

Territorial Formula Financing: Reform Options



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Territorial Formula Financing: Reform Options

Introduction

The Expert Panel on Equalization and Territorial Formula Financing has been asked to provide the Government of Canada with advice on a number of issues related to Territorial Formula Financing (TFF). One of these is the allocation of TFF funding among territories, which is the focus of this paper. It examines the current allocation procedures and considers some options for reform.

In order to focus on the Panel's task at hand, the paper avoids covering familiar ground. It spends little time on either the TFF's history or its methods of determining the size of grant paid to each territory. Instead, it concentrates on describing and analyzing options for reforming TFF allocation. It proceeds by,

- Setting out basic principles to be respected by any allocation procedure
- Indicating how the current system measures up to those principles
- Describing six reform options,
- Assessing each in terms of its adherence to the basic principles
- Recommending next steps that the Panel might wish to take with respect to these options

Diagnostique

Basic Principles for the Original TFF System

The federal government provides the TFF grant to give territories the financial means to furnish their residents with public services that are reasonably comparable to those available to other Canadians without having to impose taxes that are out of line with those paid elsewhere in the country.

If a territory is to achieve this “reasonably comparability” goal, its TFF grant must be sufficient to fill the gap¹ between the funds needed pay for comparable services and the revenues that the territorial government has at its disposal, before it receives its TFF grant. These revenues may come from the taxes, fees and user charges the territorial government can raise on its own (*own-source revenues*) as well as from the non-TFF transfer payments it receives from the

¹ The goal of “filling a needs gap” for each territory is no longer relevant under the post-October 2004 New Framework, which sets out a growing envelope for the sum of all three territorial grants.

federal government. How well a grant fills the gap is the primordial basis for assessing its success. It is sometimes referred to as “adequacy”.

The grant should be computed with accuracy to ensure that the expenditure need/potential revenue gap is neither over nor under filled by the TFF grant.

If each territory’s financial gap is exactly filled, the TFF grants will be fair in that each territorial government will be able to offer its residents comparable public services at comparable levels of taxation. There are also considerations of fairness as between transfer payments to territories and those to provinces. TFF grants should allow territorial governments to provide public services that are reasonably comparable to those the provincial governments, with the help of Equalization payments, can offer Canadians living south of 60.

A TFF grant that exactly fills the financing gap will also be responsive, in that a territory’s grant will rise and fall from year to year as the territory’s needs and its ability to raise revenues ebb and flow.

TFF was introduced in 1985 as part of the territorial evolution to maturity. Territorial governments were to be funded according to a formula, not by the former process of close federal scrutiny and judgment of the appropriateness of individual spending items. Territorial governments were to be accountable to their residents for their spending and revenue-raising choices, not to the federal government. A good TFF allocation process should respect territorial autonomy.

Autonomy can be diminished by direct controls on what a territorial government can and cannot do. It can also be restricted by a formula that rewards territories financially for certain spending and revenue raising actions and punishes them for others. While some transfer payments are intended to influence the receiving government’s behaviour, the TFF is not. Such indirect interference with autonomy should be minimized. TFF grants should be determined in a way that is neutral with respect to the policy choices made by territorial governments.

The size of transfer payments a government receives helps determine the quantity and quality of its public service offerings and the amount of tax revenues it must raise. The levels of public services and of taxation in turn influence where individuals and firms decide to live work and carry on business. Grants should not be so large as to encourage excessive moves to the North, or so small as to discourage economically efficient in-migration.

At a more practical level, TFF grant determination should support the budget-making process of the territorial and federal governments. Stable grants, ones that don’t change drastically from year to year, can help budget planning.

Grants need not be completely stable, but they should be predictable so that territorial budget planners can anticipate rises and falls in their TFF funding. If

territorial governments have a good idea of where their grants are headed, they can adjust their expenditures and non-grant revenues accordingly.

The grant determination process should also result in payments that are affordable to the federal government. This criterion is not of direct relevance to the allocation discussion in this paper. The total amount of TFF grants to be paid out each year until 2009-10 has been set. All allocation options presented here involve the same total TFF cost to the federal government.

Any intergovernmental grant program must assign weights and make trade-offs among these various principles (adequacy, accuracy, responsiveness, stability, etc.). The original TFF and its subsequent evolution embody one view of these trade-offs. The New Framework for TFF (discussed below) may well call for a different set of trade-offs (see separate Secretariat Paper "Is there a need to fundamentally rethink TFF?"). In a "fixed envelope" world, principles of accuracy, responsiveness to need and "filling a gap" may take on a different meaning than under a "variable envelope" world.

Assessment of the Interim TFF Allocation System

The term "interim" in the title above should be clarified.

In the fall of 2004, the federal government announced a *New Framework* for Equalization and TFF that introduced fundamental changes. On the TFF allocation front, at least for 2004-05 and 2005-06, the three territories were to receive fixed shares of the total TFF pool that the federal government has set. These shares were determined by the relative sizes of the grants each territory received in 2001-02, 2002-03 and 2003-04, with the greatest weight placed on the most recent year. The allocation under the *New Framework* is the current TFF allocation system.

