

Income Splitting or Trojan Horse?

The Federal Government's Proposal and its Impact on Provincial Budgets

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Summary

This *Mowat Note* examines an overlooked element of the federal government's family income splitting proposal, which could be introduced in the 2015 federal budget at a cost of almost \$3B to the federal government. As a result of tax collection agreements signed by provinces and the federal government, provinces would be forced to mirror the federal initiative at an additional cost to their budgets of roughly \$1.7B a year. Provinces have also recently been compelled to follow the federal government's introduction of pension income splitting and Tax-Free Savings Accounts.

Federal-provincial tax collection agreements were signed over the past several decades by the provinces in good faith to reduce administrative duplication and strengthen the Canadian economic union. It was not anticipated by provinces that the federal government would use these agreements as a Trojan horse to foist policy choices upon provinces and weaken their balance sheets. In Ontario alone, it is estimated that family income splitting would cost the government over \$1B annually at a time when it is already struggling to reduce its deficit. This *Note* examines the impact of the federal proposal on provinces' balance sheets and suggests ways the federal government can avoid making the provinces pay for its controversial policy choices.

Introduction

In its 2011 election platform, the Conservative Party of Canada committed to introduce family income splitting for couples with dependent children.¹ This measure is expected to be introduced in the 2015 federal budget and would cost nearly \$3B. This would likely be both the most expensive allocation of the government's anticipated surplus and the biggest new expenditure in the budget. Given the many challenges facing Canada, it is prudent to ask whether income splitting is the best use of the federal government's money.

The federal government's use of tax collection agreements to force policy choices on provinces and dictate their budgetary priorities was not anticipated when those agreements were signed in good faith.

There are a number of studies that raise concerns about the federal government's proposed income splitting approach. Although it is possible to make an equity-based case in favour of the measure, there are a variety of economic and social reasons to oppose income splitting. It discourages labour market participation, rewards high-income families but does nothing for single parents and may have no positive impact on economic productivity.

But one issue has not received much attention: the fact that all provinces (except Quebec) will be required to mirror the federal income splitting initiative if it is introduced, as a result of tax collection agreements which require provinces to use the federal definition of taxable income. Provinces signed these agreements to save money,

avoid duplicative administrative processes and forge a stronger economic union by building a national—rather than a balkanized—system of tax collection in the country.

The federal government has recently, with the introduction of pension income splitting and Tax-Free Savings Accounts, begun to exploit the fact that provinces must use the federal definition of taxable income to compel policy choices on provincial governments. Income splitting for families, however, represents the least convincing and most costly policy measure to date. In Ontario, for example, the income splitting proposal is likely to cost the province over \$1B on an annual basis. This will further weaken the province's fiscal position, make deficit-reduction more difficult and constrain Ontario's ability to invest in social programs or new infrastructure. Other provinces will also see their fiscal position deteriorate.² In total, the proposal will cost provinces roughly \$1.7B a year.

The federal government's use of tax collection agreements to force policy choices on provinces and dictate their budgetary priorities was not anticipated when those agreements were signed in good faith. Unilaterally reducing provinces' revenues represents an unwanted and unhelpful federal intrusion on provinces' treasuries. It should be up to provinces to determine whether a substantial income splitting expenditure is how they choose to allocate their scarce resources.

This *Mowat Note* assesses the impact of income splitting on provincial revenues and proposes some simple, more collaborative alternatives for consideration. These would include compensation to provinces or designing the federal measure as a tax credit instead.

1 Conservative Party of Canada Platform, "Here for Canada" (2011) http://www.conservative.ca/media/2012/06/ConservativePlatform2011_ENs.pdf, p26.

2 At the 2014 Council of the Federation meeting in PEI, Premiers noted in their communiqué that "should the federal government introduce income splitting this would impact revenues of some provinces and territories." http://www.councilofthefederation.ca/phocadownload/newsroom_2014/communique-final.pdf.

1. Family Income Splitting: A Brief Overview

What is it?

The federal government’s family income splitting proposal is a relatively straightforward concept. It would permit married couples with minor children to notionally allocate up to \$50,000 of the taxable income of the higher-earning spouse to the lower-earning spouse in order to reduce tax liability.

