
Establishing User Fees: Theory and Practice in Canada

There is much debate surrounding the increasing application of user fees in the municipal context. This article establishes basic guidelines for the establishment of user fees and demonstrates that water/sewer services, recreational services, and urban parking are strong candidates for their use.

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User fees are not a recent phenomenon. Municipalities have been charging citizens for water and sewage services and parking and recreation facilities for years. Charges also are commonly applied to garbage collection, licensing and inspection services, and even for fire and police services used by non-residents of a municipality who are involved in accidents or false alarms.

Faced with fiscal restraint, the Canadian federal government has downloaded considerable responsibility to the provinces, which in turn, have transferred responsibility for service delivery to municipal governments. The pressures of provincial downloading also have been complicated by public demand for increased service provision; the result has been a serious problem for local governments that rely on limited property tax revenues. The examples and arguments presented in this paper have been drawn from the experience of Canadian municipalities. The key issues discussed, however, are universal in nature and provide direction to policy makers internationally.

The need for new or improved service provision has resulted in municipal units considering user fees for a broad range of services. However, while much discussion surrounds user fees, municipal governments have not greatly increased their use. A comparison in the distribution of municipal government revenue in Canada from 1988-1998 reveals user fees as a portion of total revenue have risen by only .7 percent. In those cases where user fees have been used, the rationale has been largely to simply increase financial resources. Individual analysis of the prov-

inces reveals a different trend. The largest portion of total municipal revenue is collected in Ontario and Quebec; their lack of increased use of user fees has kept the total Canadian number low even though municipalities in other provinces have increased the percentage of total revenue derived from user fees. Nova Scotia has experienced a 50 percent increase in user fee revenue with a rise from 10 to 15 percent over the 1988 to 1998 period. Similarly, British Columbia experienced a 10 percent increase over the same period; Alberta, Saskatchewan, and Manitoba all experienced similar growth in user fees revenue, as well.

Argument Supporting User Fees

User fees are based on three main arguments: philosophic, political, and economic rationales. The *philosophical* rationale assumes that those who clearly benefit from a service should be the ones to pay for it. For example, if the cost of acquiring a service is greater than the benefit the consumer derives from using it, then he or she will adjust their level of consumption. Service levels and the size of the fee charged develop and change as consumption levels and costs change; in the end, a higher level of service can be provided without subsidies from property tax or some other source.

The political rationales for user fees are based on representativeness and accountability. Representativeness refers to the degree to which citizens' interests are reflected in decisions made by governments. Since governments generally have conflict-

ing preferences to balance in making policy and fiscal decisions, it is impossible to fill every citizen's demands. Further, the options are limited: taxation as a means of generating revenue removes control over decision making from the hands of the individual. Given the alternatives, user fees can be an attractive option offering enhanced accountability when they are earmarked for a given purpose.

Where hard-pressed urban officials see user charges as a revenue source, economists see economic efficiency. User charges provide information to consumers and officials about the demand for and cost of providing services, enabling them to make personal choices that maximize their financial resources. Economic efficiency occurs when fees are set at a level where the cost of producing an extra unit of a good is equal to the value that consumers place on that extra unit. Efficiency results because neither the producers, nor the consumers, can be made better off by shifting their money into consuming or producing some alternative good or service.

But focusing user fees on efficiency can result in problems for policy makers. In the case of many services, the cost of producing extra units is close to zero. In such cases, charging citizens a fee based on the extra cost (marginal cost) would not generate enough revenue to provide the service. For example, the cost of an extra person enjoying a walk in an un-congested park is negligible. The literature suggests that it may be appropriate to charge a fixed amount for the privilege of accessing the service, and then an additional variable amount that equals the marginal cost of producing the last unit consumed.