The pool of funds from which territories are to draw their fixed shares was pre-determined in the *New Framework* -- \$1.9 billion in 2004-05, \$2 billion in 2005-06 and increasing by 3.5 per cent each year until 2009-10. Not only are the shares of each territory fixed, but also there is also a "fixed pot" from which these shares are paid out.

There was an implication that the *New Framework's* fixed share allocation was to be temporary. The Expert Panel, set up in conjunction with the *New Framework*, was tasked with recommending an allocation procedure for 2006-07 and beyond. This suggests that the fixed share approach, although strictly speaking the current one was not intended to remain in place indefinitely.

Throughout the TFF's prior history, the determination of grant amounts was made according to formulas that were spelled out in agreements with each of the

territories.² Even though this system is not strictly “current”, it is nevertheless important to assess it. An appreciation of the strengths and shortcomings of this “nearly current” grant-determination system is a good departure point for the Panel’s considerations, since a return to this approach may be a de facto default allocation option.

The *New Framework System* (post October 2004) and the “Interim Regime”.

It is important to distinguish between the “fixed pot” (a permanent feature) and “fixed share” (a temporary fix) aspects of the *New Framework* system with regard to the federal government’s intentions for each. The federal government set out a predetermined overall funding track to the end of the decade, in order to meet territorial requests that they be granted the same predictability and stability as equalization receiving provinces. But it did not intend that the fixed share allocation approach remain in effect beyond a brief interim period during which a more permanent and more satisfactory replacement allocation regime could be identified and instituted. Indeed, that is why the Expert Panel was constituted.

Nevertheless, the interim regime does adhere to some of the design criteria for a good grant determination system. Applying fixed shares to a known-in-advance funding total means that each territory can predict exactly how large a grant it will receive. This delivers predictable and relatively stable funding. The system is not affected by, nor should it influence, territories’ policy choices, thereby preserving their autonomy.

On balance however the “fixed pot, fixed share” system does not measure up well against the basic principles just described. Were its fixed share aspect to remain in effect over the medium and longer term, it would be particularly wanting in an environment where territories follow divergent development paths, one that is likely to characterize the next several years.

The amount of a territory’s grant would be completely unresponsive to its own fiscal, economic, social and demographic conditions. It would not “fill the gap” except by chance.

As conditions changed, and particularly as they changed differently from one territory to another, the fairness of the grants would be called into question. The financing gap in one territory might be increasing and that of another decreasing, but their grants wouldn’t respond. If initially the grant allowed residents of all

² The term “allocation” may not be appropriate with respect to this pre-October 2004 system. Each territory’s grant was computed independently. The total amount of TFF grants to be paid by the federal government was the sum-of-the-parts, where the parts were three independently determined territorial amounts. The territories’ grants were not then determined by allocation of a pre-set total.

territories to enjoy “reasonably comparable public services at reasonably comparable levels of taxation”, over time diverging conditions and non-responsive TFF grants would undermine comparability.

Under this system, a territory’s fiscal gap might decline but its grant would continue to grow. It would be able to afford to offer a higher level of public services, to cut its taxes, or both. Workers and business would find it more attractive to move to that high-service, low-tax territory, even if such fiscally induced migration were not economically efficient. The opposite scenario, where a territory’s fiscal gap was growing faster than its grant, would entail similarly adverse consequences for migration and economic efficiency.

The problems with a fixed share allocation system would become more serious as time went by and conditions changed. In particular, the Northwest Territories economy is in the midst of a resource boom that is likely to continue for some time to come. Yukon and Nunavut may also benefit from the same forces, but not as soon and, initially at least, not by as much. A TFF allocation procedure that was filling the fiscal gap of all three territories in an accurate, fair and responsive manner would modify the shares of the three territories to reflect their changing relative economic positions.

The “fixed pot or fixed envelope” feature of the *New Framework* system is, according to the Panel’s Terms of Reference, to be taken as a given. Its implications for the design of an allocation formula are not dealt with in this paper.

The “Original” TFF System (pre- October 2004)

As TFF developed over the years, it retained the basic structure established in 1985, until the *New Framework* was announced in October 2004. This framework is designated as the “original” TFF system in this paper.

The original system gave territorial governments considerable latitude with respect to their spending and revenue-raising actions and assigned them responsibility for the consequences of their decisions.

It aimed at filling the financial gap between each territory’s expenditure needs and its potential revenues. As discussed in the *Basic Principles* portion of this paper, measurement of this gap must be accurate if a system is to be fair to all territories and fair as between territories and the rest of Canada. This latter, North/South dimension of fairness is a consideration that distinguishes TFF from Equalization. Accuracy requires that the measurement of expenditure needs and potential revenues be uniform from territory to territory and comprehensive across all types of expenditures and revenues.

In practice, the original TFF system's success in accurate gap filling has left much to be desired, on both the expenditure and the revenue sides of the formula. This was true even at the TFF's inception.

