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Re-visiting cost recovery for government services

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ABSTRACT

Theory indicates that charging for government services provided to identifiable clients should improve resource allocation. The question arises - what level of fees and charges should be applied. One popular theory is that charges should be calculated by dividing costs in proportion to 'public' and 'private' benefits, with the client paying only the 'private' component. This paper suggests it is more logical to recover *all* costs at the point of service delivery. The only basis for subsidising services should be in cases when demand for a particular service is less than acceptable at an unsubsidised cost recovery level and other means of increasing use of the service eg cash transfers, taxation concessions are either inefficient or politically undesirable.

Key words: beneficiary pays principle, cost recovery, user charge

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Background

In Queensland, the Department of Primary Industries (DPI) provides a wide range of services and products to improve the contribution that primary industries make to State economic growth. The bulk of its funding comes from State based allocations, special grants and research levies. In the main, this funding enables DPI to provide services for which it would not be either inefficient and/or socially unacceptable to charge directly users and/or beneficiaries of the service. A good example of this is the present fire ant eradication program that has to be funded by taxpayers through State and Federal governments, as it would be inefficient and inequitable to charge individual clients and beneficiaries¹.

DPI also provides a range of products and services to individual clients and groups. For example, there are a large number of regulatory activities for which DPI is legislatively responsible. These are primarily in the animal and plant health areas and in fisheries and food safety regulation. Apart from that, DPI also supplies a wide range of information and products to individual customers at their request. These products and services include analytical and diagnostic services, advisory services, commissioned research and consultancies as well as physical products such as animal semen and vaccines. For most of these services, there is some type of fee structure in place although, in a minority of cases, the services are provided free of charge.

Objectives

1. To outline the advantages of introducing a regime of fees to recover the costs of goods and services provided to identifiable clients.
2. To discuss the issue of whom should pay.
3. To discuss the different types of goods and services provided and to put forward charging principles that should apply to the different types.

The economic issues involved in user charging were discussed in a previous AARES contributed paper (Wilson, Bartholomew and Baker, 1994). That paper discussed the issue of charging for goods and services provided for identifiable clients, and also for clients who could not be identified. In other words, it discussed the issue of user charging for both private and public goods.

¹ One reason is the difficulty of identifying the beneficiaries, who, in the main lie outside the infected area.

This paper is more limited in scope. It discusses only an approach to user charging for services provided to identifiable clients, that is, an approach for recovering the costs of providing private goods. These types of goods and services are both rival and excludable.

Advantages of fees and charges

General taxation and grants are the major sources of funding available to DPI and to most other government departments. A major problem with funding in this way is that the costs of providing a service tend to be hidden from the users of the services. There can be an appearance the services are provided for 'free'. Introducing fees and charges for services provided to individual clients has the following effects:

1. Users of the services can better recognise the costs of the resources involved and have an incentive to adjust their use of services in line with their willingness to pay;
2. Cost recovery results in those who benefit from services paying for those services;
3. The government receives clearer signals about the demand for its services and can adjust supply accordingly. This leads to greater efficiency in the use of resources;
4. Fees and charges set at commercial levels ensures the government does not undercut alternative private sector providers; and
5. The extra revenue may enable expansion of services where there is under-provision at the subsidised price.

It should be emphasised that revenue raising per se is not the primary objective of introducing a regime of fees and charges. Rather the objective should be to increase the efficiency with which government funds are being used and to gain the best possible social outcomes.

Who should pay?

Given that the introduction of fees and charges is socially worthwhile, there is the question of who should pay. The 'beneficiary pays' principle is generally accepted. In most cases, it is appropriate that the user of a product or service pay the costs, as he/she is the major beneficiary. For some services, it is appropriate that costs are subsidised to achieve equity or social policy outcomes. The Queensland Treasury's Full Cost Pricing Policy (1994) outlines five situations where it is appropriate for government to subsidise activities. In DPI's case, the major circumstances would be where it would be necessary to supply a service at a

uniform price regardless of cost, where it is necessary to help disadvantaged groups, and where industry assistance is required.

