FINANCING ABORIGINAL SELF-GOVERNMENT

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Table of Contents

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I. Introduction

Self-government by aboriginal communities, as with any other community, necessarily implies fiscal responsibilities. The exercise of those fiscal responsibilities requires financing whether from own sources or from the outside. The purpose of this study is to investigate the forms of financing that might be made available to aboriginal governments and how the financial arrangements for aboriginal governments might be related more generally to the fiscal arrangements that exist between the federal government and the provinces and territories, and between the provinces and territories and their local governments. This is relatively uncharted territory, given the uniqueness of aboriginal governments compared with other political entities with decision making powers, and given the financial relationship that has existed to date between aboriginal communities and the federal government.[1] As such, it is our view that it is necessary to proceed from general first principles, followed by how those principles may be applied to an aboriginal setting. The purpose will not be to come up with particular numbers or even specific formulae for determining funding. Instead, some of the important features that funding arrangements should satisfy will be stressed. In the end, much of the application of the principles will need to be implemented through negotiation among the interested parties. Those negotiations will be better informed if the principles can be agreed upon in advance.

More particularly, the plan of the study is twofold. Our first objective is to articulate a set of general principles which we believe should underlie the design of any mechanism for financing aboriginal self-government in Canada. Our second task is to discuss alternative financing models at a fairly broad level, and to show to what extent these different possible approaches are consistent with this set of underlying principles. It should be noted that although we shall typically refer to a financing mechanism, in the singular, in actual practise there will no doubt be need to design financing mechanisms, in the plural. Apart from the fact that different objectives may be met by different programmes, just as equalization, EPF and CAP payments have distinct targets, it may also be the case that the actual variation in the breadth of responsibilities that different aboriginal communities choose to exercise may necessitate the development of a *menu* of financing plans. Nonetheless, all of these plans would be grounded on the same basic principles.

The outline of the study is as follows. In the remainder of this introductory section, we first articulate a set of general principles which we argue must underlie any satisfactory approach to financing aboriginal self-government, and then briefly discuss particular technical characteristics that should be sought in the financing mechanism. Then, in section II, we review those elements of the theory of fiscal federalism that are relevant to the present analysis before proceeding, in

[1] See, however, Malone (1986) and Courchene and Powell (1992).

section III, to briefly discuss the mechanisms that are used to finance existing self-government agreements, and to evaluate the extent to which these financing mechanisms are consistent with the general principles expounded here, and whether or not they display the technical qualities identified later in this section. Then, in section IV, we analyze a procedure by which fiscal equity may be achieved, and in particular examine the application of a two-step process for financing aboriginal self-government which incorporates key features of a desirable set of fiscal arrangements, including especially equalization. In section V, we discuss alternative sources from which aboriginal governments may choose to seek revenue. Section VI addresses the specific issues that must be resolved with respect to Treaty-based First Nations. Section VII focuses on some of the foreseeable difficulties that will be encountered in seeking to design a financing mechanism which is consistent with the general principles we advocate, as well as examining issues related to the transition to self-government. Our conclusions are contained in section VIII.

1.1 General Principles

Canada is a highly decentralised federation in which economic decision making is shared by federal, provincial/territorial, regional and municipal governments. The fiscal relationships among these various governments are highly developed and exhibit a number of features, many of which reflect desirable characteristics of fiscal federalism. An important consequence of the implementation of aboriginal self-government will be to increase the number of participants in Canada's fiscal federation. Although it is impossible, at the present time, to know precisely what powers and responsibilities will be exercised by aboriginal governments once self-government agreements are negotiated, it seems safe to affirm that the scope and content of these agreements may vary significantly from one aboriginal community to another. Moreover, it is unlikely that one will be able to draw an exact parallel between the set of public services which aboriginal governments will undertake to deliver to their citizens and those that are currently delivered by provincial, territorial or municipal governments to their respective constituents. This implies that the actual institutions which will link aboriginal governments to other levels of government in Canada, and most importantly to the Federal government, may or may not be directly comparable to the existing federal-provincial, federal-territorial, or provincial/territorial-municipal frameworks.

Notwithstanding these differences, we maintain that the first step that must be taken in designing a satisfactory mechanism for financing aboriginal self-government is to recognize that *if Canadian aboriginals are to be truly self-governing then the fiscal relationship which is established between existing levels of government and aboriginal governments must be founded on the same principles of fiscal federalism as those which presently shape the fiscal relationships among existing governments*. We take this `equal treatment' principle to be a consequence of consistency of treatment of the different self-governing communities in the federation and part of what it means to be a self-governing member of a federation. Indeed, at a more fundamental level, since governments can be viewed as simply the collective representation of the constituents they serve, the equal treatment of governments principle is itself a consequence of the principle that citizenship entails equal rights, regardless of whether they are aboriginal or not. Or, to put it as an economist might, persons in like circumstances ought to be treated alike; this is the so-called

principle of horizontal equity. As we shall see, it is a principle that to a considerable extent drives the form of fiscal arrangements in Canada. It entails that citizens should be given comparable treatment by the public sector whether they live in, say, Alberta or Nova Scotia. Applying this to aboriginal governments, otherwise similar citizens should receive comparable treatment whether they are residents of an aboriginal community or not. \vskip10pt This is a somewhat contentious point of view to take when it comes to aboriginal peoples. Basically, it says from the point of view of citizenship rights, aboriginals are no different from any other Canadian citizens. For example, they are entitled to the same protections of the Charter of Rights and Freedoms, and are governed by the same constitutional provisions. An alternative point of view is that aboriginals are members of sovereign nations with inherent rights of self-government, and that their fiscal treatment is determined solely by `government-to-government' treaties and negotiations. Abstract principles of equal treatment with non-aboriginal Canadians are then of no relevance, and constitutional provisions and protections such as the Charter of Rights and Freedoms need not be viewed as fully applicable to aboriginals. To the extent that one subscribes to this position, our general principles become less compelling. What might replace them from the point of view of guiding financing arrangements is not clear. Presumably, the latter would have to be determined by treaty-type negotiations with each First Nation unguided by principles of equal treatment. In particular, it is not evident that grounding a financing mechanism for aboriginal governments on the principle of appropriately meeting existing fiduciary responsibilities would enable aboriginal governments to provide their citizens with public services as of high a standard as those enjoyed by non-aboriginal Canadians. We believe that the strongest guarantee of ongoing adequate and equitable financing for aboriginal governments is obtained by basing the design of the financing mechanism on the principal of horizontal equity, which is at the heart of the financial arrangements between present participants in Canada's fiscal federation.

We are not in a position to rule on the validity of the general principles we are adopting. Our views on this are essentially informed by both the Charter of Rights and Freedoms and by Section 36(1) of the Constitution Act, 1982 (discussed in detail below), which lay out the basic precepts of equal treatment in a way that appears not to distinguish between aboriginal and non-aboriginal Canadians. We believe that this is not incompatible with the view that aboriginals have an inherent right of self-government, albeit a right that will be exercised as part of the Canadian nation. We suggest that these two positions can be reconciled by viewing the terms under which these nations will become participants in the Canadian fiscal federation as one dimension of the negotiations to be entered into between aboriginal nations and the government of Canada. Our analysis therefore remains pertinent under the assumption that the `terms of participation' are such that the precept of equal treatment applies. We therefore proceed on the premise that aboriginals should be treated equitably with non-aboriginal Canadians by the fiscal actions of governments in Canada, and therefore that the same sorts of principles which govern financial relations among existing governments in the federation, all of which reflect the extent of `self-government' of those units, should also govern the financial arrangements for aboriginal governments. Consequently it is worth spending some time enunciating our view of the key features of existing fiscal arrangements within the Canadian federation. These will be addressed in somewhat more detail in the next section.

The Canadian federation exhibits a number of characteristics. The constitution recognises two main levels of government --- federal and provincial. Local governments are typically subservient to the provinces in which they are located and are governed by provincial constitutions and legislation. Similarly, the territories are essentially creatures of the federal government, but with some exceptions are treated effectively like provinces. From a financial point of view, the territories receive somewhat more generous equalizing transfers from the federal government than do the provinces, but unlike the provinces they do not have direct access to natural resource revenues. Where it is not important for the context, we shall not explicitly differentiate territories from provinces. This political structure gives rise to a hierarchical financial relationship in the federation, with the federal government dealing with the provinces and territories, and the provinces and territories dealing with local governments within their jurisdictions.

On the expenditure side of the budget, the provision of goods and services by the public sector is highly decentralised in Canada in comparison with other federations around the world, with the provinces (and their local governments) responsible for virtually all of the major public services, such as education, health and welfare. The federal government is restricted in its provision of goods and services to national public goods, such as defense, foreign affairs and the operation of the monetary system. The consequence is that in terms of goods and services expenditures, the provinces are considerably bigger than the federal government. In practise, much of what the federal government does is to make *transfers* of various sorts --- to individuals, to businesses and to governments. About one-quarter of federal programme expenditures (i.e., expenditures excluding interest payments on the federal debt) go as transfers to the provinces, reflecting a common characteristic of federations that expenditure functions are more decentralised than are revenue-raising responsibilities. That is, there is a *fiscal* gap at the provincial level of government.

On the tax side, the federal government and the provinces co-occupy most of the main tax sources, particularly the individual and corporation income taxes, and the sales and excise taxes. This has led to certain forms of tax sharing and tax harmonisation arrangements. In the case of the individual and corporation income taxes, the Tax Collection Agreements allow each province to turn over to the federal government the right to collect taxes on its behalf provided the province agrees to abide by the federally-defined base and the rate structure. Provinces retain the right to set their own tax rate levels. Though not all provinces belong to the Tax Collection Agreements, the latter have nonetheless resulted in a highly harmonised income tax system in which the base is common and the allocation of revenues among provinces is agreed to. Notably, the fact of a common base has enabled the federal government to use the transfer of income tax points as one means by which funds are transferred to the provinces as the latters' expenditure responsibilities have grown. In the case of the indirect taxes, no comparable institution of tax harmonisation exists. In principle, there is no reason why similar tax sharing arrangements could not be negotiated between the federal government and the provinces. Indeed, there has been some movement in that direction with the implementation of the federal Goods and Services Tax (GST). For example, Quebec has harmonized the base for its retail sales tax with that of the GST and has

participated in the joint administration of sales tax collections within the province. In the case of aboriginal governments, tax sharing is unlikely to represent a significant source of revenue, at least initially. The issue of own-sources of revenue is treated in more detail in section V below.

The provinces, in turn, decentralise to their local governments much of the responsibility for providing some key services, particularly in the areas of education and welfare, and, to a lesser extent, health, though they retain an important overseeing role. As with the federal-provincial case, the local governments face a fiscal gap and rely to a considerable extent on transfers from the province to finance their expenditure responsibilities. There tends to be relatively little explicit tax sharing between the provinces and their localities. The localities tend to rely on their assigned tax bases for own source revenues, especially the property tax and various user fees and licenses, and the provinces on theirs. Nonetheless, property taxes tend to administratively harmonised, and in some provinces centrally collected.

This feature of federal fiscal systems in which expenditure responsibilities are relatively more decentralised than revenue raising, and in which intergovernmental transfers play an important role is an almost universal characteristic of federations. It reflects the fact that the advantages of decentralising expenditure responsibilities are greater than those of decentralising taxes. Expenditure decentralisation has the advantages of public services being provided which are more closely tuned to local needs and preferences, and in which efficiency, accountability and innovation are more likely to result. In contrast, more centralised collection of taxes prevents lower level governments from engaging in beggar-thy-neighbour and distortionary tax policies, and also facilitates the pursuit of nation-wide equity (redistributive) and efficiency goals.

However, this is not the whole story; after all, when tax sharing and harmonisation arrangements are in place that limit the extent to which provinces can engage in distortionary tax policies there is probably no real economic limit to the ability to decentralise revenue raising responsibilities. In a federal system with decentralised expenditure responsibilities, fiscal transfers from a higher to a lower level of government take on an important role in their own right. Essentially they give the higher level of government a policy instrument with which to ensure that decentralised programme spending by, say, the provinces does not violate national economic objectives. In other words, the design of transfers allows the federation to reap the full advantages of decentralised decision making without compromising national concerns.

What are these national economic objectives? Governments at all levels are generally understood to have two major economic roles. One is the promotion of *efficiency*. This involves ensuring that economic resources are allocated to their most beneficial uses in such a way that wastage is minimised. The other is the promotion of equity. This involves ensuring that the benefits of economic activity are shared fairly among different persons in the economy. The specifically national objectives that these give rise to are as follows.

National efficiency objectives include the maintenance of an efficient internal common market or economic union by promoting the free and undistorted flow of goods, services, labour

and capital within the federation and by `internalising' spillovers among jurisdictions. Lower level jurisdictions acting independently may violate national efficiency norms if their policies give rise to distortions across their political boundaries, if they engage in wasteful fiscal competition with one another, or if they generate spillovers (positive or negative) into neighbouring jurisdictions. Thus, for example, provincial government local procurement rules preclude cost-minimization in the provision of government services; occupational licensing requirements interfere with the free flow of labour across provincial boundaries; regulation of local securities markets do the same for capital; imposition of residency requirements for local public services distorts the mobility of persons among provinces; and differential tax policies can cause economic activity to be allocated inefficiently within the federation. Decentralisation may also violate national efficiency to the extent that it leads to differing fiscal capacities among jurisdiction at a given level, for then labour and capital will be induced to move from one jurisdiction to another for fiscal reasons alone and not for reasons of economic productivity.[2]

The system of federal-provincial transfers is one of the most important means by which the federal government can address the violations of national efficiency that would otherwise result from decentralisation. One way the federal government can influence programme design so as to ensure that national efficiency concerns are taken into account and the integrity of the internal common market maintained is through the use of conditional grants; this is also known as the *spending power* of the federal government. However, even unconditional grants can be important in achieving national objectives as we shall see. For example, in addition to facilitating a greater degree of decentralisation of expenditure than of tax responsibilities, they also can be designed to offset differences in fiscal capacity among recipient governments that would otherwise give rise to a misallocation of labour and capital among jurisdictions.

National equity concerns are twofold. The first concerns `vertical equity', that is, the extent to which the fiscal system redistributes from the better off to the less well off. Naturally, the system of taxes and transfers to individuals addresses vertical equity concerns, and it is important that the federal government maintain the integrity of that system by retaining a prominent role in the income tax system. More important from the perspective of federal-provincial transfers is the fact that many of the goods and services that are provided by lower levels of government are essentially instruments of redistribution. For example, much of the rationale for public provision of education, health and welfare services is justified by redistribution (rather than by efficiency). Indeed, it can be argued that as much redistribution takes place through the expenditure side of the budget as through the tax side, and much of this is in areas of provincial responsibility. To the extent that the federal government is concerned with redistributive equity, it will be concerned by the design of programmes that are essentially outside their legislative jurisdiction. If left to themselves, provinces may not provide programmes which adequately provide for the less well to do, perhaps because of competition with other provinces, or because of an absence of incentives to take account of mobile components of the population. Again, as with national efficiency objectives, the federal government can use its spending power to provide provide the provinces

[2]This is referred to as `fiscal inefficiency'. See Economic Council of Canada (1981).

with financial incentives to design their public service programmes to be compatible with national equity objectives. The same applies to provinces with respect to their local governments.

The second national equity objective involves `horizontal equity', the principle that requires that like persons should be treated in like ways across the nation from a fiscal point of view. As we have pointed out above, this can be likened to a consequence of citizenship in the country --- equal fiscal treatment regardless of province of residence. The decentralisation of fiscal responsibility will generally lead to the violation of the equal treatment principle. This occurs because, in the absence of corrective intervention, the decentralisation of financial responsibilities will result in variance in the financial ability of different jurisdictions to provide comparable public services. Horizontal equity across regions, or *fiscal equity* as it is called, is one of the key principles embodied in existing Canadian intergovernmental fiscal relationships.[3] Essentially what fiscal equity requires is that reasonably comparable economic opportunities and levels of public service be available to *all* Canadians at reasonably comparable cost (i.e., tax rates), regardless of their place of residence. This does not mean that *identical* public services be available to all persons regardless of residence. This would contradict the very idea of federalism, which is to decentralise fiscal responsibilities to lower level jurisdictions. Rather, it means that all lower level jurisdictions have the fiscal capacity, or the potential, to be able to provide comparable public services at comparable tax rates. How precisely they choose to exercise that potential is a matter for them to decide, albeit one that might be constrained by a requirement that some norms of national equity be achieved.

It is this principle of fiscal equity that lies behind intergovernmental fiscal arrangements in Canada, both federal-provincial and provincial-local. Given that aboriginal Canadians are entitled to the same rights of citizenship as non-aboriginal Canadians, and that the principle of horizontal equity should apply to them, the pursuit of fiscal equity should also constitute a cornerstone of the financing mechanism for aboriginal governments. The most important exposition of this principle is found in Section 36 of the *Constitution Act*, 1982, which it is useful to reproduce here in full:

(1)Without altering the legislative authority of Parliament or of the provincial legislatures, or the rights of any of them with respect to the exercise of their legislative authority, Parliament and the legislatures, together with the government of Canada and the provincial governments, are committed to
(a)promoting equal opportunities for the well-being of Canadians;
(b)furthering economic development to reduce disparity in opportunities; and
(c)providing essential public services of reasonable quality to all Canadians
(2)Parliament and the Government of Canada are committed to the principle of making equalization

[3]The principle of fiscal equity has come to be one of the important cornerstones of the literature on fiscal federalism not only in Canada but for all federations. A clear enunciation of the principle and its implications for the fiscal arrangements between the federal government and the provinces may be found in Economic Council of Canada (1981). For a more recent discussion of the principle in the broader context of the economics of federal states, see Boadway (1992).

payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable levels of public services at reasonably comparable levels of taxation.

Section 36(1) explicitly makes the Government of Canada and the provincial governments jointly responsible for pursuing the goal of equity, which is specifically seen to include the promotion of equal opportunity and economic development, and the provision of essential public services. It can be interpreted as recognising that the federal government has a vital interest in vertical equity, and in seeing that the programmes are in place for ensuring equal opportunity or access to essential public services, even if those programmes are delivered by the provincial governments. Since the capacity of the provincial governments to honour their obligation to provide reasonably comparable levels of public service at reasonably comparable levels of taxation, which is necessary if all Canadians are to enjoy the same economic opportunities, effectively requires them to have reasonably comparable levels of resources, Section 36(2) formally commits the Federal government to making equalization payments to provinces. Importantly, Section 36(2) requires that the *level* of equalization payments be set so that horizontal equity (fiscal equity) across jurisdictions can be achieved.

Despite the fact that the language of Section 36 is in terms of the federal government and the provinces, the Section is of great importance to the discussion of financing mechanisms for aboriginal self-government in Canada. This is both because of the explicit constitutional commitment that it places on the government of Canada to ensure that *all* Canadians, including aboriginal Canadians, have access to essential public services and are faced with equal opportunities, and because of the enunciation and general relevance of the principle itself. If the implementation of aboriginal self-government is to be consistent with Section 36, then the level of resources made available to the governments of aboriginal peoples must be such that the public services which they undertake to provide can in fact be delivered to their citizens at a comparable standard to that enjoyed by other Canadians and at a comparable cost to themselves.

It should be noted that at the present time, there is a widespread perception that aboriginal Canadians receive public services of distinctly lower quality than those that are provided to non-aboriginal Canadians. Thus, if one of the consequences of self-government is that members of aboriginal communities obtain the right to provide these services for themselves, and are funded in consequence, it can be expected that the total flow of resources to aboriginal communities would have to increase. However, this increased expenditure should not be attributed to self-government *per se*, but rather as due to the pursuit of the government of Canada's obligations under Section 36. As we discuss later, in Section VI, the provisions of Section 36 as they apply to aboriginal Canadians does not override or contradict any fiduciary responsibilities that the federal government has assumed as a result of treaties with First Nations. These can be seen as complementary responsibilities. Of course, it may well be the case that the achievement of the principles set out in Section 36 are more than sufficient to satisfy simultaneously the federal government's fiduciary responsibilities. Nonetheless, as we discuss later, the design of transfers must take account of existing obligations that arise from treaty rights, or the exemption from taxation.

Section 36 has typically been interpreted as imposing a political and constitutional obligation on the federal government to maintain an effective equalization programme. What must also be stressed, however, is that by making the attainment of national standards a responsibility of the government of Canada, Section 36 also creates a role for the Canadian Parliament to use its spending power more generally (such as via conditionality in its transfer schemes) to influence the level of provision chosen by other levels of government. This seems to be a necessary consequence of the need to satisfy the equity obligations set out in Section 36(1).

Although these national efficiency and equity roles can be separated in principle, this is generally not so in practise. It is certainly the case that particular components of the present intergovernmental fiscal relationships typically reflect both of these roles to some degree, although each is designed to respond primarily to one or the either of these objectives. For example, EPF payments, by being contingent on conditions laid down in the Canada Health Act ensuring that national standards are met in the provision of health care across the nation, are certainly an important instrument for pursuing equity objectives. However, the fact that national standards exist also promotes efficiency: Canadians are not tempted to migrate from one province to another in order to benefit from significant differences in the level of provision of public services, and provincial governments are discouraged from engaging in potentially destructive tax and expenditure competition due to their obligation to collect tax revenue sufficient to enable them to provide services of adequate quality. Furthermore, since EPF payments are made in equal per capita amounts to all provinces and territories, but are financed by progressive taxation, they are redistributive in effect and contribute to the pursuit of the objective of reducing disparities across provinces in the ability to provide public services. Thus, the EPF scheme contributes to a variety of national objectives. So it is with the other major transfer schemes, as discussed in the next section.

