

User Fees: The Hidden, 'Other' Tax

By CJ Eisenbarth Hager
Senior Policy Analyst
Morrison Institute for Public Policy

Faced with falling revenues, many states are looking to user fees to provide additional revenue. According to Fall 2010's *Fiscal Survey of States* by the National Governors Association and the National Association of State Budget Officers, Arizona was among 17 states that raised fees to help cope with shortfalls in fiscal year 2011. In total, these states are projected to generate an additional \$1.1 billion from fees in this current fiscal year. Colorado leads the way, hoping to raise its fee collection by \$200 million, while Arizona's projected net increase is much more modest at \$12 million.

While fees are another way of raising revenue, we pay them but might never think much about the theory and practice behind them. Revenue production is only one aspect of why and how they are used. Proponents of user fees say they are a more precise way of generating revenue based on demand. When done properly, user fees encourage government to mimic the private sector in efficiency. However, governments often fail to price fees accurately, which means that fees do not reflect the true cost of providing a service.

This primer reviews the role of user fees, lessons learned from various government entities, and looks at current fees charged by some Arizona state agencies.

What are user fees?

A user fee is a payment for a government service. We pay fees for a privilege. Nuances differentiate user fees, user charges, surcharges, and licensing or regulatory fees, but we will treat them the same. Fees are another way to generate revenue for governments.

User fees are levied for voluntary activities, such as park or museum entrance fees. Other fees defray the cost regulatory review. Government agencies are typically the only provider of these regulatory activities, such as driver's licenses, zoning fees, or licensure fees for regulated professions. Other user fees cover the cost of a service or commodity that happens to be provided by a governmental entity, such as garbage removal.

What's the difference between a fee and a tax?

"A user fee is related to some voluntary transaction or request for government goods or services above and beyond what is normally available to the public, such as a request that a public agency permit an applicant to practice law or medicine or construct a house or run a broadcast station. Taxes, on the other hand, arise from the government's sovereign power to raise revenue and need not be related to any specific benefit, and payment is not optional; when Congress imposes taxes, it need not consider benefits bestowed by the government on an individual but may base taxation solely on an individual's ability to pay."

– *Federal User Fees: A Design Guide*

These user-fee examples have two conditions in common:

1. The user can be identified.
2. Ways of calculating the cost of the activity and charging for the privilege are clear.

Advantages

User fees help regulate the supply and demand of a service

When water usage is not metered, consumers have no incentive to conserve it. Consequently, they may use more than they need. Likewise, if a parks and recreation department does not charge for the use of public tennis courts, they may light the courts at night, regardless if anyone is using them. These are examples of how a service could be over-supplied without a user fee. A user fee can bring balance to what is asked for and what is made available, thereby reducing waste.

User fees are efficient

The economic theory underlying user fees is the *beneficiary-pays principle*. The cost of the service is paid by those who use the service. Proponents say that user fees prevent the general fund from subsidizing services that benefit a few people rather than the entire community. User fees are a more precise way of charging for services. As in the example above, not everyone in a community uses the public tennis courts. The maintenance and operating costs are shouldered by those who choose to use them, proponents say.

User fees can benefit everyone

While fees are levied on those who benefit most, the resulting activities can be advantageous to all. Medical and legal professionals are charged licensing fees to practice their profession. Everyone benefits by knowing these professionals meet a minimum standard, and that there is a legal grievance procedure if we are wronged by someone in that profession. Revenues from dog licenses help ensure fewer homeless canines.

User fees can provide community amenities and increase the quality of life

User fees can help provide services that may otherwise go unmet. Parks, recreational and cultural activities, and light rail transportation systems may go unrealized without user fees. These types of services enhance a community's livability, even for those who choose not to partake in them.

User fees mimic a private-market business model

User fees are a response to those who want to privatize the functions of government. While user fees are employed by government entities, they can push government to act more like the private sector, where demand determines supply and price.

Philosophical debate: public versus private

An underlying tension of user fees is that many see it as a move toward privatizing public goods. Ultimately, this begs the question: What is the role of government?

Economists and philosophers have provided varying perspectives.

On one end of the spectrum is the notion that the state is best positioned to provide "natural monopolies" (such as national defense) and to safeguard social welfare.

Privatization advocates claim their approach is more efficient, based upon current market forces, and is less prone to corruption.

