A THEORY OF RACIAL HARMONY
ALVIN RABUSHKA

ISBN 0-87249-302-4

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By Alvin Rabushka

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STUDIES IN INTERNATIONAL AFFAIRS NO. 11

by Alvin Rabushka

Published for the Institute of International Studies
University of South Carolina
by the

University of South Carolina Press
Columbia, South Carolina
For NYREE
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FOREWORD

There is no subject more likely to move rational men toward emotive exchange than race relations. And all too frequently this fact has prevented us from exploring economic, institutional, or even technological relationships to racial tensions. Professor Alvin Rabushka has dared to "think the unthinkable" and "ask the unaskable". The result is a volume which is not likely to be received with total equanimity. Yet the logic of his arguments deserves at least the courtesy of intellectually detached examination.

Since race and ethnicity are likely to continue as a formidable factor in international politics—witness only the most recent sessions of the United Nations and the emotional manner in which these problems were approached—and the search for racial harmony in global terms must continue, Rabushka's thesis that "racial tensions and conflict are kept to a minimum under conditions of voluntary exchange in free markets" can represent a refreshing and original contribution. He challenges us to break out of the confines of one so-called academic discipline and view problems in race relations from a multiple perspective: sociological, historical, international relations, and economic.

Much of Rabushka's insight derives from practical experience in an area where racial tensions have erupted into real violence—Malaysia. So he is not an inexperienced or esoteric theorist. It can only be hoped that his volume in our Studies in International Affairs series will prove as stimulating and productive as was his visit to the University of South Carolina when faculty and graduate students explored his ideas with him—there was never a dull moment. The Institute of International Studies is happy indeed to present Professor Rabushka's volume as #11 in our series.

May 15, 1973

Richard L. Walker
James F. Byrnes Professor of
International Relations

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This book is an effort by a political scientist to apply the tools of modern welfare economics to what is generally a subject for sociologists. I have, in the process of preparing this book for publication, received helpful comments and suggestions from scholars in the three disciplines of economics, political science, and sociology. For their help I want to thank James S. Buchanan, Susan Cochrane, Marshall R. Colberg, Stanley L. Engerman, Nathan Glazer, Richard D. McKelvey, Jeffrey Richelson, Paul Craig Roberts, Kenneth A. Shepsle, Gordon Tullock, and several anonymous readers. My thanks also to Bruce Marshall for arranging a firsthand opportunity to test the ideas in this book on a group of scholars in Columbia, South Carolina, and to the Institute of International Studies of the University of South Carolina for its support in the publication of this book.

For typing several drafts of the manuscript, I thank Louise Doying, Peg Gross, and Janice Brown. The first draft of this study was written while I was a National Fellow at the Hoover Institution on War, Revolution and Peace of Stanford University during the 1971–1972 academic year. I want to express my appreciation to the Hoover Institution for providing a stimulating and creative environment. As is customary, of course, neither my critics, typists, or financiers are responsible for the views I hold and present.
A THEORY OF RACIAL HARMONY
I

A POSITIVE THEORY OF RACE RELATIONS

Ten years ago a state of wishful euphoria aptly described race relations in every corner of the globe. With promises of racial harmony, a host of multiracial nations had either received or were about to receive their independence in Africa, Asia, and Latin America.¹ In the United States, Southern “freedom riders” in the early 1960s and the passage of the 1964 Civil Rights Act culminated a long period of postwar changes that gradually but steadily improved the economic, social, and political condition of Black Americans. As recently as 1962 or 1963, one might have been inclined to say that racial problems were fast becoming a distant unpleasantness, that man had finally learned to live and let live with his multicolored neighbors; in short, that the race problems created out of European colonization in the fifteenth and succeeding centuries seemed once and for all within reach of peaceful resolution.

From the vantage point of the 1970s, however, the wishful hopes of the early 1960s appear unfounded. Few of us are likely to have escaped the media’s constant exposure to racial turmoil that began in 1963 in the streets of Rochester. From Rochester the strife spread to Watts in Los Angeles, to Detroit, Cleveland, Gary, Nashville, Newark, and other American cities throughout the hot summers of the mid-sixties. When Americans enjoyed their first cool summer in a long while in 1968, the media turned to daily reporting of the three year slaughter in Biafra,

followed by nine months of genocide in East Pakistan (now Bangladesh), now replaced by television pictures of sniping, burning and killing in Belfast and Londonderry. Moreover, the issue of busing to achieve racial balance in American public schools dominated the early 1972 Presidential primaries and gave George Wallace an impressive early victory in Florida and Michigan. Indeed, several political commentators feel that the racial issue played a major role in Nixon's 1972 landslide victory. The voting returns reveal that the President's strongest gains over 1968 erupted in areas of the most intense racial polarization—through the whole South and in such big city Democratic strongholds as Cleveland, Chicago, New York, and Philadelphia. Race has again become a salient political concern to many Americans both for domestic and foreign policy. It now seems that racial problems, whether at home or abroad, are not within easy reach of resolution; rather they are and perhaps will continue to be a most important source of potential conflict for the indefinite future.

