CHAPTER 14

Civil Rights

It is of great importance in a republic not only to guard the society against the oppression of its rulers, but to guard one part of the society against the injustice of the other part.

—James Madison

If you think you know the solution to affirmative action, you don’t understand the problem.

—Michael Heyman, Chancellor, University of California at Berkeley

Human rights belong to people as such, so everyone has the same amount and no one can get rid of them. Political philosophers, however, disagree about the list of human rights. A standard list includes liberties, such as freedom of speech, worship, and assembly. In addition to liberty rights, the list of human rights advocated by many political philosophers includes freedom from discrimination on grounds of race, ethnicity, sex, and religion. The struggle for freedom from discrimination in the United States focused originally on the rights of citizens, such as voting in elections and equality in court, and now extends to nondiscrimination in many private transactions, including freedom from discrimination in purchasing services and finding employment in private organizations.

“Civil rights” now refers to freedom from all forms of discrimination. The absence of discrimination gives different kinds of people an equal opportunity to compete for offices, jobs, wealth, privileges, and honors. Civil rights are especially those equality rights concerned with opportunities.

Sex, ethnicity, religion, etc., form part of each person’s identity, which lies at the core of personality. Discrimination based on these traits involves an indignity that provokes powerful emotions, which motivate strong moral judgments. The moral judgments of different people, however, contradict each other. As expressed in the quote from Chancellor Heyman, conflicts in deeply held moral judgments preclude consensus solutions.

Powerful feelings cloud judgment, which makes analysis urgent and controversial. This chapter uses economic theory to analyze the consequences of different forms of discrimination and alternative legal remedies. Although a careful analysis cannot solve the problem of discrimination, it can improve the quality

of debate and provide reasons for each person to modify his views. Here are some examples of questions analyzed in this chapter.

Example 1: The owner of a profession basketball team that refused to hire African-American players would suffer a competitive disadvantage and lose a lot of money. When does market competition tend to eliminate discrimination by making discriminators pay its costs? Conversely, when does market competition aggravate discrimination by making victims pay its costs?

Example 2: Assume that one ethnic group prevents employers from hiring people from another ethnic group to work in skilled jobs. How will a law ending discrimination affect the wages of skilled and unskilled workers in each group?

Example 3: A public housing project with equal numbers of European-American and African-American residents finds that applications from blacks to fill vacancies exceed applications from whites. Management decides to fill vacancies with whites and blacks in equal numbers. Is this decision unconstitutional discrimination against blacks or a legal method of preserving residential integration?

Example 4: An automobile insurance company's statistics reveal that Latinos and young males create more risk of accidents than do other people, so the company charges them higher rates. What is the best means for law to prevent the insurance company from using ethnic traits or gender to set rates?

U.S. CIVIL RIGHTS: BRIEF LEGAL HISTORY

The struggle against bigotry and discrimination toward African Americans preoccupies much of American history. I will apply economic analysis to some of the doctrines of constitutional law that figure prominently in this history. First, however, I sketch briefly the history leading to recent developments in U.S. civil rights laws.

When African captives were first imported into British colonies in the beginning of the seventeenth century, slavery was common in many countries, but not in western Europe. British law did not recognize the status of “perpetual, hereditary slave.” The closest status in British colonies was that of “indentured servant,” which was not hereditary or perpetual. In response to the slave trade, colonies of Britain and other European countries created the legal institution of slavery. Humanitarians were appalled by the cruelty of slavery, but slave owners wanted to keep their wealth. The slave trade in the British colonies created a powerful movement to abolish slavery and a vested interest in perpetuating slavery.

2 My thanks to Robert Post for help with this section.

3 “Servitude” was common in Britain, whereas “indentured servitude” was restricted to colonies as a device to assure repayment of travel costs. The U.S. colonies apparently got much of its slave law from British Caribbean colonies, which in turn got it from the Portuguese in Brazil and Dutch in the Guianas. (Wiecek 1977).
In the United States, the abolitionists prevailed in the North, which gradually eliminated slavery in the eighteenth and early nineteenth centuries, whereas slave owners prevailed in the South, which gradually eliminated the status of “free Negro” (Wieck 1977). In the new territories of the West, the two legal orders confronted each other and struggled for superiority. The attempted secession of the Southern states prompted the bloody Civil War that ended with the South’s military defeat in 1865 and implementation of the U.S. Constitution’s Thirteenth Amendment, which outlaws slavery and any form of “involuntary servitude.”

Northern victory left the Southern states under the control of the occupying army and the abolitionists, who tried to impose a legal framework that would bring African Americans into full participation in political life. Thus the Fourteenth Amendment to the U.S. Constitution excluded secessionists from holding many federal offices, and the Fifteenth Amendment forbade states from denying the right to vote on grounds of “race, color, or previous condition of servitude.” The Civil Rights Act of 1866 made it a crime to deprive anyone of a broad list of rights.

For black Southerners, the years immediately following the Civil War were a time of political and social liberation, tempered by economic hardship and unreliable law enforcement. In contrast, many white Southerners experienced these years as a period of vindictive foreign domination and anarchy. Control of the South by Northerners did not last long. The former soldiers of the Southern armies formed vigilante organizations that imposed their version of rough justice and often terrorized African Americans. Once the occupying armies withdrew, white Southerners regained control of governments and excluded blacks from political power by law and practice.

Southern legislatures eventually enacted the so-called Jim Crow laws that facilitated or required segregation in public services such as transportation, restaurants, and schools. To illustrate, these laws relegated African Americans to sitting in the back of buses and streetcars, thus ending the practice of people sitting wherever they wanted. Economic historian Jennifer Roback has argued that many forms of segregation, such as separate seating in public transportation, were unsustainable without the force of law. She concludes that law, not the market economy, segregated the South (Roback 1989). (Endemic discrimination in the North is another story.)

Just as slavery induced a political movement for abolition, segregation induced a political movement for integration. The civil rights movement challenged segregation on constitutional grounds. “Judicial review” refers to the power of U.S. courts to scrutinize legislation for consistency with the constitution. Laws mandating segregation were potentially in violation of the Fourteenth Amendment, which guarantees “equal protection of the laws” to everyone, regardless of race, and which forbids states from depriving “any person of life, liberty, or property, without due process of law.” After a series of cases, the Supreme Court ruled

4 A technical point of law worth noting is that the Fourteenth Amendment's strictures against discrimination apply to actions by state governments. To reach the federal government, the courts have found similar strictures in the Fifth Amendment.
in *Plessy v Ferguson* (1896) that state and local governments can permit or require separate facilities for blacks and whites, provided that the facilities are equally good. “Separate but equal” provided the legal foundation for segregation through the first half of the twentieth century.

