

It must be emphasized that there are fatal problems with using these two sample families to draw appropriate conclusions about tax fairness. First of all, the principle of horizontal equity cannot be applied to these families, since they are very clearly not in the same situation (even though they have the same money income). In the first case (the one-earner family), the father earns $50,000, while the mother is able to take the time to care for her children and do home work. In the second case (the two-earner family), the total income of both spouses is $50,000, and child care and home work must be provided in other ways, or by taking time on evenings and on weekends. The first family has a higher level of well-being and should therefore pay more tax.

To see this more clearly, imagine that the woman decides to stay at home in both families. Then the first family would have more income – $50,000 versus $30,000 – and should pay more tax. Then imagine instead that the woman decides to take paid employment in both families, earning $20,000. Again, the first family would have more income (now $70,000 versus $50,000) and should pay more tax. It is only by ignoring the contribution of the extra time for home work to the family's well-being (effectively concluding that women's work in the home has no value) that it is possible to conclude that the families have equal levels of well-being and capacity to pay tax. A one-earner family and a two-earner family who have the same *market-generated earnings* are not equally well off, so should not pay the same amount of tax.

Second, the example is also misleading because it ignores the real financial situation of the two-families. The one-earner family has an after-tax income of $37,513 ($50,000 minus $12,487 in taxes). In comparison, the family with two employed parents earns after-tax income of $42,527. But this family has to pay $8,000 for child care. After this, the family only has available $34,527 to spend on the sorts of things purchased by the first family. The two working parents are financially *worse off*, not better off.

Further, when the mother stays at home, the family does not incur work-related expenses for the mother. In addition, the family has available to it the other kinds of household production (beyond child care) provided by the mother during the day.

Why then do one-earner families feel discriminated against? We believe that the reason is actually relatively subtle. Thirty years ago, there was no child care expense deduction. All families received family allowances and tax exemptions for children, both of which have disappeared in recent years (the money has been redirected towards poor families with children). At the same time, rates of taxation have risen dramatically. Upper-middle class families with children are taxed far more heavily than they were thirty years ago. On top of this, they see that employed mothers now have a tax break that was not available in the past (the Child Care Expense Deduction). One-earner families feel that the balance has been shifted.

There is an element of truth in this view. However it reflects the *unfair treatment of employed mothers 30 years ago* and not any favouritism towards them today. As the examples above have shown, two-earner families are not, in general, advantaged by the tax system.

6. Can you calculate for us the income taxes paid by one-earner and two-earner families in different income classes and show us which families are better off and worse off according to their after-tax situation?

This comparison is an instructive one, because it suggests that the complaints of one-earner families are not, when all evidence is considered, based on unfair treatment relative to two-earner couples. After considering the costs of going to work, including the costs of purchasing child care, the tax system *advantages* rather than disadvantages one-earner families who have the same level of money income as a two-earner family (for incomes below $120,000).

We consider one-earner families with $50,000, $80,000 and $120,000 of income and two-earner families with the same total incomes (see Table 1). The lower-earner in the two-earner families is assumed to earn 40 percent of family income, while the higher-earner earns 60 percent. This comparison assumes that each two-earner family spends $8,000 on child care expenses in order to permit the second earner to be employed. Each earner in a family has $3,000 of work-related expenses (transportation, work clothing, and so on) which are not deductible for tax purposes but which do not increase the consumption of the family. Canada/Quebec Pension Plan and Employment Insurance payments are not included as taxes or as tax credits for this calculation, and we ignore any pension contributions. We use the 1998 federal income tax forms and assume that provincial taxes are simply 50 percent of federal taxes.

Table 1

Comparison of the Net Income Position of One-Earner and Two-Earner Families After Taxes and Work-Related Expenditures

Total Family Income and Family Type	Regular Income Tax Payable	Federal Surtaxes Payable	After-Tax Income (after Regular Taxes and Surtaxes)	Consumable Income (after Taxes and Work-Related Expenditures)
$50,000 • *One Earner*	$12,487	$250	$37,263	$34,263
$50,000 • *Two Earners*	$7,471	$149	$42,380	$28,380
$80,000 • *One Earner*	$25,125	$715	$54,160	$51,160
$80,000 • *Two Earners*	$17,552	$351	$62,097	$48,097
$120,000 • *One Earner*	$42,525	$1,643	$75,832	$72,832
$120,000 • *Two Earners*	$32,975	$802	$86,223	$72,223

The table makes it clear that one-earner families do pay more tax than do two-earner families at the same money income level. This happens because the splitting of household income allows two-earner families to pay at lower tax rates, when individual incomes are taxed progressively, and because two-earner families are able to deduct child care expenses. One-earner families, for similar reasons, pay considerably more in federal surtaxes.

