

Insurance and the Limits of Rational Discrimination

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In recent years, the insurance industry has come under attack for engaging in “discriminatory” practices against minorities. Critics assert that black applicants for insurance are often charged higher rates than white applicants, or are even denied certain kinds of insurance altogether.¹ In response, insurance companies offer the following defense: any difference in rates between racial groups simply reflects the underlying riskiness of the average white and black applicant in society. In other words, insurance companies suggest that they have a perfectly rational reason to discriminate against minorities. On average, minorities are more expensive to insure.²

The profit-making objective of this kind of “rational discrimination”³ distinguishes it from bigotry or “irrational discrimination.”⁴

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1. See Gastel, *Rate Regulation*, Insurance Information Institute, May, 1990, at 1 (NAACP filed suit against auto insurer for race discrimination); Hamilton, *Insurance Co. Accused of Bias Asks Court to Stop Md. Panel From Holding Hearing*, Wash. Post, Mar. 18, 1979, § B, at 1 (Maryland Human Relations Commission charges Equitable Life Assurance Society with race discrimination); Ellis, *Insurance Stereotyping Robs Women—and Men*, 367 CIV. LIBERTIES 7, 7 (1989) (insurers engage in racial rate-making).

In this paper, I will focus on discrimination against Blacks. The principles I develop, however, should be directly applicable, in varying degrees, to other groups which have been affected by economic discrimination.

2. Evidence of a correlation between race and risk exists in at least some areas of insurance. E.g. Bradford & Bates, *Loan Default among Black Entrepreneurs Forming New Central City Businesses*, 17 Q. REV. ECON. & BUS. 25, 26-27 (Autumn 1977) (small business ventures owned by Blacks more likely to fail than those owned by Whites); Ellis, *supra* note 1, at 7 (Blacks die earlier than Whites). For the purposes of this paper, I will accept this evidence as valid.

3. See, e.g., Strauss, *The Myth of Colorblindness*, 1986 SUP. CT. REV. 99, 108 (1986) (where race and risk correlate, discrimination may be “rational” or “efficient”); Stiglitz, *Approaches to the Economics of Discrimination*, 63 AM. ECON. REV. 287, 293 nn. 17 & 18 (1973) (describing rational race-based decision-making).

4. Irrational discrimination, or bigotry, is also known as “intentional” discrimination. Bigotry is irrational, from an economic point of view, because it involves decision-making according to a criterion—race—which is seen as irrelevant to the decision being made. See G. BECKER, *THE ECONOMICS OF DISCRIMINATION* 14 (2d ed. 1971); Arrow, *The Theory of Discrimination*, in *DISCRIMINATION IN LABOR MARKETS* 3 (O. Ashenfelter and A. Rees eds. 1973). But see Darity, *What’s Left of the Economic Theory of Discrimination?* in *THE QUESTION OF DISCRIMINATION: RACIAL INEQUALITY IN THE U.S. LABOR MARKET* 335 (S. Schulman & W. Darity, Jr., eds. 1984) (suggesting that bigotry might be quite rational, as it can serve to exclude “outsiders,” preserving scarce positions and benefits for one’s

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While bigotry is generally symptomatic of racial animus, rational discrimination is motivated only by financial concerns. Hence, it is difficult to incorporate any element of fault, or malevolent intent, into an analysis of rational discrimination. The only intent necessary to rationally discriminate is the intent to maximize profits.

Rational discrimination occurs in many areas, in addition to insurance, where race correlates with economic variables. Mortgage lending, where race and credit-worthiness are linked,⁵ and employment, where race and education or skill may be correlated,⁶ are two common examples. The insurance industry, however, is perhaps the best place to examine the paradigm. Insurers, after all, are in the business of making quantitative decisions based on proxies for risk. Also, in the insurance market, it is relatively easy to identify the distribution of benefits and burdens that would result from interference with rational discrimination.

In several insurance markets, insurance companies have been prohibited by law or custom from engaging in "overt" rational discrimination—that is, from explicitly classifying individuals on the basis of race.⁷ Insurance companies, however, often use non-racial predictors of risk that are closely correlated with race and, hence, have a disparate impact on minorities. While some jurisdictions prohibit racially correlated classifications such as geographical location ("redlining"), no state has instituted a comprehensive prohibition of "impact" rational discrimination.⁸ A few jurisdictions, in

own group). Additionally, as this paper will make clear, race may *become* relevant to certain economic decisions.

This paper will not focus on bigotry or "intentional discrimination" since this form of discrimination is clearly prohibited under a number of laws (*see, e.g.*, U.S. CONST. Amend. XIV, § 1; Civil Rights Act of 1964, Title VII, 42 U.S.C. § 2000e (1978)), and is relatively uncontroversial at this point in history.

5. *See, e.g.*, Nash, *Panel Is Told of Racial Bias in Lending*, N.Y. Times, May, 17, 1990, at A17 (lenders claim disparate terms reflect racial differences in risk).

6. *See, e.g.*, Willborn, *The Disparate Impact Model of Discrimination: Theory and Limits*, 34 AM. U.L. REV. 799, 810 (1985) (employer may make decision based on education, which differs between races due to past discrimination).

7. A number of states have laws prohibiting the overt use of race by insurers in rate making. *E.g.*, CAL. INS. CODE § 679.71 (West 1990); DEL. CODE ANN. tit. 18, § 2304-22 (1989); 40 PA. CONS. STAT. § 1183(e) (1987). Additionally, Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e (1978), prohibits rational discrimination in some forms of insurance offered by employers. *See City of Los Angeles Dep't of Water and Power v. Manhart*, 435 U.S. 702, 717 (1978) (rational discrimination prohibited in employer-offered benefits plan). Many insurers have stopped using overt racial classifications, even where the use of race is not prohibited by law, as a matter of custom or professional pressure. *See Ellis, supra* note 1, at 7 (National Association of Insurance Commissioners "vigorously condemned" the use of race-based rates at its 1988 Annual Meeting).

8. *Compare, e.g.*, MONT. CODE ANN. § 33-18-210-5 (1985) (prohibiting "redlining") with MONT. CODE ANN. § 33-18-210-5(a) (1985) (permitting use of otherwise prohibited

fact, actually appear to *require* "impact" rational discrimination under certain conditions.⁹

As the state of the insurance industry indicates, policy makers and academics have reached little consensus about how to address the implications of rational discrimination. This Current Topic argues that rational discrimination should not be viewed simply as a question of profitability or financial interests, but must also be approached from a moral perspective. Part One examines the underlying cause of rational discrimination in one particular insurance market,¹⁰ locating its ultimate source in the historical injustices perpetrated against Blacks. This section condemns rational discrimination for perpetuating and even exacerbating social inequalities. The analysis suggests that our society will not fully succeed in reducing economic asymmetries between Blacks and Whites unless it confronts rational, as well as irrational, discrimination.¹¹

Parts Two and Three examine two alternative methods of interfering with rational discrimination in insurance: prohibiting the practice altogether or compensating for its deleterious effects

classification for "a business purpose which is not a mere pretext for unfair discrimination").

9. *E.g.*, CAL. GOV'T CODE § 12993(b) (West 1990) (insurers should use "customary and reasonable or actuarially sound underwriting practices"). Note, however, that a California insurer could not overtly rationally discriminate—use race itself as a classification—even if it were a "sound underwriting practice," CAL. INS. CODE § 679.71 (West 1990).