Although separate facilities were in fact unequal, the civil rights movement had little success in attacking discriminatory laws during the first half of the twentieth century. Civil rights litigants, however, patiently pursued a sequence of minor victories that built up to the breakthrough in 1954 when the Supreme Court gave the Fourteenth Amendment a new interpretation. In *Brown v Board of Education*, Chief Justice Earl Warren wrote:

> Does segregation of children in public schools solely on the basis of race, even though the physical facilities and other “tangible” factors may be equal, deprive the children of the minority group of equal educational opportunities? We believe that it does ... in the field of public education the doctrine of “separate but equal” has no place. Separate educational facilities are inherently unequal. Therefore, we hold that the plaintiffs and others similarly situated ... are, by reason of the segregation complained of, deprived of [equal protection of the laws under the Fourteenth Amendment].

*Brown* eventually came to stand for rejecting the old principle of “separate but equal” in favor of the new principle of integration.5

The integration of public transportation and restaurants took a different course. After the Civil War, protestors sometimes disrupted integrated businesses in order to promote segregation. In the 1960s, this practice was reversed, with protestors disrupting segregated businesses in order to promote integration. The most famous example was the boycott of segregated public transportation in Selma, Alabama, which was organized by a young black minister named Martin Luther King. His philosophy of active, nonviolent disruption of segregated businesses proved effective in integrating transportation, restaurants, and other services across the South. The triumph of civil rights in the streets was not without its blood and tears, or its heroes and villains. Instead of retelling these dramatic tales about a time when “giants walked the earth,” I will return to developments in law.

Federal judges became intensely active in pursuit of civil rights during the 1960s and 1970s. Courts issued orders, called “structural injunctions,” requiring schools and other institutions to change fundamental practices and policies that sustained segregation. Later, judicial activism on civil rights dampened under the influence of conservative judges appointed by Presidents Nixon and Reagan.

Congress did not enact civil rights laws until a decade after the Supreme Court decided *Brown*. The assassination of President Kennedy in 1963, the forcefulness of his successor President Johnson, and a massive march on

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5After *Brown*, the fourth circuit interpreted *Brown* to mean “No segregation,” whereas the fifth circuit interpreted *Brown* to mean “Integration.” Over a period of years, the fifth circuit’s interpretation won.
Washington organized by Martin Luther King eventually persuaded Congress to overcome the opposition of Southern senators and enact civil rights legislation. The Civil Rights Act of 1964 and its subsequent amendments attacked discrimination in politics, courts, business, and work. Congress subsequently enacted legislation to withhold federal financial aid from school districts that remained segregated. 6

I will discuss briefly some doctrines that courts developed to promote integration. As noted in Brown, U.S. courts frequently review statutes affecting civil rights to see whether they conform to the “equal protection” and “due process” clauses of the Fourteenth Amendment. U.S. courts have struggled to give more precise and definite meaning to this amendment. Courts have found that laws violate the Fourteenth Amendment if, among other things, they discriminate against some groups of people (“unequal protection”) or restrict their rights without following correct procedures (“illegal process”). Explaining the reach of these expansive doctrines would require many pages. 7 Instead, I will suggest the flavor of the arguments by discussing some key terms.

Some racial and ethnic groups have been deprived of the laws’ protection more than others. If a statute draws a distinction based on the race or ethnicity of people who have historically suffered discrimination (“suspect class”), then the courts subject the statute to “strict scrutiny” of its constitutionality. To survive strict scrutiny, the state must need the racial distinction in the statute to achieve a “compelling purpose.” Not many statutes that explicitly refer to race or ethnicity can survive strict scrutiny. Strict scrutiny removed many racial and ethnic categories from state laws.

Many statutes differentially affect races or ethnic groups without the law’s explicitly referring to race or ethnicity. Such a statute is racially neutral on its face. Instead of strict scrutiny, facially neutral statutes are examined for the lawmaker’s intent to discriminate. 8 Laws with discriminatory intent violate the U.S. Constitution. A statute that is neutral on its face may have a “disparate

6 The traditional view that court activity following Brown had large effects on prompting integration has been challenged in Rosenberg 1993. According to Rosenberg, schools in the South remained segregated for ten years after Brown, whereas congressional legislation tying school funding to integration in the 1960s induced school integration in the South.

7 U.S. Supreme Court Justice William Brennan wrote: “The Declaration of Independence, the Constitution and the Bill of Rights solemnly committed the United States to be a country where the dignity and rights of all persons are equal before all authority. In all candor we must concede that part of this egalitarianism in America has been more pretension than realized fact. But we are an aspiring people, a people with faith in progress. Our amended Constitution is the lodestar for our aspirations.” If the Supreme Court views the Constitution as the lodestar of national aspirations for equality, then the Constitution will require much amendment by interpretation.

8 The demonstrations in earlier chapters that many people with dissimilar intentions act collectively to make a law should make the reader uneasy about finding a unified “intent”—whether discriminatory or nondiscriminatory—in the making of a statute. Perhaps the relevant court cases can be understood without relying on the concept of intent articulated in them. One scholar has suggested that the key to these cases is the significance of the racial minority’s interest. According to this view, the court will strike the practice down if it adversely affects the vital interests of the minority, even without a showing of discriminatory intent. See Ortiz 1989.
impact" on a minority group that historically suffered discrimination. Disparate impact alerts courts to the possibility of discriminatory intent by lawmakers. For example, school boundaries with a disparate impact were often found by the courts to have been drawn by the school district with the intention to discriminate.

Even without discriminatory intent, laws with disparate impact may violate U.S. civil rights statutes. For example, Title VII of the U.S. Civil Rights Act prohibits employment discrimination based on race, sex, or age. State officials who have no intention to discriminate may adopt a practice that violates federal law by depriving a racial group of equal opportunity in employment.

To illustrate these complicated doctrines, consider a case of alleged employment discrimination among police. The city of Washington, D.C., required applicants for its police force to take a test of basic verbal skills (reading, vocabulary, and so forth). The rules for applying the test did not refer to race or ethnicity, so the practice was "facially neutral" and thus escaped "strict scrutiny" by the Supreme Court. More African Americans, however, failed the test than did individuals from other groups, so the test had a "disparate impact." To decide whether the examination violated the Constitution, the Supreme Court had to ask whether or not the test was designed with the intent to discriminate. The Supreme Court did not find an intent to discriminate when applying this test to job applicants.

Having disposed of constitutional issues, the question remained as to whether the test violated Title VII of the Civil Rights Act, which guarantees "equal opportunity" in employment without regard to race. To comply with this statute, the Supreme Court required the city to demonstrate the validity of the test, which means that the test measures characteristics relevant to job performance. Thus Washington had to try to demonstrate that greater literacy makes better policemen.