The discussion of these principles is couched in terms of relations between the federal government and the provinces, but similar principles should apply among localities within each province. The decentralisation of expenditure and revenue-raising responsibilities to the local governments would give rise to inefficiencies and inequities across localities. The system of transfers from a province to its municipalities ought to be designed so as to counter these effects and to take province-wide concerns into account. Of course, unlike with the federal-provincial fiscal arrangements, those between the provinces and their localities are far from uniform. As well, they are probably far from ideal. Nonetheless, they do exhibit many of the same features as their federal-provincial counterpart. In particular, many include a significant equalising component, as well as conditionality of grants and some harmonisation of the tax system.

To summarize this discussion, what general lessons can we learn from the way in which fiscal federalism is practised in Canada for the financing of aboriginal self-government, given our presumption that the principles underlying the financing mechanism for aboriginal governments should be comparable to those underlying the mechanisms used to transfer funds between other governments in Canada? The following points represent the general characteristics that we think

the financing arrangements ought to satisfy.

- First and foremost, the financing arrangements ought to conform with the principles stated in Section 36 of the Constitution Act; that is, they ought to ensure that each aboriginal government has the capacity to be able to provide reasonably comparable levels of public services at reasonably comparable tax rates to other jurisdictions in Canada (including non-aboriginal jurisdictions); this might be thought of as the equalising function of the financing arrangements.

- Self government implies truly decentralised and independent decision making; thus, the financing arrangements should incorporate as great an element of unconditionality of transfers as is consistent with national norms of efficiency and equity. Equivalently, aboriginal self-governments should not be faced with conditions that are not also applied to non-aboriginal governments exercising similar functions.

- By the same token, aboriginal governments should not be subject to requirements of accountability that do not apply to other governments in Canada with similar responsibilities; this implies that they are responsible for the manner in which the funds are used, and they must bear the consequences of badly administered public programmes.

- Conditions may be imposed on transfers to provide an incentive to design the programmes such that desirable national standards of equity and efficiency are met; as with any use of the spending power, ultimate decision-making authority ought to reside with the aboriginal government; the spending power cannot supplant legislative authority; it should only provide financial incentives.

- Apart from the legitimate use of the spending power to induce national standards, the design of the system of transfers should be such as to be neutral with respect to aboriginal government decision making; that is, it should provide no incentive for particular forms of behaviour.

- Where it is appropriate, aboriginal governments ought to be able to participate in federal shared-cost programmes.

- Where it is appropriate, aboriginal governments ought to be able to participate in federal tax sharing schemes, including those specifically designed for aboriginal governments.

1.2 Desirable Characteristics of the Financing Mechanism

In applying these general principles to the case of aboriginal self-government, we must recognize and take account of the fact that aboriginal communities differ in some relevant ways from non-aboriginal ones. The financial arrangements will need to take these into account. Some of the most important differences are as follows.

- There is considerable heterogeneity across communities, much more so than for non-aboriginal ones. Some are land-based and others are not. Even in the case of land-based communities, the land-holding may not be contiguous. Different communities have very different governing systems. Some are mixed in the sense that aboriginal and non-aboriginal persons live in the same communities. Features such as population density, remoteness, and whether or not the community is urban or rural differ across communities. The financing system take appropriate account of these differences.

- Membership of aboriginal communities for the purposes of self-government may not be defined by residency. Thus, a member of a given aboriginal people may reside in a non-aboriginal community; or, non-aboriginal persons may reside within an aboriginal community without being part of the political constituency. This means that issues of *extraterritoriality* must be resolved. (Existing fiscal systems and interjurisdictional transfers tend to be based on residency.)

- In the event of self-government, different communities are liable to take on very different degrees of responsibilities, even if all are given the same menu from which to choose. Furthermore, degrees of responsibility are likely to evolve over time, with some communities gradually taking on more responsibilities. The system will need to be flexible enough to cope with this.

- The mix of functions exercised by aboriginal self-governments may well include some that the provinces currently perform, some that local governments perform, and maybe even some that the federal government performs. Comparisons with other levels of government will therefore be difficult.

- There is no intermediate layer of government between individual aboriginal communities and the federal government; that is, there is no analogue to the provinces between the localities and the federal government. In the absence of such a layer, the primary relationship of each community would presumably be with the federal government. Some observers have proposed a layer of government above the community level, essentially analogous to a province for aboriginal communities (Courchene and Powell, 1992).

- An important feature of local governments is the fact that they tend to be creatures of the provinces and do not have independent legislative authority. This detracts from their self-governing status, and may in some cases lead to accountability and auditing requirements imposed by the province that would be incompatible with true decentralisation. Even though many of the functions that aboriginal governments would take on would be municipal-type functions, the fact that they are to be fully self-governing communities with independent legislative authority would suggest that they not be subject to accountability requirements that sometimes characterise the relationship between local governments and provinces.

- Most aboriginal communities, in addition to being small, have very low tax or revenue-raising capacities. This means that the system of financing will be heavily dependent upon transfers from other governments. Moreover, given the constitutional responsibility of the federal government for aboriginal peoples, the financing arrangements should be with the federal government.

- Aboriginal Canadians have enjoyed a special tax-exempt status with respect to other levels of government. Should this continue, it will have an effect on the sorts of permissible arrangements. A somewhat separate issue concerns the power of aboriginal communities to tax themselves. Whether or not this power is assumed will also affect the financing schemes.

Accounting for these properties of aboriginal communities will make the task of finding a suitable financing scheme difficult. In the remainder of this section we consider the sorts of special features that they imply for financing schemes.

Although there are many different criteria which can legitimately be advanced for judging the appropriateness of alternative proposed financing mechanisms, not all such criteria can be expected to command widespread support. An obvious example is the extent to which different mechanisms may have very different consequences for the level of the flow of resources from the government of Canada to aboriginal communities. Whereas the government of Canada will almost certainly prefer mechanisms which require it to transfer less revenue to aboriginal governments, the preferences of aboriginal Canadians are liable to be very different! Nonetheless, we shall argue that if the financing mechanism for aboriginal governments is to respond to the special characteristics of these communities it will have to demonstrate the four following technical characteristics. Specifically, the financing mechanism should (i) be flexible; (ii) promote cost-effective, responsible and innovative approaches to providing public services; (iii) be inexpensive to administer; and (iv) take account of all sources of fiscal inequity across aboriginal communities, that is, not merely differences in own-revenue generating capacity.

Flexibility

At the present time, there appears to be widespread agreement that the implementation of aboriginal self-government will require considerable institutional flexibility. Even if the final division of powers that is negotiated between the government of Canada and aboriginal peoples accords identical jurisdictional authority to each aboriginal government, it is unlikely that all communities will move at an identical pace in actually taking over responsibility for these areas. Furthermore, there may even be persistent differences (most obviously, between land-based and non-land-based aboriginal peoples) in the sorts of public services which they choose to provide for themselves. Consequently, the mechanisms developed for financing aboriginal self-government must be designed to deal equally well with aboriginal communities which are pursuing more or less broad programmes of self-government.

In this context, what must be stressed is that the financing mechanism must be designed so that it does not itself place pressure on aboriginal communities to take on fewer (or, for that matter, more) powers than they would otherwise desire to exercise. It is relatively straightforward to develop scenarios in which this would not be the case. For example, if the financing mechanism is administratively cumbersome, so that large `bureaucracies' must be set up in order to have access to relatively modest levels of resources, then in undertaking to provide certain public services themselves, aboriginal governments may find that, after meeting administrative costs, they are left with a significantly lower level of resources to devote to providing this service than would have otherwise been allocated to its provision by some other level of government. Consequently, the community may decide not to exercise this power, even though it is potentially the most efficient and appropriate provider of this service.

Alternatively, the financing mechanism may pressure aboriginal communities to exercise their jurisdiction in areas which they might (at least initially) prefer to leave to some other level of government. For example, suppose that education and transportation were both to be areas over which aboriginal communities could exercise jurisdiction. While a particular aboriginal community might be quite anxious to proceed immediately to provide educational services to its members, it may be initially reluctant to involve itself in the business of road-building. Let us also imagine that this particular aboriginal community accords high priority to educational spending, and is less preoccupied by the quality of the road system. If the financing mechanism is not appropriately conceived, it is possible that in order to be able to devote as high a level of resources to education as they desire, this particular community will not only have to exercise its authority over education but *also* over transportation, so that it can transfer money from the `road works' envelope to the envelope for education. If the financing mechanism itself distorts the decision of aboriginal communities as to whether or not they will exercise their constitutional powers, then this imposes real economic costs (in the form of increased transfer payments and/or lower levels of service) on aboriginal and non-aboriginal Canadians. Every effort must therefore be made to minimise such costs.

Of particular concern in this context is that the financing mechanism be sufficiently flexible to provide equitable treatment of land-based and non-land-based self-governing communities. This will certainly be one of the significant dimensions in which the approach to financing aboriginal self-government must depart substantially from existing intergovernmental models both in Canada and elsewhere. When we think of, for example, equalization formulas, or the EPF and CAP plans, it is clear that they are designed to finance provincial governments who must serve residents in a contiguous geographic area. But if, say, provincial governments had to provide public services to individuals not on the basis of their place of residence, but on the basis of where they were born, then the financing mechanisms would have to change. For example, in the equalization formula it would no doubt be desirable to incorporate some index of the extent to which the population base was dispersed across the country or geographically concentrated, because all other things held equal, it would surely be more costly to provide services for a geographically disparate population.

Cost-Effectiveness, Responsibility and the Incentive to Innovate

A second desirable characteristic of the financing mechanism is that it should encourage aboriginal governments to be innovative, responsible and cost-effective in supplying goods and services to their citizens. In particular, to the extent that it is possible for aboriginal communities to obtain public services of a higher quality for a comparable cost (or of comparable quality for a lower cost) by `combining forces' with each other or with non-aboriginal communities, then the financing mechanism should encourage them to do so, and not constrain them to each provide the service individually. For example, it may be highly cost-effective for several aboriginal communities to establish jointly a school system for their members. It should not then be the case that to obtain financing for the provision of education, each government would be required to set up their own school board, and run their own system. Similarly, if aboriginal communities find that their budgets are reduced when they adopt a more cost-effective approach to delivering a particular public service, they will not be encouraged to innovate.

Aboriginal governments should also behave in ways that are responsive and responsible to their constituents. In the absence of self-government, this has not been a requirement. Such responsibility as has been assumed has often been to those who provide the funding (i.e., the federal government) rather than to those being served. Not surprisingly, this has inhibited the development of decision-making and administrative experience and expertise, as well as to a possible absence of democratic or representative decision-making. It is our belief that the only way to foster responsible decision-making is to impose full fiscal responsibility of the communities concerned. This entails not only making aboriginal governments as fully responsible as possible for implementing their own programmes in an independent fashion, but also taking on a commitment by the federal government not to make good any costly mistakes by the aboriginal government. This also entails a minimum of accountability by aboriginal governments to the federal government for the way in which the funds are used. This is obviously a very different mode of operation to that currently used to finance aboriginal communities, where accountability requirements are high and funds transferred are closely related to actual costs incurred on a programme-by-programme basis. Of course, given the absence of expertise in aboriginal communities in designing and delivering programmes, there may well need to be a transition or training period involved.

If cost-effective and responsible service provision and innovation are to be promoted, then this suggests that a significant proportion of the resources transferred to aboriginal governments be provided in the form of an *unconditional* transfer unrelated to community spending patterns, which can then be allocated between alternative uses as the community sees fit. Alternatively, if conditions need to be imposed for reasons of national equity or efficiency, they ought to be imposed other than via matching grants. The mechanism in place in federal-provincial EPF transfers to finance health insurance is an example of this. The grant is a non-matching block grant, but to receive the grant in full recipient provinces must operate health care systems which satisfy certain criteria.

It should be pointed out that a financing mechanism that promotes cost-effectiveness, responsibility and innovation in the provision of services does not necessarily preclude more costly provision patterns than those presently implemented. In essence, what the financing mechanism should do is encourage the members of a given community to take into account *all* the costs and *all* the benefits of adopting one pattern and service provision rather than another. For example, Indian and Northern Affairs Canada (INAC) has in practise often refused to construct and staff high schools in many small, isolated, aboriginal communities, so that local youth have been forced to leave the community for larger centres to obtain secondary schooling. If the citizens of these communities attach a very high value to the local availability of high school education, then under self-government they may wish to use their own budgets to construct many more high schools than presently exist. The opportunity cost to them of so doing should be simply that they have less funds available for other uses in the community; the absolute size of their transfers should not depend on that sort of decision. In that sense, the financing mechanism should allow the community to resolve for itself the tradeoffs between devoting more resources to high schools, say, versus recreational facilities. Once again, it is evident that if a significant proportion of the total resources transferred to aboriginal communities are in the form of an unconditional grant, then these tradeoffs correctly perceived by the community.

Minimising Administrative Costs

The financing mechanism should not itself constitute an unnecessary fiscal drain. As we shall have reason to recall below in reviewing current self-government agreements, one of the complaints that has often been expressed by aboriginal communities concerning existing agreements with INAC that transfer responsibility (and resources) for providing particular public services to aboriginal communities is that an unusual proportion of the resources transferred are swallowed up in administration, including detailed accounting for the expenditures, rather than in producing the public service. Furthermore, in view of the fiscal crisis currently besetting all levels of government, it is particularly important that considerable care be taken in designing mechanisms for financing aboriginal self-government so that the vast majority of those resources which are transferred to aboriginal communities will actually be available for providing services rather than being absorbed in meeting reporting requirements.

Although there is fairly widespread awareness of the extent to which current financing agreements impose high administrative costs on both aboriginal governments and INAC, there is less understanding of the fact that as the number of distinct `financing plans' increases, so will the cost of transferring resources to aboriginal governments. Indeed, these costs will increase dramatically unless there is a relatively *simple, formula-based procedure,* rather than a discretionary one, that is followed to determine the amount of resources to be transferred to each government. Of course, given the variability in the degrees of responsibilities that will be taken on by different aboriginal governments, there will have to exist a wider *menu* of financing programmes than exists in the context of Federal-Provincial relations. Nonetheless, it is important that the financing mechanism not require that each aboriginal government undertake separate negotiations with the

federal government, albeit to determine the level of a two, three, or five-year block grant. In effect, this would be comparable to each province having to negotiate its own particular level of funding from the federal government, rather than receiving financing under the Equalization, CAP, and EPF programmes. Such an approach would require both federal and aboriginal governments to continue to devote a significant level of resources to these negotiations, and would almost certainly give rise to significant fiscal inequity across aboriginal communities. It is also clear that entering into separate funding negotiations with each aboriginal government bestows far greater bargaining power on the federal government than when all aboriginal governments are funded via a common menu of financing plans. And of course, the financing agreement must fund the set of services delivered by aboriginal governments; administrative costs are proportionately higher if the negotiations are on a programme-by-programme basis. The funding arrangements should be formula-driven and broad-based, rather than being subject to negotiation and administrative discretion.

The issue of accountability is bound to be a controversial one. There will be many observers who will insist that funds transferred by the federal government to aboriginal governments be accounted for in some detail, and that accountability requirements serve as a disciplinary device to ensure that the funds are not wasted. Ultimately, this issue will have to be resolved by the political process. In our view, accountability requirements, though understandable, are liable to be quite counter-productive since they detract from the exercise of responsible self-government. To be truly self-governing with full legislative discretion entails that aboriginal governments be accountable primarily to their own constituents. This will require that democratic machinery be put in place for ensuring that decisions are taken that are in the interests of the community. But it does not entail fiscal accountability to another level of government. The correct analogue is with the provinces. They have full legislative responsibility for matters within their jurisdictions, and as such are not accountable to the federal government. It is true that the exercise of the spending power by the federal government may impose some constraints on the behaviour of provinces, but these are of a general nature. To be self-governing in that sense, aboriginal governments should be subject to no more accountability than are the provinces. As we have mentioned above, this implies somewhat less accountability than many local governments face, since the latter may be viewed to some extent as agents of their provincial government.

Fiscal Equity

The attainment of fiscal equity both among aboriginal communities and between them and non-aboriginal communities poses special problems because of the diversity of types of aboriginal communities and because of the fact that they are typically much less well off than other Canadian communities. Existing mechanisms for addressing fiscal inequities among provinces or among municipalities tend to focus heavily on revenue equalization; that is, they attempt to make up for differences in tax capacity across jurisdictions. Given that these jurisdictions are relatively homogeneous, this is a sensible approach, though other major transfer programmes such as EPF and CAP can be viewed as contributing to the equalization objective in ways other than tax capacity equalization.

Given the marked differences among aboriginal communities, however, revenue equalization supplemented by EPF and CAP themselves would not be sufficient to satisfy the principles contained in Section 36 of the *Constitution Act*. The limitations of these schemes has been recognized, for example, in the special system of transfers applying to the territories.

Differences in fiscal capacity across aboriginal communities are likely to result at least as much from differences in the need for and the cost of providing public services as from differences in tax capacities. Indeed, for a substantial proportion of such communities, tax capacities are likely to be minimal. Thus, a satisfactory system of equalizing transfers is likely to be based not only on tax capacity but also on expenditure need differentials.

1.3 Summary

To recapitulate briefly, the concern of this first section has been to enunciate a set of general principles which should underlie the design of any mechanism for funding aboriginal governments. Our fundamental premise is that if Canadian aboriginals are self-governing, then the fiscal relationship which is established between existing levels of government and aboriginal governments must be founded on the same principles of fiscal federalism as those which presently shape the fiscal relationships among existing governments. A key feature of Canadian federalism is the fact that expenditure responsibilities are relatively more decentralised than revenue-raising ones (i.e., there exists a fiscal gap), so that goods are provided by those governments that are most sensitive to the preferences of local citizens. The federal government, however, has a particular responsibility for the pursuit of national equity objectives, as well as such efficiency objectives as the maintenance of an efficient economic union. The financing mechanism developed to transfer funds to aboriginal governments should also exhibit these features. However, the actual mechanisms by which resources are transferred cannot be expected to be directly modeled on such programmes as Equalization, EPF and CAP, since the circumstances and responsibilities of aboriginal governments will not be directly comparable to either provincial or local governments, and there will additionally be considerable variance in the implementation of self-government be different aboriginal peoples.

In view of these principles, however, and the differing circumstances of different aboriginal peoples, it is clear that the mechanism developed for funding aboriginal governments must exhibit four characteristics. Specifically, it must be flexible enough to be responsive to the differences in the circumstances of each nation; it must provide incentives to supply services in an innovative, responsible and cost-effective manner; it must impose minimal administrative costs on the governments involved; and it must be consistent with the attainment of fiscal equity by aboriginal Canadians.

II. Fiscal Federalism: Theory and Canadian Practise

In this section we first provide a concise review of the economic theory of fiscal federalism, before reviewing the existing structure of intergovernmental fiscal arrangements in Canada.

2.1 The Theory of Fiscal Federalism

The economic theory of fiscal federalism seeks to provide a coherent analytical framework for assigning responsibility for various governmental roles to different levels of government. Which levels of government should collect revenues? Which should be responsible for delivering which sorts of programmes? Which should be the principal players in pursuing equity objectives? And which should seek to promote economic efficiency? In some respects, the theory of fiscal federalism may be viewed as presenting an economist's prescription for an ideal division of responsibility between governments in a federal state.

Before providing answers to these questions, it is first necessary to review what in fact economists believe to be the role of government in a capitalist economy, such as is Canada's. The functions of the public sector take a variety of forms, but basically they are directed to three main objectives. One is the *stabilization* objective which is concerned with managing the aggregate level of demand in the economy so as to achieve full employment of resources and price level stability. Although it is widely agreed that this is most effectively done at the federal level, it will be of no concern to us in our analysis since it is of little relevance to the issues surrounding the financing of aboriginal self-government.

A second is the *efficiency* objective. It arises because private markets do not always operate efficiently, i.e., they fail to allocate resources in such a way that it would be impossible to redistribute those resources between the different actors in the economy so as to make one agent better off without simultaneously making some other agent worse off. So-called *market failure* occurs when some of the benefits and/or costs of certain goods and services are not fully reflected in the market price. As a consequence, the private sector will provide these goods inefficiently. One of the common reasons for which the production of some goods and services is characterised by market failure is that the average cost of production falls as the scale of production increases, i.e, there are *increasing returns to scale* in provision of the good. Another important source of market failure is that some goods or services simultaneously provide services (both good and bad) to many consumers, i.e., there are *externalities* associated with the provision of such goods.[4]

The third, and in practise probably most important, function of government is the *equity* or *redistributive* objective which is ultimately involved with redistributing resources from the

[4]When it is impossible to provide the good or service to one individual without simultaneously supplying it to all members of the community, economists describe the good in question as a *public good*. It should be noted, however, that the goods and services which are in fact supplied by the public sector in Canada are not necessarily public goods in this technical sense.

better-off to the less well-off so as to achieve some desired degree of equity. On the expenditure side of the federal budget, transfers of all types comprise two-thirds of program spending. Most of these have redistribution as a major objective. Transfers to individuals are dominated by unemployment insurance, payments to the elderly and family allowances, all of which are redistributive in nature. A substantial part of transfers to firms consist of regional development grants and agricultural subsidies, both of which are redistributive in nature. Finally, transfers to government, as we shall see, also fulfil a redistributive function. Thus, much of what the federal government does is directed towards redistributive objectives. It should also be pointed out that the fact that such a substantial proportion of provincial and territorial government budgets are directed towards health, education and welfare services means that these governments are also heavily involved in redistribution. As will be seen, much of the disagreement between representatives of aboriginal peoples and other levels of government in Canada about financing native self-government presupposes some view about equity, and it is important to recognize this at the outset.