- The territories' 1985 expenditure needs were captured in the formula's initial Gross Expenditure Base (GEB). This start-up GEB reflected actual territorial spending in 1982, adjusted to 1985 levels by a generalized inflation measure. The amount actually being spent in that single year, 1982, may have been too little or too much to deliver "reasonably comparable" public services to territorial residents. No attempt was made to assess expenditure needs as distinct from expenditures actually being made. Nevertheless, that 1982 snapshot remained embedded in the territorial formulas until 2004³.
- The original TFF system's revenue capacity measure, Eligible Revenues, looked at both own-source revenues (taxes, fees, user charges etc.) and other (non TFF) federal transfers. It assumed that each territory's own-source revenue capacity was equal to 85 per cent of what would be raised if average provincial tax rates were applied in that territory. The 85 per cent adjustment was based on a proposition that it was more difficult for territorial governments to raise revenues than it was for their provincial counterparts. Eighty-five per cent was an arbitrary figure when it was introduced and has never been adjusted since. Furthermore, the use of a single "discount" figure assumed that each territory has exactly the same handicap compared to provinces in terms of raising revenues.

In summary, TFF's success in measuring the financial gap to be filled was questionable from birth. Moreover, the situation has deteriorated over the years. On the expenditure side,

- The 1982-based GEB for each territory has been escalated by the growth rate of provincial and local government expenditures (P/L) and, after 1990, by population growth in the territories relative to Canada as a whole.

This population-adjusted P/L escalator had no necessary relationship to growth in territories' expenditure need. If the expenditure needs of the territories were diverging from those of the provinces, the P/L-driven GEB would increasingly have drifted away from the territorial expenditure needs that it was supposed to be measuring.

³ When Nunavut was created in 1999, the Northwest Territories' GEB was split between the two successor territories, with a supplementary amount added in recognition of the higher cost of governing two territories rather than a single one. This division of the GEB was based on an analysis of the location (eastern, soon to be Nunavut, or western NWT) of actual Government of Northwest Territories expenditures in 1996. The size of the supplementary amount was determined through negotiation. Thus, there was no direct measurement of expenditure needs at the time of Nunavut's creation. Rather, TFF continued to rely implicitly on the original, 1982, GEB estimate.

There are good reasons to believe that expenditure need grew differently for provinces and territories. The mix of services in the territories differed from those in the south, as did methods and costs of delivery. Territorial expenditure needs may have tracked more closely the spending of provinces in their northern and remote areas than their overall spending.

- In the early days of the TFF, territories were taking on new roles and adapting to their greater responsibilities. Over time they presumably learned the ropes and got better at managing government. This maturing process should have allowed them to carry out their functions more efficiently, which would have curbed the growth in territorial expenditure needs relative to those of provinces. Territories may well have realized larger cost-saving economies of scale over the 1985-2004 interval, as their populations grew by one-third. Provincial population grew more slowly and provinces, even the smallest ones, were much more populous to begin with, so that economies of scale effects would be of less importance in determining expenditure need.
- The P/L escalator then probably did not measure the growth in territorial expenditure need adequately. Even if, fortuitously, it did give an accurate picture of the evolving expenditure needs of one territory, it is doubtful that it tracked well for each of them.
- The GEB has been adjusted for reasons unrelated to expenditure need. For example, in years when the ceiling was effective, the GEB diverged from the path it would otherwise have followed and remained off track thereafter. The expenditure restraint measures of 1995-96 had a similar impact. The introduction of the Economic Development Incentive (EDI) in 1999 required a technical adjustment to the GEB. None of these changes had any link to actual expenditure need.

The picture is no more reassuring on the revenue side of the formula.

- The original TFF system did not measure territories' revenue-raising potential directly on an annual basis. Rather the 85-per-cent-of-receipts-at-average-provincial-tax-rates estimate was calculated infrequently, most recently for 1992-93. In subsequent years, this "benchmark" amount was "kept up" by applying the growth in provincial and local government revenues. It is a leap of faith to imagine that each territory's revenue potential has tracked that of the provinces over such an extended period.
- Territories have assumed control over additional revenue sources since the TFF's creation, including those derived from certain natural

resources⁴. The treatment of these resource revenues in TFF differs from territory to territory and from resource to resource. In some cases (e.g. Yukon), resource revenues are handled under separate revenue-sharing arrangements, which are treated in a non-standard way in TFF. Territories' revenues are thus not captured in a comprehensive or uniform manner when measured by TFF. For example, an extra dollar of resource revenues may be worth more to a territorial government's overall budget than an extra dollar of income tax revenues, once TFF and revenue-sharing effects are taken into account. This casts further doubt on the fairness of the results of the original TFF system.

- Territories receive significant transfers from the federal government apart from TFF. In its early days, TFF looked at virtually all such revenues when evaluating the size of the gap to be filled by the TFF grant, but over time TFF's revenue coverage has been eroded when it comes to these non TFF transfers. For example, since 1999 all increases in the CHT/CST have been excluded from potential revenues as measured by TFF.⁵
- The introduction of the EDI in 1996 removed an arbitrary 20 per cent from the assumed incremental revenue capacity of each territory.