As a result, when we compare the *after-tax income* positions of one-earner and two-earner families (column 4), two-earner families appear to be better off than one-earner families with the same gross incomes. A two-earner family with children earning $50,000 appears to have about $5,000 extra to spend relative to a one-earner family at the same income. The two-earner family earning $80,000 appears to have nearly $8,000 extra to spend. The two-earner family earning $120,000 appears to have over $10,000 extra to spend.

However, this comparison is incomplete. To see whether the tax system advantages two-earner families relative to one-earner families, we must compare apples to apples. Two-earner families necessarily have additional work expenses and child care expenses which means that their *consumable income*, after taxes and after work-related expenditures, is much lower than stated in column 4. Column 5, *consumable income*, gives the true after-tax and expenses position of the two family types. Assuming that there are $8,000 worth of child care expenses (already deducted in the calculation of taxes payable) and $3,000 of work expenses for each working parent, we must deduct $3,000 for one-earner families and $14,000 for two-earner families to arrive at their true position after taxes and after work-related expenditures.

As a result, when we compare the after-tax and after-work-expenditure income positions of one-earner and two-earner families (in column 5), *one-earner families are found to be better off than two-earner families with the same gross incomes*. A one-earner family earning $50,000 has about $6,000 extra to spend relative to a two-earner family at the same income. The one-earner family earning $80,000 has nearly $3,000 extra to spend. The one-earner family earning $120,000 has about $600 extra to spend (i.e., essentially the same consumable income as a two-earner family at the same income). Of course, this comparison ignores the additional value of home work (over and above child care) that benefits the one-earner family because this comparison focuses only on money incomes and expenditures.

7. Should we allow income splitting for single earner families?

A primary technique for 'income-splitting' would be to allow the single-earner in the one-earner family to pay his spouse for household production. This payment could be deducted, therefore lowering taxable income. The non-employed partner would gain income, but pay little tax if his or her income were still low. The market income of the one earner would, in effect, be split between the two family members, lowering their total taxation. Is this desirable?

As suggested above, when viewed properly, one-earner families already receive considerable tax advantages because of the non-taxation of household production. Income splitting would worsen this tax advantage and, further, would be of the most advantage to upper-income Canadians who need it the least.

Also, as suggested above, income splitting would amount to moving towards family taxation as opposed to individual taxation. Assuming that we retain a progressive tax system, this would create a considerable marriage subsidy. Depending on the evolution of the definition of families in the tax code, this could also create enormous incentives for individuals with disparate incomes seek to form families for tax purposes.

8. **Stay-at-home parents do not get the benefits of the Child Care Expense Deduction. Isn't this evidence of unfair discrimination against stay-at-home parents?**

Stay-at-home parents do not get to use the Child Care Expense Deduction because they do not pay child care expenses in order to earn taxable income. The principle behind the CCED is the same one that has us taxing net income for businesses. A business person with office expenses is properly taxed, not on *gross* income but on *net* income, that is, the amount available after paying those office expenses. This is because the office expenses are a necessary cost of earning income and are not really otherwise of benefit to the business person. Only the net income after office expenses is available to the business person to *spend on consumption* and, thus, only net income should be taxed.

Similarly, we tax households on the incomes that they have available to *spend on consumption*. This is the appropriate definition of taxable income accepted by most economists who specialize in taxation issues (the Haig-Simon definition of taxable income). Since children must be cared for when their parents are employed, child care costs are a necessary cost of employment for most families with employed parents. That necessary expense is paid for by working parents, and is *not* a form of consumption. Only the parent's income, net of child care expenses, is available for household consumption so only the parent's income, net of child care expenses, should be taxed. The Child Care Expense Deduction is, therefore, a measure designed to improve horizontal equity in the tax treatment of families with different amounts of work-related child care expenses.