In this book I present a theory of racial harmony and conflict. A reading of the *International Encyclopedia of the Social Sciences* under the entries of "Race," "Race Relations," "Discrimination," "Minorities," "Prejudice," and "Segregation" reveals a vast literature that includes the disciplines of psychology, sociology, anthropology, history, political science, linguistics, biology, and economics. The more than two hundred books and scholarly articles listed in these reviews are only a small fraction of the total literature. Sociologists and anthropologists easily dominate, indeed almost monopolize, this literature on race. They emphasize the study of social structure and how race, defined either socially or biologically, explains social and cultural differences among people. Among other topics, they research the

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2 Residents of Northern Ireland often liken their religious differences to the racial differences found in other societies. I use the word race in this book because of its more dramatic effects. The analysis easily extends also to differences in religion, language, tribe, custom, or region.


4 A good example of this type of approach is Brewton Berry, *Race and Ethnic Relations*, 2nd ed. (Boston: Houghton Mifflin, 1958).
A Positive Theory of Race Relations

history of race relations, personality aspects of different racial configurations, how differences in social and political structures affect race relations, the social psychology of prejudice and discrimination, and the economic and political status of minorities. A careful count of the citations identifies eight that have been written by economists, only one of which is booklength. So far, economists have had little to say about race.

Methods of Research

I can best describe the approach used in this book as a study of the political economy of race relations. Political economy, as I understand the term, refers to the relationship between public choice decision rules (i.e., politics) and economic organization. Put another way, it is the study of the linkages between markets and governments. A political economy of race relations thus involves both the economics and politics of race. Economics is chiefly the study of markets and market exchange and has developed a substantial body of theory about various forms of economic exchange. Recently, economists have also begun to study nonmarket decisions or "public choice" wherein they focus primarily on the economic functions and roles of the state. This emphasis contrasts sharply with the more traditional topics of political inquiry (political party organization, legislative behavior, interest articulation, socialization, communications, voting behavior, etc.) which often place little emphasis upon the economic activities of governments. A political economy of race relations involves, under this view, an analysis of how race relations are affected by different sets of public decision rules. To state the matter somewhat differently, how does the extent of the political use of economic resources affect race relations? Note that this approach differs from a strictly economic interpretation of market aspects of such features of race relations as,

See Gary S. Becker, The Economics of Discrimination (Chicago and London: University of Chicago Press, 1957). Since 1968, several additional economic analyses of race relations have been published, but the total list is still trivial compared with sociology.
say, discrimination or segregation. It draws our attention to the changes in race relations that are produced by government economic activity.

A word about the organization of this book. The remainder of this chapter offers a preview of the theory of racial harmony and conflict and some caveats that specify both theoretical and practical limitations. Chapter 2 presents a brief account of market exchange which, as we will see, begins with the individual citizen, rather than with groups or "races," as the unit of analysis. Chapter 3 then sets forth an economic view of politics in which governments are seen in their economic roles (e.g., suppliers of "public goods") and in their ability to perform these activities.

The nature of race relations under conditions of voluntary exchange in the context of free markets is the subject of Chapter 4 and the effects of public economic activity, both direct and indirect, on these relations is taken up in Chapter 5. The major results of the book are summarized in Chapter 6, which also presents a "normative" theory of racial harmony.

A Preview

The theory can be put in quite straightforward terms. Under conditions of voluntary exchange in free markets, racial tensions and conflict are kept to a minimum. Individuals, as members of specific racial groups, stand to gain or lose on the basis of their marginal value of productivity (which may be conditioned by genetic, historical, political or cultural reasons). Groups of individuals with low marginal values of productivity attempt to compensate by gaining public control over resources, thereby using political power and the decision-making authority of...
government to re-allocate wealth to their own advantage. The public activities of government in the multiracial environment thus convert private economic competition among individuals in markets into social and political conflict between races. When the economic well-being of groups is significantly affected by political activity, politics becomes a fight between groups (or races) for survival. Thus, in a society where race is politically salient, the greater the extent of the public use of resources (i.e., the greater the extent of government economic activity), the greater the likelihood of racial conflict. Efforts by government to do away with racial conflict tend to intensify it further. Moreover, the blame for existing racial problems can be attributed to prior government activity, such as licensing slavery, establishing apartheid, imperialism, or enforcing segregation. Hence, governments should be seen as a chief cause of racial conflict, rather than as a promoter of racial harmony.

The normative implications of this theory are treated in Chapter 6, which argues that whether or not interference by government is desirable depends on who benefits and who loses. Those who are not successful in a competitive economic world or who seek unfair advantage stand to gain from substantial public activity when they control the reins of government. Those who possess competitive advantage in free markets, on the other hand, may suffer when government interferes with those markets. We must thereby separate the normative aspects from the positive theory of racial harmony. It is one thing to theorize about racial harmony; it is another to achieve it.

