Currents

The Abuse of Power (Continued)

Somewhat below the level of public awareness, our government is engaged in a continued abuse of its trade and regulatory powers. Two recent initiatives by the Clinton administration should provoke outrage in any thoughtful uninterested party.

Leaning on the Japanese

Current negotiations on a new "framework" arrangement for U.S.-Japanese auto trade are expected to be completed in February. The terms of that arrangement, as proposed by the U.S. government, are entirely unilateral, grossly discriminatory, and would be illegal under U.S. law. The government of Japan, for example, is expected to issue "guidance" to the Japanese auto companies producing in the United States to

- increase their U.S. expenditures for research and development, design, and engineering;
- submit projections of their purchase of auto parts for 1995 and subsequent years; and
- increase their purchase of U.S. auto parts, "with special consideration for non-Japanese U.S. auto parts."

The last provision is especially egregious, because it would force the Japanese transplant companies to discriminate among U.S.-based producers of auto parts on the basis of the nationality of the company's owners. Other U.S.-based auto companies, whether U.S.- or European-owned, would not be subject to the same requirement. This is a gross violation of the national treatment standard embodied in all other U.S. trade and investment agreements and of our general commitment to not discriminate on the basis of race.

Under other terms of the proposed arrangement, the government of Japan is expected to "actively facilitate and support" the purchase of foreign-produced automobiles and parts by promotional notices and seminars, changes in their tax code, regulations affecting auto repair and parts certification, and antitrust enforcement; and by "guidance" to Japanese auto manufacturers, dealers, and repair shops. Our government, in summary, is demanding that the Japanese government "guide" Japanese firms to achieve U.S.-specified outcomes. All, of course, in the name of fair trade.

Fifteen years ago, the primary policy position of the major U.S. automakers could be summarized as, "If the Japanese want to sell in our market, they should build cars in the United States—the way we do in Europe." The major Japanese auto companies, in response to U.S. trade pressure and a stronger yen, invested billions of dollars and employed over 100,000 Americans in their substantial transplant manufacturing base in the United States. A major additional benefit of that Japanese investment has been to prove that American labor, operating under American taxes and regulations, can build autos that are competitive across the whole product line. Moreover, the Japanese companies have been model corporate citizens in their local communities. In Washington, however, no good deed goes unpunished. The Japanese transplants are now being held hostage to the managed-trade agenda, in gross violation of any standard of fairness, the explicit provisions of international agreements, and U.S. law.

One wonders why the government of Japan agreed to negotiate on the proposed terms of this arrangement. Sooner or later, some Japanese government will "just say no" to such demands. One wonders how outraged Americans would be if some other government made similar demands on our government. Fair trade, like fair games, is a matter of rules, not outcomes. Managed trade, by its nature, is not fair trade.

Leaning on the Banks

Ask yourself: Are banks likely to forgo profits by denying loans to minority applicants who are good credit risks? An affirmative answer to that question is both implausible and without any empirical support. Loan applications by minorities are rejected at a higher rate, but credit risks are also higher among these groups. If banks discriminated against minority applicants on any basis other than a credit risk, however, the *default* rate on loans to minorities would be lower than on other loans. As it turns out, a result that does not surprise economists, there is no evidence that default rates differ significantly by race. In other words, bankers seem to care about the amount, but not the color, of their money.

For many years American banks have been subject to a complex web of regulations, primarily to protect their solvency and, in turn, the solvency of the federal deposit insurance funds. The Clinton administration and the Federal Reserve, however, are now using those regulatory powers for other purposes, one effect of which may be to reduce bank solvency.

In the most disturbing recent case, the Federal Reserve has held up approval of several proposed acquisitions by Shawmut National Corporation pending resolution of a discrimination suit brought by the Justice Department against Shawmut's mortgage company subsidiary. The facts of the case are clear. During the period when the alleged discrimination occurred, Shawmut had an aggressive and effective program to *increase* mortgage lending to minority applicants. Shawmut relaxed its normal lending criteria, substantially reduced the rejection rate on loan applications by minorities, and doubled the amount of new mortgage lending to minorities.