User fees diversify revenue sources

The utilization of fees grew in the 1980s in response to a backlash against high property taxes. User fees have helped governments diversify their revenue structures, thereby decreasing the volatility of revenues and better preparing governments for economic downturns.

Limitations

User fees limit access

Public goods and services are especially important to those with limited resources. By definition, user fees regulate the supply of public goods and services. This control most directly affects those with limited incomes or resources, such as the poor, elderly, and small businesses. User fees can take on the characteristics of a regressive tax where low-income families pay a higher percent of their income for taxes and fees than a high-income family. The same can be applied to a small business.

Governments are often slow to make price adjustments

While user fees can push government to act more like private companies, government agencies do not have the flexibility to change swiftly with the marketplace. Fee structures may be limited by statute. Changing the law can take years. Often, agencies must follow a rule-making process in order to modify a user fee. Although usually not as cumbersome as passing new legislation, the rule-making process can take several months or more. Unlike the private sector, government cannot quickly (or frequently) change its prices to accurately reflect the cost or use.

Public goods don't always fit a user fee model

Some government services do not conform to a user fee framework. Objectives of social service programs, national defense, public safety, and primary and secondary education do not fit well with user fees. In other cases, such as access to parks or public transportation, fees are typically subsidized with broad access in mind. Access to parks and public transportation has benefits for non-users also, including the protection of natural environments and reduced traffic congestion.

How much fee to charge?

One approach is to set the fee so it will capture the entire cost of providing the service, known as *full cost recovery*. This includes all direct and indirect costs associated with the service.

Sometimes, a full cost recovery approach would make the user fee too expensive. New public transportation systems are extremely costly. Land acquisition, infrastructure and labor costs, and long

Costs to consider when setting user fee

- Accounting services
- Capital facilities – upfront costs, and maintenance
- Collection and enforcement of fees
- Computer access, hardware, and usage
- Consulting
- Insurance
- Rent on buildings and equipment
- Research
- Salaries and benefits
- Travel
- Utilities

– *Government Finance Officers Association,
U.S. Governmental Accountability Office*

planning and construction periods would mean high fees for cost recovery. Similar arguments could be made for water and sewer fees and park entrance fees. In many cases, *partial cost recovery* is a more appropriate approach, where the fee is set to cover all or most of the on-going operational costs, or a fixed percentage of costs. Partial cost recovery can be applied to services that are beneficial to the broader community – users and non-users alike. In the public transportation example, the use of a light rail system not only provides transportation to the riders (the users), it also reduces road congestion for those who are not riders.

In other cases, a *price differentiation* approach may be helpful where upfront costs are very high. In this situation, users are charged a higher fee when demand is high, and a lower fee when demand is low. Peak and off-peak fees help to balance uneven demand for a service. Utility services and public transportation are examples where peak pricing is used during period of high usage, and off-peak pricing is used when demand lowers.

However the pricing is calculated, practitioners stress two important issues: transparency and regular review. What is included in calculating the user fee should be clear, follow an understandable rationale, and be available to the public. Factors that might prompt review of cost of a user fee include inflation, staff efficiency, or change in service demand. User fees should be reexamined regularly to take into account cost changes. Many practitioners suggest annually, but more often may be necessary if costs change unexpectedly or dramatically, such as when the price of oil rose significantly in summer 2008.

Lessons learned

A number of research organizations have evaluated federal, state and local fees. While the administrating agencies and fee structures vary, the best practices and lessons learned are consistent:

- User fees should not be inflated in order to generate extra revenue for the general fund. The National Conference of State Legislatures suggests that using fees to pad the general fund could leave governments “vulnerable to court rulings that such charges are taxes. Taxes are subject to much stricter court scrutiny.... Also, a court ruling that a fee is really a tax may subject it to voter approval or supermajority requirements imposed on tax increases.”
- Monitoring and adjusting the fee are important, especially in a full cost recovery pricing model. Some practitioners suggest building in funding to continuously monitor the precision of the fee. Most objective analyses agree that user fees typically fail to keep pace with the true cost of the service.

What does Arizona law say about government fees?

