
Perspectives

on current developments

“Heavy Landing” for Canadair: A Tale of Industrial Policy

At Britain’s Farnborough air show this fall, a Canadian-made De Havilland “Buffalo” pulled lazily out of a tight turn, pitched suddenly forward and, to the horror of onlookers, slammed into the tarmac, bursting into flame. Luckily, the crew managed to escape unharmed. In the end, what was most memorable about the crash was the official British commentator’s description of it as a “heavy landing.” To many Canadian observers, the incident seemed the perfect metaphor for their government’s involvement in the aerospace industry, which, in recent years, has been characterized by one nonfatal disaster after another—most of them financial, all of them swaddled in official euphemism.

The Canadian aerospace industry is probably best known to Americans for the \$100 million extendible arm (the “Canadarm”) that Spar-Aerospace Ltd. built for the space shuttle. Although the Canadarm was heavily subsidized—the Canadian government presented the first one to NASA free of charge—it at least satisfied a perceptible demand. By contrast, the Canadian government’s two other major forays into the aerospace business have resulted in products that, judging by their sales, nobody seems to want. In the last eight years, two state-owned firms, Canadair Ltd. of Montreal and De Havilland Ltd. of Toronto, have between them consumed more than \$2 billion in public money.

The biggest money-sink has been Canadair, which produces “executive” jets and also does contract work for several major U.S. aerospace firms. Canadair is no stranger to the public sector: founded privately in 1921, it was nationalized during World War II and then denationalized in 1947. In 1976 it was again taken over by the state, after its American owner, General Dynamics, decided to liquidate the

company and no private Canadian buyer could be found. (Canadair’s subcontracting business had been declining since the early 1970s, with the drop in defense spending both at home and in the United States.) The government’s stated objectives in buying the firm were (1) to maintain a Canadian presence in the aerospace industry, (2) to preserve and create high-tech employment, and (3) to stimulate high-tech exports.

These rationales for government intervention are familiar enough to students of “industrial policy” (though, of course, most economists would argue that policy should aim instead at encouraging the use of resources where they will earn the highest returns). In Canada, however, arguments for intervention usually fall on more sympathetic ears than in this country. One reason is many Canadians’ belief that a major difference between the two countries is that Canadians are less afraid of intervention than Americans are. One not atypical popularizer of Canadian history writes that his countrymen are distinguished from Americans by their “respect for authority . . . hunger for security . . . yearning for peace, order, and good, strong government,” and so forth. Thus, many Canadians regard the 300 or so federal and provincial “crown corporations” as expressions of national identity, while Canada’s perpetual insecurity about U.S. cultural and economic domination encourages what has become almost instinctive protectionism. (See Readings, page 72.)

Soon after the bailout, Canadair’s management approached its new owner, the federal minister of industry, trade and commerce, with an ambitious plan to change the company’s mission. Hitherto most of Canadair’s business involved subcontracting on U.S. airliners and military planes. Now it proposed to enter the executive-jet market with its own super-quiet, fuel-efficient wide-body plane. The development costs of this “Challenger,” as the plane was to

be called, were projected at a modest \$106 million; the government would have to fork over, at most, \$128 million, on top of the \$47 million it had paid for the company. It would take just thirty months, Canadair said, to get from design to first sales—just half the industry rule of thumb of five years.

In retrospect, these estimates were spectacularly optimistic. The first Challengers were delivered in 1981, more than two years late; development costs ended up at \$460 million; and the government's cumulative contribution was a whopping \$1.5 billion. Hindsight is always perfect, of course, but even at the time a more sophisticated shareholder than the government almost certainly would have seen that the odds against the scheme were unrealistically high. The plane was an entirely new design, and the company had never before been involved in such a complex drawing-board to runway project. By the mid-1970s its engineering division had declined to 135 employees, which by industry standards is less than a bare-bones operation. A maxim in the industry holds that to develop a new plane is to bet the company; in 1976 Canadair hardly had a company to bet. But the government approved and the project was launched.

Problems arose at virtually every stage of development. The largest subcontractor failed to deliver the plane's engines on time, which prompted Canadair to file a \$100 million lawsuit against it and switch suppliers. The first "600" model of the Challenger failed to meet its promised performance specifications. (The engineers finally succeeded with a later model, the "601," which came on line in 1983.) Once the Challenger did become available, there were further delays in getting it certified for airworthiness. And in 1981, just as production models were finally ready to roll out in earnest, the recession hit, and the executive-jet industry went into a nose dive. (The industry is particularly susceptible to economic downturns: the best predictor of sales is U.S. corporate profits. Yet Canadair was slow to recognize the recession for what it was. As late as June 1981 the company was revising its sales projections upward, even though it had received no new orders for two years.)

These delays were costly in several ways. The company had to finance large inventories by borrowing at very high real interest rates.

And one of the Challenger's major distributors sued Canadair for the financial losses it suffered as a result of the delay, a suit that culminated in an out-of-court settlement whose terms remain secret.

Accounts of the Canadair of the late 1970s give the clear impression that no one or, perhaps worse, too many people were in charge. At the peak of the Challenger program Canadair's 6,000 employees included no fewer than twenty-two vice-presidents, with another five in its U.S. marketing operation. One year the company sent thirty people to the Paris air show. Yet in 1982 the office of the internal auditor listed only one employee.

