

EMPLOYMENT DISCRIMINATION: AN ECONOMIC PERSPECTIVE

J. G. MacIntosh*

I. INTRODUCTION

Much has been written, and undoubtedly much more will be written, about discrimination in employment. The enactment of the *Charter*¹ has only served to add to the already considerable scholarly output. And yet, it is commonplace to overlook some important aspects of the causes and consequences of employment discrimination. It is the aim of this paper to bring these arguments to light in the interests of fostering more informed discussion.

To this end, I have set for myself four related tasks. First, to briefly clarify what we mean when we talk about discrimination. Second, to examine some aspects of the positive economics of discrimination to see what insights might be gained into the functioning of markets in the presence of discrimination. Third, to offer important qualifications to the arguments of a number of conservative economists and lawyers whose writings suggest either, that most employment discrimination is benign and aimed at reducing employer costs, or that the market will eliminate most examples of inefficient discrimination. Fourth, to determine if these insights furnish any basis for grounding anti-discrimination legislation, affirmative action, and other policy initiatives in consideration of economic efficiency. In respect of the latter, I will suggest that there is indeed a case for active government intervention in the market. One of the primary reasons for this paper is to make the argument for such a case.

It may seem strange to some, particularly those who view an act of discrimination as a moral affront, to even consider the *economics* of discrimination as a relevant matter. This apparent irrelevance may be compounded for those who believe that anti-discrimination legislation, like the provincial human rights codes and the *Charter*, create (and ought to create) true "rights" which attach to *individuals*.² The aggregative

* Faculty of Law, University of Toronto.

¹ *Canadian Charter of Rights and Freedoms*, Part I of the *Constitution Act, 1982*, being Schedule B of the *Canada Act 1982* (U.K.), 1982, c. 11 [hereinafter *Charter*].

² See, e.g., L. Brilmayer *et al.*, *Sex Discrimination in Employer-Sponsored Insurance Plans: A Legal and Demographic Analysis* (1980) 47 U. CHI. L. REV. 505; D. Laycock & T.A. Sullivan, *Sex Discrimination as "Actuarial Equality": A Rejoinder to Kimball* [1981] AM. B. FOUND. RESEARCH J. 221 (arguing that American federal anti-discrimination legislation attaches not to groups, but to individuals).

calculus of efficiency,³ which is analogous to the calculus of utilitarianism from which it derives, weighs together community gains and losses backed up by a willingness to pay. It does not appear to yield any true rights-based theory of discrimination. The only right conferred on an individual by an aggregative calculus is the right to have her preferences⁴ counted along with those of everyone else. It is important to clarify at the outset what a consideration of economics and efficiency can add to the debate. I do *not* start from the strong Posnerian claim⁵ that the pursuit of wealth-maximization constitutes an overriding moral *desideratum*, nor even that it constitutes *a* moral *desideratum*. I propose to advance the much weaker, although not unimportant, claim that an understanding of the causes and effects of discrimination is at least *relevant* to the debate about the propriety or efficacy of discrimination or of efforts to eradicate it. For the purpose of admitting such relevance, it is not necessary to subscribe to any particular consequentialist ethic. Many non-consequentialist normative theories of discrimination may yield policy prescriptions which cannot be effectively implemented without a grasp of positive economics. Thus, certainly at the margin, the costs and consequences of government action (or inaction) in relation to discrimination are important.

The inquiry will turn first to the question of defining discrimination. Then I will examine the economic origins and consequences of the two primary types of discrimination in labour markets, in each case pausing to reflect on the derivative policy implications. Although the paper is primarily concerned with discrimination in the employment context, I will conclude with observations on the positive economics of discrimination with respect to pensions and insurance. This discussion is intended to illustrate the relativity of the concept of "discrimination" — that discrimination in one context and for a specific purpose may be completely benign, where in another context and for a different purpose it may work great harm.

³ In this paper I use the word "efficiency" not in the sense of Pareto superiority, but in the more commonly used sense of Kaldor-Hicks efficiency or *potential* Pareto superiority, usually referred to simply as *wealth-maximization*. This is the sense in which the word "efficiency" is most commonly employed by those engaged in the law and economics discipline. See, e.g., R.A. Posner, *ECONOMIC ANALYSIS OF LAW*, 2d ed. (Boston: Little, Brown & Company, 1977) at 10-12, para. 1.2.

⁴ To a utilitarian, all preferences must be weighed in the balance. To a wealth-maximizer, only those preferences which are backed up by a willingness to pay are counted.

⁵ See R.A. Posner, *Utilitarianism, Economics, and Legal Theory* (1979) 8 J. LEGAL STUD. 103; R.A. Posner, *The Value of Wealth: A Comment on Dworkin and Kronman* (1980) 9 J. LEGAL STUD. 243; R.A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication* (1980) 8 HOFSTRA L. REV. 487.

II. DISCRIMINATION: A TAXONOMY

A. *Three Types of Employment Discrimination*

“Discrimination” is a social phenomenon which goes back to the dawn of recorded history, and doubtless existed long before. It is a subject which in debate is as likely to provoke heat as light. It is not always clear whether those who decry various forms of discrimination outnumber those who, overtly or covertly, practise it. What is eminently clear, however, is not only that different types of discrimination meet with varying degrees of approval from different quarters, but that the term “discrimination” itself means many different things to many different people. It is unfortunate that the debate which has raged, and which will continue to rage, over discrimination is as often as not a debate lost in conclusory assertions about what is and what is not “discriminatory” and ought *therefore* to be prohibited.

Discrimination, in its broadest sense, is the very essence of cognitive functioning. The first meaning assigned to “discriminate” by the Oxford English Dictionary is: “To make or constitute a difference in or between; to distinguish, differentiate.”⁶ The ability to reason itself starts with the ability to draw distinctions between objectively different stimuli. In this sense, an act of discrimination is purely an act of perception, unencumbered by the pejorative baggage commonly associated with the use of the word “discrimination”.

An example will illustrate. In a blind test, a connoisseur of fine brandies will likely be able to distinguish cognac from a run-of-the-mill brandy. If she is a bit more discriminating she will be able to tell the difference between a “V.S.” and “V.S.O.P.” cognac, and perhaps between a “Grande Champagne” and a “Fine Champagne” cognac. If her discriminatory facility is particularly acute, she may even be able to tell from which vineyard the wine from which the brandy was distilled came. Some might consider such discrimination unavailing, but few would consider it invidious. Indeed, many would applaud it.

The act of perceptual discrimination may lead to consequences. It is almost certain, for example, that our connoisseur will discriminate in favour of a high-quality brandy in selecting an after-dinner libation (provided, of course, that she can afford it).

Another example of discrimination arises in the selection by a law school of candidates for admission. Applicants will present themselves with varying qualities. Some will have superior records and glowing recommendations; many will be less distinguished. Those who are charged with the task of admitting applicants must discriminate between them on the basis of the records submitted. Again, perceptions of difference are translated into action.

⁶ THE OXFORD ENGLISH DICTIONARY, vol. 3 (Oxford: Oxford University Press, 1933) at 436.

These examples of discrimination, trivial though they may be, nevertheless serve to emphasize a point which is often forgotten in discussions about discrimination — that is, that an *act* of discrimination (for example, the selection of a brandy) deriving from perceptual discrimination is not, in and of itself, a *wrongful* act. Whether or not the discrimination is invidious or unacceptable from a public policy perspective depends on a careful scrutiny of the *purpose*, *motive*, and *consequences* of discriminatory choices. Once these are known, then the propriety of the act of discrimination may be judged in light of some relevant normative theory.⁷

My first task will be to suggest a taxonomy of types of discrimination based on purpose and motive. The examination of consequences which follows will form a greater part of the substantive portion of the paper.

1. *Statistical Discrimination*

In hiring employees, an employer must assess the suitability and capabilities of applicants presenting themselves for employment. Such assessments must be based on information which is inevitably imperfect and costly to produce. If hiring and firing costs were zero, employers could hire at random, assess productivity, then keep or let go. But this will never be the case. Hiring an employee is an investment which may be lost if the employee does not work out. For example, training costs may be wasted. Even where no training costs are incurred, there may

⁷ The conclusory approach to defining discrimination can lead to nonsense, as in the comment of the United States Supreme Court that there may be a “legitimate non-discriminatory reason” for engaging in discrimination. See *Texas Dep’t of Community Affairs v. Burdine*, 450 U.S. 248 at 254 (1981). Examples of the conclusory approach are not uncommon in the academic literature. See, e.g., D.L. Hiestand, DISCRIMINATION IN EMPLOYMENT: AN APPRAISAL OF THE RESEARCH (Policy Papers in Human Resources and Industrial Relations No. 16) (Ann Arbor: Institute of Labour and Industrial Relations, University of Michigan, Wayne State University & National Manpower Policy Task Force, 1970) at 1 (“discrimination is inseparably equated to injustice and, indeed, illegality”).

Hiestand also notes, however, that “[o]ne of the basic problems in research into discrimination in employment is that different researchers employ different concepts of discrimination. Their definitions are rarely explicit, but become discernible only through careful examination of their writings and analysis.” Hiestand at 5. See also Hiestand at 5-8 (alternative definitions of “discrimination”).

Those expressing a view similar to my own in this respect include S.L. Kimball, *Reverse Sex Discrimination: Manhart* [1979] AM. B. FOUND. RESEARCH J. 83 at 103-05; G.J. Benston, *The Economics of Gender Discrimination in Employee Fringe Benefits: Manhart Revisted* (1982) 49 U. CHI. L. REV. 489; H. Demsetz, *Minorities in the Market Place* (1965) 43 N.C.L. REV. 271; T. Sowell, *MARKETS AND MINORITIES* (New York: Basic Books, 1981); W.E. Williams, *THE STATE AGAINST BLACKS* (New York: McGraw-Hill, 1982) at 22-27; H. Marx, *Entrenchment, Limitations and Non-Obstante* in W.S. Tarnopolsky & G.-A. Beaudoin, eds., *THE CANADIAN CHARTER OF RIGHTS AND FREEDOMS: COMMENTARY* (Toronto: Carswell, 1982) 61. See also *MacKay v. R.* (1980), [1980] 2 S.C.R. 370 at 406-07, 114 D.L.R. (3d) 393 at 422-24, McIntyre J. (explicitly recognizing that unequal or discriminatory treatment may be eminently justifiable).

be a lag before productivity becomes apparent, during which time the employee may impose costs on the firm. There may be legally generated costs of firing; for example, severance pay or the cost of breaking the employment contract.⁸ With respect to hazardous jobs, an unskilled or unqualified worker may be injured more easily, an undesirable consequence not only for the employee, but for the employer, who may lose work time or be forced to pay higher insurance premiums. Finally, the process of evaluation is itself costly and turnover will increase evaluation costs.

In the face of hiring and firing costs as well as *imperfect* and *costly* information about productivity, employers will often attempt to reduce employee selection costs by using readily observable characteristics which are thought to be associated with productivity. A familiar example of the use of such information proxies outside of the employment context arises in the case of automobile insurance. A profit seeking insurer must set premiums at a level which will cover anticipated loss experience and yield a reasonable profit. In the case of automobile insurance, this requires some knowledge of the riskiness of individual drivers. However, it is very costly to observe directly the care and skill with which an individual insured conducts his or her automobile. Precisely because such information is very costly to obtain, insurers typically resort to the use of information proxies such as age and sex to predict an individual's level of risk. Premiums are set to reflect a statistical average level of loss experience for a large number of persons in a given age/sex class. In like fashion, employers may use "statistical" indicators to predict how well individuals will perform in a job. In the employment context, these indicators will be of two types. One type is ascriptive characteristics or "indices" over which the individual has no control. Included in this category are such proxies as race, sex and age. Another type includes characteristics over which the individual has some control, like appearance or level of education. Following Spence,⁹ I will refer to this latter category as "signals". Employers may use both types of statistical indicators in the belief that they will improve the efficiency of hiring decisions.¹⁰

⁸ The existence of a union will dramatically increase the costs of firing, since there will almost certainly be a grievance procedure and costly hearings to go through.

⁹ A.M. Spence, *MARKET SIGNALLING: INFORMATIONAL TRANSFER IN HIRING AND RELATED SCREENING PROCESSES* (Cambridge, Mass.: Harvard University Press, 1974).

¹⁰ A rational profit-maximizing employer will use such information proxies to the point where the marginal cost of producing extra information is equal to the marginal benefit obtained. It should be noted that employers may engage in what is ostensibly statistical discrimination as a subterfuge for indulging tastes for discrimination, in order to give a more benign appearance to the discrimination. This is not truly statistical discrimination. *See infra*, Part III.A.

2. *Tastes for Discrimination*

(a) *Employer Tastes for Discrimination*

Employers may discriminate in hiring or wage decisions on the basis of factors having nothing to do with the suitability of the candidate for the job in question. The employer may be seeking to indulge a "taste for discrimination";¹¹ that is, an inborn bias for or against a certain group of people. The employer, for example, may dislike Indians or women and turn down qualified Indian or women applicants in favour of equally or less qualified white males.

Far from seeking to maximize profits, employers who discriminate because of an inborn taste for discrimination are in fact willing to sacrifice profits in order to give effect to their prejudicial tastes.

(b) *Employee Tastes for Discrimination*

An employer who himself does not have a taste for discrimination may nevertheless have one or more employees who have a taste for discrimination, and who may refuse to work with other employees from designated groups of individuals or demand a wage premium to work with members of these groups.¹² If such is the case, a profit-maximizing employer may choose not to hire members of the disfavoured group in order to minimize his wage bill.¹³

Both the motive and purpose of the discrimination in this case differ from a case where the employer himself has a taste for discrimination. The motive for engaging in the discrimination rests with someone else, namely the employee's discriminatory preferences. The purpose of discrimination is profit-maximization.

(c) *Consumer Tastes for Discrimination*

In like fashion, those who purchase the employer's products or services may have tastes for discrimination. For example, it may be that buyers of perfumes would prefer to buy from a saleswoman rather than

¹¹ The phrase, coined by G.S. Becker in *THE ECONOMICS OF DISCRIMINATION* (Chicago: University of Chicago Press, 1957), has since become a standard in the literature on the economics of discrimination.