Employees have used Title VII in many suits alleging discrimination. Statistical analysis of Title VII lawsuits discloses a paradox and also resolves it. Most people believe that employment discrimination against women and minorities declined in the United States between 1970 and 1989. During these years, however, employment discrimination suits increased over twenty times. How are these facts reconciled?

Many of the original suits were brought against hiring practices that discriminated against classes of people. The success of these suits and the abatement of discrimination for other reasons caused more minorities and women to move into better jobs and more integrated work environments. These changes greatly increased the possibility for a new wrong: discriminatory firings. As time passed, the character of Title VII complaints changed from discriminatory hiring of classes to discriminatory firing of individuals.


Generalizing, if more persons enjoying legal protection against discrimination are employed and the economy slumps, then more protected employees get discharged. Discharging more employees in protected classes causes more lawsuits. The frequency with which a company experiences suits alleging discriminatory discharge depends on the number of its protected employees and the state of the economy.\footnote{See John J. Donohue III, "Further Thoughts on Unemployment Discrimination Legislation: A Reply to Judge Posnett," University of Pennsylvania Law Review 136 (1987): 523.}

Many people feel that the historic victims of discrimination deserve something more than an equal chance to compete. Instead of passive equality, many Americans take affirmative action to reverse the consequences of past discrimination. To illustrate, many law schools search for able students from minority groups, urge them to apply, and admit them with lower grades and test scores than those of other applicants. To pass review under the Fourteenth Amendment, affirmative action programs in state schools must have a compelling purpose for making racial and ethnic distinctions, such as reversing the consequences of a specific discriminatory practice in the past.

In groping for the boundary between “affirmative action” and “reverse discrimination” in the Bakke case, the U.S. Supreme Court distinguished “targets” from “quotas.”\footnote{University of California Regents v Bakke, 438 US 265 (1977).} Thus a medical school may aim to have, say, 20 percent African-American students if this is a “target” chosen for the sake of “diversity,” but the goal is illegal if it is a “quota” chosen to remedy “social wrongs.” Although U.S. law permits racial targets under Bakke, a referendum in the state of California banned such practices by the state. In addition, federal court decisions are placing more restrictions on the advantages that can be given legally to the historic victims of discrimination. Lower courts have recently forbidden some forms of affirmative action, and many commentators believe that the Supreme Court is poised and waiting for the right case to limit affirmative action as now widely practiced in the United States.

Questions

1. U.S. states organize and administer elections. Some states and localities formerly prevented African Americans from voting. Most of these laws and practices were eradicated in the 1960s and Southern blacks now vote in large numbers. Use the “median rule” to predict the consequences of enfranchising African Americans in the South. Use a model of legislative bargaining to make the same prediction. How do the predictions differ?

2. California ended many affirmative action programs by the state as a consequence of a ballot initiative called Proposition 209. Use the median rule to explain why direct democracy might treat minorities less favorably than representative democracy would.

3. “Judges should be one step ahead of society, but not two steps.” Do you agree with this saying as applied to civil rights?
In the United States and other countries, the law restricts the criteria that can be used when employers fill jobs, universities award scholarships, or retailers sell commodities. To discriminate against people by race, sex, religion, ethnicity, age, or disability may violate morality and law. Fairness in competition generally requires that the criteria for sorting winners from losers measure performance on dimensions appropriate to the activity in question, such as speed, accuracy, comprehension, endurance, originality, or productivity. 

Traits of persons such as race, sex, ethnicity, or age do not measure performance. Antidiscrimination laws prohibit sorting winners and losers by personal traits rather than performance. The absence of discrimination gives people with different personal traits an equal opportunity to compete for offices, jobs, wealth, privileges, and honors.

Given an equal opportunity to compete, skill and luck determine outcomes. Because people differ in skill, an equal opportunity to compete does not give everyone an equal probability of winning. Because people differ in luck, an equal opportunity to compete does not assure victory for the most deserving people. Some philosophies, such as the theory of justice developed by John Rawls and discussed in chapter II, advocate an ideal distribution that reduces the influence of skill and luck. These ideals imply redistributive policies that go beyond equal opportunity.

Equal opportunity to compete in economic transactions can conflict with freedom of contract. Complete freedom of contract implies the right to deal or not deal with anyone for whatever reason, including personal traits. In contrast, antidiscrimination laws prohibit parties from allowing some traits to affect their transactions. In general, equality rights conflict with liberty rights, because the former regulates transactions to achieve equality, whereas the latter creates a sphere of autonomy.

To illustrate, a law forbidding economic discrimination would prohibit a black Muslim bakery from hiring only black Muslim employees. In this example, the right of job applicants to nondiscriminatory evaluation conflicts with the baker’s preference for employees with specified traits. Similarly, a law forbidding economic discrimination would prohibit a white supremacist who owns a restaurant from dealing exclusively with white customers. In this example, the customer’s right to nondiscriminatory service conflicts with the restaurant owner’s freedom of contract.

Discrimination under Perfect Competition

In most countries, economic activity follows historical patterns that involve discrimination against some groups. Designing laws to undo discriminatory
practices presupposes an understanding of them. Some laws succeed in reducing
discrimination, while other laws merely increase the transaction costs of contin-
uing the same discriminatory practices. To develop the required understanding,
I begin by analyzing the effects of competition on discrimination.

Competition among organizations generally undermines discrimination by
them. In labor markets, discriminatory employers constrain themselves by
refusing to hire or promote people with disfavored traits. The constraint imposes
higher costs to obtain the same quality of labor. In perfect competition, lower-
cost producers eliminate higher-cost producers. Thus perfect competition elimi-

ates discrimination by employers.

To illustrate, a professional football team in the United States recruited the
best available white players in the 1950s and refused to recruit African
Americans. The discriminatory team competed against other teams that recruited
the best available players, regardless of race. Over time, the discriminatory
team's popularity and profits plummeted as it lost more of its games, so it
eventually abandoned discriminatory recruitment.

Having discussed how competition affects discriminatory employers, now
consider how competition affects discriminatory employees. Imagine a world
whose people are blue or green, in which some blues refuse to work with greens,
but otherwise people are nondiscriminatory. Workers of different color substitute
perfectly for each other on the job, except that organizations employing discrimi-

natory blues must pay the extra cost of segregating them from greens. Thus the
value of a discriminatory worker to an employer equals the value of any nondis-

criminatory worker minus the incremental cost of segregation. Competition in
the labor market aligns each worker's wages with his value to employers. The
perfectly competitive wage of discriminatory workers thus equals the wage of
equivalent nondiscriminatory workers minus the incremental cost of segregation.
Perfect labor-market competition imposes the cost of segregation on workers
who demand it.