Many of the company's other practices were also dubious. Canadair went to great lengths to show full order books. Federal Express of Atlanta was able to book twenty-five planes on the strength of a \$250,000 deposit. In at least three cases planes were sold to customers and then immediately leased back by Canadair. And there were other instances of what could safely be characterized as unusual business practices. At one stage, incredibly, several Canadair executives got into the business, aside from their normal duties, of leasing Cessnas to the company for use by its executives.

Although its negative cash flow was enormous, until 1982 Canadair persisted in reporting operating profits. This was the (presumably intended) result of management's extremely aggressive accounting methods, which allowed capitalization of even the softest development costs. The original sales projections for the Challenger turned out to be hopelessly optimistic, of course. Whereas the prospectus called for completion of design by the end of 1976 and first deliveries by late 1978, the first production models were not shipped until 1981, three years late. Thus, while Canadair planned on having delivered a total of 150 planes by mid-1982, only 54 sales had been completed by then.

By 1981 Canadair's financial hemorrhage had become so acute that the government was forced to act. It set a ceiling of \$1.35 billion on guaranteed loans (which by this time were the only kind of loan Canadair could get). Then in late 1982, as sales continued to decline, it directed the Canada Development Investment Corporation (CDIC), a government holding company, to take over.

Where had Canadair's directors been during the debacle? According to a parliamentary committee that recently reported on the Challenger, the directors had trouble getting clear in their own minds whether the program's goal was to make money or to provide some other sort of benefit to the country. They also tended to defer to the government representative on the board, whose dual role, as the parliamentary committee pointed out, could be subject to serious conflicts of interest.

For its part, the federal government seems to have exercised only the most tenuous control over Canadair, apparently content to regard the funds the company was soaking up as the price that had to be paid for a Canadian presence in this high-tech industry. In 1979 the Treasury Board, Canada's equivalent of the U.S. Office of Management and Budget, issued a report criticizing Canadair's sales projections, but with no perceptible effect on its behavior or, it would seem, the government's. The auditor-general of Canada, Kenneth Dye, repeatedly complained about the company's failure to provide Parliament or the public with financial statements (although, in fact, crown corporations are not required to do so under the applicable law). But because the government was guaranteeing Canadair's borrowing with "letters of comfort," which can be granted by the cabinet, there was no occasion for a specific parliamentary appropriation or, more important, for any public scrutiny of the company's books.

Having stepped in to pick up the pieces, CDIC was forced to make drastic cuts. It reorganized the company, cutting the overall work force by 25 percent and reducing the number of vice-presidents to twelve. It commissioned two outside firms to forecast the demand for Challengers and adopted the most conservative of their sales forecasts—fifteen planes a year. It assumed Canadair's debt, a move that should help persuade potential customers the company will be around in the future—always a big problem for a failing enterprise. Most important, it bit the financial bullet and wrote off \$1.1 billion of development costs it judged could never be recovered—the largest corporate write-off in Canadian history.

As a result of these changes, it appears the new Canadair can at least hope to cover the out-of-pocket costs of building planes, although it

obviously can never hope to recoup more than a small fraction of the Challenger's development costs. But generating a positive cash flow may not be enough to keep the company afloat. CDIC has consistently argued that, to be a serious force in their industry, aircraft companies must be prepared to produce several generations of a given model—something Canadair has not committed itself to do. In fact, about the only promise the company has made is that from here on out all investments are to be evaluated and financed on what amounts to a commercial basis: the government will not be asked to fork over more equity financing, though Canadair has not ruled out further borrowings. Of course, if Canadair is to be operated on a commercial basis, an obvious question is why the company belongs in the public sector at all. In fact, there is talk in Ottawa that several commercially oriented crown corporations, including Canadair, are slated for "privatization" by the new Progressive Conservative government.

Some Canadair supporters are unrepentant. The former president of the company, who was relieved of his duties in CDIC's reorganization, argues that the lost \$1.1 billion was well spent. Other witnesses have told the parliamentary oversight committee that research and development create spillover benefits that justify government support—though these benefits are seldom described in any detail. (Whether such hypothetical spillovers remain in Canada—given that most of Canadair's customers and many of its suppliers are foreign—is an open question.) Others say that, after all, other countries subsidize aerospace development by way of defense spending. (Canada does not have much of a defense aerospace program to spin off such by-products.)

There clearly are chastening lessons in the Canadair experience for advocates of "industrial policy," that new cure-all for the economic problems of the 1980s. Not all government enterprises perform as badly as Canadair did, of course. But it takes only one or two Canadairs to offset any gains that a "picking-winners" strategy may create. The Canadair experience also shows that governments are no better equipped than anyone else to judge the likely success of investment projects—and may be worse. They certainly are more likely to ignore the bottom line on a losing project, especially

if giving up would mean firing constituents whom they encouraged to move or acquire new skills in the first place.

