



Spend & Tax:

Improving the efficiency and
accountability of taxation in HRM



HARRY KITCHEN

February 2008

Atlantic Institute for Market Studies

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ABOUT THE AUTHOR

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EXECUTIVE SUMMARY

The Halifax Regional Municipality (HRM) is to be commended for undertaking a review of the structure of its taxation system. An optimal tax structure is a critical ingredient for cities that wish to grow and prosper in a highly competitive, globalized economy.

This paper adopts the benefits-based model of public finance: those who benefit from local public services should pay for them. This model promotes allocative efficiency, accountability, transparency, and fairness.

This paper analyzes a variety of taxation schemes and makes recommendations regarding which ones should or should not be implemented in HRM. Several types of new taxation powers for HRM are proposed.

At the outset, it must be noted that the recommendations in this paper to change the current property tax and user fee structure and to add new tax tools must **NOT** be interpreted as a call for higher taxes and user fees overall. Instead, these recommendations are about correctly taxing and pricing municipal services. Only in this way can HRM move towards a more efficient, accountable, transparent, and equitable local finance system. This, in turn, would lead to a more judicious use of local taxing and charging tools, and could lead to lower property taxes and user fees overall.

As well, the proposals provided here ignore political constraints such as the possible need for provincial government approval of some measures.

Specific recommendations include the following:

1. The property tax base should be market value with all properties assessed in a uniform and frequent manner.
2. Assessed property values should not be frozen or capped and preferential assessment of some properties should be avoided.
3. Variable tax rates should be used to capture differences in costs of servicing different properties (by neighbourhood or property type).
4. The practice of over taxing commercial/industrial properties should be stopped.
5. User fees should be expanded to include more services, especially solid waste collection and disposal.
6. Fee structures for all services should be carefully designed to capture all costs and to control for efficient use of local services.
7. The range of services for which infrastructure charges can be applied could be expanded to include arterial road construction and expansion, recreation complexes and facilities, libraries, emergency measures facilities and vehicles (police, fire, and ambulance).

8. HRM should be given access to the personal income tax by ‘piggybacking’ onto the provincial tax with the tax rate set by the HRM council.
9. HRM should be permitted to implement a dedicated municipal fuel tax to fund a portion of public transit and transportation projects with the tax rate determined by the HRM council.
10. HRM should be given access to tax incremental financing instruments. This is a special classification for property taxes where taxes on assessed property values arising from, redevelopment of brownfield areas, are earmarked for specific public improvements (streetlights, curbs, and so on) in the area undergoing development.

The opportunity to provide this input to HRM council and staff as they contemplate changes to the city’s tax structure is appreciated. Of course, all recommendations for new taxing powers are premised on the assumption that all relevant officials will use such powers wisely and judiciously!

INTRODUCTION

The recent initiative by the Halifax Regional Municipality (HRM) to undertake a review of its tax structure including a consideration of alternatives is a progressive and forward-looking step. It has created an opening to re-examine the principles of municipal taxation and an opportunity to implement a local tax structure that will improve the City's economic and fiscal environment as it becomes a more active participant in the ever-growing and increasingly competitive global economy.

Throughout this initiative, HRM has invited public input and this submission is part of the process. It offers suggestions for what should be done and what should not be done. It begins with a brief discussion of a framework for considering revenue options and when each instrument should be used and how each might be structured for financing capital and operating expenditures. It should be noted that many of the recommendations would require provincial approval while a few could be implemented by HRM on its own. For some, provincial approval may be seen as a significant constraint and indeed, it may be. This proposal, however, ignores that constraint in the interest of making recommendations for an improved local tax and finance system. After all, if municipal tax policy is improved, provincial tax policy is improved. Why should the province stand in the way?

At the outset, it must also be pointed out that the recommendations in this paper to change the current property tax and user fee structure and to add new tax tools must **not** be interpreted as a call for higher taxes and user fees overall. Instead, these recommendations are about correctly taxing and pricing municipal services. Only in this way can HRM move towards a more efficient, accountable, transparent, and equitable local finance system. This, in turn, would lead to a more judicious use of local taxing and charging tools, and should lead to lower property taxes and user fees overall.

FRAMEWORK FOR EXAMINING OPTIONS

To set the framework, let us turn to the constitutional place of municipal governments in Canada. Municipal governments are ‘creatures of the province’. Because of this, it is generally accepted that the most appropriate way to examine each government’s fiscal roles and responsibilities is within the principal-agent framework of provincial-municipal financing arrangements. Municipal governments, including HRM, are the agents while the province is the principal. More specifically, this means that the province has the power to alter jurisdictional boundaries, to change revenue and expenditure responsibilities of the agent, and to change intergovernmental fiscal arrangements to overcome differing objectives between the principal and the agent. HRM’s role should be to provide and fund services that benefit local constituents; hence, financing of each service is best completed within the benefits-based model of public finance

The underlying principle of the benefits received model of local finance is straight-forward: those who benefit from local public services should pay for them. This is particularly important because those who benefit and pay participate directly in expenditure – finance decisions. Participation, through elected officials, along with both paying for and receiving benefits is critical in leading to efficient local government.

The benefits received model satisfies the following criteria that are important in designing a local government fiscal system.

