HOUSE RESEARCH

November, 1985

R90

Information Brief

Lisa Larson, Legislative Analyst
296-8036

USER FEE SYSTEMS: DESIGN AND OPERATION

This is the fourth information brief in a series on user fees. The others are:

- an information brief on user charges and legislative policy;
- an information brief on statutory provisions governing state agency fee setting; and
- an information brief on methods for setting state user fees.

This information brief outlines several user fee components and discusses their operation and design:

- ADVANTAGES AND DISADVANTAGES - page 2
- USER FEE COMPONENTS - pages 3 - 5

  Service Pricing
  Earmarking of Funds

- DESIGN EFFECTS - pages 5 - 6

WHEN IS IT APPROPRIATE TO CHARGE A USER FEE FOR GOVERNMENT SERVICES?

User fees represent a potential non-tax source of revenue. If the costs of an agency service are to be partially or totally financed through a user fee system, two criteria must be met:

1. Goods and services must be separated into individual and community benefits and the public must have some choice in the level and intensity of the service and whether or not to use it.

2. Charges for the agency costs attached to the benefits must be imposed through a pricing system that is economically efficient, socially responsible and politically responsive.

WHAT ARE SOME ADVANTAGES AND DISADVANTAGES OF USER BASED FINANCING?

Advantages

In theory, government can control the costs of, and charges for, its services through an efficient and appropriate method of levying charges for services provided to its constituents. In doing so, it can improve equity among heavy, moderate, light and non-users of a service.

Advantages of user based financing include:

- Allowing the demand for a service to be measured and regulated
- Establishing a more equitable relationship between
  - users and non-users of a predominantly private good
  - residents and non-residents of a service providing jurisdiction
  - tax exempt and tax paying organizations, institutions and properties
- Preventing or minimizing the shifting of part of the social costs of private activities to the community (e.g. requiring the private sector to pay for its polluting).

Disadvantages

A major disadvantage of user based financing is the possible fragmentation that could result from separating service functions and their respective financial sources into insulated compartments. This fragmentation negates the comprehensive and cohesive purposes of general government.

It has been argued that as a trend, user based financing provides a way of disaggregating community burdens. This might ultimately complicate the management of common interests if the focus on the individual starts to challenge the concept of community. The principle of a broad heterogeneous constituency (for whom resource claims are comprehensively assessed) could also suffer as a result.

WHAT ARE THE COMPONENTS OF A USER FEE?

The three categories for separating goods and services into individual and com unity benefit portions are **private, mixed, and public.**

Private The benefit accrues primarily to the individual.

i.e. hunting or fishing privileges

A private service may be largely supported by a charge or fee.

Mixed The benefit derived from a private good endowed with a public purpose accrues to both individuals and the community. It is practical and equitable to finance only a portion of the expenditure from fees and charges.

i.e. consumption of an urban water supply

A public service with private beneficiaries may be supported by a combination of a fee or charge and a public subsidy.

Public The benefit accrues to the entire community. It is impossible to exclude any consumer from "using" the service.

i.e. a mosquito control program

An entirely public service may be supported through general taxation

Service Pricing

The price of a service, if it is to be a user fee and not a tax, should be no greater than the full cost of that part of the service which benefits the individual to the exclusion of the community.

High collection and administrative costs may deter an agency from initiating user charges. These costs include:

- collecting information on the consumption of the service or product
- delivering service at an ascertained level and volume which may or may not be cost effective
- collecting the charges which can vary widely among services and products.

The actual price of a service is the sum of three charge components:

(1) Quantity,
(2) Capacity, and
(3) Location.

Quantity
The quantity charge is equal to the short run cost of current output at the time the service is produced and consumed. It will vary with the quantity of the service consumed; peak loads produce higher charges.

Capacity
The capacity charge is equal to the difference between the quantity charge and full production costs at a designed capacity level. High construction or fixed costs will increase the capacity charge.

Location
The location charge is equal to the long-run costs of serving residents at each location and the development density.