Having identified the main objectives of public sector activity, it is now possible to discuss the roles that different levels of government should play in pursuing the objectives of equity and efficiency via the adoption of appropriate public policies and expenditure programmes; we subsequently examine the relationship between this pro-active role of government and the collection of public revenues. Insofar as efficiency is concerned, a natural approach would seem to be to assign responsibility for correcting market failure to the lowest level of government which has jurisdiction over all of the economic actors whose choices are affected by this failure. For example, if a local company pollutes its neighbours then the local government should be held responsible for developing and implementing an appropriate corrective policy. If the polluting activity affects not only local residents and businesses but also citizens and firms operating in neighbouring communities (or in other provinces) then the provincial (or federal government) is best placed to take into account the interests of all the concerned parties.

Efficiency arguments also tend to support the proposition that many of the services which are to delivered by the public sector should in fact be provided by lower (provincial and/or local governments) levels of government, rather than higher ones. Many economists would argue that provincial delivery of services such as health, education and welfare ensures that the form of the services will be more responsive and accountable to local needs, as well as encouraging innovation. Only those services that apply nationwide (such as defence, foreign affairs, control of the currency, etc.) should be reserved for the federal government. Decentralization of service provision has been carried out to a significant extent in Canada, so that provincial expenditures, especially those on goods and services, are considerably higher than those of the federal government.

Such decentralised provision has traditionally been conspicuous by its absence in the context of service provision to Canada's aboriginal peoples. Presumably, one of the consequences of aboriginal self-government will be that greater decentralisation of service provision will enable the same welfare gains to be realised with respect to the supply of public services to native Canadians as have been realised with respect to the non-aboriginal population. This much said, it is well

known in the public finance literature that problems, particularly due to competition amongst different governments, can arise with such a decentralised provision. For this reason, in achieving fiscal harmonisation a special role is played by conditional grants, such as the EPF programme.

It is less straightforward to assign ultimate responsibility for redistributive equity to any particular level of government. Many public finance economists have tended to take the view that the main responsibility for equity ought to lie with the federal government. This view results from the notion that persons ought to be treated symmetrically no matter where they reside in the country, what economists refer to as *horizontal equity*. Only the federal government can ensure that horizontal equity prevails across the nation and that otherwise identical persons are treated the same no matter where they reside. Others argue that there is a role for the provinces in pursuing redistributive objectives. The argument is that the degree of redistribution is a matter of taste, and residents of different provinces have differing tastes in that regard.

Regardless of one's view on the issue of `national' versus `regional' tastes insofar as redistributive policy is concerned, the analysis of the appropriate division of responsibility for equity is further complicated by the fact that the process of redistributing from the better-off to the less well-off itself has efficiency costs; it reduces the amount of goods and services ultimately available to the economy. This is because of the fact that redistribution affects the incentives of both the donors and the recipients of redistribution to engage in productive activities. For example, if a particular provincial government seeks to implement a more generous programme of social assistance than is the norm elsewhere in the country, and adopts a more progressive tax structure in order to finance this redistributive activity, then it is reasonable to predict (i) that the province will experience some inflow of recipients of social assistance from other provinces, who are attracted by the more generous conditions offered, and (ii) there will be some corresponding outflow of more highly taxed individuals and firms, who find that they can earn higher revenues elsewhere. Thus, if provincial (or territorial, or local) governments are to undertake redistributive policies, they will have to choose these policies in full cognizance of the impact of changes in those policies on the composition of the province's population. In contrast, when the federal government is made responsible for pursuing equity on a national basis, there will not be interprovincial flows of labour or capital induced by differences in redistributive policy. In sum, therefore, it is clear that the national government has a particularly strong mandate to pursue equity objectives, although lower levels of government may also have some role to play.

A key issue here is the extent to which national equity objectives ought to apply to aboriginal peoples, and this will of course be the subject of negotiation between the Federal government and the representatives of Canada's aboriginal populations. From an economic perspective, one would argue that one of the roles of the Federal transfer system vis-a-vis the provinces is to ensure both a free flow of resources amongst communities and a comparable level of provision of public services. To this end, making the payment of transfers conditional upon the achievement of national standards may be one of the few instruments available to the federal government to ensure that equity is achieved.

Turning now from the responsibility for policy formation and public spending to the question of taxation, it might be argued that to the extent that equity and efficiency considerations dictate a particular division of spending amongst different levels of government, the responsibility for raising the revenues necessary to finance these expenditure programmes should be similarly apportioned. However, there are several important reasons to believe that greater economic efficiency can be attained if the federal government takes on a larger role in the collection of taxes than would be implied by the division of expenditure responsibilities. Decentralization of taxing responsibilities would give rise to an unacceptable level of tax competition among provinces resulting in a distortionary and fragmented system of taxes and a disincentive to raise revenues in the amount that would be required to finance the desired level of public services. In particular, the provinces might find it impossible not to engage in tax competition over the rate structure itself as a means of attracting high-income persons to the province, and would leave some provinces in a much stronger financial position relative to others, thereby inducing both inequities and inefficiencies across provinces. Also, a dominant federal position in the raising of taxes contributes to the maintenance of a harmonised tax system. This is of particular importance in the income tax fields where the existence of a single harmonised income tax system with one collection authority contributes greatly to an efficient tax system from the point of view of the taxpayers, the tax collectors and the national economy. Equity arguments can also be marshalled in favour of a preponderant role for the federal government. Specifically, the federal government might find it difficult to maintain the desired degree of progressivity in the rate structure given a large provincial presence in the raising of taxes. Furthermore, the tax-transfer system is the main instrument available to the federal government that it can use to discharge its commitment to national equity.

2.2 Intergovernmental Fiscal Arrangements in Canada

There exists a highly developed system of fiscal arrangements involving federal, provincial, territorial and local governments in Canada. We summarize here the key features of federal-provincial, federal-territorial and provincial-local government relations in turn.

2.2.1. Federal-Provincial Fiscal Arrangements

The system of federal-provincial fiscal arrangements has evolved to its existing form over a large number of years. The system is characterized by four key features --- a) a significant vertical imbalance, or *fiscal gap*, b) *equalization* among provinces, c) the use of *conditional* grants, and d) a significant degree of *fiscal harmonisation* of both tax and expenditure programs.

The federal government collects significantly more revenue than it needs for its own purposes, turning the rest over to the provinces as transfers. Thus, 22% of federal program expenditures are transfers to the provinces, while 20% of provincial revenues come from federal transfers. This imbalance between federal tax collections and own expenditure requirements is referred to as the fiscal gap. It arises not due to any fundamental inability of the provinces to raise their own taxes, but as a matter of conscious policy. The provinces have the constitutional ability to raise whatever revenues they need. Indeed, they may well be more able to do so than the federal

government given their ability to tax natural resources. However, as discussed above, there are good economic reasons for the collection of taxes to be more centralized than the responsibility for expenditures, and this is reflected in current practise.

The Tax Collection Agreements are relevant for our discussion as an alternative institutional vehicle by which revenues can be reallocated between the federal and the provincial (and territorial) governments. Notwithstanding the income tax exemption accorded to status Indians living on reserves, they are not of particular significance to aboriginal self-government since aboriginal communities have limited income tax bases. Under the Tax Collection Agreements, the federal government collects personal and/or corporate tax revenues on behalf of the provinces and passes on to the provinces their share of the tax proceeds according to the amounts collected in each. To be party to the Agreements, the province must accept the same tax base as the federal government, but each province has the right to set its own tax rates and to establish a system of non-discriminatory credits. In return, the federal government collects taxes free of charge for the provinces and administers credits for a small fee.

The tax bases covered by the Tax Collection Agreements are co-occupied by the federal and provincial governments. The total tax rate applied to those bases must somehow be divided between the federal and provincial governments. That is, the division of the tax room must be determined. The larger the federal tax rate, the less tax room there is for the province, and the relative amounts of funds available to the federal and provincial governments are thereby partly determined by the division of the income tax room. In practise, the capacity of the federal government to make sizable grants to the provinces is due to the amount of tax room it occupies relative to the provinces. Thus, there is an important interdependency between the Tax Collection Agreements and the system of federal-provincial transfers.

i. Equalization

The Equalization scheme is a system of transfers financed from federal government general revenues and allocated as unconditional transfers to the ``have-not'' provinces under the Federal-Provincial Fiscal Arrangements Act. The intent of Equalization is to transfer moneys to those provinces whose tax capacity (defined for the purposes of equalization as the amount of tax revenues per capita that would be generated by applying national average tax rates to a common set of representative provincial tax bases) is below the average for five provinces (Ontario, Quebec, Manitoba, Saskatchewan, British Columbia). The have-not provinces are those which are below this average, and the amount transferred is that required to bring each have-not province up to the five-province average. At present, all provinces except Ontario, Alberta and British Columbia receive equalization payments.

The intent of the scheme is, as stated in Section 36(2) of the *Constitution Act*, to help provinces provide comparable levels of public services at comparable tax rates. However, it does not achieve this goal completely for a variety of reasons. For one, Equalization moves have-not provinces up towards the five-province average, but it does not move wealthier provinces down.

Second, since a five-province standard is used, the standard to which the provinces are being equalized is not the national average: the omission of Alberta, with its very important oil and gas revenues, lowers the tax capacity of the standard, although this is counterbalanced by the fact that the least well-off provinces are also left out. Finally, because Equalization focuses only on the capacity to raise revenues, it does nothing to equalize differences in the ability of provinces to provide comparable public services arising from such things as differences in the need for, or the cost of provision of, various public services. As we shall see, this is one of the reasons that Equalization does not apply to the territories, and is particularly salient to the design of mechanisms for financing native self-government.

Since we will have much occasion, below, to refer again to financing schemes based on the principles of equalization, it is worthwhile pointing out two key features of this scheme. First, because the calculation of provincial revenue generating capacity is based on national average tax rates, rather than on the actual rates imposed by the province, provinces that choose to increase their tax rates in order to raise additional revenues do not suffer a one-for-one decrease in their Equalization payment. This is a very attractive feature of Equalization, since it does not penalize provinces which choose to impose higher tax rates in order to supply more public services. Secondly, provinces which choose to apply tax rates lower than the national average do not thereby obtain an increase in their Equalization payment; their entitlement is calculated on the basis of national average rates, and they consequently bear the costs of taxing themselves more lightly.

ii. Established Programs Financing[5]

EPF transfers are made from federal general revenues to the provinces (and the territories) based on a block funding formula. The transfers, which began in 1977 with the EPF Act, are to defray provincial costs incurred in providing health and post-secondary education programs. Prior to the EPF Act, health care grants were matching and were tied to the costs of the programs in the provinces. Similarly, transfers for post-secondary education were related to overall provincial expenditures in that area. With the EPF Act, contributions for health care and post-secondary education were brought together under one Act and they were changed from a shared-cost basis to a block funding formula.

EPF transfers are calculated on an equal per capita basis; this means that provinces in which a relatively larger proportion of the population pursues post-secondary schooling, or whose universities attract a large number of out-of-province students, or whose citizens are more reliant on

[5]It is anticipated by many observers that in the February 1995 federal Budget the government will announce its intention to combine the transfers made under EPF and the Canada Assistance Plan. The discussion provided here nonetheless casts light on the way in which the federal government may use its spending power to influence the pattern of service provision by provincial governments, thereby discharging its equity obligations as laid out under Section 36. The use of the spending power for this purpose is not precluded by consolidation of the major transfer programmes into a bloc grant.

the health care system in practise receive less money per student or per patient. The magnitude of the payment is determined by two factors. First, the level at which the transfers were first introduced in 1977 was set at the level of per capita national average transfers made under the previous cost-sharing arrangements that existed for health and post-secondary education in 1975--6 plus the equivalent of two tax points (to compensate for the loss of the so-called revenue guarantee from the 1972 tax reform). Second, the per capita transfers were to rise each year at the rate of growth of per capita nominal GNP. However, the actual rate of increase has been lower than this. Budgetary pressures have lead successive federal ministers of finance to impose a series of measures that have lead to a reduction in the growth in EPF payments.

The federal government finances its EPF contributions through a combination of tax transfers and cash payments. The tax transfer consists of a reduction in federal income tax rates, thereby making room for an equivalent increase in provincial rates without consequence for the taxpayer. The remainder of the EPF contribution is paid to the provinces in cash, and the combined equalized tax points and cash payments ensures that each province receives an equal per capita transfer, at least until the cash component disappears. Initially, the tax transfer component amounted to about half the entitlement. However, as time has passed the tax transfer component has assumed greater importance than the cash component. Indeed, because of the measures taken to reduce the growth in EPF payments, if the EPF scheme is maintained in its present form the cash grant component will be eliminated for most provinces within the next ten years.

While Equalization redistributes revenues horizontally across provinces according to the relative tax capacities of the provinces, EPF redistributes tax revenues vertically between the federal and provincial levels of government. The federal government selects its tax rates so as to generate enough revenues to finance its own expenditures as well as to finance its transfers to provinces. In turn, the transfers received by the provinces reduce their revenue requirements so they can choose lower tax rates than they might otherwise have done. The overall effect of the existence of these transfers is that the federal government occupies more tax room and the provinces relatively less than would be the case in the absence of the transfers. However, as the cash component is phased out, this feature of EPF will disappear.

To qualify for full payment of the cash component for insured health services under the EPF Act, provinces must satisfy certain criteria set out in the Canada Health Act, 1983, Sections 7--12.[6] The criteria state that the provincial health insurance plans must be characterized by: a) public administration, b) comprehensiveness, c) universality, d) portability and e) accessibility, each of which are defined in the Act. In the event that these criteria are not satisfied, and after consultation with the province, the EPF transfer can be reduced in whole or in part depending on the gravity of the default (section 15). In addition, in those provinces in which either extra billing by medical practitioners or dentists occurs, or in which user charges are levied, the grant is reduced by an amount equal to the total amount of extra-billing and user charges paid within the province (Sections 18--20).

[6]This Act repealed the Hospital Insurance and Diagnostic Services Act and the Medical Care Act, which stipulated very similar criteria.

There are several features of EPF transfers which are relevant from an economics point of view. Despite the fact that the grants are notionally divided into health and post-secondary education components, they are otherwise unconditional except for those criteria listed in the Canada Health Act as discussed above. That is, the notional division between the components need bear no relation to the proportions in which the funds are spent by the provinces. Thus, there is no financial incentive provided to provinces to change the level of their spending on health and post-secondary education, or of the allocation of spending within these categories, as there was prior to 1977. The main effective conditions attached to the use of the funds are through the incentives applied by the Canada Health Act. The dollar-for-dollar reduction for any moneys collected within a province through extra billing or user charges does not preclude provinces from engaging in these practices, but they cannot increase total spending on health care by allowing such charges. There is, as well, the ultimate sanction of withholding a portion of EPF transfers entirely if a province does not maintain a health insurance system which is universal, portable, accessible, comprehensive and publicly administered. However, this sanction has never been applied and it is not clear what circumstances would induce its application. The other important characteristic of EPF transfers is that, because they combine financing from general revenues with equal per capita payments to all provinces they, on balance, redistribute revenue from high-income to low-income provinces.

iii. Canada Assistance Plan

The CAP is a matching conditional grant program under which the federal government transfers to each province one-half of the costs of eligible social assistance and social services expenditures. Eligible social assistance expenditures include transfer payments made to the needy in the form of provincially- or locally-administered welfare assistance. Eligible social service expenditures include operating costs in excess of those for 1964--5 incurred in providing various social services to needy persons. The CAP is distinguished from the other major grants in being both conditional and matching. The conditional aspect restricts the use of the transfers for particular purposes while the matching aspect provides a financial incentive for provinces to increase their spending. A dollar's worth of spending ``costs'' the province only fifty cents and so provides a financial incentive for provinces to maintain welfare programs satisfying the federal conditions. But provinces retain the discretion to implement and administer the programs and to choose their own levels of spending. Thus, decentralized decision-making is ensured, but the federal government maintains an influence so as to induce provinces to follow national standards. This is consistent with the joint responsibility for equity as stated in Section 36(1) of the Constitution Act.

2.2.2 Federal-Territorial Fiscal Arrangements

Although the territories do not have provincial status, they have many of the expenditure and taxing responsibilities of a province. However, there are some important differences. For one thing, their expenditures patterns are different. Because of their special geographical circumstances, the cost of providing services is generally higher and they spend considerably more on transportation and

communications services than do provinces. Indeed, that is the largest category of expenditures in the Yukon as well as for local governments in both territories. The territories have a greater responsibility for local services than do the provinces. They also spend much more per capita than the provincial governments.

On the revenue side, the territories participate in the Tax Collection Agreements for income taxes, but in practise rely much less on the income tax as a source of revenue than do the provinces. There are no retail sales taxes, and, because the federal government controls resources, resource revenue is a much smaller proportion of total revenues than in the provinces. Due to their higher expenditures needs, territorial government revenues per capita are much higher than provincial government revenues; however, this is almost entirely due to transfers from the federal government. In the Yukon, for example, transfers comprise over 75\% of total revenues, three-quarters of which is unconditional. The territories are full recipients of EPF and CAP. Though average incomes of the employed are quite high, there are relatively large native populations whose incomes are low and unemployment rates tend to be high. They often work in low-income traditional occupations, including hunting and trapping. Consequently, although territorial governments are not eligible to receive Equalization grants, it is not obvious that they would be have-not provinces if the calculation were to be done.

In lieu of Equalization, the territories receive equalizing transfers in another form under a five-year agreement on financial arrangements beginning in the year 1990--1. The grants are based on territorial expenditures in 1982--3 escalated by the growth in total provincial and local government expenditures and population growth in each territory, but reduced to take account of own taxes levied in the territories. At the same time, the reduction is adjusted to take account of territorial tax effort in 1987--8. The tax effort factor used takes account of the extent to which the territories are imposing tax levels on their own residents which are different from the national average using equalization data. The amount received is thus related *both* to expenditure needs and fiscal capacity. This is quite unlike the provincial Equalization calculation, which is based solely on tax capacity. The amount received by the territories is considerably higher than tax capacity alone would dictate. This provides further support for the notion that the principle enunciated in Section 36 is, in fact, applicable to self-governing communities other than provinces, and so should apply also to aboriginal communities.

2.2.3 Provincial-Local Government Fiscal Arrangements

The local governments located within provincial boundaries derive all their powers from their respective provinces, including their expenditure and revenue-raising responsibilities. These vary from province to province, though there are some common features which may have some relevance to the implementation of aboriginal self-government. Local governments are responsible for providing services of a local nature, including water, garbage collection, sewage and sanitation, fire and police protection, local roads, recreation, etc. They may also be charged with varying degrees of responsibility for the delivery of such provincial programs as welfare, health services and

education. Furthermore, some are involved in the provision of utilities either directly or through a utilities commission, though this tends to be on a self-financing basis.

Their activities are financed from a variety of sources. These include various types of local taxes, grants from the provincial government, and other local non-tax revenues. Basically, their tax-raising capabilities tend to be fairly confined. They do not have access to the main broad-based taxes --- personal and corporate income taxes, and sales taxes. They are thus left with property taxation as their most important source of own revenues. In fact, property taxes are mandatory in all provinces except Newfoundland, where local governments are left to decide. Property taxes are imposed on both land and buildings. They vary from province to province and from municipality to municipality both in structure and rates. In two provinces, the property tax is imposed province-wide. Different rates can apply on residential, commercial and industrial properties. Property taxes can be earmarked for various uses, such as school and hospital versus general purpose. The assessed value on which taxes are imposed can vary depending upon the use of the revenues. Typically, services which are mandated province-wide such as health, education and welfare, but which are delivered locally, are financed only partly by local property taxes. The remainder comes from grants, discussed below. Since government-owned property cannot be taxed, provincially- and federally-owned property and Crown corporations are exempt from the property tax. In place of it, most pay grants in-lieu-of-taxes, which are essentially unconditional grants. In some cases, the grants equal the full property tax; in others, provinces only pay the amount that would be owing according to general local government mill rates.

After the property tax, the most important source of local tax revenues is the business tax applied by local governments to most commercial and residential properties, and is over and above the non-residential property tax. As many as eight different bases are used across the provinces. Some provinces admit non-property taxes, but they are not a significant source of revenues. These include land transfer taxes, amusement taxes, poll taxes, sales taxes on liquor, hotels and restaurants, taxes on liquor licenses, telephone use, water and sewage and fire protection. Much larger sums are obtained from non-tax revenues including the sale of goods and services, permits and licenses, and the return from investments.

As with provinces, it is the case for local governments that their own revenue does not cover their expenditures (i.e., there is a fiscal gap) and the revenue-raising capacity, as well as need and cost of expenditures, varies considerably across communities. To address these features, there is an extensive system of provincial-local government grants in place within each province. (There are also some federal-local government grants, but they tend to be used for capital projects.) On average, local governments within provinces receive 47% of their total revenues from provincial transfers. The corresponding figure for the Yukon is 48%, while for the Northwest Territories it is 64%.

The grant structures tend to vary considerably across provinces, but there are some common features to all. The grants contain both unconditional and conditional components (although in Nova Scotia all non-capital grants are unconditional). The unconditional grants are typically

equalizing in nature, though the elements equalized for vary from province to province. An element based on tax capacity (i.e., the property tax assessment base), analogous to the federal case, is common to many. However, elements reflecting the cost of local services and the need for local services are sometimes also included. Examples of the former include road mileage, size, population density and, in Ontario, northern location. Examples of need entering the equalizing formulae include local government expenditures of various sorts, such as social assistance and general expenditures, and population size. Some western provinces operate a provincial-local government revenue sharing scheme whose size is explicitly tied to a percentage of provincial income and resource revenues. It is important to note that in many cases the method of equalization goes beyond the use of tax capacity only, as is the case for federal-provincial Equalization. Provinces are willing to compensate for other forms of diversity across communities in order to assist each in providing some common basic level of public services to residents. And, as mentioned, one large province is willing to take special measures to assist northern communities, presumably in recognition of the higher costs of providing services. This is similar to the special treatment afforded the territories in the federal unconditional grant system.

