

ACHIEVING A NATIONAL PURPOSE  
*Improving Territorial Formula Financing and  
Strengthening Canada's Territories*

EXECUTIVE SUMMARY

Expert Panel on Equalization and Territorial Formula Financing

*May 2006*



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May 2006

The Honourable James M. Flaherty, P.C., M.P.  
Minister of Finance  
House of Commons  
Ottawa, Ontario

Dear Minister,

We are pleased to provide the report and recommendations of the Expert Panel established to review Territorial Formula Financing (TFF).

For the past year, Panel members have listened to the views of territorial governments and people in the North. We have learned about the unique challenges and circumstances in the territories and their aspirations for self-sufficiency. Clearly, Territorial Formula Financing is critical for the territories and, while there is tremendous potential for economic development in the North, TFF will remain an essential program for the territories for years to come.

We have analyzed a wide range of ideas and options for Territorial Formula Financing, explored alternatives and assessed the impact. We believe that the package of recommendations outlined in our report will provide a significant improvement over the current arrangements and establish a solid new approach for the future of Territorial Formula Financing.

We would like to thank the territorial governments, federal government officials, and a host of people in the North who contributed to our review. We hope our report reflects the aspirations and expectations of people in the territories and most important, that it helps secure a stronger future for the territories.

Yours sincerely,

Original signed by:

*Al O'Brien (Chair)  
Fellow, Institute of Public Economics,  
University of Alberta*

Original signed by:

*Fred Gorbet  
Principal, Strategy Solutions*

Original signed by:

*Robert Lacroix  
Founding member, Centre for Interuniversity Research  
and Analysis on Organization (CIRANO)*

Original signed by:

*Elizabeth Parr-Johnston  
Principal, Parr Johnston Economic  
and Policy Consultants*

Original signed by:

*Mike Percy  
Dean, School of Business,  
University of Alberta*

### **Members of the Expert Panel on Equalization and Territorial Formula Financing.**

- Al O'Brien (Chair)            Fellow, Institute of Public Economics, University of Alberta
- Fred Gorbet                    Principal, Strategy Solutions
- Robert Lacroix                Founding member, Centre for Interuniversity Research and Analysis on Organization (CIRANO)
- Elizabeth Parr-Johnston      Principal, Parr Johnston Economic and Policy Consultants
- Mike Percy                     Dean, School of Business, University of Alberta

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### **Members of the Secretariat to the Expert Panel**

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## Achieving a national purpose

“The current fiscal fragility of the north is a leading indicator of a future greatly in need of immediate attention. Clearly, the north is very much in transition. There is a necessity to invest in the north if it is ever to achieve the self-sufficiency anticipated by the original objectives of the formula financing arrangements between Canada and the territories.”

Government of the Northwest Territories,  
Government of Nunavut, Government of Yukon<sup>1</sup>

Those words, written in 2003, certainly ring true today.

As part of its review of Territorial Formula Financing (TFF), the Expert Panel on Equalization and Territorial Formula Financing (the Panel) was struck by a number of key points.

- The situation in Canada’s territories is vastly different from the challenges faced by the provinces. Communities are small and isolated. Costs are substantially higher. Although economic diversification is currently limited, there are significant opportunities for resource development.
- Although the three territories share common aspirations and dreams for the North, there are substantial differences among the three territories that call into question the effectiveness of one-size-fits-all solutions.
- All three territories rely heavily on TFF and other federal transfers to pay for essential public services. In 2005–06, TFF made up between 64 and 81 percent of territorial budgetary revenues.<sup>2</sup>
- A number of indicators point to serious health and social problems combined with lower health and education outcomes, inadequate housing, and an urgent need to replace and expand existing infrastructure. Although there are challenges in all three territories, the situation in Nunavut is particularly serious.
- There is great potential for economic development from natural resources in the territories; however, there are significant financial and social costs involved. Additional investment is needed to address these costs and achieve the territories’ fiscal, economic, and social potential.

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<sup>1</sup> Government of the Northwest Territories, Government of Nunavut, Government of Yukon. (2003). *Territorial Business Case: Joint Paper on Fiscal Issues*, p. 3.

<sup>2</sup> This percentage is based on 2005–06 Revised Estimates provided by the three territories in their 2006–07 budgets.