A simple example³ (see Table 1), demonstrates the concept in practice for a family where spouse A earns \$86,000 and spouse B earns no income:

It is important to note that income splitting only provides benefits to families when two factors are present. First, there must be an income discrepancy between the individuals. Without an income discrepancy, there is no benefit to a notional sharing of income as the individual’s tax rates would be the same. The larger the discrepancy (and the more money that the family is allowed to split), the greater the benefit.

Secondly, the tax system must have a progressive nature (i.e., higher levels of income are taxed at

higher rates). Under a system with the same tax for all income levels (e.g., Alberta’s 10% flat tax on personal income), there would be no benefit to splitting income as the lower-earning spouse would be paying the exact same tax rate as the higher-earning spouse.

Arguments—For and Against

There are policy arguments both in favour of and against income splitting. These arguments have been well covered in other reports⁴ but are worth briefly summarizing.

Advocates of income splitting argue that it reduces the discriminatory treatment of the current tax system against certain types of family units - those with a single or high-income earner and a lower-earning spouse or parent who stays at home to take on child-care or other household responsibilities. As Prime Minister Harper stated in 2011, “the tax system does not recognize the fact that many, even most families, pool their income to pay their household bills. Nor does it recognize that families share together the special expenses of raising their

TABLE 1
Income Splitting in Practice, a Simple Example

Tax rate	Tax owed without Income Splitting		Tax owed with Income Splitting	
	SPOUSE A (\$86K INCOME)	SPOUSE B (NO INCOME)	SPOUSE A (\$43K NOTIONAL INCOME)	SPOUSE B (\$43K NOTIONAL INCOME)
15% on first \$43,000 of taxable income	6,450	0	\$6,450	\$6,450
22% on next \$43,000 of taxable income	9,460	0	0	0
Tax owed (individual)	15,910	0	\$6,450	\$6,450
Tax owed (family)		\$15,910		\$12,900

3 Note, this example does not include the impact of various non-refundable tax credits (e.g., the basic personal amount) or other tax measures which would affect tax payable.

4 See for example: Alexandre Laurin and Jonathan Rhys Kesselman, “Income Splitting for Two-Parent Families.” C.D. Howe Institute (October 2011); David Macdonald, “Income Splitting in Canada: Inequality by Design.” Canadian Centre for Policy Alternatives (January 2014); “The Big Split: Income Splitting’s Unequal Distribution of Benefits Across Canada.” Broadbent Institute (June 2014).

children and planning for the future. Instead it treats families the same as roommates living under the same roof with no financial attachment. That is not realistic. That is not fair.”⁵

If two families living next door to each other both make \$150,000, there is a simple logic to the argument that they should both pay the same amount of taxes. However, under a progressive tax system with no income splitting provision, this would not be the case if one of the families relied on a single-income earner while the other family had two spouses earning roughly the same income. This is the reality in Canada today, and means a difference in tax owing of thousands of dollars to the detriment of families with a single or high-income earner.

The Conservative platform noted that the measure is expected to provide tax relief to roughly 1.8M Canadian families, saving them on average \$1,300 a year.⁶ For selected families (i.e., those with children, a very high-earning spouse and a spouse with no income who live in provinces with highly progressive tax rates), annual tax savings from income splitting could be in the range of \$11,000 to \$12,000 a year.⁷

Criticisms of income splitting are numerous.⁸ The federal government’s proposal would only benefit couples with children under the age of 18, excluding single parents, childless families, people living on their own and couples caring for elderly family members. The Broadbent Institute’s research, which examined federal tax savings, indicates that 90% of Canadian households would see no benefit whatsoever under the proposed policy, and fewer than 1% of households would be eligible for more than \$5,000 in benefits, with an average benefit for all households of \$185.⁹ These findings are consistent with C.D. Howe’s study, which looked at both federal

and provincial tax savings and found that 85% of households would see no gain whatsoever from income splitting, with only 9% of households seeing gains of over \$500.¹⁰

A recent Canadian Centre for Policy Alternatives study found that 31% of the benefits, including both federal and provincial costs, would accrue to the wealthiest 10% of families in Canada, while only 3% of the benefits would accrue to the bottom 50% of families by income level.¹¹ A study by Kathleen Lahey examining the breakdown for federal costs demonstrates similar findings (see Table 2, next page).¹²

With the lowest-earning 10% of families only receiving an average federal benefit of \$9, while the top 1% of families receive a benefit of \$2,857, there are obvious equity issues with the income splitting proposal. If the federal government is spending \$2.7B on an initiative to deliver ‘fairness’ to families and ease the child-care burden, these distributional impacts are not fair, in any meaningful sense of the word.

