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# Bureau of Management Consulting

Self-Government for Aboriginal Communities: Funding Principles and Options

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## I. INTRODUCTION

In November 1985, the federal government approved an approach to aboriginal self-government involving the constitutional process as well as parallel processes emphasizing community self-government negotiations.

Under the self-government initiative, although federal transfers will still continue to dominate band finances, band governments will be primarily accountable to their own communities. They will be provided with new financial institutional arrangements, resulting in increased fiscal autonomy and stable federal funding.

The Bureau of Management Consulting (BMC) was requested to assist Indian and Northern Affairs, Canada (INAC) in developing funding principles and options for aboriginal self-government. The expected benefits of establishing such principles and options were to:

* expedite the conclusion of future self-government agreements with individual communities; and

* contribute to a consistent treatment of aboriginal communities across Canada.

This report summarizes the principles developed, presents the most attractive of the options that were analyzed in the course of this assignment, and outlines potential needs for further work.

## II. PRINCIPLES

In designing funding options and in selecting specific options for a particular community, the following broad principles can be stated:

1. Band Accountability:
   Aboriginal bands should be accountable to their own communities for their spending priorities.

2. Administrative Simplicity:
   The design of the funding arrangements should take into account the practical limitations imposed by the size of the community and the ease of access and verification of administrative data.

3. Fiscal Certainty:
   The level of funding to aboriginal communities during the course of a five-year agreement should be based , as much as possible, on formulae rather than depend on bureaucratic discretion.

4. Horizontal Equity:
   Communities with similar levels of spending needs and similar levels of own revenues should receive similar levels of federal funding.

5. Vertical Equity:
   Communities which are financially less well off and /or have higher expenditure needs, relative to other communities, should receive relatively higher levels of federal transfers.

6. Funding Adequacy:
   Aboriginal bands should have an adequate and stable financial base to provide a level of services to their members which is comparable to that enjoyed non-aboriginal people in other communities.

7. Cost-Sensitivity:
   Changes in the level of funding over time should be directly related to changes in the level of need in the community, as reflected in changes in the size of the community and the unit cost of services.

8. Revenue-Sharing:
   Changes in the level of federal funding should be inversely related to changes in the ability of aboriginal governments to raise their own revenues.

9. <u>Economic Incentive:</u>
The relation of funding to spending need and fiscal capacity should reflect the importance of preserving incentives for band self-help and revenue-raising.

10. <u>Voluntary Participation:</u>
Participation to self-government negotiations should be voluntary; aboriginal governments not wishing to take advantage of the new funding arrangements should continue to be funded under the existing programs.

11. <u>Community Approach:</u>
The negotiation of the new funding arrangements be community oriented, conducted at a practical level and at a measured pace, and tailored to the specific circumstances that exist today.

12. <u>Fiscal Neutrality:</u>
The primary focus of funding arrangements under self-government is to improve the funding system within existing funding levels.