Arizona Revised Statutes § 41-1008:

- A. Beginning on July 1, 1999, except as provided in subsection C, an agency shall not:
1. Charge or receive a fee or make a rule establishing a fee unless the fee for the specific activity is expressly authorized by statute or tribal state gaming compact.
 2. Make a rule establishing a fee that is solely based on a statute that generally authorizes an agency to recover its costs or to accept gifts or donations.
- B. Beginning on July 1, 1999, an agency shall identify the statute or tribal state gaming compact that authorizes the fee on documents relating to collection of the fee.
- C. An agency authorized by statute or tribal state gaming compact to conduct background checks may charge a fingerprint fee without a statute expressly authorizing the fee.

Ongoing monitoring should include an examination of how fees affect those with a limited income. Tax credits or subsidies, such as transit passes, can help offset regressive user fees.

- Full cost recovery is the preferred method of pricing. Regardless, the method used to calculate the user fee should be clear and reviewed regularly.
- Fees set in statute do not allow an agency to change prices quickly enough to adapt to changes in costs. Fees should be set by the administering agency.
- When administered properly, fees can help government manage its functions more efficiently. Fees provide incentives for government-provided goods and services within a monetary limit.
- User fees are not deductible on federal income taxes, whereas property and income taxes are. Taxpayers who itemize their federal income taxes will pay more in federal taxes if user fees are used to replace taxes.

How Arizona compares

Arizona lags behind the rest of the country in fee collection, regardless of how we measure it. The U.S. Census Bureau collects data on state budgets.¹ The most recent data (2008) ranks Arizona near the bottom in terms of total current charges.² Arizona collected \$1.7 billion in current charges in 2008, ranking 33rd in the nation in terms of total fees collected. As a percent of total state revenue generated by fees, Arizona ranks near the bottom at 47th. *Governing's State and Local Sourcebook for 2006* ranks Arizona last for local and state fees collected per capita.³

How Arizona agencies administer fees

The Arizona Revised Statutes (A.R.S.) § 41-1008 sets the parameters for agencies to create user fees. A fee is defined as “a charge prescribed by an agency for an inspection or for obtaining a license.” The statute specifies that an agency may only establish a fee where a statute specifically allows it. A master list of state fees that details the purpose and amount of each one has not been compiled.

Typically, when a state agency charges a fee, revenue from that fee goes into a special revenue fund, separate from the general fund. In turn, that special revenue fund is statutorily required to finance certain activities, usually related to the fee. The Legislature appropriates monies from the fund to the agency.

Arizona fees in practice: Department of Water Resources

The Arizona Department of Water Resources (ADWR) was created to secure long-term, dependable water supplies for the state. The agency administers and enforces the groundwater code and surface water rights laws. It protects Arizona's Colorado River water supply. ADWR represents the state in water rights discussions with the federal government.

¹ www.census.gov/govs/state/

² The U.S. Census definition of current charges is broad, and includes items such as charges to patients at public hospitals, and tickets prices to state-funded university athletic games. While this measure isn't perfect, it does highlight the difference between the states. For a full list of what is included in the U.S. Census' definition of current charges, go to http://ftp2.census.gov/govs/class06/ch_4.pdf

³ <http://sourcebook.governing.com/subtopicsresults.jsp?ind=666>

A.R.S. § 45-113 gives ADWR latitude in developing a fee structure through the rule-making process: “Except as otherwise prescribed, the director may establish by rule and collect fees for applications, certificates, licenses and permits relating to surface water, groundwater, water exchanges, wells, grandfathered rights, substitution of acres, adequate and assured water supply, groundwater oversupply and lakes and for inspections relating to dam safety.”

ADWR’s fee schedule is complicated. ADWR lists 12 fee schedules in the *Arizona Administrative Code*, with most based upon water usage, location, or size of property or water body.

In addition to the general fund, the legislature appropriates monies from 17 different special revenue funds to ADWR. Not all of these funds are financed by fees or licenses. We will look at three of the largest fee-financed special revenue funds dedicated to ADWR.

Arizona Water Protection Fund

The fund is financed by “fees in lieu of taxes” from the use of Central Arizona Project land (A.R.S. § 48-3715.05). Statute mandates that the legislature also appropriate \$5 million each year from general fund to the Arizona Water Protection Fund. This fund is used for the development and implementation of measures to protect water and restore rivers and associated riparian habitats.⁴

In fiscal year 2009, the fund had a carryover of nearly \$9 million. It also had fee revenues totaling \$5.2 million. The Legislature appropriated \$2.8 million of the Arizona Water Protection Fund to the ADWR, but also transferred \$2.2 million from it to the general fund. A similar transfer of \$2.3 million took place in fiscal year 2010.