In this respect, the new Progressive Conservative movement may not be much different from its predecessors. It would dearly love to consolidate the dramatic political gains it made in the politically crucial province of Quebec in last September's federal election, and, in fact, one of its first acts in office was to offer a \$15 million bailout to a failing Montreal petrochemical firm. Since most of Canadair's employees live in Quebec it is unlikely that the new government, whose minister of finance condemned the Challenger project as ill-advised while in opposition, will withdraw financial assistance even if Canadair is returned to private ownership.

Can Regulation Sweeten the Automotive Lemon?

More than a few consumers have been soured, at one time or another, by the automotive lemon. Legislators and regulators pay close heed to these consumer experiences. Thirty-three states now enforce lemon laws, which typically require dealers to buy back (at a discount) new cars with defects that cannot be fixed within prescribed deadlines and standards.

The federal government's involvement with lemons has been largely confined to the other side of the auto market, the used-car business. In 1981 the Federal Trade Commission promulgated a rule requiring (among other things) that used-car dealers disclose a car's known defects on a window sticker. The rule has had a tortuous history. Congress legislatively "vetoed" it in May 1982, bowing to vigorous opposition from automobile and trade associations. The legislative veto was itself declared unconstitutional by the Supreme Court in June 1983, and a few months later the disclosure rule (which had also been challenged in court on its merits) was remanded to the FTC with its acquiescence for further consideration. Last July, the FTC, by a narrow 3-2 vote, tentatively struck the defect disclosure clause—concluding that it would be ineffective and might even mislead some consumers—and enacted the remainder of the rule once again.

The commission's decision remains highly controversial; attorneys general from forty-one states filed comments supporting the known defects disclosure provision. The FTC, however, can cite new evidence for its decision, in the form of research conducted by Michael Pratt and George Hoffer of Virginia Commonwealth University on the state experience with used-car defect disclosure laws. Pratt and Hoffer's research suggests that there are in fact a disproportionate number of lemons in the used-car market. But they reach the conclusion, not unfamiliar in public policy experience, that none of the regulatory responses appear to do consumers much good.

The case for the "known defects" rule turns on three questions. Is there a problem that the market alone cannot solve? If so, what can regulators do about it? And will their response work?

Both intuition and empirical data suggest that the used-car market attracts lemons. The intuitive argument is straightforward enough; it derives from the asymmetry of information between buyers and sellers. There is often no exterior difference between a "lemon" and an above-average car—what some owners call a "creampuff"—and even if a used-car dealer can tell the difference, most buyers cannot. Thus buyers, including dealers, will tend to offer similar prices for each. But sellers, faced with a less-than-appropriate price gap between lemons and creampuffs, will tend to dump the former and hold on to the latter.

The process feeds on itself, since buyers, aware that the used-car market attracts lemons, discount their bids accordingly, leading sellers to withhold even more average-to-good cars from the market. To compound the problem, of course, sellers can engage in deceptive practices to "doctor" the appearance of used cars—which in the long run causes buyers to discount their bids even further. In a market in which sellers have more information about product quality than buyers, then, bad goods will tend to drive out good. Note that the for-sale-by-owner market for used cars is just as susceptible to the problem as the dealership market.

A number of market mechanisms serve to alleviate these problems. The most visible solutions take the form of dealer guarantees and warranties, which recently have been beefed

up with extended coverage backed by national insurers. Indirectly, dealers invest in brand-name maintenance (local television ads, for instance), which makes it more costly for them to renege on a reputation for quality. The reputation of the parent automakers is also laid on the line. All four domestic car manufacturers have certified the quality of the better used cars sold by their dealers. Two generations of Chevrolet dealers, for example, have designated better used cars with an "OK" stamp of the dealer's confidence in the car's marketability.

Despite these measures, the most widespread view is that the used-car market remains lemon-dominated nevertheless. The available empirical evidence, it should be noted, is not free from doubt. The economists who have examined the market for used pickup trucks, which tends to resemble the used-car market, have come to opposite sets of conclusions. Eric Bond, writing in the *American Economic Review* in September 1982, studies census data on pickup truck maintenance records and concluded that there was no significant difference in maintenance problems for trucks of a given age between those still held by the original buyer and those bought used. In the same journal, however (September 1984), using the same census data with a different definition of the used-car market, Pratt and Hoffer reached the opposite conclusion. They found that a pickup truck bought used is more likely to be a lemon than one of the same age still in the hands of the original owner.

It is worth noting that we would still expect to see the used-car market attract more than its share of lemons even in the happy event that warranties and brand names fully compensated for buyers' lack of information. The reason is that not all customers are equally lemon-averse. Perhaps no one positively prefers to drive a lemon, but some people feel much more strongly than others. The sort of owner that is peculiarly lemon-averse may be mechanically inept, tied to a punctual schedule that is ruined by automotive breakdown, and far too busy to spend time in repair shops. The opposite sort of car owner might be a student or retiree, perhaps in a family for which the lemon is a second car, who knowingly buys the lemon (for a suitably low price) on the assumption that he can handle it. Such buyers, it is not implausible to assume, tend to congregate in the used-car

market. The optimal function of a lemon-dominated market would be to transfer cars from the first sort of driver to the second sort.