## III. OPTIONS

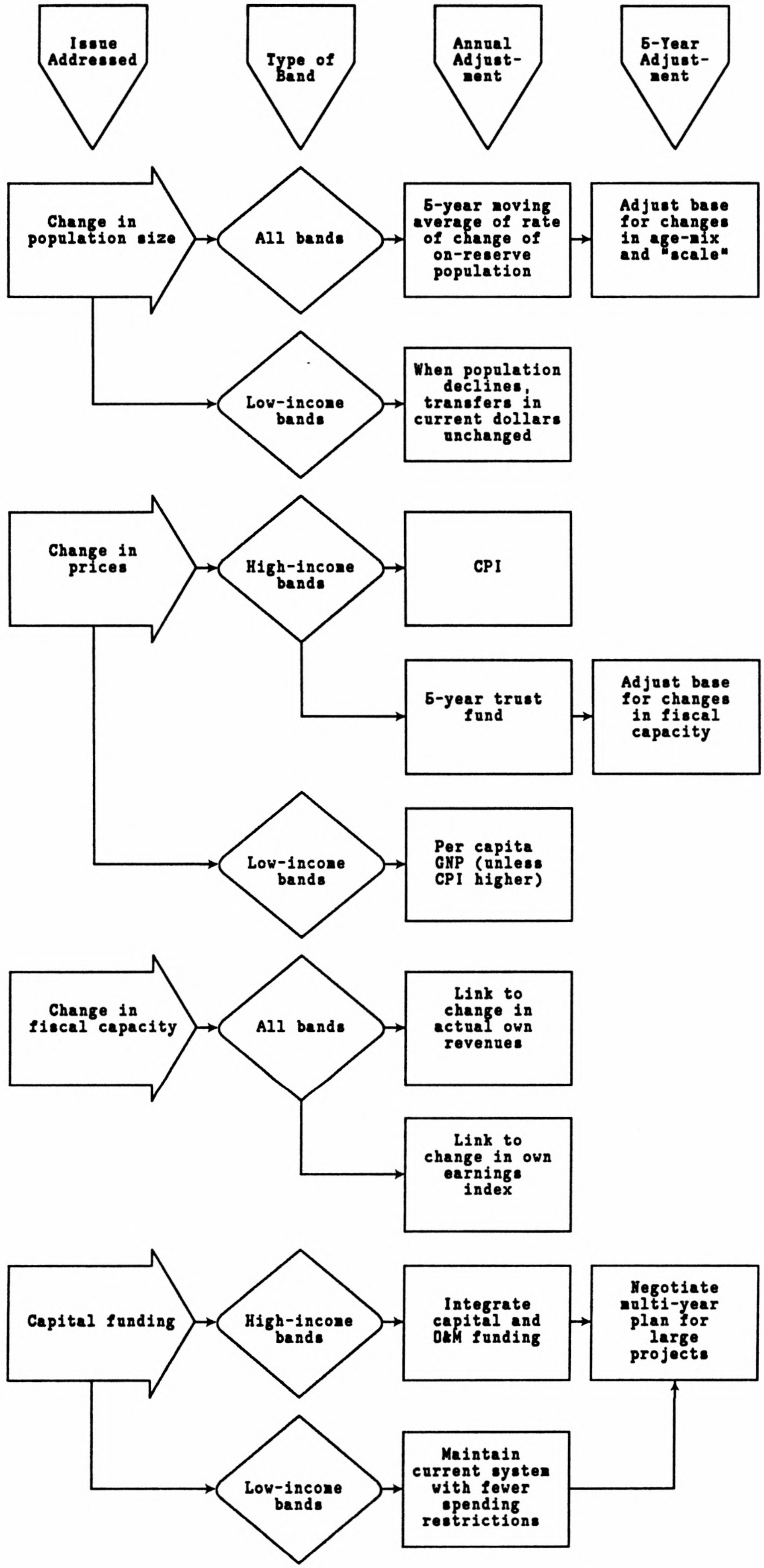
The options and recommendations presented here attempt to reflect the above principles and address potential conflicts. In particular:

(a) The horizontal equity principle requires that the same options are made available to all bands. At the same time, the principle of community approach to negotiations necessitates the development of a reasonable range of options to allow the tailoring of funding arrangements to the needs of each individual community.

(b) The principle of fiscal neutrality requires that the bands receive the same level of transfers as under the current system. At the same time, the vertical equity and funding adequacy principles require some flexibility in dealing with the relative poorer bands. Such flexibility could be introduced by offering additional funding options to bands with a limited capability to raise revenues on their own to finance a level of services that keeps up with that in other communities.

In what follows, a distinction is made where applicable between options that are appropriate for all bands and additional options that should be offered to relatively poor bands only. Options are presented with respect to population and price escalators, the treatment of fiscal capacity, and the funding of capital. They are summarized in Chart 1.

## Chart 1
## Summary of Funding Options



## A. POPULATION ESCALATORS

Issue:
The impact of population changes on spending needs is particularly important among aboriginal communities, given their high rate of population growth relative to the national rate.

Because of the small size of most aboriginal communities, an increase or decrease of their population by even a few members may lead to sharp year-to-year percentage changes in the population. This may result into considerable instability in the level of funding to aboriginal communities.