Exhibit 1
DISTRIBUTION OF MUNICIPAL GOVERNMENT REVENUE, 1998
(percentage of whole)

Revenue Source	Nfld.	PEI	NS	NB	Que.	Ont.	Man.	Sask.	Alta.	BC	Yukon	NWT	Canada
Property Taxes	54.1	60.2	70.4	53.2	68.5	56.4	43.3	53.6	42.6	52.4	46.9	14.4	56.7
Other Taxes^a	1.7	0.5	0.2	0.4	0.3	1.1	1.8	4.5	1.3	3.0	1.8	0.5	1.2
User Fees	15.6	28.4	15.9	22.1	15.4	19.5	20.8	24.1	30.4	26.7	19.7	29.2	20.7
Investment Income	1.7	2.3	2.8	0.7	1.9	3.7	5.8	7.5	13.3	8.2	4.7	1.3	4.9
Other Own-source Revenue^b	0.6	1.6	0.4	0.6	2.4	0.6	0.8	1.0	1.3	0.5	0.7	0.3	1.1
Total Own-source Revenue	73.7	92.9	89.7	77.0	88.5	81.4	72.5	90.8	89.0	90.8	73.8	45.7	84.6
Total Grants	26.3	7.1	10.3	23.0	11.5	18.6	27.5	9.2	11.0	9.2	26.2	54.3	15.4
Total Revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Kitchen, Harry, *Municipal Finance in a New Fiscal Environment*, C.D. Howe Institute Commentary, No. 147, November 2000, www.cdhowe.org

^a Other taxes include licenses, permits, and miscellaneous taxes such as the extra 2 percent sales tax on hotel rooms in British Columbia, the surcharge on the Saskatchewan Power Corporation in Saskatchewan, and sales tax revenues from electricity and gas sales in Manitoba.

^b Other revenues include amusement taxes, fines, and penalties.

User Fees and Equity

User fees are not without their critics. Debate is particularly strong surrounding issues of equity. Low-income individuals are the first to be driven out of the market for services that are highly demand responsive (e.g., recreation) when a charge is implemented. Charging fees for optional services such as recreation will change demand by a greater extent than if a fee is charged for a necessary service such as water. The consequence of this may be that the poor or the elderly are affected disproportionately which would clearly be politically unpopular. Similarly, in fire and police protection services those individuals that require the services often, and have a decreased ability to pay, may not use them in an emergency.

Charging also may result in unplanned and undesired income redistribution. Approaches such as the allocation of grants and subsidies where warranted (e.g., transit passes for low-income individuals) may be employed as a means of addressing equity concerns. Determining the level of subsidy would

be difficult to establish and would be political in nature. However, the key principals of fairness and ability to pay can be used to guide policy makers. A key issue for policy planners would be selecting a measurement to base the rebate upon: property assessment? income level?, etc. In order to target those who may not be as able to pay the fee, it would have to be based on some measure of wealth. Then questions can arise as to whether or not municipal units should be party to this information.

Advice to Local Governments

Unfortunately there is no complete guide to user fee design. Individual circumstances require careful consideration of the impact user fees may have. Nonetheless, a few general issues need to be remembered. First, it is important that a government, or its agent, has actual legal authority to charge fees for particular services. In the case of water/sewer services, recreation, and urban parking municipal units,

most in Canada are mandated with this responsibility.

The earlier citizens are invited to join the consultation process the better. Citizens may be able to provide information that is useful in designing an implementation strategy. Consultation also provides government with an opportunity to “sell” or explain why a fee is going to be charged for a service, enhancing transparency.

Pricing of user fees provides a foundation for other design decisions. The design of a fee system should include a decision on whether consumers will pay for a service when they consume it, or if they will be billed. Before a government body starts charging a fee, payment schedules/timelines should be clearly published and penalties for non-payment should be transparent to consumers. In the case of water/sewer services, a billing system is the obvious option. Parking and recreational services can easily be purchased as citizens use them, or be billed on a monthly or annual basis. In all cases, the design

of the collection system must be efficient so that it does not artificially inflate the price of the service offered.

