

Preference, Prejudice, and Difference— **RACIAL REASONING IN UNFREE MARKETS**

Walter E. Williams



THE MOST STRIKING FEATURE of U.S. racial relations today is how much we spend to regulate the expression of various kinds of racial reasoning in our behavior. The purpose of this spending is to promote racial justice. But in no small measure, the conspicuous social programs we have brought into being in the attempt to realize this purpose have themselves contributed to racial strife and mistrust, while doing little to ease the problems of racial inequality. Why?

There is general agreement that minorities, at least in the past, have suffered injustices at the hands of the majority. But agreement is not as readily reached on what the remedies should be. Much of the difficulty stems from the fact that racial problems are discussed mostly in moral terms and in value-laden language. Since there is no thoroughly accepted standard for testing moral statements, there is not always a rational way to settle these arguments. Another part of the difficulty stems from the imprecise and ambiguous use of language by scholars and laymen alike. In analytical usage, it is necessary not only to separate the connotative from the denotative (literal) content of words, but also to make precise and operationally useful distinctions. My modest aim here is to suggest more precise ways of analyzing racial problems and to show how these ways will help us to understand the problems better and hence promote more effective policy.

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Working Definitions

The three words I am seeking to demystify—to restore to their strict (denotative) meanings—are discrimination, preference, and prejudice. I will also consider briefly the matter of real differences.

Racial Discrimination. Discrimination—as distinct from those things that produce it (preferences, prejudice, and real differences)—may be defined as an act of choice based upon utility maximization, and racial discrimination as an act of choice wherein racial attributes provide the criteria for choice. In this view, racial discrimination does not differ in any fundamental sense from other kinds of discrimination. All selection necessarily and simultaneously requires nonselection—that is, choice requires discrimination. When we preface the word “discrimination” with the word “racial,” all we do is to state the attributes selected as the criteria of choice.

Our lives are largely spent discriminating for and against selected activities, objects, and people. For example, many of us discriminate against those who have criminal records, who bathe infrequently, and who use vulgar speech. Some employers discriminate against applicants who speak with a foreign accent, or have low intelligence, or cannot read, or went to the “wrong” college. There is also evidence of discrimination in politics—not many short men have been elected to the U.S. presidency. Furthermore, personal discrimination is not

consistent. Sometimes people discriminate against theatre in favor of parties, against women in favor of men; and at other times the *same* people do the reverse.

When a choice is made on the basis of race, that choice *may* reflect the preferences of the chooser for a particular race, but it also *may not*. It is impossible for an observer to say whether choices based on a particular physical feature reflect the indulgence of preference (tastes) *or* the attempt to minimize information costs (prejudice) *or* the recognition of real differences. Let me spend some time on the distinction among the three.

Racial Preference. In everyday language as well as in economic analysis, an individual is said to prefer A to B if he places a higher value on A than on B. In economic theory we postulate that each individual has a consistent set of preferences—that is, tastes—and chooses the combination he most prefers from the available alternatives. When we are speaking as economists, there are no objective criteria by which we can judge whether one set of preferences is “better” than another. We cannot prove, for example, whether it is better or more righteous for a person to prefer the wines of Bordeaux to those of Burgundy or to prefer blue cars to red cars. The most we can ever objectively say is that, *given his preference pattern and income and price constraints*, the chooser is—or is not—doing the best he can.

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This holds true as well when we come to individual preferences for physical attributes such as height, weight, “richly” endowed body, hair color, and so forth: these are solely matters of individual taste. And given that there are individual preferences for or against physical attributes in general, we expect people to exhibit preferences for or against racial attributes as well. Indeed, so far as our analysis is

concerned, there are no conceptual distinctions between racial and other preferences.

It may be rejoined that racial preferences are not comparable to other kinds of preferences in the consequences they have for society and for individuals. However, although the indulgence of racial preferences has specific effects that the indulgence of preferences for certain wines does not have, are the preferences basically different? If so, how do they differ? The preference for Bordeaux wines “harms” Burgundy producers by reducing the value of resources that are held for Burgundy production. If the consequences of preferences are generally to reduce the value of some resources and increase the value of others, then it can be said that preferences for physical attributes have effects similar to those of other preferences. The essential difference—by no means small—between preferences for racial features and those for wines is that the latter are not as specialized as the former. In other words, if Burgundy producers see that consumers prefer Bordeaux, they will try to shift their resources to Bordeaux production. On the other hand, for example, people who are black cannot become white.