10. The insurance market for entrepreneurs, such as construction contractors, is used as an illustration primarily because of the importance economists have placed on entrepreneurial markets in explaining the persistence of racial economic asymmetries. *E.g.*, Palmer, *Equality, Incentives, and Economic Policy*, 70 AM. ECON. REV. 123, 123 (1980) (concentration of Blacks in low-productivity jobs is major cause of racial income disparities). Additionally, this market has received a high degree of publicity in the wake of *City of Richmond v. J.A. Croson Co.*, 109 S. Ct. 706 (1989), a recent Supreme Court decision that deals with anti-discrimination principles.

11. Although there is some disagreement over the extent of racial wage and occupational asymmetries and whether these gaps are decreasing, it is virtually undisputed that these asymmetries exist. As to wage gaps, compare Freeman, *Black Economic Progress after 1964: Who has Gained and Why?*, in *STUDIES IN LABOR MARKETS* 247, 251 (S. Rosen ed. 1981) (usual weekly earning of non-White males up from 69% of White male earnings in 1967 to 78% in 1976) with Bates, *Black Economic Well-Being Since the 1950's*, 12 REV. BLACK POL. ECON. 5, 7 (Spring 1984) (non-White family income relative to White family income up only 1%, from 59% to 60%, between 1967 and 1976). As to occupational gaps, compare Freeman, *Black Economic Progress Since 1964*, in *CURRENT ISSUES AM. ECON.* 173, 175 (R. Puth ed. 1980) (likelihood of black college graduate obtaining managerial job compared with likelihood for white college graduate up 26%, from 41% in 1964 to 67% in 1975) with Palmer, *supra* note 10, at 124 (ratio of white collar to service workers 1.08:1 for Blacks compared with 4.2:1 for Whites in 1974). Wage and occupational gaps are clearly related: if Blacks cannot gain access to high paying jobs, it follows that their average income will be less than that of Whites, who hold such high paying jobs.

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through a subsidy. While either approach will reduce the correlation between race and risk, this analysis suggests that a subsidy offers significant moral and practical advantages over a prohibition.

I. Potential Bases for Interfering with Rational Discrimination

A precondition for rational discrimination in insurance is that race must be correlated with risk. Any such relationship, however, must be presumptively suspect, given our society's belief that the races are inherently equal.¹² To explain a correlation between being black and being "high risk" by suggesting that Blacks are inherently more prone to risky behavior would not only be racist but would also lack any evidentiary basis.¹³

The difference might be explained as a product of "free choice": that Blacks, for some reason, choose disproportionately riskier behavior than Whites.¹⁴ To argue that Blacks are inherently less rational than Whites in making risk decisions, however, is again both racist and unsupported.¹⁵ Similarly, to claim that Blacks place a different "value" on risky behavior also lacks any convincing proof.¹⁶

12. "[I]n the eye of the law, there is . . . no superior, dominant . . . class of citizens." *Plessy v. Ferguson*, 163 U.S. 537, 559 (1896) (Harlan, J., dissenting).

13. Cf. Kahneman and Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263 (1979) (cognitive theory of risky decision-making; no suggestion of racial disparity in decision making skills); Machina, *Choice Under Uncertainty: Problems Solved and Unsolved*, 1 *J. ECON. PERSP.* 121 (1987) (review of extensive literature updating Kahneman and Tversky theory; no suggestion of racial disparity in decision-making skills).

14. Choice-based models of racial inequality have been suggested by the U.S. Supreme Court. *City of Richmond v. J.A. Croson Co.*, 109 S. Ct. 706, 726 (1989) ("Black . . . career and entrepreneurial choices" may explain "dearth of minority participation" in construction contracting market). Such theories have been suggested by some economists as well. See, e.g., T. SOWELL, *ETHNIC AMERICA* 280 (1981) (suggesting that differences in career choices between ethnic groups might result from different attitudes towards learning and self-improvement).

15. See *supra* note 13.

16. Certain "choice" theories of racial differences imply that Blacks have more to gain than Whites in taking certain risks. Since the gain from taking a risk is properly measured in terms of utility rather than money, Blacks could conceivably make decisions which make them look systematically less well off in monetary terms although they are really equally well off in utility terms. For example, Sowell suggests that Blacks might choose less education than Whites (that is, they might choose to accept the risks of entering the job market with less education) as a result of ethnic or community norms. T. SOWELL, *RACE AND ECONOMICS* 163 (1975). The implication is that conforming to such norms yields utility. The problem with this theory is that we live in a society where utility seems closely tied to money. Unless Blacks get less utility from money (i.e., more utility from alternatives to money, such as leisure time), it is difficult to imagine how a norm which results in lower income could survive. There appears to be no evidence that Blacks have different income-utility preferences than Whites. Given this fact, and the history of race discrimination in this country, it seems fair to presume that most of the racial income (and risk) differentials which persist today cannot be adequately explained by choice theory.

One might argue, more reasonably, that Blacks' opportunities to choose less risky activities differ, on average, from those of Whites. Under this hypothesis, Blacks are compelled to undertake more risky activities not by choice, but by necessity. An illustration in an entrepreneurial market may clarify the relationship between risk and opportunity.

A. *Opportunities in Small Business*

One important area where race seems to correlate with risk is entrepreneurship. It appears that small business ventures owned by Blacks are less likely to succeed than those owned by Whites.¹⁷ This correlation should directly affect insurance rates for policies that cover the risk of business failure, such as bonding for construction contractors.¹⁸ Bonding is a form of insurance that protects the buyer of construction services against the risk that a contractor will default; contractors generally provide bonding as a matter of either law or convention.¹⁹ Thus, this form of insurance is considered to be a precondition for doing business.

Economic research suggests that two major factors that account for the correlation between race and entrepreneurial risk are experience and wealth/income.²⁰ These studies show that black potential entrepreneurs have less relevant business experience than white potential entrepreneurs, reducing their prospects for success. Further, having less wealth/income prior to starting the business venture, black entrepreneurs are less likely than white entrepreneurs to have a financial "safety net" that might enable them to "feed" a marginal business venture until it becomes profitable.

Wealth/income and experience, however, seem to serve less as explanations for Blacks' relative disadvantage than as symptoms of the problem. After all, part of the reason Blacks lack the resources and experience to enter a market is because they have been unable to succeed in the market in the first place. What is needed is a fuller

17. Bradford & Bates, *supra* note 2, at 26-27.

18. Indeed, Black contractors have reported that they often pay relatively high rates for bonding, making it difficult for them to compete. *See, e.g.*, *City of Richmond v. J.A. Croson Co.*, 109 S. Ct. 706, 724 (1989) (citing Brief for Appellant).

19. *See Note, The Nonperpetuation of Discrimination in Public Contracting: A Justification for State and Local Minority Business Set-Asides after Wygant*, 101 HARV. L. REV. 1797, 1807 n.62, 1808 n.65 (1988) (bonding required for virtually all government contracts; difficult to break into contracting market without winning government contracts).

