

**Joint Territorial Submission
to the
Expert Panel on Equalization and Territorial Formula
Financing**

**The Departments of Finance
Nunavut
The Northwest Territories
Yukon**

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EXECUTIVE SUMMARY

At the request of the Expert Panel, territorial finance officials have jointly drafted a paper outlining two options for changing Territorial Formula Financing (TFF). Both options start from the established principles of previous TFF arrangements.

The TFF arrangements for each territory must be separate, stand alone arrangements because of the significant differences among the territories in both political and economic development.

The two options are as follows.

1. Simplify the revenue side of the previous TFF arrangements by changing eligible revenues to include only the five major taxes of: personal income tax, corporate income tax, gas tax, diesel tax and tobacco tax.

These changes are made revenue neutral in the first year by adjustments to the Gross Expenditure Base (GEB). Under this option, the additional funding in the New Framework is added to the GEB in the first year (2005-06) of the new calculation. The condition of revenue neutrality is not applied to the Economic Development Incentive (EDI) for the five tracked taxes remaining in eligible revenues. The EDI is increased from 20 per cent to 30 per cent without an adjustment to the GEB. The option also calls for an individual territory to have the choice of increasing the EDI if it is willing to accept the risk through a corresponding decrease in the GEB in the first year.

2. Escalate the legislated 2005-06 fixed amounts for each territory by each territory's population-adjusted growth in provincial/local government expenditures escalator as calculated under the previous TFF arrangements.

Adjustments can be made for new revenues as a result of devolution agreements or changes to revenues arising from Aboriginal self-government agreements. Under this option, own-source revenues no longer affect the TFF Grant, effectively providing a 100 per cent EDI. This will increase the instability of total territorial revenues. Consequently, the option would also institute a Revenue Stabilization Fund to be funded from federal revenues received from non-renewable resource developments in the territories. This Stabilization Fund would be used to assist territories if revenues decline dramatically.

Joint Territorial Submission to Expert Panel

INTRODUCTION

One of the outcomes of the October 2004 First Ministers' Meeting (FMM) was a fundamental change to Territorial Formula Financing (TFF). The October 2004 FMM established an aggregate fixed amount for TFF, a value escalated by 3.5 per cent per year after 2005-06, and allocated among the three territories. The federal government has established a third-party panel of experts to determine the allocation of TFF payments among the territories. The purpose of this paper is to summarize the implications of the new framework and to offer alternatives for improving federal-territorial fiscal arrangements based on the established principles of TFF.

The two options presented in this paper start from the premise that TFF arrangements for each territory should be separate, given the significant differences among the territories in both political and economic development. The first option simplifies the revenue component of the previous TFF and retains the established principles of Territorial Formula Financing. The second option endeavours to retain the New Framework transfer concept while attempting to mitigate the more negative aspects of the proposed New Framework.

WHAT IS TERRITORIAL FORMULA FINANCING

The previous TFF was a commitment to constitutional, political and economic development in the North and evolved through many commissions, working groups and multilateral negotiations. The design of the previous TFF was based on the principle that the territories must be able to provide comparable levels of public services at comparable levels of taxation to those that exist in southern Canada, while recognizing the unique circumstances in the North. Each territory received an unconditional transfer from the federal government that represented the "fiscal gap" between each territory's expenditure requirements to provide comparable public services and its revenue-raising capacity.

Each territory's expenditure needs were represented by its Gross Expenditure Base (GEB). Actual expenditures were used as a proxy for the expenditure requirements and cost of services in the North. Under the previous TFF arrangements, the expenditure bases were program costs in 1982, escalated by the growth in provincial and local government expenditures. The logic of this mechanism was that this proxy was a reasonable representation of the territories' expenditure needs and the escalation would keep these expenditure needs in line with the increased expenditures of provinces. Adjustments were made to each territory's GEB as needed, including additions to the GEB as new program responsibilities were devolved to the territory.

The revenue-raising capacity of each territory was represented by its Eligible Revenues. These revenues were those that each territory could raise if it applied base-year tax rates to current year tax bases, subject to adjustment for tax effort and an economic development incentive. Eligible revenues also included revenues over which the territorial governments did not have control over the rates; for example, investment income, federal transfer payments, and cost recoveries.

The GEB minus the adjusted Eligible Revenues equalled the Grant entitlement for a fiscal year.

Appendix A provides a detailed description of the previous TFF arrangements. However, a review of the principles of TFF and some of the outstanding issues with the previous arrangements is presented in the following two sections. This material is provided as background for the logic informing the territories' options for the new TFF arrangements.

PRINCIPLES OF FEDERAL-TERRITORIAL FISCAL ARRANGEMENTS

The following principles, which were agreed to by all parties, were to be used to guide the TFF discussions for the renewal of the Territorial Formula Financing Agreements for the five-year period starting 2004-05.

Responsibility and Accountability - to promote territorial fiscal responsibility and accountability for their budget decisions while maintaining the federal government's accountability for federal-territorial fiscal transfers.

Adequacy and Comparability - to provide the territorial governments with adequate funds to provide services which are reasonably comparable to those in other Canadian jurisdictions at reasonably comparable levels of taxation, while reflecting the special circumstances in the challenge of providing programs and services to their residents.

Affordability - to ensure affordability for the federal government and thus sustainability over time.

Predictability and Certainty - to permit both levels of governments to project, with an acceptable level of predictability and certainty, the levels of federal/territorial financing in order to promote orderly long and short-term fiscal planning.

Neutrality - to provide funding through a neutral mechanism, whereby the level of funding is not subject to the discretionary actions of either the territorial or the federal governments.

Stability - to provide stability of funding to meet the special needs resulting from significant fluctuations in territorial own-source revenues and expenditures caused by changes in economic and fiscal conditions.

Flexibility - to provide flexibility to accommodate changes with provisions to allow for adjustments to accommodate the implementation of Aboriginal self-government, federal initiatives, and further federal program devolution.

Disincentives and Incentives - to avoid disincentives for revenue increases on the part of the territorial governments and to provide appropriate incentives for the territorial governments to promote economic development, expand revenue sources, address social issues and foster self-sufficiency.

OUTSTANDING ISSUES OF PREVIOUS TFF

The TFF represents between 65 and 90 per cent of each territory's total revenues and therefore its adequacy is of fundamental concern.

Funds were adequate in 1985 when the first Formula Financing Agreements were implemented, and the growth in provincial/local government spending (adjusted for population) was appropriate as a proxy for the growth in territorial spending requirements. Consequently, it would be reasonable to assume that the Formula

Financing Grant would have remained adequate over time barring any changes to the Formula Financing Arrangements.

However, there have been a number of arbitrary reductions to the GEB and other alterations to the Formula Financing arrangements that make the adequacy assumption break down. Consequently, financing levels no longer correspond to the “expenditure needs gap” as defined in the original formula. By definition therefore, the Formula Financing Grant is inadequate. Federal adjustments to the Formula Financing Grant include:

- Gross Expenditure Base Ceiling - The ceiling in effect from 1990 to 1993 resulted in permanent annual reductions to the post-division NWT’s GEB of approximately \$90 million, Nunavut’s \$90 million and Yukon’s \$50 million.
- Gross Expenditure Base Cut - In 1996-97, the federal government reduced territorial GEBs by 5 per cent, causing a 7 per cent cut in the Yukon Grant and a 6 per cent cut in the pre-division NWT Grant. This base reduction represented a permanent and ongoing annual reduction in funding.
- Fiscal Capacity Measures - a Tax Effort Adjustment Factor (TEAF) was introduced in 1990-91. This Factor had two effects: first, it increased the revenue offset against the grant without a compensating adjustment to the GEB; and second, it introduced perversity into the Formula by clawing back more than a dollar from the TFF for every dollar generated by a territory in own-source revenue. The introduction of the TEAF meant that territorial revenues did not increase with the growth in the economy. The investments made to develop each territory’s economy did not increase its government’s revenues while expenditures continued to increase as a result of economic growth. The tax effort measure was flawed for a number of reasons including poor data quality.

Consequently, the TFF no longer met its original objective of allowing the territories to keep pace with provincial expenditure growth. In addition, current estimates of rebasing the Tax Effort Adjustment Factor (TEAF) from 1992-93 to 2000-01 reduce the NWT’s and Yukon’s Grant entitlements by as much as \$50 million (8 per cent) and \$25 million (6 per cent) annually, respectively. Data shocks such as rebasing can dramatically change Formula Financing entitlements.

When the TEAF was imposed on TFF, the expectation was that the combination of Catch-Up Factor (CUF), Keep-Up Factor (KUF) and tax rate adjustments would mean that rebasing the CUF on a five-year interval would have little or no revenue impacts. From 1992-93 to 1998-99, the KUF was slightly above one and since 1999-00, the KUF has been decreasing, which means that provincial tax effort has decreased. Over the same period, territorial tax rates have increased. The logical conclusion is to assume that a re-based CUF would be less than the current 1992-93 CUF. Instead, the 2000-01 CUF is significantly greater than the 1992-93 CUF for both the Yukon and the NWT.

The reasons for the higher than expected 2000-01 CUFs can be explained by the mechanics of calculating the CUF, and are discussed in Appendix B. The weights of revenues within the calculation drive the result and demonstrate that there are significant reasons why using the RTS tax bases are not appropriate. Proxy bases in particular are especially problematic.

The arguments concerning the inadequacy of the Formula Financing Grant have been made on numerous occasions. As a result of the February 2003 First Ministers’ Meeting,

the federal government recognized the issue of adequacy in federal/territorial fiscal arrangements and challenged the territories to present a defensible business case on the issue. Both a joint and individual territorial papers on the inadequacy of the TFF were prepared for discussions with Finance Canada and the Privy Council Office in August 2003.

SEPTEMBER AND OCTOBER 2004 FIRST MINISTERS' MEETINGS: CHANGES TO TFF ARRANGEMENTS

The following changes to TFF were established at the September and October 2004 First Ministers' Meetings.

- The total 2004-05 TFF Grant for all three territories was a fixed amount of \$1.9 billion. This fixed amount was allocated based on the shares of each territory's 2004-05 Grant (estimated in October 2004) and set in legislation for each territory. The estimated value of the total 2004-05 TFF Grants, including the federal 2004-05 budget adjustments, is \$1.835 billion. The change increased the total Grants by \$65 million (based on February 2005 estimates) over what would have been the case under the previous Formula, including changes announced in the February 2004 budget.
- The total 2005-06 TFF Grant is a fixed amount of \$2 billion. This legislated amount is allocated on the basis of each territory's share of the average of the 2002-03 to 2004-05 Grant estimates as of October 2004. The change increased the total Grants by \$88 million above increases already announced in the 2004-05 federal budget.
- The 2005-06 \$2 billion fixed level for the total territorial Grant entitlements will be escalated at a rate of 3.5 per cent for subsequent years. The allocation among the territories is undetermined.
- The escalation rate and TFF amounts will be reviewed in March 2009.