The fee that capitalizes the Arizona Water Protection Fund is based upon a calculation set in statute that takes into account water usage and total property taxes.

Assured and Adequate Water Supply Fund

This fund is supported by fees paid by municipalities and private water companies to evaluate the adequacy of their water supply, and used to pay for the costs associated with these evaluations.

The Assured and Adequate Water Supply Fund brought in \$301,000 in fees in fiscal year 2009, while the Legislature transferred \$87,000 from this Fund to the general fund. The fees used to capitalize the Assured and Adequate Water Supply Fund are set by rule (R12-15-730).

Water Banking Fund

This fund is capitalized through a general fund appropriation and by fees associated with the delivery of Colorado River water to municipalities and industries. The Water Banking Fund is used to purchase and store unused portions of Arizona’s Colorado River water allotment.⁵

⁴ Arizona Governor Janice K. Brewer, The Executive Budget, State Agency Budgets Fiscal Year 2011.

⁵ *Ibid.*

In fiscal year 2009, fees brought \$9.4 million into this fund, which was already capitalized at \$40 million from a carry-over from the prior fiscal year. In 2009, the legislature transferred \$15.2 million from the Water Banking Fund to the general fund. In the following fiscal year, the legislature transferred \$6 million to the general fund. The fee structure for the Water Banking Fund is set in statute, and is based upon land and water usage.

Exception: 90/10 agencies

An exception are Arizona’s “90/10” agencies. Most Arizona professional and occupational regulatory agencies are funded by fees and the issuance of licenses. These agencies retain 90% of the fees, which go to a special revenue fund, and deposit 10% of the fees collected into the state’s general fund. Most 90/10 agencies are funded only by the special revenue funds.

Examples of 90/10 agencies include the Arizona Medical Board, Board of Accountancy, Board of Homeopathic Medical Examiners, Office of Pest Management, Registrar of Contractors, State Board of Appraisal, State Board of Chiropractic Examiners, State Board of Dental Examiners, State Board of Dispensing Opticians, and State Board of Nursing.

Most of these agencies have statutory fee caps. Once the agencies’ fees have hit the cap, legislation must be passed to raise it.

Once 90% of the revenue generated is deposited in a special revenue fund, the monies in this fund must be legislatively appropriated back to the agency. During lean financial times, legislators face a temptation to reallocate or sweep these special revenue funds to the general fund to use for other purposes. In legislative terms, this is called a fund transfer. Many 90/10 agencies faced this issue in recent fiscal years.

Arizona fees in practice: State Board of Nursing

The State Board of Nursing is a 90/10 agency that licenses and regulates nurses and nursing assistants. It oversees and approves continuing education programs and investigate public complaints. In fiscal year 2009, the board monitored more than 80,000 nurses and more than 24,000 nursing assistants, and investigated 920 complaints.

The Board of Nursing charges fees for its services. Fee caps are set by statute (A.R.S. § 32-1643). The fee structure is set and approved by the governing body of the Board of Nursing. The table below gives a sample of the fee structure for fiscal year 2010, and the caps set by statute.

Like other 90/10 agencies, the Board of Nursing deposits 10% of all monies into the general fund, and the remaining 90% goes into the Nursing Board Fund (A.R.S. § 32-1611). The Nursing Board Fund was at \$6,126,000 in fiscal year 2009, of which \$4.1 million was generated from fees and

	Current Fee	Statutory Cap
Initial Certification - School Nurse	\$75	\$75
License Renewal	\$160	\$160
License Renewal – School Nurse	\$25	\$50
Fingerprint Fee	\$50	\$50
Copying of Records	\$.50 per page	\$.50 per page
<i>Sources: www.azbn.gov/AgencyFees.aspx, and A.R.S. § 32-1643</i>		

\$2 million was a carryover from the prior fiscal year. For 2009, the Legislature appropriated \$3,943,000 to the State Board of Nursing from the Nursing Board Fund; the Legislature also transferred \$1 million from the Nursing Board Fund to the general fund.

For fiscal year 2009, the Board of Nursing was appropriated \$4,040,700, nearly all of which came from the Nursing Board Fund.