The pricing of a service also should follow a clear rationale. Where possible, pricing should be based on market prices or on full cost recovery, and the fee structure should be simple and transparent. In the case of water and sewer service, full cost recovery may not be possible given the large initial capital investments. Similarly, the cost of acquiring lands for recreational purposes may be so high that they could not be recovered through the application of a fee. In some circumstances, if use levels are high enough, a portion of the fee could be dedicated to initial cost recovery.

If the goal is cost recovery, this may lead to a different approach to charging than if the aim is to achieve greater efficiency. This will influence the choice among fee structure and pricing alternatives. Among the charging options are:

- 1) full cost recovery;
 - 2) incremental cost recovery; and
 - 3) charging a fee equal to the market value of the service when it is one that competes directly with the private sector.
- Fees also can be structured to recover

some fixed percentage of costs. Other options are benchmarking (comparing prices to those charged by other municipalities) and indexing prices over time (e.g., to reflect increases in the cost of living). If the goal is greater efficiency, the literature suggests that marginal cost pricing yields the “best” user charges because it encourages the efficient use of public sector resources. If a service is priced below marginal cost and demand is price sensitive, individuals will consume more than they otherwise would. Marginal cost pricing presents practical challenges because it is difficult to determine costs in many public sector activities, and even if costs can be determined, they may not be easily quantifiable.

Monitoring of a fee program is crucial to its success. Some analysts suggested earmarking a portion of a fee to be used for study and review purposes. In this way, the charging department or agency would be better able to respond to a growing demand for its service through increasing its expenditures as service revenues would grow.

Organizations may wish to consider price differentiation (for peak and off-peak periods, for example) as a means of spread-

ing out demand for the service. This structure would be beneficial for the use of parks during peak seasons or parking in urban cores during periods of increased congestion. Another option is to charge a premium for priority service. Accurate pricing of a government-delivered commercial service should take into account the costs faced by private-sector bodies delivering the same service to ensure competitive neutrality. In cases where an organization provides both a commercial service and a monopoly service, it should be made certain that the monopoly service is not subsidizing the commercial service.

User Fees and Behavior Modification

User fees can impact the consumption patterns of citizens. The extent to which consumption is affected depends on the fee design put in place and on the elasticity of demand (i.e., responsiveness of demand to higher fees). For these reasons, fees can be used as a fiscal instrument to curb undesired behavior in society and to reduce the consumption of scarce resources.

Many Canadian municipalities have gone from unmetred water service funded

Exhibit 2
DISTRIBUTION OF MUNICIPAL GOVERNMENT REVENUE, 1988
(percentage of whole)

Revenue Source	Nfld.	PEI	NS	NB	Que.	Ont.	Man.	Sask.	Alta.	BC	Yukon	NWT	Canada
Property Taxes	41.9	50.0	58.0	41.7	68.8	41.7	44.5	48.1	36.3	48.0	31.7	16.6	48.6
Other Taxes^a	1.9	0.5	0.6	0.5	1.0	1.3	2.2	3.9	1.0	2.5	1.4	0.8	1.4
User Fees	12.6	30.7	10.8	18.9	16.5	20.0	17.7	21.4	26.5	23.7	13.9	33.8	20.0
Investment Income	1.9	3.7	1.2	3.0	5.1	8.3	6.7	12.8	10.1	4.1	2.1	2.1	6.0
Other Own-source Revenue^b	0.4	1.2	0.8	0.6	2.0	0.7	1.0	1.4	1.4	0.5	0.6	0.2	1.1
Total Own-source Revenue	58.8	86.1	73.7	63.0	91.3	68.8	73.7	81.3	78.0	84.9	51.8	53.6	77.1
Total Grants	41.2	13.9	26.3	37.0	8.7	31.2	26.3	18.7	22.0	15.1	48.2	46.4	22.9
Total Revenue	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

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^a Other taxes include licenses, permits, and miscellaneous taxes such as the extra 2 percent sales tax on hotel rooms in British Columbia, the surcharge on the Saskatchewan Power Corporation in Saskatchewan, and sales tax revenues from electricity and gas sales in Manitoba.