Table 1. Comparison of New Framework and Previous TFF (\$ Millions)

Legislated amounts				
	Yukon	NWT	Nunavut	TOTAL
2004-05	466	678	756	1,900
2005-06	487	714	799	2,000
Previous TFF Calculations as of March 2005*				
	Yukon	NWT	Nunavut	TOTAL
2004-05	450	654	731	1,835
2005-06	468	682	761	1,911
Increase in Grants				
	Yukon	NWT	Nunavut	TOTAL
2004-05	16	24	25	65
2005-06	19	32	38	89

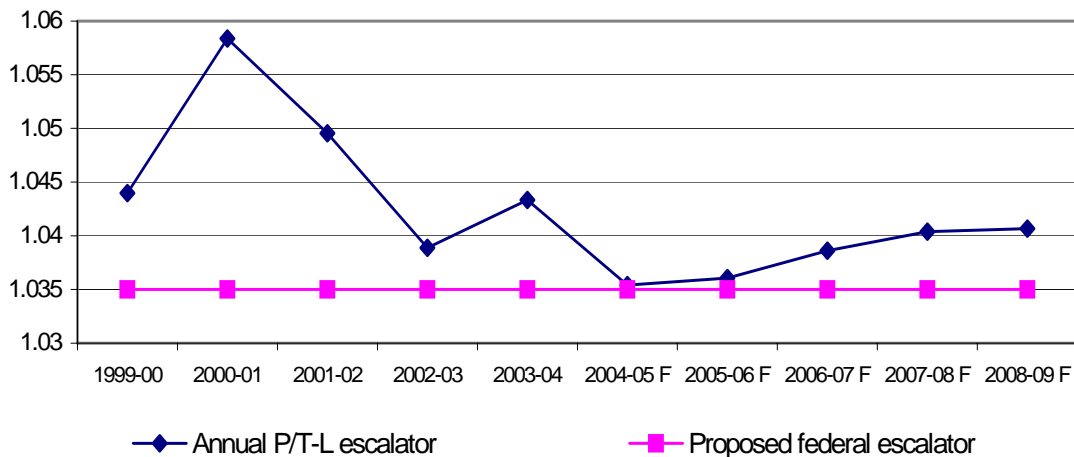
* Includes 2004-05 federal budget GEB adjustments.

IMPLICATIONS OF THE CHANGES TO TFF ARRANGEMENTS

There are four main implications of the new arrangements.

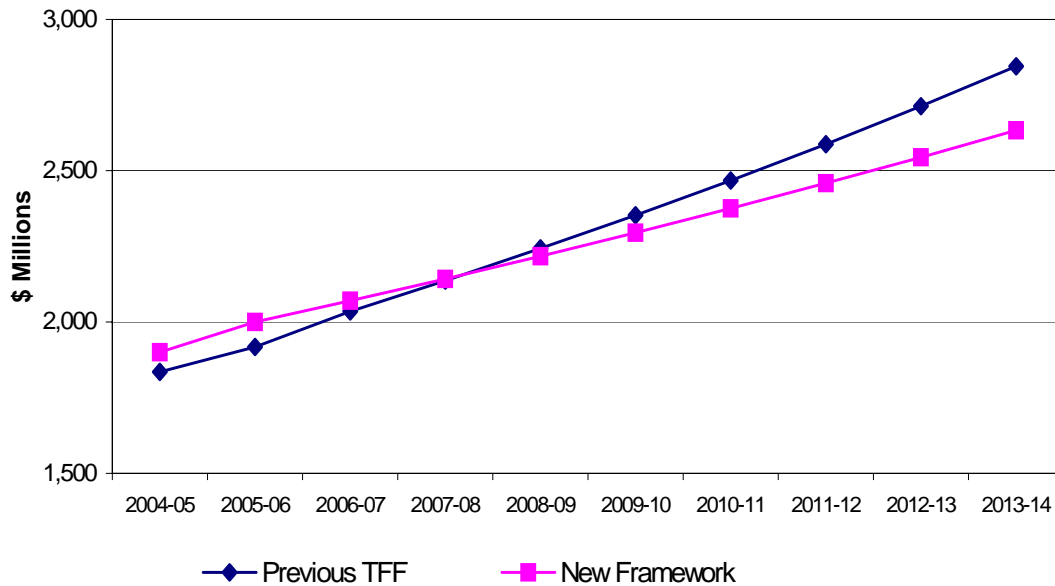
- The initial fixed amounts do not restore the adequacy of TFF in relation to its original definition. Further, the allocation shares for 2005-06 do not reflect the full program responsibilities of the Yukon government, since the average of the TFF shares used to determine the allocation include a year for which the Yukon did not have devolution of resources.
- The fixed 3.5 per cent escalator after 2005-06 is inadequate compared to the population-adjusted GEB growth rate defined under the previous TFF. The TFF entitlements under the previous arrangements would increase at a more rapid rate than 3.5 per cent because provincial/local government spending adjusted for territorial population growth has outpaced growth in Eligible Revenues. Figure 1 shows the Conference Board of Canada forecasts for provincial/local government spending growth. Figure 2 provides a comparison of the TFF under the previous arrangements (including GEB adjustments committed to in the 2004-05 federal budget) and the new framework. Using these forecasts, the new framework may provide less total funding than would have resulted under a continuation of the previous arrangements as early as 2008-09.
- Since the 3.5 per cent escalator is imposed for both the Equalization program and TFF, growth in per capita funding to the territories will be less than for the provinces. As Figure 2 shows, the population growth rates in the territories are significantly higher than the population growth rates in Equalization-receiving provinces. The 3.5 per cent escalator does not incorporate a population adjustment factor that reflects the North's relatively greater population growth. A uniform escalator can therefore be considered an impediment to the notion of adequacy in the formula arrangements.
- Setting a fixed amount for total TFF creates a zero-sum game for the territories, whereby gains to one or two territories must necessarily come from another territory (or territories). Each territory will, in effect, share the revenue growth or losses of the other two territories.

Figure 1. Provincial/Territorial-Local Government Expenditure Growth



Source: Statistics Canada and Conference Board of Canada

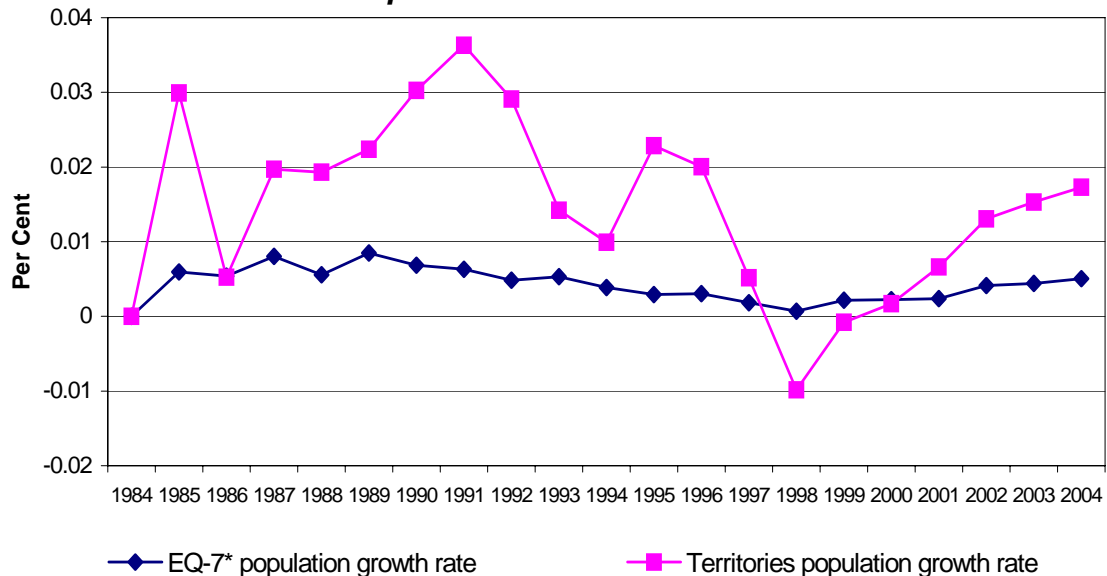
Figure 2. Comparison of Growth in Previous TFF and New Framework



Previous TFF Assumptions:

- 2004-05 and 2005-06 based on March 2005 federal estimates plus GEB additions from 2004-05 federal budget.
- PL growth after 2005-06 is 3.8 per cent annually (Conference Board forecast average to 2008-09).
- Annual population adjustment factors after 2005-06 are 1.005 for NWT and 1.01 for Nunavut. Yukon's population adjustment factor 1.0082 and 1.0041 for 06-07 and 07-08 and 1.0 thereafter.
- TFF is not rebased from 1992-93 base year
- Eligible revenues grow at 2.5 per cent annually for the Yukon, 3.5 per cent annually for NWT and 2.0 per cent annually for Nunavut.
- Does not include pension data adjustment in PL series since is in addition to New Framework amounts.

Figure 3. Comparison of Territories' and Equalization-Receiving Provinces' Population Growth Rates



Source: Statistics Canada

*EQ-7 refers to the seven provinces that typically receive Equalization (Newfoundland and Labrador, New Brunswick, Nova Scotia, Prince Edward Island, Quebec, Manitoba, and Saskatchewan)

WHAT THE TERRITORIES WOULD LIKE TO SEE IN NEW TFF ARRANGEMENTS

Adequacy

As noted previously in this paper, the TFF Grants represent the vast majority of territorial revenues and, therefore, their adequacy is of fundamental importance in the ability of each territory to deliver government programs and services to their residents at comparable levels as the provinces, at comparable levels of taxation. Table 2 shows the gap between actual TFF in 2005-06 and TFF entitlements if the original TFF path had been retained. The total gap in 2005-06, including a reduction for the new framework increases is over \$220 million.

Table 2. Adequacy Gap, 2005-06

<i>\$ Millions</i>	Yukon	NWT	Nunavut	Total
Impact of original GDP ceiling	66	115	111	292
5% GEB cut	26	41	40	107
Total Cuts	92	155	151	399
Less additions to total funding				
CHST additions since 1996-97	19	26	18	64
New framework extra funding	26	41	47	114
Total Enhancements	45	67	66	178
Annual adequacy gap	47	88	86	221

The adequacy of federal transfers to the territories was the main issue discussed in the renewal process for the TFF prior to the announcement of the new framework. As part of these discussions, the territories presented a joint paper to Finance Canada that discussed adequacy within the context of previous federal/territorial financial arrangements as well as individual papers that examined issues specific to each territory. In addition, the territories expressed deep concern about the theoretical foundation of the Tax Effort Adjustment Factor (TEAF) because preliminary estimates of rebasing the TEAF for the 2004-05 to 2008-09 TFF renewal produced results that were theoretically inconsistent with predicted behaviour, failing the test of theoretical validity (see Appendix B). Adequacy discussions between the federal and territorial governments concerning the 2004-05 TFF renewal were not completed by the October 2004 First Ministers' Meeting and is an area that the Expert Panel may wish to consider further.

Stability/Predictability

The change in TFF announced at the October 2004 FFM was hailed by the federal government as a significant improvement in stability of TFF payments. However, while the territories understand the federal government's need to have predictability in its transfers, the total TFF transfer is a small federal program, and variability in total TFF payments is insignificant from a federal budgeting perspective. For the territories, stability in the TFF is secondary to the stability and adequacy of total revenues. It is more important that the TFF entitlements are responsive to changes in territorial own-

source revenues (particularly if those revenues are decreasing) than that the TFF payments themselves are stable. However, since the TFF represents the vast majority of all three territories' government revenues, it is important that the TFF also be adequate and predictable for territorial budgeting purposes.