Some Caveats

This book is chiefly theoretical in nature, being more of an exercise in logical inquiry, than an evaluation of large amounts of evidence. I chose this strategy for several reasons. First, as will become apparent, the data that would allow a critical test of my theory do not exist; only indirect support (or lack thereof) can be brought to bear, as I will explain in Chapter 5. Secondly, in two previous books I have been chiefly con-
cerned with the data of race relations and here I want to consider some theoretical relationships on their own merits. Where appropriate, however, I try to show that my views are consistent with the research findings of several students of race relations.

A second caveat. This book investigates the logic of race relations under conditions of market exchange and how governments alter those relations by their activities. As such, the preferences and values of members of different races are taken as given. I do not investigate how people come to have various nonpecuniary racial values, e.g., how those preferences and values that relate to compassion and envy are formed and altered.

My theory, therefore, does not encompass many of the social, psychological, historical, or cultural factors that others often investigate. I do not deprecate the importance of studies that relate those factors to conditions of racial harmony and conflict, nor should my approach be construed as criticism of them. In many ways, these different approaches should be considered complementary. I believe, however, that an exclusive focus upon the political economy of race relations will lead to a set of questions previously unasked and provide new and refreshing results, some of which may challenge the prevailing lore. Moreover, this approach facilitates comparative understanding of race relations in different historical, institutional, social, and cultural contexts, and thus treats as constant many variables that are frequently the object of study by others.

A third and final caveat. This book presents a "positive" theory of race relations and turns only in the last chapter to its normative implications. Social engineers are thus given a general policy guideline for the achievement of racial harmony. However, it does not and cannot provide them with a political how-to-do-it manual. The politics of distribution in a multiracial society may preclude the implementation of my theory. Put another way, the factors that motivate groups of people to seize political power are the same that motivate them to retain it.
II
MARKETS: THE PRIVATE SECTOR

Ghazali lives in the Malayan countryside in a riverine village. There, with his friends and covillagers, he catches and preserves fish, raises domestic fowl, harvests the abundant fruit of the tropical forest, and perhaps taps the few acres of rubber trees that he owns. His womenfolk, in addition to the customary domestic chores, often weave and help in such farming activity as growing rice. In the nineteenth and earlier centuries, the Ghazalis of rural Malaya were relatively self-sufficient and, if the folklore is correct, content and happy.

Wong, on the other hand, lives in the bustling, noisy, and often overcrowded city. He and his kinsmen are the nation's shopkeepers, traders, bankers, engineers, doctors, and manufacturers (management and labor). Mrs. Wong is often found alongside her husband in the family shop while managing enough free time to look after and raise the children, until they too enter the family business.

A brief trip to Malaya, for reasons either of business or leisure, quickly reveals that Ghazali owns a transistor radio, perhaps a television, a motorbike and numerous other amenities of the twentieth century. Wong, on the other hand, has papaya at the breakfast table, rice and fish at the dinner table, and is able to complement his urban life style with the produce of the countryside. Neither Ghazali nor Wong is self-sufficient, nor

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could they become so without a drop in their standards of living that neither would cheerfully accept. How then do Wong and Ghazali come to enjoy each other's productive efforts? By trading with each other in the marketplace! Using the medium of money, though barter may be as effective in primitive situations, Wong and Ghazali exchange the goods and services that each produces in his own specialized activities. In the marketplace all of the Wongs and Ghazalis, and the Ramasamys in Malaya's multiracial society can compare their personal valuations with each other for the goods and services offered for sale. Ghazali sells his rural produce for whatever price the market will bring and in turn uses his proceeds to purchase, subject to budget limitations, whatever he wishes to buy. The profits that Wong realizes from the family business enable him to feed his family as he chooses from the available foodstuffs in whatever combination he both likes and can afford. When market day is over, both Wong and Ghazali return home with their needs more nearly satisfied than before. Presumably Ghazali, if he bought that new transistor radio he had been eyeing, is now better off in his own subjective view or else he would not have bought it. Wong, having purchased papaya instead of passion fruit must also be subjectively better off, or else he would have bought the passion fruit. In hundreds of marketplaces up and down the Malayan peninsula such exchanges take place each day: Wong buys the fruits of the countryside and Ghazali those of the city. Each judges himself better off after every trade or else trading would not continue.

With the help of this simple example we arrive quickly at the essence of markets: the goods and services produced in specialized activities are traded through a medium of exchange, most commonly money. Markets, today, are universal except in those remote parts of the globe where the self-sufficient family provides for all its wants. Markets not only allow each person to exchange those goods and services he produces for those he wants, they also allocate resources for the society as a whole. People interacting in markets determine just what products and services are provided within a society, how much of each is
produced, what price is attached to each item, and so forth. But can simple examples of commodity exchange really capture the intricate complexity of the marketplace in the modern industrial world? Surely the modern world is too complex to admit of such simple and naive accounts! Complexity requires, in this view, complex explanations. And here the economist must turn to his "models."

Economists profess to study the allocation of scarce resources in society. To do this, they try to develop simple models of exchange, but ones that capture the essential properties of the complex real world. Models are kept simple to prevent the mathematics of them from becoming unmanageable too quickly, or for reasons of personal aesthetics. Economists, and philosophers of science as well, generally prefer simple models to complex ones, especially if each helps explain equally well complex economic reality. For our purposes, the basic model of the free market seems to capture a good portion of complex reality without itself becoming so cumbersome as to be unmanageable. It is this model of market exchange that is the subject of this chapter. With a knowledge of the workings of markets and exchange before us, we can then turn to study its effects on race relations.