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through general revenues to a metered system where users are charged a fee based on their level of consumption. The pattern has been for water consumption to drop by a significant amount initially and then to rebound to levels lower than original consumption once consumers become accustomed to the new pricing system.

In terms of structure, fees that are not related to actual consumption or usage of a service are less likely to cause individuals to limit their consumption. Elasticity, or responsiveness, of demand varies according to the type of service to which a charge is being applied. The example provided earlier of the different demand outcomes related to charging fees for recreation and water services may be recalled.

Issues for Canadian Municipalities

Canadian municipalities face a number of unanswered questions when delving further into the realm of charging fees for the services that they provide to citizens.

In much of the literature, advice is offered in assessing whether or not a fee should be charged for a service. It has been suggested that it may not be advisable to charge a fee because the commitment of resources for pricing a service, establishing, and then administering a fee system may not be efficient. This depends on the capacity of a government or its department/agency and on how widespread the service is used. The literature is vague, however, in terms of when this is not feasible. How many consumers of a service are too few to charge a fee? How small does a government's capacity have to be in order for pricing a fee system rigorously to be inefficient? Depending on the answers to these questions, it could be that the goal of achieving economic efficiency through user charging is unrealistic for local governments of a particular size due to their capacity and consumer base. Perhaps answers to these questions are impossible on a generalized basis. Without "benchmarks" in terms of capacity and consumption to aid in planning, the decision to charge may be, at least at the local level, a trial and error process.

At the local level, careful consideration of guidelines advocated in the literature is not as important due to the relatively smaller size of organizations and the amount of revenues involved. Perhaps the bulk of advice provided applies to national and sub-national levels of government where appropriate capacity exists. Similarly, the research does

not identify any municipal impact studies on access to services and ability to pay issues that were prepared before a user fee was implemented. This is important to highlight from the perspective that services provided by local governments are basic, general services that are important in the day-to-day lives of citizens and if there have been negative re-distributional impacts.

Recognizing obstacles faced by municipal governments and points made that may lead to a reconsideration of the notion of user fees as the panacea for fiscal restraint, what are the alternatives in both Canada and the United States? In the context of decreased transfers from other levels of governments and a desire to leave property tax rates relatively unchanged due to public pressure, municipalities may be more appropriately given other revenue raising sources such as user fees.

Conclusion

While examples in this paper are based on the Canadian experience, the issues presented are universal in nature and can provide direction for policy makers in other countries. Arguments in favor of charging user fees have been made from philosophical, political, and economic perspectives. These arguments span issues of fiscal equivalence, accountability, cost recovery, and economic efficiency. Conversely, arguments against charging user fees have been made on the basis of concerns with equity, potentially high administrative costs, and political unpopularity. In this context, municipalities wishing to charge fees for water/sewer services and recreation are advised to take care in designing user fee systems. An initial identification of the reason for charging a fee is essential. Is the goal cost-recovery or to modify citizens' consumption levels of a service? While initial cost recovery for water/sewer service, recreational parks, and urban parking may be too high to be recovered through fees, revenues can be generated to cover operating costs. As explained above, user fees also provide a fair and efficient policy tool to manage the consumption of these goods. Particular attention must be paid to the relationship between the cost of service provision and fee determination, keeping in mind that simplicity is best. In addition, policy makers must be aware of the importance of equity issues in fee design.

Local governments face a number of challenges in designing and implementing user

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fees. Among these challenges are unanswered questions related to capacity. Are municipal governments big enough to be designing and administering fees appropriately? Should local governments charge fees if they do not have the resources to conduct impact assessments and economic analyses? It must not be thought that user fees will be the ultimate response to fiscal restraint. Other alternatives need to be explored.

Any discussion of user fees must include a consideration of the broader societal impacts resulting from their application. The degree of this impact is difficult to predict but should be considered by policy makers. The application of user fees in the proper context along with careful attention to issues outlined in this paper can be beneficial to local governments. □

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