Incentives

A key objective of all three territories is to reduce their dependence on federal transfers. All three territories agree that there must be incentives within TFF to make the investments necessary to encourage economic development and subsequently increase territorial own source revenues.

The GNWT is experiencing growth in own-source revenues as a result of economic growth. However, previous arrangements do not provide adequate net revenues to allow the territory to benefit significantly from this economic activity, nor do previous arrangements provide the incentives to encourage economic development. The GNWT is arguing for greater incentives, such as enhanced incentives for the TFF, to help align the benefits and costs due to economic development.

For the other two territories, the previous GEBs were growing faster than own source revenues. Since the previous EDI reduced the GEB by the same amount as the EDI in the first year of implementation, it cost Yukon and Nunavut on a net fiscal basis. In reality, for the Yukon and Nunavut, there was no net benefit to the previous EDI and as a result, it reduced their capacity to invest in economic activity.

Increasing the incentives to grow territorial revenues decreases the stability of total revenues. Understanding this inherent conflict is necessary for finding a balance between the two principles. This balance differs depending on each territorial government's risk tolerance. The possibility of having different EDIs was part of the adequacy discussions between federal and territorial officials, and was an option that was possible under the previous TFF arrangements.

Simplicity

TFF includes a number of proxy components. Examples of these proxies include the GEB as a proxy for expenditure needs and the CUF/KUF/tax rate adjustments as proxies for tax capacity. Given the use of proxies, having to calculate all revenues at base year rates to the nearest dollar imposes an unnecessary administrative burden. In the previous 1999-00 to 2003-04 TFF agreements, the NWT and Nunavut used a revenue block for smaller fees and charges from the first year of the Agreement (1999-00) and kept this block unchanged over the next four years. In the case of the NWT, the difference between the revenue block and the actual revenues included in the block was less than \$1 million annually, or less than 0.2 per cent of the annual NWT TFF Grant.

Neutrality

TFF was intended to provide a neutral mechanism for fiscal arrangements whereby the level of funding would not be subject to discretionary actions by either the territorial or federal governments. The principles and objectives of stability and predictability cannot be maintained in absence of neutrality. Specifically, fiscal arrangements must be based on neutrality if stability and predictability is to be realized by both the federal and territorial governments.

TERRITORIAL FORMULA FINANCING OPTIONS AFTER 2005-06

Federal Constraints

The federal government has constrained the Territorial Formula Financing options by imposing a fixed amount of \$2 billion in 2005-06 escalated by 3.5 per cent annually thereafter.

The contention within this paper is that the purpose of TFF arrangements is to provide the territories with adequate fiscal resources to deliver comparable levels of government programs and services as the provinces while recognizing the unique circumstances in the North.

Criteria for Evaluating Options

In addition to adhering to the principles of federal-territorial fiscal arrangements, the new approach to TFF must consider the following factors:

- economic growth (positive and negative),
- population growth (positive and negative),
- changes in tax effort,
- fiscal implications of Aboriginal self-government,
- devolution of program transfers (such as resource devolution), and
- territorial and federal interests.

Considerations

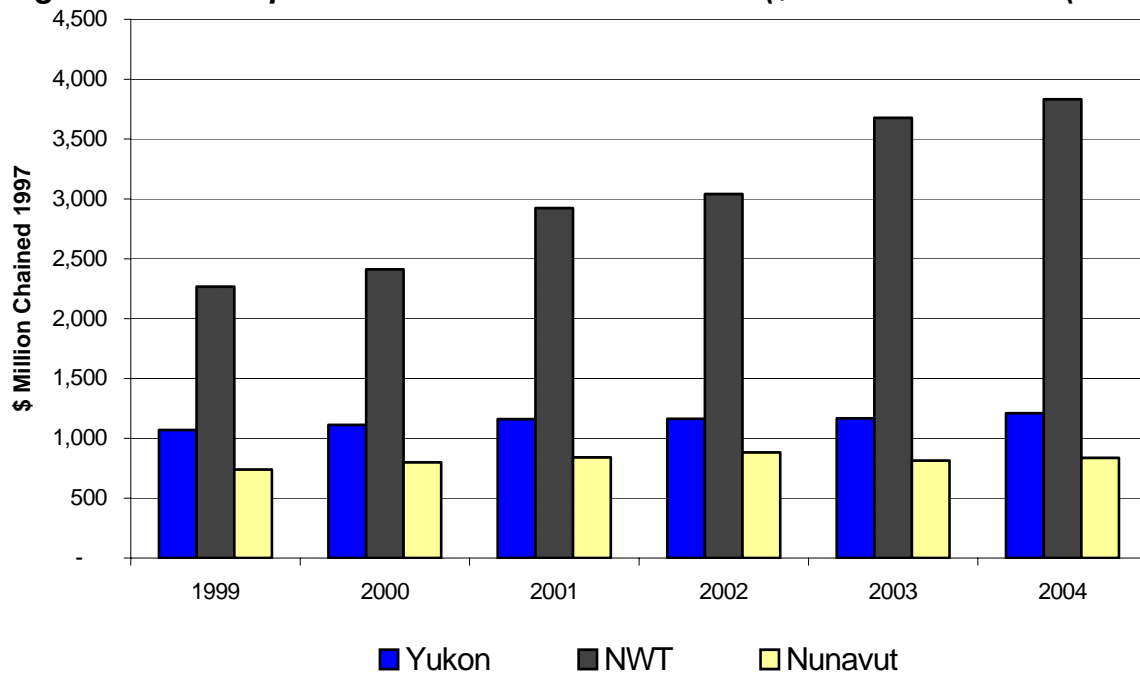
The variance within the North is as great as the variance across all jurisdictions and these different circumstances create different costs for providing government programs and services, and also dramatically different fiscal capacities. None of Nunavut's 26 communities are served by roads, compared to 15 out of 33 communities in the NWT and all but 1 community in the Yukon that have year-round road access.

Demographics are also different in the three territories. The Aboriginal population in Nunavut is 85 percent, in the NWT is 51 percent and in Yukon is 23 percent of total population.

Economies of scale vary significantly. Of 26 communities, Nunavut's largest community, Iqaluit, has only 20 per cent of that territory's population, compared to the NWT where 42 per cent of the population lives in Yellowknife, or the Yukon where 75 per cent of the population lives in Whitehorse.

The differences in the economies of the territories are especially dramatic. As Figure 4 shows, the NWT's real GDP has grown 69 percent since 1999 to \$3.8 billion in 2004, mainly because of diamond mine developments. Over the same time, Yukon's real GDP has grown 13 percent to \$1.2 billion and Nunavut's real GDP has grown 13 percent to \$838 million. These differences also show up in the composition of each territory's economy. The government share of the Nunavut domestic economy is 76 percent compared to 56 percent in the Yukon and only 40 percent (and declining) in the NWT.

Figure 4. Comparison of Territories' Real GDP (\$ Millions Chained (1997))



These differences have resulted in the evolution of different TFF compositions for each territory, as demonstrated by the changes in percentage shares of their GEB, Grant, and population since 1999-00 (Table 3). The NWT's share of the aggregate GEBs is declining while Nunavut's is increasing due to Nunavut's higher population growth rate. Similarly, the NWT's share of total TFF is declining due to both lower population growth compared to Nunavut and higher revenue growth. The Yukon's shares of both are relatively stable.

Table 3. Per cent Shares of GEBs, TFFs, and Population

	NWT	Nunavut	Yukon	Total
Per cent shares of aggregate GEBs, including one-time payments				
1999-00	39	36	25	100
2004-05	37	38	25	100
Per cent shares of aggregate Formula Financing Grants				
1999-00	37	39	24	100
2004-05	36	40	25	100
Per cent shares of population by territory				
1999-00	41	27	31	100
2004-05	41	29	30	100

The TFF makes up the majority of total territorial government revenues in all three territories. However, as shown Table 4, the TFF share of total Yukon and NWT revenue is about 65 per cent compared to an average of 83 per cent of Nunavut's total revenue. This is another example of the different circumstances in each territory.

Table 4. Composition of Revenues

4a. Yukon - Composition of Revenues, 1999-00 to 2004-05

(\$ millions)	Own- Source Revenue	Transfers from the Federal Government			Total Revenue
		TFF	Other	Total	
1999-00	153	310	20	330	483
2000-01	166	367	20	387	553
2001-02	129	349	26	375	504
2002-03	148	382	20	402	550
2003-04	171	426	30	456	627
2004-05 F	203	452	37	489	692

Per cent of total revenue

1999-00	31.7	64.2	4.1	68.3	100.0
2000-01	30.0	66.4	3.6	70.0	100.0
2001-02	25.6	69.2	5.2	74.4	100.0
2002-03	26.9	69.5	3.6	73.1	100.0
2003-04	27.3	67.9	4.8	72.7	100.0
2004-05 F	29.3	65.3	5.3	70.7	100.0

Source: Brown-Green Book, February 2005 - Finance Canada

F = forecast

4b. Northwest Territories – Composition of Revenues, 1999-00 to 2004-05

(\$ millions)	Own- Source Revenue	Transfers from the Federal Government			Total Revenue
		TFF	Other	Total	
Year					
1999-00	140	519	53	572	712
2000-01	268	571	45	616	884
2001-02	642	290	25	315	957
2002-03	438	346	62	408	846
2003-04	-43	854	61	915	872
2004-05 F	210	712	116	828	1,038

Per cent of total revenue

1999-00	19.7	72.9	7.4	80.3	100.0
2000-01	30.3	64.6	5.1	69.7	100.0
2001-02	67.1	30.3	2.6	32.9	100.0
2002-03	51.8	40.9	7.3	48.2	100.0
2003-04	-4.9	97.9	7.0	104.9	100.0
2004-05 F	20.2	68.6	11.2	79.8	100.0

Source: Brown-Green Book, February 2005 - Finance Canada for 1999-00 to 2003-04;
NWT Forecast for 2004-05 from March 30, 2005

F = forecast

4c. Nunavut - Composition of Revenues, 1999-00 to 2004-05

Year	Own-Source Revenue	Transfers from Federal Government			Total Revenue
		TFF	Other	Total	
1999-00	55	537	54	591	646
2000-01	76	596	56	652	728
2001-02	66	599	90	689	755
2002-03	95	662	51	713	808
2003-04 F	71	720	63	783	854
2004-05 F	74	778	70	848	922

Per Cent of total revenue

1999-00	8.5	83.1	8.4	91.5	100.0
2000-01	10.4	81.9	7.7	89.6	100.0
2001-02	8.7	79.3	11.9	91.3	100.0
2002-03	11.8	81.9	6.3	88.2	100.0
2003-04 F	8.3	84.3	7.4	91.7	100.0
2004-05 F	8.0	84.4	7.6	92.0	100.0

Source: *Brown-Green Book, February 2005 - Finance Canada*

F = forecast

These differences between the three territories have significant implications for the logic of a fixed value TFF. This paper asserts that the fixed amount will not work and that TFF must be separate for each territory.