These facts are depicted in figure 14-1. The horizontal axis indicates the
quantity of labor and the vertical axis indicates the wage rate. Workers are
distinguished into those who discriminate, indicated by a subscript "d," and
those who do not discriminate, indicated by a subscript "n." The curves S_d and
S_n indicate the quantity of labor each group will supply as a function of the
wage. The demand curves D_d and D_n indicate the value of the two kinds of
labors to employers.

Initially, assume that the cost of segregation is nil in figure 14-1, so both
kinds of labor are equally valuable to employers and they receive the same
wage, w_d = w_n. Now assume that segregating the workplace becomes costly.
As the cost of segregation increases, the demand curve for discriminatory labor
shifts down from D_d to D'_d as shown, and the discriminatory wage falls from
w_d to w_d'. The reduction in use of discriminatory labor causes an increase in
demand for nondiscriminatory labor, as indicated by the upward shift in demand
from D_d to D'_n. Consequently, a gap opens in the wage of the two groups, with

15 See Becker 1973.
Discriminatory labor receiving the lower wage $w_d$ and nondiscriminatory labor receiving the higher wage $w_n$.

I have explained why perfect competition causes discriminatory workers to pay for segregation. In general, perfect labor markets impose an increase in the cost of production on anyone who demands special working conditions. If segregation increases the costs of production, workers who demand segregation will pay its costs.

Now I turn from labor markets to markets for goods and services. Discriminators sometimes refuse to buy or sell goods or services to some groups of people. A similar argument can be made about “refusal to deal” as was made about employment discrimination. As before, first consider discriminatory sellers and nondiscriminatory buyers. If sellers refuse to deal with some buyers, the discriminatory sellers may bear additional costs. In perfect competition, all goods sell at cost, so discriminatory sellers will charge more than nondiscriminatory sellers for the same good. By assumption, buyers are nondiscriminatory, so they will purchase from the sellers with the lowest prices. Thus perfect competition eliminates discriminatory sellers, just as it eliminates discriminatory employers.

For example, a restaurateur who insisted on segregated dining facilities might have higher costs, which nondiscriminatory patrons would refuse to pay. If all restaurant patrons are nondiscriminatory, then the higher prices charged in the segregated restaurant will cause it to fail.

Now consider the case of discriminatory buyers. Once again, product markets strictly parallel labor markets. Specifically, consumers who prefer discriminatory sellers will pay a surcharge for the products they buy relative to nondiscriminatory consumers. The surcharge will equal the additional cost of segregating buyers. For example, diners who discriminate will pay the extra cost of segregating dining facilities.
Insofar as the model of perfect competition is accurate, discriminators pay its costs. Some people with strong preferences for segregation may be willing to pay the cost of discrimination. Should the law allow people to "buy" as much segregation as they are willing to pay for, or should the law prohibit segregation? Fortunately, debates about segregation and the law seldom have to address this question, because the most troubling cases of segregation do not involve the discriminators paying the cost of segregation. Rather, the most troubling cases of segregation occur when the victims of segregation pay its costs. In other words, the most troubling forms of discrimination occur in social interactions different from perfect competition. As explained in the next section, these interactions occur outside of markets or in imperfectly competitive markets.

Questions

1. In *Diaz v Pan American World Airways, Inc.*, males alleged discrimination in airline hiring, such as exclusive employment of pretty, young female stewardesses. The court found that discriminatory preferences of customers cannot justify discrimination in hiring airline staff. Economic theory counts satisfying discriminatory preferences as a social benefit. In a case like *Diaz*, do you agree with standard economic methodology?

2. Assume that some workers demand more integration than maximizes the firm's productivity. In perfectly competitive labor markets, who would bear the cost of the additional integration?

3. Assume that some men refuse to be led by women, but most women are willing to be led by men. The state seeks to implement a law prohibiting sex discrimination in hiring and promotions. What obstacles will the labor market present to implementing this law?

Discriminatory Power

As explained, the model of perfect competition predicts that discriminators will pay for discrimination. Testing this prediction requires estimating the effects of discrimination on earnings, which is notoriously difficult. The best empirical estimates, however, do not confirm the prediction that discriminators pay for it. Rather, empirical studies suggest that the targets of discrimination in the United States historically received lower wages than others with equivalent skills, and that civil rights laws helped raise the income of African Americans. Given the satisfaction as equally valuable, regardless of whether the preferences are immoral, but others disagree. For discussion and citations, see Lewin and Trumbull 1990.


18 The empirical evidence is reviewed in Epstein 1992, chapter 12, "The Effects of Title VII." For especially careful econometric work, see Heckman 1991.
evidence, the model of perfect competition apparently cannot explain discriminatory practices in the United States. Although the perfectly competitive model describes powerful forces at work in the economy, something goes wrong in its simple application to discrimination.

In subsequent sections of this chapter, I will consider several market failures that might explain how discriminators shift the burden of segregation to its victims. To begin, I develop a model of discrimination based on power, not competition. Just as producers collude to fix prices and obtain monopoly profits, so social groups sometimes collude to obtain the advantages of monopoly control over markets. To enjoy the advantages of monopoly, a social group must reduce competition from others by excluding them from markets. In this way, the more powerful social group can shift the cost of segregation to its victims, so that the victims of discrimination are worse-off and the discriminators are better-off.

To illustrate, recall the hypothetical example in which some blues discriminate against greens, and perfect competition causes the discriminatory blue workers to bear the cost of segregation. Now suppose that discriminatory blue workers organize themselves and acquire enough power to disrupt the workplace. The blues could use this power to threaten employers who failed to discriminate against greens. Faced with the power of the blues, employers might find that they could maximize their profits by avoiding disruption, even at the cost of segregating workers and confining greens to lower-level jobs. This example describes circumstances in which segregation reduces productivity and its victims bear the cost.

The consequences of discriminatory power in the market for skilled and unskilled labor are depicted in figure 14-2. The demand for skilled labor is indicated by the curve labeled $D_s$, and the supply of skilled labor by greens, blues, and the sum of greens and blues, is indicated by the curves $S_g$, $S_b$, and $S_g + S_b$, respectively. In the absence of discrimination, the wage for all skilled workers is $w_s$. The demand for unskilled labor is indicated by the curve labeled $D_u$, and the supply of unskilled labor (blue and green) is indicated by the curve $S_u$. In the absence of discrimination, the wage for unskilled workers is $w_u$.