Recommendation:
**Escalate annual transfers to all bands by the average rate of on-reserve population over the preceding five years. This basic option should be available to all bands.**

Issue:
To further protect the relatively poor bands from the impact of a rapid decrease in population, the above basic option could be supplemented by the following provision:

Recommendation:
**In the case of relatively poor bands, when population decreases, limit the extent of decrease in transfers by not allowing adjustment for inflation. In other words, do not reduce transfers in current dollars but let inflation take care of the adjustment in real terms over a longer time period.**

Issue:
A change in the age mix will impact on the level of needs of a community. Ideally, changes in the age mix should be reflected in the population escalator through the appropriate weighting of the various age groups. However, this is likely to compound the problem of instability of the population escalator. A better approach would be to:

Also, the basic option does not recognize the effect of changes in the size of the community on the per unit cost of services, as a result of economies scale and other considerations. However, because the size of the community is not likely to change dramatically over a five year period and because of the multitude of considerations involved, the most practical approach is:

Recommendation:
**Assess the impact of changes in the age mix and "scale" of the population on the community spending needs and adjust the level of transfers accordingly every time a new five-year agreement is negotiated. This option is applicable to all bands.**

## B. PRICE ESCALATORS

Issue:
A fundamental consideration is whether federal transfers should reflect only changes in the unit cost of providing existing services or, also, allow for keeping up with improvements in the level of services in the rest of the country.

The most widely used escalator is the Consumer Price Index (CPI). It is an "absolute" type escalator because it only reflects changes in the unit cost of services and does not reflect changes in service standards over time.

Recommendation:
**Escalate annual transfers by the rate of change in the Consumer Price Index. This option should be available to all bands.**

Discussion:
The above escalator could be refined by re-weighting the components of CPI to closer reflect the spending pattern of aboriginal communities. Also, a three-year moving average could be used to introduce more stability in the rate of escalation of transfers.

Issue:
Under the basic option, however, poorer communities with limited potential for raising own revenues, will be unable to upgrade service standards and will increasingly fall behind the rest of the communities. Since the cost of living and improvements in the standard of living across the country are reflected on the per capita Gross National Product (GNP), another option that should be considered is the following one:

Recommendation:
**In the case of poorer communities, escalate annual transfers by the rate of growth of per capita GNP.**

Discussion:
The above escalator could be refined by switching to the CPI escalator when the CPI escalator exceeds the per capita GNP escalator. The latter situation would occur during a period of negative productivity growth (i.e., inflation rate exceeding the rate of increase of the value of total production).

Issue:
Some bands may feel that the best way of assuring an arms-length relation between them and the federal government is by being granted a five-year trust fund. This option could work as follows:

Recommendation:
**Create a fund for each band entering a self-government agreement equal to five times the base-year level of funding. During the course of the agreement, the band withdraws a certain percentage of the fund each year, while the balance earns interest. This option should be available to all bands.**

Discussion:
Under this option, a band could withdraw funds from the trust fund according to the following schedule:

1st year: 1/5 of original trust fund;
2nd year: 1/4 of balance
3rd year: 1/3 of balance;
4th year: 1/2 of balance; and
5th year: remaining balance.

This type of scheme in effect escalates annual payments to the rate of return of the portfolio (e.g., to the rate of return of one-year Treasury Bills). Historically, interest rates have tended to roughly equal the rate of inflation plus the rate of productivity growth, the latter typically being in the 2 to 3 percent range. Since the growth of Indian population is approximately within the same range, indexing transfers to the rate of interest would be roughly equivalent to using a CPI and a population escalator.

Under this option, annual transfers depend on the base level funding and interest rates. Adjustments to changes in fiscal capacity would need to be made every time a new agreement is renegotiated. Possibly, this adjustment could be extended to included changes in the size and age-mix of the population.

## C. FISCAL CAPACITY

Issue:
A fundamental fiscal principle is that the level of federal funding should be linked to the fiscal capacity of each community -- i.e., their ability to raise their own revenues. In the absence of such a link the following may occur:

(a) Entitlement Trap: Communities with growing revenues from own sources will continue receiving the same level of Federal transfers, while more funds could have been available for the poorer bands.

(b) Fiscal Insecurity Communities with declining own revenues may be unable to continue funding the same level of services; this possibility would make the option of self-government less attractive to communities faced with declining or unstable fiscal capacity.