Again, no good deed goes unpunished. Although no private person filed a discrimination complaint, the Justice Department charged Shawmut with discrimination, based on a finding that some loan officers had not been as aggressive as others in approving loans to minority applicants and that Shawmut had no internal review procedure to assure that all loan officers used the same lending criteria. Shawmut agreed to settle that absurd case in order to remove a barrier to the approval of its proposed acquisitions, set aside $1 million as a settlement fee, and worked with the Justice Departments to find some "victims" of the alleged discrimination to share the fee.

The Shawmut case is only the most recent example of a pattern in which the government demands that banks make a certain amount of loans to favored groups as the price of continuing to operate as chartered banks. The consequences of this abuse of regulatory powers are clear and disturbing:

• Some banks will fail for making more bad loans, at a cost to the deposit insurance funds and taxpayers;
• The interest rate on bank loans to borrowers with good credit will increase;
• Some borrowers with the best credit will shift to other financial institutions not subject to bank regulations, increasing the risk to bank portfolios;
• Some banks with the best access to nondeposit credit will drop their bank charters to operate as another type of financial institution not subject to bank regulations; and
• Other groups will seek favored access to credit through bank regulation.

All of that without any evidence that banks are denying loans to minority applicants with acceptable credit risk, without any valid evidence of discrimination.

One wonders whether the Justice Department has any principles of justice based on anything but statistical disparities. One wonders why the Federal Reserve collaborated in the extortion of Shawmut; perhaps to strengthen the administration's support to counter micromanagement of the Fed by Congress. The price of that support, however, appears to be micromanagement by the administration. With friends like that, the Fed doesn't need enemies.

William Niskanen

Dual-Class Stock, Telecommunications, and the SEC

What do TCI, Viacom, the New York Times Company, Comcast, the Washington Post Company, Times Mirror, Nextel Communications, Pulitzer Publishing Company, Affiliated Publications, Media General, Rogers Cantel Mobile Communications, Dow Jones & Company, LDDS Communications, United States Cellular, E.W. Scripps, Westwood One, Infinity Broadcasting, McCaw Cellular, Liberty Media, Vanguard Cellular, Turner Broadcasting, and now even Bell Atlantic have in common? Take a breath. The answer: those companies have capital structures that include multiple classes of common stock, one of which has disparate voting rights or disparate dividend rights, or both.

In the 1980s, the Securities and Exchange Commission (SEC) attempted to force the exchanges to adopt listing standards that would have prohibited member firms from recapitalizing with dual-class stock, leaving exemptions in place for stock dividend issuances and issuances related to business mergers or acquisitions. While the SEC's efforts were struck down in court, the New York Stock Exchange (NYSE) and the National Association of Security Dealers (NASD) nevertheless adopted listing standards that reflected the position of the SEC. Recently, a number of the smaller self-regulatory organizations, such as the Pacific Stock Exchange, have expressed their intention to adopt a restrictive dual-class listing standard of their own. Currently, only the American Stock Exchange expressly permits dual-class recapitalizations by its member firms, a codified version of which has been waiting for SEC approval since 1991.

Practice over Theory

Capital formation does not function uniformly through time or across industries. For example, some projects should be financed with debt, others with equity. In high-tech industries where asset specificity is high (thus limiting the preemptive claims of bondholders), equity becomes the preferred financial instrument. In those same industries where founding entrepreneurs or family ownership groups seek to expand internally or pursue more aggressive acquisition strategies, a dual-class format can offer a strategic advantage over single-class firms. Recent events in telecommunications (currently, the leading area of merger and acquisition activity) are illustrative.

In 1993, the New York Times Company acquired Affiliated Publications, and AT&T acquired McCaw Cellular. In each deal, at least one of the firms involved had a dual-class structure. Turner Broadcasting recently purchased New Line Cinema and Castle Rock Entertainment and is expected to pursue more acquisitions in its attempt to build a major studio. Its dual-class structure enables this acquisitive strategy to proceed without disrupting the current voting positions of key shareholders such as Time Warner and TCI, which have 21 and 23 percent stakes respectively in Turner Broadcasting. Infinity Broadcasting and Westwood One have just agreed to combine their radio network operations. Between the two companies, there are five classes of common stock. In the battle for Paramount Communications, a single-class firm, no less than five of the firms involved have dual-class structures: Viacom, Turner Broadcasting, Liberty Media, Comcast, and TCI. Dual-class use is not confined to U.S. firms. Rogers Communications, which is Canada's National Communications Company, also has a dual-class capital structure as does Swedish telecommunications company Telefon AB L.M. Ericsson.