OPTIONS FOR CONSIDERATION

This paper presents two options as alternatives to the new TFF framework. Both adhere to the principles of TFF while providing a degree of simplification from the old TFF arrangements. The options were developed in response to the queries of the Expert Panel as to territorial preferences for a new TFF framework:

- Option 1 - Simplification of the previous TFF. This option reflects the original objectives and principles of the federal commitment to the long-term development of the North. Its departure from the previous TFF is that it focuses on simplifying the revenue side of the arrangements.
- Option 2 – Expenditure/revenue simplification. This option is a hybrid of the New Framework that mitigates the more negative implications of the New Framework. This alternative is an accommodation using some of the basic elements of the “New Framework”.

Although both options use the principles of Territorial Formula Financing as their base, the weight given to each principle varies between the options. Both options provide for stand-alone TFF grant calculations for each of the three territories. The sum of the three TFF grants is not restricted to an escalated aggregate amount for the three territories; however, both Option 1 and 2 allow the aggregate of the TFF grants to either exceed or be less than the current legislated arrangement of \$2.0 billion in 2005-06 escalated by 3.5 percent annually.

The following lists the starting point for both options to modify federal/territorial fiscal arrangements.

- **Retain the fiscal gap-filling concept in some form.**
- **Separate, stand-alone Grants.** The federal government set a fixed amount for total new framework funding. As stated in this paper and previous presentations by territorial finance officials, having the formulas of the three territories linked by a fixed total amount creates a zero-sum game where gains in Grant revenue to one territory come at the expense of the other two. Separate stand-alone grants are the most appropriate way to provide the flexibility in the formula to accommodate changes within each territory with respect to economic development, the implementation of Aboriginal self-government, further federal program devolution and other federal initiatives. In other words, stand-alone grants recognize the different development stages of the territories.
- **Continue using the population-adjusted provincial/territorial-local government expenditures as the GEB escalator.** The purpose of the escalator is to ensure that the TFF Grants grow at a sufficient rate to ensure that the territories have the fiscal resources to provide comparable levels of services as the provinces. Previous TFF discussions have concluded that the growth in provincial-local government expenditures is the best proxy to achieve this purpose and is essential to meeting the basic premise of the transfer.
- **Continue to adjust the GEB escalator for population.** Both the federal government and the territories have agreed previously that the growth in GEBs should be adjusted by population growth relative to the national average to ensure that growth in a territory's Grant does not decline on a per capita basis relative to the provinces.

OPTION 1 - SIMPLIFICATION OF THE PREVIOUS TFF

The focus of Option 1 is to simplify the revenue side of the TFF arrangements. For the purposes of this option, it is assumed that, while the GEB for each territory is inadequate due to arbitrary federal adjustments, no one territory has a more or less adequate GEB than the others. The territories also consider that the former Formula Financing arrangements, although inadequate due to ad hoc federal measures and with significant unresolved issues around revenue capacity measures, were designed to fulfill, in a broad sense, the established principles of federal/territorial fiscal arrangements in an acceptable manner.

Option 1 changes the revenue side from calculating all territorial own source revenues at base year rates to using only the five largest tax revenues of personal income tax, corporate income tax, fuel tax, and tobacco tax at National Average Tax rates. This creates more administrative simplicity and avoids some of the more obvious problems with the previous tax effort adjustment factor. All other revenues, including other recoveries and other federal transfers and are excluded from eligible revenues.

Changes to the revenue side in Option 1 will cause the Grant levels to change in the initial year from the Grants under previous arrangements, thereby imposing exogenous one-off effects. In order to restore the original fiscal gap, the Gross Expenditure Bases in the option will be adjusted to ensure revenue neutrality in year 1. This approach will also

allow each territory to look at the merits of the option in terms of balancing the different TFF principles instead of whether it wins or loses in the short term.

The actual mechanics of the option are as follows:

- The 2005-06 GEB will be starting point.
- Adjustments will be made to the GEB to reflect changes in the Eligible Revenue calculation. This will ensure revenue neutrality in year 1 (2005-06).
- The increases in each territory's 2005-06 Grant from the TFF under the previous arrangements and the legislated 2005-06 amount will be added to the 2005-06 GEB and escalated for 2006-07.
- Eligible revenues would consist of personal income tax, corporate income tax, fuel taxes, and tobacco taxes at National Average Tax Rates (NATR). The NATRs are calculated using the Representative Tax System (RTS) of the previous Equalization system. These taxes were chosen because they are some of the largest sources of tax revenues imposed by all three territories. Other large revenue sources such as liquor revenues and property taxes were not included due to the difficulty in applying NATR. (Liquor is problematic because of differences in the bases and also because Nunavut and NWT use a mark-up method to raise liquor revenues while the Yukon imposes a liquor tax. Property taxes are especially problematic given that some municipalities collect property taxes and the use of NATR to determine the rate to apply to property outside of established communities in the North would be arbitrary.) Together the five tracked taxes comprise between 57 and 66 per cent of each territory's own source revenues.
- The EDI for the five tracked taxes is increased from 20 percent to 30 percent. This increase is part of the territories' adequacy argument and is not revenue neutral.

The proposed option is evaluated in comparison to the TFF Grants from 2001-02 to 2005-06 under the previous arrangements. Additions to the GEB in 2004-05 and 2005-06 announced in the 2004 federal budget are not included in the base case in order to make previous TFF amounts directly comparable to the federal estimates. Since the budget additions were never authorized in federal legislation, they are not included in federal estimates. A technical adjustment to the previous territorial GEBs relating to the provincial-local government pension expenditure data within the data series used to calculate the previous GEB escalators is not included as the adjustment is currently being paid annually based a letter from the federal Minister of Finance. However, the understanding is that that this technical adjustment will be added to the GEBs in 2006-07 and that this amount will be addition to the legislated amounts of the New Framework.

Tables 5a to 5c provide a comparison of the simplified version to the previous TFF arrangements for each of the three territories. The example starts in 2001-02 to avoid the problems created by the large one time corporate income tax collection experienced by the NWT in 2000-01. As Table 5 shows, simplifying the TFF comes at a price for all three territories because revenues have grown slower than growth in the GEB. Therefore, reducing the GEB to impose revenue neutrality in the first year means that, over time, the simplified Grant will generate less revenue than the previous TFF arrangements.

Table 5. Comparison of Previous TFF to Proposed Variant

Table 5a. Yukon (\$ Millions)

Previous TFF	2001-02	2002-03	2003-04	2004-05	2005-06
Gross Expenditure Base	437	451	512	530	550
Eligible Revenues	(78)	(79)	(78)	(86)	(89)
Grant	359	372	434	444	461

Option 1: Five Tracked Taxes at National Average Tax Rates

Initial Gross Expenditure Base	437				
Cat. 1 revenues adjustment	(15)				
Cat. 3 revenues adjustment	(4)				
Cat 2 revenues adjustment	(7)				
Gross Expenditure Base	412	425	485	502	521

Eligible Revenues - Tax Capacity in each tax using NATR

1. PIT revenue	40	41	37	42	45
2. CIT revenue	9	8	9	10	11
3. Tobacco tax revenue	4	5	5	6	6
4. Gasoline tax	9	9	9	9	9
5. Diesel fuel tax revenue	5	5	5	5	5
Total - five tracked tax bases	67	68	65	73	76

EDI adjustment (20%: offset in GEB)	(13)	(14)	(13)	(15)	(15)
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EDI adjustment (10%: not offset in GEB)	(7)	(7)	(6)	(7)	(8)
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Total EDI adjustment	(20)	(20)	(19)	(22)	(23)
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Adjusted Eligible Revenues	47	48	45	51	53
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Grant	366	378	440	451	468
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Difference between new Grant and previous TFF Grant	7	6	6	7	7
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Difference between new Grant and previous TFF Grant before additional 10% EDI adjustment	0	(1)	0	0	(1)
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Table 5b. Northwest Territories (\$ Millions)

Previous TFF	2001-02	2002-03	2003-04	2004-05	2005-06
Gross Expenditure Base	706	739	774	810	846
Eligible Revenues	(160)	(151)	(148)	(163)	(173)
Grant	546	588	626	647	673
Option 1: Five Tracked Taxes at National Average Tax Rates					
Initial Gross Expenditure Base	706				
Cat. 1 revenues adjustment	(11)				
Cat. 3 revenues adjustment	(8)				
Cat 2 revenues adjustment	(5)				
Gross Expenditure Base	682	714	748	783	817
Eligible Revenues - Tax Capacity in each tax using NATR					
1. PIT revenue	72	81	79	83	94
2. CIT revenue	65	41	37	52	54
3. Tobacco tax revenue	5	8	8	9	9
4. Gasoline tax	6	6	6	6	6
5. Diesel fuel tax revenue	22	24	26	27	27
Total - five tracked tax bases	170	160	157	177	190
EDI adjustment (20%: offset in GEB)	(34)	(32)	(31)	(35)	(38)
EDI adjustment (10%: not offset in GEB)	(17)	(16)	(16)	(18)	(19)
Total EDI adjustment	(51)	(48)	(47)	(53)	(57)
Adjusted Eligible Revenues	119	112	110	124	133
Grant	563	602	639	659	684
Difference between new Grant and previous TFF Grant	17	14	12	12	11
Difference between new Grant and previous TFF Grant before additional 10% EDI adjustment	0	0	(3)	(6)	(-8)

Table 5c. Nunavut (\$ Millions)

Previous TFF	2001-02	2002-03	2003-04	2004-05	2005-06
Gross Expenditure Base	682	725	764	800	836
Eligible Revenues	(69)	(68)	(71)	(77)	(85)
Grant	613	656	692	723	751
Option 1: Five Tracked Taxes at National Average Tax Rates					
Initial Gross Expenditure Base	682				
Cat. 1 revenues adjustment	(15)				
Cat. 3 revenues adjustment	(5)				
Cat 2 revenues adjustment	(11)				
Gross Expenditure Base	651	692	729	764	798
Eligible Revenues - Tax Capacity in each tax using NATR					
1. PIT revenue	35	34	31	36	38
2. CIT revenue	4	6	5	7	7
3. Tobacco tax revenue	4	6	6	6	7
4. Gasoline tax	1	2	2	2	2
5. Diesel fuel tax revenue	3	3	2	3	2
Total - five tracked tax bases	47	50	46	54	56
EDI adjustment (20%: offset in GEB)	(9)	(10)	(9)	(11)	(11)
EDI adjustment (10%: not offset in GEB)	(5)	(5)	(5)	(5)	(6)
Total EDI adjustment	(14)	(15)	(14)	(16)	(17)
Adjusted Eligible Revenues	33	35	33	38	39
Grant	618	657	696	726	759
Difference between new Grant and previous TFF Grant	5	0	4	3	7
Difference between new Grant and previous TFF Grant before additional 10% EDI adjustment	0	(4)	(1)	(2)	2

Table 6 shows the fiscal implications of the option compared to escalating each territory's Grant by 3.5 per cent. Under this option, the difference between the 2005-06 fixed amounts provided at the October 2004 First Ministers' Meeting and the March 2005 TFF estimates under the previous arrangements would be added to each territory's GEB. Consequently, the new TFF starting in 2005-06 would exactly equal the legislated 2005-06 amounts for each territory. This approach does not restore the original path of the each territory's TFF, but does reduce the total adequacy gap by \$90 million.

The Economic Development Incentive for the 5 tracked taxes is increased from 20 per cent to 30 per cent without a corresponding decline in the GEB. The territories need to retain additional revenues generated from their investments in order to make such investments worthwhile. The capital investments needed to create the environment for economic development are substantial and beyond the territories' current fiscal capacities. While these investments would generate economic activity and therefore more revenues for a territory, they also create other social and economic pressures that strain each territory's financial resources. As well, because only the five major taxes are included in Eligible Revenues, each territory has an incentive to promote activities that will raise revenue from other sources.

