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## THE PROS AND CONS OF PUBLIC SERVICE USER FEES

Without fanfare, the Quebec government recently took a sharp turn towards implementing user fees for public services. Beginning with its first budget in June 2003, the government stopped reimbursing parents for fees required by elementary and secondary schools. Then it announced an increase in contributions to the drug insurance plan and lifted the freeze on electricity rate increases. In November it announced an increase in fees at childcare centres and allowed public transit corporations to hike fares.

This is just the beginning: the Environment Minister announced he is in favour of further user fees for drinking water; the City of Montreal has decided to go forward and do it. Despite government word to the contrary, the rumour of university tuition increases refuses to go away.

The government is turning to user fees while promising to reduce Quebecers' taxes by a billion dollars per year, beginning in 2004-2005.

Table 1 shows

that close to two thirds of this money could come from increasing user fees. However, in its pre-election financial platform, the Quebec Liberal Party indicated that it would reduce taxes by "reviewing government programs to eliminate waste and non-essential spending;" there was no mention of an increased reliance on user fees. Given this shift, it's time to investigate the pros and cons of this method of financing public services.

### Towards better resource allocation

A fee causes people to put an explicit value on the benefits they get out of a government-provided service. If the benefits outweigh the fee, people are willing to pay; if the opposite is true, they will reduce consumption. When someone forgoes a rationed service because the cost outweighs the benefit, this frees up a supply of the service for someone else. Think about

a family that has secured a place in a childcare centre, even though one of the parents is available to look after the child. If fees are too low, there is nothing to incite the family to leave the spot for a family whose need is greater and yet remains on the waiting list. This second family will be ready to pay a higher fee, as the spot holds a higher value for them.

As a rationing tool,

user fees can be more respectful of the variety of personal circumstances than a waiting list. Rationing through a waiting

Table 1

Proposed or established fee increases (as of November 27, 2003)

|   |                |
|---|----------------|
| 1. Elementary and secondary school education: elimination of the departmental reimbursement to parents for school fees              | \$15M          |
| 2. Drug insurance: increase in the annual premium from \$422 to \$460, and increases in the monthly deductible and coinsurance rate | \$62M          |
| 3. Electricity: 6% rate increase  | \$415M         |
| 4. Childcare centres: increase in fees paid by parents from \$5 to \$7 a day  | \$104M         |
| 5. Public transit corporations: fare hikes ranging from 4% to 11%   | \$40M          |
| <b>Total</b>  | <b>636 M\$</b> |

Source: [http://www.iedm.org/main/show\\_publications\\_en.php?publications\\_id=59](http://www.iedm.org/main/show_publications_en.php?publications_id=59).



list can lead to schemes and favours that reduce public confidence in the system. User fees — and especially the personal cost-benefit assessment they require — are the most tamper-proof way of directing public resources to the people who will most benefit.

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Rationing is useless when dealing with services where consumption by some people doesn't reduce availability to others; think of Environment Canada weather forecasts. In contrast, the more a service's benefits are privately captured, the more rationing becomes necessary; think of a doctor who can treat only one patient at a time. Only the individual knows how bad he or she needs to see a doctor. Although Canadian law currently prohibits it, setting user fees for medical services may help distinguish between different degrees of need.

A fee may convince an individual to assess the value associated to the specific moment in time he or she uses a product or service. Thus telecommunications companies have adjusted their rates according to time of day and day of the week. Hotels offer high- and low-season rates. This adjustment encourages some clients to use services in off-peak periods in order to save money. Similarly, a toll on a bridge that operates only during peak hours may encourage some drivers to take the bridge at other times. Displacing some consumption to off-peak periods slows the growth of peak demand as well as the associated requirements for additional capital expenditure.

When substitutes exist for a government-offered service, a fee incites people to compare their options. Thus the best way to encourage homeowners to better insulate their houses is to stop selling electricity below cost. The best way to encourage drivers to use public transportation is to have them assume the cost of the highways. When no substitute exists, the simple fact of paying directly from their pockets pushes people to demand cheaper, better quality services.

Fees are at their most useful as price signals when service providers are allowed to vary their rates. For example, private secondary schools can require different tuition fees even though they are government subsidized. Faced with higher fees, parents expect superior quality service. The same goes for seniors' residences. Fees should not be uniform where there are several providers and where quality may vary. Thus if universities had greater latitude in setting tuition fees, those with the best faculty and facilities could justify higher rates.

Finally, users' reactions to fees inform government about the value of services provided more objectively than does the clamour of lobby groups. If the service doesn't respond to a need for which people are willing to pay the full cost, imposing a fee that comes close to paying the cost will reduce use. Consider a subsidized performance hall. However, if there is a significant waiting list, the fee won't necessarily lead to a reduction in the volume of activity. Imposing fees thus promotes the reallocation of public resources to the most highly valued activities, at the expense of activities that are surely worthy but that people are nevertheless willing to forgo.

### **Ambiguous distributional effects**

When a public service benefits a subgroup of the population (e.g. families benefiting from places in a childcare centre), its financing through general taxes — paid by all taxpayers — entails a redistribution to the subgroup. Increased reliance on fees will reduce this redistribution.