Economists also argue that the CCED is essential if mothers are to make sensible decisions on whether or not to work. Economic efficiency requires that the mother should enter the labour force if she is of more productive value to her family and to the economy working outside rather than inside the home. Since the resources used to produce child care are not taxed when mothers stay at home, taxing them when mothers are employed would bias decisions about employment. Economists believe that many mothers will be led to make inappropriate and inefficient decisions about employment if child care expenses are not deductible.

9. **Should the CCED be made into a credit to provide more assistance to low income families?**

This would be an appropriate idea if the CCED were an income support program. In that case, we would want to design it so as to direct the most benefits to the families with the lowest incomes. However, the CCED is properly seen as a *deduction for work-related expenses* and deducting work-related child care expenses produces the appropriate measure of taxable income (net of expenses).

The CCED is a measure designed to achieve horizontal equity and tax fairness. It deals with the appropriate definition of exactly what is taxable income. Child care expenses should remain a deduction,, and not a credit, for the same reason that businesses are given deductions, and not credits, for expenses when computing net income for tax purposes.

10. Would increased tax credits or tax deductions for families with children be a good idea (perhaps a non-targeted credit)?

This is a complex question. If the only principle of concern is horizontal equity (tax fairness), then the argument will depend on several factors. First, tax credits can be justified only if children are viewed as something more than just a consumption decision made by their parents. If children are simply a type of consumption by parents, with no special social value, then we should no more offer tax relief for parents with children than we should offer such tax relief for owners of pets or expensive cars. After all, having children uses up the family's resources, which are then not available for other types of consumption, but so does owning a pet or a car.

If, on the other hand, children are viewed as having considerable social value, then parents, who voluntarily take on responsibility for raising children, should receive some consideration for part of the cost of that responsibility. Comparing the financial situations of parents and non-parents with the same gross incomes, parents clearly have fewer resources available for their own *personal* consumption and thus should pay lower taxes (if horizontal equity is to apply).

Another way to express this would be to use the concept of discretionary income. The 'Personal Amount' which is part of the Canadian tax credit system (i.e., the basic exemption of about $6,500) is a way of recognizing the fact that individuals should pay tax only on the portion of their income that is left after providing for some of their necessities. If children are not merely a consumption good but are part of those necessities, then discretionary income for families with children will be lower than for families with the same money income and no children. Full equity would require that taxes should be correspondingly lower.

A significant tax credit available to all families with children would be one easy way to provide these lower taxes. Of course, there is no particular reason why we might prefer a tax credit to a deduction or any other form of relief. The tax credit is worth the same amount to all taxpayers, independent of their taxable income. An exemption or deduction is worth more to higher income taxpayers. An argument that a child 'eats up' 10 percent of family income (to pick a number out of the air!) would seem to argue for an exemption equal to 10 percent of gross income (assuming that we treat children as a pure social good). This is probably too extreme, and the temper of the times does seem to favour credits of equal value to all families.

The elimination several years ago of the tax exemption for dependent children made little sense in terms of tax fairness. At that time, the argument for this measure was that the money could be used to assist lower income children and, in fact, that is exactly what happened with the Child Tax Credit, now called the Canada Child Tax Benefit. Yet it made little sense to finance programs for low-income children through a tax increase only on higher-income families *with children*, rather than through a tax increase on *all* higher-income families.

All of the argument thus far has been in terms of tax fairness, or horizontal equity. Although the tax credit is said to be *for* children, there is in fact no guarantee that any tax savings resulting from it will be spent on children. A generalized tax credit puts more money in parents' pockets but does not compel them to spend it in any particular way. Tax relief for families with children will presumably increase a variety of family expenditures, some of which will benefit children and some of which will not.

There are policy alternatives to generalized tax credits to families with children. If our social goal were to increase the money spent on children, then more targeted forms of tax relief would be more effective. For example, special deductions for expenditures on children's summer camps or on nursery schools would likely direct more resources to children than equal-cost, non-specific tax credits. Policy makers may want to consider expenditures on direct services for children and, for instance, direct subsidies to programs providing effective early childhood experiences, rather than tax changes, if the effects on children's development are a prime concern.

11. Should subsidies or tax breaks for families with children be financed by eliminating or reducing the Child Care Expense Deduction?