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- The territories’ determination to become self-sufficient and self-reliant is an important priority for Canada. Changes to TFF should support the territories in achieving their goal of self-sufficiency.

These points provide an important backdrop for the Panel’s report and recommendations. They underscore the reason why TFF is distinctly different from the Equalization program in approach, in objectives, and in design. Because of the significant differences in the two programs, the Panel has chosen to devote a separate report to TFF issues and recommendations.

Issues and ideas

Canadians have long been committed to the concept of sharing and the idea that, no matter where people live, their children should have reasonably comparable opportunities to get a good education. They should have comparable health care, social services, and other essential public services. And they should pay for those services with reasonably comparable levels of taxes.

TFF has been in place since 1985–86. Although it has been through a number of modifications, the basic idea underlying the program is that a federal grant helps fill the gap between the amount of money a territory needs to allow it to provide “reasonably comparable” public services and the amount of revenue it can raise from a combination of taxes and other sources of funds. When the program was first established, the amount of funding provided through TFF was considered adequate to meet expenditure requirements in the territories.

As part of its consultations about TFF, the Panel heard about a number of issues related to how TFF works today and ideas about how it could be improved. Key issues focused on:

- The adequacy of TFF in meeting unique needs in the territories and the clear message that current funding levels, even with the funding increases in the past two years, are not sufficient to meet their needs or reflect substantially higher costs, particularly in Nunavut.
- A recognition that, although the territories have similarities and similar challenges, they are distinct, with different circumstances, and they should be treated in comparable but separate ways.
- The importance of self-sufficiency and economic development in the territories and ensuring that TFF supports both of these goals.

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- The negative impact of the New Framework introduced in October 2004 and the idea of a fixed pool on relationships among the territories.
- The need to make TFF more simple and transparent, thereby improving accountability to Canadians.
- The importance of making TFF flexible enough to accommodate agreements on Land Claims, Aboriginal self-government and devolution and resource revenue sharing.

## A new approach to Territorial Formula Financing

The Panel considered all the ideas and options presented during its consultation process and developed a comprehensive new approach to TFF. The Panel's recommendations are:

1. **Replace the fixed pool under the New Framework with a formula-driven approach, providing three separate gap-filling grants to the territories.**

While a legislated, fixed pool provides greater financial certainty for the federal government and a predictable and growing source of funds for the territories, the downside impact on the territories outweighs the benefits. It's important to have a program that reflects the differences among the territories and fills the gap between their expenditure needs and their own fiscal capacity.

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2. **Address concerns with the adequacy of Territorial Formula Financing through an adjustment to the Gross Expenditure Bases for each of the territories to create New Operating Bases.**

The Panel recommends that the current Gross Expenditure Bases (GEBs) for the territories be adjusted to reflect the 2005–06 New Framework funding levels for TFF. The Panel also recommends that these adjusted bases be renamed the New Operating Bases.

3. **Simplify the TFF formula by measuring revenue capacity using a Representative Tax System (RTS).**

Using a Representative Tax System (RTS) approach simplifies the process, eliminates many of the previous adjustment factors, and is preferable to broader macro measures. The contentious tax effort adjustment factor would also be eliminated. It provides reasonable comparability among the territories and also adds administrative simplicity, greater transparency, and sound incentives.

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- 4. **Further simplify the measurement of revenue capacity by establishing a Revenue Block that includes seven of the largest own-source revenues for the territories.**

Seven tax bases should be used to determine the territories’ fiscal capacity: personal income tax, corporate income tax, payroll tax, gas and diesel, tobacco, and alcohol tax revenues. This not only simplifies the formula, but also covers up to two-thirds of the territories’ own sources of revenues.

- 5. **Improve the incentives for the territories to raise their own revenues by including only 70 percent of territories’ measured revenue capacity in the formula.**

Economic development is crucial to the future of the territories. Under this recommendation, the territories would be able to keep more of the financial benefits of economic development without seeing a corresponding drop in TFF funding.

- 6. **Exclude resource revenues from the calculation of revenues included in Territorial Formula Financing.**

Unlike the provinces, the authority for developing and managing natural resource developments in the territories lies with the federal government. Since the 1980s, the Government of Canada has been engaged in discussions to devolve this authority to the territories. In principle, the Panel believes that, just like the provinces, the territories should see direct benefits from the development of resources in the territories. Each of the territories is in a different stage of discussions regarding devolution and resource revenue sharing. Yukon is the only territory with an agreement in place. Excluding resource revenues provides the flexibility necessary to accommodate future agreements and support resource development in the territories.

