

Chapter 3

How the Profit Motive Reduces Racial and Other Discrimination

Discrimination in choosing employees by reason of race, creed, sex, beauty, or age will be more pronounced in not-for-profit firms than in business firms.

— Armen A. Alchian (2006), “Some Economics of Property,” p. 48.

Go into the London Stock Exchange... and you will see representatives of all nations gathered there for the service of mankind. There the Jew, the Mohammedan [Muslim], and the Christian deal with each other as if they were of the same religion, and give the name of infidel only to those who go bankrupt.

— Voltaire

Murray Wax, an emeritus sociology professor at Washington University in St. Louis told one of us the following story. As a young man in the late 1940s, Wax had been a member of the US Communist Party. While earning his graduate degree in the early 1950s, he applied to the city college system in Chicago for a teaching job and was hired to teach at Wright Jr. College. But just before the academic year was to begin, the City of Chicago’s superintendent of education invited him for a visit. The superintendent showed him a thick dossier that the FBI had gathered about Wax’s earlier political activities and told him that the teaching offer was withdrawn. Figuring that all the government-run colleges in the Chicago area would now be similarly off limits, Wax got a job as a freelance market researcher for two years, and then went to the Toni Company for an additional few years. Neither his clients nor, later, the Toni Company asked, or seemed to care, about his political background. Said Wax,

“I had absorbed all this Marxist teaching, but until then I hadn’t realized this paradox: The corporations didn’t care about my Communist background, but academia—which I had thought of as mine—was willing to not hire me for reasons totally unrelated to my teaching ability.”⁷

That story would not have surprised UCLA economists Armen Alchian and Harold Demsetz. The government-run city colleges of Chicago could discriminate against a high-quality applicant because no one owned the university and, therefore, no one bore a cost for this discrimination. But the ad agency was a for-profit company. If the company passed up the opportunity to hire someone who would do a good job, it wouldn’t do as well financially. By taking longer to find someone as good or by settling for someone less skilled, the company would suffer financially for its decision to discriminate, which is why the company that hired him didn’t ask him about his political background—it didn’t care enough to risk its profits.

In 1957, Gary Becker, then an economics professor at Columbia University, published a path-breaking book titled *The Economics of Discrimination*. The book’s most important message is that an employer who discriminates in hiring on the basis of race rather than on the basis of productivity gives up profits. In other words, there is a cost to discriminating. Becker was careful to note that that does not imply that there will be no discrimination. Some employers are willing to give up profits in order to exercise what Becker called their “taste for discrimination.” But his point was that discrimination is costly for those who do it and that that cost limits the amount of discrimination. The law of demand, which says that when the price of something rises people buy less of it, applies to discrimination as well.

Alchian and co-author Reuben Kessel of the University of Chicago took Becker’s insight and ran with it. In his book, Becker had noted that black people were discriminated against more frequently by monopolistic enterprises. While Becker didn’t see that fact as a puzzle, Alchian and Kessel did. In their famous 1962 article, “Competition, Monopoly and Pecuniary Gain,” they asked, “But why do monopolistic enterprises discriminate against Negroes more than do competitive enterprises?” They went on to point out that there was no good reason, or at least no reason that Becker gave, to

⁷ Phone interview with Murray Wax, August 29, 2000.

expect monopolistic enterprises to discriminate more against black people than competitive enterprises did.

Alchian and Kessel provided the missing logic. Monopolies, they noted, tend to get their monopoly power from the government. Governments often prevent other firms from competing. Public utilities are an example. But often the government, in return for granting monopoly power, regulates the profits of the monopolies. Wrote Alchian and Kessel: “Their cardinal sin is to be too profitable.”

In their article, Alchian and Kessel noted an important implication: “If regulated monopolists are able to earn more than the permissible pecuniary rate of return, then ‘inefficiency’ is a free good because the alternative to inefficiency is the same pecuniary rate of return and no ‘inefficiency.’” In other words, once regulated monopolies bump up against the profit constraint imposed on them by government, they can’t legally earn more and so they “spend” what would otherwise be the additional profits on things that can be considered consumption items. Alchian and Kessel, writing in a less politically correct era, gave a long list of these other items, a list that includes “pretty secretaries,” “lavish offices,” and “large expense accounts.”

Where does racial discrimination come in? As noted above, the cost of racial discrimination limits the amount of racial discrimination that will occur. But if the government constrains firms to earn lower profits than they could otherwise earn, racial discrimination, like inefficiency, becomes a “free good.” Therefore, we would expect to see more racial discrimination in monopolistic firms whose profits are regulated by governments.

Alchian and Kessel tested their hypothesis by analyzing a sample of 224 non-Jewish and 128 Jewish MBA students who had graduated from the Harvard Business School. The graduates were employed in 10 major industry categories. Of the 10, they wrote, the two industries with the greatest regulatory restrictions discouraging efficient production were “transportation, communication and other public utilities” and “finance, insurance and real estate.” Although 36 percent of the MBAs were Jewish, their representation in the two most heavily regulated industries was only 18 percent. The probability of this outcome happening by chance, they noted, was less than

0.0005.8 Attenuating the rights of the owners of the regulated companies to use their property to increase profits had the effect of encouraging anti-social behaviour and outcomes.