Not having to "buy" the additional 10 percent EDI is part of the territories' adequacy arguments. However, a territory should have the option to further increase its individual EDI if it is prepared to accept the risk of more instability in total revenues. The territory would have to accept the risk through an adjustment to its GEB.

Table 6. Fiscal Implications of TFF Simplification Option

Table 6a. Yukon (\$ Millions)

Option 1: TFF Simplification - Five Tracked Taxes at National Average Tax Rates

	2005-06	2006-07	2007-08	2008-09	2009-10
Initial Gross Expenditure Base	550				
Cat. 1 revenues adjustment	(15)				
Cat. 3 revenues adjustment	(5)				
Cat 2 revenues adjustment	(8)				
New Framework Adjustment	26				
Gross Expenditure Base	548	575	602	627	651
Eligible Revenues - Tax Capacity in each tax using NATR					
Total - five tracked tax bases	76	78	80	82	84
EDI adjustment (20%: offset in GEB)	(15)	(16)	(16)	(16)	(17)
EDI adjustment (10%: not offset in GEB)	0	(8)	(8)	(8)	(8)
Total EDI adjustment	(15)	(23)	(24)	(25)	(25)
Adjusted Eligible Revenues	61	55	56	57	59
Grant	487	520	545	570	592

Table 6b. Northwest Territories (\$ Millions)**Option 1: TFF Simplification – Five Traced Taxes at National Average Tax Rates**

	2005-06	2006-07	2007-08	2008-09	2009-10
Initial Gross Expenditure Base	846				
Cat. 1 revenues adjustment	(10)				
Cat. 3 revenues adjustment	(16)				
Cat 2 revenues adjustment	5				
New Framework Adjustment	41				
Gross Expenditure Base	866	905	945	987	1,031
Eligible Revenues - Tax Capacity in each tax using NATR					
Total - five tracked tax bases	190	197	203	211	218
EDI adjustment (20%: offset in GEB)	(38)	(39)	(41)	(42)	(44)
EDI adjustment (10%: not offset in GEB)	0	(20)	(20)	(21)	(22)
Total EDI adjustment	(38)	(59)	(61)	(63)	(65)
Adjusted Eligible Revenues	152	138	142	147	153
Grant	714	767	803	840	879

Table 6c. Nunavut (\$ Millions)**Option 1: TFF Simplification – Five Tracked Taxes at National Average Tax Rates**

	2005-06	2006-07	2007-08	2008-09	2009-10
Initial Gross Expenditure Base	836				
Cat. 1 revenues adjustment	(25)				
Cat. 3 revenues adjustment	(4)				
Cat 2 revenues adjustment	(10)				
New Framework Adjustment	47				
Gross Expenditure Base	844	882	922	964	1,008
Eligible Revenues - Tax Capacity in each tax using NATR					
Total - five tracked tax bases	56	57	58	60	61
EDI adjustment (20%: offset in GEB)	(11)	(11)	(12)	(12)	(12)
EDI adjustment (10%: not offset in GEB)	0	(6)	(6)	(6)	(6)
Total EDI adjustment	(11)	(17)	(18)	(18)	(18)
Adjusted Eligible Revenues	45	40	41	42	42
Grant	799	842	881	923	966

Table 4d. Summary of Fiscal Implications of Option 1

	2005-06	2006-07	2007-08	2008-09	2009-10
New Framework - Individual TFF escalated by 3.5%					
Yukon	487	504	522	540	559
Northwest Territories	714	739	765	792	819
Nunavut	799	827	856	886	917
Total	2,000	2,070	2,142	2,217	2,295
Year over Year % Change	5.3%	3.5%	3.5%	3.5%	3.5%
Option 1: Simplification of the Previous TFF					
Yukon	487	520	545	570	592
Northwest Territories	714	767	803	840	879
Nunavut	799	842	881	923	966
Total	2,000	2,129	2,230	2,332	2,437
Year over Year % Change	5.3%	6.5%	4.7%	4.6%	4.5%

Issues to Resolve under Option 1 – Simplification of the Previous TFF

The above option retains the fiscal gap-filling principle of the previous TFF while reducing the complexity of the previous arrangements. However, this option contains the following technical details/issues that must be addressed and resolved:

- methodology for calculating eligible revenues,
- treatment of resource revenues with TFF, and
- revenue sharing with Aboriginal Self-governments.

Methodology for Calculating Eligible Revenues

Measuring the territories' tax capacity by applying NATRs to each territory's respective tax bases requires ensuring that the method used to determine the NATRs is consistent with the method used to determine the tax bases. The RTS is a hypothetical tax system that does not correspond exactly to the territories' tax systems making it difficult to apply the NATRs from the Equalization calculations to the territories' tax bases. The following describes the calculations used for this paper. However, it is fully recognized that more discussion must be given to this issue.

For personal income tax (PIT), the RTS calculation of each province's tax base requires the application of the Personal Income Tax Microsimulation Model (PITAX). In the timelines for this paper, territorial data using the PITAX model was not available. For the calculation in this paper, we used the Canada Revenue Agency's (CRA) published taxation statistics to approximate the territorial personal income tax bases.

For corporate income tax (CIT), the RTS calculation uses the Corpac model, several variables from CRA special studies, and includes amounts relating to profits from government business enterprises. As with PITAX data, these data were not available for the territories in the time allotted for this exercise. As an alternative, this paper used the

CRA's taxation statistics to calculate a NATR for both small business income and regular business income, which was then be applied to the territories' actual tax bases.

For fuel taxes, provinces and territories have widely different definitions of taxable fuel consumption. This paper used the NATR calculated under RTS and ignores the fact that territories do not define their fuel tax bases in the same manner as the RTS.

There is a high degree of similarity between the definition of the tax base for tobacco tax under the RTS and those used by the provinces and territories. Therefore the measurement of tobacco tax capacity using the RTS is considered reasonable.

Resource Revenues and Treatment within TFF

One of the main fiscal goals of all three territories is to maximize own-source revenues and thereby lessen dependence on federal government transfers. Part of the strategy for maximizing own-source revenues is to ensure that the territories receive a net fiscal benefit from the extraction of non-renewable resources. Non-renewable resources are an asset that once capitalized are no longer available.

While the NWT and Nunavut have yet to reach non-renewable resource revenue sharing agreements with the federal government, the Yukon has reached such an agreement for resource revenues, both on-shore devolution of oil and gas resources and shared off-shore management and resource revenues sharing, although the terms for shared offshore management and treatment of offshore revenues have yet to be negotiated. NWT and Nunavut have had responsibility for forestry since 1987.

Although all territories should receive comparability on any resource revenue agreement with respect to TFF treatment, this does not mean that existing arrangements should be used as precedent for future arrangements. Furthermore, nothing recommended by the Expert Panel on resource revenue treatment within TFF should be allowed to preclude, or close down, non-renewable resource revenue sharing discussions.

Resource revenues from offshore non-renewable resources also need to be addressed. The treatment of any revenues from these resources should be treated at a minimum in the same way as other resource revenues in the TFF. In fact, it could be argued, that the recently amended Newfoundland and Nova Scotia Offshore Accords established precedents that offshore revenues should be treated more favourably than those from onshore development.

Furthermore, consideration must be taken of situations where the federal government has chosen to take an equity position in a resource project in lieu of royalties. A federal equity position should be considered as benefiting the federal government in the same manner as normal resource royalties.

Current Situation

Yukon

The Yukon has separate offset arrangements for combined oil and gas resources and different rates for forestry, minerals, water and land revenues. Yukon keeps 100 percent of the first \$3 million in each grouping of resource revenues: oil and gas, minerals;

forestry, water and land revenues. For oil and gas revenues above the \$3 million level, the Yukon keeps 40 percent of each dollar and this rate declines progressively to 20 percent. However, for minerals, forestry, water and land revenues, the Yukon keeps no revenues above the \$3 million level. Canada takes 100 percent of these revenues leaving the Yukon with no net fiscal benefit from resource development above the \$3 million. Yukon's land revenues are net of development costs.

All Yukon resource revenues and their associated tax bases were outside of the TFF arrangements. The application of national average tax rates to Yukon's resources would not have provided a net fiscal benefit for resource revenues, hence their exclusion from TFF. Further, Yukon had three distinct offset arrangements for its land revenues based upon when Yukon took administrative control of the lands¹.

The Yukon has arrangements with its First Nations within their Land Claims Agreements in regards to the sharing of Yukon's resource royalties.

Overall, Yukon's treatment of resource revenues is similar to that provided to the provinces. The Yukon's resources in effect have a separate tax base because of their distinct characteristics. However, all resource revenues are lumped into two separate groupings, one for oil and gas revenues, and one for forestry, minerals, water and land revenues.

Northwest Territories

The NWT is seeking the devolution of 100 per cent of resource revenues to NWT governments (territorial and Aboriginal), along with adequate fiscal resources to permit the governments to manage the resource programs. It is expected that resource revenues will be an integral component of federal/territorial/Aboriginal governments' financing arrangements.

Resource revenue offset arrangements must recognize two critical differences between resource revenues and other sources of government revenue. First, resource revenues are associated with a non-renewable resource. The territories' residents must be compensated for the loss of this valuable resource and receive a fair net fiscal benefit in order to create an incentive to promote development of the resource. Second, resource development entails significant costs to government, costs that must be recognized in offset arrangements.

The NWT proposal to Canada calls for the retention, without any offsets, of the first \$68 million dollars of annual non-renewable resource revenues (oil and gas revenues and mineral revenues). For revenues above \$68 million, the NWT proposes an offset rate of 60 per cent. The initial excluded amount recognizes the significant expenditure impacts created by non-renewable resource development on the NWT, and the need for significant investment to promote further development. This amount would be shared between the territorial and Aboriginal governments and recognizes the need for Aboriginal governments for revenues to support capacity building and to deal with development impacts. The GNWT has provided detailed analysis supporting its

¹ For lands transferred to the Commissioner before TFF came into effect, there is no offset and the Yukon keeps 100 per cent of these revenues. For lands acquired between April 1, 1985 and March 31, 2003, the revenues are offset against the Tax Effort Adjustment Factor. For lands acquired with the Northern Affairs devolution on April 1, 2003, the offset arrangements are as noted above and these revenues are grouped with minerals, forestry and water revenues.

proposal, including information on the direct costs for infrastructure, training and increased social programming caused by non-renewable resource development.

The NWT's forestry revenues are included in Eligible Revenues under the previous TFF arrangements.

Nunavut

Like the NWT, Nunavut is also seeking a devolution agreement that would permit future Nunavut governments to manage both renewable and non-renewable resource programs. The federal government has indicated that it expects devolution negotiations will be initiated.

First Nation/Aboriginal Self-Government Revenues

The Yukon, Northwest Territories and Nunavut have distinct arrangements in regards to their First Nation and Aboriginal peoples. These distinct arrangements need to be respected within the context of TFF arrangements.

Yukon

Yukon has ten First Nations with Final Agreements (signed land claims agreements). An additional four have yet to sign Final Agreements. Yukon has a commitment to transfer back to Canada any net savings that Yukon may realize as a result of a First Nation drawing down program responsibilities being provided for by the Yukon government.