20. *See, e.g.*, Bradford & Bates, *supra* note 2, at 29. In their research, Bradford and Bates treat wealth and income as two distinct indicators of risk. In my analysis, however, the impact of these two variables is similar, so I will consider them collectively as wealth/income.

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economic understanding of the risk of entrepreneurial failure, an understanding that incorporates both present and historical obstacles to minority opportunity. A "cost structure" analysis of risk provides one enlightening approach.²¹

B. Cost, Delay, and Disadvantage

Risk, for an entrepreneur, depends largely on her cost structure.²² The higher her cost structure is, relative to her competitors' cost structure, the greater will be her risk of failure in the market.²³ This effect will be reinforced by the fact that a significant cost faced by any producer is the cost of risk. This cost is manifested in the premium she will have to pay for insurance such as bonding. A high-cost/high-risk competitor must pay high insurance premiums, further adding to her cost.

Racial differences in risk might thus be explained by racially disparate cost structures. Indeed, intentional discrimination almost inevitably imposes a cost on its victims relative to those who are not so violated.²⁴ It is fairly uncontroversial, for this reason, that where victims of intentional discrimination can locate and identify a

21. Cost structure analyses are not new to the discrimination area. Some commentators have suggested that such analyses might be useful in examining the continuing effects of past intentional discrimination on economic opportunity. See, e.g., Cruz, *An Antitrust Approach to Equal Employment Opportunity*, 55 FLA. B.J. 261, 261 (1981) (pointing out similarities between occupational discrimination and monopolistic exclusion). Others have noted how specific barriers to entry contribute to racial occupational disparities. See Note, *supra* note 19, at 1807 (highlighting several economic barriers to entry in the construction industry to show why race-neutral policies might exacerbate the effects of discrimination); Norton & Norton, *A Setback for Minority Businesses*, LEGAL TIMES, May 1, 1989, at 31 (arguing that discriminatory practices have limited access to the prerequisites for significant business development). To my knowledge, however, no author has systematically applied such an analysis to explain the correlation between race and risk and the moral implications of such a relationship.

22. The term "cost structure" is used to describe the way an entrepreneur's costs vary over time. An entrepreneur's production costs can generally be imagined as a curve that starts high and decreases downward over time as she gains experience and becomes more efficient. In determining her prospects for success, looking only at present costs will not be fully informative; it is necessary to look at future costs as well. Thus, I will speak of cost structure, rather than static costs. Any isolated cost encountered by an entrepreneur will affect her cost structure.

23. Success in the market will depend almost exclusively on cost structure. A high cost producer generally will face one of two options: She can charge the same price as her competitors, accepting a smaller profit margin on each good sold, or she can raise her prices, keeping profit margins constant but selling fewer goods. Either way, she will earn less total revenue than her competitors, reducing her likelihood of success in the market.

24. A slave, for example, is stripped of any profit she might earn from her labor, while a freewoman retains the value of hers. A Black freewoman who is barred from the market or occupation of her choice loses any profits that she might gain in that market. A bar to the market might take the form of a "Jim Crow" law, or "custom" (enforced by

perpetrator, they can recover those costs.²⁵ Unfortunately, racial cost differentials may persist well beyond the time when acts of intentional discrimination have ceased—and beyond the time when the perpetrators are likely to be identified or held liable for those acts.²⁶

One might think that cost differentials between Blacks and Whites would slowly subside once intentional discrimination ends; that, at the very least, a successful black entrepreneur might earn enough profit to pay off the cost imposed on her by past injustice. These costs, however, are unlikely to disappear during the lifetime of the producer. Even if a black producer, B, tried to cover the additional cost out of her sales revenues, a competing white producer, W, could use comparable revenues to invest in her business to maintain her cost advantage. B's competitive disadvantage will persist, or even increase, depending on the relative success of W's investments.²⁷

Competitive advantage—and, hence, competitive disadvantage—can also be passed down through subsequent generations. First, a parent like W can leave a successful business to her heirs, giving them a strong advantage over their peers who lack this opportunity. Such heirs are spared virtually all start-up costs and often already possess a significant lead in experience, name recognition, and wealth/income. They have both lower cost structures and greater resources to cover those costs. Descendants of parents without such

the threat of racist violence). Alternatively, a bar might result from intentional discrimination in other areas; for example, a would-be producer may have been denied an education or other qualification necessary for market entry because of her race. Even if she can actually enter the market, furthermore, discriminatory sellers of supplies can increase her costs and discriminatory buyers can reduce her profits.

25. See, e.g., *Albermarle Paper Co. v. Moody*, 422 U.S. 405, 418 (1975) ("It is . . . the purpose of Title VII to make persons whole for injuries suffered on account of unlawful employment discrimination."); *Franks v. Bowman Transp. Co.*, 424 U.S. 747, 763 (1976) (*aff'g Albermarle*). See also Civil Rights Act of 1964, Title VII, § 706(g), 42 U.S.C. § 2000e-5(g) (1978) (granting courts broad equitable power to fashion compensating remedies for victims of unlawful discrimination).

26. Many of the parties responsible for the most egregious forms of discrimination (i.e., those forms that imposed the greatest and most persistent racial cost differentials) are most likely dead. See, e.g., DeCanio, *Accumulation and Discrimination in the Postbellum South*, in *MARKET INSTITUTIONS AND ECONOMIC PROGRESS IN THE NEW SOUTH 1865-1900* 103-04 (G. Walton & J. Shepherd eds. 1981) (slavery and emancipation without assets are major causes of present-day racial economic inequalities). Liability may also be precluded because many of the discriminatory acts that imposed large costs on black producers were legal at the time they were committed. Additionally, even after such discriminatory acts had been prohibited by law, responsibility may be dispersed among so many parties and markets, and over such a length of time, that the portion imposed by any one perpetrator has become too attenuated for an effective legal remedy.

27. No reason exists to expect that Whites will make less efficacious business investments than Blacks. See *supra* note 13 and accompanying text.

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advantages will suffer when competing against established family businesses. Second, even if descendants of advantaged parents do not benefit from inheriting a family business, they generally will be given or will inherit more assets than descendants of disadvantaged parents, making capital formation in any new business endeavor easier and less costly.²⁸ Thus, B's daughter is likely to inherit much of the disadvantage that B may have suffered during her lifetime as a result of intentional discrimination, while she is unlikely to inherit any antidiscrimination law claims that B might have had.

It is possible, of course, that the costs imposed by past intentional discrimination might eventually disappear. Bad investment decisions by white entrepreneurs and inheritance taxes may whittle away cost differentials.²⁹ Yet even if the cost structures faced by black and white producers or their heirs were eventually to reach the same level, the cost differential, while it existed, may have delayed Blacks' entry into the market. B (or B's heirs) may be in a position to enter the market with the same cost structure that W faced when she entered the market; but B will only be in this position after several years (and possibly generations) have elapsed. This delay, itself, represents a form of disadvantage.