At a time when Canada’s population is aging and many baby boomers are retiring, income splitting discourages workforce participation by introducing a tax benefit that is optimized when one spouse stays at home. The disincentive would likely be particularly acute for women, who are more frequently the lower earning spouse, which raises significant concerns about gender equity and eroding gains in women’s labour market participation, as well as women’s bargaining power and welfare within the home.¹³

There is also a good case to be made that the equity argument put forward by proponents of income splitting is on shaky ground. With both parents in the workforce, a variety of other costs are significantly higher, most notably childcare. Treating families

5 CBC News, “Harper pitches income splitting for families,” (March 29, 2011). <http://www.cbc.ca/news/politics/harper-pitches-income-splitting-for-families-1.1074534>.

6 Conservative Party of Canada Platform, p26.

7 Laurin and Kesselman, p8-9.

8 See for example: Andrew Jackson, “Costly and Unfair: Stephen Harper’s income-splitting scheme,” (October 7, 2013) <https://www.broadbentinstitute.ca/en/blog/costly-and-unfair-stephen-harpers-income-splitting-scheme>; Laurin and Kesselman, p3-5; Macdonald, p16.

9 Broadbent, p3.

10 Laurin and Kesselman, p8.

11 Macdonald, p17.

12 Kathleen A. Lahey, “Income Splitting: Huge Tax Cuts for Rich Families,” (January 28, 2014) <http://www.taxfairness.ca/en/news/income-splitting-huge-tax-cuts-rich-families>.

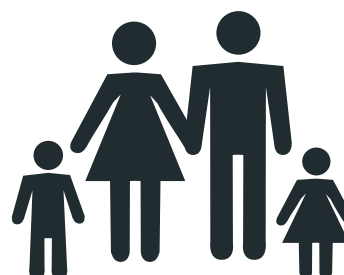
13 See: Elisabeth Gugl, “The Impact of the Income-Splitting Proposal on Labour Force Participation and Other Household Decisions.” *Canadian Tax Journal* (2013) 61:3; Jackson; Laurin and Kesselman, p13-14.

with one working parent exactly the same from a tax standpoint as those with two working parents actually provides significant financial advantages to the family with a stay-at-home parent.

Finally, the proposal would benefit families living in provinces with more progressive tax structures significantly more than those with flatter tax structures. Maximum tax savings for families in Ontario, Nova Scotia and B.C. would be between \$4,500 and \$5,700 higher than for families living in Alberta.¹⁴ Such wide geographic variations for a national program seem, once again, to fly in the face of the ‘fairness’ argument put forward by the federal government. Families in Nova Scotia and Alberta that are both eligible for the maximum benefit should, presumably receive roughly the same benefits.

Taken together, these criticisms paint a picture of an initiative based on a shaky equity argument that provides a significant tax benefit to Canada’s richest families, dampens labour force participation (particularly for women), ignores the large majority of Canadian households, does next to nothing for those most in need of assistance and distributes benefits haphazardly across the country. Any or all of these are sufficient reason to take issue with the federal government’s proposal, and many observers have skillfully done so. The remainder of this paper, however, will focus on a less well publicized issue—the federal government’s ability to drag the provinces along on its ill-conceived journey.

TOP 1%
 Families earning over **\$425,000**
SAVE \$2,857*



LOWEST 10%
 Families earning under **\$30,000**
SAVE \$9*

TABLE 2
 Beneficiaries of income splitting by family income decile (federal costs only)