But the fact that racial characteristics are unchangeable does not put them in a class by themselves. Persons with average IQs are preferred to those with below-average IQs, and persons who are not physically disabled are preferred to those who are. In each of these cases, the less-preferred characteristics are unchangeable and in each the less-preferred person suffers a competitive disadvantage. This disadvantage is to be expected. Disadvantage and advantage are inevitable consequences of differences in individual tastes, abilities, and traits, on the one hand, and of freedom of choice in a democratic society, on the other.

What I have said could be construed as trivialization of the problems of minorities and a defense of the status quo in racial matters—in which case it will necessarily offend the sensibilities of decent people. I do *not* consider the problems trivial, do *not* defend that status quo, and *do* personally find choices made solely on the basis of racial preferences obnoxious. However, in what follows, it will be shown that many racial outcomes are the results *not* of racial preferences per se but of political restraints on voluntary exchange. In a world

where racial preferences are not the sole cause of these outcomes, policies that assume they are will fail.

Racial Prejudice. The term prejudice has the Latin root meaning "to judge before," and a prejudiced act may thus be defined as a decision made on the basis of incomplete information. (Note that prejudice, like preference, is not the act but the cause of the act.) Making decisions without complete information is necessary in a world of scarcity and uncertainty, and in a complex world erroneous interpretation of the available evidence is by no means uncommon. Moreover, different individuals may arrive at different conclusions even if confronted with the *same* evidence, and the behavior of any given individual may sometimes not respond to changes in the evidence.

Consider a simple example of how decisions are made on the basis of incomplete (and perhaps misinterpreted) information. If a fully grown tiger suddenly appeared in the room, most of us would rush for the door, not because of what we knew about that *particular* tiger but because of our stock of information—and misinformation—about tigers as a class. The response is based on a stereotype—that is, the individual makes a prejudiced decision. He makes no attempt to seek additional information, but rather ascribes known or surmised group characteristics to the individual tiger. Examples of prejudiced behavior abound—not talking to strangers, running in response to rustling in the bushes, not buying bent cans of food, not recruiting employees from certain schools, and so on.

Decisions to prejudge are inextricably tied to individual judgments on what constitutes optimal information search. Information is not a free good; it is acquired by the expenditure of time, effort, money, and income foregone. As a result, wealth-maximizing individuals can be expected to economize on information costs. For any of us there will be a point at which the cost of acquiring one more unit of information is equal to the expected gain from that unit—which means that further information will not be acquired because the added cost would exceed the expected added gain.

A vast number of decisions must be made during our lives. Some of them, such as deciding to greet a passerby in the morning, require

relatively small amounts of information. Others, such as selecting a marriage partner, require relatively larger amounts. A person is not prejudiced or unprejudiced. Rather, a person *always* exhibits prejudiced behavior to the extent that he substitutes general information (prejudgment or stereotypes)—which is less costly—for more costly specific information. What distinguishes among people are their comparative degrees of prejudiced behavior when facing similar situations.

In the literature on racial behavior the word "prejudiced" is most often used pejoratively to refer to those whose optimum quantity of information is deemed by the observer to be too small. Behavior based on racial or sexual stereotypes is commonly viewed as making use of too little information and thus viewed as opprobrious—and in many cases, of course, it is illegal. However, the quantity of information effectively collected before decisions are made (which is the reciprocal of prejudice) is up to the individual's calculation—for there is no social standard or optimum amount of search that is applicable to all individuals in all cases. For example, for the prospective house buyer, there is no socially determined optimum number of houses to be looked at before making a decision. Instead, the amount of information collected by free individuals before acting is determined by and reflects, among other things, the efficiency of the individual in converting resources into information and the value of those resources as measured against the expected value of a "correct" decision.