These changes in the original TFF system's measurement of the financial gap to be filled by the grant were all introduced for reasons judged to be convincing at the time, even if it meant that accuracy in measuring the gap had to be sacrificed. For example, providing territorial governments with proper incentives for economic development was felt to be sufficiently important in the 1999 TFF renewal as to justify leaving some revenues be left out of the gap-measurement process.

Compromises such as these are sometimes also justified so as to keep the system simple and understandable to elected officials and the public at large. Such simplification/clarity arguments cannot realistically be invoked in the case of TFF however. If any of the design decisions were inspired by a wish to avoid complexity, they were not successful. TFF is extremely complicated, even opaque, for the non-expert. If anything, the original TFF system's departures from clean measurement of the financial gap have increased rather than reined in complexity.

In summary, the current TFF measure suffers from a variety of shortcomings. It is not now and perhaps never was accurate in its measurement or expenditure

⁴ Forestry in Northwest Territories. Oil and gas and subsequently forestry and mining in Yukon.

⁵ The CHT/CST increases were distributed to the provinces and territories on an equal per capita basis. This meant that, whether these revenues were counted for TFF purposes or not, the relative financial positions of the three territories would not change. If they were counted for TFF purposes, all territories would have seen their overall revenues decline by the same per capita amount.

need and potential revenue. It is not comprehensive in its coverage of revenues. It does little to ensure that territories receive uniform treatment in measuring their ability to deliver comparable public services at comparable levels of taxation. It does even less to guarantee uniform treatment of territories as compared to provinces. The deficiencies of the original TFF system justify a search for better alternatives.

Options for Reform: Description

Retain Fixed New Framework Shares

The *New Framework* for TFF announced in October 2004 establishes a total TFF grant amount in each year to be allocated among the three territories according to fixed shares. For example, in 2005-06, \$2 billion in TFF grants is to be divided among the governments of the three territories. Nunavut will receive \$799 million or just under 40 per cent, Northwest Territories \$714 million or almost 36 per cent, and Yukon \$487 million or a bit more than 24 per cent.

Next year the total grant amount will increase by 3.5 per cent, from \$2 billion to \$2.07 billion. Under the “retain fixed shares” approach, the percentages mentioned in the previous paragraph would continue to be used to allocate this \$2.07 billion. Nunavut, Northwest Territories and Yukon would receive \$827 million, \$739 million and \$504 million respectively. Under this option, the same approach, with the same fixed territorial percentages, would be used in years beyond 2006-07.

Return to Original TFF System

The original TFF system was not an allocation method strictly speaking. There was no “fixed pot” total grant amount to be divided among the territories. Rather, the grant that each territory received was determined independently, without a constraint on the total.

The original system can however be fairly readily be transformed to an allocation device. A financing gap would be calculated independently for each territory each year as before, by computing GEB, Eligible Revenue, and the resulting gap between the two. These gaps would no longer be used directly for determining grant amounts. Rather, they would be used to allocate the predetermined grant total. An example is presented in the following table.

In this example, the financing gaps for the three territories as calculated under the original TFF system happen to sum to \$1,800 million (Column (1) Total). The territories percentages of this sum work out to 41, 35 and 24 per cent

respectively (Column (2)). Under the “Return to Original TFF System” option, these percentages are used to compute the grant each territory receives out of the predetermined 2006-07 total of \$2,070 million (Column (3)).

Original TFF System as an Allocation Method: Example			
	(1) GEB – Eligible Revenues (example only)	(2) Per cent of total (Column (1) / Column (1) Total)	(3) 2006-07 Grant (Column (2) * Column (3) Total)
Nunavut	\$733 million	41 %	\$843 million
NWT	\$633 million	35 %	\$728 million
Yukon	\$433 million	24 %	\$498 million
Total	\$1,800 million	100 %	\$2,070 million

Update Original TFF System

Under this option, the structure of the original TFF system (GEB, Eligible Revenues, gap filling grant) would be retained. However, the basic components would be updated.

- The GEB would be based on the actual spending of each territory in some year more recent than 1982, ideally the most recent year for which territorial public accounts are available.
- The benchmark year for assessing potential revenues⁶ would be advanced from 1992-93 to the most recent year for which the necessary data are available.

In subsequent years, the GEB and Eligible Revenues would be updated using the original TFF system procedures. The GEB escalator would remain growth in provincial and local expenditures (P/L), adjusted for population change. Territorial revenues would be “kept up” with the growth in provincial revenues.

Looking further ahead, the benchmarks for GEB and potential revenues would be updated more frequently than in the past – perhaps every five years.

⁶ Potential revenue would still be measured as the amount each territory would raise if it applied tax rates equal to 85 per cent of the provincial average.

Actual Expenditures and Revenues

In computing the GEB and Eligible Revenues, the original TFF system avoided using the actual amounts that territorial governments choose to spend or to raise. There are good reasons for this. If the TFF grant was based on actual expenditures and revenues and automatically filled whatever gap a territory chose to budget for, an important fiscal restraint would be lifted. The territory could spend more or tax less and suffer no financial consequences. It would not be obliged to impose any taxes at all. This would remove an important discipline on its spending.