Visionaries in those industries realized early on that capital structuring could be a key part of their strategic planning. Moreover, they realized that successful firms in high-tech, high-growth, and highly regulated industries would require periodic external financing for internal expansion as well as greater flexibility to engage in strategic acquisitions and consolidations when appropriate. For example, in reaction to the impending Paramount takeover, TCI and Liberty Media have agreed to consolidate only two years after TCI had spun off Liberty Media to calm congressional concern about its power in cable systems and programming. Similarly, LDDS Communications, the fourth largest long-distance communications company in the United States, has been involved in no fewer than 11 acquisitions and three mergers in the last three years. During a seven-month period in 1990-91, cable and wireless firms Rogers Cantell, Adelphia, Comcast, and Nextel took advantage of high public equity valuations and issued almost $700 million worth of limited voting stock.

William J. Baumol and J. Gregory Sidak, in *Toward Competition in Local Telephony*, have proposed that dual-class stock could be used as a means of overcoming regulatory fears of cross-subsidization among telecommunications firms if the line of business restrictions in the Modification of Final Judgment were lifted. The Modification of Final Judgment is the consent decree that broke AT&T into eight separate companies and barred the divested companies from entry into information services, telephone equipment manufacturing, and long-distance services.

And while dual-class structures add flexibility to overall firm decisionmaking, they keep the key decisionmakers (such as John Malone, Bob Magness, or Sumner Redstone) in control of the firm's voting power. That enables firms to take advantage of new developments in technology or changes in regulation faster than single-class rivals whose actions may require a more extended or costly voting process. For example, firms may use limited voting rights stock as means of financing expensive fiber-optic installations, purchasing interests in competitive access providers, or deploying personal communications services. In telecommunications, where technology breakthroughs and court decisions create instantaneous opportunities and challenges, firms demand the dual-class option. The *New York Times*, Dow Jones, the *Washington Post*, E.W. Scripps, and others also use dual-class stock for what might be called editorial integrity.

The exchange-based exemptions to dual-class prohibition, while less often used (most firms use dual-class stock when initially going public), can nevertheless serve important strategic ends. They assume an even greater importance in takeover bids financed with stock. For instance, Bell Atlantic and TCI have utilized one of the above-mentioned NYSE exemptions on dual-class prohibition in the recently announced purchase of TCI. In that all-stock deal, Bell Atlantic, with shareholder approval, will issue a second class of common stock to TCI shareholders. This second class (Class B Bell Atlantic Common Stock) will, for a time, have lower dividend rights although it must be converted into Class A Bell Atlantic Common Stock after five years. Conversely, cable companies such as Century Communications and Continental Cablevision have used limited voting stock in purchases of independent telephone companies.

The justifications offered for the use of dual-class stock are Rawlsian: centralizing control in those receiving the class with the superior voting rights somehow will increase the value of the company and, as a result, will increase the value of the shares with limited voting rights as well. The idea is simple. By giving current management voting power, they will be induced to invest their firm-specific human capital without the fear that future equity-financed expansions will dilute current control positions. For example, family-owned firms such as Comcast use a dual-class structure to promote and protect their original entrepreneurial investment while enabling the firms they manage to access otherwise unavailable capital markets.

Once implemented, a dual-class structure allows holders of super voting stock to diversify away their unsystematic risk in the company by selling shares rather than through horizontal acquisition strategies that improperly diversify the systematic risk associated with stock ownership. Without that added source of capital, risky projects or more vertically integrated acquisitive strategies may go unfunded or be replaced with less risky projects that are inefficient for diversified public shareholders. Yet, even when management groups choose not to engage in subsequent sales of stock, the public shareholders benefit because management has such a large share of their personal wealth riding on the performance of the firm, an idea traditionally championed by organized shareholder groups.

Empirical evidence supports that theory. For example, research has found that firms undergoing dual-class recapitalizations have higher growth rates both pre- and post-recapitalization; significantly higher sales and advertising expenses; significantly higher market-to-book ratios; and significantly lower pre-transaction tax liabilities than firms which than have undergone an leveraged buyout. Dual-class firms have also been found to increase capital expenditures post-transaction significantly more than do firms that went through leveraged buyouts.

