State and Local Government Financing of Essential Services with User Fees

February 2005
**SEMCOG . . . Local Governments Advancing Southeast Michigan**

**Mission**

SEMCOG’s mission is solving regional planning problems — improving the efficiency and effectiveness of the region’s local governments as well as the quality of life in Southeast Michigan. Essential functions are:

- providing a forum for addressing issues which extend beyond individual governmental boundaries by fostering collaborative regional planning, and
- facilitating intergovernmental relations among local governments and state and federal agencies.

As a regional planning partnership in Southeast Michigan, SEMCOG is accountable to local governments who join as members. Membership is open to all counties, cities, villages, townships, intermediate school districts, and community colleges in Livingston, Macomb, Monroe, Oakland, St. Clair, Washtenaw, and Wayne Counties.

**Responsibilities**

SEMCOG’s primary activities support local planning through use of SEMCOG’s technical, data, and intergovernmental resources. In collaboration with local governments, SEMCOG has responsibility for adopting regionwide plans and policies for community and economic development, water and air quality, land use, and transportation, including approval of state and federal transportation projects. Funding for SEMCOG is provided by federal and state grants, contracts, and membership fees.

**Policy decision making**

All SEMCOG policy decisions are made by local elected officials, ensuring that regional policies reflect the interests of member communities. Participants serve on one or both of the policymaking bodies — the General Assembly and the Executive Committee.

Prior to policy adoption, technical advisory councils provide the structure for gaining input on transportation, environment, community and economic development, data analysis, and education. This deliberative process includes broad-based representation from local governments, the business community, environmental organizations, and other special interest and citizen groups.
Abstract
This paper describes the problems encountered by local governments and the state in using fees to finance various services. The causes and effects of uncertainty over the appropriate application of fees are explained, including future implications. This discussion of problems and future implications is intended to serve as a basis for dialogue on acceptable solutions. The goal is for that dialogue to result in government policy that clarifies the circumstances under which fees can, and cannot, be used to fund services.

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State and Local Government Financing of Essential Services with User Fees

Purpose

This paper describes the problems encountered by local governments and the state in using fees to finance various services. The causes and effects of uncertainty over the appropriate application of fees are explained, including future implications. This discussion of problems and future implications is intended to serve as a basis for dialogue on acceptable solutions. The goal is for that dialogue to result in government policy that clarifies the circumstances under which fees can, and cannot, be used to fund services.

Background

The State of Michigan has been experiencing fiscal stress for several years. The processes of adopting balanced budgets and subsequent actions needed to correct for revenue shortfalls are constant reminders of this fiscal stress.

Similar levels of fiscal stress are being experienced by local governments. In fact, state decisions are having a stark impact on local government fiscal resources, most notably, cuts in revenue sharing.

At the same time, state and local government responsibilities for providing a range of services for protecting public health, safety, and welfare and the environment are increasing. The ability of local governments to fund essential services has been defined by a series of seemingly unrelated structural, constitutional, legislative, and judicial decisions, including the Headlee Amendment, Proposal A, cuts in revenue sharing, tax law definitions, and court actions on fees. (Attachment A is a brief overview of revenue raising options available to local government.)

While some of the current financial difficulties facing state and local government in Michigan are related to the sluggish economy, many problems of government financing are structural and will not be resolved by an improved economy. This report addresses one of those structural issues: the ability of government to use fees to support provision of numerous expected, essential services subsequent to the Bolt v. City of Lansing court decision.

Summary of Bolt Decision

The Michigan Supreme Court rendered its decision in Bolt v. City of Lansing in 1998. The court held that a storm water utility fee imposed by the City of Lansing on all sewer users in the city to pay for a sewer project benefiting only 25 percent of the users was a tax, and not a valid user fee. The court’s conclusion (as opposed to its rationale) was completely consistent with long established Michigan law, which has always required that fees are valid only if imposed on those who use the service for which the fee was charged.