Some state regulators apparently believe, however, that the lemon phenomenon arises less from the consumer preference factor than from the informational asymmetry factor—and that the asymmetry is one that can be rectified. The ways they regulate used-car quality vary, with several degrees of stringency. Wisconsin is an example of strict regulation. Since 1974 it has enforced a law, much like the original FTC proposal, that requires used-car dealers to inform retail customers about significant existing mechanical and structural defects or damages ascertainable through a dealer's test drive, walk-around inspection, and under-the-hood inspection. In 1983 a requirement was added that the notice be placed on a car window placard that the customer ultimately signs.

Other states have less stringent laws. More and more states are requiring certification of odometer mileage. Iowa and several other states require safety inspection when a car's registration is about to change hands. Some states dictate only that information about prior police and taxi use of the used car be revealed. And yet others, like Minnesota, have no vehicle inspection or disclosure requirements of any kind. Dealers may be bound by express warranties, or implied warranties defined by the Uniform Commercial Code, or they may simply offer to sell a car "as is."

Do the more stringent state laws provide a cost-effective way to generate information for used-car buyers? Pratt and Hoffer's analysis suggests that the answer is no.

If disclosure laws accomplish their intended purpose, they should widen the resale price gap between lemons and cream puffs so that first owners of cars will find it advantageous to unload fewer of the former and keep fewer of the latter. The mix of cars sold in the used-car market should then begin more to resemble the mix in the new-car market (not completely, since new-car buyers may remain more "lemon-averse" than used-car buyers).

An incidental effect should be that more of the buyers of lemons are the appropriate buyers who like lemons (because they are cheap) and know what they are getting. But—of most relevance here—buyers of used cars should, on average, spend significantly less on repair and

In Brief-

Knowledge of the Law Is No Excuse. The Karen Silkwood memorial award for 1984 must surely go to the D.C. Circuit Court of Appeals for its opinion in *Ferebee v. Chevron Chemical Co.* Richard Ferebee contracted pulmonary fibrosis, allegedly from exposure to paraquat, a herbicide distributed by Chevron. Ferebee's estate recovered damages under Maryland state law, on the theory that Chevron had not adequately warned of the risk on the label affixed to paraquat containers. Quite proper, said Judge Abner Mikva.

But wait. Under the Federal Insecticide, Fungicide, and Rodenticide Act (FIFRA) the Environmental Protection Agency regulates the labeling of paraquat in minute detail. "After extensive scientific testimony," Mikva conceded, EPA had approved the sale of paraquat with the label at issue in Ferebee's case. Furthermore, FIFRA forbids manufacturers from using any different label without EPA approval. Even Maryland itself could not have ordered Chevron to do so: FIFRA expressly provides that a state "shall not impose or continue in effect any requirements for labeling

... in addition to or different from those required" by EPA.

No problem, for Judge Mikva at least. "[I]t need not be the case . . . that [Chevron] can be held liable for failure to warn only if the company could actually have altered its warning." He pointed out helpfully that "Chevron can comply with both federal and state law by continuing to use the EPA-approved label and by simultaneously paying damages to successful tort plaintiffs" who claim that the label is inadequate. "Successful actions of this sort may lead manufacturers to petition EPA to allow more detailed labeling of their products; alternatively, EPA itself may decide that revised labels are required in light of the new information that has been brought to its attention through common law suits." The Supreme Court has denied review.

Imperfect Recall. Also from the D.C. Circuit Court of Appeals is this regulatory vignette. A line of General Motors' 1979 engines was found to exceed EPA's emissions standards. Recalling the cars to fix the problem would be expensive. So GM and EPA instead agreed to have the automaker implement more-than-offsetting emission reductions in new model cars. The net effect would be less overall pollution than under a recall, at less expense to GM.

But the Public Citizen Litigation Group (representing, one must as-

sume, public citizens who want both more air pollution and more expensive cars) successfully challenged the agreement. The court of appeals was persuaded that the Clean Air Act simply is not flexible enough to allow for anything as radical as less pollution at less cost.

Have It Their Way, or Else. Fast food has never been a popular phenomenon in progressive circles, and now the District of Columbia government is doing something about it. The D.C. Zoning Commission is adopting regulations that bar "fast-food" restaurants from locating in most residential areas. On the other hand, what one might call slow food can still be served in such neighborhoods.

The D.C. government has had trouble defining exactly which class of restaurants to single out for invidious treatment. At last report, it has decided that a fast-food restaurant is one that features carry-out service, disposable utensils, and food that is already cooked and packaged when customers arrive. This definition manages to take in McDonald's and Burger King, but it omits their burger archrival Wendy's (which cooks its patties quickly on the spot). And any of the chains could in theory qualify for a residential location just by slowing down its service and cooking more food to order. Just what everyone needs: an incentive for slow service in restaurants.

maintenance costs than they did in an unregulated market, while those who bought their cars new—having less incentive to dispose of lemons—should spend more. The effect should be visible in gradations, with states with comprehensive disclosure laws like Wisconsin at one end of the spectrum, states with less comprehensive laws like Iowa in the middle, and states like Minnesota with no protective provisions at the other end.