However necessary it may be to measure hypothetical, rather than actual, expenditures and revenues, it greatly complicates the administration of the TFF. Furthermore, as the *Assessment of the Current TFF Allocation System* section of this paper argues, the formulas' real world approximations of the hypothetical concepts of expenditure need and potential revenue leave much to be desired.

With these limitations in mind, another option is to compute the gap between each territory's actual expenditures and actual revenues (apart from its TFF grant) in some recent past year. No adjustments would be made to these actual figures (e.g. no EDI reduction from revenue). Each territory's gap would be expressed as a percentage of the three-territory sum of these financial gaps. These percentages would then be applied to the predetermined TFF grant total. An example is provided in the following table.

The year of reference for the actual expenditures and revenues should be the most recent one possible for which good data are available, perhaps two years prior to the year for which the grant is being computed.

Actual Expenditures and Revenues as an Allocation Method: Example			
	Actual Gap (2004-5) = Actual Expenditures minus Actual Revenues ex TFF grant	Percentage of Grant Actual Gap Total (Column (1) / Column (1) Total)	(2006-07) (Column (2) * Column (3) Total)
Nunavut	\$814 million	41%	\$852 million
NWT	\$659 million	33%	\$690 million
Yukon	\$505 million	26%	\$528 million
Total	\$1,978 million	100%	\$2,070 million

Direct Measurement of Expenditure Need & Potential Revenue

The “Actuals” approach is a rough and ready one that puts a premium on simplicity. The “Direct Measurement” approach is at the opposite extreme. Its focus is on improving the accuracy of the original TFF system’s measurement of expenditure need and potential revenue.

Expenditure Need

There has been much discussion of the pros and cons of incorporating *expenditure need* to the Equalization program. Suffice it to say that

- expenditure need should ideally (data allowing) be measured directly rather than by taking the original TFF system’s indirect approach of using actual expenditures from the distant past and updating it using a dubious escalator,
- Measuring expenditure need directly requires considerable effort, good data and relies on value judgments that will create controversy.

To estimate expenditure need, it is necessary to,

- Compile a list of the public services that territories typically provide (e.g., health, public education, social services)
- Establish the amount of each of these public services that territories must offer to meet comparability standards (e.g., 12 years of schooling, 25 pupils per teacher)
- Determine a reasonable cost to deliver a unit of each service (e.g., the per pupil cost of education, including teachers, supplies, facilities). Reasonable cost takes into account input costs and the efficiencies with which inputs are combined.

Each of these design decisions involves value judgments. For example,

- Should particular public services, such as culture or tourist promotion, be included or excluded in the measurement of expenditure needs? Should only a few main public services be measured directly and the remainder handled in some more ad hoc fashion?

- What are the typical or acceptable or appropriate standards for delivery for each service (e.g., acceptable waiting times for various medical procedures)? Must they be uniform from jurisdiction to jurisdiction?
- Is it reasonable to apply identical unit costs for all territories, or if not, how should unit costs be modified to capture local conditions?
- Should input costs that are higher by the territories own choice at least to some extent (e.g., collective bargaining outcomes) be compensated for?

Once contentious issues such as these have been addressed, it is necessary to collect data for each territory, including caseload information (e.g. how many school-age children) and data on conditions that affect costs (e.g. proportion of the population in remote locations). Ideally the data would be collected and expenditure needs assessed each year to permit the TFF grant to respond to changes in expenditure need.

Lest the difficulties of this approach appear overly daunting, it should be noted that direct measurement of expenditure need is used in some equalization systems, such as Australia's.

Representative Tax System

There are fewer problems on the revenue side. It is possible to measure each territory's potential revenue each year. This is already done for provinces in Canada's Equalization program, using the *Representative Tax System* (RTS) approach. The RTS could be applied to the territories as well. It would involve an annual evaluation of tax bases for each territory in respect of each of the various revenue sources (e.g. income tax, sales tax, gasoline tax, etc.), and application of a national average tax rate to each of these bases. Under the original TFF system, it was judged to be unduly harsh to expect territories to exert the same tax effort as provinces. If that judgment still prevails, a "discount factor" (85 per cent?) could be applied.

This RTS approach is already used with regard to the territories in "benchmark" years (currently 1992-93). This option would have the operation carried out every year. Further research is required to ascertain the feasibility of annual RTS calculation for territories.

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The estimates of the territories' fiscal gap calculated from a direct measurement of expenditure need and RTS potential revenue would be used to allocate the predetermined total TFF grant.

Macro Approach

In the Equalization context, there are advocates of using a highly aggregated “macro” measure of economic activity, such as provincial GDP, for assessing each jurisdiction’s capacity to raise revenues. The main argument for a macro approach is that it is much simpler than, for example, a RTS measure of potential revenues. A buttressing argument is that macro measures are very difficult for a recipient jurisdiction to manipulate. Since the policies of territorial governments have little impact on the macro measures, authorities will not be induced by the prospect of larger grants to adopt one policy rather than another.