Arizona fees in practice: recent complications

Recently state agencies have experienced problems with their approach to fees. In early 2009, 13 health professional associations sued the governor and state treasurer over special revenue fund sweeps. The Legislature transferred monies from several special revenue funds, which were capitalized by 90/10 agency fees, to the general fund. *Arizona Association of Chiropractic et al. v. Brewer* argues that by taking these funds, paid as license fees to be used to regulate the professions and promote public safety, the state has created a tax that is in conflict with the Arizona constitution and existing statutes. The suit seeks the transferred funds be returned to the original special revenue funds.

Later in 2009, the fiscal year 2010 state budget lifted the statutory fee cap for child care provider licensing fees. The budget authorized the Department of Health Services (DHS) to set its own fee structure for child care provider licensing. The budget also instructed DHS to organize the child care licensing responsibilities to function like a 90/10 agency, where DHS would fund these licensing activities with 90% of the revenue generated from the fees, and deposit 10% of the revenue into the general fund. The old fee structure was a flat rate (\$150) for all providers, which had not been revised since 1976. With the goal of full cost recovery, the new fee structure varied according to the number of children, and proposed substantial fee increases.

Opponents to the fees organized an effective media and public education campaign. They calculated that the new licensing fee structure could raise fees by as much as 8,800% for some providers. While keeping the new fee structure, public pressure pushed DHS to provide assistance to providers serving low-income families.

Arizona fees: conclusions

The Board of Nursing, ADWR, and the above 90/10 agencies highlight some problems with how Arizona approaches fees, such as using fee revenue to subsidize non-fee related activities. They also illustrate how sudden and significant fee increases (after many years of stagnancy) can mobilize public outcries.

- The Arizona Legislature has set many fee caps in statute, which compromises the ability of agencies to increase (or decrease) fees as the cost in providing services increases (or decreases).
- Most of Arizona's regulatory and licensing agencies are self-funded. However, by definition of a 90/10 agency, agencies either overcharge or are underfunded for their services by 10%. This overcharge or underfunding does not encourage efficiency at the agency level, nor does it reflect the true cost of the services. The State of Arizona should not view user fees as a supplemental revenue source for the general fund.
- Facing a budget crisis, the Arizona Legislature has raided special revenue funds, which were

financed by regulatory fees. This continual transfer of funds has threatened the ability of regulatory agencies to carry out their mission. This problem is particularly grim where regulatory agencies are charged with protecting the health of the public.

The Citizen's Finance Review Commission also observed the inequities and inefficiencies in the way that many of the state's fees are structured. The commission made the following recommendation in 2003, but resonates particularly well today:

The state should hire a consultant to examine the fairness and extent of miscellaneous taxes and fees imposed by the state for services.... The commission believes that the fees charged do not accurately reflect the fair market value of the services provided or even cover the real cost of providing the services. Although some regulatory agencies cover their own costs through fees collected from the groups they regulate or serve, many do not. The result is that certain groups receive services subsidized by taxpayers. At a minimum, the users of the governmental services should pay a fee equal to the real cost of the service they receive.

In 2010, Governor Jan Brewer created a permanent Fee Review Commission. User fees are complicated managerially and pose philosophical questions, which suggest that fees are not *the* answer to Arizona's revenue shortfalls. Staffed by professionals with expertise in market research, pricing and evaluation, a commission can bring consistency and objectivity to a fee system that oftentimes lacks these qualities.

Sources

The Appropriate Role of User Charges in State and Local Finance, National Council of State Legislatures, July 1999.

Bowlby, Mark J., Patricia MacDonald, and Mark Gilbert, "Establishing user Fees: Theory and Practice in Canada," *Government Finance Review*, February 2001.

Federal User Fees: A Design Guide, U.S. Government Accountability Office, May 2008.

A Fiscal Toolbox, Citizen Finance Review Commission, 2003.

Local Government User Fees, Wisconsin Legislative Audit Bureau, April 2004.

Practical Exercises in Local Government Finance, Government Finance Officers Association, 1993.

The Use and Abuse of User Fees and Charges, Worcester Regional Research Bureau, June 2003.

The Fiscal Survey of States, National Governors Association and National Association of State Budget Officers, Fall 2010.

January 2011 / Morrison Institute for Public Policy is a leader in examining critical Arizona and regional issues, and is a catalyst for public dialogue. An Arizona State University resource, Morrison Institute uses nonpartisan research and communication outreach to help improve the state's quality of life.