¹² Because of the employee taste for discrimination, the employee's money wage is perceived as being subjectively lower than in the case where the employee does not have to work with other employees from the disfavoured group. The idea that non-money income can properly be viewed as a component of wages can be attributed to Becker. *Ibid.*

¹³ Whether or not this will lead to a disparity in wages paid or only a segregated work-force is a matter of some controversy. Compare Becker, *ibid.*, and J.E. Stiglitz, *Approaches to the Economics of Discrimination* (1973) 63 AM. ECON. REV. 287 at 288-89. See also *infra*, note 56 and *infra*, Part III.B.

a salesman. Patrons of an Italian restaurant may prefer to be served by an Italian than by a Pakistani. A profit-maximizing employer may tailor his work-force to accommodate the discriminatory preferences of his customers.¹⁴

3. *Exploitative Discrimination*

The commonest form of exploitative discrimination is slavery — the collective subjugation of a group of persons in order to exploit their labour. Exploitative discrimination need not operate through the vehicle of slavery, however. An agreement by all employers, explicit or implicit (and whether or not backed by legal sanction), to offer inferior wages to a group of persons would also be an instance of exploitative discrimination. However, neither of these types of exploitative discrimination are noteworthy phenomena in Canada (or in other Western countries). Slavery is illegal. And, in a decentralized market economy, at least without the sanction of the state, it will be difficult or impossible to achieve the second variety of exploitative discrimination. Because of this, nothing more will be said of this variety of discrimination.¹⁵

B. *Disparate Treatment and Disparate Impact*

It has become commonplace to distinguish between discrimination stemming from *disparate treatment* of *individuals* and that extending from a *disparate impact* on a *group of persons*.¹⁶ In the former case, employees (or prospective employees) who are virtually identical in some defined sense are treated in a formally disparate manner. Thus, an employer with a taste for discrimination who always selects a white applicant over an equally qualified black applicant might be said to be engaging

¹⁴ This type of discrimination will be more common in service industries or retailing, where customers have direct contact with employees. It would be less common in manufacturing concerns, where such contact is eliminated. A peculiar and relatively uncommon variant of such discrimination is a consumer boycott in response to perceived discrimination *against* employees as in the continent-wide boycott of California grape growers, or more recently, consumer resistance to purchasing products from South Africa.

¹⁵ See generally K.J. Arrow, *Models of Job Discrimination* in A.H. Pascal, ed., *RACIAL DISCRIMINATION IN ECONOMIC LIFE* (Lexington, Mass.: D.C. Heath, 1972) 83 at 99-100; Stiglitz, *supra*, note 13 at 288 n. 2; T. Sowell, *RACE AND ECONOMICS* (New York: David McKay, 1975) at 169-72.

¹⁶ See generally O.M. Fiss, *A Theory of Fair Employment Laws* (1971) 38 U. CHI. L. REV. 235 at 237ff.

¹⁷ Disparate treatment may occur in relation to the like treatment of unlikes as much as the unlike treatment of likes. This sentiment is well expressed by Mr. Justice Frankfurter's comment that: "The Procrustean bed is not a symbol of equality. It is no less inequality to have equality among unequals." See *New York v. United States*, 331 U.S. 284 at 353 (1947) (dissenting opinion). See also R. Dworkin, *TAKING RIGHTS SERIOUSLY* (Cambridge, Mass.: Harvard University Press, 1977) at 225-29; R. Dworkin, *Seven Critics* (1977) 11 GA. L. REV. 1201; G. Rutherglen, *Sexual Equality in Fringe-Benefit Plans* (1979) VA. L. REV. 199 at 213.

in disparate treatment of the white and black applicants.¹⁷ Where, however, an employer engages in statistical discrimination, the discrimination may have a disparate impact on a group of persons. For example, a police force may require that all successful applicants be at least six feet tall and weigh 160 pounds.¹⁸ This type of test treats all individual applicants in a formally identical sense, but is almost certain to exclude more women candidates than men. Thus, it can be said to have a disparate *impact* on women *as a group*.

Much discussion of the propriety of discrimination has centered on the question of whether or not anti-discrimination legislation does or ought to forbid disparate treatment or disparate impacts.¹⁹ I will, as much as possible, avoid placing any emphasis on this largely sterile dichotomy for a number of reasons. First, as a definitional matter, the question of what constitutes disparate treatment is fundamentally tautological in nature. For example, an employer may refuse to hire native applicants for jobs as retail sales clerks because her customers disfavour this group and will shop elsewhere if she hires them. Whether or not the native applicant is treated in a formally disparate manner from the white applicant depends on matters which are definitional rather than deductive. We might say, for example, that the native applicant's innate abilities are equal to those of the white applicant and that the refusal to hire is an instance of disparate treatment. However, we might also point to the fact that, from the employer's point of view, the two employees — whose innate abilities do not differ — nevertheless have widely differing marginal productivities, owing to the reaction of the store's customers to each. On this view, the native and white applicant are in no sense identical; hence, a refusal to hire the native cannot be characterized as unequal treatment of equals, and hence is not disparate treatment. The difficulty is that the characterization of an act of discrimination as "disparate treatment" requires a *prior* assessment of which characteristics are relevant to the employer's decision. This assessment itself determines the answer to the question of whether or not the activity is "discriminatory" in a sense which might be regarded as invidious.²⁰ Thus, a matter of characterization determines the outcome of the substantive matter in question.

A characterization of an activity as one having a disparate impact is not much more likely to yield useful information. In the example used earlier, an employer may require, in good faith, that all successful applicants for a job pass a skill-testing examination for the purpose of testing job-related abilities. However, the use of a test may also be a

¹⁸ See, e.g., *Re Adler and the Metropolitan Bd. of Comm'rs of Police and Re Colfer and the Ottawa Bd. of Comm'rs of Police* (January 1979), Report of a Board Inquiry under the *Ontario Human Rights Code* (Chair: P. Cumming).

¹⁹ See, e.g., Kimball, *supra*, note 7; Benston, *supra*, note 7; Brilmayer *et al.*, *supra*, note 2; Laycock & Sullivan, *supra*, note 2.

²⁰ Put somewhat differently, since disparate treatment involves the unlike treatment of likes (or the like treatment of unlikes), the logical prior step to answering the question involves the determination of what are, and what are not "likes" and "unlikes".

colourable device unrelated to job qualifications and designed to exclude from employment applicants from certain disfavoured groups.²¹ Assuming that a decision is made to permit the former but forbid the latter type of discrimination, simply stating that in each case there is a disparate impact accomplishes little. The watershed test of the propriety of the conduct consists of an evaluation of the purpose, motive and consequences of the discrimination.²²

As well, the discussion of disparate treatment versus disparate impact sometimes assumes that anti-discrimination legislation can or ought to forbid *only* one or the other but not *both* types of discrimination, or that such legislation exists *primarily* to address one variety of discrimination, or that one or other of these two varieties of discrimination is inherently worse than the other.²³ These claims are untenable. Either type of discrimination may be allied to a motive, a purpose, or bear sufficiently invidious consequences so as to render it a fitting candidate for prohibition, as I hope the examples used in the paper will illustrate. Moreover, it is far from clear that any exclusive partitioning of the world into the two types of discrimination can withstand scrutiny in all circumstances (even assuming that the definitional difficulties referred to earlier can be overcome). That which constitutes systematic disparate treatment of individuals identifiable by membership in a group, for example blacks, will translate into a disparate impact with respect to that group of persons. This relativistic view suggests that context is all important and that anti-discrimination legislation ought not to be drafted or interpreted by the courts to cover only one, but not the other type of discrimination. Identification of a disparate impact is, at most, cause for further investigation; as suggested, employers may design job qualifications for apparently benign profit-maximizing purposes, but in fact be furthering their discriminatory tastes. A disparate impact caused by the application of for-

²¹ See, e.g., *Griggs v. Duke Power Co.*, 401 U.S. 424 at 429-33 (1971) [hereinafter *Griggs*]. See also *Robinson v. Lorillard Corp.*, 444 F.2d 791 (4th Cir. 1971), cert. denied 404 U.S. 1006 (1971). The holding in *Griggs* was that discrimination which results in a disparate impact is barred under relevant federal anti-discrimination legislation unless the employer can demonstrate a business necessity for the discrimination. This holding is consistent with the arguments presented in the text. See *infra*, Part VI.

²² It is not at all difficult to think of practices which, while resulting in a disparate impact, are nonetheless quite acceptable. For example, retail food sellers charge everyone the same price for food. This clearly has a disparate impact on those with hearty appetites, such as men (as a group) and fat people. Yet it would be unthinkable to argue that a supermarket charging all its customers identical prices could be engaging in improper discrimination against fat people and men. Equally, disparate impacts in employment do not necessarily entail the conclusion that an improper form of discrimination has occurred. See C. Hoffmann & J. Reed, *When is Imbalance not Discrimination* in W.E. Block & M.A. Walker, eds., *DISCRIMINATION, AFFIRMATIVE ACTION, AND EQUAL OPPORTUNITY* (Vancouver: Fraser Institute, 1982) 183.

²³ See articles cited, *supra*, notes 2 & 7.

mally neutral criteria may justifiably provoke further inquiry into whether or not the job qualification is a *bona fide* qualification.²⁴

III. STATISTICAL DISCRIMINATION

A. *A Conventional View: Statistical Discrimination as Employer Profit-Maximization*

I have already suggested that the reason why employers engage in statistical discrimination is to reduce the costs of selecting suitable employees. In the face of an inability to gauge precisely the productivity of a job applicant, employers consult information proxies such as appearance, education, and perhaps indicators such as age, race or sex. These proxies are used because of the belief that they assist the employer in selecting qualified workers, while minimizing hiring costs. On this view, statistical discrimination conduces to the pursuit of efficiency.

The efficiency argument has been advanced by Posner²⁵ and others.²⁶ Indeed, Posner suggests that *most* discrimination is of this efficiency-fostering variety, given that market forces will not only tend to eliminate inappropriate proxies, but will also eliminate those types of discrimination which do not have a similar profit-enhancing property.²⁷

The policy implications of such a view (using the wealth-maximization criterion as the benchmark) are clear: Statistical discrimination is not only acceptable, but in fact *desirable*.

B. *The Problem of Adverse Selection in Labour Markets: Statistical Discrimination and Disadvantaged Minorities*²⁸

The efficiency-enhancing properties of the Posnerian view of statistical discrimination depend on two critical assumptions. One of these is that the market will weed out inefficient proxies, so that only proxies that genuinely convey information to an employer remain. The second

²⁴ Compare Griggs, *supra*, note 21.

²⁵ R.A. Posner, *THE ECONOMICS OF JUSTICE* (Cambridge, Mass.: Harvard University Press, 1981) at 351-63.

²⁶ See, e.g., Arrow, *supra*, note 15; Stiglitz, *supra*, note 13; Williams, *supra*, note 7 at 28-29; Sowell, *supra*, note 7 at 28-29.

²⁷ The degree to which competition will eliminate forms of discrimination not based on statistical indices in an attempt to reduce hiring costs is discussed, *infra*, Part IV.

²⁸ What follows draws heavily on the work of G.A. Akerlof, *The Market for "Lemons": Qualitative Uncertainty and the Market Mechanism* (1970) 84 Q.J. ECON. 488; G.A. Akerlof, *The Economics of Caste and of the Rat Race and other Woeful Tales* (1976) 90 Q.J. ECON. 599; Arrow, *supra*, note 15; Stiglitz, *supra*, note 13; G.S. Becker, *HUMAN CAPITAL: A THEORETICAL AND EMPIRICAL ANALYSIS, WITH SPECIAL REFERENCE TO EDUCATION*, 2d ed. (New York: National Bureau of Economic Research, 1975); and especially Spence, *supra*, note 9. See also R. Axelrod, *THE EVOLUTION OF COOPERATION* (New York: Basic Books, 1984) at 146-50.

is that there is no dynamic tendency for the use of statistical indicators to shape the market of applicants presenting themselves for jobs. There is good reason to believe that neither of these important assumptions can always be sustained. I will suggest that, at a minimum, there is no more *a priori* reason to believe that the assumptions are true than that they are incorrect.

The basis for this assertion is the phenomenon of adverse selection, which is most easily illustrated in relation to insurance markets. By way of example, a great many insurers will sell automobile insurance. The insurer will have imperfect information about the applicants presenting themselves to buy insurance. Some will represent a greater and some a lesser risk to the insurer, depending on a variety of factors like driving skill and habits, temperament, physical condition, and so on. In order to set an appropriate premium for an individual applicant, most insurers will use information proxies to gauge the risk assumed by agreeing to insure the individual. For example, the age and sex of the applicant are two almost universally utilized information proxies. Statistical information reveals that young drivers tend to have a much higher accident rate, as do male drivers. Thus, young male drivers will pay the highest premiums. Older drivers and women will pay lower premiums. But, even assuming the statistical accuracy of these proxies at an aggregative level, each individual driver will possess better information about her level of risk than the insurance company. Some insureds, placed by the insurer in a high risk category, will in fact be low risk drivers. However, they have no easy (or inexpensive) way to convey this information to the insurer. Left to their own devices, they might choose not to purchase automobile insurance at all, given the excessively high price of the insurance. Drivers of unusually high risk, on the other hand, will find insurance a bargain at the price offered by the insurer. They will purchase insurance; indeed, they will probably purchase excessive insurance, given the bargain price. Subsequently, the insurer will discover that the pool of insureds has a higher loss experience than initially predicted, since the self-selected population of insureds is weighted towards risky drivers. The insurer will re-evaluate its expected loss experience for the subsequent period based on the past loss experience of its current clientele and raise its premiums to cover the higher expected losses. But this will have a reflexive effect once again on those who choose to purchase automobile insurance. More drivers of relatively low risk will opt out of the market, while those of relatively high risk will continue to buy insurance. Successive iterations of this process will either result in premiums being set at a stable but inefficiently high level (relative to a situation in which the insurer can precisely gauge the risk level of each insured) or a disappearance of the market for this type of insurance altogether.

The source of this "adverse selection" problem is asymmetrical information — the insured knows more about her risk level than the insurer. While the use of information proxies almost certainly reveals

some useful information to the insurer,²⁹ the mechanism operates imperfectly owing to the inaccuracy of the proxies in respect of many individuals within each rating group.

This phenomenon may also accompany the use of information proxies in labour markets, although the dynamic is more complicated and the effects likely to be seen only over a long period of time. This is best illustrated by at first adopting the simplistic assumption that employers evaluate only one characteristic when deciding to hire: race. If the applicant is of Race X, then her skill level and potential for advancement is assumed to be high. If the applicant is of Race Y, her skill level and potential for advancement is assumed to be low. On this basis, applicants of Race X will initially be hired only into (or trained by employers for) high paying skilled jobs, and applicants of Race Y only into low paying unskilled jobs. In this situation, the returns on high skills for members of Race Y, and hence returns on an investment in "self-improvement" designed to raise skills, will be zero or near zero. Thus, few such investments will be made. If the information proxy based on race is initially accurate, there will be no tendency for its accuracy to change over time. The beliefs of employers as to the relative skill levels of the two races will be continually and repeatedly reaffirmed. Even if employer beliefs as to the differential skill levels are initially inaccurate, the absence of incentives for self-improvement for Race Y will mean that, over time, the average skill level of members of Race Y will diminish, ultimately rendering the information proxy an accurate one. The use of the proxy in this case will be a self-fulfilling prophecy.

