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INTRODUCTION

In this article, I consider the income-splitting proposal put forward by the Conservative Party of Canada in 2011 and assess its impact on the distribution of welfare within a household. I assume that spouses make joint decisions governed by a bargaining process in the family based on various types of bargaining models as discussed in one of my previous articles.2

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2 Elisabeth Gugl, “Income Splitting, Specialization, and Intrafamily Distribution” (2009) 42:3 Canadian Journal of Economics 1050-71. I use the terms “family” and “household” interchangeably.
Since the seminal work of Manser and Brown and McElroy and Horney, economists have moved away from the assumption that a couple behaves as if it were one economic agent. Instead, many family economists now treat household decision making as the result of bargaining between the partners.

Bargaining models characterize family decision making as a cooperative conflict; they capture the tension of each family member between self-interest and concern for the family as whole. That actions of family members are governed by both a willingness to cooperate and self-interest is best illustrated by the following anecdote.

When I recently picked up my daughter from the house of one of her friends, I complimented the friend’s mother—let’s call her “A”—on her attractive garden, and she said, “It’s so hard to keep up with the work! We already have so many expenses: daycare for the kids, the nanny; we can’t afford to hire somebody to take care of the garden! I have a good-paying job, but sometimes I wonder if it wouldn’t be easier just to stay home and take care of the kids and the garden myself.” These comments speak to a desire shared by many couples: to produce the greatest benefit to the family as a whole with the financial and time resources that the family has at its disposal. Simply put, household members pool their resources to achieve a common goal.

However, A also mentioned, with a sigh of regret, “My husband used to take care of our garden but then he discovered marathon running.” This speaks to another important feature of family decision making: While couples make decisions trying to do what is best for the family, they also balance their own interests with their concerns for the family as a whole. Clearly, A would have liked her husband to spend more time gardening and less running, while her husband preferred running to doing more gardening. Bargaining models explain how A and her husband divide their time between activities that benefit the family as a whole and activities that mostly benefit one spouse individually. They also explain how the family allocates goods, not just time; if A’s bargaining power increases, the expenditure pattern of the household reflects her preferences to a higher degree than her husband’s.

In this article, I use numerical examples to illustrate the findings in my earlier study. I consider a couple’s labour supply decision in the current year and its implications for their earning potential five years from now under the current system of family taxation and under the income-splitting proposal. The proposal creates incentives for the secondary earner in the family to reduce his or her labour supply and instead work more in household production. I discuss the bargaining rules

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5 Details of this story have been changed to preserve the anonymity of the individuals concerned.
6 Supra note 2.
7 By earning potential, I mean the amount of pre-tax income that an individual could earn if he or she worked full-time.
under which a decrease in the earning potential of the wife in the future can have such a high negative impact on her bargaining power relative to her husband’s that she is worse off under the proposal than under the current tax system.

I first introduce the particular policy and then show the different effects of the proposal on different household types. In my analysis, I abstract from other taxes and focus on the federal income tax schedule only. I also assume that the change in the tax schedule for families does not alter who enters into a relationship with whom. Holding partner characteristics constant, the question I answer in this article is, “How does the welfare of each partner change as couples are allowed to split their income according to the Conservative Party’s plan?”

Throughout the analysis I assume that there is no change in the service level of the government as revenues decrease from the tax change. In the conclusion, I discuss how changes in the expenditure level or increases in tax rates to make the tax change revenue-neutral could further change the distribution of welfare within a family.

THE INCOME-SPLITTING PROPOSAL

The Conservative Party of Canada went into the federal election in May 2011 with a promise to change how Canadian families are taxed. In particular, the proposed change would allow couples with at least one child under the age of 18 to transfer up to $50,000 from the spouse with the higher taxable income to the spouse with the lower taxable income.8 Since marginal federal tax rates increase with taxable income, such a transfer would reduce a couple’s joint tax liability whenever the marginal tax rate of one spouse was different from the marginal tax rate of the other under the current system of individual taxation.