- *Economic (allocative) efficiency* is achieved when the user fee or tax charged for the service equals the cost of providing that service. If the price or tax per unit is lower than the production and delivery cost, users will consume too much of the service and resources will be wasted or misallocated. If the price or tax per unit is higher than the cost of production, too little will be consumed and society will be worse off in the sense that too little of the service is consumed. Charges applied in this fashion are efficient for funding services where the beneficiaries can be clearly identified and the costs correctly derived. Prices or taxes ration output to those who are willing to pay and serve as a signal to suppliers (local governments or their delivery agents) that will assist them in determining the desired quantity and quality of output.
- *Accountability* is more likely to be present when there is a close link between consumption and the price or tax paid per unit of consumption.
- *Transparency* is increased as long as citizens/taxpayers have access to information on the way in which local taxes and user fees are set. Increased transparency will lower the risk of corruption by public sector policymakers.
- *Fairness* within the benefits model is achieved because those who consume public services pay for them, just as someone who benefits from purchasing milk or a movie ticket pays for it. Concerns about the tax burden on lower income individuals should be addressed through income transfers from senior levels of government and social assistance programs targeted to individuals in need. It is far more equitable and efficient to handle income distribution issues through income transfers or targeting than to tamper with charging or taxing mechanisms to these concerns.

The benefits model,¹ then, is most easily approximated where beneficiaries can be identified easily; where services do not generate spillovers or externalities; where the services are not income redistributive in nature; where individuals can be excluded from consuming the service; and where precise measurement of output and costs can be calculated. The benefits model can be applied to groups where benefits can be identified to accrue within a specific geographic area and finances can be obtained from the area. While this is not as precise as may be achieved with individual user charges for some services, it is the best that can be achieved for many local government services.

¹ An alternative approach would be to argue for taxation on the basis of ability to pay. This is appropriate for governments that have access to income taxes (federal and provincial) and where services funded by these taxes benefit all of society as opposed to specific beneficiaries that can be easily identified.

FINANCING LOCAL SERVICES IN PRACTICE

HRM provides services ranging from those that exhibit mainly private goods characteristics (examples include water, sewer, solid waste, and some recreation) to those that exhibit mainly public goods characteristics (examples include local roads and streets, street lighting and sidewalks, police and fire, neighbourhood parks, libraries, land use planning, and other recreational programs). For services with mainly private goods characteristics, individual beneficiaries can be identified, income redistribution is not a goal, spillovers are unlikely to exist, and operating costs can be measured and recorded. Here, a user fee would be the best financing instrument for satisfying the principles of efficiency, accountability, transparency, and fairness.

For services providing mainly collective or ‘public goods’ benefits (specific beneficiaries cannot be identified), user fees are inappropriate. These services should be funded from a local tax on residents with partial grant support to cover a portion of the costs of services whose benefits partially spill over into neighbouring jurisdictions. In other words if 20 percent of the benefits at the margin accrue to neighbouring jurisdictions, then one could argue that 20 percent of the costs at the margin should not be funded from the local tax base, but from grants.

For services that are partially private and partially public, a combination of user fees and local taxes may be appropriate.

Grants are not discussed in this paper because it is the author’s view that municipalities, especially large metropolitan areas such as HRM, have little argument for grant support. Instead, it is the author’s view that HRM should concentrate on designing and implementing a local finance system over which it has control. This includes municipal property taxes and user fees plus a range of new financing instruments which, of course, the province would have to approve.

FINANCING INSTRUMENTS

This section concentrates on specific changes that should be made in the financing instruments. It concentrates on property taxes, user fees, new tax sources and infrastructure charges.

PROPERTY TAX

There are two important parts to the property tax – the tax base and the tax rate.

Tax Base

Since the assessment system serves as the tax base for applying property taxes, there are a few things that are essential if it is to operate in a fair, transparent, accountable, and non-distortionary (neutral) manner. These revolve around the choice of the assessment system and its application. The following summarizes possible assessment systems and comes up with a preferred choice.

Market Value Assessment

Market value is the price that is determined between a willing buyer and a willing seller in an arms length deal. Market value estimates the value that the market places on individual properties. For properties that sell in any year, market value is the selling price. For properties that do not change hands in the year, market value must be estimated. This is the most popular assessment base world wide. It is used in most developed and many developing countries where there are functioning real estate markets. Examples include Canada, Australia, Germany, Japan, the U.K., the U.S., China, New Zealand, Hungary, Latvia, Argentina, Colombia, Mexico, Indonesia, Philippines, Thailand, Kenya, South Africa and Tanzania.

Site Value Assessment

In its purest form, site value assessment (SVA) is a special case of market value assessment where only land is assessed. All capital improvements (buildings, for example) are excluded from the assessment base. Under a graded SVA system, capital improvements are included in the base and taxed at lower rates (sometimes significantly lower) than land, with the level of gradation varying according to the taxing jurisdiction's policies and practices. A form of site value assessment is used, at least partially, in Australia, parts of Russia, Kenya, Tunisia and the city of Pittsburgh.

Unit-Value or Area Assessment

Under unit-value or area assessment, the tax base is a combination of building area and lot area. For each property, assessed value is the sum of lot area times an assessment rate per square metre plus building area times an assessment rate per square metre. The assessment rate may be the same for both building area and for land area or it may differ, as it often does, with a lower rate applied to buildings to encourage development. This is favoured in countries or parts of countries without functioning real

estate markets: for example, Hungary, Poland, parts of Russia, Ukraine, Chile, parts of China and India, Estonia, the Czech Republic, Slovakia, and Armenia.