In either case, but especially the second, the human capital of members of Race Y will be systematically under-exploited. The talents of those members of Race Y with superior innate skills will never be harnessed. Thus, the use of the information proxy in this case operates, in a dynamic sense, as an engine of *inefficiency*, even though from the atomistic (and static) perspective of the individual employer it serves an apparently useful sorting function.³⁰

²⁹ For a theoretical analysis showing the welfare loss which would result from barring the use of statistical indicators in the insurance and life annuity contexts, see S.A. Rea Jr., *The Market Response to the Elimination of Sex-based Annuities* (1987) S. ECON. J. 55; S.A. Rea Jr., *INSURANCE CLASSIFICATIONS AND SOCIAL WELFARE* (University of Toronto, 1984) [unpublished].

³⁰ It might be objected that there is also no incentive for the members of Race X to engage in self-improvement, since they will all be assumed to be of the higher skill level. However, the absence of skill (or potential) of an employee hired to perform a job requiring a high level of skills will be easily detected, while the presence of superior skill or potential in an employee performing low skill work will be difficult to detect. For example, it will be easy to detect the unsuitability of someone with the skills of a janitor hired to be a doctor, but difficult to detect that someone hired as a janitor has the ability to become a doctor. Thus, members of Race X will engage in self-improvement because there is an almost certain pay-off in so doing, while members of Race Y will not.

In this way, the beliefs of employers cause or at least perpetuate a segmentation of the labour market into favoured and disfavoured groups. This segmentation persists over time even where the employer's beliefs are initially inaccurate, and without reference to the presence or absence of an *invidious* discriminatory motive on the part of any employer.³¹

It is important to note that race is what I earlier referred to (following Spence) as an *index* — that is, it is an information proxy over which the individual has no control. Members of Race Y cannot escape the results of the use by employers of the information proxy by changing their race. Other indices which might be used include sex, ethnic origin, age, and the like.

This model is, of course, highly simplistic. Most employers will consult information proxies other than race or similar indices in deciding whether or not to hire a job applicant. Applicants may use a variety of means to convince the employer that his beliefs about the individual's skill level, derived from beliefs about the group to which she belongs, are erroneous. The clearest example is by achieving credentialization through the educational process, by acquiring a college degree for example. Other means might include personal references, a well-tailored appearance, a business-like demeanor and so on. These factors, over which the individual has some control, *signal* the applicant's superior quality to the employer. The question is whether or not an ability to signal will constitute a complete answer to the plight in which members of Race Y might otherwise find themselves.

While there is reason to believe that the ability to signal will soften the segmentation of the labour market, there can be no confidence that it will eradicate it. An employer who continues to use race as a proxy for ability, albeit tempered by the use of other proxies, will depreciate the informational content of a signal by a member of Race Y as compared to a member of Race X. The assessment of each candidate now consists of a composite of all the information proxies available to the employer. An assumption that members of Race Y are less capable will result in a

³¹ Freed and Polsby furnish a good example:

If employers in general were allowed to rely upon the generalization that women tend to cut back on their careers when they have children — in other words, that women tend to be merely supplementary wage earners in their families — women who had determined *not* to be secondary wage earners would, notwithstanding this decision, be relegated to low-level jobs anyway, positions that are easy to quit on the merits because such jobs generally lead nowhere. The statistics, when they are duly compiled, will allow the interpretation of this phenomenon as indifference to career and preference for children.

M.G. Freed & D.D. Polsby, *Privacy, Efficiency, and the Equality of Men and Women: A Revisionist View of Sex Discrimination in Employment* [1981] AM. B. FOUND. RESEARCH J. 583 at 634-35. See also Hiestand, *supra*, note 7 at 9; B. Friedan, *THE FEMININE MYSTIQUE* (New York: Dell, 1974). An example of this type of reasoning which is almost identical to the example used in Freed & Polsby is found in Hoffmann & Reed, *supra*, note 22.

higher required level of signalling by a member of Race Y than of Race X to convince the employer of the applicant's quality. This results in a lower return on self-improvement for members of Race Y as compared to members of Race X whatever the type or extent of the self-improvement. For example, while a Masters degree may be sufficient to ensure that a member of Race X is hired into a particular type of job, a member of Race Y may be forced to acquire a Ph.D. Quite understandably, fewer members of Race X will engage in self-improvement. Thus, even where applicants have an ability to signal their quality, employer beliefs will continue to shape the market of applicants from Race Y in such a manner as to result in a lower average skill level for members of Race Y, confirming initial employer expectations. Once again, this will be the case whether or not the beliefs of employers are initially correct. The ability to signal may dampen, but will not eliminate, the disparity between the two groups and the under-utilization of the human capital of members of Race Y.

The objection may be raised that this process might just as well operate against the most talented members of Race X, as well as those of Race Y. For a number of reasons, however, the severity of the adverse selection phenomenon will be expected to be much greater in respect of the disfavoured group. One reason for expecting this to be so is precisely because the returns on self-improvement will remain greater for members of Race X than those of Race Y, leading to greater investment in self-improvement by Race X. Second, and equally important, an employer may well use a different balance of information proxies in evaluating candidates from Race X than from Race Y. Assume, for example, that Race Y is initially a relatively small and homogeneous group, and that employers' beliefs about members of Race Y are initially correct. This might plausibly be true about a small immigrant population from an underdeveloped country or an indigenous minority population with a history of past discrimination and disadvantage. In this situation, the short-run returns from using race as a proxy for a low skill level will be high, given the accuracy of the proxy, and the likely costs will be low, since mistakes in gauging skill level will be infrequent because of the relative homogeneity of the group. In this situation, employers will accord the race proxy a high degree of weight in determining suitability. Assume, by contrast, that members of Race X form a majority of the population and that skill levels amongst this group are relatively heterogeneous. Given the much greater variance in skill levels, the returns from using race as a proxy are lower, while the costs (in the form of predicted errors in gauging skill level) are higher. In this situation, an employer will likely pay little heed to race as a proxy for members of Race X, engaging more in an assessment by reference to signals like educational attainment. Under these assumptions, adverse selection bias is much more likely to affect the quality of applicants from Race Y seeking jobs than from Race X.³²

³² As Becker suggests, the criterion for efficient allocation of the total investment

An important question is whether or not this situation can persist even in the face of vigorous competition for employees. The answer would appear to be that it can. Spence has convincingly demonstrated, by mathematical proof, the existence of multiple market equilibria, many of which will be inefficient.³³ A market equilibrium occurs when employer beliefs about employee skill levels are not disconfirmed by contrary evidence. Stable but inefficient market equilibria may exist because, as already suggested, employer beliefs condition the market of job applicants in such a way as to rule out disconfirming evidence. As Spence puts it, "there can be stable prerequisites for jobs which convey no information by virtue of their existence, and hence serve no function."³⁴

It is important to distinguish once again between a situation where employers consult only "signals" in their hiring decisions (those factors over which the individual has some control) and one in which employers use *both* signals such as education *and* indices such as race to gauge skill levels. In respect of the former, the inefficiency which results from the market settling at an inefficient signalling equilibrium appears to be no worse than a potentially excessive investment in education (or other self-improvement) by many individuals. This extends from the fact that signalling requirements may be set at an inefficiently high level and no experience of the employer will disconfirm the perceived necessity of a requirement for a high educational attainment. But where race is also used as a proxy for ability, the process of adverse selection may be set in motion against the disfavoured race. A corollary of the observation that signalling requirements can be set too high for a given population is that signalling requirements may differ in respect of identifiably different *sub*-populations, such as Races X and Y, even where the distribution of innate abilities amongst the races is virtually identical.³⁵ Thus, the formal requirements for the persistent use of an erroneous information proxy by profit-maximizing employers facing vigorous competition have been amply demonstrated.

A number of additional factors will tend to exacerbate the adverse selection dynamic. One factor is the imperfection of capital markets and the inability of disadvantaged minorities to borrow against their human

in human capital is that the "marginal social rate of return be the same for all persons". Further, "[i]f one assumes that the ratio of social to private rates is identical for everyone, this criterion simply requires equality between all marginal private rates, while inefficiency can be measured quantitatively essentially by the inequality in these rates." Becker, *supra*, note 28 at 129. The adverse selection dynamic will virtually insure that there is inequality in marginal private (and hence social) rates of return.

³³ See Spence, *supra*, note 9.

³⁴ *Ibid.* at 25. Spence demonstrates mathematically that this proposition is true whether or not the educational "signal" actually contributes to job skills or merely serves to indicate that some applicants possess superior abilities. See also Williams, *supra*, note 7 at 71-72; I. Berg, EDUCATION AND JOBS: THE GREAT TRAINING ROBBERY (New York: Praeger, 1970).

³⁵ Spence, *ibid.*, c. 3.

capital in order to “buy” the appropriate signals (such as an education). The legacy of past job discrimination will render the disfavoured group without the ability to finance an education (or other signals) out of individual or family savings, requiring resort to the capital markets. But, while the innate ability of many members of disfavoured groups would justify a substantial loan to finance self-improvement, it is probable that relatively few such loans will be made. Lenders will have no better information than employers about the abilities of individuals within the class. Even if an individual borrower is clearly talented, the lender will also have poor information about her motivation and perseverance and the likelihood that the investment will actually be carried to fruition. Although the lender will therefore experience considerable risk, a loan for the improvement of human capital cannot be secured (as a consequence of legal prohibitions against offering human capital as collateral). These problems will almost certainly ensure market failure in the furnishing of capital to many or most disadvantaged individuals whose innate qualities would merit such an investment.

Members of disfavoured groups will also tend to be less “networked” — that is, they will not have the same contacts to find out about available positions and few friends in privileged positions to assist them in acquiring jobs.³⁶ Discrimination in housing may also contribute to the dynamic of adverse selection; ghettoization of disfavoured groups may result in concentration of these groups in areas removed from the places where jobs are available and unable to afford transportation to these areas.³⁷

The adverse selection dynamic will also be assisted by the psychological effects of continued rejections in the employment market upon minority job applicants. Such rejections set up a pattern of negative reinforcement which may result in such persons viewing themselves as inferior human beings who are incapable of higher achievement, dulling the aspirations of the class of persons yet further.³⁸

³⁶ Stiglitz, *supra*, note 13 at 291-92; Hiestand, *supra*, note 7 at 26; M. Lurie & E. Rayack, *Racial Differences in Migration and Job Search: A Case Study* (1966) 33 S. ECON. J. 81.

³⁷ J.F. Kain, *Housing Segregation, Negro Employment, and Metropolitan Decentralization* (1968) 82 Q.J. ECON. 175; J.D. Mooney, *Housing Segregation, Negro Employment and Metropolitan Decentralization: An Alternative Perspective* (1969) 83 Q.J. ECON. 299; J.R. Meyer, J.F. Kain & M. Wohl, *THE URBAN TRANSPORTATION PROBLEM* (Cambridge, Mass.: Harvard University Press, 1965).

³⁸ Compare Stiglitz, *supra*, note 13 at 294. The United States Supreme Court, citing an eminent psychologist, found this argument persuasive in its seminal judgment in *Brown v. Bd. of Educ.*, 347 U.S. 483 (1954), holding, at 494, that segregated schools gave rise to a feeling of inferiority “in a way unlikely ever to be undone”.

C. Evidence and Policy Implications of the Adverse Selection Phenomenon

The foregoing casts considerable doubt on the simplistic view that statistical discrimination, by enabling employers to more easily choose suitable employees, fosters efficiency. There may well be short-run savings in costs to employers if the proxies used are accurate. However, there is no reason for believing that the market will ensure that only accurate proxies survive. Inaccurate proxies may persist indefinitely where employer beliefs condition the market of job applicants in such a way as to confirm prior expectations. Whether or not the proxies are initially accurate, the adverse selection dynamic will almost certainly ensure that, in the long-run, there is under-investment in the human capital of disfavoured groups. The main engine of inefficiency in this process is the use by employers not of "signals" over which the individual has some control, but of "indices" such as race, sex or age, over which the individual has no control.

It would, of course, be helpful to have empirical evidence supporting the existence of an adverse selection dynamic. While little direct evidence exists, important indirect evidence may be found in the form of rates of return on the most important form of self-improvement: education. I have already suggested that an important precondition for the development of the adverse selection dynamic is the existence of differential rates of return on self-improvement for members of different groups. There is now a compelling body of empirical evidence which suggests that rates of return on education for advantaged and disadvantaged (minority) groups differ, in some cases by quite substantial margins.³⁹

The literature of psychology also suggests how stereotypes, such as the use of indices to gauge individual members of identifiable groups, alter perceptions of the behaviour of minority group members in such a manner as to cause stereotypes to persist even where incorrect. Studies

³⁹ See, e.g., Becker, *supra*, note 28; P.M. Blair, *JOB DISCRIMINATION AND EDUCATION: AN INVESTMENT ANALYSIS* (New York: Praeger, 1972); T.W. Schultz, *The Rate of Return in Allocating Investment Resources to Education* (1967) 2 *J. HUMAN RESOURCES* 293. Figures cited by Becker (and others) showing a lower return to minorities may understate the true differential, since what is ultimately important in examining incentives to invest in education is subjective utilities. Although the marginal utility of each additional dollar will be greater for those in lower income groups, this may easily be offset by the greater absolute dollar return on education realized by majority groups. Becker's figures, for example, show that disadvantaged minorities have a lower cost of education because they attend lower quality schools and also because the opportunity cost for a disadvantaged person is lower. Thus, even a commensurate rate of return necessarily means a lower absolute dollar return (also confirmed by Becker's data). See Becker, *supra*, note 28 at 172ff. If the differences in absolute dollar returns are large compared to the differences in marginal utilities, the added utility of education may be significantly greater for a member of the favoured majority than for a member of the disfavoured minority, widening the disparity in incentives.

by Duncan,⁴⁰ Sagar and Schofield,⁴¹ and Rothbart, Evans and Fulero⁴² suggest, not only that objectively similar behaviour of favoured and disfavoured groups tends to be viewed dissimilarly, but that those with stereotyped visions of identifiable groups will tend to remember evidence which confirms the stereotypes and forget disconfirming evidence. Other studies strongly suggest that stereotyped attitudes tend to produce the expected behaviour in a manner which transforms the attitudes into self-fulfilling prophecies.⁴³

There is, therefore, good reason to believe that the costs of the adverse selection dynamic may be considerable. There is also good reason for believing that abandoning the use of statistical indices over which individuals have no control may not be very costly. The value of an information proxy consists not in the absolute benefit obtained from its use, but in the *marginal* benefit as compared to the next-best predictor of employee suitability. In the employment context, the marginal benefit resulting from using an *index* rather than a *signal* to gauge suitability for employment may be small. For example, instead of assuming that only men are physically capable of performing stevedoring work, a prospective employer might, at a modestly greater cost, give all job applicants a weight-lifting test.