Now consider how discrimination changes wages in figure 14-2. If blues exclude greens from the market for skilled labor, the supply falls from $S_g + S_b$ to $S_b$, and the skilled wage rises to $w_b$. Discrimination forces greens to work as unskilled labor. The additional greens entering the unskilled labor market swells the supply from $S_u$ to $S'_u$, which causes wages to fall from $w_u$ to $w'_u$. Thus discrimination increases wages for skilled blue workers and lowers wages for unskilled blues and all greens.

Discrimination as depicted in figure 14-2 divides blues against each other by increasing the wage of skilled blues and decreasing the wage of unskilled blues. However, the unskilled blues could also use discrimination to their advantage if they obtained power in the market for unskilled labor. For example, unskilled
demand is higher for “blue work” than for “green work,” then segregating tasks will cause the wage of unskilled blue workers to rise above the wage of unskilled green workers.

This market analysis can be applied to Title VII of the U.S. Civil Rights Act of 1964. The law prohibits employment discrimination based on race, sex, or age. In practice, most workers fall within its protection except for young white males. Complaints of discrimination must be filed with a commission (Equal Employment Opportunity Commission) that vets them. The commission can issue a finding but cannot issue an injunction. Unresolved complaints can be taken to court, which can order the defendant to cease the discriminatory practice. The court can also order the injurer to pay foregone wages to victims.

To illustrate, a court might order a company that wrongfully denied a job to someone two years ago to hire the person and pay compensation equal to the difference between his current wage and the higher wage in the better job for two years. In terms of figure 14-2, a skilled green worker who was forced to accept unskilled employment could sue for the difference between \( w_s \) and \( w_u \). The fact that the law limited damages to back-pay discouraged lawyers from taking small cases on a contingency fee. Revisions in Title VII in 1992 brought employment discrimination closer to tort law by broadening damages, which makes employment discrimination cases more attractive to lawyers.

**Antidiscrimination as Antitrust**

In general, the members of a group benefit from reducing competition with outsiders for business. This is true regardless of whether the group is a cartel of industrialists or a group based on race, ethnicity, religion, age, or sex. Discriminatory social groups resemble business cartels, and a discriminatory
Cartels are unstable because each member can increase its profits by defecting from the group. For example, the Organization of Petroleum Exporting Nations (OPEC) tried to fix prices in the early 1970s, but countries like Algeria secretly discounted oil in order to sell more of it. As a cartel becomes large, detecting and preventing such "cheating" by members becomes harder. Without legal backing and formal enforcement of their agreements, large cartels like OPEC usually collapse.19

Similarly, social groups can exert power to increase their wages by restricting competition in the labor market, but individuals can profit from violating the restrictions. To illustrate, recall figure 14-2 in which blue workers exclude green workers from skilled jobs. An employer can reduce wages from $w_f$ to $w_s$ by ending segregation and integrating the workplace. To prevent employers from ending segregation, blue workers must bear the inconvenience, expense, or danger of threatening employers and participating in industrial disruptions. Skilled blue workers who cease to participate in these activities, however, continue to enjoy the discriminatory wage $w_f$. In economic jargon, individual blues have an incentive to "free-ride" with respect to discriminatory norms by withholding enforcement effort. So the self-interest of employers and blues as individuals does not prompt them to sustain discriminatory norms.

In general, sustaining discriminatory norms requires the collusion of many people, which presupposes sanctions to discipline them. Informal sanctions such as gossip, ostracism, and boycotts can operate spontaneously, especially when a culture stresses group solidarity.20 In the past, many Americans used informal sanctions to punish individuals who failed to keep the races separate or women "in their place." However, informal sanctions were probably not enough to sustain many forms of segregation in the United States without buttressing by formal laws.21 To illustrate, Southern states formerly outlawed the integration of schools, and the board of realtors in many localities prohibited its members from selling houses to black families in white neighborhoods.

Antidiscrimination laws, which ideally increase competition, can sometimes diminish it. To illustrate, suppose the greens in figure 14-2, who were the historic victims of discrimination, acquire legislative power and enact laws mandating preferential hiring of greens. For example, the law might mandate filling job openings for skilled workers with greens until 60 percent of the workers are green. (Perhaps 60 percent of the population is green.) Thus blues cannot compete with greens for jobs until the green quota is filled, which causes the green wage to rise above the blue wage for skilled workers.

Figure 14-3 depicts these arguments, which underlie the claim that affirmative action is reverse discrimination. Figure 14-3 reproduces the supply curve for skilled green workers $S_g$ as already depicted in figure 14-2. As already explained in figure 14-2, the wage in a free market without discrimination or reverse

19 The instability of cartels is a standard topic in the economic theory of monopoly. For example, see Telser 1978.
discrimination equals \( w_s \). As depicted in figure 14-3, the wage \( w_s \) results in the supply of \( q_c \) of skilled green labor. The quota, however, requires the employment of \( q_s \) skilled green labor. To satisfy the quota, the wage for skilled green labor must rise to \( w_e \). In order to satisfy the quota, skilled green labor must be paid more than skilled blue labor. The quota causes the "surplus" enjoyed by skilled green workers to increase from \( B \) to \( A + B \).²²

The phrase "rent-seeking" refers to the efforts of people to secure laws that convey monopoly power and profits upon themselves. Writing a law into the constitution can reduce rent-seeking by removing the law from ordinary politics. For example, constitutional protection of private property inhibits state officials from expropriating private property for themselves. Similarly, constitutional guarantees against discrimination can reduce rent-seeking by social groups. Constitutional protection against discrimination, like constitutional guarantees of property, can facilitate competition and preclude wasteful efforts to redistribute income among social groups by political means.

On the other hand, the creation of vague and uncertain constitutional rights by courts can unleash extensive rent-seeking through litigation. Social groups, including racial and ethnic groups, are paradigmatic interest groups in many respects. Like other interest groups, they seek to collude and redistribute wealth to themselves by inefficient restrictions on competition.

Self-interest and morality, however, often prompt individuals to evade these restrictions. Thus, discriminatory social groups suffer the same problems of instability as do other cartels. To sustain discriminatory norms, evaders must be

²² By definition, the surplus equals the difference between wages and the value of labor to the people supplying it. Without the quota, the skilled green workers receive \( B + C \) in wages, and then...
punished by a combination of informal sanctions and formal laws. By under-
mining these sanctions, law can cause the discriminatory norms to disintegrate.
As with business cartels, the best public policy against a racial or ethnic cartel under­
mines it by aggravating its natural instability.