However, if federal funding is too sensitive to changes in the fiscal capacity of communities, federal transfers could create a welfare trap, by leaving little incentive to them to embark on economic development initiatives or exploiting their fiscal potential. Two alternative options are outlined:

Recommendation:
**Further investigate the relative merits of the following two options:**

**Option 1: Relate the level of funding to each community to changes in the actual level their own revenues.**

**Option 2: Relate the level of funding to each community to changes in an index of earnings received by members of the community.**

Discussion

Option 1
Under option 1, the calculations will operate as follows:
i. First, the combined price and population escalator that applies to a particular band will be calculated. For example, if the price escalator is 1.10 (i.e., 10 per cent inflation) and the population escalator is 1.05 (i.e., 5 per cent population increase) then the combine escalator is 1.155 (i.e., 1.10 x 1.05).

ii. The above combined escalator is than applied to the base level of own revenues to provide a <u>benchmark</u> figure of own revenues. For example, if the base level of own revenues is $1,000,000, the next year's benchmark own revenues (assuming a combined escalator of 1.155) will be $1,155,000.

iii. The change in fiscal capacity is then calculated by subtracting from actual revenues the benchmark revenues (as calculated above). The change in fiscal capacity can be positive or negative. If for example, actual own revenues in the next year are $1,255,000, then fiscal capacity has increased by $100,000, from the previous year.

iv. To the above change in fiscal capacity a certain <u>revenue sharing percentage</u> is applied (e.g., 35 per cent). This percentage should not exceed the implicit average revenue sharing percentage in provincial-municipal arrangements. In the above example, and assuming a 35 per cent revenue sharing percentage, transfers to the band will be reduced by $35,000. If the change was negative, the band would have received $35,000 (in addition, of course, to increases resulting from the application of the price and population escalation).

<u>Option 2</u>
Under option 2, the calculations will be similar to the previous option, with the following exception: actual revenues will be replaced by potential revenues, by multiplying base year revenues by the rate of increase in the earnings index.

The earnings index can be calculated, for example, by using earnings information collected for the unemployment insurance program and available through the Record of Employment.

This earnings index could be used for two purposes:
(a) to estimate potential revenues (as explained above); and
(b) to classify communities by income status using a nationally consistent standard.

## D. CAPITAL FUNDING

Issue:

Until now, no distinction was made between O&M funding and capital funding. A main difficulty in funding capital through a formula is that capital expenditures tend to grow unevenly over time.

The two options described below share the same potential benefits:

(a) Simplify administrative procedures and increase the sense of responsibility by the bands.
(b) Strengthen the incentive to maintain capital by providing funding through formula.
(d) Increase certainty about the level of federal transfers, an advantage to both bands and the Federal Government.

Recommendation:
**Integrate capital funding with O&M funding. This option should offered to all bands.**

Discussion:
The above option is the simplest solution. A possible modification of this option is to restrict to housing and project below a certain ceiling, while fund larger projects as at present.

Issue:
In the case of poorer bands, with the more serious gaps in capital facilities, there may be some resistance to formula funding of capital.

Recommendation:
**Offer poorer bands the additional option of maintaining the current system of estimating capital funding needs, but remove most spending restrictions.**

## IV. FURTHER WORK

Future analytical work could focus primarily on the following three areas:

(a) Empirical Analysis:
Basic analysis of the various options has already been conducted, using data from Statistics Canada and from a small sample of bands. However, a number of important issues have not been addressed:

1. How good a proxy of fiscal capacity is an earnings index based on earnings reported on the Record of Employment?
2. How close to the historical levels of funding would federal funding had been if the proposed options were already implemented?

(b) Operational Support:
Basic database development and analysis was conducted for the purpose of assessing alternative options. This effort could be expanded to provide the means for assessing the current and future cost of negotiated agreements and facilitating their monitoring. The most pragmatic approach would be to use bands currently negotiating self-government as a prototype and extend the database to include new bands as they enter into self-government negotiations in the future.

(c) Policy Development:
The process of designing options for funding arrangements under self-government is a dynamic one. As more agreements are signed, options for new agreements or for renewing previous ones would be refined. This process could be strengthened by instituting a process of assessing issues, including a survey of bands regarding their views about self-government.