Bringing Home the Bacon
China’s WH Group Buys Virginia’s Smithfield Foods

Last September, shareholders of Virginia-based Smithfield Foods, the United States’ largest pork producer, approved the company’s purchase by the Chinese company WH Group for $4.7 billion.

The deal valued Smithfield at $7.1 billion taking into account assumed debt. Shareholders received $34 per share, a 31 percent premium over the closing price the day before the purchase was announced in May. The acquisition was the biggest purchase ever of an American company by a Chinese company.

WH Group, a holding company that also owns China’s largest meat processor, purchased Smithfield primarily to gain access to a reliable source of imports. Pork accounts for more than three-quarters of China’s meat consumption, and demand has multiplied as more people move into the middle class. But the country’s farm system is fragmented and inefficient, and processors have struggled to keep pace. At the same time, Chinese consumers are increasingly wary of Chinese brands after a history of food safety scandals, including the discovery of the illegal additive clenbuterol in the pork of a WH Group subsidiary.

The purchase is also part of WH Group’s efforts to appeal to global investors, as was a name change in January from Shuanghui International. WH Group is currently owned by an assortment of private equity firms, including the private equity arm of Goldman Sachs, but the company started taking orders for a $5.3 billion initial public offering in mid-April. The IPO will be the largest in Asia since Japan Airlines raised $8.3 billion in September 2012.

For Smithfield, the deal is an opportunity to keep growing despite a stagnant domestic market. Total U.S. pork consumption has been flat for the past three decades as per capita consumption has steadily declined. “China is the fastest-growing and largest overseas market,” Smithfield CEO Larry Pope said in a statement. “Increasing our sales to China is central to our growth strategy.”

American pig farmers also stand to benefit from increased exports; the North Carolina Pork Council endorsed the deal for leading to “expanded overseas sales and more opportunities for the thousands of North Carolinians who work in the pork production chain.” North Carolina is the United States’ second-largest pig farming state, with $2.56 billion in sales in 2012.

But some politicians and farmers’ unions are worried about the effects on U.S. food safety, national security, and intellectual property. The Senate Agriculture Committee held a hearing about the merger in July at which senators expressed concern that the purchase could harm the United States’ food supply, or that it was a ploy by WH Group to appropriate Smithfield’s expertise and technology in order to encroach on U.S. producers’ share of other export markets.

The acquisition required federal clearance. The Committee on Foreign Investment in the United States (CFIUS), a multi-agency body, reviews proposed foreign takeovers of U.S. companies for their potential national security implications. Both Smithfield and WH Group executives have stated that WH Group will not seek to export Chinese pork to the United States. In addition, WH Group has pledged that it will retain Smithfield’s entire management team, continue to operate all of Smithfield’s facilities, and honor the company’s existing union contracts. CFIUS approved the merger without conditions in early September.

Smithfield Foods got its start in 1936 as a small meat-packing company in Smithfield, Va., the home of “genuine Smithfield hams.”
Matthew Slaughter, associate dean of Dartmouth's Tuck School of Business, says that the deal is likely to be good for both Smithfield and the economy as a whole. "What often happens is that when a U.S. company is acquired by a foreign company, the foreign company's connections and expertise in other parts of the world will help pull exports from America," he explains.

And more generally, Slaughter says, foreign direct investment can lead to higher productivity and wages in the receiving country. "The preponderance of evidence for the United States and many other countries shows that on net, cross-border foreign investment generates large benefits for the countries that are involved, and for a lot of the workers that are involved too."

Some Smithfield workers are nervous about the change, but so far it appears to be business as usual. WH Group's chairman and CEO visited Smithfield's headquarters on their first official day as owners, which happened to be employee appreciation day. While the executives toured the facility, their new employees ate burgers and barbecue (pork, of course) on the lawn outside.