Producers like W who have already entered the market may have been able to build brand loyalty, entrenching themselves in the market. To woo customers away from such incumbents, a new entrant like B will have to offer some incentive—generally, a lower price than that offered by incumbents.³⁰ Consequently, a new entrant with a comparable cost structure will face a disadvantage in attempting to

28. This argument finds support in DeCanio's research on the effects of initial asset distribution on relative group incomes. DeCanio, *supra* note 26, at 125 (even under optimal economic conditions and in the absence of postbellum discrimination, Blacks would nevertheless face a substantial income gap for an extremely long time as a result of being emancipated without any property—by being stripped of all wealth as slaves). This problem may be compounded by apparent difficulties in Black families of transmitting any gains which are made through subsequent generations. See Dachter, *Race/Sex Differences in the Effects of Background on Achievement*, in *NINE THOUSAND AMERICAN FAMILIES—PATTERNS OF ECONOMIC PROGRESS* 359, 359 (M. Hill, D. Hill and J. Morgan eds. 1981) (Black heredity—the ability to pass on family economic gains—appears to be less effective than White heredity).

29. It should be noted, however, that inheritance taxes are unlikely to be a particularly efficacious way to eliminate cost differentials. Even if we assume that present antidiscrimination laws succeed in preventing new acts of intentional discrimination, these laws have been in place for only a short period. Title VII, for instance, was not made effective until 1965. Not many inheritance tax cycles have passed since that time. Additionally, each tax cycle eliminates only a percentage (and often a relatively small percentage) of any existing cost difference. Thus, while the difference will become progressively smaller, it will never actually disappear.

30. Theoretically, the new entrant might lure customers from an entrenched incumbent by offering a higher quality product. This strategy, however, does not avoid price

penetrate an established market.³¹ Her cost structure must be superior.³²

In summary, a cost structure analysis suggests that markets tend to maintain disparities arising from past intentional discrimination in two principal ways. First, cost differentials are likely to be sustained between competitors, and even between their heirs. In addition, even if these cost differentials were to subside, the delay in entry that they cause can itself be viewed as a disadvantage. For both these reasons, insurers face a market skewed by past intentional discrimination and characterized by Black competitive disadvantage. To maximize profits, these insurers will rationally discriminate, charging higher rates for black entrepreneurs than for similar white entrepreneurs. In one sense, then, rational discrimination serves as a "reflection" of the disparities introduced into the market by past intentional discrimination.

In a deeper sense, however, rational discrimination also operates as a critical mechanism in a troubling cycle: it translates black disadvantage into high insurance rates which, in turn, further prevent or delay Blacks' entry into the market, sustaining their high risk status. Preventing insurers from rationally discriminating would interrupt this cycle. It would relieve Blacks of at least some of their disadvantage, allowing them to compete successfully in the market. In this sense, rational discrimination serves to perpetuate, or even exacerbate, racial economic disparities.³³

competition. Such an entrant essentially enters a sub-market (for high quality products), in which she must compete with prices set by other high quality producers.

31. See *supra* note 23 and accompanying text.

32. The disadvantage from delay in the scenario above will occur only if the market has become less competitive (i.e., more "monopolistic") as a result of entrenchment. When any producer enters the market, she will face a certain level of entrenchment. Even the first producer in a market must woo customers away from entrenched producers of substitute goods. The costs of overcoming such entrenchment and developing a market niche, therefore, can be viewed as part of any entrant's cost structure. Thus, if the level of entrenchment in a market remains stable and the effects of past discrimination have subsided, both W and B will face similar entry costs. If the level of entrenchment rises over time, however (as is likely), the cost of entry will rise as well. B will have to cover the added cost which has resulted from delay.

Even if the level of entrenchment in a market remains stable, however, delay may impose a burden on B which W was spared. During the time in which B could not enter the market because of her high cost structure, she was effectively forced to accept some less preferred (and presumably less lucrative) alternative employment. That is, she faced an "opportunity cost" as a result of not being able to enter the market for the delay period, irrespective of entrenchment.

33. To the extent that rational discrimination slows the reduction in racial cost differences, it causes unnecessary delay in market entry. If rational discrimination were prevented, these cost differences would subside more quickly and marginal Blacks would be able to enter sooner. See *infra* Section II. The injury caused by this delay would not

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C. *Moral Implications of Rational Discrimination*

Even to the extent that rational discrimination reflects an unjust distribution—and even to the extent that this practice can be seen as a factor in maintaining this distribution—it remains unclear that something should be done about it. As a society, we might refrain from remedying one injustice where the remedy is likely to result in new injustice. This danger seems particularly acute where the remedy is not based on fault.

In its starkest terms the moral issue raised by rational discrimination can be framed as follows: Assume that W has some good that is undeserved. As a result, B does not have this good, although she deserves it. W, however, did not personally take this good from B, nor did she commission its taking. Hence, the good has been unjustly distributed, but there is no identifiable wrongdoer. W might have a moral duty to give the good to B. Yet it is not clear why W should be forced to honor that moral duty; after all, W committed no wrong. Traditionally, redistribution—especially racial redistribution—has been justified only when fault can be assigned to a specific party.³⁴

In certain areas, however, society consciously redistributes benefits and burdens in the absence of fault. Perhaps the best example comes from another insurance controversy: no-fault motor vehicle liability. The no-fault paradigm rests on the belief that when the benefits of a good are widely enjoyed throughout society, but the costs of the good fall disproportionately on a particular subgroup within society, cost spreading—redistribution—might be justified.³⁵ For example, motor vehicles provide tremendous benefits to most members of society. The costs of driving, however, do not fall evenly among those who enjoy its benefits. Those unfortunate

occur but for rational discrimination. In this sense, rational discrimination causes disadvantage; it exacerbates the cycle of exclusion.

34. See Sullivan, *Sins of Discrimination: Last Term's Affirmative Action Cases*, 100 HARV. L. REV. 78, 80 (1986) ("sin-based paradigm" underlies affirmative action and racial redistribution jurisprudence). The prospect of redistribution without fault carries with it the danger of creating a moral hazard. See Stiglitz, *Risk, Incentives and Insurance: The Pure Theory of Moral Hazard*, 8 THE GENEVA PAPERS ON RISK AND INSURANCE 4 (1983) (moral hazard results from interference with competitive allocation of costs of risk; may eliminate incentives to avoid unnecessary risk). In addition, faultless racial redistribution might permit unrestrained favoritism by government. See, e.g., *City of Richmond v. J.A. Croson Co.*, 109 S. Ct. 706, 723 (racial redistribution without fault has "no logical stopping point") (citation omitted); *Croson*, 109 S. Ct. at 722 (O'Connor, J., for plurality) (indicating fear that affirmative action plan benefiting Blacks where Blacks comprise 50% of population and majority of City Council might represent political opportunism, rather than remedy for past discrimination).

35. See G. CALABRESI, *THE COSTS OF ACCIDENTS* 261-63, 308 (1970).

enough to get into an accident bear a disproportionate portion of the cost of driving. If we believe that getting into an accident is largely a matter of chance, we might want to spread some of this cost from the victims of accidents to those non-victims who enjoy the benefits of driving.

A fault-based system distributes the costs only to those who are, in some sense, responsible for accidents. In contrast, a no-fault system (used to supplement a fault system), would provide relief for those victims unlucky enough to be in an accident where fault could not be established or, possibly, where the person at fault could not pay. The cost of this relief would be borne by—or “spread” among—all of the beneficiaries of driving. The cost of faultless accidents, after all, is a cost of driving.

