

# Chapter 5

## Options for FSIS

FSIS faces a complicated regulatory task. The more than 6,000 Federally inspected establishments perform different functions. At the broadest level, one must distinguish between plants that slaughter live animals from those that process meat that has been slaughtered elsewhere. Slaughter plants typically specialize by species, with cattle, hogs, chickens, and turkeys being the primary (but certainly not the only) species. Plants also vary by size, with the largest plants operating two shifts per day, while many smaller plants operate on irregular schedules. Inspection tasks and the costs that they impose on FSIS typically vary with plant characteristics of function, species, and size. Moreover, FSIS spends money on tasks other than meat-plant inspection, including import and egg products inspection, diagnostic testing, standard setting, and label review. An inclusive system of user fees needs to recover costs for all agency activities, and an effective system of fees needs to be sensitive to how inspection costs vary with plant function, species mix, and size.

### Fee Structures

In principle, FSIS could base fees on one or more of a variety of measurement bases. FSIS could base fees on:

- an hourly fee, based on an hourly rate for inspection time;
- a volume fee, based on production volume, such as pounds of inspected meat;
- a value fee, based on gross plant sales or on plant employment;
- a service fee, based on rates specified for each specific task; and
- an annual license fee, which could vary with the size (sales or employment) of the plant.

### Information Requirements

Each of these fee bases has different information requirements, and FSIS does not have the necessary information for all of them. Currently, FSIS can reliably identify the amount of time spent in inspection tasks at different plants. The agency also maintains reliable information on carcasses and carcass weights at slaughter plants. This information is collected by FSIS during inspection operations; each piece of information is easy to measure and difficult for plants to manipulate.

Other USDA agencies currently charge fees for laboratory services. If FSIS does not now develop cost estimates for the time, materials, and equipment used in laboratory tasks, the agency could do so in the future without great difficulty.

The same cannot be said for measures of employment and plant sales. Neither is collected as part of normal FSIS inspection operations. FSIS does not have precise measures of plant employment or sales but rather obtains estimates from a consultant. Plant employment estimates (approximate in that a range is reported) are routinely collected and published by private sector marketing services firms that carry out their own surveys. Those firms then estimate sales figures by multiplying estimated employment by average sales per worker in the relevant industry; average sales measures are derived from U.S. Census data. The resulting employment estimate is quite approximate, and the sales estimate is more so. Firms whose fees were based on this estimate would have strong incentives to understate or to reduce employment. The incentive to lay off workers would be particularly strong for annual license fees, which typically jump substantially at discrete thresholds, such as 20, 100, or 500 workers. Plants that otherwise would be just over a threshold would face very strong incentives to restrict output and employment to get under the threshold and thereby reduce fee payments.

### Designing a Fee Structure

ERS believes that inspection costs are best recovered through an hourly fee based on an hourly rate applied to inspection hours. Experience in other agencies, other countries, and in current FSIS user fees (for overtime) suggests that this approach is feasible. Given the information available to FSIS, an hourly-based fee best reflects the costs to FSIS of conducting inspection services. Fees that are cost-based are easier to defend to industry representatives and to government oversight agencies. Fees based on the costs of providing services can allow the agency to operate more efficiently because they lead the agency to develop detailed information relating costs to agency actions. Fees can improve efficiency indirectly when they induce firms to use inspection resources in low-cost ways.

If hourly fees are to reflect costs, the agency will need to develop hourly rates that vary with costs. Fees should be adjusted for differences in time of day and day of week, plant location, inspection skills required, and volume commitments if these allow the agency to operate with less inspector downtime. Fees should reflect the full costs of providing inspection services. In addition to inspector wages, fees also should reflect benefits, travel and downtime, inspector training, report writing, review actions, and the costs of supervisory staff.

Ideally, hourly fees would be designed to recover only the costs associated with plant inspection. Separate charges could be developed for testing and consulting services and for agency overhead. Hourly fees do not have to be based on actual hours at the plant, especially if there is concern that such a basis could generate unnecessary conflicts between inspectors and plant managers. Fees could instead be prospectively based on typical hours and tasks for a plant of the type being inspected. Those fees would require a substantial agency investment in information systems.

Although overhead costs, to the extent that they are not directly related to inspection actions, can be recovered through add-ons to hourly charges, the process could lead to some disincentive effects. Instead, overhead could be recovered through charges on volume or through per-plant registration fees. Volume fees are likely to be small enough to avoid any disincentives, and the agency maintains reasonably good information on measures of slaughter volume. If the agency incurs costs associated with plant registration and record keeping, it may improve efficiency by imposing annual plant fees that reflect those costs. However, because of the extremely wide range of plant sizes in the meat sector and the very large number of small plants, FSIS should be alert to the possibility that fixed plant fees will introduce disincentive effects: plants might close because of the fee, or they might choose to downsize or to hide the truth to avoid paying fixed fees that vary with plant size.

## **Financial Management**

### *Spending Authority*

The elements of financial management frequently involve choices and often require negotiations. If user fees are to be introduced, FSIS should strive to obtain investment authority over its reserves, even though most

agencies do not have such authority. Investment authority can provide the agency with additional funds of between 1 percent and 6 percent of annual fee revenue depending on interest rates and the amount of money retained in reserve accounts.