Finally, the provinces also provide conditional grants, both operating and capital, to the local governments for a variety of specific purposes. (Operating grants comprise about 90% of the total.) Again, each province has its own unique system, but there are common features. The largest conditional grant in absolute terms applies for educational expenditures. A large proportion of health services and social welfare are funded by provincial conditional grants. There are also significant grants in the areas of transportation and communications. While conditional grants typically fund a high proportion of certain operating expenditures to which they apply, they usually fund a much lesser proportion of capital costs.

As is the case with federal conditional grants, these serve various functions. They provide some financing based on need. The conditions attached to them allow the provinces to maintain province-wide standards which satisfies both equity requirements as well as efficiency ones by harmonising the system. And, they preclude elements of tax and expenditure competition between local governments that otherwise might exist. There is, of course, no analog of the controversy over excessive use of the spending power at the provincial level since the local governments have no independent legal status. However, there is still much debate concerning the extent to which the provincial government intrudes on decentralized decision-making of its local governments.

In the Yukon, unconditional equalizing grants are provided to all local governments. They are designed to bring their financial capacity up to a common level for expenditures on general government, protection, public works, environmental health, and recreation and culture. The formula used is based on a standard tax rate and a standard expenditure per dwelling unit. The total transferred unconditionally escalates by the lesser of the rate of increase in territorial revenues and expenditures. Specific purpose grants are also made to cover amounts up to the full cost of providing certain local government services. Thus, the use of grants is comparable to that of the provinces. It is useful to note that, as with the provinces, they are highly equalizing.

2.3 Summary

This section has briefly reviewed the economic theory of fiscal federalism, and the key features of the major programmes by which resources are transferred between different layers of government in Canada. In an economy such as Canada's, economists believe that government has three major roles: stabilization, the pursuit of economic efficiency, and the promotion of equity. The latter two are of significance in the context of financing aboriginal self-government. Efficiency arguments suggest that responsibility for the provision of public services should be decentralized; thus, in particular, public services to Canada's aboriginal citizens are presumably best provided by aboriginal governments. Responsibility for the pursuit of equity cannot be easily assigned to any one level of government; however, the federal government does have a responsibility to pursue horizontal equity, that is, to ensure that regardless of place of residence all Canadians, including aboriginal Canadians, can enjoy a comparable level of public services at comparable cost to themselves. The three major programmes --- Equalization, EPF and CAP --- by which resources are transferred from the federal government to provincial ones all lead to a redistribution of resources from wealthier provinces to poorer ones. The amounts transferred to provinces under both the Equalization and EPF programmes are unaffected by the actual costs of public service provision incurred by the provinces; however, payments received under the CAP do vary directly with provincial spending. Importantly, relatively little `conditionality' is attached to these grants. Indeed, there are no conditions attached to Equalization payments, and only broad design criteria (embedded in the {\it Canada Health Act) attached to EPF. The most stringent conditions are attached to CAP payments, in that funds received must be used for specific ends, and the amount transferred depends on provincial spending. Relationships between the federal and territorial governments and between provincial and local governments also involve both equalization components and some use of conditionality.

III. Review of Financing Arrangements Underlying Existing Self-Government Agreements

In this section, we briefly review alternative financing models that are currently in place to fund aboriginal governments. Our goal in undertaking this review is not to provide a detailed account of how native governments are currently financed; this task is being carried out by other researchers preparing reports for the Royal Commission on Aboriginal Peoples.[7] Rather, we wish to draw attention to the different approaches that characterize current financing arrangements, and where appropriate to indicate the extent to which these approaches are consistent with the general principles outlined earlier. In examining current financing arrangements, we distinguish between two broad categories: (i) administrative models, and (ii) existing self-government agreements. We shall review each of these in turn.

3.1 Administrative Models

Although historically the vast majority of services to on-reserve Indians have been provided by DIAND, since 1956 when funds were first provided for local education committee[8] there has been some piecemeal devolution of the responsibility for service provision to band councils, so that at present many bands administer the provision of many local government-type services, as well as many services normally provided by provinces, specifically housing, education, health and natural resource services. This form of devolved administrative responsibility is the most common form of `self-government' currently in place. As is the case with local governments vis-a-vis the provinces/territories, the band councils derive all their powers from the federal government.

As band councils have assumed increasing responsibility for service delivery, new financing arrangements have had to be developed. Initially, resources were transferred to bands exclusively through contribution agreements, whereby DIAND devolved responsibility for service delivery to band councils, and the councils were then accountable to DIAND for the funds received. Contribution agreements are open-ended financing arrangements, whereby DIAND undertakes to finance all eligible expenditures incurred in providing the agreed services to band members. DIAND, however, retains all control over programme design, so that bands have no discretion with respect to how the funds received are to be allocated, and are subject to substantial reporting requirements. Following the publication of the *Penner Report*, which argued strongly against this approach to devolution, DIAND has developed a Comprehensive Funding Arrangement (CFA) programme whereby resources are now transferred through a mix of contribution agreements, lump sum grant funding and (since 1990-91) flexible transfer payments (FTP); 65% of all monies transferred by DIAND are allocated through CFAs. According to DIAND, Contribution Agreements now fund only those programmes and projects involving a high level of technical complexity or a high level of risk, e.g., social assistance programmes. Insofar as the grant portion of

[7] See, for example, Drewes and Kitchen (1993), Siksika Nation (1993), Malone (1993).

[8] DIAND, (1993), p9.

the CFA is concerned, no specific terms or conditions are attached to the funds transferred; however, the majority of these monies are intended to finance the institutions of band governments and their administration. Finally, the FTP programme is essentially an alternative to contribution agreements. Annually-determined budgets transfer fixed amounts to aboriginal governments for the delivery of specified services. Band councils may choose whatever means they wish to provide these services, and may use any surplus that may be generated as they see fit. Furthermore, the reporting requirements for funds received under the FTP programme are considerably less onerous than is standard in Contribution Agreements.

In 1986, the *Alternative Funding Arrangements Program* (AFA) was initiated as an alternative to CFAs. Twenty percent of the resources transferred to First Nations by DIAND currently are paid out under the AFA programme.[9] The AFA programme shares some of the features of the FTP scheme; however, considerably more autonomy is retained by the aboriginal governments regarding the allocation of funds between alternative usages. For example, the First Nation can decide what proportion of its capital fund to allocate to the construction of housing as opposed to any other capital project. In contrast, if funds are transferred to bands under an FTP to construct housing, the agreed number of housing units must be constructed. In essence, when a band negotiates an AFA it enters into detailed budgetary negotiations with DIAND to obtain a conditional grant for the provision of particular services. However, once the funds are transferred it has full authority to reallocate funds between projects and redesign programmes, subject to certain performance criteria. It should be noted that the performance criteria are specified in terms that are considerably more general than is true of funds transferred under a CFA, and that the reporting requirements are also less onerous. AFAs can run for between one and five years; anecdotal evidence suggests that most of the AFAs currently being renegotiated are for a three year term. This would appear to be due to the fact that five year terms impose significant financial risks on First Nations governments. It should also be noted that band councils who have negotiated an AFA with DIAND may also receive some services from other federal departments and agencies such as Health and Welfare, Secretary of State, Employment and Immigration, C.M.H.C., and Industry, Trade and Commerce.

In evaluating the extent to which the CFA and AFA funding mechanisms are consistent with the general principles adumbrated above, it is evident that they fail to exemplify many, though not all, of the criteria previously advocated. Clearly, the process by which the level of funding provided by DIAND is determined takes no account of differences in the resources available to different bands. Furthermore, very little provision is made for differences in the cost of provision encountered by different band councils in providing the same services, apart from some limited recognition of the costs due to remoteness. The absence of any equalization element in the funding formulae used means that different bands are in fact able to provide different levels of service to their members. Furthermore, it is important to point out that funding through both the CFA and AFA programme is available to band councils to deliver services to on-reserve members only. They are not funded to provide services to off-reserve members, and non-land-based aboriginal

[9]DIAND (1993), p. 13.

peoples, such as the Métis, are not eligible for federal funding on this basis.

Turning now to the technical characteristics of the CFA and AFA mechanisms, it is arguably the case that these approaches are relatively flexible, in that the scope of service provision covered by the agreement can vary from band to band. However, the mechanism will influence the scope of service provision which bands seek to negotiate. Lack of recognition of the differences in the costs of provision means that band councils which anticipate higher costs than are allowed for under the standard costing formula used by DIAND are discouraged from providing that service. However, the fact that band councils are free to choose the means by which services are provided when funds are received through an AFA or as a FTP, and can retain any surpluses, does create significant incentives to provide services in a cost effective and innovative manner. Regrettably, these incentives for sound management practises by bands are diluted, particularly in the case of CFAs, by frequent DIAND policy and form changes,[10] and also due to the fact that the `subject to Parliamentary appropriation' clause has been used by DIAND to reduce the amount of money flowing to bands under multi- year agreements, making forward planning difficult.[11]

Perhaps the most significant criticism of these administrative approaches to devolution, however, is that they are extremely costly to administer, and that they lead to considerable horizontal inequity. Indeed, it is widely recognized that both the negotiation process and accountability requirements use up a lot of the time and energy of aboriginal political leaders and DIAND officials alike. DIAND administrative costs are alleged to be excessive, and much of this is said to be a result of the costs of advising and monitoring services devolved to bands. Indeed, the demands placed on band councils in order to satisfy the accountability requirements are said to be both excessive and complex, surpassing what is required of provincial and local governments. For example, contribution agreements for social services require that bands submit monthly claims and detailed documentation to DIAND, as well as being subject to periodic program reviews of social development programs.

The history of the CFA and AFA programmes underscores the importance of a formula-based financing mechanism, rather than one which requires separate negotiation between the Federal government and each aboriginal government, both as a means of reducing negotiation costs and to promote equity across aboriginal communities, as well as between aboriginal and non-aboriginal Canadians. When funding levels are negotiated on a community-by-community basis, not only must each aboriginal government (and the federal government) allocate scarce resources to the negotiation process, but considerable potential exists for differential treatment, and aboriginal communities risk being `nickled-and-dimed' to death. A financing system requiring individual negotiations between each aboriginal government and the federal government --- a key

[10] In Siksika Nation (1993) it is indicated that the CFA, which accounted for approximately $4 million of a $26 million Nation budget, was amended 17 times during the 1992-93 fiscal year.

[11] Hankinson (1993) has indicated that the amount received by Siksika has been less than the amount negotiated under its five-year AFA. The AFA is, of course, subject to Parliamentary appropriation.

element of the current system --- would mean that significant levels of resources would continue to be expended by band councils in order to verify that others are not being better treated than they are themselves. In contrast, when the level of transfer payments is determined via transparent funding formulae, which are negotiated simultaneously between all aboriginal governments and other levels of government, the negotiation process is simplified and equity is seen to be achieved. It should be noted that since the 1980s, DIAND has taken some steps in this direction, notably in its increasing reliance on standard-costing models to determine the amount of funds to be transferred to bands for delivering any given service; however, as these models take only limited account of differences in the cost of programme delivery, and are not adjusted to reflect differential levels of own-revenues, they are not fully equalizing. It is worthwhile pointing out that if the financing system for aboriginal self-government is based on historical levels of transfers to aboriginal communities from other governments in Canada, present-day inequities will be perpetuated.

3.2 Financing Non-Administrative Models of Aboriginal Self-Government

There are a limited number of aboriginal self-government arrangements in place, and it is worth spending some time providing a brief overview of the financing arrangements that have been developed. These include the James Bay Cree and Naskapi, the Northeastern Quebec Inuit (Kativik Regional Government)[12], and the Sechelt people in British Columbia. As well, a limited amount of information is available from the Yukon First Nations Umbrella Final Agreement concerning future self-government agreements in the Yukon.[13] Financing of self-government activities comes from a combination of own source revenues and transfers from the federal government. Given the limited tax bases of aboriginal communities, the former is typically a rather minor source of revenues. We consider each funding source in turn.

i. it Own Source Revenues

Own source revenues include taxation, resource revenues, development corporation funds and various non-tax revenues. Taxation powers are typically restricted both by type and by size of base (tax capacity). Typically, they are limited to local government-type taxes. The Cree Regional Authority has the authority to levy all forms of local taxation except income taxes over all persons on category 1A land. No tax can be levied on provincial and federal crowns. Nor can taxes be applied on the use and development of land and resources. Also, user charges are effectively restricted by the requirement that any charges be levied on an ``equitable basis," and by precluding the raising of revenue beyond anticipated cost. Similarly, the Kativik Regional Government can use

[12] To become the Nunavik Regional Government. See also Drewes and Kitchen (1993) and Malone (1993).

[13] Although a final settlement has been reached between the federal government and the Inuit of the Nunavut Settlement Area concerning the Nunavut land claim, a financing package has not yet been finalized for funding the ongoing responsibilities of the new government of Nunavut.

local property taxation, and Kativik's municipalities can tax businesses, stock in trade and rental properties. The Regional Government can levy municipal-type taxes on land outside municipal boundaries and can tax each municipality equivalent to a fraction of Kativik's expenses. It can also issue building permits and licenses. However, as pointed out by Malone (1993), many of these taxation rights are essentially empty; for example, the fact that there is essentially no private property in northern Quebec means that the property tax base is essentially non-existent. The Sechelt Band Government has the legal status of an Indian Government District. Its taxation powers derive from its own constitution, which allow it to use all local taxes, including property taxes and taxes on land leased from the Band from non-Indians as well as business licenses. In particular, District status eliminates taxation from other jurisdictions when the Indian government assumes tax jurisdiction, and permits some additional fiscal benefits if legislation is implemented to fit the District into the provincial system. The rights to resources held by the province are not changed.

The Yukon First Nations, under the Umbrella Agreement, will also have local government-type taxing powers, though the precise form of taxes is a matter of negotiation. The federal government will pay all the property taxes on taxable settlement lands in the first year of an Agreement and this will be gradually phased out by ten percentage points each year. Yukon First Nations may also develop their own resource revenues and obtain revenues therefrom, the first $20 million of which will not be taxed by other jurisdictions. They may also tax resource developers on Category A lands and may share a part of the royalties received by the Yukon Government, contingent on the federal government transferring the administration and management of Yukon resources to the Yukon Government. Under the draft agreement for the Champagne and Aishihik First Nation, income taxes are precluded, but direct taxes such as business and property taxes may be used, as may fees and permits. As well, the federal and Yukon governments ``may enter into an agreement with the First Nation on tax sharing,'' presumably as part of a general funding package.

An important distinction should be made between any financial compensation that aboriginal peoples may receive for land and other claims, and that which they may receive explicitly in connection with the implementation of self-government; although both are lump sum payments, the two are conceptually quite distinct. To foreshadow somewhat the preoccupations of sections IV and V, it is appropriate here to point out that compensation claims negotiated as part of self-government agreements are once and for all wealth transfers to aboriginal peoples. Consequently, in calculating the potential sources of revenues for aboriginal governments, funds transferred as part of the settlement of self-government agreements --- e.g., the `buy-out' of the Yukon Indians tax exemption --- should not be viewed as a potential source of funding for aboriginal governments. The investment of settlement moneys can be expected to generate considerable income for aboriginal communities, certainly far more revenue than might be collected from the application of any tax measures. In contrast to the settlement payment itself, there are good economic arguments that can be used to defend the proposition that this income earned from the investment of compensation claims obtained under self-government agreements should be counted as a potential source of own-financing for aboriginal governments. The level of funding that the federal government should be expected to provide would then be reduced. It is consequently salient to observe that under the terms of the Yukon First Nations Umbrella Agreement, the terms

of the tax buy-out of Section 87 of the Indian Act mean that in return for Yukon First Nations and Indian People consenting to be subject to full federal and Yukon income tax laws they are to receive $26.57 million in payment from the federal government. This settlement claim will not be taxed. Furthermore, providing that the investment income earned on these funds are spent in certain ways, it will not be taxed; to avoid taxation, the investment income must be spent on such items as economic development or on social, cultural or educational programs of value to the bands. Otherwise, the income earned will be taxed.

In the case of payments to settle land and other compensation claims, a similar distinction can be drawn between the wealth transfer (the `principal') and the income derived from the investment of the moneys received (the `interest'); we return to the appropriate treatment of these payments from the point of view of calculating aboriginal governments' revenue-generating capacity in sections IV and V.

ii. Grants from the federal government

Given the limited revenue-generating capacity of most aboriginal communities, it is clear that the ability of aboriginal governments to provide basic public services to their citizens will largely be determined by the size of the grants they receive from other governments. As we have seen, this is also true of local, provincial and territorial governments elsewhere in Canada (as well as in virtually every other federation in the world). We will briefly review the major features of each of the existing financing agreements for aboriginal communities that have signed self-governments agreements.

The statement of understanding signed in 1984 between the Government of Canada and the Cree Regional Authority and Naskapi Band provided for two separate five-year funding agreements, one for operations and management, and the other for capital expenditures.[14] The operations and management agreement covered the provision of services previously funded by DIAND as well as funding for health services from Health and Welfare Canada. It excluded, however, education and social development programmes, which were negotiated with Quebec. The capital agreement covered the provision of community infrastructure normally funded by DIAND, excluding the construction of schools. Funds are transferred essentially in the form of an unconditional grant, subject to the provisions of the Cree-Naskapi Act, and there are minimal audit requirements attached to these funds.

The total level of funding flowing to the Cree- Naskapi under the 1984 agreement for

[14] It should be noted that the Naskapi Band negotiated a financial agreement with the federal government for operations and management and capital in 1990; the Cree Regional Authority, however, is yet to sign a financial agreement to succeed the original agreement which ended in 1989. An agreement was signed, however, between Canada and the Oujeboogoomou Cree in 1992, based on the same principles, terms and methodology as the previous Cree-Naskapi agreements.

operations and management was essentially determined by costing out the provision of services for these communities. The grant was determined by subtracting own-source revenues from the total estimated expenditures; interestingly, the agreement did not provide for any reduction in the level of transfers from the federal government were own-source revenues (other than user fees) to increase. No particular methodology was used for establishing the level of funding under the Capital agreement, except that it was consistent with the amounts spent by DIAND on First Nations elsewhere in Canada. Provision was made for automatic adjustment of the funding level, incorporating such factors as population increase and the level of the consumer price index. It has been alleged that since the initial agreement was signed, the band has not received the appropriate amounts of annual adjustment for funding, and Treasury Board has not approved the adjustment formula. The Cree-Naskapi also receive some conditional grants, subject to continuing DIAND approval, which enables them to deliver services directly in certain areas. Again, such funding is subject to the proviso that they must be consistent with existing levels of DIAND spending on programs.

The Sechelt Band Government also receives federal funding on a basically unconditional basis. A five year financial agreement was signed in 1986 between the Government of Canada and the Sechelt Indian Band, and was renewed in 1991. This agreement covers all DIAND funding and some funding from Health and Welfare Canada's Medical Services Branch. Unlike the Cree-Naskapi agreements, no distinction is drawn between operations and management, on the one hand, and capital expenditures, on the other. The funds are essentially transferred as an unconditional grant, although certain performance criteria must be met, specifically with respect to the provision of health services meeting national standards.

In effect, the total level of funding was determined on the basis of DIAND and Health and Welfare Canada's expenditures on the Sechelt Band. The agreement provides for automatic adjustments in the base funding level to reflect changes in population and the Consumer Price Index. Provision is also made for adjustment if there are changes in the number or types of programmes delivered by the Band. Interestingly, no provision was made in either of the first two agreements for adjustments in the level of funding due to increases in band revenues; however, a memorandum of understanding on future cost-sharing has been signed by the band and the federal government. For four of the five categories (administration, local government infrastructure, social assistance, and economic development), the band can allocate funds as it sees fit, though it must provide audited consolidated financial statements to the Minister. For education expenditures, the funds transferred are specific to that purpose. Overall, there seems to be a fair amount of discretion left to the Band Government over the use of its funds.

Under the terms of the James Bay Northern Quebec Agreement, responsibility for funding the provision of services by the Kativik Regional Government (KRG) was transferred to the province of Quebec, which in return receives funding from the federal government. To the considerable frustration of Inuit political leaders, the KRG and other regional institutions do not deal with one Quebec government ministry, but with more than seven different government departments! In each case, separate agreements concerning the level of support must be negotiated

on an annual basis, so that an excessive level of resources must be devoted by the KRG to presenting its claims for financing. However, the respective ministers have the final word over funding, and it is clear that here, as in the other cases, ministerial discretion is the rule rather than a more general set of criteria embodied in a more binding way such as constitutional obligation (as is the case with federal-provincial Equalization payments), or legislation (as with provincial-local government grants). It has been recognized both by the KRG and by the province of Quebec that new financial arrangements should be entered into. Negotiations as to the form of such new arrangements have yet to be concluded. The details and pressing issues concerning the financing of the Kativik Regional Government are laid out in Malone (1993).

The funding arrangements for the Yukon First Nations are presently being negotiated; negotiation of these agreements is part of the Yukon Indian Comprehensive Land Claim Agreement which specifically states that *Financial Transfer Arrangements* are to be a subject for negotiation for Yukon First Nations with the federal Government. The intent of financial transfer arrangements is stated to be to set out a method for determining how much money the First Nation should get for its programs and services, to set out the obligations of all parties, including basic minimum standards for program delivery, and to set standards for accountability. The arrangements may provide for five year block funding, to be renegotiated every five years.

The *formula grant* to Yukon First Nations which sign self-government agreements will be calculated as the difference between the First Nation's own revenue-generating capacity and its gross expenditure base; the gross expenditure base reflects historical levels of federal government spending as well as resources available from the Yukon Region vote 5. As well, provision is to be made for both start-up and ongoing costs associated with the implementation of self-government; the amounts to be paid are to be determined by reaching agreement over expected costs. The formula grant will be adjusted annually for changes in population and an annual price escalator, using a three-year moving average. In terms of own-source revenues, an important feature of the self-government agreement is that Yukon First Nations have agreed to become subject to both federal and territorial income tax regimes. The agreement stipulates, however, that no reduction in the level of federal funding will occur to reflect First Nation revenue-generating efforts during the first three years of the agreement, and that their will be only partial off-setting during a number of subsequent years. Provision is also made for the First Nation to enter into a tax sharing agreement with the federal and territorial governments.