The Study of Markets: Some Tools

The economist employs a number of tools in his practice. Of these, some are strictly logical and take the form of definitions or assumptions. Others are empirical. In this section we examine some of the more important tools that economists use in order to construct a model of the marketplace.

Although a full exposition of markets is better left to the "principles of economics" textbook, some features of markets bear repeating here. Such concepts as "marginal productivity," "pareto-optimality," "allocative efficiency," and "jointness of supply," which, among others, are central to my argument, are not always readily grasped. Accordingly, in the interests of clarity I outline for the noneconomist the basic features of markets with their underlying assumptions, a presentation that professional economists may find redundant. However, to the best of my knowledge, most analysts of race relations possess little training in economics.
We begin our treatment with the concept of preference. Preferences reside with the individual whether as a buyer, seller, citizen, or voter. Every individual has tastes, values, and opinions over a whole range of objects such as food, drink, women, cars, housing, and scholarship. These preferences may be determined or conditioned by genetic makeup, religious beliefs, cultural practices, style of upbringing, or other factors. Though some find it rewarding to identify the origins of preferences or how preferences change, an economist typically takes preferences as given. He observes, and thereby asserts, that different people want different things, or that the same person may want different things at different times.

Note the first feature of this concept of preference, its emphasis upon the individual as the unit of analysis. To speak of group preferences or of groups having preferences, is to mean that a group contains many like-minded individuals. A group, in and of itself, does not have a preference apart from those of its members. This interpretation is not to deny that membership in a group does influence an individual's views. It only means that talk of preferences is talk about individuals, and that talk of groups is talk about collections of individuals, each with his own preferences.

A second feature is that of subjectivity. The concept of preference assumes that individuals are capable of knowing their own desires, excepting the mentally incompetent. More important, subjectivity also implies that there are no such things as correct preferences. This point is critical and cannot be overemphasized, since what may be a correct preference for one person may be anathema to another. Does it make sense to say that the one preference is correct and another incorrect, or that one is good and one is bad? These are, and must be, personal valuations based on whatever principles, values and tastes an individual may hold. Unless one believes that men receive knowledge by revelation, there is no way that an objectively correct preference can exist for a person apart from his own
Markets: The Private Sector

point of view. To say that an individual is able correctly to order his own preferences is not to say that he has the "truth" for others. Hence in economics, the only correct conception of preference is from the subjective standpoint of the individual.

A third feature of preference is the focus upon choice. Economists do not study the source of an individual's preference. Rather, they make inferences and generalize about motives on the basis of observation. What they observe are the choices made when individuals express their preferences in the supermarket, the sports arena, the auto showroom, the bookstore, and the voting booth. Choice is what transforms private preferences into public activity. When an economist assumes or postulates certain motives, such as that people prefer more money to less, he looks at the choices people make to see if they are consistent with those motives. The judgments that economists make are based on observed market behavior, which in turn is a reflection of the choices consumers and producers make on the basis of their preferences.

A fourth and final feature of preferences is that they are fixed and taken as given in the short run. Preferences can and do change in the long run, but for purposes of analysis they are considered as given. The neglect of changing taste is justified when observation seems to support the short-run stability of taste assumption. For now, it suffices to say that tastes among individuals are highly varied. This is especially clear to anyone who has ever lived in a multiracial society!

Preferences, then, are subjective, inferred from choice, considered fixed in the short run, and reside within the individual. When we seek an overall picture of the marketplace, we sum up all the individual bargains and interactions that together make up a market. We do not look beyond the individual to some organic entity named a market that has an independent existence all its own.

Scarcity

Goods are scarce! This is an empirical generalization, not a logical definition. To assert scarcity is simply to claim that some
human wants remain unsatisfied. Until and unless all wants are fully sated, scarcity must remain a fact of life. Let us examine this concept of scarcity with the help of a production possibility boundary diagram. Since it is not my intent to focus on the principles of economics per se, but rather to show their implications in a multiracial setting, I will use the simplest illustrative tools available, which are often as effective as more complex ones. Throughout this book I will construct hypothetical cases that are based on Malayan settings, the multiracial country with which I am most familiar.

Let us begin by assuming that in the Orient it is better to be holy than well-fed. Hence, all of the available resources in Malaya—land, labor, capital—are funneled into the construc-
tion of religious works. Assume further that the only relevant choices for construction are Chinese temples and/or Muslim mosques. From Figure 1 we see that for any given time span, say one month, a maximum of eight Chinese temples can be built if no Malay mosques are constructed (point a) or, alternatively, that six mosques can be put up when no resources are invested in Chinese temples (point c). The smaller number of potential mosques is due to their more ornate appearance which make them more expensive to build than Chinese temples. Of course, as a group Malayans might desire some combination of temples and mosques; point b, for instance, represents an output of four temples and three mosques, again in a given time period. Precisely what combination of mosques and temples is selected is a matter of resource allocation and politics, but for now note that efficient use of all available resources yields an output of mosques and temples that falls somewhere on the production possibility boundary. Any point to the right of that boundary (e.g., point d) is a nonachievable output area—at least until some way is found to make production of religious monuments more efficient. Any point to its left (e.g., point e) is inefficient production, i.e., the society has the resources to produce a greater combination of mosques and temples than its current output. But the fact of scarcity, shown by the production possibility boundary, limits the output of religious institutions to that which the available management, technology, capital and labor force can achieve.