First Nations with Final Agreements have full taxation authority on their Settlement Lands. Yukon's taxation authority is also not diminished on these lands. How much tax capacity is available to each of the Yukon and the First Nation governments needs to be determined before a change to the previous treatment of Yukon revenues, based on a 1992-93 Catch-Up Factor, can be introduced into TFF arrangements. Both First Nations and Yukon governments cannot be expected to collect revenues at NATR from the same tax base. The combined Yukon and First Nation tax rate is limited to the NATR. One cannot impose the collection of twice this amount and maintain reasonable comparability of taxation levels.

Tax sharing between the territorial government and First Nations/Aboriginal governments also needs to be considered when changing the treatment of tax revenues under TFF. Yukon First Nations had a PIT tax moratorium in place before their land claims came into effect. NWT Aboriginal governments did not have such a moratorium. The NWT was informed that if it shared PIT with Aboriginal governments, it would not receive the same consideration for Eligible Revenues as Yukon was receiving in regards to its sharing of PIT with its First Nations. This ability to exclude revenue means that the Yukon has a number of issues related to fiscal capacity that are not issues for the NWT and Nunavut.

Northwest Territories

There are currently seven active self-government negotiation processes in the NWT, covering one-half of the territory's population. Financing issues are a critical element of self-government. The federal government continues to maintain that the incremental costs of creating Aboriginal self-governments can somehow be paid for from within

existing spending and has not addressed the issue of funding for building community capacity. Only the Tlicho have finalized their self-government agreement, but have not yet implemented it.

The expected outcome of Aboriginal self-government is that Aboriginal self-governments will be recognized as having the legal authority to tax their citizens on their lands and in their communities, and a number of these governments may wish to exercise this authority as part of becoming a responsible government. However, for this authority to be exercised equitably for all NWT residents, the optimal solution would be for the federal government and the GNWT to co-operate to vacate tax room. This would represent a revenue loss to the GNWT. Unless an Aboriginal self-government takes responsibility for program expenditures currently provided by the GNWT, the GNWT cannot share tax room without being compensated under the TFF Grant.

The GNWT approach to self-government negotiations to date has been framed within the context of the previous TFF structure. The changes announced under the New Framework add uncertainty to financing discussions, as it is expected that flow-through of financing for NWT self-government entities from the GNWT will be done in a similar manner as the GNWT receives funding from the federal government.

Nunavut

The arrangements with Aboriginal people are totally different in Nunavut from those within the other territories. The creation of Nunavut was a result of the Nunavut Land Claims Agreement (NLCA). Article 25 of the NLCA states that Inuit have the right, in each and every calendar year, to be paid an amount equal to 50 per cent of the first \$2 million of Nunavut resource royalties received by any government and an additional 5 per cent of any additional royalties.

OPTION 2 - EXPENDITURE/REVENUE SIMPLIFICATION

A simpler option to Option 1 would be to disaggregate the new framework transfer by using each territory's individual share of the 2005-06 fixed transfer as the starting points and to escalate each territory's 2005-06 legislated amount by an appropriate escalator (i.e. not the arbitrary 3.5 per cent escalator imposed by the federal government). A return to the population adjusted growth in provincial-local government expenditures is advocated by the territories as the most appropriate escalator for both options because it re-establishes the previously accepted proxy for providing the territories with sufficient fiscal resources to deliver government programs and services at levels comparable to the provinces.

This alternative eliminates the previous GEB and eligible revenues calculation and instead starts with an initial base transfer, which is each territory's 2005-06 "fiscal gap" based on an average of each territory's fiscal gaps from 2002-03 to 2004-05 (October 2004 estimates). This initial transfer is the former TFF expenditure base net of all calculated eligible revenues for each territory and would equate to the New Framework's aggregate transfer value (essentially a net expenditure base). As revenues are, by design, part of the initial transfer base, this option would eliminate the revenue calculation other than for specifically defined arrangements.

This approach then requires that the established relationship between the former expenditure base net of revenues or the “fiscal gap” would then be escalated by the population-adjusted growth in provincial-local government expenditures.

Own-source revenues are exempt because the relationship between revenues and the transfer has been established in the determination of the base year transfer (represents the old expenditure base minus eligible revenues). Since Option 2 excludes other territorial revenues from the Grant, territories are able to benefit from their rate and volume increases, providing the territories with a clear incentive to invest in economic activities. Further, excluded new revenues from other federal program funding eliminates the intervention in new federal program funding by federal officials that was a problem in the previous TFF arrangements.

Table 7 shows the fiscal implications of Option 2 compared to escalating each territory's Grant by 3.5 per cent before consideration of resource revenues, Aboriginal revenues and future need for change. As with Option 1, the technical adjustment to each Grant due to a provincial/local government pension data in the previous TFF escalator is not included because it is being paid to the territories through other legislation. However, it is expected that this adjustment will be added in 2006-07.

Table 7. Fiscal Implications of the Expenditure/Revenue Simplification

	<u>2005-06</u>	<u>2006-07</u>	<u>2007-08</u>	<u>2008-09</u>	<u>2009-10</u>
New Framework - Individual TFF escalated by 3.5%					
Yukon	487	504	522	540	559
Northwest Territories	714	739	765	792	819
Nunavut	799	827	856	886	917
Total	2,000	2,070	2,142	2,217	2,295
Year over Year % Change	5.3%	3.5%	3.5%	3.5%	3.5%
Option 2: Expenditure/Revenue Simplification					
Yukon	487	509	531	552	574
Northwest Territories	714	745	778	812	848
Nunavut	799	838	881	923	966
Total	2,000	2,093	2,191	2,287	2,388
Year over Year % Change	5.3%	4.6%	4.7%	4.4%	4.4%
Difference from Fixed Amount Escalated by 3.5%					
Yukon	0	5	9	12	15
Northwest Territories	0	6	13	21	29
Nunavut	0	11	26	37	49
Total	0	23	48	70	93

The New Framework Hybrid would also provide flexibility in adjusting for devolution or adding new federal programs and initiatives. A formal negotiated adjustment for any new responsibilities transferred to a territory would be made to the base transfer in the year the new responsibilities were assigned. An adjustment to the base transfer for any new

federal programs or federal initiatives would be the cost of the new program less any associated revenues.

Structure of Option 2

Table 8 provides an example of how Option 2 could treat revenues in the case of the Yukon.

A. Escalator

This option suggests the adoption of a new non-arbitrary escalator to adjust the new Final Base Transfer (Initial Base Transfer plus associated adjustments). The most appropriate candidate would be the original escalator used in TFF as it was based on the growth of provincial/local government expenditures (PL) and the differential growth in the territorial population compared to the national population. A return to the interactive escalator of the growth in provincial/local government expenditures and the population growth factor used in the previous TFF would provide a more responsiveness and adequate escalator, while reflecting the reality of the expenditure needs of the territorial governments.

B. Base Transfer

The dynamics of the “New Framework” are that of a zero sum game. The perversity of the competitive environment for the territories may be similar to equalization. However, in a three-player game where the stakes are 70 to 90 percent of total revenues and in the absence of the flexibility of own-source revenues (as provinces have) marginal gains are significant and competitive behavior necessary. This approach is not in the interests of long-term development of the territories. Consequently, this option also disaggregates the transfer into three separate territorial transfers.

B.1 Initial Base Transfer (Table 8)

The hybrid option adopts the concept of a base transfer (call it the Initial Base Transfer [IBT] to distinguish it from the Gross Expenditure Base it no longer represents). This is the “New Framework’s” current transfer but disaggregated into three separate transfers, one for each territory and independent from each other. The IBT is the net grant that reflected the interaction between the original expenditure base and the total eligible revenues and recoveries under TFF and could be viewed as a net expenditure base.

B.2 Base Adjustments (Table 8)

This option suggests the need to address the adequacy failings of the current transfer. The “New Framework” quantum was fabricated on an inadequate expenditure base as a result of federal actions and consequently should be augmented with adjustments for 5 per cent cut and GDP ceiling (as documented in August 2003 Joint Territorial Business Case). A simple adjustment based on the Business Case should be made as a one-time adjustment to each of the new IBTs.

This option also permits base adjustments for the ongoing evolution of the North and eliminates the inflexibility of the “New Framework”. Specifically, adjustments would be accommodated to adjust the initial base transfer for devolution, new federal programs and initiatives, and other changes that may emerge in the future (an example is the need

for an adjustment for 2005-06 to reflect Yukon's full program responsibilities as a result of devolution of the Devolution Transfer Agreement). Other adjustments would include the EDI buyout as it is no longer part of revenues or for such issues as devolution the amount of the adjustment would be part of the transfer agreement and represent a negotiated value. For other funding, such as new federal program or initiatives, the adjustment could simply be the cost of the initiatives net of associated revenues (recoveries for new agreements would be part of revenues and exempt - the only IBT adjustments to be made would be anything not covered by the funding payments or as part of an agreement between the territory and the federal government).

C. Revenue Adjustments

The application of the concept of the IBT assumed that most revenues would be excluded from any calculation. The IBT is a net concept that represented the grant value for the territories, or simply the original gross expenditure base less eligible revenues. A disaggregated IBT then assumes that all eligible revenues have been netted out and that all other revenues by design were excluded at the time of determining the "New Framework" quantum. Any new revenues then would also fall outside of the IBT and therefore excluded.

However, there may still be some revenue offsets or additions depending upon the associated agreement in areas such as resource revenues, First Nations/Aboriginal self-government, and other future needs for change.

C1. Resource Revenues (Table 8)

Resource Revenues would be treated as established by negotiated agreements. The Yukon resource revenues agreement is an example – the Yukon would retain the agreed upon revenues and the rest would be returned to the federal government.

C2. First Nations/Aboriginal Government Revenues (Table 8)

Creative solutions to dealing with First Nations/Aboriginal government could be developed. There would be no need to address First Nations/Aboriginal government revenue capacity, as territorial revenue capacity would not be re-calculated. However, any tax revenue sharing would have to be addressed via an addition to the new GEB measure. Any net cost savings would have to be adjusted in the actual program transfer to take into account any sharing of tax revenues with First Nations or Aboriginal governments by subtracting an appropriate amount from the GEB adjustment for the shared revenues.

Other Territorial Revenues (Table 8)

CHST/CHT/CST and other transfers are part of territorial revenues and would flow as to the provinces, exempt from any offset or conditions other than imposed for provinces. Territories would also receive all other transfers currently available and again not subject to any adjustment.