Conversely, the justifications for more prohibitory listing standards offered by the SEC are grounded in traditional shareholder passivity theory whereby shareholders' powerlessness is held to be an inevitable result of the diffusion of ownership. Another explanation maintains that dominant shareholders coerce a wealth transfer from public shareholders to themselves by bundling what is thought to be a wealth-decreasing transaction with an unrelated proposal that shareholders may independently desire (e.g., an incremental dividend increase). For those reasons the SEC has attempted to deny shareholders the opportunity to vote on dual-class recapitalizations. However, as A.A. Sommer, Jr., a former commissioner of the SEC, has noted about the current SEC position, "It all smacks of Central American democracy: if you don't like the results of the election, stop having the elections." In fact, many of the rules the SEC has formulated have caused shareholders to undervalue their voting rights.

In the short time since those positions were formulated, corporate governance and corporate finance have changed dramatically. More specifically, recent innovations in financial instruments and the increasing activism of institutional investors have necessitated a reevaluation of restrictive listing standards and the SEC's one share, one vote perspective.

Institutional Investors

The influence that institutional investors have on corporate management is now well documented. Notwithstanding recent short-term declines in the share of U.S. equity instruments held by institutional investors, institutions still remain the dominant owners of many Fortune 500 companies, and hold more than 48 percent of all U.S. stocks. A recent survey conducted by Carolyn Kay Brancato noted that as recently as 1980, institutions owned only one-third of U.S. equities. In the early 1960s, the percentage was in the teens.

Forsaking the "Wall Street Rule" (selling shares to express dissatisfaction), large security holder activity has taken the form of "voice" rather than "exit." Because the diversification associated with large stockholdings creates economies of scale in monitoring, institutions are more likely to pay attention to structural issues such as dual-class stock use. That activism comes at a time when the SEC has enabled shareholder groups to coordinate activity more easily. Among institutional investors (public pension funds, corporate pension funds, insurance companies, mutual funds, banks, foundations, and endowments), public pension funds are commonly recognized as the most vocal. And while commentators such as Roberta Romano have correctly noted that public pension funds are not immune to the conflicts that restrict the potency of opposition afforded by other fund subgroups, public funds represent a formidable force in policing managerial misbehavior. A recent survey, called the Brancato report, noted that such funds have bucked the above-mentioned trend and actually increased the equity component of their portfolio from 39.7 percent in 1990 to 47.8 percent in 1992.

Finally, surveys of institutional investors have shown they view dual-class proposals skeptically, indicating that such proposals will be evaluated closely to ensure they are beneficial to more general shareholder interests.

Financial Innovation

As new financial products are introduced into corporate finance to satisfy investors and firms alike, a shift will take place from the traditional focus on optimal levels of debt relative to equity to tinkering with and examining the specific characteristics of individual debt and equity instruments. As common stock is broken down into its economic components, voting rights are expected to become part of the process. Unless constrained by regulation, the optimal division of voting rights will not always involve a traditional one share, one vote split; the optimal number of common share classes will not always be one. For instance, while McCaw and Viacom have two classes of common stock, Times Mirror and Infinity Broadcasting have three, and AT&T and Time Warner have one.

Because the success of an exchange ultimately depends on the amount of trading that takes place, exchanges have incentives to adopt rules that benefit investors. Exchanges operate in a competitive environment, and competition among organized exchanges, as well as competition between exchange securities and other ways to invest wealth, provide additional incentives for exchange rules that benefit investors and the overall cost of capital of member firms. The result is that over the long term, exchanges will engage in a "race to the top" to provide standards and rules that enhance shareholder welfare.

Dual-class use in an era of vertical integration, whirlwind decisionmaking, and increasingly competitive industries should be perceived as an expression of discontent by corporate financiers and entrepreneurs with traditional capital structuring methods and the restrictions those methods impose on decisionmaking and risk-taking. With all the benefits it has to offer, and with the protections in place to deter its misuse, shouldn't dual-class stock be an option for all of the nation's listed companies? Let's hope the SEC thinks so.