The court further held that the tax violated the provisions of the Headlee Amendment to the Michigan Constitution because it had not been approved by the Lansing electors. However, since municipalities have limited taxing authority, the City of Lansing had no basis for seeking voter approval to impose the fee on all sewer users in the city.
In the *Bolt* decision, the court established a three-part test for distinguishing a valid user fee from a tax:

- The fee must serve a *regulatory purpose* rather than a revenue raising purpose.
- A user fee must be *proportionate* to the necessary costs of the service.
- A user fee must be *voluntary* – users must be able to refuse or limit their use of the commodity or service.

These criteria are being used to distinguish whether a government-imposed charge is a fee or a tax. As noted in Attachment A, this distinction is important because there are constitutional and statutory limitations on a government’s authority to impose taxes. A charge which is determined to be a tax is subject to those limitations. The *Bolt* decision, and subsequent court decisions, have far reaching implications for both state and local governments. While the *Bolt* case dealt with a fee imposed by a local government for a sewer project, the fee versus tax test laid out by the *Bolt* court has been applied in a number of cases beyond water and sewer fees at both the state and local level. The result of the *Bolt* decision has been a lack of necessary certainty and predictability with regard to using fees as a mechanism to fund the provision of essential governmental services.

Complicating the situation, this uncertainty comes at a time when there is an increasing reliance on user fees to fund governmental services – and not just at the local level. In recent years, state government has increased its dependence on user fees to meet budgetary needs. For example, the Michigan Department of Environmental Quality’s general fund appropriations were reduced by almost 60 percent between 2003 and 2005, from $69.4 million to $28.7 million. During this same period, fees charged by MDEQ increased about 36 percent, from almost $33 million to nearly $45 million. In fact, for every dollar budgeted to MDEQ from the general fund in FY05, $1.60 is raised through fees. Other state departments are also increasing their reliance on fees.

**Overarching Concerns**

By examining the court’s decision, subsequent cases directly related to that decision, other cases where the theory of the *Bolt* decision is being introduced, and several decisions of state and local government, many overarching concerns have emerged with major implications for government finance. Each of these concerns must be addressed in the process of proposing and discussing the merits of policies designed to clarify the circumstances under which fees can, and cannot, be used to fund services.

1. The issue extends well beyond the provision of water- and sewer-related services to such areas as building inspection fees and cable franchise fees.

2. The issue extends well beyond local government and could include numerous state services, many of which are increasingly supported by fees. Examples include motor carrier fees, vehicle registration fees, and solid waste disposal fees.

3. There is a growing mismatch between citizen expectations for services from local government and local government’s ability to meet those expectations. State and federal mandates are becoming more burdensome while local government’s capacity to raise revenue to cover the cost of services necessary to comply with those mandates is diminishing.
4. Bolt requires that fees serve a “regulatory rather than a revenue raising purpose.” But, by definition, all fees raise revenues. Therefore, any fee imposed by state or local governments can face the specter of a Bolt challenge.

5. The decision could be interpreted as questioning whether the exercise of police powers by local governments (for reason of public health, safety, and welfare) and compliance with state or federal mandates constitute a “regulatory purpose” within the meaning of Bolt.

6. Bolt threatens to undermine long established and well recognized accounting and public finance rules and procedures for utility ratemaking. These accepted ratemaking procedures are used to ensure that the process of calculating the cost of providing many public services will adequately cover those costs with user charges. These procedures are applied by the public finance sector in determining if the rates will recover the costs of the service and if the rates will withstand legal challenge. Our ability to finance and administer public services relies on clear legal standards consistent with established ratemaking practices.

7. The cloud of uncertainty about the legitimacy of any particular fee application is leading to lawsuits with little or no merit. This results in unnecessary exposure to liability and a diversion of public resources to cover legal costs instead of paying for essential services. Of course, uncertainty cannot be eliminated. But it must be minimized if we are to avoid the prospect of defending every fee in court.

In summary, although Bolt related to fees for a storm water utility, Bolt and subsequent Michigan Court of Appeals and circuit court decisions interpreting Bolt raise significant questions in three different areas: (1) the ability of local governments to charge fees to support all municipal utilities, including the more traditional sewer, water, and power utilities; (2) the ability of local governments to charge fees to support other governmental functions, such as building inspections; and (3) the ability of the State of Michigan to charge fees for services that it provides or programs that it administers, such as solid waste disposal fees.