Table 8. Option 2 – Treatment of Revenues – Yukon

\$ Millions	2005-06	2006-07	2007-08	2008-09
New Territorial transfer				
A. Escalators				
P/L Growth	1.0383	1.0367	1.0384	1.0399
Population Factor	1.0097	1.0082	1.0041	1.0000
Escalator	1.0484	1.0452	1.0427	1.0399
B. Base Transfer				
Initial Base Transfer	487.1	509.2	530.9	552.1
Base Adjustments	7.3	7.6	8.0	8.3
PL pension data adjustment	7.3	7.6	8.0	8.3
Devolution	?			
Adequacy	?			
Other	?			
Final Base Transfer	494.4	516.8	538.9	560.4
C. Revenue Adjustments				
Resource Revenue	-0.96	-0.96	-0.96	-0.96
First Nations	0	0	0	0
Other	0	0	0	0
Total Revenues Adjustment	-0.96	-0.96	-0.96	-0.96
D. Total Federal Transfer	493.5	515.8	537.9	559.4
Other Territorial Revenues				
A. Other Transfers				
CHST/CHT/CST	37.75	31.01	32.12	33.25
Other Transfers	0.46	0.5	0.5	0.5
Total Other Transfers	38.21	31.51	32.62	33.75
B. Own-source Revenues				
Own-source Revenues	75.7	76.5	77.6	78
Stabilizer Adjustment	0	0	0	0
Total Own-source Revenues	75.7	76.5	77.6	78
Total Other Territorial Revenues	113.91	108.01	110.22	111.75
Total Territorial Recoveries	34.7	45.1	45.1	45.1
Total Revenues and Recoveries	642.1	668.9	693.2	716.2

Revenue Stabilization Fund

Given the volatility of resource based northern economies, there will be a need to provide stability to overall territorial funding. Dramatic decreases in government revenues as the territories have experienced in the past, are a primary concern for the territorial governments. Under Option 2, it is proposed that a “stabilizing adjustment fund” be established.

The stabilizing adjustment fund would place the net federal revenues generated from the resource revenue sharing agreements into revolving funds (possibly for a set period of time) to be used in the event of dramatic year-over-year declines in territorial own-source revenues.

If the revenue stabilization fund were not required within a specific period, some of the accumulating funds could flow out of this revolving fund to the federal government as new resources revenues are introduced (example: a five year fund could be established in which the proceeds [or a part thereof], are put into the fund each year. If monies are not needed after five years, the funds that were put in five years earlier could be taken out as the current year's contributions are put in).

Alternatively, a total value of the fund could be established and once met and held constant (allowed to grow as an investment), the rest of the federal portion of resource revenues would flow to the federal government.

The justification for such a fund is based on the fact that these resource revenues are the product of the North and represent the depleting capital of this region. These funds are a product of the North and should benefit the North in some manner, especially in downturns in their economies.

CONCLUSION

This paper was in response to the Expert Panel's request that the territories provide a joint proposal expressing what the territories would like in terms of new Territorial Formula Financing Arrangements. The paper starts from the premise that the New Framework with a fixed amount escalated by 3.5 percent is inappropriate in the context of federal/territorial fiscal arrangements. The fixed amounts create a zero sum game for the territories where increases in one territory's TFF Grant comes at the expense of the other territories. Given the widely divergent stages of political and economic development in the territories and the fact that the TFF is the vast majority of each territory's revenues, the fixed amount proposed by the New Framework is not appropriate. The territories acknowledge the federal government's objective to increase stability in transfer payments. However, TFF is a small program and the variability of entitlement is relatively small for the federal government.

The paper provided two options for the new TFF arrangements. Both options start from the premise that each territory's TFF arrangement must be separate and stand-alone. Both options adhere to the established principles of TFF, although the weights given to the different principles vary. The prevailing view in the territorial governments is that the previous TFF arrangements have served the needs of the territories reasonably well. However, the major weakness of the former TFF arrangements resulted from arbitrary adjustments to the previous TFFs arrangements that made them inadequate to fully cover the gaps between the expenditure needs of each territory and its ability to raise revenues. The territories are now at very different stages in their economic and political development. By offering the two options presented in this paper, the territories are seeking arrangements that will continue to fill the fiscal gap while recognizing the very different circumstances that each faces.

APPENDIX A. HISTORY AND STRUCTURE OF TERRITORIAL FORMULA FINANCING

The majority of territorial revenue is from the annual Territorial Formula Financing Grant. This note describes the calculation of current Formula Financing Grant and changes to the Grant calculation since it was introduced in 1985-86. Since 1985 and until the October 2004 First Ministers' Meeting, the Territorial Formula Financing arrangements between the Government of Canada and the territories were provided in the form of agreements that were renewed every five years. These agreements were used to calculating the annual Territorial Formula Financing Grant from Canada.

A. BASIC STRUCTURE OF THE PREVIOUS FORMULA FINANCING GRANT

The previous *Territorial Formula Financing Agreements 1999-00 to 2003-04* between the Governments of Canada and the three territories describe the basis for the calculation of each territory's Formula Financing Grant. The Grant is based on the "gap-filling" principle and theoretically measures the difference between the territory's expenditure requirements (needs) to provide comparable levels of public services as the provinces and its revenue-raising capacity (means) at comparable levels of taxation as the provinces, as shown below:

$$\text{Grant} = \text{Expenditure Requirements} - \text{Revenue-Raising Ability}$$

Expenditure requirements were proxied by a Gross Expenditure Base (GEB). The GEB is intended to represent the amount of expenditure requirements of the each territory, taking into account the higher costs and needs in the North to deliver public services of similar quality to those in the provinces.

The original 1985-86 GEB was set equal to actual 1982-83 expenditures of the Yukon and GNWT (predivision) escalated by the growth in provincial-territorial/local spending from 1983-84 to 1985-86. In 1996-97, as part of the federal government's fiscal restraints, the GEB was reduced by 5 per cent. This reduction has not been fully restored, although increases in the Canada Health and Social Transfer since the cut are considered partial restoration. At division of the Northwest Territories into NWT and Nunavut, the GEB was split as of 1996-97 based on the ratio of expenditures within each jurisdiction and each territory received an enhancement to the GEB to take account of higher costs of government in the smaller jurisdictions.

The revenue-raising ability of the territories take into account the various revenue sources that the government has at its disposal in order to raise revenues, including federal transfers (not including the Grant itself), various taxes and fees, and recoveries. The revenue raising ability examines how much each territory could raise from these sources either at actual values (in the case of transfers or recoveries) or at hypothetical values that reflect a standard amount of tax effort (in the case of taxes and fees). This revenue-raising ability is referred to as Eligible Revenues.

Hypothetical revenues are used in the Formula Financing instead of actual revenues to create the incentive for a territory to raise its own revenue through tax rate increases.

Similarly, the GEB is a proxy for each territory's expenditure needs, not actual expenditure needs, allowing the territory, through an unconditional block transfer, to determine its own spending priorities.

B. THE CALCULATION OF THE GROSS EXPENDITURE BASE

The Formula Financing Grant's Gross Expenditure Base (GEB) is escalated by the lesser of the growth in provincial/territorial-local government spending (P/T-L escalator) or the growth in the Canadian economy (GDP ceiling) multiplied by the ratio of the population growth in the NWT relative to the population growth for Canada (Population Adjustment Factor or PAF escalator). The resulting escalator is called the Population Adjusted Gross Expenditure (PAGE) escalator. Each part of the PAGE is calculated using a three-year moving average of the annual growth rates. Therefore growth in an escalator takes three years to be fully realized in the calculation of the GEB.

The PAGE escalator ensures that the GEB grows at the same rate as aggregate provincial/territorial-local per capita government expenditures, whenever the ceiling provision does not bind. The GDP ceiling was removed effective 2002-03.

Adjustments may be made to the GEB through negotiations with the federal government. Common adjustments to the GEB include those resulting from the transfer of program responsibilities to a territory from the federal government. When transferred programs involve expenditure responsibilities, the federal government generally provides additional funding to the territory in the form of a GEB adjustment. After the amount of the transfer is negotiated between the two governments, the GEB is increased by the amount of the transfer and the escalator is also applied to the transferred amount.

The GEB may also be adjusted to reflect expenditure requirements imposed by the federal government on the territories as a result of federal initiatives that are beyond the ability of the territories to control or absorb into its existing budget. One-time payments may also be added to the GEB; however, these are not included in the GEB subject to PAGE.

C. THE CALCULATION OF ELIGIBLE REVENUES

Eligible Revenues are territorial revenues that are subtracted from the GEB calculated annually from adjusted actual territorial revenues for the fiscal year.

Revenues explicitly excluded from the original GEB and new revenues associated with new expenditure initiatives that have not been compensated for through a GEB adjustment, are excluded, since they are required to fund expenditures not covered by the GEB. Therefore, any new recovery or transfer payment program introduced after March 31, 1985 and any new revenue source introduced or revenues resulting from rate increases introduced after the base year (1992-93 in the 1999-00 to 2003-04 Agreement) are excluded from the Formula.

Revenues are included in the Formula when they fund expenditure responsibilities that are funded through the GEB to avoid double funding. These include revenues:

- collected by the territories in 1982-83 and, therefore, are included in the original GEB; or
- transferred through a program transfer and compensated for by an adjustment to the GEB.

There are three categories of eligible revenues: transfers (Category 1), taxes and fees (Category 2) and recoveries and fines (Category 3).

Transfers, recoveries and fines (Categories 1 and 3 revenues) enter the Formula as their actual values and therefore reduce the Grant dollar for dollar as their collections increase.

Category 2 revenues include all revenues for which the territory controls tax or recovery rates, such as all taxes, all fees and licenses, and some recoveries over which the territorial government has control of the recovery rate, as, for example, staff housing rentals. Since the 1990-91 Agreement, Category 2 revenues have been adjusted for tax effort from a base year. Revenue from tax rate increases since the base year of the Agreement is excluded from the Grant calculation.

Tax effort is the measure used to calculate the extent to which a government uses the tax room, or fiscal capacity, available to it. For example, none of the three territories levies a sales tax but they have the potential to do so and therefore their tax effort for the sales tax revenue source is zero. The territories' tax efforts are measured against 85 per cent of the national average tax rate for each revenue source. This 15 per cent reduction is referred to as the Northern Conditions Discount but there is no background work indicating how this number was derived.

The tax effort measurement, called the Tax Effort Adjustment Factor (TEAF), has two parts: the Catch-up Factor (CUF) and Keep-up Factor (KUF). The CUF is calculated using the Representative Tax System (RTS) of the federal-provincial Equalization program.

The CUF is determined at the beginning of the five-year Agreement using a base year with actual data (usually 2 years prior) and is calculated as:

$$\text{Catch - Up Factor} = 0.85 \times \left(\frac{\text{Territory's fiscal capacity in base year}}{\text{Territory's actual tax revenues in base year}} \right)$$

The Keep-up factor measures the cumulative change in the tax effort of the provinces since the base year and is calculated using the Equalization program estimates:

$$\text{Current Year Keep - Up Factor} = \left(\frac{\text{Provincial - local tax effort in Current Year}}{\text{Provincial - local tax effort in Base Year}} \right)$$

The CUF multiplied by the KUF equals the TEAF.

For administrative simplicity, the 1999-00 to 2003-04 Agreements for NWT and Nunavut included a Revenue Block that includes all minor Category 2 revenues subject to the

TEAF. These revenues are determined in the first year of the Agreement (1999-00) and were not adjusted for the remainder of the Agreement. All large tax revenues and liquor revenues were calculated on an annual basis.

Category 2 hypothetical revenues are also adjusted by the 20 per cent Economic Development Incentive (EDI). The EDI excludes 20 per cent of adjusted hypothetical Category 2 revenues from the Grant. The EDI was introduced in 1995-96 to 1998-99 Formula Financing Agreement at the request of the territories to provide more of an incentive within the Formula for the territories to encourage economic development that would generate more government own-source revenues.