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The Disappointments of Affirmative Action: Reputational and Other Effects

Affirmative action programs are based on a simple concept: those who have been discriminated against in the past should be compensated for their losses through positive discrimination now, thereby creating a competitive environment that is equitable over the long run. It has been almost three decades since affirmative action was adopted in U.S. higher education and across much of the business world, and there is broad unhappiness with its results. Minorities feel that they have not benefited sufficiently and demand more, while many others feel that affirmative action is a failed policy that should be abandoned or scaled back. How can a policy that was so well intentioned and that was expected to be so helpful have created such discord?

In attempting to understand the problems of affirmative action, it may be useful to begin with two observations:

(1) If institutions are going to discriminate in favor of one group, they must discriminate against another. The number of places in the entering class of a highly competitive college or positions for young lawyers in a firm are limited, so if one group is favored, another must be "disfavored." That group may be Asians, Jews, WASPs, or simply everybody who is not a member of the favored group.

(2) In forming expectations about future abilities and productivity, employers and others will use every bit of information available to them, including information that many people would prefer that they not use.

Those two propositions lead to the argument that affirmative action will often produce results that contradict its intentions because of perverse reputational effects. Attempts to discriminate against a group can partially fail for the same reason.

The possible perverse effects of affirmative action can be illustrated by a brief hypothetical situation: late Saturday night you develop a number of threatening medical symptoms of unknown cause. Your family doctor cannot be reached and you are taken to the emergency room of a local hospital, where you sit in a cubicle waiting for a doctor. A doctor arrives who is a member of a group that is widely known as a major beneficiary of affirmative action programs. What is the first thought to go through your mind? A nurse enters, calls the first doctor away, and another doctor arrives who will actually care for you. He is a member of a group that is known to be discriminated against by medical school admissions offices. Now how do you feel?

The intended beneficiaries of affirmative action can fall into one of four subcategories:

(1) Those accepted because of affirmative action, and who survive, i.e. who graduate, or successfully practice medicine or law;

(2) Those accepted who would have been accepted even without affirmative action;

(3) Those who, despite being members of an affirmative action group, are turned down; and

(4) Those who would have prospered in a less competitive college or profession, are accepted because of affirmative action, and fail, i.e. have to leave college for academic reasons, or are unsuccessful in their profession.

The first group clearly benefits from affirmative action, but its benefits depend in part on society's believing that this group was graded or evaluated on the same basis as others once its members arrived in the college or the profession. Any suspicion that members of this group were given special treatment will reduce the benefits.

The other three groups, in varying degrees, lose. Members of the second group are presumed to be less able than they actually are and suffer a reputational loss, as do members of the third group who have insult added to injury. The losses to the fourth group are more substantial. Attempts by faculties (or employers) to reduce losses to the fourth group often involve the creation of special programs or majors. Such efforts reduce losses to the fourth group at the cost of reducing benefits to the first group and increasing the reputational losses to the second group. Members of the second group can minimize those undesirable effects by avoiding such special programs; for example, major in physics and do not apply for jobs in the community relations department of a company.

Group three absorbs a nasty insult because of affirmative action. If you cannot get into a college or profession despite being a member of a well-known affirmative action group, you and everyone who knows of your rejection are being told that you are a very poor prospect. Three of the four subgroups in the favored category actually lose because of affirmative action.

Long before affirmative action became a policy in this country, these effects could be seen in highly competitive colleges whose admissions offices strongly favored the children of alumni. Although such admissions policies obviously benefited some alumni children, others were harmed. Those who were sufficiently able to have been admitted without such favoritism often found that faculty members and fellow students assumed that they were quite dense unless they could prove otherwise, and the proof had better be convincing. Since such favoritism was well known, any child of an alumnus who was turned down was viewed as a complete dunce, which did not ease the child's relationship with a parent/graduate. The largest losses, however, were imposed on such favored students who would have prospered in a less demanding atmosphere, but who flunked out of a college they could not quite handle. It is not clear that such colleges were doing those students and their families a great favor.

