

### **Chapter 3-- The Role of Discrimination: A Primary or Secondary Cause of Poverty?**

This chapter concludes the introduction to the issues concerning poverty and redistribution. But before we discuss how government policies adversely affect the poor, we need to devote some time to the "non-government" factors which contribute to poverty-- or more generally, why incomes differ between individuals and groups. Wages and incomes vary for many reasons, including everything from job skills to union participation and discrimination.

#### **What Causes Income Differentials?**

One crucial factor is the level of human capital (job skills) that people bring to the labor market. Human capital can be endowed through natural ability or earned through investments in education, training or job experience. In each individual's endowment, genetics and environment are significant-- although their relative weights are the subject of an age-old debate. The pursuit of education and the accumulation of experience are perhaps the primary determinant of one's earnings potential. Further, the quality of education available to people, especially the poor, is an extremely important issue.

One's geographical location is another important factor. For instance, poverty rates in 1989 ranged from New Hampshire's 6.4% to Mississippi's 25.2%.<sup>1</sup> In addition to the inner cities, (measured) poverty is concentrated in certain geographic areas-- the lower Mississippi and Rio Grande river valleys, Indian reservations and Appalachia. Further, in the context of income differentials that would cause little concern, it could be that one of two equally talented and experienced engineers works in Mississippi, and the other in Massachusetts. Because the cost of living is so much higher in New England, incomes will be higher there as well. Although it would be measured as an "income differential," such differences in "nominal" income are irrelevant in comparing "real" income or purchasing power.

Membership in a union also has a bearing on income. Because union workers are paid a premium above what an equally-qualified non-union worker would earn, differences in income are also a function of whether or not one belongs to a union.

Since wages are only part of the compensation one receives for working, there may be differences in wages without differences in compensation and vice versa. Some jobs have substantial fringe benefits; others have sizable pensions. Two people may begin the same job with one choosing to receive some of their compensation in the form of fringe benefits or a larger pension, while the other chooses more cash. In such cases, we would still measure an

"income differential" where no difference in opportunity exists.

Individual tastes and preferences are another important factor. For certain job characteristics, there are "compensating wage differentials"-- additional payments required to persuade workers to accept some undesirable aspect of a job. This explains the relatively high rates of pay for people who haul garbage or work in construction. Workers will require additional compensation to do a job which is unpleasant or dangerous. The resulting income differential is not indicative of a difference in opportunity.

In addition, people have different tastes and preferences for "non-market activity"-- schooling, household work and leisure. These help determine whether people choose to work over-time, full-time, part-time, or not at all. Two individuals (or families) may have equal abilities and opportunities, but may make different decisions concerning the number of hours to work. Unfortunately, the resulting outcomes would be measured as an income differential.

The choice of statistical measures can also make a difference. For instance, holding per capita income constant, measures of family income and household income would differ over time as demographics change-- the age distribution, the propensities to get married and remain married, more college students or elderly living with their extended families, etc. It is possible that measurements of household or family income can increase or decrease while giving a mistaken perception of the extent of economic change.

Sometimes these differences are only important when comparing individuals. However, if a group is disproportionately represented in one of these categories, the group would have lower/higher incomes than the average.<sup>2</sup> For instance, a large proportion of blacks live in the deep South where incomes and cost of living are lower. To a limited extent, lower incomes for blacks as a group are a function of where many of them live. In fact, for non-Southern families with both parents, black family income was 96% of whites as early as 1970.<sup>3</sup> Likewise, a large proportion of union labor is male; to some extent, lower incomes for women as a group are a function of their more limited involvement in unions.

Like the poverty rate, income is only a proxy for measuring standards of living and economic opportunity. Many of the above variables cause differences in income which are unrelated to opportunity. Therefore, in order to be useful, statistics which measure income differentials between groups or individuals must take differences in these variables into account. Otherwise, one is comparing apples to oranges.

For example, newspapers often report that on average, women earn 76% of what men are paid. (Until the 1980s, this statistic had remained around 60% for decades.) However, this raw number does not account for differences in the groups' average job experience, training/education, representation in various job fields, etc. This results in a comparison of one group of people who have more training and experience to another group which is disproportionately inexperienced and has less training. It should come as no surprise that the former group has a higher average income. Because it fails to hold such important variables constant, the raw number (76%) tells us nothing about income differentials between equally-qualified men and women.

In a more useful comparison, June O'Neill found that 27-33 year old women who have never had a child earn 98% of their male counterparts.<sup>4</sup> Likewise, fathers with working wives earn 20-25% less than those who are sole "bread-winners."<sup>5</sup> Some claim that this is a "daddy penalty," again arguing discrimination. A more compelling explanation is a difference in tastes and preferences between the two types of fathers.