Family income deciles	Amount of \$2.7B going to each decile	Share of \$2.7B to each decile	Average \$ benefit per family
1: Up to \$30,600	\$3.5 mill.	0.1%	\$9
2: \$30,600-\$43,200	\$29.1 mill.	1.1%	\$74
3: \$43,200-\$53,900	\$40.9 mill.	1.5%	\$104
4: \$53,900-\$67,000	\$111.8 mill.	4.1%	\$283
5: \$67,000-\$80,600	\$236.2 mill.	8.6%	\$599
6: \$80,600-\$94,500	\$299.7 mill.	11.0%	\$760
7: \$94,500-\$112,600	\$430.0 mill.	15.7%	\$1,091
8: \$112,600-\$135,500	\$429.6 mill.	15.7%	\$1,091
9: \$135,500-\$175,600	\$397.9 mill.	14.6%	\$1,008
10: \$174,600 and over	\$753.3 mill.	27.6%	\$1,914
All deciles	\$2,732.0 mill.	100%	\$693
Top 5%: \$221,300 and up	\$474.1 mill.	17.4%	\$2,407
Top 1%: \$425,500 and up	\$109.8 mill.	4.0%	\$2,857

Source: Lahey (2014)
 *Average Federal benefit per family

14 Laurin and Kesselman, p9.

2. Understanding Tax Collection Agreements and the Impact on Provinces

Tax collection agreements

The federal government has never been shy about making decisions in its own policy domains without consulting provinces. Tax policy, an area of shared jurisdiction in which both the provinces and federal government make decisions, is no different. The federal government often introduces new initiatives or makes changes to existing policies in the tax field—whether reducing the federal corporate tax rate, or introducing tax credits for transit use or child care expenses. Why should income splitting be any different? Clearly, the federal government can choose to forego federal tax revenue if it wants and the provinces shouldn't have any say in the matter.

Unfortunately, things aren't quite so simple. With both the federal and provincial governments levying their own corporate and personal income taxes, there has long been recognition of the need to coordinate in this area. When income taxes started becoming an important revenue source for governments in the 1930s, there was initially little coordination amongst governments. This earned the 1930s the moniker of the “tax jungle” era.¹⁵ Beginning in 1941, governments recognized this needed to change, and began entering into agreements to facilitate more effective administration of income taxes, first through rental agreements and then, by 1962, tax collection agreements.

These tax collection agreements between the federal government and provinces have had a variety of names in the intervening period, but all were signed on the understanding that they serve to “reduce complexity and duplication; promote

tax harmony...help Canadians identify which order of government is responsible for their taxes; and... provide provinces with a degree of flexibility over their tax systems.”¹⁶

Today, all provinces and territories (except Quebec)¹⁷ have tax collection agreements with the federal government. Under the terms of those tax collection agreements (TCA), the federal government agrees to collect and administer personal and corporate income taxes on behalf of the province. These TCAs simplify tax filing for individuals and businesses and reduce administration costs for both government and business.

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For example, in 2006, Ontario and Canada signed a Memorandum of Agreement that would allow the federal government to administer and collect Ontario's corporate income tax beginning in 2009. Finance Ministers from both governments, as well as business leaders, hailed the agreement as a smart step forward that would result in lower compliance costs (savings were estimated at the time at \$100M a year for business, that figure is now over \$135M¹⁸) and reduce overlap and duplication by having one

¹⁵ Marc Leblanc, “Tax Collection Agreements and Competition Amongst Provinces,” Library of Parliament (2004) <http://publications.gc.ca/collections/Collection-R/LoPBdP/PRB-e/PRB0344-e.pdf>, p2.

¹⁶ Discussion paper: Personal Income Tax Coordination: The Federal-Provincial Tax Collection Agreements, June 1991, page i. as cited in Federal Administration of Provincial Taxes, New Directions (January 2000) <http://www.fin.gc.ca/fapt-aipf/fapte.pdf>.

¹⁷ Note, Alberta does not have a tax collection agreement for corporate income tax.

¹⁸ Government of Ontario Budget (2012) http://www.fin.gov.on.ca/en/budget/ontariobudgets/2012/papers_all.pdf, p235.

set of rules and one tax collector.¹⁹ The TCAs are a strong model of cooperation and rationalizing roles between two levels of government involved in the same policy space.²⁰

Provinces surely did not anticipate when they signed TCAs with the federal government that the definition of taxable income would become a Trojan horse for major tax and social policy initiatives.

Provinces retain the ability to introduce their own tax credits and set their own tax rates and income thresholds for tax rates under the terms of these TCAs. In exchange for the federal government's collection and administration of income taxes, the provinces agree to use the federal definition of "taxable income" in their own income tax legislation.²¹ However, this last point can prove to be problematic in certain circumstances. The TCAs have bound the provinces to any federal amendments to the definition of taxable income.

