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MEMORANDUM

TO DEH CHO NEGOTIATION TEAM
CC PATRICK SCOTT
FROM COLIN
DATE JULY 5, 2010
RE BACKGROUNDER TO FISCAL ISSUES

At the last Table session I undertook to provide a written background to the Fiscal Issues. Here it is. I have also laid out some of the concepts visually to help it make sense. I apologize for taking so long to get it done and I look forward to an opportunity to take the team through it.

How does OSR work?

The purpose of the OSR mechanism is to have the First Nation Government (FNG) bear some of the costs of governance when it is capable of doing so. OSR, or the own source revenue mechanism, works to reduce the amount of money Canada provides in the Financing Agreement depending on how much self-generated revenue (own source) a FNG generates. In this way the FNG contributes to the costs of governance.

As described in the slides, there is a block of funding that comes in the Financing Agreement that is made up of core governance funding and the programs that are drawn down. That amount, paid by Canada, is called the Base.

The OSR Formula:

Gross Base – ((OSR – Exemption Amount) x Inclusion Rate (50%) x Phase in Percentage) = Net Base \geq 1,000,000

Where:

Gross Base = governance funding (negotiated amount) + drawn down program funding.

Exemption Amount = usually 1 million (first amount of self-generated income not included, a negotiated amount)

Inclusion Rate = discount rate on self-generated income, 50% in other agreements.

Phase in Percentage = OSR mechanism phases in over 20 years by gradually raising the percentage up to full inclusion rate.

The OSR Floor:

The OSR mechanism also includes a \$1 million dollar floor. This means that no matter how much self-generated revenue a FNG has Canada commits to fund at least \$1 million.

What is included for OSR?

The basic rule is that all self-generated revenue is included, unless it is specifically excluded. See the attached slides.

Issues with the Current First Nation Government Funding Model:

Adequacy of the Base Funding Amount (before Programs):

Canada, in other Agreements, does not adequately fund the Base amount to cover the costs of the FN Government. The shortfall is generally made up by the FNG putting in virtually all of its self-generated revenue to fund the costs. However, without significant self-generated revenue then FNG's will not be able to cover the shortfall.

i.e.

If FNG costs 20 million

If Gross Base = 3 million

Self-Generated Revenue = 17 million

Assuming full OSR (post phase in)

Assuming the FNG is willing to put virtually all of self-generated revenue into covering governance costs.

Gross Base – ((OSR – Exemption Amount) x Inclusion Rate (50%) x Phase in Percentage) = Net Base \geq 1,000,000

$3,000,000 - ((17,000,000 - 1,000,000) \times 50\% \times 100\%) = - 5,000,000 = 1,000,000$
minimum

Therefore: the FNG has $17,000,000 + 1,000,000 = 18,000,000$ to cover its costs.
 $18,000,000 - 20,000,000 = - 2,000,000$.

Thus there would be a **shortfall of \$2,000,000** because of OSR and an inadequate Base. And this is true even with the FNG pumping in **\$17,000,000** of self-generated funds (all) into the cost of FNG.

Double OSR:

OSR mechanism is supposed to be the way that FNG's contribute to the costs of funding their FNG. But, as we see from the above example, FNGs are self-financing significant portions of the costs without the operation of OSR. Thus, when OSR comes into play they are self-funding with their self-generated revenue and having Canada's contribution through the Financing Agreement reduced by the OSR mechanism – this results in FNG's paying double OSR. Canada's OSR mechanism does not take into account any FNG self-funding.

OSR Frustrating Implementation of Treaty Rights - Program Draw Down:

Canada has taken the position that if a FNG draws down a Program then that funding is added to the Gross Base and is subject to OSR. The problem with this position is that FNG could end up having to fund programs themselves if they have sufficient self-generated funds. Since the costs of these programs are huge, the OSR mechanism works as a barrier to implementation of the new Treaty rights. In other words, the costs associated with exercising your treaty rights to control education won in the Dehcho Agreement could act as a barrier to ever exercising them. This is particularly true where the addition to the Base would mean that there was less money to run the program.

i.e.

