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Policy Brief

In Praise of Taxes: The Link between Taxation and Good Governance for First Nations Communities

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Introduction

The word 'taxes' evokes a shudder among most Canadians, but especially among many First Nations people. The Indian tax exemption has become a key symbol of the unique relationship of First Nations with Canada, whether its source is seen as the treaties, an inherent Aboriginal right, or Section 87 of the *Indian Act*. A survey by the Indian Taxation Advisory Board suggests that First Nations people object to taxation not only by provincial and federal governments but by their own First Nations governments too.[1] But what if taxation by their governments were to improve governance in their communities?
That question is the theme of this policy brief.

Based on a much longer paper,[2] the policy brief outlines the linkages between taxation and good governance as described in public finance theory and the literature on international development. It begins by presenting the link between taxation and good governance, then indicates what effects the *lack* of a tax relationship between a government and citizens might have. It then applies the lessons to First Nations communities, indicating some of the positive effects of introducing broad-based taxation on reserve. The policy brief concludes by outlining options First Nations now have in occupying tax jurisdiction and by providing some advice on how political leaders might gradually introduce taxation into their communities.

The Tax Relationship

We first turn to the link between taxation and good governance in general terms. The decision to impose taxes is not based simply on sober fiscal analysis, but is rather an intensely political decision. In a democracy, government tax decisions are the outcomes of a critical relationship underlying taxing and spending: the relationship between citizens and their elected government. In order to gain and retain power, political officials must persuade a substantial number of their citizens that they can tax and spend public funds wisely.

This theory has been upheld by recent practice in American and Canadian election campaigns during a world-wide economic crisis. Citizens scrutinize the taxing and spending decisions of their governments. Such scrutiny establishes a survival rule whereby governments attempt to win elections (generated in part through spending) and avoid defeat (by the many disgruntled voters whose revenue source is being taxed). Thus, the citizen-government relationship that lies at the heart of taxing and spending activities helps define, constrain and steer those activities.[3]

The objection could be raised that the tax relationship pertains only to Western democracies. Yet there is also evidence of such a relationship in developing countries abroad. In fact, a burgeoning literature presenting so-called fiscal theories of governance indicates that struggles over taxes and services tend to produce greater deference of governments to citizens in developing countries as well.[4]

[1] Results of ITAB First Nation Taxation Questionnaire, cited in Fiscal Realities, "First Nation Taxation and New Fiscal Relationships," paper presented to the ITAB and Department of Indian Affairs and Northern Development (August 1997).

[2] John Graham and Jodi Bruhn, "In Praise of Taxes: the Link between Taxation and Good Governance in a First Nation Context" Institute On Governance (March 2008).

[3] W. Irving Gillespie, *Tax, Borrow and Spend: Financing Federal Spending in Canada, 1867–1990* (Ottawa: Carleton University Press, 1991), 2, 16–18.

[4] See, for example, Mick Moore, "How Does Taxation Affect the Quality of Governance?" Working Paper 280, Institute of Development Studies (April 2007); Barak D. Hoffman and Clark C. Gibson, "Political Accountability and

Notably, such a tie also appears to have existed in traditional First Nations practice. The *First Nations Real Property Taxation Guide* published by the First Nations Tax Commission reminds that First Nations prior to contact practiced a form of taxation in customs such as paying tribute for occupying or using territory, and distributing wealth through ceremonies like the potlatch or giveaway dances. Cree storyteller Joy Asham describes how the leader of the buffalo hunt, the Poundmaker, was always the last to receive the meat from the hunt, awaiting the portion the warriors gave him as their expression of gratitude and respect.[5]

First Nations people on reserve might not be accustomed to taxation now, but it appears that this had not always been the case. Traditionally, Aboriginal people both shared resources within the community and ensured the accountability of leaders through mechanisms that can be compared to taxation.

Taxation and Good Governance

How precisely does taxation enhance good governance? In its publications, the IOG has argued that there are five universally applicable principles of good governance. Dependence on broad-based taxation, if fairly and effectively administered, should lead to some beneficial governance outcomes affecting all five, including:

- More responsiveness to the service preferences of citizens (performance and voice)
- Increased government emphasis on prosperity of citizens (direction, performance)
- More political engagement of citizens, who monitor how revenues are spent (accountability, legitimacy and voice)
- Over time, citizens comply with the tax regime in exchange for influence over taxation levels and the form and uses of tax revenues (voice, accountability, legitimacy)

As a cumulative effect of the positive effects of taxation on governance, political scientist Mick Moore predicts an improved quality of life for citizens of regimes applying broad-based taxation, if it is fairly administered.[6]

Of course, many other factors affect the quality of governance: sound institutions and a supportive political culture, for example. Beyond this, there can be simple mistakes in the political calculations of citizens and governments, rendering the 'survival rule' only a general rule of thumb. Yet further evidence of the positive effects of taxation arises not only where the taxation relationship is present, but perhaps even more forcefully where it is absent.