The group being discriminated against because of affirmative action can be divided into three subcategories:

(1) Those who were qualified yet were turned down because of discrimination;

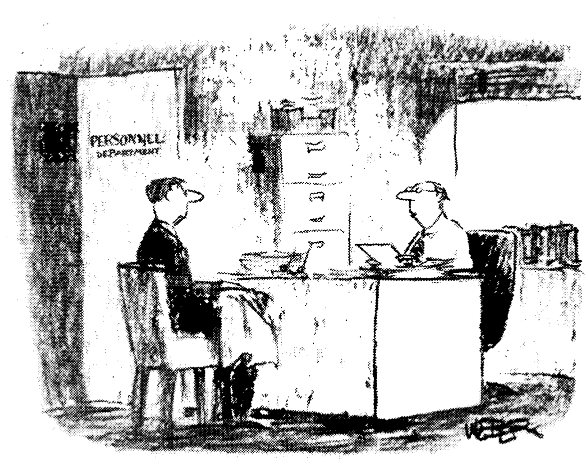
(2) Those who, despite being discriminated against, are accepted into the college or profession; and

(3) Those who are turned down, and would have been turned down even if they were not members of a group that is discriminated against.

The first group clearly loses from being discriminated against, but the second and third groups gain through reputational effects. For the second group, those gains may be sizable. Its members survived a much tougher screening process, and therefore are presumed to be far more able. For the third group, the reputational gain may be minor but helpful. ("Joe would have gotten into that college if he had not been discriminated against," when in fact Joe was a totally unacceptable applicant whatever his group membership. This makes Joe and his parents feel better, because they do not have to face the realities of his academic performance.) Two of the three subgroups within the group discriminated against gain from its reputational effects.

Out of a total of seven subgroups, five are affected perversely, that is, in ways that are the opposite of those intended by the designers of the discriminatory programs. There is no way to measure the number of people in each group or the size of the impacts, but discriminatory programs clearly produce large perverse effects.

How can rational people design discriminatory programs that produce important impacts that are the opposite of what they intend? Perhaps rational is an inappropriate word. More reasonably, this is an example of the Law of Unintended Consequences. When governments or other institutions interfere with market processes, and fail to think very carefully about all of the likely consequences of their actions, they typically face unhappy outcomes. Affirmative action is merely one more application of this iron law.



"We've embarked on a minority-hiring program, and at present we're taking on only people with small, aristocratic feet."

Drawing by Weber; © 1993, The New Yorker Magazine, Inc.

This is not to suggest that affirmative action can simply be abandoned. Colleges and professions have legitimate reasons for preferring diversity, and many still want to help those who have been discriminated against in the past. Affirmative action may be something that is so important that it is worth doing badly. Its undesirable effects, however, need to be minimized. The following policies may work toward that end.

• Do not set quotas for groups. Work on the margin instead, and set a clear range of acceptable grades, etc., for the favored group. Based on experience, colleges should know the lowest SAT scores and high school grades that are acceptable if a student is to have a normal prospect for success without special help or sheltered workshop programs. Do not go below that level of performance in accepting students. Employers should be able to set up similar procedures.

• Do not create special programs for affirmative action groups in order to protect them from normal competitive pressures. The perverse reputational effects of such programs are large and if the suggestions in the previous paragraph have been followed, such programs will be unnecessary.

• Try to focus any publicity about affirmative action narrowly at the favored group. It is important that such programs be known to members of the minority community, so that they will understand that they do have real prospects for success and therefore will be encouraged to work harder in school; but publicizing such programs to the rest of society increases their perverse reputational effects. When members of affirmative action groups noisily demand increased quotas or more favorable treatment, they have apparently not thought about the reputational impacts.

• Remember something our parents told us a long time ago: the road to hell is paved with good intentions. It is not sufficient to intend to solve the problems of past discrimination. Hard thought about what policies will actually succeed is needed, and there has sometimes been a shortage of such thought in the history of affirmative action.

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Fire, Rats, and the Endangered Species Act

Cindy and Andy Domenigoni are fifth generation farmers in Riverside County, California, working a 3,200-acre property first farmed by Andy's great-great grandfather who settled the valley (that is now named after him) in 1879. Their farm has also been home to the Stephens' kangaroo rat, a species the government has listed as endangered since 1988. In compliance with the Endangered Species Act (ESA), the Fish and Wildlife Service (FWS) has prohibited the Domenigonis from farming 800 tillable acres that are considered prime rat habitat.