## **Discrimination**

Despite the importance of the above factors, the most popular topic concerning income differentials between groups is discrimination. With a controversial subject, it is important to clearly define the terms to be used: prejudice is to "pre-judge" something or someone-- it is a belief or opinion; discrimination is "prejudice in action." Note that in order to discriminate, one must (1) have a prejudice; (2) be in a position to turn the belief into action; and (3) be willing to bear the costs (if any) of those actions. In the context of Economics, we will discuss how discrimination occurs in product and labor markets.

Discrimination can also be defined as an occasion when an individual's wages or income are unrelated to their productivity and job characteristics. When labor economists measure discrimination, they control for the variables discussed in the previous section. Whatever remains is considered "unexplained" differences in wages and is designated as (the upper bound of the extent of) discrimination. There are two types of discrimination: personal and statistical.

## **Personal Discrimination**

This is the most frequently discussed type of discrimination. It is a matter of

indulging one's tastes and preferences concerning the buying or selling of products or the choice of whom to employ. For instance, I might get a kick out of not hiring or promoting women. Or I might decide against buying something from a certain store simply because it is operated by an Asian or a redneck. Or I might decide not to sell a product to someone because they are black or Jewish. Both parties are cheated out of a mutually beneficial trade because of one party's personal prejudices.

This type of behavior is costly to the one who is discriminated against. However, on average, the degree of competition in a given market and the number of discriminatory firms determines the extent of the cost. For example, in Houston a few years ago, one gas station owner decided to charge those with foreign automobiles a few cents more than the market rate. Since there were many gas stations in the city and only one station was participating, the cost was minimal to those discriminated against.

As long as the discrimination is limited to a few firms in a large market, the only significant result will be some segregation. And even if a large number of firms discriminate, this gives non-discriminating entrepreneurs an incentive to enter the market and sell to (or hire) those who have been discriminated against. As a result, they would be able to operate at lower costs and earn higher profits than the existing firms.

In addition, personal discrimination is usually costly to the one who discriminates. To indulge their tastes and preferences, they would have to turn away good workers in favor of more expensive or less productive workers. The cost of such behavior tempers the desire to engage in it. Remember that discrimination is the willingness to put prejudicial opinions into action. The question then becomes: "do I really want to lower my income in order to discriminate against someone?"

### **How Government Encourages Personal Discrimination**

Sometimes government policy encourages discrimination by reducing its cost to zero. When governments regulate a monopoly's prices and profits, they inadvertently provide an incentive for the firm to inflate its costs. If government is going to reduce my profits to "an acceptable level," why not lower profits myself by artificially raising costs? One way to do this is to indulge tastes and preferences concerning others-- to discriminate. The cost is zero since government would confiscate the "extra" profits anyway.

A more common case occurs when government prevents a market from functioning

normally-- a "market distortion." For instance, a price floor on wages (a minimum wage) creates a surplus of workers (unemployment). With a surplus of unskilled workers wanting to work at the minimum wage, employers can costlessly turn down any particular applicant because there are countless others looking for a job at that wage. The employer can costlessly discriminate because of the surplus created by government. Another example is rent control which creates a housing shortage. With people waiting in line to get apartments at an artificially low price, landlords can costlessly choose those who fit their tastes and preferences.<sup>6</sup>

Government agencies are generally more interested in maximizing budgets than profits; they have an incentive to pursue (budget) size over efficiency. This inefficiency may include discriminatory hiring practices. If the goal is to expand budgets, bureaucrats may be unconcerned with hiring the best people for the job and may tend to hire less efficient workers who fit their tastes and preferences. (This tendency can lead to discrimination for or against individuals and groups.<sup>7</sup>) Further, their monopoly power can allow discriminatory selling practices. If everyone must purchase a product or service through a government monopoly, there is little incentive to please customers of any type.

The point is not that government agencies or landlords in cities with rent control always discriminate-- or that personal discrimination never occurs in competitive markets. Rather, the point is simply that discrimination is less costly and therefore more likely in markets which are either not competitive or distorted by the government. In competitive markets, unless there are widespread discriminatory attitudes and a willingness to bear costs, personal discrimination is unlikely to substantially affect individuals and will not be a significant factor for a group.

If personal discrimination is widespread, enforcement of civil rights law may be effective. But from economic analysis, we can see that promoting competition and eliminating government's market distortions would be a useful way to curb discriminatory behavior. Finally, because personal discrimination is difficult to prove by its very nature, our energies are probably better focused in areas where we know minorities are hurt on a routine basis. That is the subject of Part 2 and beyond.