There are two common, albeit very different, situations where governments can afford not to tax their citizens: where they enjoy large non-tax revenues, or where they receive aid or transfers from other governments. To explore the link between governance and taxation further, we now turn to the negative case: the effects of the absence of a need to tax as presented in the comparative and development literature.

The "Curse" of Non-Tax Revenue

Canadians are broadly familiar with the 'curse of oil,' the thesis that oil wealth impedes democratic governance. Some of the international literature suggests that sudden oil wealth inflicts even greater damage on democratic practices in poor states than in wealthy ones. Economist Paul

Fiscal Governance in Africa," unpublished manuscript (March 2006), 5, 23.

[5] Joy Asham, "The Buffalo Hunt of the Plains Cree, as told by Plains Cree Elders of Echo Valley, Saskatchewan," reprinted in the *Métis Voyageur*, December 2007, 19.

[6] Moore, "How Does Taxation Affect the Quality of Governance?" 17–18.

Collier cites dependence on natural resource exports as one of three characteristics that make a country prone to civil war (the other two being low income and slow economic growth). Two major difficulties face developing countries that are rich in natural resources. First, their main revenue source is volatile, which contributes to poor planning. Second, their abundance of public money makes it more effective for incumbants simply to buy votes to stay in power. Where patronage politics is not only feasible but more cost-effective, those attracted to public life tend to be crooks seeking a share in the spoils.[7]

Extending the curse of oil logic to provincial or state governments receiving large fiscal transfers, political scientist Carlos Gervasoni suggests that the ‘curse’ stems less from the revenues arising from natural resources than from their not arising from taxation. Yet funds from outside can also flow from central governments to sub-national ones in any country practicing fiscal federalism. Based on his study of sub-national governments receiving large fiscal transfers in Argentina, Gervasoni observed effects similar to those of the natural resource curse. Among the symptoms: a disproportionately large public sector, bloated public payroll, widespread patronage politics and a notable lack of competition for incumbents.[8]

Applying the Research to First Nations

How might the public finance theory and the international research outlined above apply here in Canada? Questions surrounding natural resource revenues and the effects of fiscal transfers have long bedevilled commentators. Some, for example, question the effects of Alberta’s sudden oil wealth on the governance of that province. Others ask whether heavy fiscal transfers to have-not provinces only depress their economies further. First Nations in Alberta have experienced the mixed blessings of natural resource wealth firsthand. The patronage and cronyism combined with appalling social conditions that plagued the Stoneys outside Calgary or the Samson Cree Nation in the late 1990s amply attest to the effects sudden resource wealth can have on pre-existing social and governance issues in a First Nation community.[9]

Less pronounced, but still palpable, are the effects felt by First Nations depending almost solely on federal fiscal transfers for their revenues. In 2001, Fiscal Realities estimated that fiscal transfers comprise an average of 90 or even 95 percent of the revenues of First Nations governments. Manifesting a situation of “extreme fiscal imbalance,” this level was more than double that of the poorest province in the country.[10]

Public finance theory would predict serious accountability issues here. With little correspondence between the source of revenues and the recipients of services, one would expect lower levels of satisfaction among First Nations recipients and a poor upkeep of services on the part of the funding government, whose political survival does not depend on responding to the service demands of First Nations citizens. One would also expect First Nation community members—who are not paying for services—to demand more than they are willing to pay for.

[7] Paul Collier, *The Bottom Billion: Why the Poorest Countries are Failing and What Can Be Done about It* (Oxford: Oxford University Press, 2007), 32, 40–41, 44–46.

[8] Carlos Gervasoni, “A Rentier Theory of Subnational Authoritarian Enclaves,” paper delivered at the VIII Congreso Nacional de Ciencia Politica de la Sociedad Argentina de Analisis Politico (Buenos Aires: November 2007).

[9] For a description, see Jean Allard, “Big Bear’s Treaty: The Road to Freedom,” *Inroads* 11, 145–49.

[10] Fiscal Realities, “Getting First Nations Government Right—Tax and Related Expenditure,” paper presented to Indian and Northern Affairs Canada and the Indian Taxation Advisory Board (June 2001).

In terms of governance, the adverse effects may well resemble those described in the Argentinian study. First Nations, for example, tend to have a very large public sector.[11] Certainly, this is due in part to the broad scope of services First Nations governments must deliver to their citizens. But it may also follow from how the revenues spent are raised. Politics can also be highly factional and patronage-based in First Nations and the media and other organizations have reported cases of election fraud and vote buying.[12]

Of course it would be false to depict all First Nations governments as corrupt or elitist—just as it would be wrong to say that the revenue source is the sole determinant of governance quality. Indeed, some First Nations are very well governed despite the absence of tax regimes. In general, though, both governance and service quality can be expected to suffer in a governance system that lacks the crucial tie of a direct fiscal reliance upon its citizens for survival. Further, the international literature suggests that First Nations advocacy organizations should expand their focus beyond an emphasis on sharing natural resource royalties as the means to reduce the dependency of First Nations on the federal government. Notably, the Royal Commission on Aboriginal Peoples and Harvard Project on American Indian Economic Development both recommend that First Nations and American Indian tribes tax their citizens.