In 1990, as the Domenigonis were preparing to begin plowing their fields, FWS law enforcement agents and biologists ordered them to stop and warned them that disking their fields would constitute a "taking" of the endangered Stephens' kangaroo rat and they would be arrested. Furthermore, they were cautioned that if they subsequently disked their fields, they would face impoundment of their farm equipment and a year in jail or a $50,000 fine—or both—for each and every act of "taking" an individual rat. And as the FWS considers a taking to mean harassment, harm, digging up a burrow, or plowing under the grass and plants whose seeds the rat eats—almost any action a bureaucrat can conceive of as affecting the rat in any way—the Domenigonis could have been facing life sentences for plowing their 800 acres. (That is what the environmentalists refer to as "sustainable development.")

The Domenigonis have lost $75,000 in forgone crops each season for the past four years—a total loss of $300,000 in gross income—because of the FWS prohibition. They have also incurred another $100,000 in biological consulting fees, legal fees, and associated costs in fighting this regulatory taking of their property and of their livelihood. In addition, they have been prevented from raising crops on other farmland that they leased from local landowners.

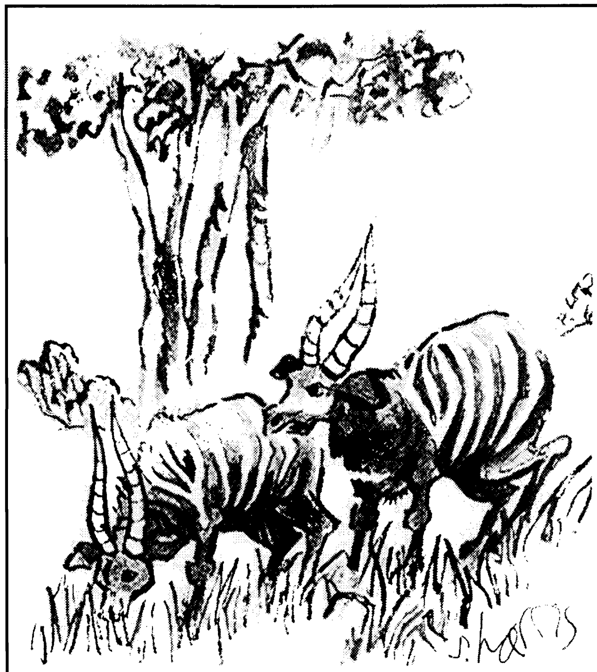
Ironically, on November 1, 1993, shortly after the devastating Southern California fires destroyed thousands of acres of k-rat habitat—as well as human habitat and homes—FWS biologist John Bradley authorized the Domenigonis to plow their fields, having determined that the endangered rats no longer lived in the area. However, it was not because the fires had burned the rat habitat (i.e., the fallow fields) to a crisp, along with the rats. Biologist Bradley said the k-rats had already left the area before the fire because the years of leaving the fields fallow had made the brush and weeds grow too thick for them!

Thus, the ESA regulations directly caused an uncompensated loss to the Domenigonis of close to half a million dollars. Their land had undergone a de facto nationalization by the federal government; they could derive no economic return from it. Yet they were still required to pay property taxes on land deprived of all economic value by government fiat. Furthermore, the government's actions apparently led to the destruction of numbers of the endangered Stephens' kangaroo rat and large areas of its critical habitat.

Some FWS spin doctors are now arguing that the fires helped the rats because they don't like thick brush and now preferred plants will take over. They also point out that there are substantial numbers of unburned seeds in the ashes and debris. However, untold numbers of rats perished in the fire, whether caught out at night or baked in their burrows. While seeds may be present now, the winter rains will soon wash them away and erosion, sedimentation, floods, and mudslides will eradicate still more rats and their burrows. Although they may not prefer thick cover, the absence of any cover will make them more susceptible to predation by birds of prey. There is also the delicate question of what the k-rats will eat until all this new preferred vegetation grows in over the coming years and finally produces seed crops. Will we see a cargo cult of preternaturally intelligent rats gathering on hilltops waiting for FWS airdrops of k-rat chow?