Alchian and Demsetz (1973) considered the effects of another way in which government attenuated rights of property owners: rent control. They noted that effective rent control, which is rent control that keeps rents below free-market levels, “prompts landlords to lease their apartments to persons possessing personal characteristics that landlords favor.” During World War II, rent control was common in major American cities. But tie-in sales of furniture and racial discrimination, unlike charging a free-market rent, were legal. The key word in newspaper ads to indicate that the landlord discriminated on racial grounds was “restricted.” Examining apartment-for-rent advertising in a Chicago newspaper, they reported:

[T]he percentage of apartment-for-rent advertisements specifying that the apartment was for rent only on a “restricted” basis or only if the renter purchased the furniture rose from a pre-war low of 10 percent to a wartime high of 90 percent during the period of World War II when rent control effectively created queues of prospective renters. (p. 21)

Unfortunately, they did not report what part of the 10 percent and what part of the 90 percent were in the “restricted” category versus the “furniture” category. Still, the findings in the Chicago newspaper ads were consistent with the idea that rent control had caused the cost of discriminating on racial grounds to fall. Black people could not legally compete for apartments by paying more money and so landlords, who, presumably, were disproportionately white, could satisfy their “taste for discrimination” at a much lower, or even zero, cost.

Free markets and well-defined and well-enforced property rights work especially well at breaking down discrimination when what is exchanged is goods rather than labour. In 1992, one of the authors went to San Francisco’s Candlestick Park to see the Giants play the Cincinnati Reds. To get into the

⁸ For an overview of this study and several other seminal studies on property rights by Alchian, see Henderson (2019).

baseball spirit, and despite the traditional rivalry between the two teams, he wore his blue L.A. Dodgers helmet. He was sitting in the stands when a young man came by selling hot dogs. Because the author was about 40 feet away, rather than try to shout above the din, he put up one finger for one hot dog. The young man looked at him, noticed the Dodgers helmet, pointed to his own head and shook his head as if to say, “No, I won’t sell you a hot dog because you’re a Dodgers fan.” Then he grinned and the author grinned, and he passed the hot dog down the row. Both the hot dog seller and this author knew that he would sell the hot dog. There was no way he was going to refuse to make money off even a Dodgers fan.

The story may sound trivial; no, it is trivial. But the point it makes is important. In our transactions for goods, people gain by ignoring characteristics of those they deal with in order to make money. Many intellectuals and many members of the public dismiss or even attack the profit motive. But the profit motive is a strong incentive for people to treat others well, whatever their skin color, ideology, or preferences about baseball teams.

The baseball helmet story is an amusing anecdote. But apartheid in South Africa was anything but amusing. UCLA graduate Thomas W. Hazlett tells the fascinating story in “Apartheid,” in David R. Henderson, ed., *The Concise Encyclopedia of Economics*. Hazlett notes that the conventional view of apartheid was that it was devised by affluent whites to suppress poor blacks. But the conventional view is wrong. Instead, apartheid, like the colour bar that preceded it, catered to white workers who didn’t want to have to compete with black workers. Indeed, white mine owners were among the strongest opponents of apartheid because it prevented them from hiring lower-wage, but productive, black workers. Hazlett notes that the white mine owners’ self-interest “was so powerful that it led the chamber [of mines] to finance the first lawsuits and political campaigns against segregationist legislation.”

A more recent example that illustrates the Becker and Alchian/Demsetz/Kessel point that well-defined property rights in free markets give even racist employers an incentive not to discriminate is the 2014 case of Donald Sterling. Sterling, the owner of the Los Angeles Clippers basketball team, had made racist comments to his young lover, and she had recorded them and publicized them. But you couldn’t tell that he was racist by looking at his payroll. At the time, the top three players on his payroll, all of whom were black or mixed-race, made a combined \$46 million while the payroll for the

whole 18-person roster was \$73 million. The free market disciplined Sterling not to exercise, in his employment decisions, his “taste for discrimination” (Yglesias, 2015, May 13).

The legal ability of owners of private property to use their human and physical assets to earn income, combined with competition from other owners of similar assets, creates a powerful incentive for those assets to be used efficiently. This is perhaps the most well-known argument for free markets. This is certainly a major theme underlying much of the research done by members of the UCLA School. However, a less well-known theme, but one having no less social importance, is that a system of private property rights combined with competition discourages behaviour that is morally and socially objectionable, perhaps, most notably, discrimination based on race, gender, religion, or beliefs.

Contrary to some contemporary claims that “capitalism” fosters discrimination against women and minority groups, work done by the UCLA School shows just the opposite. Namely, laws and regulations constraining the legal ability of owners of property to use their property to maximize profits, along with government-imposed barriers to competition, *promote* discrimination by reducing or sometimes eliminating the powerful role that competitive free markets can play in penalizing discrimination.