Good arguments can be made for offering further tax relief to all families with young children, and especially to upper middle class families who have lost benefits over the past two decades (as discussed earlier). However, good arguments can also be made against such tax relief. Wealthier families are better able to absorb the costs of rearing children, and Canada has made a conscious decision to divert resources towards subsidizing low-income families with children.

As we have emphasized, the Child Care Expense Deduction falls into a completely different category. It is aimed at restoring horizontal tax equity for those workers (generally mothers with young children) who face unusually large expenses in going to work and earning income, relative to other workers. Because a parent earning $25,000 per year and paying $8,000 per year for child care is in fundamentally the same position as a worker without children earning $17,000 per year (both earn $17,000 net of work-related child care expenses), we need to have a Child Care Expense Deduction so that they will be taxed the same.

Thus, the CCED improves tax equity, rather than being a program of assistance to children. It cannot reasonably be traded off against other programs assisting families with children. One reason for the endurance of the CCED in an era when many other tax benefits have been removed is this unique character. It improves tax equity between different types of families. Because mothers are sensitive to the effect of child care costs on their net compensation, it permits increased labour force participation by women, and it therefore contributes to total tax revenue taken by government, rather than, on balance, reducing it.

Conclusions

Except perhaps for one-earner families earning considerably more than $120,000 annually in money income, there is little basis for complaint that the tax system treats one-earner families unfairly relative to two-earner families. The Canadian tax system is based on the individual as the tax unit, rather than the family, so the amount of tax a family pays depends on the incomes earned by each individual rather than the total amount of family income. The current Canadian income tax system does not disadvantage one-earner families in favour of two-earner families. In fact, one-earner families have more *consumable income* after taxes and work-related expenditures than do two-earner families with the same money income. On top of that, the non-taxation of household production is an important, though rarely considered, tax advantage for one-earner families.

The Child Care Expense Deduction is an important element of our current tax system which partially corrects for this tax advantage, that is, for the horizontal tax inequity between families in which one parent stays at home and families in which a parent enters paid work. This deduction permits employed parents to deduct a necessary work-related expense from income before tax rates are applied.

The Child Care Expense Deduction allows us to correctly calculate the appropriate taxable income in two-earner families. Thus, the Child Care Expense Deduction is not part of some hidden ‘social agenda’ but, rather, is completely consistent with the general tax principle that expenses incurred to earn income must be deducted before taxes are calculated. One-earner families should not be eligible for this deduction because, in general, they do not have work-related child care expenses.

Reintroducing a tax exemption (or tax credit) for dependent children can be justified on the basis of horizontal equity in the tax system. However, such a measure would not guarantee that the majority of tax savings will be spent on children.

Appendix A. Details on the Tax Calculations

It is useful to work through the tax calculations for some of the various cases discussed in the paper. Remember that the calculations ignore Canada/Quebec Pension Plan and Employment Insurance payroll taxes paid by the individual, and as well any private pension plans, union dues or other deductions that would complicate the tax calculations. We also ignore child tax credits and (except for question 7) surtaxes, and simplify the provincial tax system to be 50 percent of federal taxes.

Since the purpose is to *compare* the taxes paid by various families, including all these calculations would tend to have a small effect on the comparison although the total taxes paid will be affected. The one exception to this is the impact of payroll taxes when the mother goes out to work. Since payroll taxes amount to about 6% of gross earnings and are not affected by day care deductions, they are a significant work *disincentive* in those cases where the mother is on the margin between the value of working at home and working in the labour market.

Begin with the father who earns $50,000. Because of the simplifications introduced above, the father's taxable income is $50,000. Federal taxes in 1998 are computed as $5,030 on the first $29,590, and 26 percent on the next $29,590. Thus this father's federal tax (before credits) is:

$$\$5,030 + 26\% \text{ of } \$20,410 = \$10,336.60$$

We subtract from this the father's tax credits. If the mother does not work outside the home, these are 17 percent of the personal amount ($6,456) plus the spousal amount ($5,380), or:

$$17\% \text{ of } (\$6,456 + \$5,380) = \$2,012.12$$

The father's federal tax is:

$$\$10,336.60 - \$2,012.12 = \$8,324.48$$

The father's provincial tax is:

$$50\% \text{ of } \$8,324.48 = \$4,162.24$$

The father's total tax, federal and provincial, is **$12,486.72**.