Questions

1. Compare a discriminatory social norm to a price-fixing agreement.

2. In some circumstances, a country gains an advantage by imposing a tariff on
the products of another country, especially if the other country cannot retaliate by imposing its own tariffs. Similarly, one ethnic group could gain an advantage by imposing a tariff on hiring people from the other ethnic group. What would it mean for one ethnic group to “impose a tariff” on another?23

3. Most discussions of discrimination in the United states presume that majori-
ties subordinate minorities, which is not always the case. Majorities often charge minorities with discrimination. For example, in the United States males are less than 45 percent of the population, the economically dominant Chinese are a small fraction of Indonesia’s population, and east Indian merchants are a small fraction of the population in Africa. Use collective-choice theory to pre-
dict different outcomes depending on whether the victims of discrimination are the majority or the minority.

4. Racism divides workers and retards unions. Under what conditions might employers promote racism among workers in order to hold down wages?

Discriminatory Signals and Asymmetrical Information

I first considered discrimination in the context of perfect competition, and then
I considered monopoly power. Now I consider a different kind of market imper-
fection, specifically imperfect information on the part of buyers and sellers.24
To understand the problem of imperfect information, I begin with a familiar example concerning insurance against automobile accidents. Insurance com-
panies classify drivers into broad groups and set premiums according to the probability that the average driver will have an accident. For example, young drivers cause more accidents on average than middle-age drivers, and young males cause more accidents on average than young females. The sex and age of policyholders, which are cheap for insurance companies to discover, predict the risk of accidents with sufficient accuracy to be useful for setting insurance rates. Thus, insurance companies charge higher premiums for being young and male.

Now I turn from insurance to employment. Just as insurance companies
know little about individual policyholders, so employers know little about job
applicants. In choosing among them, employers rely on signals to predict performance. For example, a job applicant with a college degree can easily provide the employer with a copy of his transcript. The college degree may signal traits that the employer values, like intelligence. Education effectively signals intelligence because more intelligent people can acquire education more easily and cheaply than can less intelligent people.25

“Good signal” is the name economists give to a characteristic that predicts accurately on average and is cheap to observe. In transactions with imperfect information, the parties search for good signals to reduce their uncertainty. Examples of good signals include the smell of a peach, the height of a basketball player, the speed in megahe_rtz of a computer chip, the class rank of a law student, the rating of a bond, and the brand name of an automobile. Similarly, sex and age of drivers signal future claims against insurance companies.

In discriminatory signaling, a fixed trait like sex or race signals an unobserved variable. To illustrate, sex is an easily observed trait, whereas strength is a variable that is relatively difficult to observe. Men are physically stronger than women on average, so some employers reject all female applicants for jobs requiring strength. By adopting such policies, an employer will often make mistakes like rejecting a strong woman and accepting a weak man, just as an automobile insurance company sometimes overcharges safe males and undercharges dangerous females. In general, if mistakes of overgeneralization cost less than gathering more individualized information, the use of the signal maximizes profits and competition will reinforce the discriminatory practice. This is a case of rational discrimination. Conversely, if the cost of overgeneralization exceeds the cost of gathering more individualized information, then the use of the signal is inefficient and competition will eliminate its use. This is a case of irrational prejudice.

Suppose that the government prohibits employers from using discriminatory signals. For example, a statute might give strong women the right to sue employers who hire men exclusively for jobs that require strength. If the prohibited signals are inefficient, the law bans what competition will eliminate. If the prohibited signals are efficient, the law augments the cost of production, which someone must bear. Competition drives the market price of a good down to the cost of producing it. Thus a reduction in an industry's efficiency typically causes the consumers of its products to pay higher prices.

To illustrate, assume that sex efficiently signals the physical strength of job applicants. If the law bans the use of this signal and the prohibition is effective, rational employers will adopt the best substitute for the banned signal. The best substitute may be a direct measure of physical strength, or the best substitute may be another signal, such as the applicant's height, weight, or age. In any case, competition translates any increase in the cost of sorting job applicants into higher product prices.26
In the absence of regulations, the victims of discriminatory signals may have private remedies. To illustrate by the preceding example, if sex signals strength and employers have no irrational prejudice against hiring women, then strong women would probably find it in their interest to undergo tests and provide employers with the results. The selective use of direct testing would occur without government intervention in the labor market.

An objection to private remedies in this example is that by assumption, female applicants would have to bear the cost of a test that men need not take. Regulations would be required to overcome this objection. The employer might be required to test directly the strength of any applicant requesting it. Or the state might provide direct tests of strength without charge.

These remedies have a distinct advantage over requiring the employer to base hiring decisions on a test of strength administered to job applicants. Such a requirement forces employers to test every job applicant. In contrast, the alternative remedies result in testing the strength of a small fraction of applicants.

In general, the economic strategy for correcting discriminatory signals is to increase the flow of information to the market so that relying on them is unnecessary. This approach usually suggests a cheaper solution than banning the use of the discriminatory signal. The savings arise from limiting the gathering of information to potential victims of discrimination, rather than forcing the gathering of more information about everyone.

Many social critics believe that decision makers frequently rely on false signals that reflect social stereotypes, not accurate averages. Competition can teach a sharp lesson to businesses that rely on false signals. Decision makers whose prosperity depends on the accuracy of their perceptions are better situated than social critics or legislators to penetrate myths. However, competitive pressures are blunted in many organizations, especially in the public sector or the nonprofit sector. Blunting competition allows decision makers to persistently rely on bad signals.

A telling example comes from the criminal courts in New Haven, Connecticut. When the state charges a person with a crime, the judge sets bail. The law requires judges to set bail at the minimum amount that creates a reasonable certainty that the accused will appear for trial. If the accused posts bail, then he can go free pending trial. The state returns the bail to the accused if he appears for trial, whereas the state seizes the bail if the accused fails to appear for trial.

In reality, most people accused of a crime in the United States post bail by borrowing the money from a specialized lender called a bail bondsman. In exchange for a fee, the bail bondsman assumes the risk that the defendant will not appear for trial. A study that compared 1,118 black and white defendants in New Haven found that bail amounts averaged 35 percent higher for blacks charged with the same crime as whites. This fact suggests that judges believed that compared to white defendants, black defendants in this sample had a higher propensity to flee. If this belief were accurate, it might justify higher average bail amounts for blacks.
This justification for judicial behavior, however, is inconsistent with the observed behavior of the bail bondsmen. Bondsmen charged black defendants rates that were 19 percent lower than the rates charged to white defendants. In a competitive market the bond rate should approximate the probability of flight (given the judicially set bail). The lower rate indicates that bail bondsmen think blacks are less likely than whites to flee when facing the same bail as set by the courts.