If FNG costs 20 million

If Gross Base = 3 million

Self-Generated Revenue = 17 million

Assuming full OSR (post phase in)

Assuming the FNG is willing to put virtually all of self-generated revenue into covering governance costs.

Gross Base – ((OSR – Exemption Amount) x Inclusion Rate (50%) x Phase in Percentage) = Net Base $\geq 1,000,000$

$3,000,000 - ((17,000,000 - 1,000,000) \times 50\% \times 100\% = - 5,000,000 = 1,000,000$
minimum

Therefore: the FNG has $17,000,000 + 1,000,000 = 18,000,000$ to cover its costs.
 $18,000,000 - 20,000,000 = - 2,000,000$.

If FNG draws down education that costs currently 20 million to run, then the Gross Base is now $3,000,000 + 20,000,000 = 23,000,000$. Assuming that the FNG would get the full amount of program funding that was previously spent – (Access to that full program funding could be an issue and a barrier in itself).

After OSR:

$23,000,000 - ((17,000,000 - 1,000,000) \times 50\% \times 100\%) = 15,000,000.$

Therefore: the FNG has $15,000,000 + 17,000,000 = 33,000,000$ to spend.

$33,000,000 - 20,000,000$ (governance) $- 20,000,000$ (program)
 $= - 7,000,000.$

Therefore there is a **\$7,000,000 shortfall** to take on the education program. The FNG would be faced with severely curtailing one or both of their governance and their education programs to make up the shortfall. And this is with the FNG putting **\$17,000,000** of self-generated revenue into the implementation of the Treaty.

Uncertainty respecting the Sharing of Federal Taxes:

If FNG's are to carry such a heavy burden of self-funding then they will need to rely on stable tax revenues to meet their requirements. As we discussed, Canada is currently willing to share virtually all of the federal GST and Personal Income Tax (PIT) room with the FNG. The way this works is that Canada vacates its GST and PIT taxes in favor of FNG taxes taking up the tax room and hence the revenue. This has worked successfully in a number of FNGs and has provided a new and significant source of income along with creating effective FNG incentives for local economic development (more people working, more tax revenues etc.).

However, Canada has not been willing to commit to certainty with respect to the sharing of the tax room. In other words, it is possible that a future Canadian Government would cancel or curtail the tax sharing schemes. In such a case, the FNG taxes would be in addition to Federal and territorial taxes. This would mean that FNG citizens would be paying significantly higher taxes than others – an unworkable situation. Therefore, the refusal to continue to share taxes (terminate the sharing agreements) has the potential to undermine fiscal capacity for the FNG, because they could not ask the citizens to bear such a steep financial burden. This issue has been raised at numerous negotiating tables.

Because Base funding has been inadequate, a loss of tax revenue means that the FNGs could not self-finance from self-generated revenues to the same extent and there would be serious shortfalls in covering the costs of implementing FNG in a modern Treaty.

Adequate Base Funding may Address some of these Problems:

Canada has steadfastly refused to agree to negotiate the removal of the OSR mechanism. Canada seems committed to the OSR policy. Thus we have sought a solution within the current OSR scheme.

The issues seem to arise from the negative effects of an inadequately funded Base. However, if the Base were adequately funded, then many of the issues identified above may be mitigated.

Adequacy and Double OSR:

i.e.

If FNG costs 20 million

If Gross Base = 20 million

Self-Generated Revenue = 17 million

Assuming full OSR (post phase in)

Assuming the FNG is willing to put virtually all of self-generated revenue into covering governance costs.