All the calculations of a couple’s tax liability in this article are based on the tax schedule presented in table 1. The table follows closely the format of schedule I of the federal T1 general tax form for 2012. I ignore any deductions that lower the taxable income of an individual and any tax credits that cannot be claimed by all taxpayers. However, I take into account the basic personal amount of $10,822. In addition, the current tax system allows an individual to lower the tax liability if his or her spouse or common-law partner has a net income that is below the personal amount.9 If the spouse does not have any net income, the spousal or common-law partner amount is $10,822. Any net income of the spouse or partner reduces this amount dollar for dollar.

To calculate the tax liability of a couple, first each spouse’s taxable income is determined and entered in table 1. The last row yields a person’s tax liability. In order to calculate the couple’s tax liability the two amounts from the last row have to be added. This method works, even if one spouse earns less than $10,822. For example, if the

8 See supra note 1.

9 In my examples, total income, net income, and taxable income are all the same. They differ in reality owing to various deductions (for example, for union dues and registered retirement savings plan contributions).
net income of a spouse is zero, according to table 1 this translates into a negative tax liability (hence a refund) of $10,822 \times 15\% = $1,623. Combining this amount with the other spouse's tax liability results in a tax liability for the couple as if the spousal or common-law partner amount had been considered explicitly. Immediately below, I present an example of how a couple's tax liability is computed using table 1 when the current law is applied or when the income-splitting proposal is implemented to transfer up to $50,000 from the higher earner to the lower earner.

Example: Calculation of a couple's tax liability under the current and the proposed tax regimes

Consider a couple consisting of a higher earner with an income of $170,000 before taxes and a lower earner with an income of $30,000 before taxes.

Current taxation

Higher earner:

\[
\begin{align*}
\text{Taxable income} & : \quad $170,000 \\
- \quad 132,406 & : \\
\text{Net taxable income} & : \quad 37,594 \\
\times \quad 29\% & : \\
\text{Tax liability} & : \quad 10,902 \\
+ \quad 28,020 & : \\
- \quad 1,623 & : \\
\text{Net federal tax} & : \quad $ 37,299
\end{align*}
\]
Lower earner:
Taxable income ........................................... $ 30,000
− 0
__________________________
30,000
× 15%
__________________________
4,500
+ 0
− 1,623
__________________________
Tax liability .................................................. $ 2,877

Tax liability for the family: $37,299 + $2,877 = $40,176.

Income-splitting proposal

Higher earner:
Taxable income ($170,000 − $50,000) ................. $120,000
− 85,414
__________________________
34,586
× 26%
__________________________
8,992
+ 15,802
− 1,623
__________________________
Tax liability .................................................. $ 23,171

Lower earner: $30,000 + 50,000 = 80,000
Taxable income ($30,000 + $50,000). ................. $ 80,000
− 42,707
__________________________
37,293
× 22%
__________________________
8,204
+ 6,406
− 1,623
__________________________
Tax liability .................................................. $ 12,987

Tax liability for the family: $23,171 + $12,987 = $36,158.

In table 2, I show the tax savings for families at various income levels where the income-splitting proposal is applied according to the 2012 tax schedule. Three levels of taxable family income are included, ranging from $75,000 to $200,000. For each level of taxable income, I consider five different earnings distributions.

As can be seen in table 2, the proposal generates greater tax savings for higher-income families (holding within-family income inequality constant) and for families
with greater income inequality (holding family income constant). Among the examples in table 2, the proposal generates the greatest tax savings for the single-earner couple with taxable income of $200,000.

A pure income-splitting proposal (without a cap on the amount of income that can be transferred from the high earner to the low earner) always leads to a family being taxed as if each earner made half of the family income. In such a case, each earner faces the same marginal tax rate. The $50,000 cap under the proposal limits the ability of some households to fully split their income. Specifically, the cap prevents full income splitting for some high-income, high-inequality households (in table 2, for the two most unequal households at the $200,000 family-income level).

Given the marginal tax rates applicable in 2012, the most that a family can save under the proposal is $6,490. Such savings are achieved when the high earner in a household earns enough so that all of the last $50,000 of his or her income is taxed at the highest marginal rate of 29 percent and the low earner earns nothing. In such a case, transferring $50,000 of income away from the high earner lowers his or her tax liability by $14,500, and increases the tax liability of the low earner by $8,010.