The linear relationship, one of constant opportunity costs, between mosques and temples that Figure 1 displays does not fit many other productive choices. Often a curvilinear boundary is more consonant with reality; here the curve, drawn concave to the origin, signifies increasing opportunity costs for the acquisition of one additional unit of the sought-after object. Taking a different example, let us compare rural electrification with urban development (See Figure 2). In order to obtain the first unit of electrification (point e), it is necessary to give up only a small fraction of one unit of urban development. To get the second unit of electrification (point d) requires giving up an
additional half-unit. But to go from the fifth to the sixth unit of electrification requires that we surrender just over a whole unit of urban development, and the cost of the seventh unit entails foregoing nearly four units, or more than half, of all urban progress. This is what the term increasing opportunity cost means: the cost of an additional unit of item $x$ is the foregone benefits of successively increasing quantities of item $y$.

Why should the production possibility curve display increasing opportunity cost? The answer is that productive factors are not always equally substitutable for each other when they are shifted from the production of one item to another. City planners, for example, are not readily substitutable for electrical
engineers. There are very few electrical engineers in Malaya and the expenditure of additional sums on rural electrification yield, at some point, diminishing returns, especially in terms of foregone benefits in urban development. The sixth and seventh units of rural electrification come only at the expense of a rapid falloff in the output of urban development. Strictly speaking, increasing opportunity costs occur when units of resources released from the production of one commodity are successively less effective in the production of the other commodity.

**Competition**

Competition always exists where there is scarcity. Individuals and/or groups of individuals compete with each other for the choice of limited options. All things being equal, the Chinese in Malaya might choose, given the opportunity, to invest entirely in temples. Malays, if given the choice, would probably fill the countryside with mosques. Thus the very fact of scarcity implies competition or conflict, not necessarily in the sense of outright violence but in the sense that Wong and Ghazali disagree on the "correct" output of holy places.

We can resolve the conflict or competition over the use of scarce resources in several ways. One is to let a dictator enforce his wishes. Another is to use the principle of majority vote. A third is to have the owners of resources exchange them with each other, driving the best bargains they can obtain, to use them later as they see fit. This latter method is the market alternative for allocating scarce resources. The former two are political. Again, since preferences are subjective, there is no correct allocative solution to the problem of scarcity, just what individuals prefer and can enforce. We can obtain and evaluate the costs and benefits of each method, however, to see which we as individuals most prefer.

**Cost**

We have already encountered the notion of cost in our treatment of scarcity. There we noted that cost for any one item is
reckoned in terms of the number of foregone units of the other. Thus we define costs in terms of foregone alternatives, rejected options, or lost opportunities, not in terms of some absolute value. Moreover, the cost of any item is, for each individual who bears that cost, the subjective value or utility of the highest valued option rejected or foregone. For Wong, the cost of another new Chinese temple is the opportunity cost of having, in its place, three-fourths of an elaborate Muslim mosque (see Figure 1).

It is important to stress the subjective nature of cost. A denominator such as money, therefore, is not a perfect measure of it. For practical purposes, though, the value of highest valued rejected option is approximately equal to its monetary price, since no better measure exists. By comparing prices between options, an individual is able to compare opportunity costs.

Recall Figure 2 with its representation of increasing opportunity costs. We want at this time not to talk in terms of total costs, but in terms of something called marginal costs. With the help of Figure 2, we can construct a table in which the notion of marginal cost is easily understood.

Let us begin by assuming that all resources are currently being invested in urban development. The cost of producing

**Table 1**

**Costs of Rural Electrification**

<table>
<thead>
<tr>
<th>Units of Rural Electrification</th>
<th>Foregone Units of Urban Development*</th>
<th>Average Cost in Units of Urban Development</th>
<th>Total Cost in Units of Urban Development</th>
</tr>
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<tbody>
<tr>
<td>1st</td>
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<td>6th</td>
<td>1⅓</td>
<td>1⅓</td>
<td>3⅓</td>
</tr>
<tr>
<td>7th</td>
<td>3⅔</td>
<td>1</td>
<td>7</td>
</tr>
</tbody>
</table>

**Note:** *This column represents the “marginal cost” of rural electrification in units of foregone urban development.
the first unit of rural electrification is giving up, or foregoing, one-eighth of a unit of urban development. This is the average, total and marginal cost of the first unit of electrification. Note that the entries on the first line of the table are all identical. When we decide to add a second unit of electrification, the cost in terms of urban development increases. The second unit now costs two-eighths of a unit of urban development. Note that the marginal price of the second unit is not identical to the average price of the first and second units taken together.