Using the ‘beneficiary pays’ principle, it is sometimes not clear whether users of services should pay the *full* costs of providing a particular product or service. This may occur when a service provided to an individual provides a direct benefit to the user and also indirectly to others who are not required to directly “pay” for the service or product. For example, a food producer may benefit from DPI advice by being able to lower his costs of production through adopting new technology. If the new technology is widely adopted, the cost savings may be passed on to consumers in the form of lower prices. These services are said to create positive spillover benefits.² The question is - should the producers pay the full costs of the service? In such cases, it may be appropriate for the DPI to provide an incentive to encourage the use of such services. However, provision of an incentive, such as a subsidy, is justified only if the government is of the view that current use of such a service is below that desirable from society's perspective. There may in fact be cases where a subsidy will promote increased use of the service and result in an overall net benefit³. There will be other cases where no subsidy is needed.

The general rule recommended here is that where possible, the costs of providing the good or service should be recovered at the point of service delivery if possible. With products and services where the clients have the discretion to use the service or not, it is reasonable to assume that clients who voluntarily use the services do so because they are obtaining a commercial benefit. Thus the ‘beneficiary pays’ principle is satisfied if they pay the costs of providing the service. Any positive spillovers are a bonus.

This paper suggests that a key factor in deciding when to charge for services is whether users of the services can be identified and therefore charged. This is somewhat different to approaches based on an assessment of ‘public’ and ‘private’ benefits. See, for example, Manson (2001) and the Victorian Department of Natural Resources and Environment, Evaluation Report Number One, Agriculture Division (2000).

Types of services

² ² Benefits to users of DPI products and services are sometimes (loosely) referred to as ‘private benefits’ and positive spillover benefits accruing to others are sometimes referred to as ‘public benefits’.

³ In calculating a net benefit, the economic effects on users and non-users ie taxpayers and other economic agents, need to be determined.

In DPI's case, products and services supplied to individual clients are of two types:

1. Regulatory services are provided to reduce the damage that might arise from the production or consumption of goods and services that have a high degree of risk attached to them. Or alternatively, regulations are used to reduce the risk of negative spillovers, for example, environmental pollution and depletion of fish stocks.
2. Non-regulatory services - the main intent is to supply information or a product to a client.

Regulatory services are non-discretionary. It may not initially seem "fair" to charge for the full cost of imposing regulatory control. However, regulations are an essential aspect of resource use and, without them, commercial use may be unsustainable or socially unacceptable. Therefore, the cost of regulatory control is an essential part of the production system and should be incorporated into the price of product delivery the same as other production costs.

For services designed to decrease the risk of damage from production or consumption of some goods, it may not be possible to charge beneficiaries directly, for example food consumers. However, it is possible to charge the firms being regulated. In this way, the prices paid for the goods and services of regulated firms reflect *all* the costs of bringing them to the market. Depending on the extent to which they can pass on the costs to consumers in the form of higher prices, the beneficiary pays principle can still be met.

Non-regulatory services are discretionary. Users have the discretion whether to accept or not accept the products or services offered, and also to decide on the amount that they will use. In some instances, private sector suppliers may be able to provide comparable services. Cost recovery charges will have an effect on the amount of a particular good or service that will be purchased. The level of charge applied will depend on whether the output demanded is acceptable to the government in achieving its priorities. If the output demanded at an unsubsidised cost recovery level is acceptable, charges should be set at that level. As noted above, if the amount demanded is less than acceptable, the government may see fit to subsidise the service. Examples of DPI products and services that should not generally be subsidised are:

1. Analytical and diagnostic services
2. Advisory services for individual enquiries and requests
3. Commissioned research and consultancies

4. Physical products such as animal semen and vaccines

When setting charges for information services, it may be necessary to distinguish between core and non-core services. The government has core information services for a number of reasons and once collected, the cost of supplying information to additional users is low, particularly with the use of electronic technology. Prices for these non-core activities should generally be set to recover only the costs of publishing and disseminating the information. Prices that are higher than this may discourage desirable uses of the information.