In its purest form, unit assessment does not take into consideration any variation in the assessment base to reflect location, market conditions, or quality of structures. In less than pure form, unit assessment may introduce variation to reflect location, zoning, use of property and other factors deemed appropriate.

Self-Assessment

In this unique approach, property owners place a value on their property and submit this to the tax authorities. Examples of countries that either do or have done this include Hungary, Tunisia, Thailand, Philippines, Colombia. This system is relatively easy to administer. It only works, however, if property owners are required to sell a parcel of property for its assessed value and if the taxing authority has the money to purchase or permit a private purchase of the property. Its downfall is that it is difficult to enforce and leads over time to under estimation of properties with lower valued properties underestimated less than high valued properties.

TAX BASE – WHAT SHOULD BE DONE?

Of the possible options, market value assessment is the preferred choice in the vast majority of countries that have fully functioning real estate markets. This is the tax base currently used in HRM and in the rest of Canada. It has much to offer as a base for local taxation and is devoid of the major problems and issues that surface with the alternatives.

In particular, market value is able to capture the amenities of the neighbourhood, amenities that are often created by local government policies (zoning legislation, for example). Area based or unit value assessment will not capture these amenities. To illustrate, assume two properties of identical size (that is, identical in building size and land area) and age but located in different parts of a community. One is adjacent to a greenbelt while the other is next to an abattoir. Under unit assessment, both would be assessed in an identical fashion, whereas the two properties would be assessed differently under market value assessment. It is unlikely that many would argue that unit value or area based assessment would be fair in such an instance.

In addition, benefits from local public services are more closely reflected in property values than in the size of the property. For example, properties close to parks and public transit systems benefit more from public services than do properties located some distance away. Furthermore, these benefits are reflected in higher property values for neighbouring properties. Market value assessment captures these benefits, whereas the other assessment systems do not.

A further example of the fairness of market value assessment should also be noted. An identical house near a good school with good streets and public safety will have a higher market value than a similar house near a poor school with poor streets and a poor public safety record. Local government services contribute to market value – better services lead to higher property values and higher taxes; poorer services lead to lower property values and lower taxes. This is fair!

Critics of market value assessment often argue that it is unfair when large annual increases in housing prices arise and higher taxes ensue. This is the same thing as having one's income tax payments increase when his/her taxable income increases. Does anyone seriously complain about an increase in taxable

income? As for property values, it is curious how people will complain about large increases in assessed values while at the same time remaining silent (or better still, bragging about it) when they observe a corresponding increase in the selling price of their property. When properties are sold in rising property markets, capital gains (sometimes substantial) ensue and the seller's ability to pay increases. The fact that a given property is not sold does not change the argument: the increase in value increases the taxpayer's capacity to consume and, hence, his or her ability to pay. If increases in assessed value create financial hardships, tax relief schemes exist and could be made available to alleviate financial hardships.

Critics have also suggested that the cost of annual reassessments is a detriment to market value assessment. Fortunately, recent use of mass appraisal assessment systems has significantly lowered the cost of annual reassessments and largely negated this concern. In addition, when this is combined with an effective and inexpensive appeals mechanism, many of the earlier estimation problems have disappeared.

Finally, switching from a value based assessment system to an area based assessment system, as many critics of market value suggest, will result in relatively greater tax burdens on low income households when compared with high income households. This arises because a tax on area does not take into consideration household income so two identical properties – one in a high income area and one in a low income area - pay the same tax with the result that the tax burden on the household in the high income neighbourhood is relatively less than the burden on the household in the poor income neighbourhood. Similarly, older houses in need of substantial repairs but with a large floor area will pay relatively high taxes.

All in all, when arguments for and against market value are weighed and considered, it has more to offer as a tax base than the possible alternatives. Having stated this, however, there are two issues that are critical in implementing a market value assessment system – uniformity of assessment and frequency of assessment.

Uniformity of assessment

Uniformity of assessment means that all properties must be assessed in the same way; that is, residential, commercial, industrial, farm, government, properties of charitable organizations and not-for-profit agencies, and so on should be treated identically. The practice of exempting certain properties or applying differential assessment rates to others lowers the tax base and creates potential problems. First, it reduces the tax base and thus increases taxes on taxable properties or leads to a lower level and quality of local public services than would otherwise be the case.

Second, for properties owned by provincial and federal governments, universities, colleges, public hospitals, and penal institutions, payments-in-lieu of property taxes should be provided at levels that reflect the property tax that could be collected from these properties.

Third, the policy of exempting properties or assessing them at a value that is less than other properties is discriminatory and unfair, leading to a mix of land use that may be different from the mix that would exist under equal treatment of all properties. If it is possible to make a sound case for the preferential treatment of certain organizations or property types, then these organizations and property types should be rewarded directly through a system of grants or through the application of differential tax rates applied to a uniform assessment base. In either case, such subsidization would be more transparent and subject to review and amendment by elected representatives according to their interpretation of the public interest.

Frequency of assessment

If the assessment base is to be fair and productive, periodic valuations and revaluations must be undertaken to ensure that assessment is kept up to date. In market value systems, a shorter time frame for reassessment is preferred (annually is the best) because this helps to maintain the legitimacy of the tax base. As well, it reduces the risk of sudden and dramatic changes in tax burdens that often arise when reassessments are conducted sporadically and infrequently such as following the removal of a cap on assessment or termination of an assessment freeze.