The economic benefits or goods of society are enjoyed even more widely than the benefits of driving. Discrimination, like accidents, can lead to a disproportionate distribution of the costs of these benefits. As with driving, if those who are at “fault” cannot be identified (as is likely),³⁶ the costs of discrimination will lie on its victims. Unlike the driving example, however, these victims are not chosen randomly. Racial discrimination has systematically victimized Blacks. Further, non-victim members of society—Whites—have systematically benefitted from this victimization even though they have committed no wrong and are thus not at “fault.”³⁷ Thus, the motor vehicle no-fault paradigm suggests that we may be willing to redistribute in the absence of fault when a good has been distributed unfairly. The no-fault paradigm seems particularly compelling in the context of discrimination.³⁸

In addition to spreading the costs of a “no-fault” risk, there are a number of other reasons we might want to remedy an unfair distribution of benefits. Such a desire might be based on expectations of

36. See *supra* note 26 and accompanying text.

37. See *supra* note 24 (pervasive disadvantage from discrimination—implies pervasive advantage to non-victims). See also Riedsel, *Racial Discrimination and White Economic Benefits*, 60 Soc. Sci. Q. 120, 126-28 (1979) (empirical data shows that discrimination against non-Whites raises White incomes.)

38. No-fault redistribution is more compelling in the context of discrimination than in the context of motor vehicle accidents for two reasons. First, the costs of discrimination are more likely to be beyond the reach of fault systems than the costs of motor vehicle accidents. See *supra* note 26. Thus, there is likely to be more need for a no-fault remedy in the discrimination context. Additionally, in contrast to the motor vehicle context, it is difficult to imagine that a victim of a discriminatory “accident” could be considered to be a contributing cause of the accident. See *supra* note 16 and accompanying text. Hence, a no-fault approach to discrimination is less likely to cause moral hazard than a similar approach in the motor vehicle context. See *supra* note 34.

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society-wide economic gain through increased efficiency.³⁹ Alternatively, such a desire might be based on a broadly held sense of responsibility—the notion that something should be done about this wrongful distribution and that failure to do so will implicate the morality of our society.⁴⁰ To the extent that rational discrimination exacerbates (rather than merely reflects or perpetuates) the correlation between race and risk and affects the resulting distribution of benefits, this sense of responsibility is heightened.⁴¹ Further, distributive effects aside, we might want to restrain rational discrimination because of its “dignitary” costs—both economic and psychological.⁴²

Whatever the reason, there is some indication that our society (or at least certain jurisdictions within our society), wishes to address the no-fault aspects of race discrimination—that portion of the unjust distribution of society’s benefits for which no at-fault party can be identified. This is particularly evident in both the construction and insurance industries.⁴³ Given this desire to address this distribution, it is necessary to examine ways to accomplish this goal. I

39. To the extent that cost barriers to entry permit inefficient incumbents to entrench themselves, any redistribution which encourages new entry into the market should increase competition and, hence, efficiency. Any producer who was previously able to “coast,” her market share protected by the barriers created by difficult entry into the market, will have to maximize efficiency or risk losing market share to upstarts. This proposition finds empirical support in Leonard, *Anti-discrimination or Reverse Discrimination: The Impact of Changing Demographics, Title VII, and Affirmative Action on Productivity*, 19 J. HUM. RESOURCES 145, 171 (1984) (new minority entry caused by race-conscious affirmative action programs failed to cause expected efficiency losses in markets).

40. See, e.g., Tribe, *Technology Assessment and the Fourth Discontinuity: The Limits of Instrumental Rationality*, 46 S. CALIF. L. REV. 617, 618 (1973) (constitutive conception of social choice: decision defines decision-maker).

41. See *supra* Section I, B (rational discrimination may perpetuate, or perhaps even exacerbate, racial disadvantage).

42. Rational discrimination tells the black victim of such discrimination: “You are not likely to succeed because you are Black.” The more a black potential entrepreneur is told this, the more likely she is to believe that it is true for her personally and the less likely she is even to try to succeed. It is fairly well documented that repeated exposure to the mere vocalization of such a sentiment can lead to mindless acceptance of its truthfulness as applied to the listener. See E. LANGER, *MINDFULNESS* 25, 52-53, 82-84 (1989) (detailing psychological tendency to translate statistical statements into categorical mindsets—i.e., statement regarding *likelihood* that listener is afflicted interpreted as “fact” that listener is afflicted—and costs of such mindlessness, including inefficiency and poor health). The Supreme Court, as well, recognizes “the danger of stigmatic harm.” *City of Richmond v. J.A. Croson Co.*, 109 S. Ct. 706, 721 (1989).

43. Many of the voluntary affirmative action programs that have been adopted by legislatures deal with the construction industry. E.g., *City of Richmond v. J.A. Croson Co.*, 109 S. Ct. 706 (1989) (minority set-aside plan for municipal construction contracts); *Fullilove v. Klutznick*, 448 U.S. 448 (1980) (minority set-aside plan for Federal contracts). Legal prohibitions on rational discrimination by insurers may be seen as indicative of a desire to redistribute risk and its costs in those markets in the absence of demonstrated fault.

will compare the distributive effects, practicality, and legality of two possible approaches: a prohibition on rational discrimination and a risk differential subsidy.

II. *Evaluating a Prohibition on Rational Discrimination*

A prohibition may be useful in combatting racial risk differentials and the undesirable effects of rational discrimination. If insurers are not allowed to distinguish between a Black risk pool and a White risk pool, the pools will merge. To the extent that Blacks are "higher risk" than Whites, this merger will result in decreased rates for Blacks relative to Whites. The relative cost of doing business will fall for Blacks, increasing prospects for success, and thus eventually reducing risk.

A prohibition's effect on cost structure and risk, as well as its distributive effects, can be illustrated with a graphic model. Imagine a pool of potential producers who, given the opportunity, would enter an entrepreneurial market. The pool can be ranked, according to the level of cost at which each would-be entrepreneur could produce; the lowest cost producer should have the greatest likelihood of entering the market successfully.⁴⁴ The number of producers who can actually enter the market will depend on the size of the market and the productive capacity of the individual firms. This model can be depicted as follows:

Figure 1:

ENTRY											
Unsuccessful							Successful				
#	#	#	#	#	#		#	#	#	#	#
12	11	10	9	8	7		6	5	4	3	2

The pool of twelve potential entrants is ranked from lowest cost (#1), to highest cost (#12). In this model, the market has room for the top six producers (#1-6).