Elaboration and Supporting Rationale

This section includes more detailed discussion on the overall concerns summarized above. A few relevant cases as of January 30, 2005 are referenced to underscore the uncertainty that needs to be minimized with policy action.

Local Fee-Based Utilities. In the aftermath of Bolt and the cases interpreting Bolt, there are a number of problems facing local governments that wish to operate utilities, generally as enterprise funds, and charge fees to users for services provided. In this context, the concept of utilities and enterprise funds means that the particular public service is operated on a standalone basis with separate finances (“the enterprise fund”) and is responsible for recovering all of the costs of providing that service from user charges with no support from general revenues. The utility is financed on the basis of its fees and maintains reserves and separate funds just like a private utility.

Furthermore, the Bolt decision explicitly recognizes there is no bright line test for distinguishing a valid user fee and a tax. Ironically, that specific recognition contributes to uncertainty over whether any particular rate setting mechanism, no matter how carefully crafted, will withstand a judicial challenge based on the Bolt tests. That recognition is also one of the primary reasons for preparing this paper and seeking public policy that provides reasonable clarification about the legitimate circumstances under which fees can be utilized by either state or local government.
The uncertainty extends well beyond fee-based storm water utilities, but also to sewer, water, and power utilities, and raises the following issues:

1. Most bond issues that finance facilities for municipal utilities have been and continue to be supported by user fees. Legal standards which appear to challenge accepted ratemaking practices creates uncertainty and unnecessarily makes rate-based public financing more difficult. An example follows.

In *Grunow v. Township of Frankenmuth*, the Court of Appeals found that a $7,500 connection charge to be paid in order to connect to a municipal water system was an impermissible tax. The Court found the tax had been imposed solely to fund a reserve fund for future improvements to the township's water system when the eventual need arises, benefiting not only those who paid the charge, but others who were not required to pay the charge. In *Grunow*, the court held that the purpose of the connection charge was not regulatory, but to raise revenue, and was not proportional to the cost of regulatory service because the cost of tapping into the water system was $800, and the charge was designed to benefit the general public.

Why is this troublesome? Because the magnitude and complexity of financing multimillion dollar infrastructure improvements and replacements involving projects with long and uncertain service lives and multi-year construction schedules means pure “pay as you go” financing is more theoretical than practical. It is premised on a presumed ability to calculate and charge each user with the exact cost (administrative, operating, maintenance, improvement, and incremental wear and tear) of providing units of service consumed in that year. The difficulty with doing this is part of the rationale for the accepted principle of public utility ratemaking that allows for creating reserve funds restricted to use for future improvements and replacements.

Creating a capital reserve fund is not only considered acceptable, but good practice. Charging today for some part of improvements which current users may or may not use might appear inappropriate. But in fact, “current” users of any system are benefiting from part of that system financed by previous users. Disallowing this practice could amount to prohibiting a unit of government from setting aside funds to pay for an inevitable need, such as a water line replacement, until the need is critical, i.e., the line collapses. Such an approach can, in fact, jeopardize the public welfare and public health government is charged with protecting because the exact failure cannot be predicted in time or magnitude e.g., a complete loss of water from pipes breaking places both drinking water and emergency response service in peril.

It is noteworthy that, as a matter of national policy, local governments are being discouraged from taking such a “pay later” approach. For example, the loss of federal funding support for major capital improvements in sewer systems to protect water quality and public health is resulting in an examination of rates to assure they reflect the true, i.e., complete, cost of providing the service. Since there will likely be little or no outside revenue support for needed major capital improvements, it is increasingly important that reserve funds be a viable option. The alternative jeopardizes public health and safety and/or could lead to the need for massive influxes of funds for improvements in short periods of time.

On the other hand, the Court of Appeals in *Graham v. Township of Kochville*, in applying the *Bolt* tests to a $7,187.50 connection charge to a water system extension, found the charge to be a valid fee, holding that the connection charge was regulatory because it was imposed on only those who would benefit from the extension, that it was proportionate, and that it was voluntary because no one was forced to connect to the extension.
2. It is unclear whether all three parts of the *Bolt* test must be satisfied in order for a proposed user fee to be valid.