Recommendation: *The property tax base should be market value with all properties assessed in a uniform and frequent manner.*

TAX BASE – WHAT SHOULD NOT BE DONE?

To ensure that the assessment system operates effectively and fairly there are at least two things that should be avoided: capping or freezing assessment and preferential assessments.

Capping or freezing assessments

Capping or freezing assessment is almost always a response to rapid increases in assessed property values. In fact, this was a major reason why the provincial government in Nova Scotia imposed a freeze on property assessment. While this practice is often politically palatable in the short run, it is simply bad policy and bad practice. It leads to inequities and distortions during the period of the cap or freeze and it often has suicidal political consequences when the cap or freeze is removed.

During the freeze, inequities exist because individuals whose property values increase relatively little pay proportionately more in property taxes than individuals whose property values increase by a larger proportion. This frequently translates into the poor paying proportionately more and the rich paying proportionately less for local services.

Distortions also exist because it is in the best interest of individuals whose property values have increased the most to put pressure on local councils to increase expenditures knowing that they will pay proportionately less to fund these additional services when compared with those individuals whose property values have increased very little.

After the cap or freeze is removed, significant increases in some property values will be required to put all properties on a level playing field. This, in turn, will lead to more criticism, more complaints, the possibility, and even probability, of the province introducing more bad policies and practices to, once again, calm the critics.

Finally, if property values are increasing quickly, property owners are better off. If they are better off, why should they not pay taxes to reflect this? If the concern is that these taxpayers are income poor even though they are asset rich, there are property tax relief schemes that could be introduced to assist taxpayers. One that is used in some provinces is called a ‘reverse mortgage’ – the homeowner continues to live in the house and when the house eventually sells, back taxes plus interest on these taxes are paid. A more common option (although not used very often in Canada) for rapidly fluctuating property values is to introduce a three year moving average to smooth out rapid changes in assessment and property taxes.

This is not without problems, however, because properties with escalating prices do not pay their fair share of taxes during the increase and they are overtaxed when properties are decreasing in value.

Preferential assessment of some properties

Uniformity in assessment is a critical component of any properly functioning assessment system. It follows, then, that special treatment should not be granted to certain property types; in particular, water front properties should not be given special consideration as some ratepayer groups are advocating. These properties should (must) be assessed in the same manner and on the same base as other residential properties in every municipality. To do otherwise would grant them favourable treatment vis-à-vis other properties and unfairly lower their share of property taxes paid to fund local services. Generally, the response of special interest groups is that they do not receive as many services as the rest of the community. If this is true, local council can and should use variable tax rates to capture these service differentials. Variable tax rates exist when different property tax rates are levied on different property types (single family residential, multi-unit residential, commercial, industrial) or different neighbourhoods or areas of a municipality. The variation, if correctly designed, will capture differentials in the cost of servicing different properties or location.

Recommendation: *Assessed property values should not be frozen or capped and preferential assessment of some properties should be avoided.*

TAX RATES – WHAT SHOULD BE DONE?

Variable tax rates have been used in HRM for a number of years. They have a number of advantages. First, they are fair on the basis of benefits received as long as the rates are set to capture the cost of municipal services used up by different property types or property location. Second, they are efficient if designed to recover the cost of local public services consumed because incentives would not exist for a household or firm to alter its behaviour or location to avoid the tax as long as it matched the cost of services consumed. Third, they could be used to distort decisions deliberately to achieve certain municipal land use objectives. For example, if higher tax rates slow development and lower tax rates speed up development, a deliberate policy to develop certain neighbourhoods or parts of a municipality instead of others might be achieved through different tax rates for different locations.

Recommendation: *Variable property tax rates should be used to capture differences in costs of servicing different properties (by neighbourhood or property type).*

TAX RATES – WHAT SHOULD NOT BE DONE?

The practice in virtually every municipality in Canada including HRM is to tax commercial and industrial (C/I) properties at higher tax rates than residential properties. This creates a number of efficiency and equity concerns. Efficiency in municipal service levels will not be achieved if revenues collected from property taxes on business properties are used to subsidize services consumed by the residential sector. Since service levels in any municipality are driven primarily by the demands of the residential sector (they vote), their subsidization means that the residential tax rate will be less than it would be in the absence of the subsidy and an oversupply of municipal services could follow. Equity is not achieved either if those benefiting from the services are not paying full costs.

Over-taxation of the commercial/industrial sector has been addressed in at least four Canadian studies that compared the property tax paid by commercial/industrial properties with the cost of municipal services consumed by these properties.² All studies concluded that the residential sector when compared with the commercial/industrial sector is the recipient of proportionately more benefits from local government. When combined with higher effective property tax rates paid by the non-residential sector, the studies concluded that the commercial/industrial sector is over-taxed and the residential sector under-taxed. Beginning in 1995, the city council in Vancouver did something to correct this. It shifted, over the ensuing five years, some of its tax burden from the commercial and industrial sector onto the residential sector. More recently, the provincial government in Ontario announced that property tax increases beyond the ‘range of fairness’ – established as a standard that is defined by taking the ratio of commercial/industrial taxes to single dwelling residential property taxes – must be imposed on the residential sector and not on the commercial/industrial sector. ‘Ranges of fairness’ were set to prevent municipalities from shifting property tax burdens onto property classes that are already subject to unfairly high tax rates, or off property classes that are subject to unfairly low tax rates.