The potential entrepreneurs can be broken down into two groups, Whites (+) and Blacks (*). In the absence of discrimination, the cost structures of Blacks and Whites should be roughly the same. Hence, the market should look like this:

44. See *supra* note 23 and accompanying text.

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Figure 2:

	ENTRY						
White	+	+	+		+	+	+
	6	5	4		3	2	1
Black	*	*	*		*	*	*
	6	5	4		3	2	1

After a prolonged period of discriminatory acts against Blacks, however, the groups will no longer be similarly situated relative to the entry line. Blacks, as a group will have been pushed backward (as a result of increased cost structures), and Whites pushed forward, so that the pools might look like this:

Figure 3:

	ENTRY										
White					+		+	+	+	+	+
					6		5	4	3	2	1
Black	*	*	*	*	*		*				
	6	5	4	3	2		1				

An insurer does not look at individuals; she looks at groups. Thus an insurer looking at the market in Figure 3 will see Blacks, as a group, as relatively high risk for any policy that reflects the risk of business failure. Accordingly, if she rationally discriminates, she will charge higher rates for Blacks than Whites. However, if rational discrimination (including "impact" rational discrimination) is completely and successfully prohibited, she will be forced to see the market as it was in Figure 2 (above). While the insurer might still subdivide the groups by other proxies for risk, she will have to charge the same rates for Blacks and Whites as groups, despite the different underlying risks. Blacks' rates and, hence their production costs, will fall, while Whites' costs will increase. Blacks will thus be given an advantage in the market relative to Whites. The groups will therefore shift such that the market might look like this:

Figure 4:

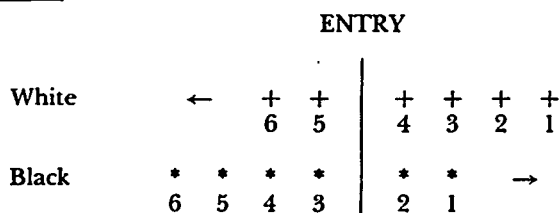


Figure 4 illustrates how a prohibition on rational discrimination would push the market closer to what it would look like in a just world. The question remains, however, who will bear the costs of such a policy.

A. Costs on "Innocent" Insureds

As the previous analysis suggests, a prohibition on rational discrimination increases white producers' insurance rates by merging the black and white applicant pools. In this sense, a prohibition effectively exacts a "tax" from all white insureds and provides a quasi-"subsidy" for all black insureds. The "tax" on white insureds, however, will fall most heavily on the marginal white entrants. As Figure 4, above, illustrates, the marginal white entrant, W5, loses her place in the market as a result of the prohibition. As a marginal producer, she was "just making ends meet" before the prohibition. The "tax" she must pay as a result of the prohibition raises her costs, forcing her out of the market. She is effectively replaced by the marginal black entrant, B2. Lower cost white producers, by contrast, should survive the cost increase.

The model, however, suggests that "innocent"⁴⁵ white producers, like W5, may reasonably be asked to bear this burden. Arguably, these marginal white entrants would not have been able to enter the market in the absence of discriminatory exclusion since they would have had to compete against more formidable black aspirants, like B2, for the marginal place in the market. Similarly, the greatest benefits of a racial rate prohibition would go to the most qualified black producers who, but for discriminatory exclusion, would have captured the market share currently held by marginal Whites.⁴⁶

45. In the following sections, I refer to certain insurers and insureds as "innocent" in the sense that they did not contribute to the correlation between race and risk through intentional discrimination. Hence, these actors can not be said to be at "fault".

46. The foregoing analysis, it may be noted, assumes that discrimination has affected all members of each group equally; that all Whites have benefitted equally from discrimination and that all Blacks have been equally hurt by it. In fact, discrimination may have

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The burden imposed on W5, however, may not be entirely justified. While W5 might not have “deserved” her place in the market in a perfectly just world, she clearly expected to be able to keep that place once she attained it. Based on this expectation, she spent time working in a given market that could have been spent developing a niche in another market. Further, she invested in her business and possibly encouraged others to invest as well. These investments might include such items as education, tools, and real estate. To the extent that these investments are specific to this particular market, she will lose their value when she is forced out. The losses resulting from a change in “the rules” of the market may be analogized to “reliance” or “expectation” costs from a breach of contract.⁴⁷

B. Costs on Insurers

A second group is likely to be burdened by a prohibition of rational discrimination: “innocent” insurers. As noted above, a prohibition of rational discrimination raises the price of insurance for white producers and lowers the price for black producers. As a result, marginal Whites will exit the insurance market, and Blacks will enter. Because these Blacks will be higher risk individuals than the Whites they replace, the amount and cost of risk in the market will increase. As insurance companies raise the average price of insurance to compensate for the increased cost, total demand for insurance will fall. Through this process—called “adverse selection”⁴⁸—insurers will lose business.

affected ranking within the groups as well as between them, implicating the fairness of helping the marginal black competitor, B2, at the expense of the marginal white one, W5. No evidence, however, appears to suggest that current intragroup rankings are the result of differential impact from past discrimination. Absent such evidence, I will assume that there has been no such differential intragroup impact.

47. To continue this analogy, we might imagine that W5 entered into an implicit contract with the government in which the government agreed to refrain from interfering with the market. In reliance on this contract, suppose that W5 invested \$1000 in education. If the government breaches, prohibiting rational discrimination, W5 loses the place which she occupied in this market. If she loses the full value of the investment as a result of a breach, W5 might claim “reliance” damages of \$1000, the amount of the investment lost as a result of the breach. (If her investment has a “scrap value,” however, as is likely, her reliance costs will fall by that amount.) In addition, she might claim as “expectation” damages the amount of return she expected to earn from the investment in addition to the recoupment of her original \$1000, say \$500, for a total of \$1500. This amount would represent her loss from the prohibition of rational discrimination; it is the cost which a change in “the rules” places on a marginal producer.

48. “Adverse selection” will occur whenever insurers fail to distinguish high risk groups from low risk ones. The extent of adverse selection will depend on the certainty with which insureds can know that they are either high risk or low risk and the strength of their need for insurance (their demand elasticities). See Rothschild and Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfection*, 90 Q.J.

The shrinkage in the insurance market might be offset, to some extent, by two long-run effects of the prohibition. First, with time, new black producers will gain experience and wealth in the underlying market, reducing their risk and offsetting some of the effects of adverse selection. In addition, the influx of new producers caused by the prohibition is likely to raise the level of competition in the underlying market.⁴⁹ Increased competition may increase efficiency in that market, reducing production costs, and hence price. At a lower price, more production will be demanded, increasing demand for insurance coverage.

In the short run, nevertheless, insurers will face the cost of a smaller "pie." The costs of this temporary reduction in the market will fall most heavily on marginal insurers who were just making ends meet prior to the imposition of the prohibition. Such marginal insurers will face expectation and reliance costs similar to those faced by the marginal producer, *W5*.⁵⁰ Moreover, unlike the marginal producer, the "innocent" marginal insurer cannot be seen as a beneficiary of the unjust distribution of risk that has resulted from past intentional discrimination. The insurer's claim of "innocence" thus seems stronger.

C. *Practical Considerations*

A prohibition that focuses solely on "overt" rational discrimination—decision making that explicitly uses race as a proxy—would be simple to implement and enforce. A number of jurisdictions, as noted earlier, have indeed instituted such a policy in the insurance industry.⁵¹ Yet, so long as insurers are free to classify risks according to racially correlated proxies such as experience or wealth/income, Blacks will continue to pay more for insurance and thus will continue to be handicapped in lucrative markets. While a prohibition limited to "overt" rational discrimination might stop the insult of being categorized as high risk simply on the basis of race, it would not eliminate the injury caused by perpetuating a cycle of racial exclusion.

ECON. 629 (1976); Wilson, *A Model of Insurance Markets with Incomplete Information*, 16 J. ECON. THEORY 167 (Dec. 1977). The fact that insurance is compulsory in a market will not prevent adverse selection. While a marginal White insured will be required to buy insurance if she remains in production, the premium imposed upon her may force her out of business altogether (*supra* Section II, A). This is a form of adverse selection.