Current Tax Options for First Nations

Having indicated that taxation by First Nations governments would help improve the governance of First Nation communities in principle, we turn to the thorny issue of how it would work in practice. Here a crucial caveat is in order. Despite the present fiscal imbalance, we do *not* recommend a reduction of federal fiscal transfers—at least not for the foreseeable future. At their present levels, the fiscal transfers do not adequately support services in any case. Beyond this, no taxes collected in small First Nations communities could ever be expected to fund such big-ticket items as education, health care, and social welfare. The goal, therefore, should not be to reduce or eliminate the transfers but to boost First Nations' overall revenues by introducing taxes alongside user fees and other own-source revenues (ranging from royalties and resource rents to revenues from First Nations-owned businesses).

There are a few legal instruments First Nations alreay have to introduce taxes on reserve. Briefly, they are:

1. **Property tax:** Subject to approval of property tax bylaws passed by band councils, First Nations communities under the *Indian Act* can now collect property taxes on all real property on reserve—either under Section 83 of the Indian Act or under the 2005 *First Nations Fiscal and Statistical Management Act*. Affecting mainly non-Aboriginal lessess and businesses on reserve, most First Nations now exempt member property interests from taxation. Some 113 First Nations now collect property taxes.

2. **Sales tax:** Since 1997, First Nations have been able to opt into legislation enabling them to pass bylaws imposing a sales tax—at first only on on-reserve sales of alcohol, fuel, and tobacco and later on all taxable goods and services consumed on First Nations land. The 2003 *First Nations Goods and Services Tax Act* (FNGST) enables First Nations under the *Indian Act* to impose a consumption tax at a rate identical to the federal GST, but only through special sharing

[11] See here John Graham, "Rethinking Self-Government: Developing a More Balanced, Evolutionary Approach," Institute On Governance, Policy Brief 29 (September 2007).
[12] See especially the work of the Frontier Centre for Public Policy, which has also created an "Aboriginal Governance Index," available at www.fcpp.org.

arrangements with Canada. Unlike the property tax power, the FNGST must apply to both members and non-Aboriginal consumers. Only 29 First Nations now apply a sales tax—12 of them are self-governing First Nations.

3. **Personal income tax:** There is no national framework legislation allowing First Nations to opt into collecting income tax. Tax jurisdiction is available only to First Nations that have concluded self-government agreements. Self-governing First Nations have a strong motivation to occupy this tax room, as the *Indian Act* tax exemption no longer applies to First Nations citizens under a self-government agreement.

Assuming that First Nations governments will one day be multi-tiered, careful thought should be given to how each tier finances itself. Property taxes and user fees would be appropriate to lower tier governments delivering services and making expenditures that relate directly to those revenue sources. Sales tax might be more appropriate revenue sources for upper-tier governments. And First Nations under the *Indian Act* may wish to press for introduction of legislation allowing them to tax the income of their members. The federal government, for its part, will wish to develop a more effective approach to communicating the benefits of taxation to First Nations. It should also fix an existing tax anomaly that allows all First Nations individuals who are exempt from personal income tax to receive the same tax program benefits—regardless of income.

The Decision to Tax

There are undeniable barriers to introducing tax regimes on First Nations. The Indian tax exemption has long served as a powerful symbol of the unique position of First Nations people within Canada. One obvious hurdle is the political sensitivity of the issue. Another is that those who would implement tax regimes as a public good—Council and administration—would be the most likely to pay taxes privately. A third difficulty is the relatively time-consuming process of negotiating a tax agreement with Canada.

Despite the substantial political hurdles of occupying tax room, though, a handful of First Nations have succeeded in raising taxes from their own citizens. The results have included new funds for projects of priority to the First Nation, a fresh emphasis on service quality, as well as a premium on economic development and increased citizen participation. The benefits are most obvious to First Nations with a large number of non-members living or travelling through the community. Yet even smaller, more remote First Nations gained significant revenue (on average, about 8 percent of total revenues).

Our interviews with taxing First Nations yielded the following advice to others:

- Link the introduction of a new tax to identifiable community projects (for example, a new community cultural centre).
- Add to the attractiveness of taxing by including non-members in the First Nations tax-base—recalling that the beneficial effects arise from taxing the membership.
- Ensure non-member taxpayers fair treament, effective service provision and adequate representation on decisions affecting them.
- Canvas first the experiences, both positive and negative, of other First Nations that have instituted tax regimes.
- Add taxes incrementally. A First Nation might begin by introducing property tax, then proceed to the FNGST sales tax.

CONCLUSION: There are significant hurdles to introducing new taxes in First Nations. Once established, however, tax regimes promise to yield First Nations both lasting sources of revenue and substantial governance improvements—and this in a matter of years rather than decades or half-centuries.