Further concerns with the over-taxation of the commercial/industrial sector arise because this tax represents a fixed charge that must be paid. The tax is fixed in the sense that it is unrelated to the value of municipal services used or profits earned. As long as the tax rate is more than necessary to cover the marginal cost of municipal services consumed or if there are no economic rents for it to capture, resources will be allocated inefficiently. This over-taxation of the non-residential sector can lead to less economic activity, lower output, fewer jobs and a less competitive business environment.

There is also an issue of whether this over-taxation plays a role in location decisions. Since firms and businesses generally locate where they can maximize their profits, the provision of fiscal inducements such as lower property taxes can influence a firm’s location decision in the same way as the reduction in other production costs may play a role. The impact of property tax differentials depends on a number of factors including the size of the differential between competing municipalities and whether this differential is sufficient to offset differentials in other costs or market factors.

While it is uniformly accepted that the cost of doing business is an important factor in location decisions, there is less consensus on the role played by property taxes in this decision. The evidence, most of which is drawn from the United States, suggests that property tax differentials are relatively unimportant in inter-municipal or inter-regional location decisions but do play an important role in intra-municipal or intra-regional location decisions. Higher effective property tax rates on commercial and industrial properties in one municipality within a region or area when compared with neighbouring municipalities create incentives for firms and businesses, especially those that are mobile,³ to locate in lower taxed municipalities. In the extreme, one might expect these property tax differentials to produce a heavy concentration of firms and businesses in the lower taxed jurisdictions. In other words, intra-municipal tax competition could be potentially destructive if it led to a race to have the lowest tax rates. A study on municipalities in British Columbia examined this issue and concluded that there is some evidence that

² Harry Kitchen and Enid Slack (1993), *Business Property Taxation*, Government and Competitiveness Project Discussion Paper no. 93-24 (Kingston, Ont.: Queen’s University, School of Policy Studies). MMK Consulting Inc. (2004), “Consumption of Tax Supported Municipal Services in the City of North Vancouver for the 2003 Tax Year” and “Consumption of Tax Supported Municipal Services in the District of North Vancouver for the 2003 Tax Year” - both reports were prepared for the North Shore Waterfront Industrial Association. KPMG, “Study of Consumption of Tax Supported City Services”, a report for the City of Vancouver, mimeograph, 1995.

³ Robert Bish (2003), “Property Taxes on Business and Industrial Property in British Columbia: Comparisons and Business Climate Observations”, Local Government Institute Working Paper 11, University of Victoria, British Columbia.

municipalities react to tax increases of their neighbours, but there is no widespread destructive competition for capital.⁴

There is at least one more positive effect that would arise from shifting the relative tax burden away from the business sector. A reduction in the property tax burden on the commercial/industrial sector reduces the potential for exporting the property tax to non-residents. Tax exporting refers to situations in which some portion of the local tax burden is borne by people who live elsewhere either through a change in product prices or a change in the net return to non-locally owned factors of production (inputs in the production process). For example, if higher tax rates on commercial and industrial properties lead to relatively higher prices charged on the sale of that community's products (exports) to people in other communities, the taxing jurisdiction will have effectively shifted part of its tax burden onto residents of other communities. If the commercial/ industrial property tax in every jurisdiction is exported to some extent, those jurisdictions exporting relatively more of the tax will be better off than those jurisdictions exporting relatively less. Finally, when the commercial/industrial sector exports its tax burden, municipal government accountability is weakened because the direct link between the municipal government responsible for providing local services and the person/agency/body ultimately paying the tax is missing.

A major defence of the over-taxation of business properties is often provided by municipal officials and some taxpayers who argue the following: since businesses can deduct all expenses incurred in earning income (including property taxes) from their corporate income tax base and since owner-occupiers of residential dwellings are not allowed similar deductions, it has been suggested that an extra tax on business is legitimate in that it attempts to even out the disparities in taxes that would otherwise exist on these two different categories of taxable property. While it is true that owner-occupiers are not able to deduct property taxes, it is also the case that owner-occupiers are not required to include in taxable income either imputed income from their owner-occupied dwellings or capital gains earned on the disposal of their principal residences. Such exclusion is similar to a deduction from income for tax purposes (as in the case of the property tax on business) in that both reduce the taxable economic income of the taxpaying unit. On this basis, it is difficult to make a case for a higher tax rate on commercial and industrial properties.

Recommendation: ***The practice of over taxing commercial/industrial properties should be stopped.***

USER FEES

Municipal governments in Canada only have two main sources of locally generated revenue – property taxes and user fees. In deciding on how services should be funded, the decision is generally between property taxes or user fees. For services where specific beneficiaries can be identified, user fees make considerable sense because those who use more of the service pay more for it. Obvious candidates include water and sewers, a portion of public transit and public recreation, solid waste collection and disposal (through the use of a specific charge per bag/container for both collection and disposal).