49. See *supra* note 39 and accompanying text.

50. See *supra* note 47 and accompanying text.

51. See *supra* note 7 and accompanying text.

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If, on the other hand, the prohibition were to be extended to all measures of risk that correlate with race,⁵² insureds ultimately would be left without *any* criteria with which to measure the risk of business failure. Indeed, so long as risk and race are correlated, every characteristic that can successfully identify high risk insureds will also identify Blacks to some degree; its use will create a disparate impact. Thus, a comprehensive prohibition of all racially correlated proxies might cause serious damage to the insurance market.⁵³ This would hurt insurers, all those who would choose to buy insurance, and actors in markets that depend on insurance for their viability.

Under these circumstances, the best solution is likely to be a compromise. Rather than a complete ban on rational discrimination, insurers might be prohibited only from using those factors that are most highly correlated with race. Under this "limited" prohibition, insurers would be forced to use less efficient, but not completely inefficient, predictors of risk. Black insureds would, on average, face reduced premiums, though Blacks' rates would remain higher, on average, than those of Whites. Thus while benefits to Blacks would be smaller under the limited prohibition, the burden borne by Whites would be accordingly less severe.

D. Legal Considerations

A prohibition on rational discrimination does not appear vulnerable to legal attack. While several jurisdictions have instituted limited bans on rational discrimination by insurers,⁵⁴ none of these regulations has been challenged in any federal court.

Other laws that interfere with businesses' ability to rationally discriminate are regularly upheld. For example, Title VII often prevents employers from making cost-based decisions that result in a

52. In other words, the prohibition would include both "impact" and "overt" rational discrimination.

53. At the very least, such a prohibition would interfere with the role of insurers as we know it. Insurers might continue to operate either as "savings banks" (where insureds estimate how much they will need to cover risks and place this money with insurance companies) or "lotteries" (where insureds all pay the same "premium," gambling that they may be awarded the payoff). Such markets would not serve the efficiency function of insurance as we know it: reducing the total effective risk through classification and the law of large numbers. See Marshall, *Insurance Theory: Reserves versus Mutuality*, 12 *ECON. INQUIRY* 476 (1974).

54. See *supra* notes 7-8 and accompanying text.

racially disparate impact—that is, from engaging in “impact” rational discrimination.⁵⁵ These decisions, furthermore, all appear to be based on statutory interpretation. Thus, even though the courts have interpreted some statutes to permit certain kinds of rational discrimination,⁵⁶ this does not imply that other statutes could not be drafted to prohibit the practice entirely. There has been no suggestion of any sort that a “right” to rational discrimination exists.

III. *Subsidizing Risk Differentials*

Irrespective of the probable legality of a prohibition on rational discrimination, we have seen that such a scheme presents certain practical and moral problems. Specifically, a workable, or “limited,” prohibition will fail to address fully the unjust distribution of risk that has resulted from “faultless” discrimination. Indeed, even a limited prohibition will burden “innocent” white insureds and insurers, particularly those at the margin. It might be possible to avoid some of the problems of a prohibition, while achieving the same benefits, by using a risk differential subsidy.

Under a subsidy plan, insurers would be permitted to rationally discriminate.⁵⁷ While insurance rates for black producers would remain higher than those paid by Whites, the government would provide a subsidy to black producers, paying some portion of their insurance premiums. This would effectively reduce the cost structure faced by black producers, increase their prospects for success, and eventually reduce their risk.⁵⁸

55. *E.g.*, *City of Los Angeles Dep't of Water and Power v. Manhart*, 435 U.S. 702, 717 (1978) (Title VII prohibits rational discrimination in operation of employee benefit plan).

56. *E.g.*, *Wards Cove Packing Co. v. Atonio*, 109 S. Ct. 2115, 2126-27 (1989) (Title VII permits hiring practice which yields disparate impact if justified by business purpose; cost of alternative selection devices relevant to business purpose justification). *See also* Brodin, *Costs, Profits, and Equal Employment Opportunity*, 62 NOTRE DAME L. REV. 318, 320 (1987) (courts have frequently accepted a cost defense in Title VII disparate impact cases).

57. Overt rational discrimination still might be prohibited under such a subsidy, since its “dignitary” or “insult” costs would be difficult to compensate. *See supra* note 42.

58. *See supra* note 23 and accompanying text. It might be asked, at this point, why limit the remedy for wrongful distribution to a subsidy of risk differentials? The differential cost of risk is only one of many barriers to Black entry in most entrepreneurial industries. As long as Blacks, on average, are less qualified than Whites in any way, it may make sense for buyers of entrepreneurial services to engage in rational discrimination (impact, if not overt, treatment). To effectively knock down all barriers to entry which are reflective of past discrimination it may be necessary to use a broader subsidy, such as a “set-aside” program. A set-aside effectively says to Blacks (in the context of government contracting): Whatever it costs you to successfully enter the market—to get qualified—will be subsidized. If you must pay more for insurance (or capital, or incremental

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As the following sections suggest, a subsidy plan does not completely eliminate the burden on “innocents.” In contrast to a prohibition, however, a subsidy distributes the bulk of these costs onto taxpayers as a whole rather than onto a narrow group of insurers and insureds. This is consistent with the no-fault approach elaborated in Section I-C, which attempts to spread burdens among as large a group of beneficiaries as possible.

A. Costs on “Innocent” Insureds

Like a prohibition, a subsidy will impose a burden upon white producers. Indeed, aid given to some producers in a competitive market will inevitably disadvantage unaided producers. Blacks, with lower, subsidized, costs will enter the market, forcing out marginal Whites.⁵⁹ Like those forced out of the market by the prohibition, these marginal Whites will suffer reliance and expectation costs.⁶⁰

On the other hand, fewer white producers will be adversely affected by a subsidy plan. This is because, unlike a prohibition, the market for producers’ goods will expand under a government subsidy.⁶¹ Thus, instead of replacing white producers in the market, many of the new black entrants will simply fill newly made positions. As a result, the costs imposed upon innocent insureds by a subsidy may be less significant than those caused by a prohibition.

B. Costs on Insurers

Unlike a prohibition, a subsidy plan is unlikely to impose a burden upon innocent insurers. In fact, the subsidy should actually *benefit* insurers by increasing the size of the insurance market. In contrast to a prohibition, the subsidy offsets the higher risk of entering Blacks. Thus, market shrinkage through “adverse selection” will be avoided.⁶² In addition, the subsidy reduces the risk costs of those

increases in education), simply bid more for the project and, if your bid is competitive among black bidders, it will be accepted. Such an approach has the advantage of coordinating the many markets which affect the contracting industry. Such a plan, however, was recently struck down in *City of Richmond v. J.A. Croson Co.*, 109 S. Ct. 706, 727 (1989). Thus, while some form of set-aside might still survive Supreme Court scrutiny, a less sweeping remedy might be more favorably received. *Id.* at 727-28 (evidence presented by defendant city will not support use of set-aside; court suggests need for more “tailored” approach). For a discussion of the legality of a risk-differential subsidy, see *infra* Section III, D.

59. This is essentially the same effect as that caused by the prohibition, graphically depicted in Figure 4. See *supra* Section III.