### **Statistical Discrimination**

This type of discrimination is only talked about infrequently, although it is more

common-- we all do it. That's right-- all of us discriminate. When you choose a can of beans at a store, do you select one with a dent in it (if it is the same price as an undented can)? Why not? Do you know there is something wrong with the can? If you are walking alone at night with three boisterous young men coming your way, do you get nervous? If possible, do you choose another path? Why? Do you know that the men intend to harm you? When you vote for offices at the bottom of a ballot, how do you decide? Name recognition? Party affiliation? Incumbency or not? Why? Do you know that the candidates you have chosen are more qualified than their opponents?

These decisions and many others have the following in common: we have incomplete information about the decision; information is costly to obtain; and the choice is of some importance. In other words, people make the best decisions they can with limited and costly information.

Part of this decision-making process involves using group information to form "best guesses" about what individuals in a group will do. When I joined our department's intramural softball team at Texas A&M, I asked the captain what position he wanted me to play. He looked at me for a moment and said, "we'll put you in right field." (Right field is where you put people who can't play very well, since balls aren't hit there very often.) Why did this happen? The captain had no idea how well or how poorly I played. But he knew that most individuals in the group I represent-- tall, skinny guys with glasses-- were not known for their athletic prowess. Until he observed my "productivity," I had to play right field.

In a November 1993 speech, Jesse Jackson expressed the concept this way: "there is nothing more painful for me at this stage in my life than to walk down the street and hear footsteps and start to think about robbery and then look around and see it's somebody white and feel relieved. How humiliating."<sup>8</sup> Jackson was using statistical discrimination to decide whether to relax or not.

The same thing occurs in labor markets. Firms use signals of all types (group information) to do their best in selecting productive employees. Information is far from perfect, gathering information on prospective employees is costly, and hiring ineffective employees is a costly proposition. Thus, firms resort to using grades, college attended, standardized tests, etc. It is not that all students who graduate with a 3.0 grade point average are better workers than those with a 2.5. But on average, a firm may have found this to be the case. It is not that all graduates of Princeton are more productive than those who

graduate from "North-Northwest Idaho State University." But on average, firms may have found Princeton graduates to be more competent. A business may use a typing test for prospective secretaries. If someone is able to type 100 words per minute but suffers from "test anxiety" and can only type 40 words per minute during a test, they are unlikely to get the job despite their ability.

Note that neither the employer nor the employee is happy about the failure of these signals to correctly predict productivity. For example, the firm wants to hire the best people available and the typing test will, in this instance, fail to find the most qualified person. But the key is that the firm must pay the cost of searching. Given this tradeoff-- although mistakes will be made, this is the optimal way to find employees.<sup>9</sup> Likewise, even if particular students from a less-highly regarded university would be a great asset to a firm, it is unlikely they will be able to signal their ability. Such workers "deserve better" in some sense, but will have to start at a lower position to demonstrate their true productivity. While "unjust" in an idealistic sense, statistical discrimination is comforting in that it is "nothing personal." People are simply doing their best to earn a living.

### **Additional Considerations about Discrimination**

First, racial conflict is not simply a characteristic of the United States in the late 20th century. It is as old as time, it happens all over the world, and it occurs between many combinations of races. We often forget other countries and their histories, but discrimination is "nothing new." In fact, one could argue that our troubles in this arena are relatively mild by any historical perspective.<sup>10</sup>

Second, neither political power nor the absence of personal discrimination are necessary or sufficient conditions for economic well-being. Blacks have struggled economically despite substantial political power, including nearly proportional representation in Congress and control of government in many large cities. In the past, the Irish held vast political power while as a group, their incomes were well below average. Meanwhile, Asians have little political power but have done exceptionally well in economic arenas. Further, Asians have been discriminated against by individuals and even government, but have continued to thrive. Sowell points out that discrimination against the Chinese is legal in Malaysia, but that they still dominate the country's economic activity.<sup>11</sup> While discrimination and political power can influence outcomes, they are not primary

explanations for income differentials between groups or economic outcomes for most individuals.

Third, degrees of integration and segregation will occur naturally. For example, in dating and religion, people of different ethnic groups pair off and gather together voluntarily in a way which resembles racial discrimination. With respect to housing, people have tastes and preferences which are largely a function of income and independent of race. Then, because incomes are disproportionately low for minorities, what is in fact a class issue is misconstrued as a racial issue. Walter Williams points to polls where concern over low-income families moving in, public housing and "flight" to the suburbs are independent of race and completely an issue of income class; middle class blacks have concerns remarkably similar to those of middle class whites.<sup>12</sup>

Fourth, just as under-representation in a field does not necessarily imply discrimination, over-representation does not imply the absence of discrimination. For instance, blacks make up the majority of players in the National Basketball Association and Asians in the United States have higher incomes than the national average. But it is still possible that individuals in both groups suffer from discrimination.<sup>13</sup>

### **Higher Prices in the Inner City**

One could accuse grocery stores of discrimination against minorities since prices in the inner city are often somewhat higher than those elsewhere. Instead of some sort of conspiracy, such accusations usually reflect an ignorance about how markets work in general and specifically, how these particular markets work.