Thus, although it cannot be stated with absolute certainty that the costs of adverse selection outweigh the benefits of using statistical indices to gauge suitability for employment, it is *probable* that the social costs exceed the social benefits (even where the private benefits to individual employers exceed the private costs).

A variety of policy implications arise from this conclusion. First and most important, an economic prescription is made out for anti-discrimination legislation which bars the use by employers of statistical indices such as race, sex, age, ethnic origin, and the like, even where the indices are shown to be accurate. This prescription in favour of anti-discrimination legislation must be tempered, of course, by a realization that the process of enforcement is itself costly. This cost consists of more than merely the cost of processing and disposing of complaints. Because

⁴⁰ B.L. Duncan, *Differential Social Perception and Attribution of Intergroup Violence: Testing the Lower Limits of Stereotyping of Blacks* (1976) 34 J. PERSONALITY & SOCIAL PSYCH. 590.

⁴¹ H.A. Sagar & J.W. Schofield, *Racial and Behavioral Cues in Black and White Children's Perceptions of Ambiguously Aggressive Acts* (1980) 39 J. PERSONALITY & SOCIAL PSYCH. 590.

⁴² M. Rothbart, M. Evans & S. Fulero, *Recall for Confirming Events: Memory Processes and the Maintenance of Social Stereotypes* (1979) 15 J. EXP. SOCIAL PSYCH. 343. See generally W.G. Stephan & D. Rosenfield, *Racial and Ethnic Stereotypes* in A.G. Miller, ed., *IN THE EYE OF THE BEHOLDER* (New York: Praeger, 1982) 92.

⁴³ See generally P.G. Zimbardo & E.E. Ebbesen, *INFLUENCING ATTITUDES AND CHANGING BEHAVIOR*, 2d ed. (Reading, Mass.: Addison-Wesley, 1977); R. Nisbett & L. Ross, *HUMAN INFERENCE: STRATEGIES AND SHORTCOMINGS OF SOCIAL JUDGMENT* (Englewood Cliffs, N.J.: Prentice-Hall, 1980).

it is likely that the process will impose costs on employers, such legislation will almost inevitably invite nuisance claims by those who are opportunistically-minded and seek an extortionate settlement from the employer. It is thus important to design a mechanism for the adjudication of claims that is both expeditious and sensitive to the possibility of minority opportunism.

While a good case is made out for barring the use of statistical indices, the use by employers of signals, such as education and job experience seems wholly justifiable. Such signals yield much useful information while in fact softening the adverse selection dynamic by allowing individuals to convey to employers information demonstrating their superior ability.

The difficult question in respect of the use of signals is an entirely different one — whether or not employers should be permitted or required to discriminate, at the level of signals, *in favour* of the disadvantaged, by hiring comparatively less qualified members of targeted minority groups. Such discrimination frequently passes under the rubric of “affirmative action” or “reverse discrimination”.⁴⁴ An argument in favour of affirmative action may be constructed on economic grounds. Just as the use of indices, such as race or sex, to *disfavour* certain identifiable groups may result in an impoverishment of the group’s human capital, so using such indices to *favour* these groups may operate to correct the legacy of past discrimination by increasing incentives for self-improvement.⁴⁵ This will result in the more efficient use of the human capital of disfavoured groups.

One technique for discriminating in favour of disadvantaged groups is by means of quotas. Employers can be required to hire or employ quotas of targeted minority groups. A weaker strategy would be to draft anti-discrimination legislation so as to permit employers to discriminate for the purpose of undertaking an affirmative action program. Neither of these strategies is likely to be very successful. Because of differences in underlying demographic factors, such as age and geographic distribution of minorities, quotas which are at once effective, and also fair to non-minority groups (that is, sufficient to achieve some effect while not being excessive) can be extremely difficult to formulate.⁴⁶ The American experience with quotas suggests that they tend to breed resentment amongst

⁴⁴ These terms are far from exact and must be used with caution. See Fiss, *supra*, note 16 at 310-13. The meaning which I attach to these phrases here is simply that used in the text: discrimination at the level of signals in favour of groups of persons who have been discriminated against in the past, with resulting disadvantage.

⁴⁵ Arguably this might result in an adverse selection dynamic being set in motion against members of the previously *favoured* group. However, if the previously *favoured* group is large enough compared to the previously *disfavoured* group, then the effects on the returns to self-improvement (and hence the magnitude of the adverse selection) for the former should be minimal. Compare Stiglitz, *supra*, note 13 at 294.

⁴⁶ Compare L. Roberts, *Understanding Affirmative Action* in Block & Walker, *supra*, note 22.

other workers.⁴⁷ Quotas also raise the spectre of costly administrative intervention in hiring decisions.⁴⁸ Abandoning quotas in favour of legislation merely permitting affirmative action programs is unlikely to succeed either, at least in the private sector. Employers in competitive markets have little incentive to undertake any significant amount of affirmative action.

An intermediate solution would be the substitution of goals and timetables for quotas. However, where these are mandatory they are merely quotas in disguise, and suffer from all the problems associated with the latter. Where not mandatory, such targets are likely to be ineffectual.

While affirmative action on the demand side of the private sector is not likely to be either very successful or cost-efficient, government can clearly play a vanguard role in giving non-quota preferential treatment in hiring to targeted minority groups. In fact, government in Canada has assumed such a leadership role in the past decade.⁴⁹

A clearly superior form of affirmative action in the private sector, which avoids problems of enforceability by substituting the carrot for the stick, is the payment of financial incentives to employers for hiring minority applicants. This technique not only generates incentives for employer compliance, rather than evasion, but also has the advantage of spreading the cost of hiring minority applicants evenly amongst all taxpayers, avoiding any differential impact on particular employers or industries.⁵⁰

Probably the most effective way to reverse the effects of the past depreciation of the human capital of disfavoured groups is by affirmative action on the *supply* side of the market, rather than the *demand* side. This might involve subsidization or the provision of financial assistance

⁴⁷ See, e.g., Williams, *supra*, note 7 at 116-19.

⁴⁸ Jencks agrees but argues in favour of quotas:

Hiring decisions inevitably depend on a multitude of complicated factors, the weighting of which is somewhat arbitrary. Proving that racial bias has affected any specific decision is therefore next to impossible. The only way to prove discrimination is to look at a series of decisions and ask whether they favored white applicants more often than comparable black applicants.

C. Jencks, Book Review of *ETHNIC AMERICA AND MARKETS AND MINORITIES*, by T. Sowell, *The New York Review of Books* (17 March 1983) 12 at 14.

⁴⁹ See *infra*, Part VI.

⁵⁰ The defeated Conservative budget of 1979 contained proposals (known as the "Private Employment Incentives Program"; see "Budget Speech — Delivered by The Hon. J. Crosbie, Minister of Finance — Dec. 11, 1979" at 18) which would have allowed a tax credit to employers hiring employees under the age of 26, the long-term unemployed, or designated disadvantaged groups such as native people, those over 55, the handicapped, and women re-entering the labour force after a prolonged absence. A very few other programs employ the strategy of offering employer incentives. See *infra*, Part VI.

for education or job-training programs for targeted minority groups.⁵¹ Colleges and universities might also be encouraged — perhaps again with the lure of financial reward — to relax admission standards in favour of minority applicants.

In addition, the government can play a useful role in assisting disadvantaged minorities in finding jobs or acquiring an education by supplying information bearing on job availability or training programs. This might compensate to some extent for the inferior networking of minority groups.⁵²

Many critics of affirmative action have suggested that, because discrimination on the basis of race, sex, or other indices is inherently invidious, the use of such indices to effect affirmative action is wrongful.⁵³ I have already suggested that a relativistic view of discrimination is more appropriate; that is, an act of discrimination must be judged in light of its purpose, motive, and consequences.⁵⁴ Minority groups may also be assisted by non-targeted assistance programs such as free or low-cost education or the provision of educational subsidies to the needy. Although not aimed specifically at disadvantaged minorities, such programs would work against the operation of the adverse selection dynamic.

IV. TASTES FOR DISCRIMINATION

A. *Employer Tastes for Discrimination*

1. *Introduction*

As indicated earlier, employers may discriminate not because of an interest in using statistical proxies for their ability to reduce hiring costs, but because of a “taste” for discrimination — that is, employers may have preferences as between groups of persons, preferring to hire from

⁵¹ The need for affirmative action on the supply side may well be greater than on the demand side. See, e.g., F. Welch, *Labour-Market Discrimination: An Interpretation of Income Differences in the Rural South* (1967) 75 J. POL. ECON. 225 at 235, finding a coefficient of discrimination against non-white labour to be .19, as compared to a coefficient of discrimination against non-white education of .72. See also N. Glazer & D.P. Moynihan, *BEYOND THE MELTING POT*, 2d ed. (Cambridge, Mass.: M.I.T. Press, 1970) at 200; S.S. Bowles, *Towards Equality of Educational Opportunity?* (1968) 38 HARV. EDUC. REV. 89; Sowell, *supra*, note 15 at 190-95; T. Sowell, *BLACK EDUCATION: MYTHS AND TRAGEDIES* (New York: David McKay, 1972).

⁵² Fiss makes a similar suggestion, *supra*, note 16 at 282-84.

⁵³ See, e.g., Posner, *supra*, note 25 at 364-407.

⁵⁴ It is somewhat ironic that a committed consequentialist like Posner should revert to expressions of moral propriety based on a profoundly non-consequentialist ethic in condemning *all* acts of discrimination as morally reprehensible. *Ibid.*

the favoured group rather than the disfavoured. This may involve the sacrifice of money income in order to indulge in discriminatory tastes.⁵⁵

The economic literature has yielded two distinct arguments against government regulation of this type of discrimination. The first, which I will denominate the "strong form", applies the wealth-maximization criterion in such a way as to suggest that the indulgence of employer tastes for discrimination is likely, in the greater number of cases, to lead to efficient outcomes. The second, which I will denominate the "weak form", accepts as a *desideratum* the elimination of discrimination motivated by employer tastes, but argues that competition will tend to eliminate non-profit motivated discrimination inspired by employer tastes. The weak form is both a claim that anti-discrimination legislation is not cost-justified, and that government interference in the market in a variety of circumstances (not necessarily directly related to the problem of discrimination) is likely to increase rather than decrease the likelihood of discrimination, by interfering with market adjustment mechanisms.

I will suggest, in partial agreement with the weak claim, that free and competitive markets are almost certain to advance the economic position of minorities. However, I will also suggest that markets may fail to eliminate discrimination in a sufficient number of cases as to leave an economically significant degree of residual discrimination.

I will then suggest that the strong form claim is both overly simplistic and likely to be wrong. The claim overlooks two important costs of employer discrimination motivated by employer tastes for discrimination. These are the likelihood that acts of discrimination will produce non-trivial externalities, and the probability that such discrimination will have a reflexive effect on investment in human capital. I will suggest that these two factors make out a case, on economic grounds, for prohibiting discrimination motivated by the discriminatory tastes of employers.

2. *The Strong and Weak Form Claims*

An examination of the wealth-maximization model and the strong form claim might start with an enumeration of the costs and benefits of an act of discrimination motivated by an employer's tastes for discrimination. The immediate costs will include the trading loss suffered by both parties by reason of the loss of an opportunity for advantageous

⁵⁵ In this section, I will be concerned with discrimination based entirely on factors which are not associated with (or not thought to be associated with) a prospective employee's marginal product. In the main the concern will be with what I have called *indices*, rather than *signals*.

exchange,⁵⁶ and the injury to feelings and dignity suffered by the discriminatee. The “benefits” in this context assume a peculiar character. It is unlikely that the employer will experience a positive utility (that is, be made happy) by the opportunity to discriminate, although some discriminators may. It is more likely that in hiring a person from a disfavoured group the employer will suffer a *disutility* as compared to hiring a member of the preferred group. Thus, the benefit of the discrimination consists of the avoidance of a disutility rather than the realization of a positive utility.

Assuming for the time being that the only losses and benefits are those experienced by the immediate parties to the (potential) exchange, a wealth-maximizer might anticipate an “efficient” outcome to the discriminatory interaction. Employer tastes for discrimination must be taken as given. The metric of wealth-maximization is “willingness to pay” and efficiency is achieved when all willingnesses to pay are registered within the framework of the exchange. An employer who discriminates is demonstrably willing to pay in order to indulge his discriminatory preferences. The payment comes in the form of lost money income.⁵⁷ Of course, the discriminatee may suffer losses as a result, both in the form of lost money income and non-pecuniary injury. At first sight, it might appear that these losses may exceed the gains⁵⁸ of the discriminator. However, should this be the case, an opportunity for mutually advantageous exchange is created, whereby the discriminatee can offer a payment to the discriminator in order to secure employment. This payment will assume the form of accepting a reduced wage, as compared to that paid members

⁵⁶ The exchange in this instance is of the employee’s human capital in return for remuneration. It is possible that the trading loss will be zero. As suggested by Becker, *supra*, note 28 at 100 and by Stiglitz, *supra*, note 13, discrimination in employment may lead only to full segregation of the work-force rather than differentials in wages, type or conditions of employment as between preferred and non-preferred groups. In fact, there is some evidence in the American South that, in the face of strong discrimination against blacks, segregation of white and black economies has led to relatively modest income differentials to those practicing medicine and law. See Sowell, *supra*, note 15 at 135-37. Complete segregation is obviously not the norm however, leading to the conclusion that trading losses as a result of employer discrimination are a virtual certainty.

⁵⁷ It is important to note that *wealth*-maximization is not, in this context, synonymous with *profit*-maximization; a mistake frequently made by non-economists. See, e.g., Fiss, *supra*, note 16 at 247-54. A wealth-maximizer maximizes more than money income: he maximizes the sum of *both* money income and non-monetary satisfactions. The benchmark of wealth-maximization is “willingness to pay”. When goods and services, etc. are allocated on the basis of the willingness to pay for them, they are efficiently allocated. See *generally* articles in 8 HOFSTRA L. REV. (symposium issue on the normative foundations of law and economics). The wealth-maximization criterion is derivative of the calculus of utilitarianism; but while utilitarians seek to maximize the sum of all the pleasures and pains, the wealth-maximization criterion seeks to maximize the sum only of those desires which are backed up by an actual willingness to pay.