60. See *supra* note 47 and preceding text.

61. Market growth typically occurs as a result of an “externalizing” subsidy. See *infra* Section III, B.

62. See *supra* note 48 and accompanying text.

Blacks who were already in the market. Thus, the subsidy effectively shifts some of the cost of risk from actors in the market (black insureds) to actors outside of the market (taxpayers), reducing the total cost of risk in the market. It "externalizes" some of the market's risk. This will reduce the cost of insurance and, hence, its price. At a reduced price, demand for insurance will increase. Insurers will gain business.⁶³

C. *Practical Considerations*

A subsidy also has practical advantages over a prohibition. A prohibition requires a compromise. Any attempt to extend a ban to all racially correlated factors will impair insurers' ability to perform their job of classifying risk. A subsidy, in comparison, can be easily implemented and can remedy all forms of rational discrimination. It simply requires insurers to measure the amount by which Blacks' risk exceeds that of Whites.

This difference can be obtained from the actuarial tables of any insurer who uses "overt" rational discrimination. It is the amount that the category "Black" adds to such a producer's insurance premium. Even if no insurer overtly rationally discriminates, accurate estimates of risk differentials could be measured indirectly from other proxies that correlate closely with race. Standard actuarial techniques can translate these risk differentials into the monetary cost of rectifying racial disparities in insurance.⁶⁴

D. *Legal Considerations*

Government subsidies to help minority businesses and individuals are fairly common.⁶⁵ These subsidies, like the risk differential subsidy, give Blacks an advantage, or "plus," over Whites in competing

63. The gain to insurers may be considered an undeserved windfall. As such, we might want to tax it. Such a tax, however, would offset some of the gains from the subsidy; it would reduce market growth by increasing the cost of bonding insurance. Fewer Blacks could then enter the market and a greater number of Whites would be forced to exit.

64. By quantifying these risk differentials, a subsidy provides a concrete measurement of the cost of redistribution. This contrasts with a prohibition, where these costs are somewhat hidden and obscured. Whether the forthright quality of the subsidy would prove a liability or an asset is certainly debatable. See G. CALABRESI, *A COMMON LAW FOR THE AGE OF STATUTES* 178 (1982) for a general discussion of the value of candor in the law.

65. See, e.g., Berry, *With Some Federal Aid, Minority Banks Flourish*, Wash. Post, July 19, 1982, Wash. Bus. Sec., at 1 (Treasury channels money to minority-owned banks); Seligman, *A Wider War on Poverty*, FORTUNE, Dec. 28, 1981, at 37 (U.S. Small Business Administration funnels federal subsidies, interest-free loans to minority-owned firms);

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for scarce positions.⁶⁶ Racial “plus” plans have regularly been upheld by the courts. In *Johnson v. Transportation Agency*, for example, the Supreme Court approved a plan by a government employer that awarded minority applicants a “plus” in promotion decisions.⁶⁷

Two factors suggest that the Court might view a risk differential subsidy even more favorably than the “plus” plan upheld in *Johnson*. First, the risk differential subsidy has less impact on marginal Whites than *Johnson*’s “plus” plan. As suggested in previous sections, the risk differential subsidy is likely to expand the market, reducing the number of Whites forced out by the plan.⁶⁸ The *Johnson* plan, by contrast, is not likely to expand the market. Hence, the impact of the *Johnson* plan on Whites is unlikely to be mitigated. The Court has expressed a clear preference for plans that minimize the burden placed on innocent marginal Whites.⁶⁹

Also, in contrast to the plaintiff in *Johnson*, an unsuccessful White who seeks to challenge the risk differential subsidy would have a difficult time establishing that her lack of success—her injury—was caused by the subsidy. In *Johnson* the applicants were competing for a specific position in which an objective measure (a scored interview) was available to determine the relative qualifications of the applicants. Thus the trial court could conclude that the non-minority status of the unsuccessful applicant was the “*determining factor*” in her failure.⁷⁰ An unsubsidized white entrepreneur forced out of the market, however, can draw only a tenuous link between her failure and the subsidy plan. It would be virtually impossible for her to establish with any degree of certainty that the subsidy was a “but

Demkovich, *Let it Simmer*, NAT’L J., June 20, 1981, at 1128 (Comprehensive Employment and Training Act provides wage subsidy for minority youth).

66. The term “plus” is used to distinguish a plan that places non-minority applicants at a disadvantage in competing for scarce positions from one which completely forecloses non-minorities from vying for those positions (i.e., a “quota”). See *Regents of the Univ. of Cal. v. Bakke*, 438 U.S. 265, 317 (1978).

67. *Johnson v. Transportation Agency*, 480 U.S. 616, 638, 641-42 (1987). Note that while *Johnson* was a sex discrimination case, the Court explicitly stated that their analysis applied to minorities as well as to women. *Johnson*, 480 U.S. at 635 n.13.

68. See *supra* note 61 and accompanying text.

69. The Court’s preference for plans with a minimal impact on innocents is apparent in the structure of affirmative action doctrine. Essentially, the greater the impact of an affirmative action plan, the stronger its justification must be. Thus, a particular justification which supports a low-impact (“plus”) plan might not support a high-impact (“quota”) plan. Compare *Johnson*, 480 U.S. at 634, 638 (desire to remedy minority underrepresentation in scarce job categories resulting from past societal discrimination justifies use of “plus” plan) with *City of Richmond v. J.A. Croson Co.*, 109 S. Ct. 706, 724 (1989) (desire to remedy past societal discrimination cannot justify use of unyielding racial quota). Though its impact is even less severe, a risk differential subsidy is based on a justification which is virtually identical to that accepted by the Court in *Johnson*.

70. *Johnson*, 480 U.S. at 625 (citation omitted) (emphasis in original).

for” cause of her injury. The Court, in fact, has indicated that the “injury” from a subsidy may not be “fairly traceable to the government.”⁷¹

V. Conclusion

Although rational discrimination is based on neutral market principles such as profitability and efficiency, its effects are far from neutral. In the insurance market, rational discrimination plays a part in perpetuating—even exacerbating—the economic disparities between the races. This seemingly “faultless” conduct not only is rooted in the harm of past intentional discrimination, it is a harm in its own right.

This article suggests that a subsidy, rather than a prohibition, offers the best approach for remedying the effects of rational discrimination in the insurance industry. A subsidy minimizes the costs imposed on innocent insureds and insurers, while offering Blacks long awaited opportunities to succeed in the marketplace. In contrast to a prohibition, which proves unable to eradicate fully rational discrimination (without impairing the insurance market’s viability), a subsidy compensates Blacks for the entire differential in risk arising from economic and social disadvantage.

Nevertheless, even a subsidy imposes a burden on “innocent” individuals. It will drive marginal white producers from the market. Even if these Whites would not have succeeded without historical injustice, we cannot lightly dismiss the burden imposed on these innocent Whites. At the very least, the government’s intervention changes “the rules” of the market and violates the expectations and plans of established competitors. It must be recognized, however, that any time society changes—even if the transformation is toward a more just state—the expectations and assumptions of certain citizens will be violated. In a sense, this cost is ultimately the cost of justice.

71. *Cf. Allen v. Wright*, 468 U.S. 737, 753 (1984) (parents of black students lack standing to sue government for subsidizing all-white private school, thereby diminishing their educational opportunities).