We can continue this line of reasoning up through the third, fourth, fifth, sixth, and seventh additional units of rural electrification. The marginal price in foregone units of urban development rises successively, and for the sixth and seventh units is far above average cost per unit. Though seven units of urban development can, if given up, buy seven units of rural electrification, the price of the seventh unit is indeed steep! Thus, the marginal cost of any additional unit of rural electrification is computed in terms of the corresponding number of foregone units of urban development. The reader should now be able to explain increasing opportunity cost in terms of marginal costs.

Nevertheless, he must remember that, since individual preferences are subjective and unknowable to the observer, we can only guess what a citizen's subjective cost estimates are when his choice makes them public. We assume whatever choice was made was one that was intended to satisfy a high ranked preference. For those who are exclusively concerned with money, we can make inferences by examining the price of the selected option. For those who are not, for example, many people prefer leisure to income, costs are hard to compute.

Substitutability

Most individuals seek a multitude of goods. Wong, for instance, would be far from content if his total stock of goods was simply a warehouse of passion fruit bought at bargain prices. Ghazali, too, may for the moment be happy with his new transistor radio, but he probably has visions of a motorbike, a
television set, new clothes, and so on. In fact, we could probably get both Wong and Ghazali to trade some of the items they possess for others they desire, assuming they agreed to the bargaining price. This proposition, that individuals seek many goods to satisfy many preferences, seems intuitively sound.

Not only do consumers reflect a willingness to substitute some goods for others, we find this behavior among producers as well. Home builders, for instance, may switch from brick to wood, or from wood to aluminum siding, if the cost of any of these grows unreasonably high relative to the other. Thus both producers and consumers are willing to sacrifice some of any one good to obtain more of other goods.

This assertion of substitutability can be stated in several ways. To obtain more of one good, a person is willing to sacrifice some of any one, or group, of other goods. Or, a person may give up some of any good he desires if he can obtain a sufficient increase in the amount of other desired goods. One can construct, on this basis, a *ratio of substitution*, which stipulates the *maximum* amount of one good that a person is willing to surrender to obtain a one unit increase in the amount of some other specified good. Wong, again, might be willing to forego one passion fruit for such local Malayan fruits as a durian or handful of rambutans, but no more. This is his ratio of substitution between passion fruit and durian or passion fruit and rambutan. If he is offered only half a durian for his passion fruit, his warehouse is likely to remain fully stocked. If he can get more than one durian for his passion fruit, he is certain to conclude the transaction at the earliest possible moment. But, at a substitution rate of one passion fruit for one durian, Wong is indifferent to the exchange. We can now call this ratio of substitution, the point at which he is indifferent to the exchange, the "indifference rate of substitution."

We must be clear what this indifference rate represents. It is not a ratio between the total amount of passion fruit and the durian Wong counts in his inventory. Instead, it is the ratio of the change of the increase in the total stock of one item and the decrease in the other, a ratio that is often called the *mar-
ginal rate of substitution. (This is shown graphically in Figure 5.) For now please observe that this indifference ratio or marginal rate of substitution is entirely subjective: it is the value Wong places on his preference for passion fruit vs. papaya or passion fruit vs. durian for his total stock of fruit. The value of the passion fruit to Wong is the exchange rate between it and some other good, at the point where he is indifferent to the exchange being made. Fortunately Wong can use the currency the Malaysian government prints to help him with these comparisons of value and he can thus express his ratios of substitution in terms of price.

Some Additional Postulates

In order to complete our picture of the economic view of human nature, we need several additional postulates. Again, these are empirical generalizations based on repeated observation of human behavior and not intellectual fictions. The first of these, and one with which very few should disagree, is that people prefer more to less. Accordingly, ceteris paribus, at no increase in personal expenditure, people prefer to have more of a good or packages of goods than they currently have, excluding, of course, the point of congestion when storage costs exceed the value of the additional goods. There appears to be no historical account of a civilization in which the vast majority of citizens preferred less to more, that is, voluntarily gave away their possessions expecting nothing in return, either on this earth or in heaven. Moreover, let us not confuse the inability to produce more wealth for reasons of scarcity, bureaucratic bungling, or lack of technology, with a preference for less wealth rather than more.

Finally, and this point cannot be overstated, each individual must subjectively determine the choice of more or less. The word utility is helpful here; an intuitive synonym would read satisfaction. Thus, we can restate this postulate to read: individuals prefer packages of goods that give greater "utility" rather than less. Utility is the companion to preference; it is a measure of value on preferences. This concept of utility should
not be confused with the utilitarian philosophy of Jeremy Bentham and John Stuart Mill in which utility was believed to reside within the objects men desire. The modern conception of utility, instead, ascribes utility to the mind of an individual who makes a subjective value judgment about each object he examines. Utility is thus a subjective judgment, not a demonstrably objective property of objects.\(^3\)

**Self-Interest**

We come now to a summary statement of human nature: *people act in their own self-interest*. Even the philanthropist who endows a public museum does so because it is in his own self-interest. This latter assertion may seem to contradict what often appears to be altruistic behavior on the part of some people. But recall that preference and its measure of utility are subjective. Endowing a public museum may provide more satisfaction for a millionaire than buying a third Ferrari. Self-interest or utility is not *exclusively* synonymous with wealth-maximizing behavior, or pecuniary motives, though for most people self-interest (utility-maximizing behavior) could be replaced by wealth- or income-maximizing behavior. Others may be maximizing nonpecuniary goals. The maximizing of utility simply means that individuals are able to rank their preferences from most to least preferred and can select that option highest on the list, the one that provides the greatest "utility." This is what the economist means when he talks in terms of a "utility-maximizing theory of human nature."