⁵⁸ Alternatively, as I suggested above, losses avoided amount to the same thing as gains.

of the favoured group,⁵⁹ sufficient to offset the non-monetary disutility suffered by the employer as a result of employing the person. Absent gaming or strategic behaviour and provided that it is possible for individuals to bargain for wages with the employer (and that the transaction costs of so doing are not prohibitive), this simple market model suggests that the market will almost always yield efficient outcomes in respect of this type of discriminatory interaction. The policy prescription of this view is that there is no role for government regulation.

It is more usual in the economic literature to find expressions of the weak form claim which lead to a similar policy prescription while avoiding what many would regard as the more offensive character of the strong claim.⁶⁰ The weak form claim consists of the assertion that a free and competitive market will best ensure that non-profit motivated discrimination is eradicated and that government regulation of discrimination is therefore at best unnecessary, at least costly, and at worst counterproductive. The weak form claim can itself be divided into two distinct subclaims. The first is that the market will eliminate discrimination in *hiring* decisions as between favoured and non-favoured applicants. The second is that the market will tend to eliminate differentials in wages between favoured and non-favoured groups. These claims are closely related and each starts from two key observations. First, at least where the firm's shareholders are merely contributors of capital and take no part in the running of the firm, their sole interest is almost certainly pecuniary profits.⁶¹ Second, where the firm carries on business in a competitive market, it will earn no economic profits.⁶² Firms which discriminate will forego potentially profitable opportunities for exchange, and will as a result earn less than zero economic profits. Bankruptcy may ensue. Alternatively, managers who discriminate and hence forego profits will be replaced by non-discriminators who will maximize profits. The inefficient managers may be replaced at the instance of the firm's current shareholders, or they may be replaced by those who, seeing a profitable

⁵⁹ By assumption, they have the same marginal product.

⁶⁰ See, e.g., Sowell, *supra*, note 15; Posner, *supra*, note 25; Arrow, *supra*, note 15; Stiglitz, *supra*, note 13; Williams, *supra*, note 7. In respect of the strong form claim, see M. Friedman, *CAPITALISM AND FREEDOM* (Chicago: University of Chicago Press, 1962) c. 12. Arguably, Becker's classic exposition of the economics of discrimination implicitly assumes the strong form claim in recognizing that wealth-maximization must have regard to non-pecuniary satisfactions backed up by a willingness to pay, as well as pecuniary satisfactions. See Becker, *supra*, note 28.

⁶¹ See generally M.C. Jensen & W.H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure* (1976) 3 J. FIN. ECON. 305.

⁶² See R.G. Lipsey, D.D. Purvis & P.O. Steiner, *ECONOMICS*, 5th ed. (New York: Harper & Row, 1985) at 150-51.

opportunity to eliminate the discrimination and increase the value of the firm, make an offer to buy the firm.⁶³

Thus, whether or not the managers must suffer the disutility of hiring members of disfavoured groups will be of little concern to remote capital contributors whose interest in investing will be a financial one. Managers with a taste for discrimination will find it to their advantage to hire qualified members of disfavoured groups, discriminating (if at all) by paying low wages to willing candidates rather than by refusing to hire.

Where minority and non-minority applicants are equally qualified (having similar marginal productivities), a competitive environment will also reduce or eliminate these wage differentials. As long as the wage paid to minority members is less than their marginal product, it will pay a profit-maximizing employer to hire only minority applicants. But, since all employers (by assumption, driven by the market to maximize profits) will compete for the same labour, the wage will be driven up to the point where it is equal to that of other similarly qualified employees.

Two general policy conclusions have frequently been drawn from the foregoing. First, it has often been suggested that anti-discrimination legislation is not cost-justified.⁶⁴ In a vigorous and competitive market the residual non-profit motivated discrimination will be reduced to a trivial level. Thus, the benefits of such legislation will be slight; although the legislation will be costly to enforce.⁶⁵ Second, as a more general matter, government or other interference with a free and competitive market place will worsen the position of disadvantaged minorities by softening the restraints which competitive forces place on the ability of an employer to indulge his discriminatory tastes.⁶⁶ For example, minimum wage legislation inhibits the ability of disadvantaged minorities to accept work at a lower wage, thus eliminating mutually advantageous opportunities for trade and resulting in the disemployment of disfavoured minorities.⁶⁷ Wage and price controls have a similar effect, as does equal pay for equal work legislation. In each of these cases, where an employer

⁶³ The mechanisms for displacing incumbent management without management's co-operation include a takeover bid and a proxy contest. Incumbent managers may also be persuaded to resign (either by current shareholders or in the course of a friendly amalgamation or sale of assets or otherwise) by an attractive severance package (or "golden parachute"). See generally R.J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers* (1981) 33 STAN. L. REV. 819.

⁶⁴ See, e.g., Posner, *supra*, note 25.

⁶⁵ Demsetz attempts to demonstrate empirically the ineffectiveness of such legislation, *supra*, note 7 at 284-86. But see P.J. Norgren & S.E. Hill, *TOWARD FAIR EMPLOYMENT* (New York: Columbia University Press, 1964).

⁶⁶ See generally Demsetz, *ibid.* at 276, 279ff.; Williams, *supra*, note 7, c. 5-7; Sowell, *supra*, note 15 at 166-67, 185ff.; W.E. Block, *Economic Intervention, Discrimination, and Unforeseen Consequences* in Block & Walker, *supra*, note 22 at 113-14.

⁶⁷ See, e.g., Williams, *supra*, note 7, c. 3; Y. Brozen, *The Effect of Statutory Minimum Wage Increases on Teen-Age Employment* (1969) 12 J.L. & ECON. 109.

selects employees from amongst a pool of applicants, and must pay members of both preferred and non-preferred groups the same wage, it is almost inevitable that he will select a member of the preferred group for employment. Trade unions, which operate without a market constraint, have also frequently been accused of furthering discrimination. This has been implemented through the mechanism of hiring halls or by virtue of union shop clauses allowing the union a voice in who may work for the employer.⁶⁸ Indeed, it has been suggested that anti-discrimination legislation itself may have the unintended effect of causing higher unemployment amongst the minorities it is supposed to help.⁶⁹

3. *The Limits of the Weak Form Claim*

In this section, I will argue that even in a vigorously competitive economy, an economically significant amount of discrimination may persist. Even in a polity which recognizes the advantages of competition, there will be a significant role for the public sector which is insulated from market forces. There will also be natural monopolies, and evidence suggests that monopolies are relatively free to engage in discriminatory behaviour with impunity. In the private sector, large public corporations may engage in discrimination either as an instance of "agency costs" arising from the separation of ownership and control, or as a manifestation of bureaucratic loss of control. The manager/owners of private corporations will be even freer to engage in discrimination given the relative weakness of constraining market forces. Lastly, in a liberal democratic polity, government interference in the market in various forms is likely

⁶⁸ Williams makes a good case that unionization played an important role in disenfranchising blacks in the post-bellum period from skilled jobs. *Ibid.* at c. 7. See also Demsetz, *supra*, note 7 at 278.

⁶⁹ Landes' empirical study led him to conclude that while state fair employment laws resulted in higher wages for blacks with jobs and an increase in the demand for blacks in order to integrate the firm, they also resulted in higher unemployment of blacks. Landes explains this as a result of a segmented market, in which some blacks have attractive high wage jobs and others continue to hold relatively low paying jobs, inducing the latter to leave their jobs in search of attractive high paying jobs, or for those who are otherwise unemployed to search longer for attractive jobs. W.M. Landes, *The Effect of State Fair Employment Laws on the Economic Position of Nonwhites* (May 1967) 57(2) AM. ECON. REV. 578.

Other forms of intervention in the market which have been criticized on these grounds include licensing and accreditation by professional associations and regulation of industry profit rates.

By implicitly accepting the idea that discrimination in the form of payment of lower wages to discriminated-against minorities is a better state of affairs than discrimination in the form of disemployment, these arguments stake out a claim which is not always clearly weak form as opposed to strong form. Nevertheless, those who advance such arguments almost uniformly appear to start from a normative premise that less discrimination is a desirable thing. See, e.g., Demsetz, *supra*, note 7. The strong form claim may be the hidden agenda of some of those ostensibly advancing the weak form claim.

to persist. Such interference disenables competition from performing the role assigned it by those asserting the weak form claim and thus *strengthens* the case in favour of anti-discrimination legislation.

Looking first to the public sector, it is clear in Canada that the activities of governments constitute an enormously important part of all economic activity.⁷⁰ The work of towns, cities, boroughs, municipalities, hospitals, universities, provincial and federal governments and the like makes government a key employer in this country. The government of Ontario, for example, is the single most important employer in the province.⁷¹ It is equally clear that government activities are not and cannot be constrained by market forces. Thus, in respect of the public sector, the weak form claim must fail.

Monopolies (or those enjoying some monopoly power) are also significant employers. Bell Canada Enterprises, for example, employs some 108,300 persons in Canada.⁷² There is evidence that monopolies are freer than corporations carrying on business in a competitive environment to engage in discriminatory employment practices.⁷³

In a competitive private sector, and especially in respect of public corporations, there are a number of devices which will constrain the degree to which employment discrimination may be practiced. One device for restraining managerial discrimination which may diminish profits is shareholder voice. Should profitability fail to meet expectations, shareholders may (through their ability to appoint directors) remove the man-

⁷⁰ According to the 1981 Census there were 7,080,090 male employees in all industries, of which 572,870 (or 8%) were employed in public administration and defence. Of 4,796,940 females employed in all industries, 335,285 (or 7%) were employed in public administration and defence. See Statistics Canada, 1981 CENSUS OF CANADA — POPULATION: LABOUR FORCE — INDUSTRY BY OCCUPATION, catalogue no. 92-923 (Ottawa: Ministry of Supply and Services Canada, 1984) at 1.1-1.2.

⁷¹ The Census reveals that of a total male labour force of 2,595,355 in Ontario, 192,625 (or 7.4%) were employed in public administration and defence. Of a total female labour force of 1,850,655, 118,915 (or 6.4%) were employed in public administration and defence. *Ibid.* at 1.17-1.18.

⁷² "Ranking Corporate Performance in Canada" *The [Toronto] Globe and Mail, Report on Business Magazine* (July 1986) 171.

⁷³ See generally O.E. Williamson, *Managerial Discretion and Business Behavior* (1963) 53 AM. ECON. REV. 1032; A.A. Alchian & R.A. Kessel, *Competition, Monopoly, and the Pursuit of Money* in a report of the National Bureau of Economic Research, New York, ASPECTS OF LABOUR ECONOMICS: A CONFERENCE OF THE UNIVERSITIES — NATIONAL BUREAU COMMITTEE FOR ECONOMIC RESEARCH (Princeton, N.J.: Princeton University Press, 1962) 157; W.G. Shepherd, *Market Power and Racial Discrimination in White-Collar Employment* (1969) 14 ANTITRUST BULL. 141; Sowell, *supra*, note 15 at 166-70; Sowell, *supra*, note 7 at 46-50. This evidence is not entirely unsurprising. As suggested by Jensen and Meckling, *supra*, note 61, profit maximizing monopolists will have the same incentive as competitive businesses to eliminate inefficient practices. Managers of monopolies who fail to do so by, for example, indulging discriminatory tastes may be displaced by shareholders or by outsiders seeking to remedy the situation and earn greater profits. The disparity between theory and evidence presents an as yet unresolved puzzle.

agers. Another disciplinary constraint is the threat or actuality of a takeover. An outside party may perceive an opportunity to realize gains by taking control of the corporation and expelling the discriminatory managers, replacing them with profit-maximizing non-discriminators. The concern of managers to ensure their continued tenure, or maximize their chances of employment on favourable terms elsewhere, will commit the managers to making profits and hence eschewing discriminatory hiring practices, no matter what their personal preferences.⁷⁴

There can be little doubt that these mechanisms will tend to limit the extent of employment discrimination indulged in by the firm's managers.⁷⁵ However, it also seems clear that imperfections in these market mechanisms might allow for the survival of *some* employment discrimination. Shareholder voice is bound to operate imperfectly. Shareholders are likely to have little knowledge of discriminatory hiring practices. Despite the volume of mandated information which must be passed on to shareholders in the form of annual reports, financial statements, managerial solicitations of proxies and otherwise,⁷⁶ none of this information touches directly on hiring practices. Even if shareholders were in possession of information showing that profits were being passed up to indulge discriminatory preferences, collective action problems would intervene to prevent effective redress.⁷⁷ The takeover mechanism will also operate imperfectly. Although relatively unspectacular profitability resulting from discriminatory practices may depreciate share prices, inviting a takeover, the transaction costs of takeovers appear to *average* thirteen per cent or more of aggregate post-acquisition share prices.⁷⁸ Clearly, no takeover will occur unless the anticipated gains exceed this figure, perhaps by a substantial margin.⁷⁹ It is highly unlikely that dis-

⁷⁴ See generally Gilson, *supra*, note 63.

⁷⁵ E.F. Fama, *Agency Problems and the Theory of the Firm* (1980) 88 J. POL. ECON. 288.

⁷⁶ See, e.g., *Securities Act*, R.S.O. 1980, c. 466, Part XVII, and R.R.O. 1980, Reg. 910, Part II; *Canada Business Corporations Act*, S.C. 1974-75-76, c. 33, Part XII, and *Canada Business Corporations Regulations*, C.R.C. 1978, c. 426, Part IV.

⁷⁷ The transient and atomistic interests of small shareholders, and the fact that each stands to capture a small part of any gains arising from constraining managerial inefficiency, result in a free-rider problem which in the main will significantly weaken shareholder control over management through the device of "voice". Shareholders with larger stakes will be more willing to intervene, but, as suggested in the text, will usually lack the information necessary to inspire action. See generally F.H. Easterbrook & D.R. Fischel, *Voting in Corporate Law* (1983) 26 J.L. & ECON. 395; R.C. Clark, *Vote Buying and Corporate Law* (1979) 29 CASE W. RES. L. REV. 776; H.G. Manne, *Some Theoretical Aspects of Share Voting* (1964) 64 COLUM. L. REV. 1427.

⁷⁸ R. Smiley, *Tender Offers, Transactions Costs and the Theory of the Firm* (1976) 58 REV. ECON. & STATISTICS 22 at 30.