In the case of TFF, a macro approach would measure a territory’s revenue potential by taking a given percentage of the macro measure.

There has been less discussion of a macro approach to measuring expenditure need, but in concept at least, something simpler than the GEB may be worth looking at. Expenditure need based on population (\$x per resident) or in weighted population (e.g., children and seniors count for more) are possibilities.

Territorial fiscal gaps computed using macro measures of revenue potential and perhaps of expenditure need could be used to allocate the predetermined total TFF grant amount.

Options for Reform: Analysis

The allocation options just described differ in various ways.

- Success in meeting the TFF objectives outlined in the *Basic Principles* section of the paper,
- Feasibility for real-world implementation,
- Clarity to those responsible for TFF and to the public at large, particularly territorial residents.

This section of the paper analyses the pros and cons of the six allocation options on these dimensions.

Retain Fixed New Framework Shares

This approach, while stable and predictable, suffers from serious deficiencies, most notable its lack of responsiveness to changing conditions. This was already addressed in the *Assessing the Current TFF Allocation System* section of the paper and will not be belabored here.

This lack of responsiveness will likely result in unfair treatment as between territories and constitutes a critical shortcoming at a time when the territories are liable to develop along different paths.

- Generally speaking, it appears that Northwest Territories' will grow considerably faster than that of its eastern and western neighbours over the next few years. The cost of economic restructuring will impact the expenditure needs of the territories differently, but will not be reflected in TFF grant allocation.
- The relative revenue raising capacity of the three territories will also no doubt shift as their economies move at different rhythms. This shift will be reinforced if control over natural resources and access to the associated government revenues are devolved to the Northwest Territories and, possibly later, to Nunavut. The fixed share option would not take these changes in relative ability-to-tax into account.
- The timing and location of pipeline construction is uncertain, but will have a substantial impact on the development and relative fiscal capacity of the territories.
- Self-government negotiations with First Nations are at different stages in the three territories. How self-government goes from here, and when, will have a differential effect on the three jurisdictions and on their expenditure needs and revenue potential.

With fixed shares of TFF funding, support for the three territories cannot respond to any of these developments or to other, as yet unexpected, events.

Not Recommended

Return to Original TFF System

This option has the advantage of using a method with a long history. Many of the bugs have been worked out. Territorial and federal officials are familiar with it and would not have to go through a trial and error period as they would with a new scheme. Neither territorial governments nor others voiced strong objections to the allocative results of this approach as it operated between 1985 and 2004.

The concept of measuring and filling a financing gap underlying the original TFF system remains sound. Its execution left much to be desired, as described at length in the *Assessing the Current TFF Allocation System* section of the paper. Even in its nascent, 1985 form, its measurement of expenditure need and revenue-raising capacity was neither accurate nor comprehensive. Compromises with the gap-filling concept multiplied over the years. The original TFF system has also been justifiably criticized for its complexity.

It is also important to note the concerns raised by this allocation system, and by virtually any other, when it is used in conjunction with a “fixed pot” of grant money, as it is under the *New Framework*.

- Territories are no longer funded to meet their absolute need, but rather their relative need.

Suppose the sum of the grants of the three territories as computed by the original system exceeds the fixed envelope of TFF funding available. Under this Return to the Original TFF System allocation scheme, all territories will receive less than what is required to fill the gap between their expenditure needs and their potential revenues, at least as the gap was measured under the original TFF approach. The deficiency is spread out on an equal per capita basis among the three territories. None of them can meet their needs (as previously assessed). In relative terms, they are equally far from being able to do so.

Suppose instead that the sum of the grants of the three territories as computed by the original system falls short of the fixed envelope of TFF funding available. All territories will receive more than what is required to fill the gap. The superfluous funding is distributed on an equal per capita basis, so once again their relative positions are assured, even though in absolute terms all are over funded according to the original TFF System standard.

- Prior to the *New Framework* the size of the total TFF grant was flexible. This meant that the federal government bore most of the financial risk of changes in the economic, social or natural conditions of the territories. If things got worse in one or more of the territories, grants went up for the affected governments without detracting from the funding for the others. Now the risk

is borne by the territories. If conditions deteriorate in one or more of the territories, their extra grants eat into the funding of their neighbors.

It is asking a great deal of the territories, which are small and traditionally fiscally weak, to “self insure” in this manner.

Recommended only as an interim arrangement to be retained, if necessary, pending development of a system that is more conceptually defensible, simpler, or both.

Update Original TFF System

This option allows a more up-to-date assessment of the expenditure needs and revenue capacity of the territories and should as a result provide a more accurate picture of the funding requirements of each.

Such an updating appears feasible.