But the data do not conform to this pattern. Using the same data by which they conclude that the used-car market is dominated by lemons, Pratt and Hoffer compared after-purchase consumer repair reports in three adjacent and economically similar midwestern

states. They found no significant differences in repair expenses between the Wisconsin market, the Iowa market, and the Minnesota market, notwithstanding Wisconsin's inspect-and-disclose requirement and Iowa's safety inspection law. This suggests that the disclosure laws are having no visible impact in improving the average quality of used cars, which suggests that they have failed to widen the price gap between creampuffs and lemons, which suggests that they have failed.

Why? It is hard to say. But, as usual, the invisible hands may be working longer hours than the visible ones. One possibility is that a disclosure rule imposes more information-related costs on dealers than buyers are willing

to pay in order to get the advantage of formal notice about defects. If this is the case, the rule may actually be counterproductive. Dealers begin to offer less for used cars to compensate for the additional costs that complying with the disclosure rule entails; individual sellers of cars are therefore less eager to sell, and would-be buyers and sellers either hold on to their current cars or are driven into the unregulated for-sale-by-owner market—with only the manifestly acrid lemons finding their way on to the used-car lot.

Eminently Domineering

The power of the government to seize property by right of eminent domain is a more fearsome power than even that of taxation, if only because it can be more readily aimed at particular citizens. Yet eminent domain is not exactly the most controversial area of the law. Most complaints about it come from the particular citizens that it affects, the people who are forced to give up their homes or farms to the government. Every so often a public controversy will erupt about one of these “takings,” the political coloration of the protest depending on whether the victims are being displaced to make way for, say, an interstate highway—in which case the sympathy comes from the left—or, say, a national park—in which case the sympathy comes from the right. But once the home is torn down the claims begin to seem hopeless, and are quickly forgotten, like those of the Baltic States.

The reason such controversies never became a major source of political division in this country is surely that the use of eminent domain was reserved for few and pressing occasions. Land was only taken for a few kinds of purposes, usually involving projects of obvious general interest such as roads or dams, where a single “holdout” could demand exorbitant compensation on the threat of blocking the project.

There were good constitutional grounds for the government’s powers in this area to be construed narrowly, too. As the Ninth Circuit Court of Appeals said recently, the Founders “foresaw that attempts would be made by the states to take away the private property rights

of the landed minority.” The Constitution and the Bill of Rights accordingly “were designed to prevent such abuses by the majority.” In particular, the Fifth Amendment contains the provision, “nor shall private property be taken for public use without just compensation,” and most state constitutions have analogous clauses that are equally strict or stricter. All of these “public use” clauses have been construed (until recently) not only to require just compensation when private property is taken for public use, but also to forbid entirely takings for purely private use.

Now, however, legislators and judges are radically expanding the government’s power in this area. First, they are gutting the requirement that private property be taken only for “public use.” Second, they are allowing governments to use the condemnation power to take more and more categories of property, including even such intangible assets as sports franchises and drilling leases.

The first process, that of defining “public use” out of existence, has been going on for some time. Long ago the Supreme Court decided that “public use” includes not only the use of such things as roads, but “matters of public health, recreation, and enjoyment” as well. Courts began upholding condemnations of land on which the government wanted to locate opera houses, county fairs, public housing projects, and baseball fields.

These takings still fell within a relatively narrow bound: the land was being taken for uses that were open to the entire public, if only for a fee. That barrier fell with *Berman v. Parker* (1954), where the Supreme Court upheld an urban renewal scheme in which the federal government condemned land, cleared it, and then sold it to private developers. The Court acknowledged that the program involved “taking from one businessman for the benefit of another businessman.” But it said that redevelopment was a proper objective of Congress, and it felt very deferential when such objectives were in question: “the means of executing the project are for Congress and Congress alone to determine.”

Berman v. Parker unleashed the urban renewal bulldozers of the 1950s and 1960s. By the early 1980s the process had gone quite far indeed. Courts allowed the city of Detroit to condemn more than a thousand private homes

to clear land for a new General Motors plant. Missouri passed a law allowing local governments to pass their condemnation power directly to private developers. The "public use" doctrine clearly seemed to be on its last legs. But it was not until this last May that the Supreme Court confirmed its demise once and for all, when it ruled in the case of *Hawaii Housing Authority v. Midkiff*.

Hawaii's land-holding patterns are a legacy of its days as a monarchy. Roughly 47 percent of the state's land is held by seventy-two property owners. The state and federal governments together control another 49 percent. The private owners have long leased their land to private tenants but were unwilling to sell. (Some may have actually preferred to lose their land through condemnation, because the tax treatment of condemnation proceeds is superior to that of sale proceeds.)

In 1967, the state legislature decided to empower the Hawaii Housing Authority to condemn residential parcels from their owners and then sell them to existing tenants. (The possibility of deconcentrating land ownership by selling some of the public sector's holdings seems not to have occurred to the legislators.) The property was not, as in ordinary urban renewal, intended to be put to a different use; the objective was redistribution pure and simple.

The Ninth Circuit Court struck down the Hawaii law on appeal as "facially unconstitutional" on the Fifth Amendment analysis quoted above. It said the law was "a naked attempt . . . to take the private property of A and to transfer it to B solely for B's private use and benefit." (Although it got the letters mixed up, it was hearkening back to a famous H. L. Mencken quote: "When A annoys or injures B on the pretense of saving or improving X, A is a scoundrel.")