⁷⁹ At least some of the gains will be shared with existing shareholders, in the form of a premium over current market price. Given imperfect information about the true financial condition of the target, the acquiror will typically discount anticipated gains by the risk of non-realization. Thus, the anticipated gains will almost certainly have to exceed the transaction costs by a substantial margin in order to attract a bidder.

crimutory hiring practices will depreciate profits by an amount of this magnitude. Nor can the market for managers be expected to operate perfectly in conforming the exercise of managerial discretion to profit-maximization.⁸⁰

Particularly in large organizations, bureaucratic loss of control may also account for discrimination. Large organizations breed complex organizational structures with a large amount of delegation of authority down the chain of command.⁸¹ Routine hiring decisions will frequently be made by relatively low-level personnel managers. Even where the firm's senior management are not discriminators, the lower-level personnel responsible for hiring decisions may be. Unless management keeps a very close watch to discern systematic biases in hiring decisions (a costly activity which will defeat the advantages of a delegation of authority), discrimination practiced by the lower-level managers may easily go undetected.

The foregoing amounts to an assertion that public corporations which discriminate may earn a less than normal risk-adjusted return. This is equivalent to stating that the firm may earn less than zero *economic* profits.⁸² However, the classic argument that *therefore* the firm will be likely to go bankrupt is apt to be misleading. Earning less than a normal risk-adjusted return is consistent with earning a positive rate of return, sufficient to meet the firm's trade obligations and remain comfortably in business.⁸³

It is likely that an even greater level of residual discrimination will survive in the case of private (not publicly traded) corporations. Market discipline slackens in the case of private corporations to a degree which is almost certain to permit greater freedom to earn a less than normal rate of return. The takeover mechanism, for example, will prove less of a constraint. There is no well-developed "market" for private companies; nor in most cases will outsiders have information bearing on profitability, resulting in them being unable to identify attractive targets. Equally importantly, an owner/manager of a private corporation will often realize a significant portion of his "return" in the form of non-pecuniary income, deriving, for example, from being his own boss. He may thus be willing to put up with some sacrifice of money income (or forego a potentially

⁸⁰ The foregoing is expressive of the fact that, in an informationally efficient market, with costly monitoring and redress for departures from profit-maximization, there will be an equilibrium level of "agency costs". See Jensen & Meckling, *supra*, note 61. These agency costs may arise in the form of a discriminatory hiring practice.

⁸¹ See H. Mintzberg, *THE STRUCTURING OF ORGANIZATIONS* (Englewood Cliffs, N.J.: Prentice-Hall, 1979) at 181-213.

⁸² See Lipsey, Purvis & Steiner, *supra*, note 62.

⁸³ *Ibid.*

profitable takeover offer) in order to remain in business.⁸⁴ Shareholder "voice" will be no answer, since the manager(s) is (are) almost certain to be the majority or controlling shareholder(s) (if not sole owner(s)).

Discrimination may also arise (in respect of either public or private corporations) *after* the hiring decision has already been made, in promotion and advancement. A competitive market is consistent with a significant degree of discrimination in respect of such decisions. Employees frequently acquire job-specific skills which are not easily or completely transferable to other employers.⁸⁵ A change in jobs may result in the loss of accumulated seniority or pension benefits. It may also impose psychological costs, as well as a loss of income between jobs, and in many cases costs associated with moving to take up a new job. Particularly if the employee is married and/or has a family, these will operate as a major incentive to remain in a job, even in the face of discrimination, giving the employer a strategic ability to discriminate once the employee is hired. The existence of job-specific skills also cedes a power to seek strategic advantage to the employee. The balance of strategic power, however, will almost certainly belong to the employer in that the cost to the employer is restricted to that of hiring and training a new employee, while the cost to the employee includes all the additional costs I have noted.⁸⁶

Thus, while it is undoubtedly true that a keen and vigorous market will tend to eliminate both discrimination in hiring and in wages, *some degree* of residual discrimination resulting from employer tastes for dis-

⁸⁴ Arrow has suggested that, because *negative* marginal utilities are associated with an act of discrimination, an entrepreneur faced with losing money income by discriminating or losing non-money income by not discriminating will, in *either* case, earn a subjective rate of return less than a normal rate. He will resolve the dilemma by choosing neither alternative. Rather, he will transfer his funds to an activity where he can earn a normal risk-adjusted rate of return without facing the dilemma — such as investing his funds in the stock market. This is functionally equivalent to suggesting that the assets of companies run by discriminators will move to the hands of non-discriminators, who, being able to realize a greater subjective return from running the business, will be willing to pay more for the firm's assets. The objection is well taken. However, those who run private businesses will frequently realize significant non-pecuniary returns from running their own businesses. These non-pecuniary returns may be sufficient to outweigh the negative marginal utilities resulting from facing the discrimination dilemma. Further, the informational difficulty noted in the text will prevent outsiders from identifying firms to purchase. Thus, while Arrow's point tempers the argument that private firms will engage in more discrimination than public firms, it is far from a fatal blow. See Arrow, *supra*, note 15 at 91-94.

⁸⁵ This is broadly conformable to Oliver Williamson's notion of "asset specificity". See, e.g., O.E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations* (1979) 22 J.L. & ECON. 233 at 239-45.

⁸⁶ Compare Comment, *An Economic and Legal Analysis of Union Representation on Corporate Boards of Directors* (1982) 130 U. PA. L. REV. 919 at 928.

crimination will survive in both public and private sectors.⁸⁷ What remains is to demonstrate that this residual discrimination may be economically significant. It is vital to note both the concentration of the economic impact of employment discrimination in those groups discriminated against, and the way in which the effects of such discrimination cumulate and intensify over time. Discrimination which has a relatively insubstantial effect on the profits of any single employer is likely to have a concentrated effect on targeted minority groups. Where majority and minority groups experience significant interaction, the greater number of a minority group member's interactions will be with majority group members and thus will be adversely discriminatory in character. A member of the majority group will also experience most of her interactions with majority group members, but these interactions will be of a positive or non-discriminatory character. Thus the economic effects of the discrimination will concentrate in the minority group.⁸⁸ Moreover, this type of discrimination will contribute to the process of adverse selection discussed earlier, resulting in a cumulative effect over time.⁸⁹ The concentration of economic impact will exacerbate the adverse selection process. In this manner, the economic impact of the residual discrimination that survives market competition will be multiplied over time. Thus, even if one takes the view that the degree of residual discrimination that will survive the forces of competition is quite small, the ultimate economic impact of such discrimination can nevertheless be economically significant.

Earlier, I noted that a number of economists, pointing to the fact that government-originated market restraints are likely to worsen the degree of discrimination practiced by employers, have argued in favour of eliminating such restraints. As a political matter, it is highly unlikely that market restraints such as minimum wage and equal pay for equal work legislation will be repealed in the interests of minimizing the degree of discrimination in the work-place (or for other reasons). Such legislation is a commonplace feature of the economic landscape of most liberal democratic polities. In the face of this, it seems less fruitful to argue against these types of government interference in the marketplace than to recognize that these restraints *strengthen* the case in favour of anti-

⁸⁷ An example is professional baseball. The complete segregation of professional baseball ultimately yielded to competitive pressures when, following the hiring of Jackie Robinson by the Brooklyn Dodgers in 1947, it became apparent to club owners that it was good business to hire talented black players. Competition for black players led to a virtual elimination of wage disparities between white and black players, although Pascal and Rapping conclude that competition did not *completely* eradicate discrimination in hiring. See A.H. Pascal & L.A. Rapping, *The Economics of Racial Discrimination in Organized Baseball* in Pascal, *supra*, note 15 at 149. Pascal and Rapping, however, fail to consider consumer (fan) prejudices as a competitive explanation for this residual discrimination.

⁸⁸ Axelrod makes this argument, *supra*, note 28 at 148-49.

⁸⁹ See *infra*, Part IV.A.4.

discrimination legislation in order to control the unintended (and unwelcome) *sequelae* of such legislation.

4. *The Limits of the Strong Form Claim*

As noted, the strong form claim goes beyond the weak form claim in suggesting that it is unnecessary to be concerned about whether or not competition will eliminate discrimination because the indulgence of employer tastes for discrimination is likely to be *efficient*. In this section, I will suggest that the efficiency of this type of discrimination can easily be doubted, given unaccounted-for externalities and a reflexive effect on the utilization of the human capital of those discriminated against.

The model I presented earlier suggested that where an employer indulges his taste for discrimination, in the process sacrificing a potentially profitable opportunity for trade, he has revealed himself willing to pay to indulge his taste for discrimination. An employee may suffer both monetary and non-monetary losses as a consequence of a decision not to hire, but may bargain with the employer to accept a lower wage in return for a job. In this manner, the employee's willingness to pay is also registered. If a "deal" is struck, such that the employee accepts work at a lower wage than members of the favoured class, the bargain must be an efficient one, since all costs and benefits of the discrimination are encapsulated within the framework of the bilateral exchange.

The first criticism of this model challenges the assertion that all costs and benefits occur only in the context of the bilateral exchange. An act of discrimination may provoke responses in third parties who are not privy to the exchange. Some may experience displeasure at knowing that an act of discrimination has occurred. Others may commiserate with the act of discrimination. These third party preferences may be conceived of as an "externality" of the act of discrimination.⁹⁰ Indeed, the externality need not attach to any particular act or acts of discrimination. It may attach in a much more general fashion to knowledge that other (unidentified) persons discriminate in a manner which is invidious to the third party. If these third party preferences are substantial, then there can be

⁹⁰ A common example of an externality is pollution produced by a factory. Although the pollution imposes a cost on the local community, neither the factory owners nor the consumers of its products pay for inflicting this damage. Thus, government regulation is appropriate. Calabresi and Melamed suggest that where such "external costs do not lend themselves to collective measurement which is acceptably objective and non-arbitrary", a case is made out for prohibiting market transactions in the entitlement, that is by formulating an "inalienable" entitlement. G. Calabresi and A.D. Melamed, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral* (1972) 85 HARV. L. REV. 1089 at 1111. See generally 1111-15.

no confidence that the bilateral discriminatory interchange between discriminator and discriminatee is in any sense efficient.⁹¹

All that is necessary for these third party preferences to constitute an externality in an *economic* sense is that third parties be willing to pay to give force to their preferences. Of course, it will be difficult to discover these preferences and their relative intensities because the transaction costs of so doing (for any population of more than trivial size) and the difficulties in achieving truthful revelation of preferences intervene.⁹² However, there may be useful evidence of the existence, generality, and intensity of such third party preferences. For example, a willingness to pay on the part of those who would seek to enjoin discrimination in the work-place might take the form of time donated to organizations whose mission is to eliminate discrimination. The opportunity cost of the time donated, whether it would otherwise be consumed as leisure or dedicated to gainful employment, can readily be converted into a monetary equivalent. Also, since anti-discrimination legislation is costly to enforce and hence imposes a burden on taxpayers, the passage of such legislation is itself an indication of the existence of substantial third party preferences.⁹³ In this respect, it is significant that there are many organizations whose activities are dedicated wholly or in part to reducing or eliminating many types of work-place discrimination and relatively few whose activities are in favour of such discrimination. Moreover, anti-discrimination legislation of a variety of characters has been adopted in most jurisdictions.⁹⁴

Of course, this evidence cannot be taken as conclusive of the efficiency of the legislation. Public choice theory suggests that "logroll-

⁹¹ Even Thomas Sowell, one of the most determined and vociferous advocates of a laissez-faire government policy in respect of discrimination, acknowledges that:

In special circumstances, the negative effects of some transactions on non-transacting parties may justify option-reduction applied to transactors — precisely in order that the excluded preferences of non-transactors be taken into account. Air and water pollution are classic examples of these external effects. In such cases, there is no net reduction of options of all the affected parties, even though the options of the immediate transactors may be reduced.

Sowell, *supra*, note 7 at 108.

⁹² See generally D.C. Mueller, *PUBLIC CHOICE* (Cambridge: Cambridge University Press, 1979) c. 2-4.

⁹³ A good discussion of the costs of anti-discrimination legislation is found in Fiss, *supra*, note 16 at 255-56.

⁹⁴ *Canadian Human Rights Act*, S.C. 1976-77, c. 33; *Charter; Alberta Bill of Rights*, R.S.A. 1980, c. A-16; *Human Rights Act*, R.S.B.C. 1979, c. 185.5; *The Human Rights Act*, S.M. 1974, c. 65, C.C.S.M. H175; *Human Rights Code*, R.S.N.B. 1973, c. H-11; *The Newfoundland Human Rights Code*, R.S.N. 1970, c. 262; *Human Rights Act*, S.N.S. 1969, c. 11; *Human Rights Code, 1981*, S.O. 1981, c. 53; *Human Rights Act*, S.P.E.I. 1975, c. 72, R.S.P.E.I. 1974, c. H-12.2; *Charter of Human Rights and Freedoms*, R.S.Q. 1977, c. C-12; *The Saskatchewan Human Rights Code*, S.S. 1979, c. S-24.1.

ing”,⁹⁵ uneven distribution of intensities of preferences, or other factors, may account for political outcomes which are not consistent with wealth-maximization. However, impressionistic evidence is consistent with the following assertions: First, third party preferences appear in fact to be empirically significant, upsetting any attempt to impute efficiency to individual acts of discrimination by reference to the overly simplistic bilateral exchange paradigm. Second, if any imputation as to the efficiency of employer discrimination motivated by tastes for discrimination is to be drawn, the evidence is more consistent with inefficiency than efficiency.⁹⁶

The existence of the adverse selection dynamic adverted to earlier reinforces this conclusion. Discrimination need not be inspired by “benign” statistical motivations to set the adverse selection process in motion. Employer discrimination motivated by a taste for discrimination will have the same effect as statistical discrimination on the return on self-improvement to members of the group discriminated against. Thus, the effect of the discrimination may be precisely the same - chronic impoverishment of the human capital of the group or groups discriminated against.⁹⁷

For these reasons, the strong form of the efficiency claim fails. Coincidentally, a case is made out for anti-discrimination legislation aimed at preventing the indulgence of employer tastes for discrimination, whether as to race, sex, ethnic origin, or the like.

B. *Employee Tastes for Discrimination*

An employer may discriminate because his employees (or some of them) have discriminatory tastes. If some segment of the working population has discriminatory tastes, then competition between employers for employees will tend not to eliminate, but to reinforce this type of discrimination. Those employees who are discriminators will view the wage offered by the employer as subjectively lower if the job involves

⁹⁵ Logrolling describes a process whereby voters, or coalitions of voters, in effect exchange votes by agreeing to vote favourably on issues the others consider important. Although logrolling can be one means whereby voters are able to register intensity of preferences, conducing to the achievement of efficiency, it may also lead to inefficient outcomes. See G.V. Tullock, *Problems of Majority Voting* (1959) 67 J. POL. CON. 571; J.M. Buchanan & G.V. Tullock, *THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY* (Ann Arbor: University of Michigan Press, 1962); T. Schwartz, *Vote Trading and Pareto Efficiency* (1975) 24 PUB. CHOICE 101. An excellent overview of the public choice literature is Mueller, *supra*, note 92.