Gross Base – ((OSR – Exemption Amount) x Inclusion Rate (50%) x Phase in Percentage) = Net Base \geq 1,000,000

$$20,000,000 - ((17,000,000 - 1,000,000) \times 50\% \times 100\%) = 12,000,000$$

Therefore: the FNG has $17,000,000 + 12,000,000 = 29,000,000$ to cover its costs. $29,000,000 - 20,000,000 = 9,000,000$ self-generated revenue in remainder with the FNG putting **\$8,000,000** in to cover its share of the costs of FNG. In such a case the contribution of the FNG is only through the OSR mechanism – no double OSR.

Program Draw Down:

i.e.

If FNG draws down education that costs currently 20 million to run, then the Gross Base is now $20,000,000 + 20,000,000 = 40,000,000$. Assuming that the FNG would get the full amount of program funding that was previously spent – (Access to that full funding could be an issue and a barrier in itself).

After OSR:

$$40,000,000 - ((17,000,000 - 1,000,000) \times 50\% \times 100\%) = 32,000,000.$$

Therefore: the FNG has $32,000,000 + 17,000,000 = 49,000,000$ to spend.

$$49,000,000 - 20,000,000 \text{ (governance)} - 20,000,000 \text{ (program)} \\ = 9,000,000$$

Therefore there are 9,000,000 in self-generated revenue in remainder with the FNG putting **\$8,000,000** in to cover its share of the costs of FNG when the FNG takes on the education program.

What about if Canada stopped sharing taxes?

If Canada stopped sharing tax room, then the self-generated revenue of the FNG would fall. If the Base was adequately funded it would be able to respond to this loss of income and the FNG could still meet its costs.

i.e.

If FNG costs 20 million

If Gross Base = 20 million

Self-Generated Revenue = 17 million – 10 million (tax sharing terminated) = 7,000,000

Assuming full OSR (post phase in)

Assuming the FNG is willing to put virtually all of self-generated revenue into covering governance costs.

Gross Base – ((OSR – Exemption Amount) x Inclusion Rate (50%) x Phase in Percentage) = Net Base \geq 1,000,000

$20,000,000 - ((10,000,000 - 1,000,000) \times 50\% \times 100\%) = 15,500,000$

Therefore: the FNG has $15,500,000 + 7,000,000 = 22,500,000$ to cover its costs.

$22,500,000 - 20,000,000 = 2,500,000$ self-generated revenue in remainder with the FNG putting **\$4,500,000** of its self-generated revenue into the costs of FNG.

Self-Generated Revenue in Remainder:

FNG's require the fiscal capacity to create and run their own programs. If all of FNG self-generated revenue is required to meet the costs of implementing FNG under the Agreement, then the FNG will not have the capacity to start its own programs and services. The Fiscal arrangements within a Treaty should not be set up to preclude the FNGs from having this essential capacity. Therefore, the fiscal arrangements should provide for sufficient self-generated revenue in remainder.

Will the Base Amount Equal the Costs of Governance?

It is unlikely that Canada will agree to a Base amount that is equal to the costs of governance (i.e. 20million Base for a 20 million cost). There is no such example in the country. Depending on the self-generated revenue capacities of the FNG, Base amounts less than 100% of governance cost can still work to the FNG's advantage. The test will be to model out the income capacity and costs of the DehCho Government and see where the appropriate solution lies.

Summary:

These are a few of the hurdles from a fiscal perspective that need to be addressed going forward. The other Modern Treaty First Nations and the other negotiating tables are struggling with many of the same issues.

Furthermore, as we learned at the Table, Canada is doing a major re-think of their fiscal relationship with FNGs. There are indications that they are thinking of moving

to some sort of a formula financing method. I have trouble seeing how a formula can take into account the very different responsibilities and characters of the FNGs across the country.

I understand that part of Canada's plan is to have an "engagement" with the FNs on their "re-think". I recommend that the Deh Cho stay active in this process. I am very concerned that Canada will develop something that does not fit your circumstances, and does not reflect FN needs and aspirations. My experience is that they develop these things and then become very rigid in what they will do thereafter.

I hope this summary is helpful. I look forward to having the time to take you all through it and have the discussion.

Best regards,

Colin