- Much of the work would rely on actual spending and revenue data. The GEB and territorial revenue from non-TFF transfers would be based on actual figures from the territories in a recent year.
- Potential own-source revenues would be evaluated by applying average provincial tax rates (with or without the 85 per cent “discount”) to territorial tax bases. Average tax rates are already computed for Equalization purposes so would involve no additional work. As for tax bases, it may be that formulating territorial estimates would present few problems for the larger components, personal and corporate income taxes. Data availability issues would perhaps arise in measuring other, smaller, tax bases however. The fact that such an exercise was carried out successfully for the 1992-93 potential revenue benchmark is reassuring in that regard. Updating the revenue benchmark would allow the grant calculation process to take into account new revenue sources that territories have obtained since 1992-93.

It should be noted that updating the own-source revenue benchmark has been proposed in the past, most recently during the negotiations leading up to the April 2004 TFF renewal (“CUF” update). However, the quantitative impact may be significant and the Panel may want to test the territories’ reactions to revenue rebasing before finalizing their advice on this option.

While updating would seem likely to improve accuracy, some of the problems of the original TFF approach would remain.

- It is based on an imperfect measure of expenditure need -- actual spending rather than need for spending.
- Potential revenue coverage is not comprehensive e.g. revenues excluded due to EDI exclusion, the majority of federal transfers are not counted.
- Updating would do little to simplify the TFF system.

An updated system, particularly on the expenditure side, may produce results that are not much different from a return to the original approach. The updated system would use the territory's actual spending in recent years as its GEB base. That actual spending was constrained to be more-or-less equal to the territory's actual revenue in that year since territories cannot run big deficits and do not run big surpluses. The territory's revenue in turn was made up largely of a TFF grant that was in turn dependent on the "old" GEB. The following box presents a more mathematical explanation of why the old and updated GEB results will be similar.

<u>Updated GEB will be Approximately Equal to Old GEB</u>		
(1)	New GEB	= Actual spending (recent years)
(2)	Actual spending (recent year)	≈ Actual revenue (recent years)
(3)	Actual revenue (recent year)	= TFF + other grants + own source revenue (OSR)
(4)	TFF	= Old GEB – other grants – potential OSR
(5)	Potential OSR	≈ actual OSR

Substituting (5) into (4), (4) into (3), (3) into (2) and (2) into (1) reveals that

New GEB ≈ Old GEB

Switching from an "old" GEB, to a new one that's tied closely to the old one is unlikely to cause a big change in the size of the grant.

Recommended as a minor change that would improve measurement to a degree without altering the basic system and probably without changing results substantially.

Actual Expenditures and Revenues

When described in the previous section of the paper, only its broad strokes were sketched out. A number of design features would have to be finalized, such as the lag between the year for which the grant is being computed and the year whose actual data would be used, and the escalator to be used to bring actual spending and revenue data up to current-year levels. Resolution of those issues would not greatly affect the basic analysis presented below.

The main advantage of this system is that it eliminates a great deal of the complexity inherent in the original TFF system. This is no small achievement if it permits a more informed public scrutiny of the program's operation.

The approach achieves simplicity at the cost of accepting a very approximate measure of expenditure need and revenue-raising capacity. The less accurate this measurement, the more difficult it is to defend the fairness of the system. Would it be fair for a territory to receive a large grant because it decided to spend a lot, even though it did not need to? Would it be fair for a territory to receive a large grant because it decided not to tax its residents very heavily, even though they were capable of paying those taxes?

Under such a system, territories would have an incentive to spend more and to tax less, because they would not suffer any adverse financial consequences from doing so. This incentive effect would be particularly strong in the "fixed pot" situation. A territory that resisted the temptation to over spend and under tax while its counterparts succumbed would find itself with a smaller share of the finite available funds. The "odd man out" would suffer a financial penalty for fiscal responsibility.

There are automatic restraints on territories pursuing such behaviour. First, the actual expenditures and revenues used in the grant calculations under this option would not be those of the current year, but of several years ago. A territory that intentionally increased its spending or reduced its revenue-raising efforts would not see any impact on its grant for a few years and would in the meantime have to suffer the financial consequences. Second, as mentioned previously, territories face limits on the size of annual deficit they can run. Even if a territory wished to open the spending taps now in anticipation of a larger grant a few years hence, it might not be permitted to run the resulting temporary budgetary shortfall.

Recommended for consideration, particularly if simplification of grant determination process is of paramount importance and it is designed with minimization of the adverse incentives in mind.

Direct Measurement of Expenditure Need & Potential Revenue

This is the “Cadillac option” in terms of accuracy of measurement of the fiscal gap to be filled. Such accuracy carries with it a host of benefits – fairness, responsiveness, and good incentive effects. As far as the feasibility of this option is concerned, the revenue side looks more promising than its expenditure counterpart.

An annually updated RTS approach to measuring each territory’s potential own-source revenue is operationally possible and would do a much better job of assessing fiscal capacity than the original TFF system’s Eligible Revenue proxy.

As for the expenditure side, it could be argued that since Australia uses a full blown expenditure need system in its Equalization program, the process could work elsewhere. Canada’s territories present some unique problems however.

Lack of reliable and timely data is probably the foremost concern. The territories have small populations, which limit the usual sampling approach to formulating statistical estimates. Confidentiality concerns restrict the publication of even some of those data that are estimated. If the underlying data cannot be published, the system loses transparency and credibility.