We now have a tool for the analysis of human behavior, and one that is especially useful in explaining economic behavior. We simply ask what the self-interest of the relevant participants to any action involves. This holds for corporate executives, politicians promising utopias, and bureaucracies guaranteeing

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swift resolution of social problems if only their budgets are increased.

The element of uncertainty, however, often makes the definition of one's self-interest a difficult task. How can a person know which candidate for president best satisfies his wants when he cannot be sure if today's campaign promises will become tomorrow's policies? How can Wong be certain that he will want to trade one passion fruit for one durian six months from now when the next passion fruit crop might fail? One cannot and he cannot. Though we can forecast or compute the probabilities that a given choice will produce a specific outcome, it is almost impossible to have certain foreknowledge.

This problem of uncertainty complicates our analysis of the utility-maximizer. Although he can rank order his preferences, he is not sure that a specific choice guarantees the desired result. Therefore, to compensate for uncertainty we say that individuals maximize expected utility. That is, individuals assign probabilities to the outcomes produced by specific choices and then select that option which provides the highest expected utility. The principle of self-interest, or utility-maximization, remains the same; we must compensate, though, for the effects of uncertainty.

The Law of Demand

We come now to the first empirical deduction that the above combination of concepts permits: the law of demand. Again bear in mind that this law is really an empirical generalization about human behavior, not a deduction from abstract logical terms that have no real world counterparts. Simply put, the law of demand asserts that the higher the price of any good, the less any individual will demand, or want to consume. Thus, price and quantity are inversely related as seen in the geometric representation in Figure 3.

The schedule, which is linear in this example, has a negative slope, indicating that for each decline in the price of any given
item, the purchaser will demand a larger quantity. Conversely, for each increase in the purchase price, he will demand less, since in this example price is a measure of each individual's subjective opportunity costs. Returning to Figure 3, point $a$ represents the amount demanded when the price per unit is eight dollars. At this price the buyer will want two units of passion fruit, durian, rambutan, jack-fruit, or mangosteen. If for some reason the price drops to six dollars per unit, our buyer will purchase three units (point $b$). A further decrease in price to three dollars per unit will result in a demand for five of them. Thus, each lowering in price yields an increase in
the amount demanded. The line \( abc \) is called a demand schedule; it signifies how a change in price affects the amount demanded (all other things being equal).

We have been talking about demand schedules for individuals. It is a short step from here to compute overall social demand; we simply add up horizontally all the individual demand curves. This is accomplished in Figure 4 where our hypothetical social demand curve of our three-citizen society is drawn. For instance, at price \( p_1 \), Ghazali buys four units, Ramasamy buys
five, and Wong buys eight for a total demand of seventeen units. Shortly we use this notion of market demand in presenting a model of the marketplace.

**The Rational Consumer**

With Mr. Wong's help, let us construct a model of the rational consumer. By rational we do not mean emotionally sound nor holding what some might consider to be the correct set of preferences. Rather, rationality implies the ability to order preferences, attach (subjective) utility values to them, and then select the option granting the highest utility.

![Indifference Curve Between Passion Fruit and Papaya](image)
The first feature of the rational consumer is that he possesses a convex set of indifference curves. Wong's indifference ratio—his marginal rates of substitution—between passion fruit and papaya is displayed in Figure 5. Wong is perfectly happy to have ten passion fruit and two papaya, or a combination of five passion fruit and three papaya, or one passion fruit and ten papaya. His indifference ratio (marginal rate of substitution) at point $a$, for example, means that to acquire one additional papaya Wong is prepared to forego one of his stock of passion fruit. But the fewer passion fruit Wong still owns, the less willing he is to exchange them on a one-to-one basis for papaya. For Wong to accept a reduction in his stock of passion fruit from three to two (point $b$), he must be given at least two papaya, and he will surrender the next passion fruit for no less than three papaya. Thus as his stock of passion fruit declines and that of papaya increases, Wong's valuation of the former increases. We can say that he derives diminishing marginal utility from each increment in papaya, as he is only willing to forego a small fraction of one passion fruit for that tenth papaya. The same holds true for an ever-increasing stock of passion fruit relative to a decline in papaya. The more one has of any item, the less one is willing to exchange for additional units.