For HRM, the introduction of user fees for solid waste collection and disposal has considerable merit and virtually no downside. Where user fees have been introduced, all studies on their effectiveness have reported reductions in solid waste because consumers increased recycling, generated less waste, and

⁴ Craig Brett and Joris Pinkse (2000), “The determinants of municipal tax rates in British Columbia”, *Canadian Journal of Economics*, vol. 33, no. 3, 695-714.

increased the use of other options such as composting. This, in turn, has reduced the demand for solid waste disposal sites. In short, prices work!⁵

User fees for garbage are not without critics, however. It has been argued that their implementation will lead to illegal diversion (in the form of dumping on road sides, in school/commercial dumpsters, stomping and burning) and that administrative costs will rise because the system will be more complex and will require additional staff to police and catch violators. Such concerns are vastly overstated, however. Where user fees have been adopted, illegal dumping has not turned out to be a problem and administrative concerns have been overcome quite easily.⁶

Recommendation: User fees should be expanded to include more services, especially solid waste collection and disposal.

Not only is the use of fees important, the fee structure is also important. User fees should be designed to take into consideration cost differentials attributed to economies of scale, capacity constraints, differential demand in peak and non-peak periods, when second-best circumstances are prevalent and when externalities exist. Ultimately, the objective in setting fees should be to establish a clear link between services received and fees paid.

Current practice in setting user fees, however, almost always deviates from that which is fair, efficient and accountable. The tendency is to set fees to generate revenue rather than to allocate resources to their most efficient use. Failure to introduce efficiency considerations (price equals marginal cost) into the pricing structure or to entertain in any serious fashion, suggestions for expanding the role for user fees has been defended on grounds that they are regressive. This claim, however, is about as relevant as the claim that milk prices and movie tickets are regressive. This is not to imply that income distribution issues are unimportant. Clearly, they are very important but they should be handled through income distribution programs that target the poor rather than changing or distorting prices where the rich frequently benefit more than the poor.

Finally, failure to price properly has created a good deal of unplanned and implicit income redistribution, much of which would be unacceptable if it were made explicit. As an example, the tendency to charge a fixed price for water, regardless of quantity consumed, on the premise that fixed income earners (poor and seniors) could not afford to pay, provides an implicit subsidy for higher income households with larger lawns to water and more cars to wash. Failure to vary charges by time of day, season of the year, when capacity constraints exist, when second best considerations are prevalent, when externalities are observed, and furthermore, failure to include all costs (asset replacement costs and a variety of opportunity costs) in charging and pricing structures has led to a demand for services and subsequently, a demand for physical infrastructure that is not allocatively efficient or optimal. In general, inefficiently set user fees have led to overinvestment and larger facilities than would be justified if more efficient pricing practices were adopted.

⁵ For a summary of these studies, see Harry Kitchen, "Municipal Infrastructure Financing: A Prescription for the Future", a paper prepared for Infrastructure Canada, February 2006 - available at http://www.trentu.ca/economics/WorkingPaper/Kitchen_060206.pdf, pp. 77-81.

⁶ Maria Kelleher, Janet Robins and John Dixie (2005), "Taking Out the Trash: How To Allocate the Costs Fairly", *Commentary*, (Toronto: C.D. Howe Institute). Marie Lynn Miranda, Jess W. Everett, Daniel Blume, and Barbara A. Roy Jr. (1994), "Market-Based Incentives and Residential Municipal Solid Waste", *Journal of Policy Analysis and Management*, vol. 13, no. 4, at 681-698.

Recommendation: *Fee structures for all services should be carefully designed to capture all costs and to control for efficient use of local services.*

INFRASTRUCTURE CHARGES

An infrastructure charge is a type of user fee that covers all or a portion of the capital cost (not operating cost) of facilities (roads, water and sewer systems, as examples) that are needed to provide municipal services. HRM currently uses infrastructure charges to capture the ‘growth related’ infrastructure costs for water, sewers, wastewater, solid waste, and public transit. This is an important financing tool for HRM and if properly designed clearly satisfies the criteria for an efficient, accountable, and fair local charge.

Two points could be raised with respect to infrastructure charges. First, the range of services for which these charges could be applied in HRM could reasonably be expanded to include arterial road construction and expansion, recreation complexes and facilities, libraries, emergency measures facilities and vehicles (police, fire, and ambulance).

Second, the most efficient infrastructure charges are those that vary by type of property (residential, commercial, or industrial), neighbourhood and distance from source of supply. In this way, each charge captures the extra cost of capital assets required to service the new or additional growth. Variable charges are superior to uniform charges because they remove the cross-subsidization that exists when development in low cost areas subsidizes development in high cost areas. While it may be naive to expect municipal officials to calculate the infrastructure cost for each new property, costs could and should be calculated for each new development area or neighbourhood. This would discourage inefficient patterns of development

Recommendation: *The range of services for which infrastructure charges are applied should be expanded to include arterial road construction and expansion, recreation complexes and facilities, libraries, emergency measures facilities and vehicles (police, fire, and ambulance).*

NEW TAX AND REVENUE SOURCES

Before making the case for additional tax sources, it may be useful to set out the desirable characteristics of a local tax. These include the following.

- The tax base should be relatively immobile so that local governments can vary the tax rates without losing a significant portion of the tax base.
- The tax yield should be adequate to meet local needs, increase over time as expenditures increase, and be relatively stable and predictable.
- The tax should not be one that is easy to export to non-residents.
- The tax base should be visible to ensure accountability.
- Taxpayers should perceive the tax to be reasonably fair.
- The tax should be relatively easy to administer.