—JESSIE ROMERO

When Hurricane Betsy hit Louisiana in 1965, it flooded thousands of homes and caused $1.5 billion in damage ($11.1 billion in today's dollars). In the aftermath, Congress created the National Flood Insurance Program (NFIP). Today the NFIP covers about 5.6 million participants and insures $1.29 trillion in assets. Almost exactly 40 years after Betsy, when Hurricane Katrina slammed the Gulf Coast, the NFIP was available to insure homeowners — but claims from Katrina and subsequent storms like Hurricane Sandy left the fund more than $20 billion underwater. To make up the deficit, Congress passed the Biggert-Waters Flood Insurance Reform Act of 2012, which began phasing out subsidized flood insurance rates in 2013.

Subsidies were seen as necessary to encourage participation early in the NFIP's history. They applied largely to properties constructed before the creation of a national flood insurance rate map in 1974. Properties that were later remapped into higher-risk flood zones could also be "grandfathered" into lower rates if they had been built using the best practices at the time. As a result, about 20 percent of NFIP policyholders receive some form of subsidy. By raising these rates to reflect current flood risks, Congress hoped to put the program back on solid financial footing. But affected homeowners balked at the costs.

“It has had a tremendous impact," says Tomp Litchfield, president of the North Carolina Association of Realtors. "I have seen rates in our area go up by anywhere from 50 percent to well over 100 percent, or in some cases 200 percent."

Some homeowners reported rate increases of more than $20,000 a year. These sudden increases trapped residents, making their longtime homes both unaffordable and unsellable. Litchfield says he has seen several home sales fall through because of the uncertainty surrounding flood insurance rates. In response to public outcry, the Senate and House passed legislation to limit yearly increases. President Obama signed the bill in March.

The fiscal challenges currently facing the NFIP have been anticipated since its inception, according to Erwann Michel-Kerjan, executive director of the Risk Management and Decision Processes Center at the University of Pennsylvania's Wharton School of Business. In a 2010 *Journal of Economic Perspectives* article, Michel-Kerjan wrote that the NFIP was "designed to be financially self-supporting, or close to it, most of the time, but cannot handle extreme financial catastrophes by itself."

A key problem in providing flood insurance is that the risks are highly correlated. In other insurance markets, such as health or auto, the burden of risk can be spread across a wide geographic area and
varying risk profiles, making it unlikely that all policyholders will face catastrophic risks at the same time. (See “Risky Business?,” p. 14.) But only homeowners in flood zones are likely to purchase flood insurance, and catastrophic events, if they occur, are likely to affect a large portion of policyholders at the same time, placing a significant financial burden on the insurer.

Raising rates to reflect true flood risks can mitigate the financial risk to the insurer, as well as address another problem: moral hazard. Insuring against consequences can encourage greater risk-taking, and subsidies increase this danger by further isolating policyholders from the costs of risky behavior. In the case of flood insurance, subsidies may encourage overbuilding in flood-prone areas. Indeed, only about 1 percent of insured properties are classified as “repetitive-loss properties” by FEMA, but nearly all of them pay subsidized flood insurance rates, and they have accounted for roughly a quarter of all claim payments between 1978 and 2008. About 10 percent of these repetitive-loss properties have cumulative flood insurance claims that exceed the value of the property itself.

In a 2013 report, the Government Accountability Office (GAO) noted that even if the NFIP’s debt were forgiven, rates would need to increase “significantly” to build up a reserve fund for future catastrophes.

“The financial reforms included in the [Biggert-Waters Act] could go a long way toward reducing the financial exposure created by the program,” the GAO concluded.

—Tim Sablik

Making Amends
NC Offers Payments to Victims of Its Eugenics Program

North Carolina is now collecting claims from victims of its 48-year forced sterilization program. The gathering of claims is part of a $10 million compensation plan signed into law by Gov. Pat McCrory last July. North Carolina is the first state to offer compensation to victims of such programs.

About 7,600 men and women were sterilized under North Carolina’s program, which ran from 1929 to 1977, with the last victims sterilized in 1974. The state authorized the practice for “any mentally diseased, feebleminded or epileptic inmate or patient” in a public institution; in addition, social workers could petition for the sterilization of members of the public. Sterilization could be done in the best interest of the patient — or “for the public good.” This phrase, combined with vague designations such as “feebleminded,” led to sweeping implementation. Victims included children as young as 10, illiterate teenagers, rape victims, and the poor.