When the case got to the Supreme Court, there were at least two things the justices conceivably could have done. They could have agreed with the appeals court that the Hawaiian scheme was unconstitutional, but distinguished the case from *Berman v. Parker* on the ground that in the earlier case the use of the property was being drastically changed. (The precedent was a bit complicated: the actual building at issue in *Berman* was not torn down, but most of its neighbors were.) Alternatively, the jus-

tics have upheld the scheme on some ground having to do with the unique circumstances of Hawaiian history.

But they did neither. In a unanimous opinion written by Justice Sandra Day O'Connor, the Court said that so long as a project could be shown to be "rationally related to a conceivable public purpose," one that is not "palpably without reasonable foundation," a court should not "substitute its judgment for a legislature's judgment as to what constitutes a public use."

Under a standard as loose as this, the traditional requirement of "public use" becomes virtually meaningless surplusage. Once in a blue moon, of course, a court may decide that the objectives of a legislative majority are "palpably without reasonable foundation." But Laurence Tribe, the Harvard Law School professor who assisted Hawaii in the case, thinks that after *Midkiff* there is no longer any "limit to the kind of thing that can be taken by eminent domain." The *Wall Street Journal* has already speculated that the courts might uphold a federal program of randomly taking and redistributing homes from members of one race to another to further the rational public purpose of residential integration.

The implications would be remarkable enough if only real estate were vulnerable to these hazards. But recently the types of intangible assets targeted for takeover have been proliferating greatly. A public utility in California is trying to seize a private company's leasing right to drill on federal land, in hopes of guaranteeing itself access to the geothermal power produced on the site. Courts in the same state are still considering whether the city of Oakland may condemn and seize the Oakland Raiders football team. (The owners had moved the team to Los Angeles back in 1982.) Moreover, Oakland's legal claims have been received respectfully by the state Supreme Court, which unanimously denied a motion by the Raiders' owner to dismiss the case. The court said that "the acquisition and, indeed, the operation of a sports franchise may be an appropriate municipal function." The issue is still being litigated on its merits in the lower courts.

The owner of the Baltimore Colts was somewhat luckier in early 1984 when he decided to move the team to Indianapolis. Baltimore officials did their best to seize the team, pushing eminent domain legislation through the

Maryland House of Delegates in hours and the Baltimore city council in just twenty-five minutes. But the owner had removed all of the team's physical assets from its training quarters the night before the council met. This stratagem may have succeeded in legally relocating the team to Indiana before the city filed suit, which leaves the city's legal prospects uncertain; the Oakland owners had had the misfortune to stay in the same state and therefore within reach of the law.

California Chief Justice Rose Bird wrote that in claiming a power that was "not only novel but virtually without limit," Oakland had posed two "particularly disturbing questions." One is whether a city can condemn a business's employment contracts as easily as it can take a tract of land. The second question is whether a city may take "a viable, ongoing business and sell it to another private party merely because the original owner has announced his intention to move his business."

The latter question is far more than academic, as the large conglomerate Gulf & Western Industries recently learned when it tried to close down its Morse Cutting Tool subsidiary in the old whaling port of New Bedford, Massachusetts. When Gulf & Western announced it would close the plant if it could not find a buyer, Mayor Brian Lawler threatened to use eminent domain to take over the plant. Lawler proposed to have the city itself run the company temporarily until a buyer could be found, or permanently, like a utility or bus line, if none stepped forward.

The issue never ended up in court. Significant opposition emerged to the notion of municipal operation—the local paper asked how city hall could operate a machine tool company "when we can't even get the city's sewers finished and the trash disposed of"—and the mayor backed off that particular scheme. Gulf & Western eventually sold the facilities to a group of investors who will keep the plant in operation.

But if push had come to shove, most legal scholars think that, after *Midkiff*, the city would have prevailed. Attorney Andrew Buchsbaum, whose Institute for Public Representation at Georgetown University assisted New Bedford, says the case was being observed closely for its precedential value as "a new legal tool" for government. Already a coalition

of religious and union activists called the Tri-State Conference on Steel has asked the governments in the Pittsburgh area to take over and run ailing steel plants wholesale through the condemnation power. And Chicago has asked a court to rule that it can take over a U.S. Steel Corporation plant located on its soil.

Such initiatives threaten to enshrine industrial policy at the local level even as it is rejected at the national level. As Robert Lockwood of the Atlantic Council has said, it takes little effort to imagine what New Bedford would be like today if, back when it was the whaling capital of the world, it had forbidden the owners of the tall ships from going out of business.

Many of these problems could be resolved if the courts were to decide to apply the commerce clause of the Constitution to eminent domain cases. A wide range of attempted seizures, especially those motivated by a company's attempt to move away, arguably interfere with interstate commerce. Land owners, however, would still be left out in the cold under such a rule. (In New York City, the Coalition for the Homeless has asked the city to seize and run skid-row hotels in hopes of improving the living standards of their residents.)

Another possible line of defense in the courts would be aggressive enforcement of the just-compensation clause, which could arguably take away the incentive for most large-scale redistribution. Unfortunately, property valuation can be a subjective process, and it is not going to be easy even for well-intentioned judges to police a flood of such cases.