The property tax achieves many of these characteristics – the base is relatively immobile, it is difficult to export the residential tax to non-residents, revenues are fairly stable and predictable, and the tax base is

visible – but it does not achieve all of them. Property values generally respond more slowly to annual changes in economic activity than do incomes; the commercial/industrial property tax can be exported to non-residents; and the tax yield is often inadequate to meet the growing expenditure needs.

Access to new taxes would let HRM establish a local tax base that captures the range of desirable characteristics. It would give HRM more flexibility to respond to local conditions such as changes in the economy, evolving demographics and expenditure needs, changes in the political climate, and other factors. Access to additional taxes has the advantage that one tax may offset distortions created by another tax. For example, the property tax may discourage investment in housing. The income tax, on the other hand, may encourage investment in owner-occupied housing because the imputed income of owner-occupied housing is not taxed and capital gains on principal residences are not taxed.

It is important to note that HRM's access to new taxes should come with the requirement that HRM set its own tax rate(s). International experience tells us that the most responsible and accountable city (local) governments are those who raise the revenue they spend. Unless local governments can alter the tax rates, they will not achieve local autonomy or accountability. Moreover, local tax rate setting provides predictability for municipal governments and gives them the flexibility to change rates in response to different circumstances.

Personal Income Tax

Personal income taxes,⁷ as a supplement to the municipal property tax, can be justified in metropolitan areas such as HRM, on the grounds that HRM is increasingly called upon to address issues of poverty, crime, regional transportation, and other region-wide needs. The property tax alone will have difficulty in providing sufficient funds to meet these growing expenditure needs. On benefits received grounds, a locally set tax rate 'piggybacked' onto the provincial tax rate can be defended as long as the funds are used to finance local services that provide collective benefits to the community. Finally, a major advantage of a municipal income tax is its revenue elasticity – it responds more quickly to economic activity than does the property tax.

HRM could piggyback onto the provincial income tax system in one of two ways. The tax could be applied as a locally determined flat rate on the same base as the provincial income tax. Alternatively, the locally determined tax rate could be set as a percentage of provincial taxes; that is, as a surcharge on the provincial tax. Taxpayers within HRM (defined by postal codes) would multiply either their personal income tax payable or their personal income tax base by the local tax rate set by HRM. The calculated local tax would be the amount remitted to the municipality.

Recommendation: ***HRM should be given access to the personal income tax by 'piggybacking' onto the provincial tax with the tax rate set by the HRM council.***

⁷ A municipal corporate income tax is not recommended because the corporate tax base is more mobile than the personal income tax base, and because Canadian business must not be made less competitive in what has become an increasingly competitive international environment.

General Sales Tax

The rationale for a municipal sales tax as a supplement to the local property tax is similar to the rationale for a municipal income tax. As long as HRM's services are funded only from property taxes and user fees, commuters and visitors benefit from some services (such as police and fire, local roads and streets, sidewalks, street lighting, local parks, and so on) without paying for them. Not only would a broadening of the local tax base help capture some of the spill over benefits, it would give HRM greater flexibility and breadth in determining its own tax structure, and would allow it to benefit from growth in the economy.⁸

Like the personal income tax, a locally set tax rate could be piggybacked onto the HST. One downside of such a tax is that it may cause people to shop outside the HRM. The extent to which this could be a problem, however, is unclear given the large geographic area of the HRM. A further problem and one that may negate its use as a local tax source revolves around an administrative issue. There could be a problem in determining the net revenue that should be remitted to HRM because of the difficulty in assigning input tax credits (under the HST) that would apply to HRM. For these two reasons, a general sales tax is not recommended at this point. If either of these concerns are insignificant, the case for a municipal sales tax increases substantially.

At the moment, however, the case for a municipal personal income tax is greater than the case for a municipal sales tax; hence, a general sales tax for HRM is not recommended.

Dedicated Municipal Fuel Tax

Many American cities levy fuel taxes, but municipalities in Canada do not. In a few Canadian cities and city-regions (Victoria, Vancouver, Edmonton, Calgary, and Montreal), provincial fuel tax revenues are shared between the province and the city or city-region. The federal government's recent initiative to provide grants to municipalities equal to five cents of the federal gas tax revenue is a form of revenue sharing and not a municipal fuel tax because the municipalities do not set fuel tax rates and have no say over the tax base.

A municipally set fuel tax may be viewed as a benefit-based consumption tax where the revenues are earmarked for funding local roads and public transit. A municipal fuel tax could raise the cost of road usage to direct beneficiaries and lower the costs on others. Not only could the application of a municipal fuel tax raise the price paid by road users to a level that is more in line with the marginal social cost (production costs plus environmental costs) of providing roads, it would provide funds for improving and reconstructing local roads and public transit and lead to a more efficient use of local roads.

Earmarking municipal fuel tax revenues offers a number of advantages. First, it provides a link between the cost of transportation and the tax rate necessary to fund it. Second, earmarking is likely to improve the efficiency of local decision makers. If funds are not earmarked, for instance, surplus revenues may be used for other purposes. This may discourage managerial efforts to improve efficiency and to reduce costs because excess revenues go elsewhere and may discourage investment that could lead to cost savings and

⁸ A general sales tax differs from a specific sales tax such as one on alcohol or fuel, however. The former is appropriate for financing general services that are broadly enjoyed by the public, such as streetlighting, police protection, and general administration. The latter should not be used to finance general public services because those who use more fuel or consume more alcohol would pay more than would be fair for services such as fire protection and dog-catching.

increased efficiency. Third, there is no solid economic reason why local taxpayers should be subsidized from revenues generated by selling a specific good or service. Such cross-subsidization may lead to undesirable distortions and less efficient and accountable pricing and investment decisions.