The evidence indicates that the bondsmen and the judges attach opposite signs to the racial signal. The authors of this study believe that competition among bondsmen causes them to estimate probabilities accurately, whereas the absence of competition among judges permits their prejudices to go uncorrected. The market for bail bonds apparently eliminates half of the effect of discrimination in bail setting.27

Questions

1. Discuss whether the following characteristics are likely to be cheap and accurate predictors of automobile accidents in the United States:
   - prior traffic accidents
   - age
   - sex
   - Hispanic surname
   - race

2. What effects would follow from a legal prohibition against using the signals in the preceding question to set insurance rates?

3. The gap in reading and writing skills between white students and black or Hispanic students has narrowed slowly over the last fifteen years.28 What effect should the narrowing of this gap have on labor-market signaling?

4. A secretary with a master's degree in English and ten years of experience may earn less per hour than a plumber with a high school degree, four years of apprenticeship, and ten years of experience. Secretaries are disproportionately women and plumbers are disproportionately men. The proponents of "comparable worth" want the state to require employers to pay secretaries at least as much as they pay plumbers. Predict the different effects of such a law based on the following three alternative assumptions about the labor market: (i) perfect competition, (ii) discriminatory power of males, (iii) sex signaling.

27 Ayres and Waldfogel 1994.
28 "Tests Show Reading and Writing Lag Continues," New York Times, 10 January 1990, B7. In the period 1971-1988, the tested reading skills of black students improved modestly along some dimensions while those of white students were unchanged, so the gap narrowed somewhat. No
EXTERNALITIES AND TIPPING POINTS: TRAGIC SEGREGATION

When each person’s action depends on what others do, the interdependency of behavior can create instabilities. To illustrate, if each buffalo follows the one in front, the whole herd may run over a cliff. Similarly, “white flight” has allegedly destabilized integrated schools and neighborhoods in the United States. White flight in the United States resembles ethnic polarization that occurs in other countries. Most recently, ethnification in Rwanda and Yugoslavia produced the slaughter of civilian populations. In this section I analyze the instabilities created by interdependent preferences toward mixed social groups.

I begin with a simple model of white flight. Assume that an all-white neighborhood consists of one hundred families who can be ranked according to their attitudes toward residential integration. At one end of the ranking, the one-hundredth white family would move out of the neighborhood if one black family moved in. Similarly, the ninety-ninth family would move out if two black families moved in. Proceeding down the ranking, the first family would move out when ninety-nine black families had moved in.

I also assume that blacks have a continuous distribution of attitudes toward living in neighborhoods with whites. Some black families would be willing to move into an all-white neighborhood, many black families would be willing to live in an integrated neighborhood, and some black families would be unwilling to live in a neighborhood with any whites.

Now assume that large numbers of blacks migrate to the city containing this neighborhood. The demand and supply in the housing market is such that whenever a house becomes vacant in a particular white neighborhood, more black families than white families want to buy it. It is not hard to see that if one black family moves into the white neighborhood, a process will be set in motion that may not end until all whites have moved out. Specifically, if one black family moves in, the one-hundredth white family will move out. Now the house of the one-hundredth white family must be sold. The buyer of the vacant house is more likely to be black than white, so it is likely that two black families will now reside in the neighborhood. As a result, the ninety-ninth white family will move out. Now it is likely that there will be three black families in the neighborhood and the ninety-eighth white family will move out. The process continues until the neighborhood is all black.

The tragedy of this situation is that many whites and blacks in the neighborhood may positively value residential integration. In spite of sentiment favoring integration, unrestricted sale of houses in a free market cannot achieve integration. Instead, the integrated neighborhood inexorably unwinds and becomes segregated. The beneficiaries are blacks and whites who want to live in segregated neighborhoods.

Notice that this model’s dynamics make no special assumptions about the cause of attitudes toward integration. For example, the attitudes of whites
blacks in the model may reflect skin prejudice, cultural pride, class-consciousness, fear of violence, or beliefs about housing prices. In every case, the basic dynamics of the model are the same.

The most familiar economic models compare equilibria ("comparative statics"), whereas this model describes a dynamic path. Indeed, this model probably describes the actual dynamic in U.S. cities after the Second World War when many neighborhoods went from all white to all black. It also probably describes forces at work in many public schools today. Since the model is unfamiliar and important, I will develop it better with a graph.

Figure 14-4 graphs the attitudes toward integration of residents in a neighborhood that is all white. The horizontal axis shows the proportion of white residents in a neighborhood who plan to move out. The vertical axis shows the proportion of black residents. Thus the graph shows the proportion of white residents who would plan to move out as a function of the proportion of black residents who move in.

To illustrate the interpretation of figure 14-4, suppose that the graph consisted of a single point at the northwest corner, corresponding to the value (0%, 100%). This would indicate that no white family in the neighborhood would plan to move out even if all the other residents were black. Conversely, suppose that the graph consisted of a single point at the southeast corner of the graph, corresponding to the point (100%, 1%). This would indicate that all whites in the neighborhood would plan to move out if only 1 percent of the neighborhood became black. The curved line in figure 14-4 represents a more realistic case in which there is a continuous distribution of sentiment toward integration.

I will analyze the dynamics of white flight created by the distribution of preferences represented by the curved line in figure 14-4. As the curve is con-
families can move out and be replaced by blacks without provoking white flight. However, once the proportion of black residents reaches 12 percent, white flight begins, as can be seen by considering point A on the graph. Since Point A lies below the 45-degree line, point A indicates that more than 12 percent of the white residents would plan to move out if the neighborhood were 12 percent black. This is an unstable situation in which integration starts to unwind, as is illustrated by considering several other points on the graph. At point B, approximately 60 percent of the white residents would be planning to move out if approximately 25 percent of the residents were black. At point C, approximately 75 percent of the whites would be planning to move out if 50 percent of the residents were black. And so the flight goes on until no whites remain in the neighborhood.

To complete the model, another graph should be drawn showing the distribution of black preferences toward integration. In this graph, the vertical axis would show the proportion of whites in the neighborhood, and the horizontal axis would show the proportion of blacks who would be willing to move into the neighborhood. The blacks who are most tolerant of white neighbors would move into it first, and the blacks who are least tolerant of white neighbors would move into it last. I omit this graph for the sake of simplicity.

In a neighborhood characterized by figure 14-4, 12 percent blacks or fewer is an unstable equilibrium, and 100 percent blacks is the only stable equilibrium. The stability conditions can be stated precisely in terms of the diagonal line in figure 14-4. The model assumes that whenever a house becomes vacant, it is more likely to be purchased by a black family than by a white family. So long as the neighborhood is at a point where the curved line representing white attitudes toward integration lies below the diagonal line, more whites plan to move out in response to the existing proportion of black residents. This is a disequilibrium. There is an equilibrium at any point where the curved line representing white attitudes toward integration touches the diagonal line. To have a stable equilibrium, the curved line must intersect the diagonal line from below as it does at point E. Stable segregation occurs when the intersection is near the diagonal line's end, as at point E in figure 14-4. For stable integration, the curved line must be redrawn so that it intersects the diagonal line from below at a point near the middle of the diagonal line.