The EDI was made revenue neutral in the year it was introduced (1995-96) by an offsetting reduction in the GEB. This offset was equivalent to the value of 20 per cent of the territories' hypothetical revenues in 1995-96. This 20 percent offset or "buy-in" was also subject to the GEB Escalator for each year following 1995-96.

Pros and Cons of Previous Territorial Formula Financing Arrangements

Pros	Cons
Reflected the principle of filling the fiscal gap between a territory's expenditure needs and its ability to raise its own revenues.	<p>The GEB level was not considered adequate following arbitrary reductions imposed by the federal government. No significant study has been undertaken into the adequacy of the GEB</p> <p>The base year/tax effort adjustment factor arrangement may result in perverse situations where an increase in own-source revenues due to an expanding tax base decreases the Grant by more than the increase in own-source revenues.</p>
Was flexible in adapting to changing circumstances and evolving responsibilities in a territory. Devolution of programs could be easily accommodated in individual Grants.	
Stabilized a territory's total revenues. If own-source revenues decreased, the Grant increased (and if own-source revenues increased, the Grant decreased).	Forecasting could be difficult because changes in data have significant effects on the TFF. Since the TFF Grants form the majority of territorial revenues, changes in data had significant effects on total revenues.
Provided incentives for the territory to raise its own revenues and set tax rates at levels comparable to other jurisdictions, with consideration for special northern conditions.	The 20 per cent Economic Development Incentive (EDI) within the Formula was not considered an adequate incentive for the territories to promote economic development and expand revenue sources once the effects of the Tax Effort Adjustment Factor were taken into account. Since the EDI was "bought" in the implementation year through an equivalent reduction in the GEB, over the last few years it did not provide a net fiscal benefit for either the Yukon or Nunavut.

Formula Financing Agreement History

Pre 1985	<ul style="list-style-type: none"> Annual Grants to territories from DIAND based on negotiations and substantiation of need.
1985-86	<ul style="list-style-type: none"> First Formula Financing Agreements. GEB escalated each year by 3 year moving average growth in provincial-local government spending.
1988	<ul style="list-style-type: none"> Escalator amended to include GDP ceiling. Three year moving average of Canadian nominal growth rate added to place limit on upper growth of GEB. Escalator used was lesser of P-L or GDP escalators.
1990-91	<ul style="list-style-type: none"> Population escalator added (ratio of each territory's population growth rate to Canadian population growth rate). TEAF introduced as Catch-up factor times Keep-up factor. Catch-up factor was reduced 15% to reflect differences in tax regimes between territories and provinces as a result of different economies. Catch-up factor equals $(.85)[\text{territory fiscal capacity in base year} / \text{territory actual tax revenues in base year}]$. Keep-up factor in year A = Provincial-local tax effort in year A / Provincial-local tax effort in base year.
1995-96	<ul style="list-style-type: none"> 1995 Federal Budget freezes 1995-96 Grant at 1994-95 levels and cuts 1996-97 Grant GEB by 5%. The 5% cut permanently reduced each GEB for subsequent years. (Cut was to reflect the cut in CHST that affected other provinces.) Economic Development Incentive (EDI) of 20% introduced on TEAF adjusted hypothetical revenues. The EDI was to remove the economic development disincentive of the TEAF. A condition of the EDI was to make it revenue-neutral in the first year by the permanent removal from the GEB of 20% of the TEAF adjusted hypothetical revenues.
1996-97	<ul style="list-style-type: none"> 1996-97 GEB cut by 5%. The 5% cut permanently reduced the GEB for subsequent years. (Cut was to reflect the cut in CHST that affected provinces.)
April 1, 1999	<ul style="list-style-type: none"> NWT divided into NWT and Nunavut. New Formula Financing Grant GEBs determined for post-division NWT and Nunavut based on identification of corporate costs and geographical allocation of program spending.
1999-00	<ul style="list-style-type: none"> P-L escalator based on gross rather than net government spending (reflected territorial spending better as it includes expenditures by health and education boards). GEB losses under GDP ceiling can now be regained in subsequent years. Revenue Block agreed to for GNWT and Nunavut. Large territorial revenues (income, tobacco, payroll, fuel taxes, liquor commission income, property tax and school levies) will be calculated each year. Other own source revenues will be fixed at 1999-2000 level for the entire agreement.
March 2001	<ul style="list-style-type: none"> Federal government agrees that all PL data is closed when a year closes and revises the 1994-95 and 1995-96 PL growth rates accordingly. This gives the NWT \$73 million in retroactive Grant payments to 2000-2001.
June 2003	<ul style="list-style-type: none"> Federal government to not rebase the 2002-03 and 2003-04 Grants from 1992-93 to 1999-00 as required in the <i>Territorial Formula Financing Agreement 1999-00 to 2003-04</i> due to data quality concerns.
October 2004	<ul style="list-style-type: none"> TFF changed to legislative fixed amounts for 2004-05 and 2005-06 and total amount for all three territories to be escalated by 3.5% annually. An Expert Panel on Equalization and Territorial Formula Financing to provide recommendations on allocation of the fixed amounts starting 2006-07. Expert Panel report expected in late 2005. The adequacy of the 3.5% escalator to be reviewed in 2008-09.

APPENDIX B. TAX EFFORT ADJUSTMENT FACTOR IN PREVIOUS TFF ARRANGEMENTS

The previous TFF arrangements included a Tax Effort Adjustment Factor (TEAF) that measures each territory's tax effort against the national average. The TEAF is described in more detail in Appendix A. However, essentially the TEAF was introduced by the federal government as a way to correct the federal perception of low tax effort on the part of the territories. The TEAF is the product of a Catch-up Factor (CUF) times a Keep-up Factor (KUF).

The CUF is the static measure of the tax effort of the territory compared to the provinces. Data issues meant calculating the CUF on an annual basis was not feasible. Tax effort is the measure used to calculate the extent to which a government uses the tax room, or fiscal capacity, available to it. Each territory's tax effort was measured against 85 per cent of the national average tax rate for each revenue source. The 15 per cent reduction in the tax effort was referred to as the Northern Conditions Discount and was a reduction in recognition of unique Northern circumstances with respect to revenue raising ability. However, the reduction was arbitrary and there is no background information to explain how the 15 per cent reduction was derived.

The CUF is calculated using the Representative Tax System (RTS) of the federal-provincial Equalization program as follows:

$$\text{Catch - Up Factor} = 0.85 \times \left(\frac{\text{Territory's fiscal capacity in base year}}{\text{Territory's actual tax revenues in base year}} \right)$$

The Keep-up factor (KUF) measures the cumulative change in the tax effort of the provinces since the base year and is calculated using the Equalization program estimates.

The TEAF is applied to Hypothetical Revenues, which are the revenues that the territory would have raised using the tax rates of the base year. This means that any tax rate changes since the base year were not included in the Formula Financing Grant calculation.

When the TEAF was imposed on the Formula Financing Grant (1990-91), the expectation was that the combination of CUF, KUF and tax rate adjustments would mean that rebasing the CUF on a five year interval would have little or no revenue impacts. From 1992-93 to 1998-99, the KUF was greater than one and since 1999-00 the KUF has been decreasing, which means that provincial tax effort has decreased. Over the same period, NWT tax rates have increased. The logical conclusion is to assume that a re-based CUF would be less than the current 1992-93 CUF. Instead, the 2000-01 CUF is significantly greater than the 1992-93 CUF for both the Yukon and the NWT.

In February 2004, federal Finance provided a 2000-01 CUF calculation for the NWT of 1.16056, which is 12 per cent higher than the NWT/Nunavut combined 1992-93 CUF of 1.03528 and almost 5 per cent higher than the NWT Finance estimate of 1.10918. The

Yukon 2000-01 CUF is almost 13 per cent higher than its 1992-93 CUF. Nunavut's CUF was 14 per cent lower, although its tax rate changes were identical to the NWT's.

Given the level of both the Keep-up Factors and the NWT tax rate adjustments, the expectation was for a lower CUF. The results of the current 2000-01 CUF calculations therefore suggest that there is something fundamentally wrong with using the current system to measure the tax effort of the territories compared to that of the provinces. In addition to the higher CUF, the territories lose their tax rate adjustments from the 1992-93 base year. This would reduce the NWT Grant entitlement by approximately \$45 million per year and the Yukon Grant Entitlement by approximately \$25 million per year. The combination of a lower CUF, but loss of tax rate adjustments will mean that the Nunavut Grant will be roughly unchanged from rebasing.

2000-01 CUF Calculations

	NWT	Yukon	Nunavut	NWT/Nunavut Combined
Federal Finance CUF Calculation (Feb. 3, 2004)	1.16056	1.48177	0.89022	1.11345
NWT CUF Calculation *	1.10918	1.53095	1.09566	1.10723
1992-93 CUF	1.03528	1.31526	1.03528	1.03528

* Incorporates NWT Power Corp income into CIT base, uses 50% user fees as per Equalization, adds payroll tax into PIT timing adjustments, and makes some adjustments to NWT revenues and tax bases.

The reasons for the higher than expected 2000-01 CUF for the NWT can be easily explained in terms of the mechanics of calculating the CUF. The weights of revenues within the calculation drive the result.

The higher CUF for the NWT was primarily a result of the combination of changes in revenue weights and tax effort factors for the miscellaneous income and business income revenue categories. The changes in weights in the CUF dominate all other factors. The 1992-93 miscellaneous income revenues include the Gross Petroleum Revenue Fund revenues, which increased both the weight and the tax effort of the miscellaneous revenues in the CUF. These revenues were mostly from Nunavut and are the main reason why Nunavut's 2000-01 CUF is so low. However, even a combined Nunavut/NWT 2000-01 CUF is still 7.6 per cent higher than the Nunavut/NWT 1992-93 CUF. The Yukon's CUF is higher than the other two territories because of different weights and tax efforts in different revenue categories.

The fundamental question is whether the CUF is an appropriate measure in the first place. Given the counter-intuitive results, a reasonable argument can be made that the tax bases used in the calculation are inappropriate for measuring the fiscal capacity and the corresponding tax effort of the territories.

There are several major technical issues with the 2000-01 calculation that have not been discussed with Finance Canada officials. If the decision is to continue with the previous TFF arrangements after 2005-06, then these issues will have to be discussed. However, the Expert Panel may decide to recommend a different approach to measuring fiscal capacities of the territories.

Tax effort is simply the ratio of actual revenues collected to the amount of revenues a jurisdiction could collect at defined levels of taxation. Since actual revenues are easily measured, the measurement issues are about what is the appropriate way to measure fiscal capacity given data constraints and unique circumstances within the jurisdictions being measured. The following provides some of the issues that should be considered.

- Does the TFF require a comparison between territorial and provincial tax efforts if the total TFF becomes a fixed amount? Would a more appropriate comparison be between the relative tax efforts of the territories?
- If the recommendation is to continue with the previous TFF arrangements, should the tax burden on residents be taken into consideration in determining tax effort? The tax burden arguments were used to create the Northern Conditions Discount that reduces each territory's CUF by 15 per cent. It is possible that the Northern Conditions Discount should be higher.
- Given the territories' unique circumstances (small economies, high cost of living, lack of ability to export taxes, NWT and Nunavut do not have resource devolution), is the representative tax system an appropriate measure of fiscal capacity compare to the provinces?
- Is there some way to alleviate the many data concerns and reduce data shocks?