<table>
<thead>
<tr>
<th>Income composition</th>
<th>Family tax liability</th>
<th>Comparison: individual versus income splitting</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low-income spouse earns</td>
<td>High-income spouse earns</td>
<td>Low income as % of family income</td>
</tr>
<tr>
<td>$75,000</td>
<td>$10,264</td>
<td>$8,003</td>
</tr>
<tr>
<td>$130,000</td>
<td>$24,148</td>
<td>$19,374</td>
</tr>
<tr>
<td>$200,000</td>
<td>$44,376</td>
<td>$37,886</td>
</tr>
</tbody>
</table>
The increase in tax liability for the low earner comes from the fact that, under the 2012 tax schedule, the low earner would pay 15 percent tax on the first $42,707 of the transferred income, and 22 percent tax on the remaining $7,293 of the transferred income.

IS IT WORTH CHANGING THE LABOUR SUPPLY AS THE TAX SYSTEM CHANGES?

In this section, I investigate the labour supply of the couple under the two tax regimes. Table 2 shows how family income of the same amount but with different composition is taxed differently under the current tax law, and it illustrates the tax savings that may be achieved under the income-splitting proposal. It is important to note that, because after-tax income under the proposal is already higher, in most cases, than it is under the current system, where labour supply stays constant across the two tax regimes, the family has more financial resources and hence is better off under the proposal. Any change in labour supply resulting from the change in the tax system, if decisions are efficient, must make the family as a whole better off under the proposal.

Table 2 is not very useful in determining how a couple changes labour supply as the tax system changes, because typically the family cannot alter the composition of earnings while holding total income constant. Rather, the spouses’ decisions will most likely lead to different earnings composition and family income, as the two scenarios described below demonstrate.

Scenario 1: Impact of Labour Supply Decision in the Year of Choice

Consider the situation of a couple with two young children over a period of one year. I focus on a family in which the earning potential of the spouses is fairly unequal.10 As noted in the previous section, the income-splitting proposal would produce the greatest tax savings for high-income, high-inequality couples. These are also the households in which the incentive for the secondary worker to drop out of the labour force as the tax system changes is greatest.

Consider the family in table 2 in which the low-income spouse earns $30,000 in taxable income and the high-income spouse earns $170,000 if both work full-time. While a growing number of women are becoming primary earners, on average, it is still more common for women to be the secondary earners in Canadian families.11

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10 Recall that earning potential is the amount of income before taxes that an individual could earn if he or she worked full-time.

For that reason, I will assume that the spouse earning $30,000 is the wife and the spouse earning $170,000 is the husband.

Assume that the couple has two children under the age of six, and annual child-care costs are $20,000.\textsuperscript{12} Let’s consider the financial resources that the family has at its disposal to buy goods (referred to here as the “disposable income” of the family). Child-care costs diminish those financial resources and hence should be subtracted from total income, in addition to the tax liability, in order to determine disposable family income. Clearly there are also other costs associated with both spouses working full-time, but I will ignore them for the sake of exposition.

Under the current tax system, the family income after taxes minus child-care expenses is $180,000 − $40,176 = $139,824. Under the income-splitting proposal, the family would keep an income of $180,000 − $36,158 = $143,842.

Now assume that the wife considers staying at home. This frees up time for her to contribute more home-produced goods in form of a clean house, a well-kept garden, clean laundry, home-cooked meals, and, most importantly, child care. I assume that child-care expenses are zero when the wife stays at home.

Under the current system of individual taxation, this would leave the family with a disposable income of $170,000 − $37,299 − (−$1,623) = $134,324. The change in disposable income is −$5,500, as compared with the amount available when the wife worked full-time.

Under the income-splitting proposal, the wife’s decision to stay at home yields a disposable income of $170,000 − $23,171 − $6,387 = $140,442. The change in disposable income is −$3,400, as compared with the amount available when the wife worked full-time.

Looking at the annual change in family income under the two tax regimes, we see that when a spouse stays at home, the reduction in disposable income is less under the proposal. At the same time, the household still has a higher disposable income with the stay-at-home wife than it had under the current tax regime when the wife worked full-time.

The example illustrates the benefits to the household of the income-splitting proposal compared to the current system, within the period in which a change in labour supply could be made. If the family chose labour supply based on within-period benefits only, the optimal scenario might be for the wife, with an earning potential of $30,000 before taxes, to reduce her earnings to zero when the income-splitting proposal is implemented, but to work full-time under the current system of taxation.