3.3 Summary

This section has briefly reviewed the various financing models that currently transfer funds from the federal treasury to aboriginal governments. It initially focuses upon the financing mechanisms used by DIAND to fund the provision of public services by band councils. This can be viewed as corresponding to an administrative model of limited `self-government'. Although quite flexible in scope, it is seen that many of the features of this approach are undesirable in the context of the implementation of proper self-government by aboriginal communities. Attention is subsequently

directed to the financing mechanisms which have been developed in the context of existing aboriginal self-government agreements --- i.e., with the Cree- Naskapi, the Northern Quebec Inuit, the Sechelt Indian Band, and the Yukon First Nations. The instruments available to each nation to generate revenues are discussed, and a brief review of the terms of the transfer agreements is provided.

IV. Possible Approaches to Financing Aboriginal Self-Government

We discussed earlier the general set of principles that the financing arrangements should satisfy. This section is devoted to discussing the implications these principles have for the design of fiscal arrangements for aboriginal governments. It is worth recalling some of the properties we have advocated that these arrangements should exhibit, reflecting our premise that aboriginal governments should be treated symmetrically to other political jurisdictions from a fiscal point of view. The most important of these principles is that of fiscal equity, which is based on the economic notion of horizontal equity. It implies that different jurisdictions ought to have comparable capacity to provide public services to their citizens at comparable tax rates. This is a defining feature of the Canadian federation, one which applies both across provinces and territories and also across local governments within provinces and territories. The fiscal arrangements ought also to allow for the federal government to use its spending power to ensure that basic notions of national efficiency and equity are satisfied across the federation, and to encourage the harmonisation of taxes and of expenditures where those are important for the efficiency and equity of the internal common market. At the same time, the fiscal arrangements should not interfere with the decentralized decision making authority of lower levels of governments except to the extent that it is clearly justified by national economic objectives.

Federal-provincial fiscal arrangements accomplish these objectives by a variety of instruments, particularly the Equalization, EPF, CAP programs and the Tax Collection Agreements. There are, of course, a series of lesser shared-cost programs in different areas of expenditure responsibility. Taken together, however, these programs have a number of important properties. Firstly, to a very real extent they succeed in equalizing the revenue-raising abilities of different provinces. The Equalization program and the EPF program are explicitly equalising, while it can be argued that the CAP program implicitly equalises on the basis of need. The programs are largely unconditional, the exceptions being the rather general conditions put on the EPF transfers by the Canada Health Act, and the conditionality of the CAP transfers. They also impose a minimal degree of accountability on the provinces. Finally, they are based on clearly stated objective rules or formulae and are relatively simple to administer. Comparable sets of fiscal arrangements designed to achieve comparable goals exist within the provinces and territories.

Starting from the premise that an appropriate financing mechanism for aboriginal self-government must also be guided by these principles of fiscal federalism, it is nonetheless evident that considerable effort must be devoted to the design of mechanisms which are both consistent with application of these principles, and workable in the context of aboriginal self-government. Although there are many issues that will need to be addressed in considering the architecture of an actual financing mechanism, it is worthwhile drawing attention at the outset to two particularly important ones. First, it should be borne in mind that the design of such a mechanism cannot be discussed independently of the division of powers between aboriginal governments and other levels of government in Canada, and the extent to which each aboriginal people chooses to exercise the powers available to it. For example, if a self-government agreement

accords an aboriginal government jurisdiction in the area of education, but it chooses not to exercise its jurisdiction in this field, then (at least) two possible procedures may be followed in calculating the appropriate level of funding for that particular aboriginal government. One possibility is that transfer payments are calculated only on the basis of powers actually exercised. An alternative is that they are calculated on the basis of all the powers that the community has the *potential* to exercise, and to then that it compensate, out of these funds, other levels of government for the services provided by them in its stead. It is of course impossible, at this time, to foresee the specific details of the self-government agreements that will be reached between aboriginal peoples and the federal government, and in particular the extent to which the division of powers specified in these agreements will or will not differ across aboriginal peoples. In our analysis below, therefore, we have tried to indicate clearly the impact that alternative assumptions regarding the division and exercise of powers may have upon our conclusions.

The second point that must be stressed in discussing the application of the principles of fiscal federalism to the financing of aboriginal governments is that it is misleading to work largely in terms of analogies to local and/or provincial governments. For not only is it the case that *all* provincial governments and *all* local governments in a given province exercise responsibility for the delivery of public services in the same areas, which is unlikely to be true of aboriginal governments, but the citizenry that must be provided for by provincial and local governments is well-defined by place of residence, which is not likely to be true of most aboriginal communities, and is certainly not true of the non-land-based aboriginal peoples. Furthermore, some of the responsibilities of aboriginal governments may correspond to provincial powers,whereas others will correspond to local or even federal areas of responsibility. Additionally, the sources of own revenue available to aboriginal governments will vary greatly across communities and will generally be of a far smaller level of magnitude than is the case for provinces and local governments; moreover, the treatment of some forms of own source revenue for the purposes of calculating transfers may well differ in the case of aboriginal governments (e.g., revenues from land claims and the continuing fiduciary obligations stemming from treaties). These issues are discussed in greater detail in sections V and VI. These differences imply that the framework used for federal-provincial and/or provincial-local government transfer payments cannot be transposed directly to determine the structure of the new fiscal relationship between the federal government and self-governing First Nations.

The scope of the fiscal arrangements encompasses several components. It would typically include both conditional and unconditional grants. The conditional grants would serve the purpose of providing an incentive for aboriginal governments to conform to norms of national efficiency and equity in their program design, and to take account of the impact of their programs on neighbouring jurisdictions. The grants might be matching or non-matching as the circumstances dictate, and they may be specific or block in nature. However, a key feature of the use of conditionality, or the federal spending power, is that the conditions should not violate the spirit of decentralization of responsibility; that is, they should be no more restrictive than is needed to satisfy the rather general national objectives of efficiency and equity. While conditional grants serve a regulating or incentive function, unconditional grants are appropriate when the objective is simply

to get funds into the hands of the aboriginal government. Finally, the arrangements will outline the extent to which the level of transfers will be adjusted to reflect the importance of own source revenues of various types, such as taxes, user charges, licenses, resource revenues and capital income, including profits from businesses. The arrangements might include some provision for tax sharing and coordination or harmonisation both among various aboriginal nations and between these nations and the federal government. It must again be stressed, however, that due to the relatively insignificant amounts of own-source revenue available to aboriginal governments (see Drewes and Kitchen (1993), Siksika Nation (1993), Malone (1993)), there will be a significant fiscal gap between their expenditure responsibilities and revenue-raising capacities, which will have to be closed by intergovernmental grants.

These various components are interrelated so the entire system must be designed as a package. The overriding issue, and the one we dwell on most in this section, is the determination of the total level of funding for each aboriginal people. This will need to be determined regardless of the way in which these funds break down into conditional, unconditional and own source revenue components. For example, the specification of conditions and the size of conditional grants can be addressed more or less independently of this issue. Ultimately, a residual unconditional transfer will be required to satisfy the overall revenue requirements of each government. From our previous discussion of the principles of fiscal federalism, it should be clear that the criterion that ought to serve as the guiding principle for determining the total funding available to each nation is fiscal equity, which is the same criterion used to allocate federal transfers among the provinces and territories, and from the latter to the local governments. Full fiscal equity would involve ensuring that all governments --- including aboriginal governments --- have the funds to be able to provide services in their jurisdictions comparable to those provided elsewhere in Canada and at comparable cost to themselves.

Several features of this prescription are worth highlighting. Firstly, the relevant comparison group for aboriginal communities should include all other Canadian communities, both aboriginal and non-aboriginal. Secondly, fiscal equity is a passive criterion in the sense that it is solely concerned with giving different communities comparable potentials for providing public services. It does not require that they actually provide the same levels and types of public services. This is important because it implies that the transfers to a given community should not depend on the specific expenditure patterns that community chooses, but only on the fiscal capacity of the community relative to others. For this reason, the grant should be unconditional and fully respect local decision making authority. Relatedly, it should be stressed that the implementation of the fiscal equity principle does not entail detailed costing of individual services that are provided by self-governments and basing the transfers on those costs. The latter procedure, which has often been used in financing services to aboriginal peoples in the past, is the antithesis of the approach suggested here. It is administratively costly, it typically interferes with the integrity of community decision making, it tends to be discretionary, and it is unlikely to result in a fiscally equitable set of transfers.

2.1 Implementing Fiscal Equity

The task of incorporating fiscal equity into the financing agreements is a very difficult one, given the diversity that exists among aboriginal communities and their relative lack of resources compared with non-aboriginal communities. As mentioned, a financing scheme ought to treat equitably not only each aboriginal community with each other, but also aboriginal communities with non-aboriginal ones. This is a daunting task, and one which cannot be done with great accuracy. The existing fiscal arrangements between the federal government and the provinces, and between the provinces and their local governments tend largely to focus on revenue equalization as a means of achieving fiscal equity. This is a reasonable approach given the relative homogeneity that exists among these communities at a given level of government. Where revenue equalization is departed from, it is done in a relatively simple, even arbitrary, way. For example, the per capita grant to the territories is more generous that the Equalization system would allow and is notionally based on historically higher expenditure needs. Similarly, within provinces, grants to local governments may be differentiated according to such things as remoteness or degree of urbanisation. In the case of aboriginal communities where revenue bases are small or even non-existent, differences on the expenditure need side are likely to be correspondingly more important both across communities and between these communities and non-aboriginal ones.

It is conceptually useful to distinguish two levels of comparison in approaching the issue of fiscal equity --- that between aboriginal and non-aboriginal communities, and intra-aboriginal comparison. Fiscal equity requires that equalisation be accomplished at both levels simultaneously. Comparability with non-aboriginal communities is likely to be especially difficult to implement because of the differences that exist between these jurisdictions and aboriginal ones. For one thing, the expenditure responsibilities of the two types of governments will differ; aboriginal communities will likely have access to some provincial-type and some local government-type expenditure responsibilities, making comparison with either difficult. Moreover, revenues-raising capabilities are likely to differ significantly between the two sorts of communities, as are expenditure needs and the cost of delivering services. This implies that aboriginal governments could not simply join the existing Equalization scheme at the federal level or its provincial analogues. The total amounts currently being transferred to the provinces or their local governments on a per capita basis would be inappropriate for aboriginal communities. Equalization among aboriginal communities should be more feasible since differences across aboriginal communities seem likely to be less significant than the differences between aboriginal and non-aboriginal ones. Here the task would principally involve comparing fiscal requirements across communities which differ mainly with respect to costs of provision and needs, since their revenue-raising capacity is likely to be rather limited.

The implementation of full fiscal equity cannot be done with any exactness, given the obvious measurement problems involved; judgment and negotiation will necessarily be involved. The best that can be expected is that the fiscal equity principle serve as the main criterion which guides the negotiations over the size of the transfer, rather than such tempting alternatives as the costing of the provision of each government's services. An obvious issue is who should be

responsible for determining the allocation of funds. In the case of federal transfers to the provinces, it is the federal government that ultimately determines the size of the transfers by virtue of its spending power, though for some programmes this is done after negotiation with the provinces. However, the Equalization programme, which essentially implements fiscal equity, is a unilateral federal initiative. Similarly, the provinces basically determine how much revenue to transfer to their local governments. Presumably, any mechanism financing aboriginal self-government will also have to respect the rule of Parliament, and in that sense will ultimately be subject to approval of the government of the day.[15] However, that does not preclude meaningful negotiations over the size and form of the transfers, as is presently exemplified by the Equalization programme. Given the complexity of the problem and the nature of relations between the aboriginal community and the federal government, negotiating the form of the self-government financing arrangements would be appropriate. As with transfers between the federal government and the provinces, or those financing arrangements that are now in place for self-governing aboriginal communities, arrangements could be for a given period of time to be renegotiated as each agreement expires. Though the agreements would have to be legislated by Parliament, since they involve federal expenditures, the use of the fiscal equity criterion as a principle for determining the size of the transfers could be given additional political or constitutional authority by appealing to the responsibilities of the federal government under section 36 of the *Constitution Act*. Indeed, it might be appropriate to consider amending the constitution so that section 36 refers explicitly to aboriginal governments in an analogous way to the provinces.

Suppose we accept the need for the financing agreements to be subject to negotiation. Since the issues involved in applying the notion of fiscal equity are somewhat different when comparing aboriginal and non-aboriginal communities than when comparing the former with one another, and since negotiations by individual aboriginal peoples with the federal government would be a cumbersome and perhaps unbalanced process, we are led to the view that fiscal equity might best be achieved through a two-stage process.[16] In the first stage, fiscal equity between aboriginal governments and non-aboriginal governments is addressed. In the second stage, equity across aboriginal communities is pursued. The object of the first stage would be to determine an amount of funds to transfer to aboriginal governments in the aggregate, on a per capita basis. The second

[15] The alternative would be to imbed the financing arrangements into the constitution, which would place them on an entirely different footing than the fiscal arrangements between existing participants in the Canadian fiscal federation.

[16] Although we discuss the two stages as if they were sequential processes undertaken by possibly separate institutions, the distinction could be thought of as a conceptual one only that serves to guide the formulation of a financing agreement by a single institution. Also, it might be worth mentioning that our distinction between aboriginal communities and non-aboriginal ones might be too broad. One might want to disaggregate aboriginal communities into finer categories (such as land-based and non-land based) and let the first stage determine a separate per capita average allocation to the two or more types of communities. Then there would be a separate second stage for each category.

stage would then allocate these funds equitably among the various aboriginal communities. Naturally, the two stages cannot be undertaken independently. For this two-stage procedure to be feasible, it would be necessary that a `negotiating team' representing aboriginal peoples negotiate with, say, the federal government. In the second stage, there would be no need to involve the federal government; the allocation of funds among aboriginal peoples could be done by the representatives themselves. In our view, there would be distinct advantages to allowing aboriginal peoples to assume responsibility for the second stage. In particular, this may facilitate the development of an approach to the pursuit of equity that is consistent with aboriginal peoples' traditions. How such a `negotiating team' might be constituted is something that others might be better placed to resolve. It could, of course, be a representative group of citizens or leaders from the aboriginal communities themselves, perhaps even an elected body.[17] Alternatively, it could be a more disinterested body of experts along the lines of the grants commissions that exist in federations such as Australia and India and which are essentially advisory in nature.

Let us consider some of the issues involved in each stage in turn.

4.1 Stage One: Aboriginal versus Non-Aboriginal Jurisdictions

The first stage would set the overall level of transfers to be made to aboriginal peoples in the aggregate. For comparison purposes and to allow for changes in population over the life of the agreement, it would be convenient to do this on a per capita basis. The size of the transfer would be intended to achieve fiscal equity, that is, to ensure that aboriginal communities have the resources required in order to be able to provide themselves with public services comparable to those enjoyed by non-aboriginal Canadians at comparable cost to themselves. In principle, this requires that both differences in revenue-generating capacity and in expenditure need be taken account of.

Two significant complications arise when seeking to achieve fiscal equity with respect to aboriginal and non-aboriginal communities. The first is that given the many differences that exist between aboriginal communities, differences in needs and costs of provision cannot be ignored. This means that merely equalizing revenues, as is done with the provinces, is inappropriate. It is not a simple matter, however, to take account of while at the same time delivering funds as unconditional grants. To do so will require that appropriate indices of expenditure need be devised that can be measured across jurisdictions. At present, in determining federal transfers need differences are typically taken into account in only a rather crude fashion, if at all. We return to a further discussion of this below.

The second complicating feature is that, even apart from differences in expenditure needs and in the cost of providing comparable services, revenue equalisation itself would not be simple to

[17] Such a body would fulfil similar functions to the First Nation Provincial government suggested by Courchene and Powell (1992).

implement. The reason is that the extent of responsibilities differs between the two types of governments. Revenue equalisation is intended to compensate for differences in the ability of governments to finance comparable levels of expenditures on public services given comparable tax effort. In the federal-provincial Equalization system, provinces whose fiscal capacities are below average are provided funds on a per capita basis to make up the shortfall between what could be raised in their jurisdictions by applying national average tax rates to their tax bases and what would be raised by applying the same national average tax rates to an average of tax bases across the nation. Since the levels of expenditures required by aboriginal governments will differ according to their responsibilities, they could not all be equalized to the same national average level.

The objective of the first stage would be to provide the financing to enable the `average' aboriginal government the provide levels of public services comparable to those provided elsewhere in Canada. Essentially, the outcome of this first stage would be a single per capita sum which the average community would be entitled to. By its nature, this task could only be accomplished very imperfectly, given the difficulties involved in determining the amount of resources which would be required to provide comparable levels of services. In the end, the entitlement would have to be arrived at by negotiation, with the negotiation being informed by the objective of the transfer, which is fiscal equity.

The per capita entitlement thus arrived at might be viewed as an aggregate of the transfer that would substitute for the main forms of unconditional grants --- Equalization and EPF. In addition, where appropriate, aboriginal governments would be able to participate in shared cost programmes that are made available to the provinces --- such as CAP. The amounts of these grants are specific to the community in question since they depend upon local expenditures. Of course, it might be the case that the matching rate differs for aboriginal communities because of cost or need differentials; it is not uncommon for matching rates to vary across provinces. There might also be revenue sharing arrangements with aboriginal governments, e.g., with respect to resource or gaming revenues. If so, this would affect the extent of the transfer since these are analogous to unconditional transfers. This is also discussed further below.

The manner in which the entitlement is distributed across communities would be the subject of stage 2, to which we now turn.

4.2 Stage Two: Fiscal Equity Across Aboriginal Communities

In this sub-section, we provide a detailed discussion of the mechanisms that will have to be developed and the issues that will have to be resolved in order to achieve fiscal equity across different aboriginal communities. The aggregate per capita transfer to aboriginal peoples is determined in the first stage. It represents only an average amount to be transferred. Some communities, presumably those less well off, will ultimately receive more than the average, and others will receive less. Our purpose now is to outline the criteria to be used to determine how the particular amount transferred to any given aboriginal government will be adjusted upwards or

downwards of this `average' amount, depending both on the level of need and on the availability of own sources of financing. It should be noted that the following discussion initially supposes that aboriginal governments do in fact exercise all of their constitutional powers; in section 4.2.3, below, we consider the adjustment of the equalisation payment if an aboriginal community exercises only some subset of these powers. The fact that different aboriginal communities in fact take on different powers will of course make it even more difficult to perform this two-part equalization exercise. We return to this issue subsequently.

If the goal of fiscal equity is to be upheld in designing mechanisms for financing aboriginal self-government, the significant disparities that exist both with respect to the capacity to generate own-source revenues and with respect to the needs for services suggest that undertaking an equalization exercise will be somewhat more complicated than in the context of, say, federal-provincial relations. Nonetheless, it would appear relatively straightforward, in principle, to resolve the double problem of revenue inequalities and differential needs and costs by undertaking a two-sided equalization exercise, i.e., by doing equalization with respect to *expenditures* as well as with respect to *revenues*. These two components of inter-aboriginal equalization are additive components which can be considered separately. In what follows, we discuss in sequence these distinct components, which we view as indispensable to the achievement of fiscal equity. Our discussion will be framed exclusively in terms of the equalization function of the fiscal arrangements. However, it must be stressed that the funds transferred to aboriginal governments in non-matching form may also serve as vehicles by which the federal government imposes conditions (`performance criteria') so as to achieve national equity and efficiency goals. An analogy may be drawn with respect to the rider placed on the EPF transfer to the provinces under which eligibility for health care grants is made conditional on provincial health programmes meeting certain conditions would be permissible. At the cost of repetition, we point out that it is inconsistent to apply conditions on transfers to aboriginal governments which non-aboriginal governments do not face. Also, as mentioned, other shared-cost programmes such as CAP could be entered into which would be over and above financing based on fiscal equity.

This process will be the analogue of the computation of Equalization transfers to the provinces. However, there are two significant differences between the system proposed here and that which applies to the provinces. For one, the procedure outlined here will be what is referred to as a `net' equalisation system. That is, it will be a system in which both the more needy communities are equalised up relative to the average, and the less needy ones are equalised down. The other difference is that, whereas the Equalization payments made to provinces are based entirely on tax capacity deficiencies, revenue equalisation is liable to play a relatively minor role in the system we are proposing. Aboriginal governments are likely to finance a relatively small proportion of their expenditures from own-source revenues; so, there will be little revenue to equalize. Nonetheless, the ability of an aboriginal government to provide a given level of services to its citizens is likely to vary considerably from one community to another because of differences in need. This is partly due to the fact that different aboriginal peoples are located in more or less remote areas, or have more or less contiguous land holdings. But this is also due to the fact that aboriginal communities tend to be small, and are consequently more likely to differ in significant

respects --- e.g., in their demographic profiles --- from the hypothetical `average' aboriginal community which was considered in stage one. For these reasons, an equalization procedure should take account of differences in expenditure needs as well. In this sense, expenditure-based equalization provides a form of risk sharing across aboriginal communities.[18]

4.2.1 Revenue equalization

What then might be involved in performing a two-part equalization exercise? On the revenue side, the exercise is at first blush relatively straightforward, in that it requires the calculation and the comparison of the capacity of each aboriginal community to generate revenues. This involves designing a programme for aboriginal communities similar to that used for the Federal-Provincial Equalization programme, under which an approximate measure of average tax capacity is calculated. In the context of aboriginal self-government, the comparison is with the revenue-generating capacity of other aboriginal governments. For example, one might imagine that if land-based governments are allowed to tax any business which is operating on its territory then, regardless of whether or not a particular aboriginal government chooses to impose such a business tax, and regardless of the rate at which it actually taxes such businesses, performing the revenue equalization exercise requires that the government's ability to generate revenues from taxing local businesses at the average tax rate for aboriginal governments be calculated for the purpose of establishing the community's revenue-generating capacity. Communities with a revenue-generating capacity lower than this average level would then receive correspondingly higher equalisation payments; that is, they would be entitled on this account to a higher than average transfer from the pool of funds available to all aboriginal governments.