In the absence of some such judicial protection, we can expect a massive increase in the politicization of the economy, as each pressure group begins to consider the ways in which the government could use the power of eminent domain to the group's private advantage. It is not quite clear what recourse property owners will have against such attacks. Presumably corporations could use some of the tactics they use to defend themselves against private takeovers, such as selling their most productive assets (the "crown jewels" defense) or giving top managers "golden parachutes." They might even try to keep their mobile assets on the run from state to state. A more powerful tactic might be to refuse to do business with a newly municipalized factory or even organize an industry-wide boycott—unless (or until) that is

held to violate restraint-of-trade laws. Whether such a boycott is consciously organized or not, expropriating states will likely find it hard to attract new investment—which, however, is no comfort to the existing owners of immobile investments.

If business finds it troublesome to defend itself, it is not easy to see where its judicial (and political) rescuers will come from. The opinion upholding Oakland's power to condemn the Raiders was written by the California Supreme Court's most conservative justice and sole remaining Reagan appointee. On the other hand, it was the court's most liberal member, Chief Justice Bird, who sounded words of warning against "creeping statism"—although even she felt "forced by the current state of the law" to concur in the decision.

As the unanimity of the *Midkiff* and California decisions show, the economic liberties mentioned in the Constitution have become the orphan liberties of the American bench, abandoned by conservative and liberal jurists alike. The conservatives, eager at all costs to exorcise the specter of "judicial activism," are reluctant to restrict democratic choice by a forthright assertion of individual rights of even the most time-honored sort. The liberals have fewer such compunctions on the general principle, but do not feel enough of a policy temptation to take action here. Who will adopt the orphan liberties?

Education Reform and Its Costs

Few movements have been so successful so fast as the movement for "educational excellence." Virtually every one of the fifty state legislatures has been churning out legislation aimed squarely at improving the schools. Colorado alone has passed 114 new laws, and Arkansas is not far behind with 112. Many of the more well-thought-of state governors have identified themselves closely with the cause. The educational establishment itself has largely abandoned open opposition; in some cases it has even put itself at the vanguard of the crusade.

A closer look at the recently enacted measures, however, suggests that there is another side to the story. In some cases, the new laws have been so watered down by political compro-

mise that their effect has been not to challenge the way things have been done in American schools, but to provide the same mixture as before, only more of it. In other cases, the reforms are real, but may have some unwelcome side effects.

The chief ingredient of the new reforms is money and lots of it. Six states have passed massive "omnibus" reform packages to overhaul their education systems: Arkansas, California, Florida, South Carolina, Tennessee, and Texas. All six boosted education spending sharply, by a collective total of \$3 billion, and all but one raised taxes. South Carolina and Arkansas are both paying for their packages by a one-cent hike in the state sales tax. Long-standing taxpayer resistance to higher school spending is being overcome by the promises of excellence.

Although the states are creating various new programs, sixty-one in South Carolina alone, most of the money is going for existing activities. Teacher salaries, in particular, are headed up. Even in states that have passed "merit pay" or "master teacher" programs, much of the new money is going to be spent eliciting not better work (as measured on some quality scale or by outside evaluators) but more work (in the form of longer hours or attendance at professional seminars).

Many states are also spending new money on school finance equalization, a favorite scheme of the 1960s and 1970s in which money is shoved around in an attempt to prevent affluent school districts from spending more per pupil than poorer districts do. (The process can be quite disruptive: in 1976 the New Jersey Supreme Court closed down that state's public schools to force the legislature to comply with such a measure.) Finance equalization may satisfy a demand for equality, but there is little evidence that it results in excellence.

Quite a few states in the Sunbelt are "catching up" in spending-per-pupil with their Northern counterparts. What is ironic is that in recent years the Sunbelt educators had been closing the test-score gap with the expensive northern school systems.

Teacher Training and Certification. Reformers had been calling for opening up both entry and exit to the teaching profession. On the entry side, the idea is to lower the hurdles that keep

so many intelligent people out of teaching, especially the requirements for courses in education. That might allow, for example, former graduate students (or even university professors) to teach elementary and secondary classes in their specialties. Opening up exit would probably mean weeding out the weakest teachers, through testing or other forms of evaluation, in order to create room for newcomers.

The record on this issue is mixed. Nearly all the states have "tightened" standards for teachers. The problem is that some states are making it even harder to become a teacher by requiring applicants to take more courses before receiving a teaching certificate. It is even being proposed that a five-year instead of four-year B.A. in education be required—which would seal off incumbents even more effectively from competition.

Other states are doing the reverse. California, alone among the "omnibus" states, has moved in a gingerly way to deregulate the certification area. A much bolder innovation is occurring in New Jersey, where Governor Thomas Kean has instituted a plan to recruit more teachers with ordinary B.A.s who pass appropriate subject matter tests and meet various other standards. New Jersey has even gone so far as to abolish the education major in its state college system.

Schooling Time. Twenty-six states have taken steps to increase time spent in the classroom by lengthening the school day or curtailing study halls. There is also growing interest in increasing the length of the school year and beginning compulsory schooling at an earlier age. Such measures would be a clear loss for the cause of family choice.