⁹⁶ Some of the evidence I have presented might, perhaps justifiably be accused of possessing an element of tautology in that the passage of anti-discrimination legislation is taken as evidence of the efficiency of the legislation, thereby justifying its passage. However, I believe it is more than merely tautological. It is an important countervailing fact to the assertion that discrimination is efficient, given that the political process is one mechanism, albeit imperfect, for registering third party preferences.

⁹⁷ Compare Fiss, *supra*, note 16 at 260.

working with members of the disfavoured group. These employees will demand compensation in the form of higher wages in order to work for an employer who hires members of disfavoured groups. Thus, it will pay all employers to segregate their work-forces, hiring only members of favoured or disfavoured groups, so that no worker demands a wage premium for working alongside others against whom they have discriminatory biases. In this manner, the existence of such discriminatory preferences may lead only to segregation of work-forces and not to wage differentials.⁹⁸ However, a number of factors may make it difficult or impossible for employers to construct wholly segregated work-forces. One of these would be an unequal distribution of skills amongst favoured and unfavoured workers. Another would be an uneven geographic and demographic distribution of majority and minority group members. In practice, either or both of these factors is likely to prevent wholesale segregation of work-forces, leading to the appearance of wage differentials, with members of the favoured group receiving higher wages for work of an equivalent level of skill.⁹⁹

Prima facie, the number of discriminatory employees in the population may be relatively small and yet still provide an employer with an incentive to discriminate in order to minimize his wage bill, both by attempting to segregate his work-force and, where this is not possible, paying unequal wages to favoured and disfavoured groups. If, for example, only twenty per cent of employees are discriminators, hiring and wage discrimination would likely result in a significant reduction in the employer's wage bill. Thus, the existence of non-majoritarian discriminatory preferences may lead to widespread discrimination in the workplace.

As in the case of employer tastes for discrimination, the existence of third party preferences may render the efficiency of employer discrimination, motivated by discriminatory preferences of its work-force, problematic. This would be the case if many find this type of discrimination distasteful and possess a willingness to pay to express these preferences. It may be the case, however, that the prevalence of widespread employer discrimination to service employee prejudices is symptomatic of generalized third party preferences favouring discrimination, weakening the case that third party preferences render such discrimination inefficient. But, as I have suggested, it may be profitable for employers to discriminate even where the number of discriminatory employees is far from a majority of the population. Moreover, the impressionistic evidence cited earlier, suggesting the inefficiency of discrimination motivated by employer tastes for discrimination, also has some bearing on

⁹⁸ See Becker, *supra*, note 28; Stiglitz, *supra*, note 13 at 288-89; *supra*, note 56.

⁹⁹ The marginal cost of a disfavoured worker will exceed that of a favoured worker, since hiring a disfavoured worker will necessitate the payment of a wage premium to discriminatory employees of the favoured group.

discrimination motivated by employee tastes for discrimination. It would be somewhat inconsistent (if not surprising) to find that, in the main, members of the populace find discrimination motivated by *employer* tastes for discrimination distasteful, but simultaneously approve of employer discrimination motivated by employee prejudices.

Aside from the existence of third party preferences, there is a further reason to believe that employer discrimination motivated by employee preferences will result in inefficiencies. Once again, such discrimination will contribute to the adverse selection dynamic by lowering the returns on self-improvement of selected groups.

To summarize, the weak form claim is even more likely to fail in respect of this type of discrimination than in the case of discrimination motivated by employer tastes for discrimination. Competition in labour markets will probably operate to increase, rather than reduce this type of discrimination. The strong form claim based on the exchange paradigm also fails for the same reason it fails in the case of employer tastes for discrimination.

C. *Consumer Tastes for Discrimination*

Employer discrimination motivated by consumer preferences presents, in the main, the same issues as discrimination motivated by employee preferences. I will not therefore repeat the arguments which I presented in the preceding section. In both cases, the weak and strong form claims are very far from having been made out. A case can therefore be made on efficiency grounds for anti-discrimination legislation.

V. STATISTICAL DISCRIMINATION IN INSURANCE AND PENSION PLANS

Insurers commonly use statistical indicators in establishing insurance premiums for individual insureds. In like fashion, statistical indicators are frequently used in setting up pension plans. A controversial feature of both is the use of what I have identified as indices — that is, ascriptive characteristics over which the individual has no control, such as race, sex, or ethnic origin.¹⁰⁰ In this section, I will argue that the use of

¹⁰⁰ The literature on this subject is extensive. See, e.g., Kimball, *supra*, note 7; S.L. Kimball, *Reprise on Manhart* [1980] AM. B. FOUND. RESEARCH J. 915; Benston, *supra*, note 7; Brilmayer *et al.*, *supra*, note 2; Laycock & Sullivan, *supra*, note 2; M.E. Gold, *Equality of Opportunity in Retirement Funds* (1976) 9 LOY. L.A.L. REV. 596; M.C. Bernstein & L.G. Williams, *Title VII and the Problem of Sex Classifications in Pension Programs* (1974) 74 COLUM. L. REV. 1203; M.C. Bernstein & L.G. Williams, *Sex Discrimination in Pensions: Manhart's Holding v. Manhart's Dictum* (1978) 78 COLUM. L. REV. 1241; Freed & Polsby, *supra*, note 31; Rutherglen, *supra*, note 17; W. Van Alstyne, *Equality for Individuals or Equality for Groups: Implications of the Supreme Court Decision in the Manhart Case* (1978) 64 A.A.U.P. BULL. 150; S.J. Key, *Sex-Based Pension Plans in Perspective* (1979) 2 HARV. WOMEN'S L.J. 1; J.S. Gerber, *The Economic and Actuarial Aspects of Selection and Classification* (1975) 10 FORUM 1205; B.A. Hedges, *Gender Discrimination in Pension Plans: Comment* (1977) 44 J. RISK & INS. 141; R.J. Myers, *Further Comment* (1977) 44 J. RISK & INS. 144; H.C. Bailey, T.M. Hutchison & G.R. Narber, *The Regulatory Challenge to Life Insurance Classification* (1976) 25 DRAKE L. REV. INS. L. ANN. 779.

indicators such as age and sex, in contrast to the results of their use in employment, is likely to achieve savings which are significant without generating great short or long run costs. Thus, their use is eminently justifiable on economic grounds. By contrast, the use of race, ethnic origin, or other indicators which have been particularly stigmatized by invidious use in the past, may generate costs which argue in favour of forbidding their use.

The use of *some* statistical indicators is absolutely essential to the functioning of private markets for insurance and pensions. If insurers are to make a profit, they must charge a premium which reflects the insurer's anticipation of the aggregate loss experience of its clientele.¹⁰¹ If claims paid out exceed premiums paid in, the insurer will have an abbreviated commercial existence. At the time of writing a premium, the insurer must forecast future loss experience which can only be based on aggregative data derived from past loss experience of persons statistically similar to the insurer's clientele. Similarly, pension fund managers must be able to anticipate the magnitude of pension payouts made under the plan in order to ensure that it is adequately funded. This will involve the use of statistical indicators bearing on longevity and mortality.

In each case, aggregative data garnered from the past experience of similar insureds is the *only* means by which such predictions can be made. The issue which has provoked considerable controversy is the *type* of statistical indicators which it ought to be permissible to use: more particularly, whether or not it is acceptable to use statistical indices such as sex or age in calculating pension or insurance premiums or pension payouts. It is no secret, for example, that automobile insurers commonly use sex and age to calculate insurance premiums, with young male drivers paying the highest premiums, based on their statistical loss experience.¹⁰² Similarly, because of statistical evidence indicating that women, on average, live several years longer than men, many private pension plans require either that women contribute more to the plan to receive a similar periodic benefit, or receive a lower periodic benefit having contributed the same amount into the plan.¹⁰³

Each of these practices is justifiable on economic grounds. In respect of insurance markets, a failure to use ascriptive characteristics like those adverted to will result in lumping more disparate types of individuals together in a given premium class. The greater the differences between individuals within an insurance class, the greater is the certainty that the adverse selection dynamic will operate. This is because individual in-

¹⁰¹ Compare Bailey, Hutchison & Narber, *ibid.*

¹⁰² See, e.g., *Report of the Royal Commission on Automobile Insurance* (Nova Scotia, 12 March 1973) (Chair: A.I. Barrow) at 57ff. and especially 69-73, 269-70.

¹⁰³ See, e.g., K. Collins, *WOMEN AND PENSIONS* (Ottawa: Canadian Council on Social Development, 1978) at 165-69, 189-93; *Report of the Task Force on Employee Benefits Under Part X of the Employment Standards Act* (Toronto: Ministry of Labour, April 1975).

insureds are more likely to have risk characteristics deviating from the mean loss experience of the class upon which the premium is based. Thus, many low risk individuals will find that it does not pay to buy insurance and will withdraw from the market or purchase an inefficiently low amount of insurance. Individuals whose risk deviates on the high side of the average will find that they can purchase insurance at bargain prices, leading to excessive purchase of insurance by such individuals. This self-selecting characteristic of the population of insureds will result in losses experienced by insurers exceeding the level initially predicted, resulting in progressively higher premiums until the insurance is not offered at all or offered at a stable but inefficiently high price.

The more refined the insurer's scheme of classification, the less the adverse selection dynamic will operate. An increased ability of the insurer to forecast risk will result in more efficient pricing, leading to a greater availability of low cost insurance to those who seek such protection.

Mandating the use of unisex mortality tables in establishing pension premiums will lead to an added difficulty. Since women tend to live longer than men, the average woman will collect her pension for a longer period of time after retirement, imposing greater costs on the fund than her similarly situated but (on average) shorter-lived male counterpart. If employers are unable to compensate by requiring that women pay comparatively more into the pension fund, the net present value of pension benefits paid to women employees will exceed that paid to men.¹⁰⁴ As a result, the wage paid to women, consisting of a combination of take-home pay and the net present value of employment benefits, will exceed that paid to men. It will therefore pay profit-maximizing employers not to hire women at all and to hire only relatively low-priced men. Anti-discrimination legislation requiring equal treatment in hiring is a partial, but not complete answer to this problem. Such legislation is costly to enforce. By supplying employers with an incentive to discriminate against women in hiring, a relatively great number of discrimination suits will result, imposing costs which could be avoided by permitting the use of sex-based mortality tables. Nor can such legislation be expected to operate perfectly. Even if it could be made to operate both perfectly and costlessly, many (especially smaller) employers will simply choose not to offer a pension plan.¹⁰⁵

A policy of mandating that insurers and pension fund managers overlook ascriptive characteristics such as age and sex will not only increase insurance costs on average and tend to result in disemployment

¹⁰⁴ See Kimball, *supra*, note 7 at 91; Bernstein & Williams, *supra*, note 100 at 1243; Bailey, Hutchison & Narber, *supra*, note 100 at 825-26.

¹⁰⁵ See M. Bossen & Associates, *SEX DISCRIMINATION IN FRINGE BENEFITS* (Ottawa: Advisory Council on the Status of Women, 1975). See also M.G. Bulger & Associates, "Report to the Advisory Council on the Status of Women Concerning the Implications of the Development of 'Unisex' Tables" (1974) [unpublished]; Benston, *supra*, note 7.

of women, but will result in large (and unjustifiable) transfers of wealth. For example, mandating unisex mortality tables in determining pension contributions will result in a transfer of wealth from men, as a group, to women. This is because, as noted, a woman will on average outlive a similarly situated man, with the result that an average woman will collect pension benefits over a longer period of time than an average man and impose greater costs on the employer. Where men and women make equal contributions to the pension fund, men will subsidize the higher level of benefits received by women. In insurance markets, the subsidization will generally work in the other direction, with women subsidizing men. For example, because women tend to live longer than men, women as a class will impose lower costs on a life insurer. Mandating the use of unisex life insurance tables will result in a premium subsidization of men by women. Similarly, women have a statistically lower average automobile accident rate than men. Forbidding the use of sex as a predictor of accident rates will result in artificially high insurance premiums for women as a class, and artificially low premiums for men, resulting in subsidization by women of generally higher risk male drivers.¹⁰⁶

Thus, requiring insurers and pension managers to use less refined rating systems may well have both allocatively and distributionally adverse consequences, distinguishing the use of statistical indices in this context from their use in employment markets.

Another key difference from employment markets, at least in respect of insurance, arises in the likelihood that few third party preferences will be engaged by this type of discrimination. The use by insurers of age and sex is widely known and accepted. Indeed, the use of age as a predictor dates back to the eighteenth century; the use of sex to the nineteenth century.¹⁰⁷ The use of such indices does not reflect in any sense on an individual's merit, capability or integrity, and is not likely to be regarded by those who are discriminated against or others as in any sense invidious.

The use of sex-based mortality tables in funding pension liabilities presents an intermediate case in respect of third party preferences. Although in no way reflecting on an individual's worth or integrity and in fact preserving equality in the conditions of employment,¹⁰⁸ the requirement that a woman deposit a larger portion of her paycheque than a man to the pension fund (or receive lower periodic payments after retirement) may strike some as invidious. As long as this is the case, the existence

¹⁰⁶ The magnitude of the wealth transfers in the United States is estimated by Benston, *supra*, note 7 at 532-41. These estimates suggest that the magnitude of *Canadian* wealth transfers would certainly be in the millions and more likely the tens of millions of dollars.

¹⁰⁷ Kimball, *supra*, note 7 at 108.

¹⁰⁸ Requiring equal pay-ins for men and women, while simultaneously paying equal periodic payments after retirement, yields a higher present value of employment benefits to a similarly situated woman (in terms of age, *etc.*) as compared to a man, because of the longer period over which it is anticipated that the pension will be collected.

of negative third party preferences colouring the efficiency of such discrimination cannot be dismissed, although it is not clear how significant these preferences are.

Although neither the use of sex nor age proxies is likely to be viewed as invidious discrimination, the use of race, ethnic origin or similar characteristics as a predictor is very likely to engage third party preferences. These characteristics have frequently been used in the past as the basis for discrimination which many would regard as invidious so as to generate significant negative third party preferences. This cost would likely render their use inefficient,¹⁰⁹ leading to the conclusion that use of such indices as statistical predictors ought to be prohibited. Because of the questionable private as well as social utility of using such proxies, such a ban is not likely to meet with resistance.