- 7. **Use the New Operating Bases as approximate measures of expenditure needs.**

The Panel saw no evidence to suggest that the New Operating Bases, adjusted on an annual basis, aren’t an adequate approximation of expenditure needs in the territories. While several suggestions were made on how to develop comprehensive measures of expenditure needs and costs in the territories, the Panel believes this would be a complex and extensive process and may not result in a better approximation than the recommended New Operating Bases.

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8. **Undertake a review of significant expenditure needs and higher costs of providing public services in Nunavut.**

While the Panel does not recommend an extensive study of expenditure needs in the territories, the case for assessing expenditure needs and higher costs of delivering public services in Nunavut is substantially different. Compared with the rest of Canada, initial evidence points to serious disparities in outcomes for health, education, and social well-being in addition to an urgent need for adequate housing. The Panel's recommendations for adjusting the funding bases for TFF and providing annual escalators are designed to address the adequacy of TFF for the territories. However, these adjustments are not sufficient to address the challenges and gaps in Nunavut. The Panel recommends that more work be done to assess expenditure needs in Nunavut as a starting point for addressing those needs on an urgent basis. The review should be done jointly by the Government of Nunavut and the Government of Canada. Any additional funding necessary to address Nunavut's needs should be provided through targeted programs rather than through adjustments to the TFF formula.

9. **Adjust the New Operating Bases annually by the relative growth in population in the territories and growth in provincial and local spending (PAGE).**

Instead of escalating the total amount of TFF by a set percentage of 3.5 percent (as is now the case with the New Framework), the Panel recommends returning to the Population-Adjusted Gross Expenditure (PAGE) escalator that takes into account comparable growth in spending in the provinces as well as relative changes in territorial population compared with the rest of Canada.

10. **Improve stability and predictability by using three-year moving averages.**

Without a fixed pool, there can be substantial year-over-year changes in TFF entitlements. Using three-year averages smoothes out those changes and provides more stability to both the federal and territorial governments.

11. **Address issues of governance, accountability, dispute resolution, and renewal through an expanded and more transparent process.**

The Panel does not support the idea of establishing a separate, independent permanent commission to address TFF issues. Continuing the current approach with a legislated TFF program, expanded accountability, annual reporting requirements, and mechanisms for Parliamentary review, is a better match for Canada's federation. It also should provide a more open process where issues involving both the territories and the federal government can be identified and addressed.

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## Benefits of the Panel’s new approach

- The new approach reflects eight principles including: responsibility and accountability, adequacy and comparability, affordability, predictability, neutrality, stability, flexibility, and sound incentives.
- There is a clearer incentive for territories to increase their own sources of revenues. This supports the shared goals of self-sufficiency and self-reliance and will benefit all Canadians.
- The Panel’s new approach means more funding for TFF. Based on some initial indicators, additional funding is required for the territories to meet pressing needs in key program areas and to achieve the goal of providing reasonably comparable services. The Panel urges territorial governments to continue to seek the most efficient and appropriate ways of providing essential services and, at the same time, managing growing costs of public services.
- It addresses the recent sources of conflict between the federal government and the territories and provides a number of significant improvements to a formula-based approach for TFF.
- It continues to recognize the very real diversity among the territories. It builds on the positive elements of TFF and includes a separate gap-filling formula and specific escalator for each territory.
- The proposed approach to governance should bring more accountability, transparency, visibility, and timeliness to negotiations and to the renewal process for TFF.
- While it’s still complex, the program is simpler than the previous TFF formula and will reduce some of the administrative burden on both the territorial and federal governments.
- The Panel’s new approach is flexible enough to accommodate adjustments to funding due to federal initiatives and program transfers, existing and future agreements arising from Land Claims and Aboriginal self-government, as well as devolution and resource revenue sharing agreements among the territories, First Nations, Aboriginal organizations, and the federal government.
- The simplified TFF has a number of added benefits including a clearer understanding of the financial circumstances of the territories and more certainty for potential investors. In turn, this should support economic development in the North and help secure Canada’s sovereignty over the Arctic.

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## Assessing the financial impact

The Panel's new approach provides more funding to the territories than they currently receive under the New Framework.