As a result, some recent federal measures have had significant impacts on provincial revenues, such as the introduction of pension income splitting in 2007 and the introduction of Tax-Free Savings Accounts in 2009. These measures cost the Ontario treasury \$250M and \$110M,²² respectively, in 2013. The federal government is contemplating doubling

TFSA contribution limits to \$10,000 once the federal budget is balanced.²³ It is estimated that the cost to the federal treasury of this change at maturity, in future decades, could exceed \$10B a year, with total provincial losses amounting to roughly 60% of the federal total (i.e., \$6B annually).²⁴

Under the terms of the TCAs, the federal government is not required to consult with, nor compensate, provinces for any federal changes that detrimentally impact provincial tax revenues. This has locked the provinces into a tenuous position. Having signed agreements in good faith to deliver services more efficiently and at less cost, they are now subject to federal policy decisions that reduce their revenue base despite having no say in those decisions.

Provinces surely did not anticipate when they signed TCAs with the federal government that the definition of taxable income would become a Trojan horse for major tax and social policy initiatives. Yet, that is exactly what has happened. The federal government is setting and pursuing policy objectives using the tax system, and the provinces are obligated as signatories to TCAs to follow in lock-step despite not collaborating in the setting of those objectives or the design of the programs intended to achieve them. In fact, in some cases, the federal objectives and policies may run counter to provincial priorities (e.g., as Ontario and other provinces seek to promote greater labour market participation, the federal income splitting proposal would subvert that aim.)

19 See joint Ontario-Federal news release: "Ontario Business will Benefit from New Tax Collection Agreement" (October 6, 2006) <http://www.fin.gc.ca/n06/06-056-eng.asp>.

20 See M. Mendelsohn et al., "Saving Dollars and Making Sense," (2010) <http://mowatcentre.ca/saving-dollars-and-making-sense>.

21 See for example definitions of taxable income in B.C. and Ontario Income Tax Acts: http://www.bclaws.ca/Recon/document/ID/free-side/96215_01; http://www.e-laws.gov.on.ca/html/statutes/english/elaws_statutes_90i02_e.htm.

22 Government of Ontario Fall Economic Statement, "Transparency in Taxation" (2013) <http://www.fin.gov.on.ca/en/budget/fallstatement/2013/transparency.html>.

23 CBC News, "Tax-free savings limit would double: Harper," (April 7, 2011) <http://www.cbc.ca/news/politics/tax-free-savings-limit-would-double-harper-1.1091397>.

24 See Kevin Milligan, "The Tax Free Savings Account: Introduction to the Policy Forum and Simulations of Potential Revenue Costs." *Canadian Tax Journal*, Vol. 60, No. 2 (2012), 355-60; Rhys Kesselman, "The Forgotten Tax Break for the Rich that will Cost Ottawa Billions" (March 2014) <http://www.theglobeandmail.com/globe-debate/the-forgotten-tax-break-for-the-rich-that-will-cost-ottawa-billions/article17267315>.

Fiscal Impact on Provinces

For many provinces, there will be significant fiscal impacts associated with being compelled to parallel the federal government's income splitting proposal. The C.D. Howe Institute's 2011 study modeled the impacts of income splitting on the federal and provincial governments' treasuries and found the expected impact in 2012 would have been \$2.73B for the federal government, and a total of \$1.72B for the provinces.²⁵ Ontario would have seen a cost of \$1.14B, by far the highest absolute figure among the provinces, with Quebec and B.C. losing \$200M and \$180M in tax revenue, respectively (see Table 3).²⁶

Due to its flat 10% tax on personal income tax, Alberta would see virtually no impact from mirroring the federal changes. It is important to note that the studies conducted on this issue do not take account of behavioural changes as a result of new rules, and that adaptive behaviour could lead to even larger revenue impacts for governments.

The federal government's proposed changes do not intentionally target some provinces more than others. But those provinces with more progressive tax systems, like Ontario, B.C. and Nova Scotia, would see a much larger proportional revenue impact. The provinces with no or little progressivity in their income tax systems, like Alberta and Saskatchewan, would see no or minimal impact on their revenue.²⁷

This hit to provincial revenues is significant. For Ontario, the \$1.14B in lost revenue represents 4% of the province's personal income tax revenue, while Nova Scotia and B.C. would face a loss of roughly 2.5-3% of their personal income tax revenue. Already facing constrained fiscal positions in the aftermath of the global financial crisis, provinces cannot afford further erosions to their revenue base that have been imposed by fiat from Ottawa.