In *Graham*, the Court of Appeals seemed to suggest that all three tests did not have to be satisfied, while Justice Corrigan of the Supreme Court, in a concurring opinion in *Duverney v. Big Creek – Mentor Utility Authority*, suggests that a user fee will only be invalid under Headlee if the fee fails to satisfy all three tests in *Bolt*, not just one of them. As a concurring opinion, Justice Corrigan’s opinion does not have the force of law, and there has been no further guidance as to whether the burden is on the challenger to a user fee to establish that none of the three tests has been satisfied or on the unit of government imposing the fee to establish that all three tests have been met. This lack of guidance is unsettling, because if all three tests have to be met, then the following issues arise:

- **Voluntary test** – This is a difficult test to satisfy when a local government has the power under the Public Health Code to require the owner of any building to connect to an available public sanitary sewer system. Ratepayers cannot avoid paying for services when they can be compelled to connect to a sewer system.

- **Using the Public Health Code** as in the example above demonstrates that the regulatory test and the voluntary test appear to be in conflict.

- **The proportionate to the necessary cost of service test** raises questions as to what costs may be included in the fee to reflect the necessary costs of the use of the utility (i.e., capital costs, reserves, sinking funds). In addition, user fees may not be used to fully amortize projects having a useful service life substantially greater than the amortization period. Therefore, the question also arises as to whether *Bolt* permits rates to be used to pay a portion of the bond issue for projects with longer lives in an amount commensurate with the decline of the project’s useful service life, with general revenues or a millage used to pay the balance.

If a purported user fee is determined by a court to be a tax, taxpayers within the municipality that imposed the fee could be liable to refund the fees collected. And, in the case of a city, if the fee is determined to be a tax, there are no provisions in Michigan law for the city to seek voter approval for such fees to raise revenues to cover the expenses of the utility.

**Other Local Fees.** In addition to serving as the basis for challenging the validity of fees charged by local government utilities, *Bolt* has also served as the basis for other challenges to the ability of local governments to charge fees for what traditionally have been viewed as governmental functions. Examples include: (1) a township challenge to a per diem fee imposed by a county to house township ordinance violators at the county jail; (2) a challenge to fees imposed by a city for building inspections performed in accordance with the Michigan Housing Act; (3) a challenge to a fee imposed by a township for photocopying charges because the cost exceeded the cost of producing copies; (4) a county challenge to a township imposing special assessments on all property within the township to the effect that the special assessments were a tax because the basis of the special assessments was the assessed value of the property; and (5) challenges by cable subscribers to franchise fees imposed by local governments on cable operators that are passed on to the subscribers.

Even though the *Bolt* challenges were rejected by the courts in each of the foregoing examples, the fact that they were litigated suggests that *Bolt* will continue to provide the basis for challenges to fee-based services that local governments provide to their citizens.

**State of Michigan Fees.** Contrary to common perception, the impact of *Bolt* transcends the use of fees by local governments and includes the State of Michigan. *Bolt* principles have already been argued in cases...
against the state, as plaintiffs have used the theories of *Bolt* as a tool for challenging state fees. While some examples are provided below, they only represent activity to-date. There is no reason to believe that, absent clarifying public policy, numerous other cases will not emerge. This is especially true considering the state’s increasing reliance on fees as a means to generate revenue to cover the costs of state services for activities that range from environmental protection to park management to professional licensing. Many of these activities were previously financed out of the general fund.

Several trucking companies challenged fees charged by the Michigan Public Service Commission pursuant to the Motor Carrier Act, a $100 fee to motor carriers for each application for a certificate of authority or permit to operate on an interstate basis and a $100 fee per vehicle for the administration of the act. The Court of Appeals found that the fees were regulatory, roughly proportional to the services they regulate, and that the certificate fee was voluntary while the administrative fee was mandatory, and accordingly, that the fees were not disguised taxes.