A similar sort of calculation would have to be done for all relevant sources of revenue and an aggregate revenue equalization entitlement would be calculated for all aboriginal governments. Some would receive above the average entitlement; others would receive below the average entitlement. However, the total entitlements would sum to zero. For each aboriginal government, the revenue equalization entitlement (positive or negative) would be added to the average per capita transfer obtained from the first-stage negotiations. This would give the community's entitlement net of revenue equalization. To this would be added the entitlement due to expenditure equalization as discussed below to obtain the overall grant entitlement appropriately equalized.

Several issues can nonetheless be identified which may render this revenue equalization exercise somewhat more complex in practise. One complicating factor is that, unless some sort of

[18] It is worth noting that if there were relatively small differences in expenditure needs, and if own-source tax revenues were minimal, a equal per capita transfer to all aboriginal communities, like the EPF grant, would suffice. Engaging in revenue and expenditure equalization exercises is appropriate only to the extent that the differences in the resources available to aboriginal governments, and in their expenditure needs, makes an equal per capita funding formula inequitable.

umbrella agreement is negotiated between the government of Canada and all Canadian aboriginal communities which ensures that these governments have the same rights to impose taxes, collect resource royalties, etc., then the calculation of revenue-generating capacity for each aboriginal government may be somewhat more complex, although not excessively so. In effect, either the community can be assigned a revenue base of zero, and so would receive equalisation payments with respect to that revenue source, or these potential sources of financing can be removed from the base for equalization calculations. It should be noted, however, that whatever solution is chosen, the fact that different aboriginal communities dispose of different potential revenue bases will affect the average revenue-raising effort with respect to any given source of own-financing. In particular, when different communities can collect revenues from a different number of sources, differences in revenue-raising effort are at least in part a reflection of the availability of particular instruments to generate income. They do not simply reflect different preferences for the level of provision of public services, as is arguably the case when all governments dispose of the same set of instruments. It is also worth pointing out that it is unlikely that a uniform umbrella agreement could be written under which all aboriginal peoples obtained the same powers to raise own-source revenues. It is not evident, for example, that it is possible for a non-land-based aboriginal governments to perceive, say, resource royalties (let alone sales taxes!), whereas this might be an option for a land-based aboriginal community.

Calculations to equalize revenue-generating capacity may be further complicated if there is reason to believe that the costs associated with collecting revenues from different sources differ across aboriginal communities. For example, it may be relatively costly for small aboriginal communities to put in place a sales tax, but considerably less so for larger communities. This means that a simple comparison of apparent revenue-generating capacity via a sales tax is misleading, since what must actually be compared is the ability of each community to generate revenues *net of administrative costs*. It should be noted that there should be no incentive to create inefficiently small revenue collection authorities; aboriginal communities should be encouraged to raise funds in as efficient a manner as possible (including using revenue sharing via tax collection agreements where appropriate).

It should be stressed that the principal focus of any revenue equalization exercise will certainly not be on equalising tax capacities. Indeed, any discussion of equalizing tax capacities is somewhat academic since most aboriginal communities at present are characterized by low levels of per capita income and economic development, and there is little potential for revenue generation through the application of an aboriginal tax system. In thinking about equalization on the revenue side the most serious complications stem from the fact that the most significant potential revenue sources are non-tax revenues. These include such things as royalty payments on resources, revenues from gaming and other local businesses, income earned from investing land claims settlements payments, user charges and licenses. In the case of royalty payments on resources, this poses no significant problem since a mechanism for equalising them has already been established for the provinces and could presumably be suitably adapted for aboriginal governments. Whether and how other non-tax revenues should be incorporated into the equalization calculations is unclear. For example, in calculating the equalization payments due to provinces, the profits of

crown-owned lottery corporations are not included; it then seems inequitable to implement an equalization programme for aboriginal Canadians which would include gaming revenues derived from aboriginal government-owned gaming corporations in the income base. Nonetheless, if all potential sources of revenue are not included in the base, then those aboriginal communities which have access to non-equalized income sources will be advantaged with respect to those which do not --- for example, if gaming revenue is not included, then those aboriginal communities situated close to urban areas are significantly advantaged with respect to those located in remote areas. What must also not be lost from view is that it would be impossible to include `potential gaming revenues' in the same way as it is possible to calculate `potential property tax revenue'. Instead, it would be necessary to include actual gaming revenues earned. This would have a significant incentive effect; in particular, it will discourage band governments from operating gambling casinos, and so increase the level of funds that would have to be transferred in stage one in order to achieve fiscal equity.

Apart from gaming, the most significant source of non-tax revenues will undoubtedly be the income earned by aboriginal governments from the investment of their land claims settlements payments. A distinction needs to be drawn between the amount of the claim itself (the value of the principal) and the subsequent income earned on claims that are invested, whether in real or financial assets. We take the view that the income earned from these claims should be incorporated into the determination of aboriginal governments' revenue-generating capacity, though not the claim itself. Land claims settlement payments constitute a resource in much the same sense as do, say, oil wells. That is, the community can derive income from the ownership of this resource. Financial resources should therefore be treated symmetrically to natural resources, and so the income earned by the community from the ownership of that resource (for example, from the sale and purchase of bonds) should enter into the equalization formula. This view can nonetheless be challenged. For example, were an aboriginal community to convert their land claim settlement money into an annuity, the entire stream of income would then be included in the base. However, were the same settlement money to be invested, only the income earned on the principle would be included in the revenue base. This is clearly unequal treatment, which would not arise were all income earned on land claims settlements excluded from the revenue base.

4.2.2 Expenditure equalization

Setting aside the purely technical issues that would need to be addressed with respect to equalizing revenue-generating capacity, the next step is to examine what would be involved in equalizing expenditures. The goal of an expenditure equalization exercise is to adjust the level of transfer payments to reflect appropriately the revenue requirements of different aboriginal governments in supplying a similar level of services to their citizens. Such expenditure equalization will yield a positive or negative entitlement to each aboriginal government according to whether its costs of providing a set of representative public services are above or below the average for all aboriginal communities. As with the revenue equalization entitlement, this would be simply added to (or subtracted from) the aboriginal government's per capita entitlement to obtain the net amount of

transfer.

Since expenditure equalization is not part of the current Equalization system, it is worthwhile briefly discussing, at a more conceptual level, the justification for performing equalization with respect to expenditures. Two sorts of factors can be identified as providing a justification for expenditure equalization: `environmental' variables, which lead to significantly different levels of costs when supplying a public service in one community rather than another, and `need' variables, which reflect the extent to which the composition of the population differs from one region to another so that, even if the taste for public expenditure were the same in different regions, the expenditure requirements of different governments would differ. It is widely recognized, for instance, that `environmental' factors such as remoteness and population density have a significant impact on the costs incurred by any level of government in supplying services. Additionally, however, there are many `social' factors which can be identified as having a significant impact on expenditure requirements of aboriginal communities. It may be legitimately argued, for instance, that the `need' for public spending is a function of, say, the proportion of citizens who depend on publicly-funded income support programs; for not only do communities with high unemployment rates require more generous funding in order to finance social assistance payments, but they also must deal with a whole series of additional problems --- such as substance abuse and mental illness --- which seem to be particularly acute and widespread when a large proportion of the members of any given community are without work.[19] And there are many other indicators that can be identified, including the proportion of elderly persons or of school-aged children, the quantity and quality of the housing stock, and the density of the road network, all of which can also be expected to influence revenue needs.

As noted above, the federal-provincial Equalization programme does not equalize expenditures. Given that the goal of the equalization programme is to enable provincial governments to provide roughly comparable levels of public service at roughly comparable levels of taxation, the absence of any expenditure equalization programme can be interpreted as meaning that the costs of delivering services, and the proportion of the population requiring specific sorts of public services, are not perceived to differ appreciably from one province to another. In contrast,provincial-local government equalization programmes, and the funding programmes for the territorial governments, are adjusted to reflect some measure of differing expenditure requirements in different areas. In view of the diversity of aboriginal communities in Canada, it is evident that any satisfactory approach to financing aboriginal governments must take into account the fact that different communities will be unequally capable of providing services to their citizens given an identical level of funding. This consequently justifies performing an equalization exercise

[19] Needless to say, it is often difficult to distinguish between the `need' and `taste' for public expenditure. For example, one may legitimately wonder whether or not there exist non-public sector alternatives to publicly-funded programmes for dealing with problems such as widespread substance abuse. If such alternatives can be identified, then the fact that a government programme is implemented to address a problem with substance abuse in the community can be viewed as reflecting a taste, rather than a need, for public expenditure.

on the expenditure side as well as with respect to revenues.

If an expenditure equalisation exercise is performed, what would it involve? At first blush, one might assume that a sensible approach would be to take average expenditures per capita in each community as an appropriate measure of need. After a little reflection, however, it is evident that such an approach is misguided. Let us assume for the moment that each government is equally efficient at providing services. If it were appropriate to take average expenditure as a measure of need, then different communities with similar tastes for public expenditure should be able to provide the same level of public service with the same level of revenues. We know, however, that the costs of providing services will differ significantly from one aboriginal community to another --- indeed, this is the reason for which an expenditure equalization exercise is called for --- so that by simply using average expenditure one is systematically understating the revenue needs of those communities in which the costs of provision are higher than average. Moreover, using actual expenditures would adversely affect the incentives facing aboriginal governments. If need were measured by average expenditures, communities would be encouraged to increase expenditure levels in the expectation that this would increase their equalization entitlements. Since all communities would respond to these same incentives, the expectation of an increase in equalization entitlements would prove illusory, and each government's share of the equalization `pie' would in fact remain constant. At the end of the day, all communities would find that they had undertaken too high a level of expenditures. Thus, some other approach is required.

An alternative strategy is to find a measure of expenditure needs for each community which is independent of the actions taken by the community. The principle would be similar to that used for revenue equalization. The funds required to supply a representative group of services to a given community would be compared with the average cost of providing the same services to all aboriginal communities. The difference would be the community's equalization entitlement. The measure used would have to be based on objective criteria and could not be related to actual community expenditures. In other words, the community would be free to choose without penalty a set of services which was different than that used for the calculation of expenditure equalization.

An example of such a procedure would be to construct (or negotiate) some sort of `population equivalence scale' that, by taking account of different indicators of need, converts into `per capita equivalent' units the raw population count in different communities. For example, it may be agreed that the need for public expenditure is greater in those communities with a higher proportion of children, due to the need for day care facilities and schools. In particular, it may be agreed that a 10% increase in the proportion of children in the community's population is equivalent to a 1% increase in the population base. Thus, were one to construct a baseline set of community characteristics, in which 60% of the population were adults and 40% were children, and this baseline community received a level of funding of, say, $1,000 per capita, then an actual community of 500 people in which 50% of the population were children would receive $1 000 per capita {*for an effective population of 505, i.e., it would receive an extra $5,000*). In the same spirit, `equivalence factors' would be negotiated for other indicators, which might include such factors as the population density, remoteness, proportion of elderly, quality of the housing stock, density of

the road network, etc. Communities would then be funded not on the basis of their actual population, but on the basis of their `effective population'.

Certain strengths and weaknesses of a method such as the `population equivalence' approach to expenditure equalization can be identified, as well as difficulties associated with its implementation. On the plus side, applying the same `equivalence factor' calculation to all aboriginal communities ensures that communities with differing levels of need are treated equitably. Furthermore, to the extent that the indicators chosen reflect characteristics of the population --- such as the proportion of elderly people, or remoteness --- that are not influenced by public policy measures, the `population equivalence' approach does not provide any incentive to aboriginal governments to modify their behaviour in order to influence the measured level of need in their communities. On the minus side, it is evident that some of the obvious indicators of need --- such as the quality of the housing stock, or the proportion of the population receiving social assistance --- are very much influenced by the policies of the community's government. Consequently, it is necessary to be concerned about the potential adverse incentive effects that would result were the public sector's revenues to fall, say, as the quality of the housing stock rose, i.e., this may discourage aboriginal governments constructing new housing.

Perhaps the most apparent difficulty with expenditure equalization is that it is likely to be considerably more complicated to apply than is revenue equalization. Notwithstanding the difficulties noted above, the measurement of revenue-generating capacity is relatively straightforward for most revenue sources.The measurement of expenditures need based on various expenditures is much more difficult to accomplish. At most, one is likely to be able to use only a representative sample of public services provided and hope that they adequately reflect overall expenditure needs. Despite these difficulties, we believe that the differences between aboriginal communities --- most obviously, due to geographic location --- are so substantial that fiscal equity cannot be achieved unless some form of expenditure equalization constitutes an integral feature of the financing mechanism.

4.3 Scope of the Equalization Exercise

The last major issue is that of the appropriate scope of both the expenditure and revenue equalization exercises. In effect, if a particular aboriginal government is not exercising all of the powers which it has the right to exercise under its negotiated self-government agreement, should equalisation be done merely with respect to the powers that it exercises, or also with respect to those which it has chosen not to assume? Our view is that the equalization exercise should be performed with respect to *all* of the powers which a particular aboriginal community has the right to exercise, regardless of how many it actually `takes on'. In effect, if this exercise is performed only with respect to those powers taken down by a given community, the financing mechanism is reduced to a form of `conditional grant'; it is payable contingent on the power being assumed. Consequently, unless the financing associated with each power is carefully designed, this version of equalisation is simply a more elaborate `standard costing' model than those used at present by

DIAND, with all of the strengths and weaknesses discussed above. For example, if a particular level of funding (per capita) is associated with each type of responsibility, aboriginal governments will be influenced in their decisions as to which responsibilities to assume and which to leave for the federal government.

In contrast, if the equalisation calculations are performed with respect to all of the powers which the community has the right to exercise, then what has in fact been calculated is a `budgetary envelope' for the provision of that particular bundle of services to that particular community. Once the size of the envelope is established, various scenarios can be envisaged for determining the level of resources that would be transferred to the community for providing some subset of these services. One scenario is that the community may be able to request any amount of funding up to the total size of the envelope for providing services to members; the residual amount would then become the federal government's *de facto* budget for the provision of the other services funded through that envelope but which the community did not provide for itself. An attractive feature of such a mechanism is that it allows aboriginal communities to shift resources from, say, road building to schools, without forcing it to actually be involved in both road building and the provision of schools. Furthermore, when the community decides to shift these resources, it has an incentive to take into account all of the costs and all of the benefits, because if it decides to allocate a huge proportion of its budgetary envelope to the provision of schooling, then the federal government's budget for the provision of other services will shrink correspondingly.[20]

An alternative scenario for allocating the `budgetary envelope' is that the aboriginal government would be allocated the entire budget, but then required to purchase the services it does not provide for its members from other levels of government; in effect, this makes the aboriginal community's government the `residual claimant' with respect to the equalization envelope. For example, an aboriginal community which chose not to exercise its constitutional power to provide secondary schools would have to `contract out' this service to some other public authority (presumably, a neighbouring school board). One important issue that would arise in implementing such a mechanism would be the price at which these inter-governmental transactions would be bought and sold. Certainly, one option would be to allow the interested parties to negotiate. However, this is unlikely to be widely viewed as an attractive option as it would almost certainly result in considerable horizontal inequity, with some governments being able to obtain services on significantly more favourable terms than others.[21]

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[20] A foreseeable problem in implementing such a mechanism is that the federal government may find the residual budget inadequate for providing the services not supplied by the aboriginal government, even at a lower level of quality than it chooses to provide for non-aboriginal Canadians. Whilst different solutions to this problem may be envisaged, two possible approaches are either that the federal Government set a `minimum budgetary requirement' as a condition of it accepting to provide the service or that the aboriginal community assume (and provide at a level of zero service) additional powers, leaving the federal Government with a larger effective budget for providing the remaining services.

[21] In particular, some communities would no doubt be able to obtain service at the marginal

What seems likely to garner the most support would be to require that aboriginal governments purchase these services at the average cost of provision, with a corresponding obligation being placed upon the government providing the service to provide it at the same quality to the members of the aboriginal community as to its other `clients'.[22] An important consequence of imposing such a mechanism is that each aboriginal community is essentially faced with the option of providing a particular public service for itself, or consuming that service at the quality level chosen by the `outside provider'. This means that different aboriginal communities will effectively be faced with different choices: for example, when deciding whether or not to exercise its authority to provide secondary schooling for its members, one aboriginal government may have the option of purchasing secondary schooling services from a well-financed school board, whereas the alternative to own-provision for an otherwise identical community may be to purchase services from a less wealthy board. In contrast, with the first scenario discussed above, in which the federal government was in effect the residual provider of public services, the set of choices of alternative bundles of public services available to different aboriginal governments is the same, regardless of the level and pattern of the provision of public services in surrounding non-aboriginal communities. For this reason, the first scenario would appear to be more consistent with the principle of horizontal equity.

4.4 Alternatives to Equalization

Given the difficulties associated with performing an expenditure equalization exercise correctly, it is natural to consider alternative approaches. The principal alternative to expenditure equalization is to try and distinguish between those aboriginal government activities which are characterized by roughly comparable cost and need structures across communities, and those where population heterogeneity can be expected to have a significant influence on revenue requirements. The first set of activities can then be funded under an equalization programme which only takes account of differences in revenue-generating capacity, whereas the second set would be funded under some sort of cost-sharing (conditional) scheme, whereby some proportion (possibly the entirety) of spending by aboriginal governments in particular areas would be reimbursed by the federal

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cost of provision, whereas others would be required to pay the average cost.

[22] Observe that, to the extent that decreasing returns to scale obtain, average cost pricing shifts some of the burden of financing the provision of these services to non-aboriginal Canadians, whereas to the extent that increasing returns to scale prevail, average cost pricing will result in non-aboriginal Canadians obtaining these public services more cheaply. This may result in conflict between aboriginal governments and external providers. Marginal cost pricing would be an attractive alternative, but it is not evident that the potential for mutual frustration is lessened: when there are decreasing returns to scale, members of aboriginal nations will tend to believe that they are being overcharged, whereas non-aboriginal governments will perceive aboriginal peoples as getting an unfairly attractive deal when there are increasing returns to scale.

government. It may be argued that this is essentially the approach taken at present by DIAND when it funds band councils under a CFA: whereas the administrative costs of band governments, for example, are financed via block funding, the expenditures linked to such programmes as social assistance are reimbursed on the basis of actual expenditures, so that band councils with a higher proportion of unemployed receive proportionately more federal funding than do their counterparts. The strengths and weaknesses of this system have been discussed briefly above, and at great length elsewhere, and we will not go into them again.

Obviously, another alternative would be to calculate the total level of funds currently flowing to aboriginal communities, and to use this as the basis for determination of a `global budget' for aboriginal governments. Although almost certainly an improvement over current arrangements, such an approach would perpetuate existing horizontal inequities both between aboriginal and non-aboriginal Canadians, as well as across aboriginal communities. A departure from a `historical funding' basis is absolutely necessary if fiscal equity is to be achieved for aboriginal Canadians.

4.5 Summary

This section has addressed the general design of a financing scheme for self-governing aboriginal communities. It has argued that in order to satisfy the principles laid out in section I, it will be necessary to develop a financing mechanism with a significant equalizing component. A two-step equalization process is proposed in which, in stage one, an aggregate transfer from the federal government to aboriginal peoples is determined; the size of this transfer is determined in order to ensure that the `average' aboriginal government will be able to provide public services of comparable quality to those provided to non-aboriginal Canadians at comparable cost to themselves. In the second stage, inter-aboriginal equity is achieved via a net equalization exercise that takes account of both differences in the average revenue-generating capacity of different communities as well as differences in the expenditure requirements of these communities. The appropriate scope of the equalization exercise is considered. It is argued that the correct way to proceed is to calculate a `budgetary envelope' for each self-governing community, equal to the transfer the community would obtain were it to exercise its powers in all areas of recognized as being of its jurisdiction in its self-government agreement; two scenarios are then reviewed concerning the division of this budgetary envelope between the community and the federal government when some subset of the powers granted to it under the self-government agreement is exercised by the aboriginal government.

V. Sources of Own Financing

In the present economic climate, in which all levels of government in Canada are seeking to reduce their spending and hence their need to raise new revenues, proposals for financing aboriginal self-government must be marked by realism. To the extent that it is true that native Canadians have historically received less than their fair share of public sector spending, a more equitable shake for aboriginal peoples must impose some cost --- at least in the short run --- upon those who have been more fortunate in the past.[23] At the same time, it is useful to consider the extent to which some revenues could be generated from within aboriginal communities themselves. Given their past reliance on federal programmes and the way in which those programmes have been structured, there has been little incentive for Band councils to raise their own revenues. As well, given the prevailing poverty of most aboriginal Canadians, their ability to do so has been quite limited. However, under a self-governing regime, there are good economic reasons for obtaining some funds internally (such as financial and political accountability), especially if, as we have suggested above, the funding mechanism does not discourage own financing. It thus behooves us to reflect upon the various possible sources of own financing for aboriginal self-government, despite the fact that this is bound to raise delicate and sensitive issues.