The structure and composition of a user price system will vary according to the type of service provided and other fiscal and equity factors, including cost assessment, service allocations and capacity expansion due to growth. These factors are reflected in the operation of a user based pricing system:

- users with the highest demand for a service will pay the highest charges; residents in areas more expensive to serve will pay higher charges than those in areas less expensive to serve.

- charges can help improve the provision of services by allocating the available supply to those who value it most.

- user charges which reflect the costs an agency incurs in serving people provide information on the desirability of increasing supply; if revenues exceed the additional costs of expansion, it is worthwhile; if they do not, expansion is wasteful.

Earmarking of Funds

The earmarking of funds is an important fiscal issue associated with user financed services. Fund earmarking occurs when revenue from service users is placed in a segregated fund reserved exclusively or primarily for financing the **operating expenditures of an agency service** (e.g. gasoline taxes paid into a highway fund or water rate revenues paid into a water fund). By establishing a connection between service fees and user benefits, earmarking may encourage:

- explicit budgetary choices to be made about program expenditures

- greater economic efficiency by agencies forced to recoup program costs

- a sense of fairness in the relationship between fees charged and services provided.

The value of this connection diminishes when benefits accrue to the community as opposed to the individual and the relationship between the charge and the service becomes more tenuous.

"Mixed" benefit services (which provide benefits to both individuals and the community) generally should not receive earmarked funds since "automatic" funding tends to reduce budgetary flexibility and preclude the kind of periodic budget review that agency services funded out of the general fund receive. Capital facilities (e.g. government buildings), providing mixed benefit services, are an exception. Financing through the use of earmarked funds in this case can be desirable since fiscally pressed governments may seek to divert elsewhere general fund monies allocated for maintenance and repair of the community's infrastructure.

WHAT ARE SOME EFFECTS OF USER FEE DESIGN?

General Equity Considerations

If government programs can be divided into discrete and economically viable services, user based financing may improve economic and social equity.

Incorporating equity into a user fee design gives government the ability to:

Prevent Subsidization
Groups receiving a private good would not be subsidized by the general public.

Encourage Conservation
Careful users would be rewarded; extravagant ones would pay an additional cost.

Shift Charges
High users of facilities costly to build and maintain would pay the highest charges.

Impose charges
Tax exempt organizations would be charged in a nondiscriminatory manner.

Impose "Development Exactions"
Government entities involved in regulating infrastructure development would exact from developers, contractors, and builders a contribution toward capital development as a price for expediting the regulatory process.

Low Income Subsidies

Incorporating equity into a fee structure requires that benefits be divided into individual and community portions. The difficulty of making such a division is illustrated by the controversy surrounding subsidies for low income individuals.

Social welfare proponents believe that the cost of essential services necessary for safe and sanitary living, which are economically regressive because they require a higher proportion of a poor person's income, should be subsidized by

the community instead of being supported by user fees charged to the individual. These proponents claim that while the notion of equity requires that individuals pay for the benefits they receive, the costs of those benefits should be distributed not only in relation to the benefit, but also

- in relation to need and ability to pay, and
- that "merit" (or essential) goods and services be received by all persons as a matter of right since their ready availability tends to stabilize communities.

The issue of subsidizing low income individuals arises when budgetary constraints make agency services vulnerable to spending reductions. Less government spending creates increased competition for subsidy size among subsidy claimants both in absolute terms and relative to other services. It is sometimes difficult to determine whether mixed health or welfare related services provided to low income residents contain sufficient community benefits to warrant government subsidies and whether such subsidies will achieve social equity. This difficulty may be compounded by considerations of economy, efficiency, fairness and ease of administration.

Effects on Business

A shift to user fees to finance part of the costs of business oriented government services from existing or increased corporate income or gross receipts tax can alter competition within an industry. State corporate income taxes and local taxes affect gross receipts from businesses. The effect of these taxes on profitability and volume will vary according to the type of business and the degree of pass-through to the customer.