Arguments for this tax at the local level are strongest when municipalities set their own tax rate and “piggyback” it onto the provincial fuel tax. A possible objection to letting municipalities set their own fuel tax rates is that it could lead to differentials across jurisdictions. While this may encourage people to purchase gasoline in other municipalities or to relocate to lower taxed municipalities, these concerns are no different than the location decisions caused by differential property tax rates. Furthermore, this tax competition can create an environment in which municipalities are more efficient in their use of resources and more accountable to their taxpayers.

Recommendation: *HRM should be permitted to implement a dedicated municipal fuel tax to fund a portion of public transit and transportation projects with the tax rate determined by the HRM council.*

Alcohol and Tobacco Taxes

Excise and sales taxes on alcohol and tobacco products are currently levied by the provincial and federal governments in HRM. Based on the benefits based model of municipal finance, there is little argument to support either of these taxes as municipal taxes. They do not differentiate between types of taxpayers (resident versus commuter/visitor). And they are not broad based enough (do not tax non-users) to justify the financing of municipal services.

Tax Increment Financing (TIF)

Tax increment financing districts (TIFs) are currently used by cities in the United States, where they play an important role in brownfield and infill development. The application of TIFs in Canada is very recent and experience is limited. At the moment, they are used in Calgary and Winnipeg and permitted in Ontario, but not yet used in any significant way.

This instrument works in the following way. For a specific period of time (long enough to recover all costs of public funds used to redevelop the property), tax incremental financing divides property tax revenue from the area into two categories. Taxes based on the pre-developed assessed value of property are retained by the municipality for general use. Taxes on increased assessed values arising from redevelopment are deposited in a special increment fund with revenue from this fund used to repay bonds that have been issued to finance public improvements in the redeveloped area. In other words, increases in property tax revenue from the redevelopment of an area are dedicated to financing public improvements in that area.

Typically, tax incremental finance-backed bonds are sold to provide up-front financing for the purchase and reclamation of the land, and for installation of public infrastructure, such as streets, streetlights, water and sewer lines, curbs, gutters and landscaping. Once the property is prepared, the land is sold to a private developer at a price that doesn't reflect the local government's cost of preparing the land – a technique known as a land cost write-down. All predevelopment and land write-down costs are funded by bonds that are repaid from the special increment fund.

TIFs are intended to stimulate private sector investment in urban areas that need revitalization so that these areas may compete with suburban and exurban areas. TIF projects make sense if they address market failures. Supporters of TIFs argue that there is no transfer of funds from a local government to subsidize a business, nor any transfer of tax dollars from one business to another because development is financed from increases in the tax revenue that it generates. Unlike bonuses or tax abatements where taxes are reduced or forgiven on a particular property, property owners in a tax increment district (TID) incur the same local tax rate as property owners outside the district. Preferential treatment is granted only in that taxes from the increased assessment base of the TID are dedicated to financing local improvements. Dedicated tax dollars reduce the risk and uncertainty facing the private sector. If used to stimulate downtown development (infilling) or brownfield remediation, TIFs could discourage urban sprawl.

Recommendation: *HRM should be given access to tax incremental financing instruments.*

SUMMARY

The tax and revenue system in HRM should be designed to satisfy the criteria of efficiency, accountability, transparency, and fairness. In general, user fees should fund services with mainly private goods characteristics. This includes water, sewer, solid waste collection and disposal, public recreation, and a portion of public transit. Property taxes should fund those services that provide mainly collective or ‘public goods’ benefits. This includes local roads and streets, street lighting, police and fire, local parks, libraries, and so on. As well, there are arguments in support of giving HRM access to a mix of local taxes.

More specific recommendations include the following:

1. The property tax base should be market value with all properties assessed in a uniform and frequent manner.
2. Assessed property values should not be frozen or capped and preferential assessment of some properties should be avoided.
3. Variable tax rates should be used to capture differences in costs of servicing different properties (by neighbourhood or property type).
4. The practice of over taxing commercial/industrial properties should be stopped.
5. User fees should be expanded to include more services, especially solid waste collection and disposal.
6. Fee structures for all services should be carefully designed to capture all costs and to control for efficient use of local services.
7. The range of services for which infrastructure charges can be applied could be expanded to include arterial road construction and expansion, recreation complexes and facilities, libraries, emergency measures facilities and vehicles (police, fire, and ambulance).
8. HRM should be given access to the personal income tax by ‘piggybacking’ onto the provincial tax with the tax rate set by the HRM council.
9. HRM should be permitted to implement a dedicated municipal fuel tax to fund a portion of public transit and transportation projects with the tax rate determined by the HRM council.
10. HRM should be given access to tax incremental financing instruments. This is a special classification for property taxes where taxes on assessed property values arising from, redevelopment of brownfield areas, are earmarked for specific public improvements (streetlights, curbs, and so on) in the area undergoing development.



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