North Carolina was not alone in its implementation of “eugenics” — a widespread movement that believed certain conditions should be eliminated from the population by sterilizing anyone who might pass them on. More than 60,000 people suffered under such programs in 32 states.

Why is North Carolina the only state, thus far, offering compensation? The reason may be very simple — its victims are likely to still be alive. Most states abolished their eugenics practices after World War II, while North Carolina sterilized 70 percent of its victims after 1945. This was partly because in the late 1940s, North Carolina began using sterilization as a way to combat poverty, which led to an increase in victims who did not reside in state institutions.

In 2002, North Carolina became one of the first states to formally apologize for its eugenics program,
and in 2011, a gubernatorial task force on eugenics was created. In 2012, the task force submitted recommendations that became the basis for the final compensation program.

The $10 million will be distributed evenly among all claimants. In order to be eligible, claimants must have been alive on June 30, 2013, and must prove they were involuntarily sterilized by the state (including minors and incompetent adults who were sterilized with parental/guardian consent). The N.C. Office of Justice for Sterilization Victims was created to assist with this process. All claims must be received by June 30, 2014, with payments expected to be made on June 30, 2015.

Information packets were mailed to 800 potential claimants in November, though public information officer Chris Mears says it is still too early to estimate how many will file claims. According to a Washington Post article in December, unnamed state officials estimated around 200 claimants, which would mean a one-time, tax-free payment of $50,000 per person.

—Lisa Kenney

Lowering the Bar for Beauticians
SC Weighs Proposal to Reduce Cosmetology Training

In South Carolina, it takes 1,500 hours of training in a state-approved beauty school to become a licensed cosmetologist. It takes only 200 hours of training to become an emergency medical technician.

The state’s Department of Labor, Licensing and Regulation (DLLR) compared those requirements in late 2013 after Gov. Nikki Haley asked state agencies to evaluate the effects of their rules and regulations on economic growth. Among many recommendations that emerged from that review, the DLLR stated that South Carolina should reduce the hours of training required to become a licensed cosmetologist. The DLLR supported its recommendation by making a classic barriers-to-entry argument: Reducing the required training would improve economic development by making it easier and cheaper for people to obtain jobs as cosmetologists. According to testimony by industry representatives before a state legislative subcommittee, students must spend $16,000 to $20,000 to obtain the necessary training.

Economists have long hypothesized that trade and professional associations lobby for licensing regulations to erect occupational barriers to entry. These barriers raise wages for licensed providers, primarily by limiting competition and improving quality.

In a 2009 study, economists Morris Kleiner of the University of Minnesota and Alan Krueger of Princeton University attempted to measure the influence of occupational licensing on the labor market. They agreed that occupational licensing “serves as a means to enforce entry barriers.” They further found that licensing in the United States is associated with wages that are about 14 percent higher for workers who are licensed.

Kleiner and Krueger also noted that licensing laws have proliferated significantly since 1950. According to the Council of State Governments, state licensing laws covered less than 5 percent of U.S. workers in the early 1950s. That share increased to at least 20 percent by 2000, according to data from the Census Bureau and the Department of Labor. In a combined measure of all government licensing, a Westat survey found that approximately 29 percent of U.S. workers needed licenses to hold their jobs in 2008.

“The occupational association has a significant ability to influence legislation and its administration, especially when opposition to regulatory legislation is absent or minimal,” they wrote. Today, most states’ licensing requirements for cosmetologists are similar to those in South Carolina. Cosmetologists and owners of beauty schools have convinced state governments that these requirements are necessary to protect the public, but the DLLR disagrees.

“Most people style their own hair every day and commercial hair dyes are sold to the public for home use,” the DLLR noted in its report to Haley’s Regulatory Review Task Force. “Nail technicians essentially paint fingernails and toenails and apply artificial nails. Estheticians practice skin care. These are functions that many people perform at home without any training.”

The South Carolina Association of Cosmetology Schools did not accept invitations to comment for this article.

—Karl Rhodes