Unfortunately, it remains to be seen whether or not there will be a parallel trend toward abolishing any of the extraneous programs that have been displacing time spent on the basic curriculum in many states, like consumer education, environmental education, and ethnic education. (In Peoria, Illinois, school officials are requiring a blind student to take a drivers' education course in order to satisfy graduation requirements.) "It is no wonder," writes education critic Lawrence Uzzell, "that today's reformers are pushing for a longer school year: It is the only way they can find enough time for the essentials."

Curriculum. Forty-one states have increased the number of courses required for high school graduation. Also, more states are going into painstaking detail in specifying curricular objectives. Vermont now requires graduating students to know how to use a word processor. Detailed statewide curriculum specifications are not a new development: California requires the teaching of kindness to domestic pets, and Oregon requires reference to the "Founding Fathers and Mothers" in social studies textbooks. But the trend appears to be on the upswing. Rigid rules, of course, tend to stifle diversity and experimentation; there is no reason, for example, why American history must be taught in the tenth grade and world history in the eleventh rather than vice versa. Researchers have found that schools that happen to organize their curriculum in unorthodox ways can still be good schools, and, indeed, as the specialized high schools of art and science in New York show, may be superior schools.

Academic Bankruptcy. Four states (Kentucky, Arkansas, South Carolina, and Texas) have recently adopted "academic bankruptcy" laws and policies. These empower the chief state school officer to declare local school districts, in effect, "bankrupt" if they persist in allowing student achievement to lag behind a given norm. Bankrupt schools are subjected to a variety of sanctions. The Arkansas law provides that if less than 85 percent of the students in a school district meet state norms, and the district fails to achieve "reasonable progress" on test scores within two years, its accreditation can be suspended. Moreover, the state can compel the district to merge into another district. Kentucky, on the other hand, uses quite different sanctions. It provides aid to "bankrupt" districts; it also may require them to reallocate their state-aid moneys in specific ways, and, if the districts fail to implement the improvement plan, may limit their authority to hire and fire, spend money, and set the school calendar.

The New Centralism. All these reforms will require whole volumes of new regulations, and will complicate the lives of both local and state administrators; officials in Illinois and Florida have already asked legislators to hold off passing more new laws until they can figure out how

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Education Reform and Its Costs

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to implement the last batch. Another effect will be to increase immensely the regulatory sway of state governments over local schools—an odd occurrence in this supposed age of deregulation, but perhaps an inevitable one given that the states are increasingly paying the bill. Even as the federal master becomes (slightly) more indulgent, the fifty state masters become stricter. In many ways, the states are even more intrusive, since while federal regulations have usually focused on “equity” (ensuring equal access to services), the states are getting into the heart of the educational process—dictating who teaches what and how.

Of course, this process of centralization is nothing new. States have been increasing their power over local schools for years. During the late 1960s and 1970s, state education agencies increased their personnel levels by several hundred percent. Not the least of the reasons was federal regulation itself. In fact, state education agencies have in some ways become creatures of Washington, which provides a huge share of their funding (much more than the federal contribution to the average school board’s budget). In addition, many federal regulations serve to increase the oversight of state education departments over local school boards.

Now, in many cases for the first time, states will be taking explicit responsibility for educational outcomes. The irony is that the new centralism, by treating school systems as if they were factories subject to management from the top down, may actually make it harder to achieve the goal of excellence. A large body of research suggests that effective schools are a “cottage industry,” best administered by those closest to the “shop floor.” The crucial factors in achieving good results are all things that depend heavily on the local environment: high expectations and demands, good leadership, effective discipline, homework, and dedicated teachers and staff. As Chester E. Finn has said, “if you want to foster the organizational characteristics associated with school effectiveness, you probably have to empower the people who staff the school to make important decisions about what happens within it.”

Such empowerment would not have to require state education agencies to go out of business. It might be possible for the states to take

a “performance standards” rather than a “command-and-control” approach, focusing on the achievement levels that come out of a school, rather than the teacher-hours and dollars that go into it. California, for example, now runs statewide achievement tests and gives official recognition to students who do well on them.

In a way, the “educational bankruptcy” laws—although they infuriate many local school leaders—point the way in this direction. When Arkansas withdraws accreditation from a bad school, it is using a market-oriented sanction for noncompliance—in effect, an informational strategy to generate parent pressure for reform. Compelling a merger into another school district is also probably an effective sanction, by giving the state an “exit option.”

The most effective exit option, however, would be to give the parents themselves vouchers with which they could transfer their children out of “bankrupt” districts and into private or other public schools. The state that builds its education policy around the idea of facilitating family choice, instead of frustrating it, will be the real educational innovator.

To Our Readers

When we asked Peter Huber and Robert Crandall to write about the science and politics of acid rain, we did not imagine the result would turn out to be this special issue of Regulation. Yet we think you'll agree, when you read what they have to say, that their stories were worth printing in full. The double-issue format made it possible to do that and also offer our usual variety of other features and departments.

In another departure from past tradition, we will henceforth publish our annual Regulation index in the last issue of each year, rather than the first issue of the next year. This step will make life easier for librarians and researchers who work with Regulation in annual bound volumes: at last the index will accompany the issues it refers to. The change begins with this issue.