5.1 Aboriginal Exemption from Taxation

A natural but necessarily contentious starting point is the aboriginal exemption from taxation. This exemption, based on constitutionally-protected treaties and guaranteed under the *Indian Act* to status Indians living on band lands, is much prized by those First Nations members to whom it applies. Furthermore, since former Finance Minister Mazankowski's Whistler speech, the federal government has committed itself to not seeking an end to this exemption in the context of self-government negotiations. This promise, which the current government may not feel bound by, may seem all the more surprising in view of the fact that the federal government sought, and obtained in counterpart of a substantial cash settlement, to buy-out the tax exemption of the Yukon Indians as part of their self-government agreement. Despite this commitment to the maintenance of the tax exemption for aboriginal peoples, it should be stressed that the Mazankowski speech gave no intimation of any possible broadening of eligibility for this exemption; in particular, the federal government is highly unlikely to agree to extend this exemption to status Indians living off ancestral lands, or to Métis peoples. It is also worth noting that, in view of the low income level of most on-reserve status Indians, the actual cost of the tax exemption to the federal government is negligible. Indeed, at the end of the day, for both the exemptees and the federal government, the most significant aspect of the exemption is its symbolic value.

In the context of financing aboriginal self-government, however, it is evident that a

[23] It is worth pointing out that if one of the long run consequences of self-government is the social and economic development of these communities, then it may be relatively less costly to finance self-government than to maintain the status quo.

possible (although initially limited) internal source of financing for aboriginal governments is the taxation of their citizens. That is, aboriginal peoples should not be viewed as exempt from taxation by aboriginal governments. Indeed, the right to tax is generally viewed as being one of the fundamental coercive powers of governments, and it is difficult to imagine that the governments of Canada's aboriginal peoples will wish to deny themselves this right in perpetuity, *even if* there is substantial opposition to the collection of personal income tax by First Nations governments at present.[24] In the short run, however, it is not clear that any pressure should be applied to First Nations governments to collect an income tax from their citizens living on ancestral lands. The low income level of Canada's on-reserve status Indian community is such that the revenue obtained from collecting income tax is unlikely to significantly outweigh the administrative costs they would incur. Furthermore, members of First Nations argue that their present tax exempt status increases the amount of savings available for precious investment in economic development; to the extent that these tax savings are in fact invested rather than consumed, this argument has some force.

Nonetheless, regardless of whether or not it is opportune (or politically feasible) for aboriginal governments to tax their members personal or business incomes at the present time, the introduction of income taxation should not be ruled out as a possible source of financing in a longer-term perspective. Indeed, this revenue could be relatively easily collected, were aboriginal governments to negotiate Tax Collection Agreements with the federal government, as do the provinces. Thus, it should ultimately be the case that the capacity of First Nations governments to raise revenues via a personal income tax system should enter into the calculation of the appropriate transfer payment due to it. It should be stressed, however, that even in the long run no aboriginal government can be constrained to apply an income tax; however, a government which chose to forgo that revenue would not receive a compensatory increase in the level of its transfer payment from the federal government.

These considerations apply to the question of First Nations obtaining tax revenues from their own citizens. They do not apply to the somewhat separate issue of aboriginal peoples being subject to taxation by federal and provincial governments. From the point of view of financing aboriginal self-government, that is not particularly relevant, since the key issue here would seem to be to identify potential own sources of revenue for First Nations governments. That is not to say that there are not important economic issue at stake. For example, it can be argued that businesses run by members of First Nation communities face a competitive advantage relative to those run by non-aboriginals by virtue of their exemption from various forms of business taxation. However, this is not directly relevant to the issue of financing.

5.2 Determination of Taxpayer Base

[24] It is worth drawing a parallel with the sales tax in Alberta. The unpopularity of the sales tax, and the availability of alternative sources of financing, have made it possible for the government of Alberta to fund its activities without introducing a retail sales tax. Nonetheless, the Alberta government would not wish to relinquish its right to levy such a tax, since it might wish to use sales taxation in the future.

A key factor in determining the extent to which aboriginal governments will potentially have access to significant own-source revenues will be the determination of the taxpayer base. It should be stressed that by `taxpayer', we are not necessarily referring to `personal income tax'. For example, land-based aboriginal governments may seek to levy property taxes, as do other municipal governments. In this context, the taxpayer base we are referring to are those property owners to whom they could apply a property tax. Alternatively, aboriginal governments may wish to raise a sales tax; the taxpayer base will then determine those individuals who are obliged to pay sales tax to this government. Typically, the obligation to pay taxes is linked simultaneously to citizenship and to residency. Canadians pay property taxes to their municipal governments, and income taxes to the government of the province in which they reside as well as to the federal government. Linking tax liability to residency is appropriate in that the responsibility for providing services is also divided along geographic lines; the municipality of Hearst, for example, is not obliged to provide services to individuals living outside Hearst. In contrast, the sphere of responsibility of aboriginal people's governments will not be tied exclusively to the governance of a contiguous land mass. Not only do many aboriginal peoples live in urban areas (or in fact do not have a land base), but an express aim of the self-governance process is to (at least partly) transfer responsibility for the provision of services to aboriginal peoples living in urban areas to agencies of aboriginal governments. Consequently, determination of a taxpayer base will be more complicated for aboriginal governments, and it is likely to be undesirable (and perhaps impossible) to necessarily tie together citizenship and residency in determining taxpayer status.

Notwithstanding the above, to the extent that citizenship and residency *can* be associated, there is good reason to continue to do so. For land-based aboriginal governments, this would mean that its taxpayer base would (at the very least) include all aboriginal persons residing on settlement lands. Similarly, off settlement lands, non-aboriginals would continue to pay taxes to the appropriate provincial and municipal governments. However, the application of this principle provides little guidance about the tax status of aboriginal peoples living off settlement lands, and about non-aboriginal Canadians allowed to reside in aboriginal communities. In particular, it would seem desirable to allow the citizens of non-land-based aboriginal peoples, and the citizens of aboriginal peoples living in non-aboriginal communities to pay their taxes --- or at least some portion thereof --- to the appropriate aboriginal government. Presumably the most natural mechanism for dividing the funds between the aboriginal government and the other levels of government would be via a negotiated revenue-sharing agreement. To ensure horizontal equity, however, aboriginal Canadians living in non-aboriginal-governed communities would presumably be subject to the same tax regime as those faced by their non-aboriginal neighbours. If non-aboriginal Canadians were able to take up residence on settlement lands, symmetric treatment would presumably apply. That is, they would be taxpayers to the aboriginal government, at least insofar as municipal-type taxes were concerned, but a revenue-sharing agreement might be negotiated with respect to other tax revenue. In any case, one important principle that should be adhered to in deciding on tax treatment is to ensure that each person is taxed once and only once; there should be no double taxation. This is a principle which is embodied in the taxation system elsewhere in Canada.

5.3 Other Own-Source Revenues Raised by Aboriginal Governments

As noted above in the discussion of revenue equalization, in the short run the most significant possible own source of revenue for aboriginal governments are likely to be from sources other than personal or corporate income taxation, specifically, from royalty payments on resources, the income earned from land claims settlements, the income earned from aboriginal government-owned businesses such as gaming corporations, and various forms of user fees including licenses and permits. Obviously, the right of aboriginal governments to obtain royalty payments on resources located on their lands will depend on the terms of the self-government agreement reached between the federal government and the aboriginal nation. While it is premature to speculate on the specific content of that aspect of any self-government agreement, it is clear that a strong case can be made for according aboriginal governments equally broad jurisdiction over resources as is accorded to provincial governments under the *Constitution Act*. For since aboriginal governments will no doubt obtain the right to exercise many provincial-type powers, it is appropriate that their revenue-raising capacities be as broadly based as that of provincial governments. This normative argument is further reinforced by the fact that their capacity to generate revenues from the traditional income and corporate tax bases is so limited, so that royalty payments constitute one of the few avenues available to aboriginal governments by which they can reduce their dependence upon transfer payments.

The second substantial other source of potential non-transfer income is the income that aboriginal governments may be able to earn from investing the monies paid from settling land claims agreements. For those aboriginal peoples without a significant natural resource base, this capital settlement will almost certainly constitute their most valuable collectively-owned resource. By investing this capital, it should be possible for these communities to generate a significant income stream. As we have emphasized above, insofar as own sources of financing are concerned, the land claims payment should not itself be treated as a source of financing for aboriginal governments for the purpose of determining federal transfers, although aboriginal governments may indeed choose to use some of those funds for public expenditure purposes. However, the *income* earned collectively from the investment of the settlement payment may certainly constitute a significant source of funding for the ongoing activities of aboriginal governments, and it can be strongly argued that it is appropriate to take account of this income stream in calculating transfers needed to finance aboriginal governments.

Finally, some comment should be made with respect to such non-traditional sources of financing as revenues from gaming, which exploit the fact that aboriginal lands constitute a `haven' close to large urban centres. Clearly, gaming corporations can be compared to provincial Lottery Corporations, in that both exploit the public's desire to engage in games of chance to increase public revenues. The only difference is that whereas the purchasers of provincial lottery tickets are (typically) residents of the province, the majority of the clients of aboriginal-run gaming corporations are non-aboriginal Canadians. Thus the development of gaming activities has

aroused the ire of provincial governments, who perceive a potential revenue loss. Whether aboriginal governments have the right to generate revenues by operating gaming corporations will of course depend on the specific terms of self-government agreements; in view of the fact that provincial governments have such a right, and the paucity of alternative sources of revenue, it seems quite probable that such a right will be obtained. For the purposes of the present analysis, we would merely again stress the fact the importance of designing a financing mechanism which will be neutral with respect to the native government's decision to engage or not in gaming activities.

5.4 Summary

This section has examined different possible own sources of financing for aboriginal governments. It focuses initially on the exemption from federal and provincial income taxation which applies to status Indians living on reserves. We argue that the exemption should not be viewed as extending to aboriginal governments; indeed, the power to tax its own citizens is generally viewed as one of the fundamental coercive powers of government. Thus, in the long run, First Nations governments may be able to generate own-source revenues by taxing their citizens. In the short run, however, there is good reason to suppose that it would not be desirable --- even if it were politically feasible --- for the governments of First Nations to introduce a system of personal income taxation for citizens living on settlement lands. In particular, the revenues that could be obtained would probably not significantly outweigh the administrative costs that would be incurred in collecting the tax. Some discussion is also provided concerning the appropriate delineation of the taxpayer base for aboriginal governments. It is argued that some portion (possibly all) of the taxes paid by aboriginal Canadians living off settlement lands could revert to aboriginal governments via revenue-sharing agreements; symmetric treatment would presumably apply to non-aboriginals who were allowed to take up residency on settlement lands. Finally, it is pointed out that, in the short run, the most significant own sources of revenues for aboriginal governments will be from sources other than personal and corporate income taxation. It is argued that aboriginal governments should obtain rights to tax resources that are as broad as those held by provincial governments. Income earned from the investment of land claims settlement payments should be expected to serve as a source of financing for the ongoing activities of aboriginal governments, but not the claim money itself. Revenue earned from the operation of gaming activities should be treated symmetrically to income earned by provincial governments from operating lottery corporations.

VI. Treaty-based First Nations

In the case of many First Nations, the relationship between the federal government and the First Nation is grounded in treaty obligations. Obviously, any discussion of the design of a financing mechanism for aboriginal self-government is incomplete unless appropriate attention is devoted to the consequences of treaty provisions for the funding process. In this section, we discuss what we believe are the key issues in adapting the sort of general equalization framework outlined in section IV to take account of treaty obligations.

At the outset, it is perhaps useful to stress that our basic premise is that treaty-based First Nations will be best served if the bulk of the funds which flow to them are channelled via the same financing mechanism as is used to finance non-treaty-based aboriginal communities, albeit with the formula suitably adjusted to take account of treaty provisions. As we have emphasized repeatedly above, reliance on nation-to-nation negotiations, even when informed by treaty provisions, will almost certainly result in a smaller flow of resources to treaty nations. In particular, this will be true because there is no reason to frame the determination of appropriate treatment in terms of fiscal equity in the context of nation-to-nation negotiations, and because the greater size of the federal government will give it significant leverage. And, of course, such an approach, based on negotiation, would mean that significant levels of resources would continue to be devoted to financial negotiations on the part of both the aboriginal and federal governments. Consequently, a key feature of the financing mechanism developed for aboriginal governments must be that, where appropriate, the mechanism can be adapted to take account of treaty provisions.

From the point of view of the discussion here, the treaty provisions that must be taken account of are those that bear on the federal government's fiduciary responsibilities, that is, its obligation to provide services for the members of treaty nations, and those which relate to the protection of particular revenue sources from revenue-raising effort on the part of the federal government, of which the most significant example is the exemption from taxation for status Indians living on reserves. In considering the possible impact of these provisions on the financing mechanism, at least two views can be identified. The first is that treaty provisions in effect define a `floor' to federal government funding flowing to the community. If the financing mechanism put in place moves more funds to the community than it would otherwise receive given treaty provisions, then in actual practise these treaty provisions would not affect the determination of the level of funding received. The second is that the financing of treaty nations must *necessarily* be distinct from that used to finance non-treaty nations, as the discharge of treaty obligations will inevitably result in preferential treatment for treaty-based nations vis-a-vis otherwise-comparable non-treaty-based nations. Our belief is that the first view constitutes a sounder basis on which to consider the impact of treaty provisions on the financing mechanism. As will become clear, this may lead in actual practise to `special treatment' of treaty-based nations. Were the design of the financing mechanism for treaty-based First Nations to be based on the second view, it would almost certainly evolve into a system based on nation-to-nation negotiations, with all the disadvantages noted above.

How then can the equalization mechanism outlined in section IV be adapted to take account of treaty provisions? Insofar as fiduciary obligations are concerned, one possible interpretation is that the funds flowing to the treaty nation must be at least adequate to discharge these fiduciary obligations. In other words, regardless of the success of the treaty nation in generating own-source revenues, the ongoing financial support provided by the federal government to the treaty nation can not fall below this minimum level. We would point out, however, that this does not preclude the federal government from providing a comparable level of funding to non-treaty nations for the provision of these same services. How then can the funding `floor' be determined? Observe that to the extent that the expenditure equalization process adjusts the equalization payment made to each aboriginal government with respect to `expenditure bases', in a way analogous to the calculation of comparative revenue bases for the purposes of revenue equalization, the expenditure equalization process provides a mechanism for measuring the cost of discharging the federal government's fiduciary obligations on an annually-updated basis. To the extent that it is possible to design the expenditure equalization process to generate this sort of expenditure-base information without compromising the incentive properties of the mechanism, it would appear to be desirable to do so.

If the expenditure equalization exercise cannot be used to measure the extent of the federal government's fiduciary obligation, it would probably be necessary for each treaty nation to enter into once-off negotiations with the federal government to establish a baseline figure for the discharge of the federal government's fiduciary obligations, and a formula for updating this amount over time. Obviously, the reasonableness of the figure arrived at by negotiation will depend not only on the relative bargaining strength of the participating governments, but also on the up-dating formula. In view of the past history of dealings between aboriginal governments and INAC, the dangers inherent in such a procedure are self-evident.

We now turn to consideration of treaty provisions for protection of particular revenue bases. Before proceeding, it should be pointed out that a bone of contention between treaty nations and the federal government will undoubtedly be the extent to which treaty provisions affect the capacity of aboriginal revenues to raise revenues from these protected bases. This has already been discussed at some length above with respect to the aboriginal exemption from taxation. In this respect, at least two positions can be identified. The first is that the revenue base is protected from the federal government, but not from own-source financing effort by aboriginal governments, and this can be taken fully acount of in determining the appropriate level of transfer to the aboriginal government. If this position is adopted, then the discussion of the revenue equalization exercise provided in section IV remains fully valid. The second position is that, even if the revenue base is not protected from own-source financing efforts by aboriginal governments, this source of own-source revenue *cannot* be taken account of in determining the financial transfer from the federal government to the treaty nation. In this second case, the revenue equalization calculation must be adjusted.

It is in fact one of the strengths of the two-sided equalization procedure outlined in section

IV that appropriate adjustment can easily be made to the revenue equalization calculation to take account of treaty stipulations. Specifically, those revenue bases that are protected can either be zero-rated, or excluded from the revenue base for revenue-equalization purposes. Under the first scenario, treaty nations with protected revenue bases would receive equalization payments *with respect to that revenue base*. Under the second scenario, the revenue equalization exercise would in effect be undertaken with respect to a more restricted set of potential revenue sources. Financial flows to treaty nations are higher if the revenue source is zero-rated than if it is excluded from the revenue base for equalization purposes. Regardless of how the adjustment is made, however, the final impact will be a higher level of support to the treaty nation.

The discussion presented above shows how the two-sided equalization process can be adapted to take account of treaty provisions. As has been pointed out, a consequence of the adjustment is that there is in effect a `floor' to the level of ongoing financial support provided to treaty nations by the federal government. Consequently, full fiscal equity may not be achieved, since some treaty-based nations may end up with higher minimum payments than other nations.[25] This may generate considerable controversy, particularly if the principle on which the funding mechanism for the implementation of aboriginal self-governments is grounded is that of fiscal equity for *all* Canadians, regardless of whether they are aboriginals or non-aboriginals, or members of treaty nations or not. Presumably, aboriginal members of non-treaty nations, and non-aboriginal Canadians, will take the view that a central purpose of the implementation of self-government is to eliminate historical sources of inequities, including inequities stemming from unequal treaty provisions. Ultimately, resolution of these issues will be a matter for negotiation; we can only hope that the analysis provided here can serve to identify certain of the key issues and principles upon which those negotiations would bear.

[25] Somewhat analogously, the Federal-Provincial Equalization does not lead to full fiscal equity, since the `have' provinces are not equalized-down to the five-province standard.

VII. Foreseeable Problems

Negotiation of a financing mechanism for aboriginal self-government will be a complex process. Although the analysis above reflects our views of what constitute the key issues that such a negotiation process should ultimately bear on, many difficulties will of course be encountered along the way. Some of the potential stumbling blocks can of course be foreseen. The goal of this section is to draw attention to some of these problems, and where appropriate to suggest how they might be dealt with.

7.1 Lack of Comparability to Provincial/Local Governments

It is unlikely that the powers of self-government acquired by aboriginal peoples will correspond perfectly to the powers exercised by any government in Canada. In particular, aboriginal governments are likely to exercise some powers that are most often the responsibility of local governments, as well as other powers that fall under provincial jurisdiction. As well, it cannot be assumed that the powers exercised by aboriginal governments will constitute a subset of the powers exercised jointly by provincial and local governments. For example, they may acquire responsibility for training, which is at present a power held exclusively by the federal government. A further respect in which aboriginal self-government will depart dramatically from the federal-provincial or provincial-local models is that the set of powers exercised by different aboriginal governments will vary across the country, whereas all provinces exercise jurisdiction over an identical set of powers.

For these two reasons, it will be misleading to make direct comparisons between the financing mechanisms which are developed for aboriginal self-government and those which presently finance the federal system of government in Canada. It should not be assumed, for example, that a programme equivalent to the CAP will necessarily have to be developed for aboriginal governments, or that they would join CAP alongside the provinces and territories in its current form. Whether or not such a programme were to constitute an appropriate vehicle for financing aboriginal self-government will depend upon the powers that are exercised by these governments. Furthermore, the fact that aboriginal and provincial governments, say, exercise different sorts of responsibilities will affect the determination of the appropriate *level* of transfer from the federal government. That is, whether or not the level of funding transferred to aboriginal governments under an ``aboriginal equalisation programme'' should be greater or lesser than the per capita amount transferred to provinces under the federal-provincial Equalization and EPF programmes cannot be determined independently of the delineation of relative areas of responsibility, or of alternative sources of financing. At the end of the day, what is important is that horizontal (fiscal) equity be achieved across all jurisdictions, and that the financing mechanism which is used to achieve equity is responsive to the particular circumstances of aboriginal, as opposed to provincial/local governments.

7.2. Conditionality of Transfers

A potentially contentious issue concerns the extent to which transfers to aboriginal governments have conditions attached to them. The purpose of self government is to devolve to these governments the political responsibility for taking their own decisions in agreed-upon areas of jurisdiction. Imposing conditions on transfers would seem to contradict that objective. The issue is a particularly sensitive one given the past history of relations between aboriginal peoples and the federal government in the area of service provision. Even when fiscal responsibilities were decentralized to band councils, there were typically many strings attached, not only on how funds were to be spent and how programmes should be designed, but also in the negotiations for funding and in the subsequent reporting and auditing. This was the antithesis of political responsibility.

At the same time, conditionality is an almost inevitable feature of federal fiscal relations. Indeed, it is a desirable feature since it is the instrument by which legitimate policy objectives of higher levels of government are taken into account in politically decentralized decision making. In the Canadian context, conditional grants have been, and continue to be, an important part of the transfers from the federal government to the provinces and territories, and from the latter to their local governments. There are also sound economic reasons for the use of conditional grants. As was expounded in section I, there are three basic reasons for conditionality of grants. The first, and perhaps the least important, concerns the fact that there are spillover benefits attached to some of the spending done at lower levels of government: local highways are used by residents and businesses of other jurisdictions; students of one jurisdiction may be, or have been, students in the educational institutions of another; welfare recipients in one community may have moved there from another jurisdiction; and so on. The existence of these spillovers provides a rationale for matching grants.

The second reason for imposing conditions on grants involves the objective of national efficiency. The national economy will be more efficient if goods, services, labour and capital are able to move freely and without distortion among different regions of the country. Some harmonisation of the services provided by lower level governments can contribute to the integrity of the internal common market without unnecessarily reducing the benefits the services are intended to provide. The use of conditions for transfers can contribute to this objective. The conditions can and should be general ones leaving plenty of leeway to the recipient government to pursue its own objectives. Moreover, the conditions need not be accompanied by a matching formula. Conditions attached by the federal government to some of its transfers to the provinces can be interpreted as being for this objective (e.g., portability requirements on grants for health care and welfare programmes). The same might be said for provincial-local government grants, for example in the areas of education and welfare.