This form of redistribution results from the evaluation policy-makers make of the extent to which a service consumed by some individuals benefits all of society. Thus, some claim that preschool education in a childcare centre benefits society as much as primary and secondary education. In the same vein, one reason among others offered by governments to subsidize public transportation is that everyone benefits through reduced CO<sup>2</sup> emissions.

*Increased reliance on user fees together with more generous cash transfers allows for better resource allocation while protecting access by the less fortunate.*



Each publicly funded service should be analyzed to determine whether the distribution of its benefits, between the individual consumer and society, matches the distribution of its financing between the user fee and general taxes. This is the user-payer principle. For many publicly funded services, such as university education, the benefits go mainly to the individual while the funding comes mostly from general taxes. In such cases, an equity-based argument can be made to establish or increase fees.

But the user-payer principle is not the only one to consider. At the other end of the balance is the individual's ability to pay, by virtue of which policymakers determine a fee or a tax based on their reading of our capacity or willingness to fork out. Thus even if the benefits of a public service go entirely to the individual and society gets nothing, the government may still want to subsidize its use through general taxes, in order to facilitate access.

The main argument against user fees is that they may prevent the less affluent from having adequate access to essential services. In principle, this problem can be avoided through cash transfers. Increased reliance on user fees together with more generous cash transfers allows for better resource allocation while protecting access by the less fortunate. However, close attention must be paid to the low- and middle-income earners whose wages are too high for income support programs but

**Table 2**

| Type of user fee  | Goal  | Examples  |
|---|---|---|
| Modulated according to time of consumptions lot (a.k.a. peak-load pricing)  | To prevent excessive demand on networks by redirecting some of the consumption to off-peak periods or substitute products | Electricity<br>Highways   |
| Modulated according to socio-economic category (a.k.a. cross-subsidization) | To promote access among some social categories by transferring part of the cost to others                                 | Electricity: residential, institutional and industrial rates<br>Public transit: student, senior and regular rates |
| Varies according to the provider  | To offer a range of quality-to-price ratios   | Private secondary schools<br>Seniors' residences  |
| User fee rates  | Goal  | Examples  |
| Rate equal to cost  | The consumer pays for the service he or she receives  | Provincial parks  |
| Rate below cost   | All of society contributes to costs assumed by individuals because part of the benefits are social                        | Childcare services<br>Elementary, secondary and post-secondary education  |
| Rate higher than the cost   | Individual consumers assume costs incurred by society   | Variable registration fees according to vehicle weight (wear and tear on the roads)                               |

not high enough to pay taxes. For these individuals, decreasing taxes will not compensate for increasing fees; increased reliance on user fees accompanied by tax breaks would instead impoverish this segment of the population.

Another means sometimes used to promote access by the less affluent is to adjust fees according to an assumption about their capacity to pay; think of student and senior rates for public transit. However, modulating fees is a stopgap measure that is less effective than a cash transfer — as it means that other users have to make up for the subsidy to a certain extent. Furthermore it overlooks the variety of financial situations within targeted social categories.



Free public services are largely financed through income taxes, which are progressive. In contrast, fees are generally independent of individual means. Consequently, even if there are ways to ensure that the less fortunate have access to public services, user fees make the system less progressive as a whole. However, generalizations should be avoided, as each case needs to be considered individually. Some publicly funded services, like university education and grants to cultural organizations, predominantly benefit the wealthy. In these cases, financing through taxation redistributes wealth from the least to the most affluent. A more progressive policy would actually be to finance these services through user fees.

*Taxpayers object to fees when they hit the poor too hard or when they are seen as a scheme to finance reductions in income taxes while maintaining the government's total draw on taxpayers' wallets.*

User fees can be charged for public services for which consumption is easily controlled, such as access to a provincial park. However, fees cannot be charged for services, such as the police, from which you cannot exclude anyone. Over and above this practical question, the government must ensure that the direct and indirect collection costs of a user fee are not too onerous compared to the expected benefits. For example, if apartment dwellers in a building all consume about the same volume of water, there is no point to install individual water meters. However, user fees for water consumption may be appropriate in the case of single-family dwellings (where people have pools and lawns) and for industrial, agricultural and commercial (air conditioning) consumers. It should also be noted that the cost of collecting a user fee can go down thanks to advances in technology. Twenty years ago, highway tolls caused traffic jams. Today, drivers don't need to stop to pay a toll.

All these considerations allow identification of public services where the appropriate use of fees can benefit society. They also help identify poorly designed fees. For example, fees required by the Registrar of Civil Status for issuing a certificate provide no benefit in terms of resource allocation. In such cases user fees serve only to finance tax cuts or spending increases.

### Conclusion

Increased reliance on user fees can improve public resource allocation by directing resources toward the most highly valued activities and toward the people that most value these activities. However, Canadian experience has shown us that taxpayers object to fees when they hit the poor too hard or when they are seen as a scheme to finance reductions in income taxes while maintaining the government's total draw on taxpayers' wallets. To respond to these legitimate concerns, the government can offset the drawbacks of user fees through cash transfers, and better explain the advantages of this method of financing public services.

## Montreal Economic Institute

Montreal Economic Institute  
6418 Saint-Hubert Street  
Montreal (Quebec)  
H2S 2M2 Canada  
Telephone: (514) 273-0969  
Fax: (514) 273-0967  
e-mail: info@iedm.org  
Web Site: www.iedm.org

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