Data availability is not the only problem however. An expenditure needs system requires resolution of some contentious issues as to what public service needs are to be measured, how much of each public service is to be supplied for purposes of measuring expenditure need, and what is a reasonable cost for supplying a unit of each public service. Australia takes such decisions out of the hands of elected officials and of Commonwealth and State public servants. It has established an independent, arms-length commission for carrying out these controversial tasks. The Panel has been asked to consider whether, in Canada, we need an Australian-type commission.

Recommended for consideration, pending further investigation of data availability.

Macro Approach

The macro approach, like Actual Revenues and Expenditures, achieves greater simplicity. It also minimizes distortions to the policy choices of territorial government since they can exert little influence over the aggregate measures used to determine their grants under this option. However, the simplicity and policy-neutrality of the macro approach come at the expense of reduced accuracy in measuring each territory's need for funding.

Of course the term "macro approach" is quite generic. A proper assessment of its feasibility and adherence to the principles of good transfer design, including accuracy, depends on which macro indicators are used. The choice of indicators may be quite limited in the context of the territories.

On the expenditure side, the most important determinant of the resources required to provide comparable public services is probably a territory's population. But a simple equal-per-capita determination of expenditure need would not pass most observers' fairness tests. For example, some people have greater need for public services than others, and more of these high-need people live in some territories than in others. A weighted population measure would be a better indicator of expenditure need, where higher weight would be accorded, for example, to seniors, to children, and to residents of remote locations. These groups need more public services, or it costs more to provide them with a given amount of public services. The parties involved will want to debate the types of people to receive extra weight in such an indicator and the amount of extra weight they are to receive. The finer the division of the population, the less "macro" the indicator becomes, and the smaller the simplicity and non-distortion advantages.

It has been suggested that on the revenue side, a jurisdiction's GDP might be an appropriate macro indicator of the revenues it can raise. One immediate reaction is that some parts of GDP can be taxed more heavily than others. In particular, portions of resource production (e.g. oil and gas) are more fertile ground for government revenue raising than are other economic activities. Since resources are already so important in the North, and since they offer the potential of becoming more so, this observation has particular relevance in the TFF context. One would probably want to weight GDP for its resource content before using it as a macro indicator. Again, this opens a Pandora's Box of potential disputes over the implicit revenue content of different components of GDP.

Estimates of territorial GDP are built up by Statistics Canada from a variety of input series. Many of these constituent parts suffer from the territory-related statistical problems mentioned earlier (e.g., small populations, sampling, confidentiality). Doubts about the reliability of input series carry over to the GDP estimates. Statistical errors in the parts may cancel out when those parts are

aggregated to GDP for Canada or the larger provinces. It is difficult to be as confident that this will occur in the territories. If GDP estimates are not reliable, it is difficult to justify using them as a macro indicator of potential revenue.

Recommended that availability and reliability of data on macro indicators for the territories be assessed and that, depending on the findings, this option be elaborated upon.

Next Steps

This paper has described six options for allocating TFF grant funds among the territories and has assessed each against a number of criteria -- principles of good transfer payment design, real-world feasibility, and simplicity/clarity.

Two options, “Retain Fixed Shares” and “Return to Original TFF Allocation System” were not recommended. The Expert Panel may wish to rule these out as allocation schemes it would advise the government to pursue.

A third option, “Update the Original TFF System”, was assessed as having some promise, but as not changing either the methods or the results substantially. The Expert Panel may wish to study the results that this method would produce in terms of grant amounts for each territory under different scenarios for developments in the three territories.

The fourth option, “Actual Expenditures and Revenues”, is attractive in its simplicity and for that reason may be worth further investigation. The Expert Panel may wish to ask for further design work on this option and development of alternative scenario projections of the outcomes it would produce. One design element of this option that would require particular scrutiny is avoidance of undesirable incentive effects.

The fifth option, “Direct Measurement of Expenditure Need and Potential Revenue”, is the most ambitious in terms of work required to implement it and to administer it once in place. This option shows the greatest promise for precisely measuring what financial contribution territories need to enable them to provide comparable public services at comparable levels of taxation. It is the feasibility of this option that is open to question, both in terms of reaching agreement on its precise structure and obtaining the necessary data. Before recommending adoption of this option, the Expert Panel may wish to delve further into the question of whether the data exist to support it.

The sixth option, “Macro Approach”, as described in this paper is largely conceptual, and in concept it has the advantages of simplicity and minimization

of undesirable policy incentives. However it is not clear that the macro indicators required to drive it are of adequate quality in the case of the territories, or even that they exist. The Expert Panel may wish to ask that a concrete, operational, macro approach prototype be developed for further assessment.

As a final note, it should be stressed that the fairness and responsiveness of all of these options will depend on how they operate in the context of the “fixed pot” total grant that is part of the *New Framework*. It would be necessary to investigate further how a fixed envelope would affect the risk-sharing properties (between Canada and territories, and among territories) and responsiveness to need of different options.