An application of this theory comes from Starrett City, which is a private housing project in Brooklyn whose construction was partly financed by the federal government. In 1977 Starrett City had approximately 20,000 tenants, with whites occupying nearly 65 percent of the 5,881 apartments and the other 35 percent being occupied by blacks and Hispanics. The managers set a racial quota of 65 percent white and 35 percent nonwhite, which they defended on the grounds that it was necessary to maintain a stable, integrated community. There were, however, fewer white applicants for vacant units than there were black or Hispanic applicants.
The National Association for the Advancement of Colored People (NAACP) challenged these quotas in a suit brought in 1979, which was settled in 1984 with the provision that allocation by race should continue, but 174 additional units should be made available to nonwhite applicants. Apparently the owners of Starrett City and the NAACP agreed that color-blind apartment allocation would lead to segregation (as in figure 14-4). Their settlement, however, was challenged by the Civil Rights Division of the Justice Department, who contended that any such system of racial quotas, even one whose purpose is integration, violates the Federal Fair Housing Act. The view of the Justice Department prevailed in federal court, which ordered an end to the racial quotas. A follow-up story reported that Starrett City was evading the court order in a way that advantaged blacks.31

Spontaneously segregated neighborhoods resemble a tragic drama in which social laws lead inexorably to an end that many people do not want. The people who want to live in homogeneous neighborhoods can satisfy their preferences, but the people who want to live in diverse neighborhoods cannot satisfy their preferences. The outcome frustrates the desire of many people of both races to live in an integrated community or to attend integrated schools.

Racially restrictive covenants (“ceiling quotas”) can avoid tragic segregation and stabilize integration. To illustrate, if 50 percent of the houses in the hypothetical neighborhood described in figure 14-4 had enforceable deeds restricting ownership to whites, the neighborhood would have stabilized with 50 percent white families and 50 percent black families. Furthermore, the 50 percent white families and the 50 percent black families in the neighborhood would tend to be those with the most positive attitudes toward integration. The federal courts have struck down racially restrictive covenants, which were used historically to keep neighborhoods all white.32

Can economists devise a way to end tragic segregation other than by relying on ceiling quotas? From the viewpoint of economic theory, continuous preferences of individuals over the racial mix in social groups causes tragic segregation. Preferences over the racial mix in social groups are economic externalities. Economists typically propose to remedy externalities with a tax, subsidy or transferable rights, rather than quotas. In principle, these remedies could be applied to racial mixing. Thus a tax might be assessed on housing sales that worsen a neighborhood’s racial mix, or a subsidy might be paid on housing sales that improve the neighborhood’s racial mix. Alternatively, a solution using transferable property rights might be developed.33 Similar devices could be used.

31 Starrett City avoided the court order by not filling any vacant apartments from its waiting list of applicants who fit the poverty criteria, black or white, but instead keeping them vacant until someone applied who was above the legal definition of poverty. The middle-class applicants who were above the poverty line were disproportionately black. See New York Times, 14 July 1990.
32 In Shelly v Kraemer, 334 US 1, 14023 (1948), the Supreme Court found unconstitutional a covenant in a deed prohibiting the sale of the property to Negroes.
in schools, such as school vouchers that increase in value when the enrollment of a pupil in a particular school improves its racial balance.

Questions

1. The intersection of a demand curve and a supply curve represents a static equilibrium. Figure 14-4 graphs a dynamic process. To make sure that you understand this technique, redraw the curve in figure 14-4 so that it has a new shape. Put arrows along the curve to indicate areas of instability and the resulting direction of change. (For example, you need to put arrows at points A, B, C, and D pointing up the curve toward E.)

2. Your vacation takes you to a foreign city inhabited by Muslims and Christians. You observe that all the neighborhoods are strictly segregated by religion. You also observe that a substantial number of people of both religions would prefer to live in a neighborhood inhabited by people of both religions. Adapt the model of white flight to explain these observations.

3. The model of white flight assumes that “tastes” remain unchanged as events unfold. How do you think that attitudes toward integration will change as segregation proceeds in figure 14-4?

4. Economists typically oppose quotas as inefficient. For example, quotas for reducing pollution tend to be inefficient because they do not reflect differences in abatement costs by different firms. Suppose the government imposes racial or sex quotas on a firm (e.g., 50 percent of the plumbers must be female). Explain how the resulting inefficiency resembles the inefficiency from pollution quotas. Explain how the inefficiency can be overcome in principle by pursuing the same goal through the use of taxes or transferable rights, rather than quotas.

Conclusion

Perfect competition eliminates discrimination or makes the discriminators bear the cost. Removing the obstacles to competition, consequently, attacks discrimination. By releasing market forces, constitutional guarantees of equal opportunity can undo discrimination. Statistical studies, however, often conclude that discrimination persists in the United States and the victims pay for it. Understanding the persistence of discrimination requires a theory of market failure. Monopoly power, asymmetric information, and externalities are three fundamental types of market failures that explain the persistence of discrimination.
Like any business cartel, a social group can gain an advantage for itself by blocking entry into labor markets by other people. A social cartel, furthermore, suffers from the same instability as a business cartel. Sustaining a social cartel requires the group to overcome free-riding by its members. Some groups overcome free-riding by private enforcement of social norms. Other groups cannot overcome free-riding except by enacting state laws to enforce discrimination. To destabilize social cartels, the state can use the same techniques as antitrust law uses against business cartels. For example, courts can strike down discriminatory laws and refuse to enforce discriminatory private contracts.

Even without market power, asymmetrical information can cause discrimination to persist in markets. Irrational prejudice consists in making decisions about individuals by using statistical averages based on false inferences from personal traits. Market competition sharply penalizes irrational prejudice. Rational use of prejudicial signals consists of making decisions about individuals by using statistical averages based on true (but objectionable) inferences from personal traits. Market competition rewards rational prejudice. To combat rational prejudice, the state must improve the information available to decision makers, so they no longer need to rely on objectionable statistical inferences from personal traits.

In addition to social cartels and discriminatory signals, the attitudes of people toward each other can create externalities that free markets cannot internalize. In the case of tragic segregation, a continuous distribution in attitudes toward mixing with other races can destabilize any integrated environment. Externalities can be corrected in principle by ceiling quotas, although U.S. courts seldom allow the use of this device. A more promising remedy comes from tax subsidies or transferable rights, such as school vouchers whose value increases when used to improve the racial balance of a school.