The third reason for conditional grants is to enable the national government to ensure that recipient governments are taking account of larger issues of equity in their decisions. For example, the federal government assumes some responsibility for redistributive equity across Canada (as enunciated in section 36.1 of the *Constitution Act* 1982). The use of conditionality is the only way

by which it can ensure that provincial programmes which have a significant redistributive component conform with federal notions of equity. We have seen how one can interpret the conditions of the *Canada Health Act* in that light. It is not just that the provinces may not want to take equity into account; it is also that mobility of labour and capital may otherwise preclude them from engaging in redistributive policies. Once again, the conditions can be quite general ones --- `performance standards' --- leaving plenty of discretion to the recipient governments. Moreover, the grants need not be of the `shared cost' type.

Clearly, the issues outlined above must inform any discussion of the possible use of conditionality in grants to aboriginal governments. However, it is useful to draw attention to several additional issues. At the outset, it must be acknowledged that the use of conditional grants elsewhere in Canada has not always conformed perfectly with these objectives. Some would argue, for example, that some of the conditions imposed on provincial health and welfare expenditures have been too intrusive, or that provinces have been too reluctant to allow their local governments to take innovative decisions, say, in the education field. Others might say that matching rates may have been excessive in many cases (such as the CAP program or the previous health care shared-cost grants), or that the federal government has not been as imaginative as it could have been in using the spending power to induce national standards in education, or more generally to encourage efficiency in the internal common market. These concerns have surfaced in recent debates on constitutional reform. The lesson that may be drawn is that the use of conditions on transfers to aboriginal governments is unlikely to be more perfect in design.

As a general principle, the extent and nature of the conditions imposed on transfers to aboriginal governments should be no more restrictive than those imposed on other governments, as we have stressed earlier. However, even this prescription might seem too restrictive. For one thing, many of the functions of aboriginal governments will be those that are typically exercised by local governments. In some cases, local governments face relatively strong constraints from their relevant provincial governments. It might be argued that this is a consequence of the clearly subservient constitutional and political relationship between provinces and local governments, a relationship which is bound to be looser between aboriginal communities and the federal government. (Recall that there is no analogue to the provincial level of government for aboriginal peoples.) Moreover, the circumstances of aboriginal communities may be such that the same national equity and efficiency concerns may be thought not to apply to them as to non-aboriginal communities. For example, mobility of labour may not be an issue, given that these communities may not be organized on a residency basis, and freedom of movement into an aboriginal nation may be restricted. Aboriginal peoples may also argue that standards of national equity do not apply to them in the same way as they apply among non-aboriginal Canadians. Obviously, this is a normative issue that will need to be addressed when deciding on the interest of the federal government in using its spending power to ensure that grants to aboriginal governments are used in ways which conform to broad equity standards applying in other jurisdictions.

In particular, aboriginal peoples may argue that their communities are distinct enough that they should be able to abide by their own ethical norms. The issue is not unlike that which is

involved in discussing whether they ought to be bound by all parts of the *Charter of Rights and Freedoms*. In the context of financing arrangements, they might point to the fact that asymmetric arrangements have existed in the treatment of different jurisdictions in the past. For example, the province of Quebec has been able to take advantage of opting out arrangements to run separate programmes from federal-provincial programmes applying in the rest of Canada (and to receive financial compensation for it). These issues will have to be addressed in designing the terms of the financing arrangements between the federal government and aboriginal governments, though they need not necessarily have an effect on the total sum transferred

7.3 Financing Service Provision off Settlement Lands

As has been repeatedly emphasized, one of the dimensions in which aboriginal self-govern\-ment departs markedly from existing models of federations is that the members of any particular aboriginal people, such as the Métis Nation, will not necessarily reside in a contiguous area. This means that aboriginal governments, even when they have a land base, may often find themselves providing services to their citizens in different locations, including off settlement lands. To the extent that such services are provided directly by a particular aboriginal community for the exclusive benefit of their own citizens, it is clear that the financing of such activities must be covered by the basic financing package that funds the activities of that nation; where services are delivered is philosophically irrelevant from the standpoint of financing, although it may influence the determination of expenditure needs.

In practise, however, exclusive provision may not be the typical pattern. Instead, in order to realize economies of scale it may be expected that this provision of services will often be undertaken jointly with other aboriginal peoples, for example, through the activities of Friendship Centres, or by setting up aboriginal schools or health centres. Equally importantly, the provision of such services to urban-based aboriginal peoples may not be initiated by the governments of the communities to which they belong, but by the urban aboriginal population itself. An important issue that then arises is whether or not the implementation of self-government should mean that these ``multi-lateral'' service organisations should be funded directly by the federal government, or whether they should be funded by the aboriginal nations whose citizens they serve.

The economic analysis of federalism suggests that such multi-lateral service providers should not be funded as governments. Instead, economic arguments lead to the conclusion that such organisations should be treated analogously to the social agencies of provincial and/or local governments, and other non-profit social service providers. That is, the provision of services by these agencies is funded via transfers from the level of government, typically provincial, which is responsible under the *Constitution Act* for the delivery of these services. Carried over to the aboriginal context, this would imply that jointly operated Friendship Centres, for example, would be financed by the aboriginal nations collectively. The financing mechanism will then have to take account of the financial costs that they will incur in funding such agencies to provide services for their citizens. Of course, particularly in the case of land-based aboriginal peoples, it is quite

possible that particular communities will choose to use their resources in such a way that a greater range of services will be made available to those members of the nation that live in a relatively restricted geographic area, e.g., on or nearby settlement lands. Consequently, citizens living far from this area may not be as well off, because the level of financial support provided for multi-lateral service organisations may be relatively low.

The fact that aboriginal governments may wish to choose a service provision pattern that favours those citizens living on or close to the community's traditional geographic base means that there may be widespread support amongst those aboriginal Canadians living away from traditional homelands for providing direct financing to multi-service aboriginal organisations in urban areas. While this is ultimately a matter of negotiation, it is our belief that this would not be desirable, since this would effectively confer governmental status on such service organisations. In our view, responsibility for achieving equity amongst members of Canada's aboriginal peoples ultimately rests with these peoples themselves, and is not the concern of other levels of government. It must be nonetheless recognized that the federal government's responsibility for the pursuit of horizontal equity does oblige it to take appropriate steps to ensure that *all* aboriginal Canadians, and not merely those living in a particular geographic area, receive an adequate level of public services.

In fact, we would argue that there are two particularly useful instruments which may be used to encourage aboriginal governments to provide an appropriate level of services to those members located away from the traditional homeland, thus obviating the need to fund service organisations directly. The first of these is the federal government's willingness to sign tax collection agreements under which it would agree to turn over to the appropriate aboriginal government some proportion (possibly all) of the tax revenue collected from aboriginal Canadians living off settlement lands. Clearly, although participation in tax collection agreements is unlikely to represent a significant source of revenue for aboriginal governments in the short run insofar as aboriginal Canadians on settlement lands are concerned, there is more potential for revenue collection for First Nations governments if they are able to obtain some proportion of the taxes paid by off-reserve members. By tying participation in tax collection agreements to the provision of services in those areas from which the First Nation derives revenue, the federal government provides considerable incentive to these governments to contribute to the funding of public services for all their citizens, regardless of their place of residence. Second, the general transfer payment under the self-government funding agreement can also be made conditional upon meeting adequate service provision standards, and in particular can be made conditional upon providing an (appropriately-defined) adequate level of support to organisations serving those citizens who do not live on settlement lands.

7.4 Minimizing Administrative Costs

At the end of the day, the most significant stumbling block to the implementation of aboriginal self-government may be the cost to the federal treasury. It is therefore appropriate to reiterate the importance of designing a financing mechanism which promotes the provision of services to

aboriginal Canadians in as cost-efficient a manner as possible. In particular, where costs can be reduced by entering into joint provision agreements with other aboriginal governments, or with nearby local or even provincial governments, the financing mechanism must not discourage such an undertaking. This would be the case if each aboriginal community were required to establish its own School Board, or Health Authority, in order to obtain funding for the provision of educational and health services. *In effect, this means that the level of resources transferred to aboriginal governments should not depend upon the particular level of government or agency which actually provides the service, but upon the characteristics of the citizenry whose public services are financed by the aboriginal government*.

A second key element of cost containment, from the point of view of both the federal and aboriginal governments, will be to pursue the relative simplicity of programme design. The administrative costs incurred by aboriginal governments will be minimized if the number of programmes under which resources are transferred, and the number of federal government departments responsible for the administration of these programmes is reduced as much as possible. This will not be feasible unless the features of self-government agreements are fairly similar both with respect to the revenue-raising powers and areas of responsibility. In this respect, the model followed in the Yukon would seem to be particularly useful, i.e., the multilateral negotiation of the Umbrella Agreement, followed by the negotiation of separate self-government agreements between the federal government and each of the Yukon Indian nations.

A natural way to contain administrative costs is to make as large a proportion of the funds transferred both formula-driven and unconditional in nature. The use of formulas reduces the need for administrative discretion in computing entitlements and reduces the costs of negotiation. Furthermore, unconditional grants need not be associated with detailed auditing and reporting by the recipient government, which can be extremely costly. The traditional reluctance to make unconditional payments to aboriginal bands has probably had to do with a fear that, because of a lack of administrative skills or democratic decision making procedures, the funds would not be well used (as well as an element of paternalism). This was perceived as a legitimate concern, for if the funds were not used for providing the required services the federal government was not discharged of its responsibility to provide these services. Proper self-government should dispel these notions. The assumption of self-government implies community responsibility, rather than federal, for providing services. There will be obvious incentives for fulfilling that responsibility if the funds are made available and it is clear that the services will not be provided by some other level of government. It may take time to develop the required local institutions and skills, in which case transitional arrangements will have to be in place.

7.5 Risk bearing

As has been noted above, one important characteristic of aboriginal communities is that they are typically quite small. Not only does this contribute to their heterogeneity, but it also affects their capacity to bear risk. In our view, careful thought should be given to the design of the financing

mechanism so that risk be distributed efficiently. As there is a tendency to confuse the issue of efficient risk-bearing with the extent to which aboriginal governments manage their finances wisely, it is worthwhile spending some time explaining what is at issue.

One of the key objectives of certain public programs of redistributive intent --- most clearly in the case of unemployment insurance --- is to redistribute income from those Canadians who are relatively well off to those Canadians who are poorer. This is referred to by economists as `social insurance'. The fact that eligibility for the receipt of these payments is tied to being without any alternative source of income means that those receiving money under these programs might be viewed as having been `unlucky'. For example, under this interpretation if the passage to and from the state of `unemployment' is random, then every worker has an equal chance of losing their job. If the unemployment rate is stable and equal to 9%, then at any one time 9 out of every 100 workers will be without a job. Since every worker faces the risk of unemployment, each can save individually against the `rainy day' when they may lose their job, i.e., they can self-insure. Under such a scheme, and depending on each individual's aversion to risk, workers who are `lucky' and are spared a spell of unemployment for some time will have enough savings to see them through the period of time that they are between jobs, whereas workers who are `unlucky' and become unemployed early on in their working lives, or who suffer more than one spell of unemployment in a relatively short period of time, are liable to find that their savings are inadequate, and will probably suffer a significant drop in their standard of living.

For these and other reasons, it is evident that reliance on self- insurance --- which forces individual workers to bear the entire risk of temporary job loss --- is an inefficient institution for bearing risk as compared to publicly provided unemployment insurance. A publicly-organized system, which redistributes funds from the working to the unemployed, can provide income support to the unlucky at less cost to those who are working than is borne by them under self-insurance. Furthermore, someone suffering more than one spell of unemployment in a relatively short period of time does not risk being entirely without the necessary resources to see themselves through the second period of low income.

While the above discussion has been framed in terms of the relative costs and benefits of self-insurance versus publicly-provided income insurance, exactly the same issues arise when one considers risk-bearing by small governments versus risk-bearing by larger governments. In effect, because of the scale of many of these communities, aboriginal government finances have to be managed with extreme prudence if they are always to have sufficient funds to cover all of the possible `rainy days', whether they be due to exceptional demands being placed on the health care system, or the welfare rolls, or the capital expenditures budget after some natural disaster has occurred.[26] Indeed, if they are required to self-insure, aboriginal governments can be sure of

[26] In this context, it is perhaps interesting to note that Ontario's new Comprehensive Health Organizations, which are funded by the Ontario government on the basis of a risk-profile-adjusted capitation fee, must have a minimum membership size of 10,000 patients since it is believed that smaller CHOs would not be able to bear risk efficiently. Of course, few aboriginal communities consist of more than 10,000 members.

having the resources necessary to cover all eventualities in the case of `rainy days' if and only if they systematically plan to run an expected surplus. This means that, systematically, they cannot expect to devote all of their resources to providing services to their citizens and, despite highly prudent financial management, may find themselves unable to discharge their obligations if too many rainy days arrive in rapid succession.

The significant resource (and welfare) costs associated with requiring aboriginal governments to self-insure means that careful thought should be given to the extent to which the design of the financing mechanism allows risk to be spread efficiently. One of the significant advantages of the Equalization approach proposed here as compared to, say, an equal per capita payment, is that it does in fact provide considerable insurance protection: payments increase if there is a drop in revenue-generating capacity or an increase in the measure of need. Furthermore, to the extent that the equalization calculation is perceived as not being sufficient to spread risk as efficiently as it might be distributed, there is an opportunity for aboriginal peoples to design the allocation of funds in the second stage so as to carve an `insurance fund' out of the aggregate transfer payment to aboriginal governments, to which communities would have access when they encountered `rainy days'.

7.6 Transition Issues

Although many issues will no doubt arise in the transition to self-government, it seems worthwhile at the present juncture to draw attention to three of them. First, although it can be expected that the level of resources transferred from the federal government to Canada's aboriginal peoples will increase significantly once they begin to exercise the full range of powers which they acquire under self-government agreements, this will probably not be the case initially. This is because we can expect that aboriginal governments will proceed gradually in taking on their additional powers, and consequently their revenue requirements will follow the same gradual adjustment path. The comparatively modest initial impact on federal government finances of moving towards the implementation of aboriginal self-government means that it should be relatively more straightforward to initiate this process than might otherwise have been feared.

Second, and related to the first, in taking on these powers, aboriginal governments will be required to develop expertise in areas in which they will not typically have previously exercised authority. This means that, exceptionally, they will be required to undertake considerable expenditure on training. In the past, self-government agreements have generally made special financing provisions for training. It will be necessary and appropriate to do so here as well.

Finally, it is natural to ask at what point the transition will begin. Specifically, will aboriginal communities which initially choose not to exercise any of the powers acquired following the negotiation of self-government agreements be involved in the process of determining appropriate general funding, etc.? Our view is that, in order to minimize the expenditure of effort on data collection, negotiation, and so on, participation in the new financing mechanism should be

restricted to those aboriginal governments who choose to exercise some subset, however small, of the powers they have acquired as a result of the self-government agreement. Those communities which choose to maintain the current status quo, relying on the federal government to provide public services, would therefore not receive general transfer payments. Since the level of resources currently being transferred to Canada's aboriginal peoples is presumably considerably less than that which they would receive were a financing mechanism to be put in place that is consistent with the pursuit of fiscal equity, the decision to maintain the *status quo* might be viewed as being of considerable benefit to the federal government. It may be hoped that in such circumstances the federal government would not simply choose to provide a level of public services comparable to that which is being provided in aboriginal communities today. It would be more fitting if the federal government instead chose to adjust its level of spending to reflect the relatively improved situation of those aboriginal communities which were able to more rapidly begin to exercise their powers under the self-government agreements.

7.7 Summary

This section has addressed a number of issues which it may be expected will pose difficulties in designing a satisfactory mechanism for financing aboriginal self-government. In particular, it has stressed the fact that the lack of comparability --- in terms of size, revenue-generating capacity, and the scope of responsibilities --- between aboriginal governments and either provincial or local governments means that it will be inappropriate to simply directly integrate aboriginal governments into the existing system of intergovernmental transfer payments in Canada. Furthermore, the level of existing intergovernmental transfer payments cannot be used as a benchmark for determining the level of funding necessary to provide to aboriginal governments if fiscal equity is to be achieved. The issue of conditionality has also been considered, and it is clear that there are sound economic reasons to believe that at least some of the payments from the federal government to aboriginal ones ought to be subject to some form of conditionality. However, as a general principle, the conditionality attached to funds transferred to aboriginal government should not be more onerous than that attached to resources transferred to other levels of government; in particular, it can be expected that these conditions can be posed in terms of rather broadly defined `performance criteria', rather than by providing funds under matching-grant type programs.

This section has also addressed the financing of the provision of services for aboriginal peoples living off settlement lands, and argues that these services should be funded by the aboriginal nations to which aboriginal peoples living in urban areas (for example) belong. Social agencies which presently serve --- or may in the future be created to serve --- these peoples should not be funded as governments. In order to ensure that aboriginal peoples living away from settlement lands have access to an adequate level of public services, receipt of full funding under the financing agreement might be made conditional on meeting responsibilities to their members residing away from the community's traditional homeland. The importance of minimizing administrative costs --- and the consequent attractiveness of reliance on formula-driven funding and grants which are unconditional --- is again stressed, and the importance of designing a finance

mechanism which allows risk to be spread efficiently is also examined. Finally, certain issues related to the transition towards self-government are analyzed.

VIII. Concluding Remarks

Our purpose in this study has been to propose a set of principles which should be used to inform the design of a system for financing aboriginal self-governments, and more generally to characterize the fiscal arrangements that should exist between aboriginal and non-aboriginal governments in Canada. The basic premise that we adopt is that the same sorts of economic principles which are reflected implicitly or explicitly in the fiscal arrangements among federal, provincial, territorial, and municipal governments in Canada ought also to apply to aboriginal governments.

Those principles are characterised by a number of features. Among the most important are:

- The principles of fiscal equity and fiscal efficiency which are reflected in Section 36(1) of the *Constitution Act*, 1982, and which are implemented through the Equalization system supplemented by EPF and CAP at the federal-provincial/territorial level, and with analogous schemes between the provinces/territories and their municipalities;

- The significant advantages of decentralised decision making in the federation as characterised by the extensive use of unconditional grant with minimal accountability provisions;

- The continuing role of the federal government in fostering an efficient internal common market by the judicious use of the spending power and by leadership in the harmonisation of taxes, and the increasing importance of this role as the federation becomes more and more decentralised;

- The joint responsibility of the federal government with the provinces, territories, and presumably aboriginal governments for the pursuit of redistributive equity as enunciated in Section 36(1) of the *Constitution Act* and as implemented by the use of the spending power and by federal predominance in the areas of direct taxation and transfers to individuals;

- The importance of maintaining a harmonised tax system, especially in the case of the direct taxes, as illustrated by the Tax Collection Agreements

Financing schemes which satisfy these characteristics, and which are characteristic not only of the Canadian federation but of most other federations in the industrialised world as well, will be very different from schemes which transfer funds according to the actual cost of providing services. These typically involve considerable administrative cost, leave relatively little room for independent decision making by recipient governments, and are not well suited to satisfying the equalisation objective of financing programs.

At the same time, implementing such a scheme is not without its difficulties. The most demanding of these is determining exactly how much to transfer to each aboriginal government.

Ideally, the total amount of the transfer from all sources ought to be sufficient to enable the aboriginal government to be able to provide comparable public services at comparable costs to community citizens as applies elsewhere in Canada. This is complicated owing to the fact that the sorts of responsibilities assumed by aboriginal governments are not likely to parallel those of either the provinces or the municipalities so that aboriginal governments cannot simply be integrated directly into existing schemes. As well, different aboriginal communities are characterised by a degree of diversity which is far greater than that, say, across provinces as well as by extremely limited capacity for generating own revenues, at least at the outset. Thus, simple revenue equalisation schemes like that used among provinces are not likely to suffice.

We have proposed instead that the task of negotiating the financing self-government be divided into two stages, the implementation of which will involve both considerable judgment and negotiation. In the first stage, some per capita sum would be agreed upon which would constitute the per capita amount that the *average* aboriginal government would be entitled to as a general transfer, not including that from specific conditional grants. Thus, the grant would be comparable to that obtained by the provinces from Equalization and EPF. The per capita amounts involved would be meant to be sufficient to enable to average aboriginal government to provide comparable public services to those elsewhere in Canada. Its amount would depend on the availability of shared-cost grants for particular public services (like CAP), which aboriginal governments would be able to participate in as well. In the second stage, this per capita entitlement would be adjusted for each aboriginal community upwards or downwards by an equalisation scheme involving aboriginal communities and which takes account both of differences in revenue-raising capacity from all sources and expenditure needs, which can vary greatly across communities.

The system would have to be flexible enough to accommodate the fact that from a given possible menu of responsibilities, a given community may choose to exercise only a subset, leaving the remainder with existing non-aboriginal governments or purchasing the services from neighbouring communities. We have proposed that the simplest way to do this, and the way which reflects the most responsibility for the aboriginal community, is to make available the full extent of the transfer to each community but then allow it to decide how much to provide for itself and how much to acquire from other communities or even from the federal government. The alternative of making the total transfer contingent on the powers actually assumed would run the risk of essentially evolving to a system in which individual services for each community are costed, an outcome which could interfere with the end objective of truly decentralised decision making responsibilities.

The amount transferred should be based on an objective formula, preferably as simple as possible, rather than being determined by administrative discretion. It should be unrelated to the levels of expenditures undertaken in individual communities, and should be as unconditional as possible. As is the case with grants to other levels of government, there is a role for conditionality, both specific purpose conditional grants, and the use of broad conditions with the general transfer programme. The conditions should be limited to achieving genuine national objectives, such as maintaining national equity and efficiency standards and correcting for interjurisdictional spillovers.

As a general principle, the conditions imposed on aboriginal governments should be no more stringent than those imposed on other governments in Canada. Decentralized decision making should be the norm unless clear benefits from federal interference are present. Effective self-government will be impossible without financial support; it will also be impossible if the financial support comes with too many strings attached.

VIII. References

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