Another challenge at the state level was brought by private nursing home operators that were required to pay a mandatory fee on a per-bed, per-day basis. The purpose of the fee was to increase federal Medicaid matching funds, but nursing homes required to pay the fee that did not participate in Medicaid would not receive reimbursement. The Ingham County Circuit Court held that the fee was in fact a tax, because it was not used to regulate nursing homes, it was not voluntary, and it could not be proportionate to the cost of the services to which it related. This example is important because it demonstrates the willingness of a court to give *Bolt* an expansive reading and extend the tests for a valid fee outside the context of the Headlee Amendment to the state. This is at a time when fees are an ever increasing source of revenue for the state to provide services. Each year, many decreases in the general fund have been offset with increases in state imposed fees.

Given the breadth of the *Bolt* decision, there is no reason to believe that challenges to fees will subside. If a local fee is determined to be a tax, then the remedy would have to be some sort of voter approval to levy taxes for the purpose intended or divert other available revenues for such purpose. If a state fee is found to be a tax, then the remedy would involve asking the legislature to treat the fee as a tax and then follow the appropriate tax-enactment procedures.

**Options for Moving Forward**

Because *Bolt* rests on an interpretation of the Michigan Constitution, the principles announced in the case cannot be reversed by the legislature. Nonetheless, there is a need to identify and evaluate the merits of alternatives that, if implemented, would reinforce the legitimacy of using fees and clarify the circumstances under which fees are an appropriate option. Fiscal responsibility and discipline would be enhanced, some more certainty would be gained, and the risks that local governments or the state faces when charging fees for governmental services would be reduced. A brief general description of options to help initiate that policy development and evaluation process follows.

1. Amend the Michigan Constitution. Proposed amendments to the state constitution can originate either from the legislature or citizen petition. However, an attempt to amend the constitution is costly and time consuming. And, proposing constitutional amendments to resolve issues of concern should be limited to rare circumstances. In fact, the legislature has major responsibility for fiscal policy and could be very helpful in resolving the concerns raised in this report.
2. Work with Michigan Legislature in securing legislation that specifically authorizes the use of fees to fund essential government services and accomplishes the following:

   a. Reduces the uncertainty of fees as an option for funding essential services;

   b. Requires fees to be calculated in accordance with accepted accounting and rate-making principles;

   c. Recognizes that fees can be used to raise revenues sufficient to cover the true (complete) cost of providing the service; and

   d. Clarifies that the imposition of fees by local governments for essential services in the exercise of police powers or in complying with federal and state laws and rules constitutes a regulatory purpose.
Appendix A: Taxes, Special Assessments, and Fees

Local governments have three basic means of raising revenues – taxes, special assessments, and fees. Local governments’ power to tax is limited to those taxes expressly authorized by constitution or statute. Local government taxing authority is primarily limited to ad valorem taxes on real and personal property and to personal income tax. The rate of these taxes is also limited by statute. In general, local governments do not have the authority to tax on any other basis and cannot impose a sales tax or a tax on consumption like state and federal taxes on gasoline. Thus, a local government does not have the authority to impose a tax on sewer or water use in order to pay for providing those services. Taxes may be imposed to raise revenues for general governmental purposes or for specific projects or objects. The Headlee Amendment requires a local vote of approval for any tax not authorized by law at the time the amendment was enacted. In addition, some authorizing statutes also require a local vote before a tax is imposed under certain circumstances.

Special assessments are assessments imposed on real property which benefits especially from a government expenditure or service. Special assessments are limited in amount to no more than the increase in value which the real property gains because of the expenditure. Local street and sewer projects are often paid for by special assessments on the real property served by the street or sewer.

Fees are charges for services offered or carried out pursuant to a local government’s “police” power, meaning government’s authority to undertake or regulate actions to promote public health, safety, and welfare. Building inspection fees paid for city building inspection services conducted as a part of the city’s program to maintain safe housing are one example of a fee. The Bolin decision, together with many other court decisions, puts bounds on the circumstances under which a local government can impose a valid fee. Because fees are the most common method in Michigan for financing the provision of safe drinking water and sewerage services, any changes in the law which affect how a local government can impose a fee are of great import to both a local government and its residents.