The higher cost of groceries is the result of greater operating costs (especially for security, crime and insurance premiums) and the heightened risks associated with doing business in the inner city. In addition, higher rates of return are necessary to make such a relatively risky investment attractive. Certainly, events in many cities have proven these risks to be far from imaginary. Ironically, riots and unrest only exacerbate such problems--further driving up the cost of insurance and the rate of return necessary to attract entrepreneurs.

Returning to the concept of personal discrimination, charges of racism implicitly assume the market structure is not competitive. Otherwise, if store owners were charging "outrageous prices," entrepreneurs would have an incentive to enter the market and undercut

their prices.

The same is true of "bank lending practices." Critics frequently complain about loan rejection rates for minorities. But they fail to hold "productivity" concerns constant. Besides, a better measure of discrimination would be default and delinquency rates. For instance, if blacks never default and whites have a 10% default rate, we can conclude that banks are dumb (avoiding good loans), they discriminate against blacks or they are constrained from loaning to blacks by the law.

Regardless, one could argue that to the extent there is discrimination, the idea of working diligently within an imperfect system is probably the best option.<sup>14</sup> Korean immigrants are known for their inner city grocery stores. They face some degree of discrimination and a language barrier, but have chosen the route of hard work as opposed to incessant moaning about injustices. The result has been economic success. Presumably that option is open to all.

I have spent nearly an entire chapter on discrimination. However, I do not mean to imply that it is a significant explanation for poverty among groups or most individuals. This goes against conventional wisdom. A 1993 Gallup Poll reported that 44% of blacks and 21% of whites believe discrimination is the main reason blacks (on average) have worse jobs, income and housing.<sup>15</sup> Because discrimination is perceived to be so important and because it is a prominent part of discussions concerning the poor, it required a thorough treatment.

In fact, an overriding focus on discrimination is wrong-headed for two reasons. First, although it certainly exists, it is not a primary explanation for the plight of today's poor. Second and more importantly, from a practical standpoint, even if it were significant, it would be very difficult to stop. As we will see throughout the remainder of the book, there are plenty of poor government policies we can fix more easily than personal prejudices.

## Notes

1. Statistical Abstract of the United States, 1993, Table #741.
2. See: T. Sowell, Race and Culture: A Worldview, New York: Basic Books, 1994.
3. Conti and Stetson, "The New Black Vanguard," The Intercollegiate Review, Spring 1993. The 1991 poverty rate for blacks was 32.7%; for whites it was 11.3%. (Statistical Abstract of the United States, 1993, Table #735.)
4. J. O'Neill, "The Shrinking Pay Gap," Wall Street Journal, 10/7/94.

5. T. Lewin, "Fathers Get Ahead If Their Wives Stay at Home," Louisville Courier-Journal, 10/13/94, citing studies by Linda Stroh (Loyola University of Chicago), Freida Reitmann (Pace University) and Jeffrey Pfeffer (Stanford University).
6. Remember that discriminatory behavior is independent of "productivity" issues-- in this context, how good a tenant the prospective renter would be.
7. However, the greatest problems with racial discrimination against blacks have been caused or perpetuated by government: slavery, the Dred Scott decision, school segregation, Jim Crow laws, Davis-Bacon laws, apartheid in South Africa, etc. Note also that the fairly popular hypotheses of gender bias against females in (government) schools and racial bias by police are consistent with government's ability to discriminate.
8. "A New Civil Rights Frontier," U.S. News and World Report, 1/17/94, p. 38.
9. In a competitive market, firms who use "bad signals" will tend to be driven out of the market by those who use better signals.
10. T. Sowell's The Economics and Politics of Race: An International Perspective (New York: Morrow, 1983) provides substantial evidence about "race" as a universal problem.
11. *Ibid.*, pp. 26-27, 36-37.
12. W. Williams, The State Against Blacks, New York: McGraw-Hill, 1982, pp. 12-13.
13. Our "over-reliance" on numbers (proxies) is caused by the difficulty inherent in trying to measure discrimination.
14. At first glance, this would seem to contradict my thesis that we should look to change government institutions ("poor policy"). However, discrimination is different because it is difficult to measure and prevent if it is occurring. On the other hand, we know what effect poor policies have on the impoverished. Those policies can be more easily changed than attitudes.
15. U.S. News and World Report, 6/13/94, p. 124.