Since all of us will seek to economize on information expense, we will substitute less costly forms of information collection for more costly forms. Physical attributes are easily observed and hence constitute a cheap form of information. If a particular physical attribute is highly correlated with some less easily observed attribute, then the physical attribute may be used as an estimator or proxy for the other. The cheaply observed fact that an individual is short, or an amputee, or a Negro, or a woman thus provides "sufficient" information for predicting the presence of some other unobserved attribute. Most of us, for example, if asked to identify individuals with advanced academic degrees *only* by observing race and sex, would assign a higher conditional probability that white males would have such de-

grees than black males or women. Such behavior is what decision theory expects where *unobservable* variables must be estimated from *observable* variables.

Real Differences. Discrimination need not, of course, be based on preferences as the word is generally understood (that is, tastes) or on prejudice (that is, judging before all the returns are in). It may be based on virtually complete knowledge of real differences and have nothing

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to do with aesthetic (or other) sensibilities. My reluctance to remain in the room with an uncaged tiger is, though reasonable, prejudice—since it is virtually certain that my sample of tigers previously experienced is statistically insignificant. My reluctance to ride in a bus may be a matter of preference—taste—if it is based on the fact that I find buses, though cheap, aesthetically unappealing. But there are other kinds of choice, and though one may object to their being included under the general rubric of discrimination, it will be seen later on that acts based on full knowledge and rational calculation have been considered “discriminatory” in the bad sense.

Prejudice in Action

Some may think my discussion of discrimination and prejudice renders the words meaningless, since it can be said that all human acts involve choice and all choices are based on incomplete information (as well as on tastes). But the discussion is useful because it permits us to avoid confusing one form of behavior with another. It enables us to see that certain kinds of choices—those made on the basis of racial, sexual, and other physical attributes—may be intelligent optimizing or may be the result of tastes. An example will clarify these points.

Suppose we are on a university campus where the racial and sexual composition of the

student body is the same as that of the U.S. population, and suppose we play a game of trying to identify students who can find the integral for the mathematical expression $\int x^2 dx$. Players are given zero information about the students’ mathematical proficiency and may not communicate with students except to ask, What is the integral? In other words, players can distinguish between students *only* by observable attributes such as race, sex, mannerisms, dress, and speech accent. The game is played for money, and it is assumed that the player’s objective is to maximize his winnings.

The player is in a situation where choices must be made on the basis of incomplete information. He is faced with identifying the observable attributes that will be the best indicators of student proficiency in calculus (the unknown and unobservable attribute). If he thinks that mathematical proficiency is equally distributed by physical attributes, his choice process will be essentially random. But if he thinks that mathematical proficiency is *not* so distributed, he must adopt a different (non-random) decision rule. In his first cut at such a rule, he may decide not to choose females because he knows that women are not well represented in the quantitative sciences. (Note that such a rule might not be as valuable in the Soviet Union, where a greater portion of women enter the quantitative sciences.) In successive cuts at a decision rule, the player may discriminate against—not choose—Negroes, Puerto Ricans, and American Indians, perhaps reflecting his awareness that math skills are related to the quality of pre-college schooling and that these particular minorities have historically received grossly inferior elementary and secondary education. In the end, the player may settle on a rule that confines his choices to males of Jewish or Oriental ancestry.

I am *not* saying that there is a genetic or causal relationship between race or sex and mathematical proficiency. What I am saying is that these variables are correlated in the real world (though I think it risky even to suggest possible explanations).

Suppose we relax the implicit assumption of neutral racial preferences and assume, instead, that the player has a distaste for Jews and Orientals but still believes these groups to be disproportionately represented in the quantitative sciences. So long as we retain the as-

sumption that the player seeks to maximize winnings—that is, economic payoff—his decision rule, his prejudice, will not be distinguishable from that of a player with no racial preferences.

This illustrates an important point that is lost in most discussions of racial issues: choices made on the basis of race (or sex) do not always permit us to put the preferences of the chooser in unambiguous categories. Moreover, the example raises a question whether anyone should care if the player in the game chose to indulge his preference and *not* select Jews or Orientals? In our scenario (assuming that Jews and Orientals are disproportionately represented in the class of individuals knowing calculus), the player who because of tastes discriminated against Jews and Orientals would win less than other players. Even the most fervent advocate of civil rights would have little reason to seek a social policy that required anti-Jewish or anti-Oriental players to give Jews and Orientals an equal opportunity to be selected. The racist (or, for that matter, any individual who permitted his choices to be determined by economically irrelevant “preferences” of whatever kind) would bear the full cost of such an action. He would lose money.