\textsuperscript{12} The 2012 federal income tax schedule allows for a child-care deduction against the lower earner’s income. With the income-splitting proposal, often there is no lower earner, and it is unclear how this deduction would be applied. I therefore ignore this provision in my calculations. Child-care costs could differ under the two tax regimes if, owing to the lower government revenues under the proposal, public expenditure on child-care centres and/or public education were reduced.
Such a change in labour supply has an impact on government revenues. Not only does the couple save (and the government lose) $4,107, as would be the case if earnings of each spouse stayed the same under both tax regimes, but also the drop in the wife’s labour supply further decreases tax revenues. The additional loss is $30,000 × 0.22 = $6,600.

**Scenario 2: Effects of Labour Market Experience on Future Earnings**

Next I consider what happens when there are two periods of labour market choice, not just one. The labour supply in the first period as described above has an impact on the wage rate that spouses can earn in a later period, because a key determinant of wages is experience. For the high earner, the extra time at work afforded by having a stay-at-home spouse enhances earnings. For a lower-earning spouse, staying out of the labour force results in the loss of potential work experience and possibly future as well as current wages. A forward-looking couple would not make a labour-supply choice in any given year on the basis of within-period benefits alone, but would look also at the consequences for the years ahead. I continue with the previous example to illustrate this point.

Consider the family in scenario 1 five years from now, when the children do not require full-time day care because they have entered school. Suppose that instead of staying at home, the wife spent those five years working full-time, earned a promotion, and is now making $40,000 a year instead of $30,000. Her husband has also made career progress and now earns $200,000. Child-care costs are down to $10,000 a year. So the family’s disposable income under the current tax system is $230,000 − ($200,000 − $132,406) × 0.29 − $28,020 − $40,000 × 0.15 + (2 × $1,623) = $179,624. Under the income-splitting proposal, it would be $230,000 − ($150,000 − $132,406) × 0.29 − $28,020 − ($90,000 − $85,414) × 0.26 − $15,802 + (2 × $1,623) = $183,129.

Even if the wife stayed at home during the last five years, she can enter the labour force now. In this case, assume that her starting wage is $27,000, owing to her lack of recent labour market experience. The husband, having had more time to network and keep up with his profession in his leisure time with the support of his stay-at-home wife, is making $210,000. So the family’s disposable income under the current tax system is $227,000 − ($210,000 − $132,406) × 0.29 − $28,020 − $27,000 × 0.15 + (2 × $1,623) = $175,674. The change in disposable income is $3,950, as compared with having the wife work full-time five years earlier. Disposable income under the income-splitting proposal is $227,000 − ($177,000 − $132,406) × 0.29 − $28,020 − ($50,000 − $42,707) × 0.22 − $6,406 + (2 × $1,623) = $181,101. So the difference is $2,028.

The example illustrates the intertemporal benefits to the household under the income-splitting proposal as compared with the current system. Although a lower first period labour supply of the wife lowers family income five years from now, it lowers it by less under the proposal than under the current system. Given the benefits of increased household production in the first period, it might still be optimal
for the wife to stay at home in the earlier period when the proposal is implemented, but to work full-time under the current system of taxation.

This example illustrates two very important points. First, the family has more disposable income and a higher level of household production under the income-splitting proposal in the first period. Even in the second period, the husband’s higher earnings and the more favourable tax treatment under the proposal make up for the wife’s diminished earnings compared to the disposable family income under the current system. Overall, the household has more financial resources in each of the two time periods under the proposal than under the current tax system.

Note that this is just one example of how labour supply decisions in an earlier period could affect the family’s earning potential in five years. The example delivers higher earnings for the husband in the second period, which make up for the lower earnings of the wife. This may not always be the case. It could be possible that the wife’s lack of experience decreases her earning potential in the future by so much that the higher earnings of the husband and the more favourable treatment under the proposal cannot make up for them.