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- Under the legislated New Framework, total TFF funding is \$2.14 billion in 2007–08. In 2007–08, the Panel's new approach means an additional \$60 million for the territories.
- Over five years, from 2005–06 to 2009–10, the Panel's approach would provide an additional \$285 million more than the legislated New Framework. To put that in perspective, the Panel's approach would result in a 20 percent increase in total funding for TFF over five years, while the New Framework would result in a 15 percent increase.
- In 2007–08, each of the territories would receive additional funding under the Panel's approach compared with the TFF entitlements for 2006–07 announced by the federal Minister of Finance in November 2005. On a per capita basis, the Panel's approach translates into \$18,148 per capita in the Northwest Territories, \$29,165 per capita in Nunavut, and \$17,114 per capita in Yukon.
- Under the Panel's approach, total funding for TFF would also be higher than under the previous TFF formula and each territory would receive more funding than under the previous TFF formula.

**Comparison of the Panel's Approach with the New Framework, 2005–06 to 2009–10**

	<i>\$ million</i>					
	2005–06	2006–07	2007–08	2008–09	2009–10	Total
<b>Panel's Approach</b>	2,000	2,098	2,203	2,304	2,406	<b>11,011</b>
<b>New Framework</b>	2,000	2,070	2,143	2,218	2,295	<b>10,726</b>
<b>Difference</b>	0	28	60	86	111	<b>285</b>

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<b>Comparison of the Panel’s Approach for 2007–08 with Announced Entitlements for 2006–07, by Territory</b>			
	<i>\$ million / \$ per capita</i>		
	<b>Northwest Territories</b>	<b>Nunavut</b>	<b>Yukon</b>
<b>Panel’s Approach for 2007–08</b>			
Total Entitlements	791	880	532
Per Capita Entitlements	18,148	29,165	17,114
<b>Announced Entitlements for 2006–07</b>			
Total Entitlements	738	827	506
Per Capita Entitlements	17,107	27,617	16,335
<b>Difference</b>			
<b>Total Entitlements</b>	<b>53</b>	<b>53</b>	<b>26</b>
<b>Per Capita Entitlements</b>	<b>1,041</b>	<b>1,548</b>	<b>779</b>

Note: TFF entitlements for 2006–07 were announced by the federal Minister of Finance in November 2005, based on October 2005 data.

## Concluding comments

Throughout the review of TFF, the Panel learned a great deal about the territories and about issues important to northerners and their governments. We heard about the hopes and dreams of the territories to achieve self-sufficiency and to reduce their dependence on federal transfers. We heard about the potential for economic development and the sense that the territories are on the verge of major change. And, we heard that the North is essential to Canadian sovereignty and security.

At the same time, we heard serious concerns about outcomes in education and health, about social conditions and housing, aging infrastructure, high costs, and the challenges of addressing those concerns in the unique context of the territories.

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*“We are now at our last frontier. It is a frontier that all of us have read about, but few of us have seen. Profound issues, touching our deepest concerns as a nation, await us here.”*

- Mr. Justice Thomas R. Berger<sup>3</sup>

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<sup>3</sup> Government of Canada, Mr. Justice Thomas R. Berger. (1977). *Northern Frontier, Northern Homeland, The Report of the Mackenzie Valley Pipeline Inquiry: Volume One*, p. vii.

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*The Panel members sincerely hope that our recommendations will help enable the territories and northerners to achieve their “great promise.”*

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Although many of these issues extend beyond the mandate of the Panel, we cannot conclude our work without urging the territories, the federal government, and Aboriginal and Inuit people to:

- Reach agreements on devolution and resource-revenue sharing
- Address significant challenges in the territories ranging from housing and infrastructure, to health care, education, and social issues
- Take urgent action to address serious problems in Nunavut
- Continue to seek innovative, effective, and affordable solutions for providing public services and meeting the needs of people in the territories

As the framework for the joint federal-territorial Northern Strategy indicates, “The North is a place of great promise. For many years northerners have spoken about the importance for all Canadians to share in a vision for the future that enables northerners to become full participants in the federation.”<sup>4</sup>

As Panel members, we sincerely hope that our recommendations will help enable the territories and northerners to achieve their “great promise.”

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<sup>4</sup> Government of Canada (2004). *Nation-Building, Framework for a Northern Strategy*, p. 1.