If the mother does work, the father's federal tax is still $10,336.60 minus the tax credit. Now the tax credit is 17 percent of the personal amount ($6,456) only, or:

17% of $6,456 = $1,097.52

The father's federal tax is:

$10,336.60 - $1,097.52 = $9,239.08

The father's provincial tax is:

50% of $9,239.08 = $4,619.54

The father's total tax, federal and provincial, is **$13,858.62**.

When the mother works, the cost to the father in higher taxes is:

$13,858.62 - $12,486.72 = **$1,371.90**

The mother earns $30,000 and pays $12,000 in day care. Her taxes are assessed on taxable income of $18,000 (net of the child care expense deduction). The mother's federal tax (before credits) is:

17% of $18,000 = $3,060

We subtract from this the mother's tax credits. These are simply 17 percent of the personal amount ($6,456), or:

17% of $6,456 = $1,097.52

The mother's federal tax is:

$3,060 - $1,097.52 = $1,962.48

The mother's provincial tax is:

50% of $1,962.48 = $981.24

The mother's total tax, federal and provincial, is **$2,943.72**.

The extra taxes due to the mother's working are:

$1,371.90 (on the father) + $2,943.72 (on the mother) = **$4,315.62**

When the father earns $30,000 and the mother earns $20,000 (with $8,000 in day care expenses), the tax calculation is as follows.

On the father:

The father's federal tax (before credits) is:

$5,030 + 26% of $410 = $5,136.60

The tax credit is 17 percent of the personal amount ($6,456) only, or:

17% of $6,456 = $1,097.52

The father's federal tax is:

$5,136.60 - $1,097.52 = $4,039.08

The father's provincial tax is:

50% of $4,039.08 = $2,019.54

The father's total tax, federal and provincial, is **$6,058.62**.

On the mother:

The father's federal tax (before credits) is:

17% of $12,000 = $2,040

The tax credit is 17 percent of the personal amount ($6,456) only, or:

17% of $6,456 = $1,097.52

The mother's federal tax is:

$2,040 - $1,097.52 = $942.48

The mother's provincial tax is:

50% of $942.48 = $471.24

The mother's total tax, federal and provincial, is **$1,413.72**.

'Best Policy Mix for Children' Research Projects

The following 10 research reports embody the findings of the CPRN Family Network research project, What is the Best Policy Mix for Canada's Children? Several of these reports are available on-line at: http://www.cprn.org.

- O'Hara, Kathy. 1998. Comparative Family Policy: Eight Countries' Stories. CPRN Study No. F-04. Ottawa: Renouf Publishing Co. Ltd.
- Phipps, Shelley. 1999. An International Comparison of Policies and Outcomes for Young Children. CPRN Study No. F-05. Ottawa: Renouf Publishing Co. Ltd.
- Michalski, Joseph H. 1999. Values and Preferences for the "Best Policy Mix" for Canadian Children. CPRN Discussion Paper. Ottawa: Canadian Policy Research Networks Inc.
- Tipper, Jennifer, and Denise Avard. 1999. Building Better Outcomes for Canada's Children. CPRN Discussion Paper. Ottawa: Canadian Policy Research Networks Inc.
- Jenson, Jane, and Sharon M. Stroick. 1999. A Policy Blueprint for Canada's Children. CPRN Reflexion No. 3. Ottawa: Canadian Policy Research Networks Inc.
- Phipps, Shelley. 1999. Outcomes for Young Children in Canada: Are There Provincial Differences? CPRN Discussion Paper. Ottawa: Canadian Policy Research Networks Inc.
- Krashinsky, Michael, and Gordon Cleveland. 1999. Tax Fairness for One-Earner and Two-Earner Families: An Examination of the Issues. CPRN Discussion Paper. Ottawa: Canadian Policy Research Networks Inc.
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- Jenson, Jane, with Sherry Thompson. 1999. Comparative Family Policy: Six Provincial Stories. CPRN Study No. F-08. Ottawa: Renouf Publishing Co. Ltd.
- Stroick, Sharon M., and Jane Jenson. Forthcoming. What is the Best Policy Mix for Canada's Young Children? CPRN Study No. F-09. Ottawa: Renouf Publishing Co. Ltd.

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