TABLE 3
Impact of Income Splitting on Provincial and Federal Budgets (2012)

Province	Cost to Provinces	Cost to Federal	Share of Provincial Personal Income Tax that will be Lost ²⁷
	(\$ MILLIONS)		(%)
ALBERTA	Negligible	490	Negligible
BRITISH COLUMBIA	180	300	2.6
MANITOBA	50	90	1.8
NEW BRUNSWICK	20	50	1.6
NEWFOUNDLAND & LABRADOR	20	50	1.7
NOVA SCOTIA	60	70	2.8
ONTARIO	1,140	1,160	4.0
PRINCE EDWARD ISLAND	5	10	1.7
QUEBEC	200	440	0.8
SASKATCHEWAN	20	80	0.8
TOTAL	1,720	2,730	Federal: 2.2

Source: C.D. Howe Institute, 2011 (Laurin and Kesselman)

²⁵ Note that although Quebec administers its own personal income tax, it may opt to adopt income splitting and has often paralleled federal changes in the past (e.g., pension income splitting in 2007).

²⁶ Note, 2014 CCPA study estimates the impact of income splitting at \$3B on federal revenues in 2015 dollars.

²⁷ Source – Laurin and Kesselman and Provincial Public Accounts, 2012-13 for each province.

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Of note, C.D. Howe modeled the impacts of federal income splitting on higher income families. It found that the accrual of tax-savings to families making more than \$125,000 a year averages 41% across the country, but is significantly higher in Alberta (55%) and Newfoundland and Labrador (53%).²⁸ As the authors concluded, given that the federal income tax rate is consistent across the country, the only logical explanation for these discrepancies is the different distribution of family incomes across provinces.

²⁸ Laurin and Kesselman, p12.

3. So what should the federal and provincial governments do? Some simple options

The federal government's family income splitting proposal is riddled with problems. It is a niche program that comes at a high cost, and it is likely that better, more productive uses could be found for \$3B. As the late Finance Minister Jim Flaherty noted in February 2014, the initiative needs a "long, hard analytical look...to see who it affects in this society and to what degree. Because I'm not sure that overall it benefits our society."²⁹

The evidence is clear. The federal government should not proceed with its income splitting initiative. Other policy tools would have more direct and more broadly-based benefits for families in Canada, including boosting the child tax benefit, enhancing the universal child care tax benefit, amending existing EI provisions relating to parental leave,³⁰ or broad personal income tax cuts. Alternatively, the federal government could make significant progress in other areas with nearly \$3B a year, such as infrastructure investments in transit or a national pharmacare program, to name but two.

Regrettably, governments do sometimes move forward with ill-conceived policies. If the federal government chooses to move forward with this initiative, there are some ways it could proceed that would, at the very least, not erode provinces' fiscal positions.

Most simply, the federal government could directly compensate provinces for the revenue loss they will experience. This will increase the cost for the federal government, but it would not impose costs on provinces for a policy that they had no hand in designing and may not want to pursue.

Another option for the federal government that would not involve re-opening existing tax collection agreements would be to design a tax credit that could achieve similar results as income splitting. This would require careful design to closely target the same beneficiaries and effects of income splitting, but would have no impact on provincial treasuries.

Alternatively, the federal government could amend the existing tax collection agreements with provinces that cover income tax to grant provinces a voice in key decisions. A model for this approach already exists under the Canada-Ontario Comprehensive Integrated Tax Coordination Agreement (CITCA),³¹ which establishes the ground rules under which the federal government and Ontario coordinate administration of the Harmonized Sales Tax (HST).

Under the CITCA agreement, the federal government collects and administers Ontario's HST and is the policy lead for all HST matters, which binds Ontario to any federal tax base changes or rulings. Critically, Ontario is protected under the CITCA from any changes to the federal tax base that would result in a 1% revenue decrease. Any such decision requires either the written agreement of the province, or full compensation for such a decision. Including a similar clause in existing tax collection agreements related to income taxes would protect provinces from unilateral federal decisions that significantly erode their revenue base.