Racial Preference, Optimizing Prejudice, or Real Differences?

For some reason these points tend to get lost in discussions of racial discrimination. We overlook the fact that not every discriminatory action reflects preferences—a dislike of Negroes per se, for example: certain discrimination may come from the rational behavior of individuals minimizing search costs or confronting real differences in the market, whether that market is free or institutionally constrained. And we overlook the fact that, in a free market, economically irrational preferences will—as in our hypothetical game—impose costs on whoever indulges them. Institutional restraints may, of course, render that indulgence costless to the indulger. If they do, the answer is to lift the restraints and reimpose the costs—in other words, to free the market.

When we are formulating policy, we must be careful to distinguish among the three sources of “discrimination”—preference, prejudice, and real differences. If we assume that

racial tastes cause the problem we are addressing, when in fact the problem is caused by something else, our policy will be at least ineffectual and quite possibly harmful to its intended beneficiaries. Let us look here at three areas where whites are generally charged with discrimination against blacks, and where the assumption is generally made that the discrimination is based on racial preference—that is, tastes. These areas are hiring, home mortgages, and the prices ghetto shoppers pay.

Hiring and Employment Discrimination. Many recruitment and hiring practices are said to reflect racial preference, but an alternative explanation can be drawn from our knowledge of hiring procedures. When a firm seeks labor, it must find out how productive those seeking jobs are likely to be and must train the persons it hires. Since this process costs money, the firm has reason to search for recruits that appear to have a high probability of success. If the firm believes there is an important relationship between a recruit’s high school performance (and the quality of his high school), on the one hand, and employee productivity, on the other, it can reduce some of its recruitment costs just by knowing the job candidate’s record (and high school). If a firm knows that blacks at grade twelve are typically three to five years behind whites in scholastic achievement, it can assign a higher probability to a white recruit’s having the desired productivity.

In the mind of the employer, skin color may be a first approximate indicator of expected worker productivity. To observe a process that selects in part by skin color and to attribute the selection to taste (in this case, to employer “racism”) would be misleading. It would be like concluding that auto insurance companies charge drivers under twenty-five years of age higher premiums and that life insurance companies charge women lower premiums because these companies dislike young people and men. In both cases, a physical attribute may act as a general proxy for some other attribute (in the case of drivers, the higher probability of an accident) that is individually more costly to ascertain.

Suppose an employer who has racially neutral preferences *incorrectly* perceives that, on the average, a Negro worker is less productive
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than a white worker. What kinds of laws would cause him to seek more information and perhaps revise his perception? Clearly, laws that require him to pay all workers identical wages or that make it very costly to fire an employee have the opposite effect because they reduce his incentive to experiment. That is, employers will be less willing to hire someone of uncertain productivity if the wage must be the same as that paid a proven worker and if they are unable (or if it is costly) to fire that employee should hiring him have been a mistake.

In fact, some of the employment problems faced by blacks are quite certainly created by systematic institutional disincentives to hire them. One such disincentive is the minimum wage law, which now requires firms to pay an hourly wage of at least \$2.90 no matter whom they hire. Thus, if prospective employees are undifferentiated except by race, an employer who has a distaste for Negroes may indulge this distaste at zero cost to him. On the other hand, if there were no wage-fixing arrangements and if a Negro worker were willing to offer a compensating differential (work for a lower wage), employers would suffer a positive cost if they based their hiring decisions on racial tastes alone. That is, they would have to forego the profits that they could have enjoyed from hiring the lower-priced worker.

The minimum wage law will produce adverse consequences for Negroes even if the racial preferences of the employers are neutral. Many people have tried to explain the unprecedented high rate of black youth unemployment (40 percent) relative to that of white youth (16 percent) by claiming racial bias (what we are calling preference). But in 1948 black teenage unemployment (9.4 percent) was *lower* than white teenage unemployment (10.2 percent), and up until 1954 the labor force participation rate of black youth *exceeded* that of white youth. Certainly this dramatic reversal has not come about because the nation's employers have become more racist since the 1940s. Rather, it is the minimum wage that is the culprit. Firms will not choose to pay the minimum wage to workers whose hourly output is less than the minimum—which, given the law, means they will not hire them—and youths, especially minority youths, tend to have hourly outputs worth considerably less than \$2.90.