The question has been raised that if the Domenigoni spread, which had been farmed for well over a century, constituted prime Stephens' kangaroo rat habitat, then how bad could farming have been in the first place? Indeed, as soon as the FWS biologists banned farming in the rat habitat, first the rats disappeared because their habitat was no longer any good, and then it all burned to the ground anyway. The k-rat breeds new generations rapidly; perhaps it had little problem adapting to dryland farming, disking, pest control, and all the activities that the Feds prohibited. Considering that the k-rat had existed for countless centuries before Europeans arrived, and had at least coexisted for over a century with ever more modern agricultural technologies, it is highly ironic that the rat vanished after a mere five years of caring federal "protection."

This travesty of justice; this violation of the constitutional rights of American citizens—specifically of the Fifth Amendment's takings clause, which declares "nor shall private property be taken for public use without just compensation;" this destruction of a federally endangered species and its habitat—through the enforcement of the ESA—is repeated over and over with examples of species after species from all across the United States. Yet the environmentalists and the Department of the Interior continue to proclaim the ESA a successful, pragmatic, and wonderful law. That requires a considerable stretch of the imagination. Or as a growing host of critics of the ESA with first-hand knowledge of its workings would attest, it demonstrates that the ESA is accomplishing precisely what it was intended to: the



"The environment people know we're an endangered species, the hunters know we're an endangered species . . . if only the lions knew we're an endangered species."

uncompensated taking of private property and control of economic growth, development, and "urban sprawl" through de facto national land-use control—all without the necessity of paying any form of compensation.

It is possible to have both a free and prosperous society and a sound and healthy environment. Much of American history attests to this. But first it requires secure property rights and positive incentives for landowners. The ESA provides neither and turns the experience and hope of private stewardship from a win-win situation into a lose-lose situation.

The brutal realities of the ESA were exhibited to the entire nation on ABC's *20/20* television news program of Friday, November 19, 1993 (hosted by Hugh Downs and Barbara Walters and reported by John Stossel), where Ms. Anna Klimko, who obeyed the federal government's orders not to create a firebreak by plowing the brush in front of her house because doing so would damage the k-rat's burrows and therefore harm the k-rat, was kneeling in the ashes of her totally destroyed home and dreams, digging for the possible remnants of family keepsakes. Ms. Klimko looked up with tears streaming down her face and asked, "In three minutes, my house was fully consumed in flames and in seven minutes, everything was gone. For what? A rat?"

Perhaps if the fires had actually benefitted the rat, some callous people might even have accepted the tradeoff. But given that it destroyed both people *and* rats, only the radical environmentalist leadership who chant that the earth is overpopulated with humans could have taken solace from that scene.

As comparable stories sweep the country, more and more landowners learn the lesson. Make sure there is nothing on your land that might attract wildlife or rare species. It will merely bring oppressive attention from federal bureaucrats. Once landowners took pride in private stewardship. Developing and maintaining wide hedgerows around their fields might cost them some income in forgone crops; however, it provided wildlife they could enjoy, bird songs at dawn and dusk, and maybe some quail or pheasant to shoot in the fall. But increasingly that has become too risky. Monoculture crops and sterilization of marginal land is more rational. The "shoot, shovel, and shut up syndrome" inspired by the ESA is rapidly becoming the norm.

The extensive media coverage of the devastating California fires, and especially the television coverage, has finally shown urban America what the ESA is all about. They've seen that it harms people and wildlife. Hopefully, at last America is ready to rewrite the ESA so that it accommodates both man *and* beast. At least two critical amendments are necessary.

First, the listing process needs to be addressed to reduce frivolous and unscientific listings and listings patently directed at achieving ends other than helping species, i.e., using the Act to halt development or resource use. Currently, the major way for a species to be taken off the endangered Species List is "original data error," which means that it was subsequently discovered that the species never should have been placed on the list to begin with. Such erroneous listings and corrective delistings represent the squandering of millions of dollars and years of effort in attempting to save something that never required saving. Meanwhile, truly endangered species go down the drain. An amendment should mandate anonymous peer review of listing proposals so an objective panel of scientists would review each listing proposal and comment on whether the scientific evidence is complete and accurate.

Secondly, the Act must be amended to state that no actions mandated by it should take private property or cause a loss of economic use or value of private property without full and just compensation. When the government undertakes actions for the public good, the Constitution requires that private property owners be compensated. Not only will this return justice and equity to the ESA, but with landowners once again secure in their property rights they will no longer have to fear having wildlife habitat or wildlife on their lands and we can return to the era of private stewardship and conservation that predated the Act.

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