The case of insurance and pensions usefully illustrates not only the relativity of the concept of discrimination, but also the importance of purpose, motive and consequence in formulating public policy in respect of discrimination. Discrimination is not *per se* invidious. It is, for example, absolutely essential for the preservation of private insurance and pension markets that insurers and pension managers be allowed to “discriminate” by consulting *some* statistical indicators. Unlike in the context of employment markets, there are few, if any, easily used low cost substitutes for measuring directly what such statistical indices are used to measure indirectly.¹¹⁰ Thus, although at first sight formally indistinguishable from statistical discrimination in employment markets, both purpose and consequences are very different. While the use of statistical indices in employment markets fosters the adverse selection dynamic and may lead to the chronic impoverishment of the human capital of select groups, the same type of discrimination in the context of insurance and pension markets will lead, in the main, to more efficient pricing and

¹⁰⁹ Compare Rutherglen, *supra*, note 17 at 203-09 (arguing that racial classifications in insurance *and* in employment are invidious, while sexual classifications with an employer efficiency objective are permissible); Freed & Polsby, *supra*, note 31 (constructing an argument similar to Rutherglen). *But compare* Brilmayer *et al.*, *supra*, note 2 (arguing that use of both race and sex should be forbidden for *all* purposes).

¹¹⁰ As indicated earlier, potential employees can “signal” their competence to the employer in a variety of ways, whether by education or by other means. Similarly, employers can use tests, such as weight-lifting or aptitude tests, to directly measure capability. Insurers have much more limited options for measuring risk. They can, and do, consult past loss experience, but this will be insufficient to set premiums for first-time insureds. Insurers also use information bearing on lifestyle and habits, but this information is frequently misstated by insureds interested in lower premiums. Insurers might conceivably question neighbours or friends about the insured’s character, but this will be enormously expensive and yield information of dubious value. In the case of life insurance and pensions, medical examinations may also be used. However, the single most predictive proxy for longevity is still sex. See Benston, *supra*, note 7 at 500-01, 517-19, 530-31; Kimball, *supra*, note 7 at 119-20; Freed & Polsby, *supra*, note 31.

greater availability, in fact *avoiding* the operation of an adverse selection dynamic.¹¹¹

VI. A SAMPLING OF CURRENT LEGISLATION

It has been my primary intention in this paper to develop economic rationales both for general anti-discrimination legislation, aimed at preventing discrimination based on factors over which the individual has no control, and other policy initiatives such as targeted assistance to designated minority groups. Nevertheless, I would be remiss in omitting any discussion of the current regulatory environment in Canada, in the interests of assessing what progress must be made to meet those policy prescriptions yielded by the analysis. In this section, using the Ontario and federal legislation as a focal point, I will suggest that on the whole, the regulatory environment conforms rather favourably with these policy prescriptions.

Anti-discrimination legislation of the kind recommended herein exists both at the provincial and federal levels. The provincial legislation is embodied in the provincial human rights codes, which apply to both public and private sector employers.¹¹² Such legislation prohibits discrimination in, *inter alia*, hiring on the basis of ascriptive characteristics such as race, sex, nationality, ethnic origin, and age. In the federal domain, the *Canadian Human Rights Act*,¹¹³ which applies to the hiring of employees in the federal public sector, contains a similarly framed prohibition against discrimination in hiring. In addition, the *Charter* provides that each individual is equal before the law, irrespective of the individual's "race, national or ethnic origin, colour, religion, sex,¹¹⁴ age or mental or physical disability."¹¹⁵ Each of these statutory prohibitions admits of exceptions. The human rights codes provide an exception where an employer's discriminatory use of an otherwise prohibited characteristic is a *bona fide* occupational qualification,¹¹⁶ and also allow for affirmative

¹¹¹ The differences in purpose, motive and consequences may result in varying policy implications where a benchmark other than efficiency is used to gauge the propriety of discrimination. Thus, this point may be generalized beyond the application of the efficiency criterion.

¹¹² See *supra*, note 94.

¹¹³ *Canadian Human Rights Act*, S.C. 1976-77, c. 33.

¹¹⁴ Section 28 of the *Charter* also provides: "Notwithstanding anything in this Charter, the rights and freedoms referred to in it are guaranteed equally to male and female persons."

¹¹⁵ S. 15.

¹¹⁶ Such a qualification appears in every jurisdiction in Canada. See W.S. Tarnopolsky, *DISCRIMINATION AND THE LAW IN CANADA* (Toronto: Richard de Boo, 1982) at 396. See, e.g., *Human Rights Code, 1981*, S.O. 1981, c. 53, s. 10(a). In general, boards of inquiry have interpreted the exception narrowly. See, e.g., *Shack v. London Driv-Ur-Self Ltd.* (June 1974), Report of a Board of Inquiry under the *Ontario Human Rights Code* (Chair: S.N. Lederman); *Gore v. Ottawa Separate School Bd.* (December 1971), Report of a Board of Inquiry under the *Ontario Human Rights Code* (Chair: W.S. Tarnopolsky).

action programs,¹¹⁷ as does the *Charter*.¹¹⁸ The equality guarantees of the *Charter* may be subjected to "such reasonable limits prescribed by law as can be demonstrably justified in a free and democratic society."¹¹⁹ These exceptions are consistent with the analysis presented earlier, in recognizing the relativity of the concept of discrimination and in prescribing, in effect, a balancing of concerns in adjudging whether or not conduct constitutes prohibited discrimination. There may be occasions, for example, where, because of a reproductive hazard posed to members of one or the other sex, an employer might legitimately exclude members of that sex from employment. This would be an example of a *bona fide* occupational qualification. Similarly, affirmative action programs are inherently discriminatory but may conduce to the pursuit of efficiency.

Governments are probably the main source of affirmative action programs in hiring. For example, at least a dozen ministries of the Ontario government operate affirmative action programs aimed at women or minority groups.¹²⁰ A number of provincial ministries assist young people either by providing informational services to find jobs, job training assistance or employer incentives to hire youth.¹²¹ The Newcomer Services Branch of the Ministry of Citizenship and Culture provides programs aimed at settlement, orientation and language training for recent immigrants. The government of Ontario also provides educational assistance to needy students through its Ontario Student Assistance Program.

At the federal level, the Indian and Inuit Affairs Program of the Department of Indian and Northern Affairs aims, *inter alia*, at assisting native people achieve some measure of economic independence. The Department sponsors employment initiatives such as the Native Opportunities Training Program and the Local Employment Assistance Program.¹²² The Citizenship Sector, Citizen Development Unit of the De-

¹¹⁷ Tarnopolsky, *ibid.* at 146.

¹¹⁸ S. 15(2).

¹¹⁹ S. 1.

¹²⁰ These are: Ministry of Agriculture and Food; Ministry of the Attorney-General; Ministry of Consumer and Commercial Relations; Ministry of Energy; Ministry of Government Services; Ministry of Housing; Ministry of Industry, Trade and Technology; Ministry of Labour; Ministry of Natural Resources; Ministry of Tourism; Ministry of Transport and Communications; Ministry of Treasury and Economics. In addition, the Subsidies Branch of the Ministry of Municipal Affairs will provide subsidies to municipalities for the hiring of affirmative action co-ordinators.

¹²¹ The Work Incentive Program of the Ministry of Community and Social Services offers grants to employers to hire young employees at the minimum wage. The Personnel Branch of the Ministry of Natural Resources operates a Youth Employment Program; the Ministry of Skills Development has an Ontario Youth Commissioner, and also operates the Ontario Youth Employment Program which (in part) provides job and life skills training and a minimum wage job to youths aged sixteen to twenty-four.

¹²² The Summer Youth Employment Program, for youths aged 15 to 24, allocated \$4,500,000 to provide 4,000 jobs for Indian youths on 650 projects during the summer of 1979, but has since apparently been discontinued. See CANADIAN GOVERNMENT PROGRAMS AND SERVICES REPORTS (Don Mills, Ont.: CCH Canadian, 1982) at para. 19,660.

partment of the Secretary of State sponsors a wide range of policy initiatives aimed at the disadvantaged or minority groups. For example, The Native Citizen's Directorate, Women's Program Directorate, Status of Disabled Persons Secretariat, and Youth Secretariat all aim at promoting the status of their designated target groups. The Secretary of State also sponsors the Canada Student Loan Program which guarantees bank loans to needy students for the purpose of engaging in post-secondary education. The Department of Employment and Immigration also provides a range of non-targeted employment assistance programs. Through more than 400 Canada Employment Centres, the Canada Employment and Immigration Commission (CEIC) furnishes information to both employers and employees designed to match the unemployed to job opportunities. The CEIC also refers workers to training programs and provides financial assistance to workers to move in order to take up new employment. The Employment Equity Program of the CEIC provides targeted assistance to women, natives, disabled persons and visible minorities.¹²³ Other departments like the Treasury Board practice affirmative action in hiring.¹²⁴ In the interest of providing equal opportunity for women, the federal government also sponsors Status of Women Canada¹²⁵ and the Canadian Advisory Council on the Status of Women.¹²⁶

It is beyond the scope of this paper to review the extent and adequacy of these and other similar government programs in redressing the economic problems identified earlier. Suffice it to say that programs of this nature fit comfortably into the policy prescriptions yielded by the economic analysis and can be supported on other than purely redistributive grounds.

One area in which the trend of recent legislation is not entirely consistent with the recommendations in this article is that of pensions and insurance. Some of the provincial human rights codes expressly permit discrimination on the basis of indices such as age and sex in the provision of insurance services.¹²⁷ However, a number of provinces have

¹²³ See *ibid.* at para. 13,100. The Department of National Defence, in conjunction with the CEIC, provides a range of non-targeted assistance programs for young people. The Public Service Commission, which reports to Parliament through the Secretary of State, also sponsors a variety of assistance programs targeted at women, natives and the handicapped. *Ibid.* at para. 60,115.

¹²⁴ *Ibid.* at para. 36,075.

¹²⁵ *Ibid.* at para. 75,310.

¹²⁶ *Ibid.* at para. 70,005.

¹²⁷ See *Human Rights Code, 1981*, S.O. 1981, c. 53, s. 21; *The Human Rights Act*, S.M. 1974, c. 65, s. 7(2), C.C.S.M. H175, s. 7(2); *Charter of Human Rights and Freedoms*, R.S.Q. 1977, c. C-12, s. 90. Similar exemptions might arise under more general provisions of other statutes. See, e.g., *Human Rights Code*, R.S.N.B. 1973, c. H-11, s. 4(4). See also *Canadian Human Rights Act*, S.C. 1976-77, c. 33, ss. 14(e), 18. Despite s. 21 of the Ontario Code, a Board of Inquiry constituted under the Code held that the use of age, sex and marital status as rating variables by an automobile insurer violated the Code. See *Re Bates and Zurich Ins. Co. of Canada* (1985), 35 M.V.R. 165, 6 C.H.R.R. D/2948 (Ont. Bd. of Inquiry), *rev'd (sub nom. Zurich Ins.*

recently adopted or introduced legislation which aims at prohibiting differential treatment of men and women in calculating either pension contributions or benefits.¹²⁸ The latter legislation will almost certainly have the unfortunate consequences discussed earlier.

VII. SUMMARY

The meaning of "discrimination" is far from precise. Although in its most basic sense referring only to the perception of difference, the word has come to be associated with conclusory arguments which declare that some form of behaviour is or is not discriminatory, with the implication that the conduct ought or ought not to be tolerated. In this paper, I have suggested that, in settling upon a coherent public policy in respect of discriminatory conduct, a classification which focuses on purpose, motive and consequences yields useful insights. Such an analysis discloses that employers may discriminate for a variety of reasons. These reasons may include the use of statistical indicators in order to reduce hiring costs, and the existence of employer, employee or consumer tastes for discrimination. All of these types of employment discrimination may result in gains of an economic character. However, the thrust of the paper is that these types of discrimination are also likely to generate costs — in the form of depreciation of the human capital of groups discriminated against (due to adverse selection) and the existence of negative third party preferences. I have suggested that these costs are likely to overwhelm whatever benefits might result, at least where the discrimination is based on indices like race or sex over which the individual has no control. Where the discrimination is statistical discrimination based on factors over which the individual has some control, like education, then the benefits of the discrimination are very likely to exceed the costs. In the result, a strong case can be made out on economic grounds for anti-discrimination legislation aimed at preventing discrimination based on race, sex, ethnicity, national origin, and the like. A case grounded in considerations of economic efficiency can also be made out for affirmative action, favouring groups whose disadvantage results from past discrimination, in order to counter the effects of adverse selection bias. In this regard, private sector affirmative action programs which rely on man-

Co. v. Ontario Human Rights Comm'n (1987), 23 C.C.L.I. 130, 8 C.H.R.R. D/4069 (Ont. Div. Ct.) [hereinafter *Zurich*]. In *Re Royal Ins. Co. of Canada and Ontario Human Rights Comm'n* (1985), 51 O.R. (2d) 797, 21 D.L.R. (4th) 764 (Ont. Div. Ct.) [hereinafter *Royal*], *rev'g* (*sub nom. Hope v. Royal Ins. Co. of Canada*) (1984), 5 C.H.R.R. D/2248 (Ont. Bd. of Inquiry), the Divisional Court held that the use by an insurer of these rating variables did *not* constitute prohibited discrimination. The holding in *Royal* and *Zurich* is the only sensible interpretation of the Ontario Code.

¹²⁸ See Bill 170, *Pension Benefits Act, 1987*, S.O. 1987, c. 35, s. 53 (assented to 29 June 1987, but not yet proclaimed in force); Bill 55, *Pension Benefits Act*, S.N.B. 1987, c. P-5.1, ss. 46-47 (assented to 27 June 1987, but not yet proclaimed in force); *Pension Benefits Act*, S.N.S. 1987, c. 11, s. 59 (in force 1 January 1988).

datory prescriptions and penalties are less likely to be successful than programs which operate through employer incentives. Affirmative action on the supply side of the market, through education and job-training, is probably the most effective answer to undoing the effects of past discrimination. A partial survey of existing governmental policy initiatives discloses a great variety of both supply and demand side programs of both a targeted and non-targeted character whose existence can be justified on the basis of the analysis presented in the paper.

Discrimination in the context of pensions and the sale of insurance was contrasted to discrimination in the employment context, illustrating the relativity of the concept of discrimination. Here, discrimination based on commonly used indices like sex and age is likely to conduce to efficient private pension and insurance markets, while discrimination based on other indices such as race or ethnic origin is not. Thus, any move to ban use of the first type of statistical indices in private pension and insurance markets is likely to result in large economic costs.