The basic characteristic that the mini-

mum wage law shares with many other laws is that it prevents people from offering compensating differentials to offset nonpecuniary differences—that is, from selling at a lower price or buying at a higher price. When there are laws that set prices and prevent voluntary exchange, less preferred people tend to be made worse off. Consider what would happen if less preferred painters were not permitted to compete in selling their paintings by charging lower prices, or less preferred doctors (interns) to compete with more preferred doctors by accepting lower wages. Institutional restraints of the sort represented by controls on prices predictably decrease price competition, which in turn means that personal (nonprice) attributes play an increased—indeed, dominant—role in choice.

Not hiring blacks may be described as “prejudice” if employers are simply economizing on information costs by accepting a stereotype whose roots are real but whose ultimate accuracy is a matter of conjecture. Or—especially in the case of black youth—it may be described as a simple recognition of real differences. But in either case, the failure to hire could be rectified (or at least substantially ameliorated) by abridging the requirements of laws regulating wages—a point that seems finally, hesitantly, tentatively, to have taken root in the minds of members of Congress, so far as those laws touch teenage workers.

Home Mortgage Discrimination. The situation is similar with redlining, a practice whereby banks and similar institutions refuse to grant mortgages for homes in certain neighborhoods. Because the practice most often applies to minority inner-city neighborhoods, the national debate about it has focused on its racial aspects, with banks being labeled as racist.

Forgotten in much of the debate is the existence of regulations that place ceilings on the interest rates banks can charge for home mortgages. Given these ceilings, banks have an incentive to ration credit—that is, to lend money to those whose perceived credit worthiness is appropriate to the permitted interest rate. It turns out that, for a number of reasons, the probability of default per dollar lent is greater in some neighborhoods than in others. Moreover, several laws designed to protect borrowers make the collection and eviction of debtors

who are in default more costly to bankers. These circumstances reduce the probability of earning normal profits in some neighborhoods.

Thus, redlining need not be a result of bankers' racism. In many cases (perhaps almost all), it occurs not because bankers are unwilling to make home loans to inner-city blacks but because the inner city is not a profitable market at the state-imposed interest rate ceiling. The real villain in the redlining issue is the legislature that imposes, say, a 10 percent interest rate ceiling. Such a ceiling in effect says that if an applicant is not a good enough risk for a mortgage at 10 percent, he will not get a mortgage at all—though without a ceiling he may get a mortgage at a 15 percent rate. Interestingly, *black-owned banks* that do not find the ghetto an attractive place to make loans are not called racist, and we should note that most black-owned banks invest more of their loan portfolio *outside* the community in which they are located than do white-owned banks.

Public policy directed at supposed banker racism will miss its mark and may, like affirmative action in lending, exacerbate the credit problems of blacks. Banks will simply move away. An effective policy would examine cost conditions in inner-city ghettos and remove or ameliorate state usury laws. Once again, what is prejudice or perhaps a recognition of real differences is misdiagnosed as "preference"—with predictably poor results.

Discrimination against Poor Shoppers. During the mid-1960s it was widely alleged that white merchants in ghetto areas exploited their customers by charging higher prices and selling lower-quality merchandise there than they did elsewhere. The merchants, it was said, were trying to earn supranormal profits as a way of acting out their racial hostility toward Negroes. But it turns out that what was involved was not preference or even prejudice.

Prices were indeed higher in ghetto areas, and several studies showed that retail food chains followed different pricing policies in ghetto and nonghetto areas. With these findings in hand, the Federal Trade Commission along with consumer advocate groups and public interest lawyers attempted, through public pressure, to require that ghetto merchants offer their customers the same terms of exchange that were offered in nonghetto areas.

But to view the merchants' behavior as exploitative or racist ignores the fact that ghettos tend to present a high cost business environment. Losses from business-related crime are higher there than elsewhere *as a percentage of total sales*; business, fire, and theft insurance premiums are also higher; and extension of credit is riskier. In addition, because of the low income of ghetto residents and its effect on sales mix and volume, merchandising techniques used to lower sales costs in nonghetto areas are not readily adaptable to ghetto areas. In other words, much of the behavior that the critics condemned is merely an economic response to an environment that raises the cost of doing business. If products and services are to be provided in the ghetto, prices must reflect these higher costs.