Spending authority matters. At the very least, the agency must obtain the authority to spend fee revenue; without that, the fees simply go to general revenues and fail to benefit the agency, the industry, or the consumer. The agency should also aim to gain spending authority that is as unencumbered as possible because restrictions make agency planning more difficult.

### *Reserve Funds*

FSIS will need to set goals for reserves based on its accrued liabilities and an estimate of the likelihood of paying those liabilities. In principle, FSIS would be responsible for the total cost of employee accrued liabilities, including the value of accrued leave balances, workers' compensation payment liabilities, shut-down costs for office closures, severance pay, and unemployment costs. However, when individual offices close or when programs are downsized, some employees quickly find other employment. As they leave, their accrued liabilities also leave. In setting a goal for reserve balances, this difference between accrued liabilities and actual payments made must be estimated to avoid setting reserve balance goals higher than necessary. The reserve balance goal should also consider variations in revenues collected relative to outlays. Shortfalls are likely to occur in years when animal slaughter and meat consumption are relatively low. In such cases plants will use fewer inspector hours and tests than normal, and user-fee revenues would fall below expected amounts. Because animal slaughter in the United States does not vary much from year to year, FSIS is unlikely to require a reserve as large as a year's outlays, but is more likely to be able to operate with a much smaller reserve balance to cover variations in revenues collected.

Reserves can be built up from two sources: through appropriations that are specifically designated for reserve accounts at the time that a user-fee system is introduced or by setting charges that yield revenues in excess of outlays early in the application of a fee system. A mixed approach would leave agency overhead, including pensions and fringe benefits, to be financed through annual appropriations. If fees are to cover only expenses that are closely tied to industry production, the

agency would require a smaller reserve balance, regardless of how it was financed.

The actual design of reserve funds is important. Some agencies use designated trust funds as sources of reserve balances. Others are able to hold reserve balances in designated Treasury accounts. If an agency is allowed to keep fees collected to finance operations, it must quickly establish adequate reserve balances.

### *Fee Adjustment*

Over time, FSIS expenses will change as inflation raises the costs of inspection and the costs of equipment and materials used in FSIS operations. The agency will need to determine an effective fee-adjustment mechanism when a user-fee system is first authorized. FSIS should resist statutory fee setting because adjustment will then require statutory action. Instead, FSIS should aim for statutory authority to set fees, while leaving the actual design of fees to the rulemaking process. The agency also should set fees for several years in a single rulemaking, a step that is more feasible in an atmosphere of low and predictable inflation. If the agency can set fees for several years at a time, it can limit its own resources spent on rulemaking, and it can provide firms with the necessary information for longer term planning.

## **Incentive Concerns**

### *Avoiding Gaming*

FSIS-regulated establishments can be classified into such different interest groupings as slaughter vs. processing, large vs. small, or red meat vs. poultry. Once a user-fee system is in place, USDA and FSIS should expect frequent proposals for amendment from interest groups and Congress. FSIS can limit gaming and can limit its own exposure to the costs of gaming by designing an original system that is based, as much as possible, on the costs of inspection. By creating a system based on costs, the agency can avoid being charged with arbitrary decisions. The agency also can set a standard for interest groups to follow: interest groups must provide proposals that are cost-based or offer strong reasons to depart from costs if the proposals are to be taken seriously. Such a rule will allow the agency to limit its own expenditure of management resources in debates over fee structures.

### *Avoiding Plant Closures and Layoffs*

Fees that are applied to all plants and that are based on incremental inspection costs will impose small per pound costs on plants; plants are unlikely to close or to alter their operations because of such fees. But some types of fees could have important effects.

In some user-fee proposals, FSIS has suggested issuing licenses. To raise significant amounts of money, the license charges would have to be fairly large. Fees would have to be based on plant size and set at low levels for small plants, then rising to significant amounts—more than \$500,000 for the largest plants—to prevent small plants from closing. Such a system, however, would likely create incentive effects for plants near any breakpoint. A plant just below a breakpoint would have strong incentives to avoid expansion if it entailed a large increase in license fees. The problem for FSIS would then be threefold: the user-fee system would unnecessarily distort firms' decisions to produce meat, some firms would complain that FSIS was keeping them from expanding, and some firms would have strong incentives to misreport output if that would limit their fees.

### *Encouraging Testing, Training, and Diagnostic Services*

FSIS performs some functions not required by law, such as some voluntary testing procedures, advice, and training; it may offer substantially more in the future under HACCP rules. Functions not required by statute may be sensitive to price. Firms may decide not to use them if a fee is charged. If those price-sensitive functions also have public health benefits, then the imposition of user fees may reduce public health benefits.

The agency needs to identify any specific functions that may be sensitive to prices—that is, for which the volume of services used can be expected to vary with the size of the user fee. It then needs to decide which of those functions generate significant benefits to the public that are beyond any benefits to direct payers. Those functions that generate public benefits and are sensitive to prices may be harmed by user fees, and the agency could provide incentives for the use of those services by limiting fees or by providing them at no charge. It could then recover costs through appropriations or through overhead charges.