Second, we can also see that choosing a lower labour supply for the wife in one period changes her earning potential over the long run, leading to a bigger gender gap in the earnings of the couple. In the first period, the earning potential ratio—that is, how much each spouse could earn if he or she chose to work full-time—is $170,000/$30,000 = 5.67. Given that both spouses work full-time in the first period, the earning potential ratio in the second period is $200,000/$40,000 = 5. If the wife stays at home in the first period, the ratio in the second period is $210,000/$27,000 = 7.78.

The above ratios do not take taxes into account. I will return to the impact of taxes on the ratio of disposable incomes in the next section. Here I emphasize that the labour supply decision in an earlier period has an impact on the earning potential of a spouse in subsequent periods, and that more specialization of spouses in earlier periods leads to a higher earning potential ratio in subsequent periods. Why this might be of concern is addressed in the next section.

**BARGAINING AND DISTRIBUTION OF WELFARE WITHIN THE FAMILY**

The previous section focused on an example in which cooperation under the two tax regimes leads to more disposable income and household production under the income-splitting proposal than under the current tax system. I now turn to the question of how this relatively higher wealth might be distributed between the spouses.

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13 Another important result from the example is that tax revenues are lower under the proposal than under the current system because the family as a whole has lower earnings before taxes and is taxed less than under the current system. The loss in revenue should be taken into account in an overall assessment of whether the proposal should be implemented. This issue is not, however, the focus of this article.
Manser and Brown\textsuperscript{14} and Horney and McElroy\textsuperscript{15} were the first to apply bargaining models to household decision making. One can think of this approach as describing principles that govern the process of how family members make decisions. If spouses cooperate, each spouse will consume shared goods and private goods that will lead to increased well-being by comparison with the consumption of goods that the spouse can afford in a state of disagreement. The question then becomes, “How should the gains from cooperation be distributed, and what constitutes a state of non-cooperation or disagreement?”

In the context of bargaining among spouses, the state of non-cooperation is interpreted as either a situation in which the spouses do not live together (remain single or get a divorce) or a situation in which the spouses still live under the same roof and remain in the relationship, but refuse to coordinate their actions. In either of these states of non-cooperation, a person’s well-being is much more closely linked to his or her own earning potential than is the case in a state of cooperation.

The well-being of a spouse in a state of non-cooperation depends on the quantity of goods and leisure that the spouse can consume in such a state. Household production plays a lesser role in non-cooperation, and so a person’s well-being is closely related to his or her disposable income from working full-time. The taxes that apply to total income have an impact on disposable income, and hence the tax schedule has an impact on a spouse’s bargaining power. For example, if the state of disagreement is taken to be the utility of a spouse when single, then the level of utility depends on the tax rates that are applied to the person’s total income. Given that each person works full-time, a proportional tax on earnings yields the same ratio of disposable income as of earning potential. A more progressive tax schedule changes the ratio of disposable income in favour of the person with the lower earning potential as compared with the ratio of earning potential.

Sorting out the disagreement point is just one part of describing the bargaining approach. The other part consists of discussing which rules should lead the spouses from their minimal claims to their actual utility in marriage. With regard to this question, I assume that if the potential gains from cooperation change without a change in minimal claims, both spouses should be either better off or worse off than before (that is, they share the gain or pain of this change).

The proposed change in family taxation increases the gains from cooperation whenever the couple can lower their tax liability, given taxable incomes before the tax change as illustrated in table 2. Whatever the actual choices of the spouses—even if they lead to a lower disposable income in the second period—family wealth as a whole

\textsuperscript{14} Manser and Brown, supra note 3.
\textsuperscript{15} Horney and McElroy, supra note 4.
\textsuperscript{16} For further discussion of this issue, see Elisabeth Gugl and Justin Leroux, “Share the Gain, Share the Pain?—Almost Transferable Utility, Changes in Production Possibilities, and Bargaining Solutions” (2011) 62:3 Mathematical Social Sciences 133-43.
will be increased when both periods are considered together. Hence, the source of any adverse effect of the proposed tax change arises from a change in the minimal claims of spouses. This change is due to the effect of the tax change on spouses’ earning potential.

Looking at the choices discussed above, we can see that the earning potential for the husband, while the same under the current tax system and under the proposal in the first period, is higher under the proposal in the second period owing to the different first-period labour supply decision. Similarly, the earning potential for the wife is the same under the current tax system and under the proposal in the first period, but it is lower under the proposal in the second period owing to the different first-period labour supply decision.