Evidence substantiates this explanation of merchant behavior. The Federal Trade Commission has shown that while gross margins were higher in ghetto areas, the difference was *more than* accounted for by higher operating costs, and the return on equity was considerably lower in the ghetto than elsewhere. The assertion that supranormal profits were earned becomes even less credible when we recognize that retailing is characterized by relative ease of entry, so that if supranormal profits existed, merchants would open new businesses until profits in ghetto and nonghetto areas were equalized. The opposite of this has occurred in urban areas: businesses have left without being replaced. Furthermore, none of those who attributed the prices charged by white merchants to racism noted that the prices charged by Negro merchants were about the same.

The crusade that blamed the problem of the ghetto consumer on the greed and "racism" of whites, may well have reduced the welfare of the ghetto consumer. The adverse publicity and boycotts (and other actions) against merchants in ghetto communities gave these merchants increased reason to move out. The result is fewer neighborhood stores, with shoppers being forced to travel longer distances or pay even higher local prices than in the past.

Clearly a policy designed to aid the ghetto consumer would emphasize ways to improve the business environment. It would, among other things, permit lower wages and provide interest subsidies, while recognizing that efforts to reduce the costs of doing business in

ghetto areas will fail in the absence of strict law enforcement to reduce crime.

Conclusion

The difficult problems faced by racial minorities are made even more difficult by their intertemporal aspect—the fact that the present-day disadvantages of blacks and other minorities are inextricably tied to the injustice of the past when they were denied even the most minimal constitutional guarantees. But to acknowledge that today's difficulties have a long history does not tell us what the proper and effective remedies would be. Upon what working principles should they be built? And what might these remedies do to the values of a democratic society? He who says that blacks should be given a competitive *advantage* in the market is, of necessity, also saying that others should be given a competitive disadvantage. This philosophy says in effect that D must compensate C because of what A did to B in some other generation—surely a strange system of justice and a dubious basis of social order.

This is precisely the case with the racial quotas imposed because firms and schools are believed to have been indulging racial preferences in hiring and in admissions. Aside from the equity issues that can be raised, quotas raise other issues as well. If, instead of racial bias, the behavior is rational discrimination in the face of imperfect and costly information, a quota policy completely misses the underlying cause of the behavior—namely, the poor education received by most blacks or the market credibility of their education certificates. But the harm caused by quotas is not limited to focusing attention on the wrong problem. Forcing firms and schools to have racial quotas that may be independent of worker or student qualifications aggravates racial hostilities, reinforces racial stereotypes, and (perhaps most destructive) creates debilitating and sometimes false expectations for young Negroes—expectations of ascribed (as contrasted to achieved) status that are, moreover, realistic only where and to the extent that “affirmative action” prevails. And, given the trend of recent court decisions, affirmative action may have heard its death knell.

Many Americans condemn racial quotas as a violation of democratic principles. But

the matter is not so easily dismissed, for the reason that the economic game is not being played fairly. A wide variety of national and state policies—laws setting minimum wages, the national labor law fostering union monopolies, occupational and business licensing laws, and regulatory laws like those administered by the Interstate Commerce Commission—discriminate against whole classes of individuals. Specifically, they discriminate against latecomers, against those without political clout, against those having little skills and capital—which means, almost by definition, disadvantaged minorities. Therefore (as just one example), given that we have laws in effect requiring membership in a union local as a criterion for employment and given that some union locals find ways to restrict minority membership, quotas may be a “second best” way of giving minorities job opportunities in the trade. The first best solution would be to eliminate the government-supported monopoly. Certainly those who find racial group membership an offensive criterion for employment should find union group membership equally offensive.

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that in the past. It is, rather, one of government restrictions on voluntary exchange. These restrictions arise because powerful political groups are able to use the coercive powers of government to subvert market competition, to eliminate the relative parity of the marketplace, and to make rules that redistribute wealth in their favor. To the extent that emotionally charged words such as exploitation and racism are to have an economic meaning, they should refer to the myriad of collusive agreements, backed by government, whereby disadvantaged minorities are subjected to a continuing disadvantage. ■