29 CBC News, "Jim Flaherty backs away from income-splitting promise," (February 12, 2014) <http://www.cbc.ca/news/politics/jim-flaherty-backs-away-from-income-splitting-promise-1.2533641>.

30 Laurin and Kesselman, p16.

31 Comprehensive Integrated Tax Coordination Agreement (2009), <http://www.fin.gov.on.ca/en/publications/2009/citca.html>.

The federal government could also renegotiate existing TCAs to permit provinces to calculate taxable income for provincial purposes in a manner that would effectively 'undo' the impact of income splitting on provinces. This would be relatively easy to accomplish, though it arguably violates the spirit of the TCAs and raises risks of administrative inefficiencies being imposed onto tax filers.

If the federal government moves ahead with income splitting but does not seek provincial consent, provide compensation or design a tax credit instead, the provinces must take a clear-eyed assessment of the benefits and drawbacks of being signatories to tax collection agreements. Provinces entered TCAs in good-faith, with the laudable objectives of strengthening the economic union, increasing coordination and reducing unnecessary duplication and overlap.³²

If the federal government chooses to move forward with this initiative, there are some ways it could proceed that would, at the very least, not erode provinces' fiscal positions.

These agreements benefit individuals, businesses and governments by simplifying the collection and administration of taxes in Canada and are a key element of our economic union. However, if the federal government continues to implement unilateral decisions such as TFSAs and, potentially, family income splitting, the provinces must weigh administrative efficiencies against revenue hits that range from hundreds of millions to billions of dollars.

Absent a more conciliatory and respectful federal partner, the provinces will at some point have to consider withdrawing from their TCAs with the federal government and re-establishing their own administrative and operational control of their tax base. This would be a gigantic step backwards for the federation and an option of last resort that would be costly and, given the suite of other options available, completely unnecessary.

³² See for example Government of Ontario Fall Economic Statement (2013) http://www.fin.gov.on.ca/en/budget/fallstatement/2013/paper_all.pdf, p148.

4. Conclusion: An Uncertain Future for a Dubious Measure

The future of the federal government's income splitting proposal is less certain in 2014 than when it was a signature platform commitment in 2011. Statements from late Finance Minister Flaherty indicate the government may be re-assessing whether to proceed, though no formal statement to this effect has been made. The perspective of provinces should play a key role in determining its fate.

When the federal government signed tax collection agreements with the provinces, all parties had a good faith understanding that they were rationalizing their roles and responsibilities to provide more efficient, effective services to Canadians. As with other partnerships that begin with the best of intentions, however, things have not turned out quite as planned for at least one of the partners.

The federal government unilaterally moved ahead with the introduction of pension income splitting and TFSAs to the detriment of, and with no consideration for, provincial revenues and fiscal positions. Although provinces raised major concerns over these issues, the policy rationales for those initiatives were clearer and their initial impacts were more modest. But we are now seeing the full effect of federal unilateral action on provincial budgets.

The 2015 federal budget could see a doubling in TFSA contribution limits and the introduction of the family income splitting initiative. Both would have significant impacts on provincial treasuries—several billion dollars in the long-run for TFSAs and close to \$2B annually in the short-term for family income splitting. Once again, the provinces were not consulted on either initiative, yet by virtue of their tax collection agreements with the federal government, are forced to move ahead in lock-step.

The provinces and federal government now face a crucial moment. They can choose to abide by the original intention of the tax collection agreements, which was to get out of the 'tax jungle' and collaborate in the interests of Canadians. This approach requires federal recognition of the impact of new tax initiatives on the provinces' fiscal positions. This approach also requires the federal government to secure provincial consent for new initiatives, introduce enhanced flexibility to existing TCAs, compensate provinces for new initiatives that would have a revenue impact or design initiatives in a manner which has no impact on provincial treasuries.

Alternatively, if the federal government fails to abide by the collaborative intention of the TCAs, provinces are left with little choice. Whether now, or at some point in the near future, the cumulative effects of unilateral federal tax policy decisions that harm the provinces' revenue bases will far outweigh any administrative savings or benefits generated by the agreements. At that point, the provinces must make economic and political calculations that protect their own interests and consider withdrawal from the tax collection agreements.

Fortunately, it is not too late for the federal government to reconsider its proposed approach on income splitting for families. In addition to other reasons for re-thinking income splitting, the damage to provincial balance sheets should also be taken seriously.