The earning potential of the wife is the same before making a decision in the first period with respect to how much to work, no matter whether the proposal is implemented or not, and hence her minimal claim to gains from cooperation in the first period stays the same under both tax regimes. The same is true for the husband. Hence, the bargaining power of each spouse in the first period is independent of the tax regime in marriage. Gains from cooperation in the first period are higher under the proposal than under the current system, so both spouses benefit from the proposal in the first period.

It is important to note that the wife is not punished for her low earnings in the first period. In this period, she has a minimal claim based on her earning potential (of $30,000), not her actual earnings in the first period. If there were no other period, staying at home would come at no loss of bargaining power to her.

In the second period, however, under the income-splitting proposal, the wife’s earning potential is lower while the husband’s is higher than they are under the current system. If bargaining in the second period is based on the earning potential of each spouse in the same period, we conclude that the wife’s bargaining power has decreased. This decrease could lower the wife’s second-period utility so much that her overall utility (that is, taking her well-being into account in all periods) is lower under the proposal than under the current system of taxation. Such a change would manifest itself in less time for leisure activities (and more for household chores) than under the current system, and in an expenditure pattern of the household that reflected the husband’s preferences to a higher degree over time.

So far, I have ignored any strategic interaction. I have assumed that labour supply is based on producing the highest wealth in household production and financial resources possible. However, we could think of a scenario in which both spouses have autonomy in deciding how much they will work. Once they have made this choice, and family income and household goods are generated, that income and those goods are distributed as before, on the basis of the bargaining power of spouses. Now the spouses take into account how their first-period labour supply affects their own welfare in the two periods, and each of them will choose how much to work on the basis of what is best for himself or herself alone, given the other person’s decisions. Note that there are still elements of cooperation: both spouses agree on what is a fair division of family income in each of the two periods.
In my earlier study, I point out that it is the husband’s actions that can have a negative impact on the wife’s welfare when spouses choose their labour supply strategically. However, if the husband does exactly the same under both tax regimes—that is, he contributes the same amount of time to household production and works the same number of hours—the wife will change her labour supply only when it is in her best interest to do so. She is aware of the implications of her actions for her earning potential in the second period, and the possibility of a lower share of gains from cooperation owing to her diminished bargaining power. In such a situation, the wife is under full control and will choose to stay at home in the first period only if doing so is in her best interest. Hence, even if she reduces her working hours and her future earning potential under the income-splitting proposal, she does so because she is better off.

In the scenario discussed above, I assumed that a husband with a stay-at-home spouse would have an advantage in making career progress as compared with a husband whose wife worked full-time. When the husband, through his own actions, increases his earning potential under the income-splitting proposal beyond his earning potential under the current system, the wife suffers a loss of bargaining power, which may have a negative impact on her welfare under the proposal, even if the spouses make their labour supply decisions strategically.

**CONCLUSION**

This article illustrates with simple examples the theoretical results derived in my earlier study. Conventional wisdom predicts that the Conservative Party’s income-splitting proposal would lower the labour force participation of women, since they are still, on average, more often the secondary earner in Canadian families. Whether lower earnings translate into lower bargaining power and lower welfare for the wife depends on the bargaining process in the family. If the ratio of within-period earning potential determines the bargaining power of spouses to a large extent, then lower labour supply in an earlier period leads to lower bargaining power in subsequent periods. The reduction in welfare of the spouse with decreasing bargaining power in later periods may not be offset by the higher welfare in the first period.

Implementing the income-splitting proposal will result in lower revenues for the government. Lower expenditure on public services or increases in other taxes to offset the revenue loss may have regressive impacts. If that is the case, the bargaining power of spouses could be further changed in favour of the spouse with the higher earning potential. Hence, it becomes more likely that wives (owing to their role as secondary earners) will be hurt by the proposal.

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17 Gugl, supra note 2.
18 Ibid.
The results presented in this article also show that the proposal cannot hurt wives if both husbands and wives do not change their labour supply as the tax system changes. In this case, spouses will just share the higher disposable income resulting from the tax savings that income splitting provides to families with children. The article by Matt Krzepkowski in this issue discusses how the proposal could be tweaked to reduce the incentives for wives to drop out of the labour force.