Services provided where there could be competitors

Where the government has decided to produce similar products to the private sector, the principle of Competitive Neutrality is important. This requires that the government should adjust prices to remove any advantages or disadvantages it may have as a result of being publicly owned, so that the emergence of a private sector capability to provide the service is not inhibited. The main operational effect of Competitive Neutrality on cost recovery is the need to consider more than costs in pricing decisions. To place itself on an equal footing with the private sector, the government also needs to incorporate tax equivalents and profit margins into pricing decisions; and review costs to identify instances where arrangements are not consistent with those available in the private sector.

What costs should be recovered?

A classification system for costs is presented in the Industry Commission Draft Cost Recovery Report (2001). Costs captured by cost recovery can include both direct costs and indirect costs. Direct costs are those that can be assigned directly against an activity, such as project salary and operating costs and asset lease fees. Indirect costs are costs that are unable to be assigned directly to an activity, such as corporate overheads. Generally, the 'full cost' of providing a service includes both direct and indirect costs.

'Avoidable costs' are a different concept. They include all the costs that would be avoided if the service were no longer provided. Avoidable costs include direct costs and any indirect costs that vary as levels of production vary. Use of avoidable cost is consistent with the Queensland Treasury's Full Cost Pricing Policy. The main difference between avoidable cost and full cost is the treatment of indirect costs such as overheads. Full cost of a service includes a share of overheads whereas avoidable costs include only that share of overheads that would cease if the service ceased. For example, if the government stopped delivering a training course, the project costs related to delivery and the salary of the trainers would be expected to cease or be diverted to other activities, but the management infrastructure would

effectively remain unchanged. Therefore, management infrastructure costs would be required predominantly for purposes other than delivery of the training and therefore should not be recovered by the training fees.

Cost recovery may apply for regulatory services and also for non-core, non-regulatory services. The recommended levels of cost recovery are summarised in Table 1.

Table 1 Costing and pricing aspects for various services

Service Type	Costs Recovered	Pricing Considerations
Regulatory	Full Cost - Project labour, operating (incl. asset lease fees) and indirect costs (incl corporate overheads).	Ensure the fee reflects the costs of delivering the service efficiently.
Non-core, Non-Regulatory Services Without Real or Potential Competitors	Avoidable Costs - Project labour and operating (including asset lease fees).	Ensure the fee reflects the costs of delivering the service efficiently. Adjust fee to ensure Government objectives for demand or use of the service can be achieved (subsidies to lower the price or premiums to increase it).
Non-core, Non-Regulatory Services With Real or Potential Competitors	Avoidable Costs (as a minimum) - Project labour and operating (including asset lease fees).	Ensure the fee reflects commercial competitor considerations, including taxation and profit margins.

Summary

The volume of literature that discusses approaches to cost recovery for goods and services supplied to individual clients by Government Departments is becoming large. This paper has attempted to distil some key points from this literature and to present some simple guidelines.

The key points are:

1. There are sound economic reasons for introducing cost recovery strategies for these types of services. Revenue raising, however, should not be the main aim.
2. This paper suggests an approach to charging that depends on being able to identify and therefore charge clients. In most cases, this will result in an unsubsidised level of cost recovery. The major reason for subsidising goods and services is in cases where the demand is less than socially acceptable at unsubsidised cost recovery levels. This is in contrast to charging models that rely on some apportionment of benefits between 'public' and 'private' benefits resulting in a consequent cost sharing procedure.
3. The recommended levels of cost recovery vary from full cost for regulatory services in most cases, through to avoidable costs for some non-regulatory services with commercial costing for services provided in a commercial environment.

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