Note that the convex shape of the curve fits our notion of substitutability: some increment of passion fruit will make up for a loss of papaya and vice-versa. Note also that any point on the line is equally preferred to any other point on the line; this is what we mean by the term "indifference curve." Wong is indifferent to or has equal utility for, any combination of passion fruit and papaya that falls somewhere on his indifference curve for the two objects. Clearly any point below or to the left of the curve is less preferred to any point on it.

An additional property of indifference curves is displayed in Figure 6, which shows two indifference curves, $U_a$ and $U_b$, that reflect Wong's marginal rates of substitution at all points between passion fruit and papaya. Note that a move from any point on line $U_a$ to $U_b$ represents an increase in utility for Wong. To see
this, examine point $a$, at which Wong is the owner of four each of passion fruit and papaya. By moving to point $b$, Wong still has four papaya, but has increased his stock of passion fruit to six. Or, by moving to point $c$, he increases his horde of papaya with no loss in passion fruit. By like reasoning for every point on $U_0$, it is easy to see that every point on $U_1$ is preferred to every point on $U_0$. Similarly, every point above and to the right of $U_1$ gives greater utility than any point on $U_0$, since all such points represent a greater combination of goods than all points on the line. A clear understanding of this will allow us to explain the behavior of the rational consumer.

At this point we need the concept of the *budget line*. Wong,
like all of us, is also a victim of scarcity. He would no doubt like to buy a Ferrari, but his income and savings permit him only the luxury of a Toyota or Datsun. Wong is clearly constrained by the amount of money he can marshall, whether obtained by inheritance, wages, or gambling. This concept of the budget line is shown in Figure 7.

Let us borrow Wong's little son for this example. Suppose Wong Jr. receives a gift of one dollar for Chinese New Year and is given the option of spending his money on either passion fruit, papayas, or some combination of the two. Suppose that each piece of fruit costs twenty-five cents. Little Wong has mastered his arithmetic and knows instantly that he can buy
either four passion fruit or four papaya with his dollar (points 
a and d). But, he could also buy three passion fruit and one 
papaya, or two of each if he chooses (points b and c). Unless 
he is really adept at bargaining, his resources do not permit any 
combination of more than four fruit (point e) since he cannot 
afford (does not have the resources) to pay for the fifth piece 
of fruit.

If we superimpose the budget line over Wong or little Wong's 
set of indifference curves between passion fruit and papaya, we 
can forecast which combination he will buy, i.e., we can de-
scribe the "rational consumer." A graphical representation of 
the rational consumer appears in Figure 8.

![Figure 8](image)

Figure 8
The Rational Consumer (Utility Maximizer)
Wong's indifference curves are labeled $I_1$, $I_2$, and $I_3$. Every point on the higher numbered curve is preferred to any other on a lower numbered curve because it provides a greater basket of fruit. Note that the budget line intersects $I_1$ at points $a$ and $b$, which means that Wong can afford to buy either of those combinations of passion fruit and papaya between which he is indifferent. But observe that the budget line also touches $I_3$ at point $c$, which means that Wong can afford the combination of goods point $c$ represents. And, we know that every point on line $I_3$ is clearly preferred to every point on $I_3$. Therefore, Wong will choose combination $c$ as opposed to either $a$ or $b$.

We also know that people, including Wong, prefer more to less. Wong would be much happier with combination $d$ since it lies on a still higher indifference curve. Unfortunately Wong's budget does not permit the purchase of $d$; he must, therefore, be content with $c$. Strictly speaking, the indifference curve that is tangent to the budget line represents the point of rational consumption—no other combination of goods can give Wong equally great satisfaction given his budget constraints. The utility maximizer is, therefore, the rational consumer, the person who selects that combination of goods providing the greatest utility, i.e., the one that lies on his highest indifference curve, subject to his budget limitations.

The Rational Producer

The rational consumer has his counterpart in the "rational producer." In this section, however, we dispense with utility and speak in terms of costs as measured by prices. Recall our earlier definition of cost as the (subjective) value of the highest valued rejected option, that is, the value of the opportunity foregone. Here we treat cost in much the same way, except to say that cost is the value of the output foregone when a unit of resource is withdrawn from any use. We know that, since resources have many uses, building materials, architects, and bricklayers can be used either in the construction of Chinese temples or Muslim mosques; therefore we can calculate the
value of the alternative products in which they might be consumed.

The Production Function

The physical output of a particular good depends on the various resources or factor inputs used in its production: the quantities of them, their qualitative characteristics, and the methods used in combining them. Thus, output is a function of the various factor inputs. It is useful, however, to know how a change in the amounts or kinds of resources used affects the output. We especially want to know how variations in each of the separate inputs, holding the others constant, alters the output.

Note first that in many cases hundreds of forms of substitution for inputs are available. The builder of a mosque can use wood, aluminum, stucco, brick, clay, or other material. Secondly, the final reckoning of costs depends on the choice of productive techniques. Here we assume that producers will use the best-known techniques for holding down costs, since they will otherwise fail to meet the competition and go out of business. Thus, the final cost of a product resides with the skills of the producer; the law of survival ensures that only those combinations of resources and productive techniques will be used, ceteris paribus, which minimize cost.

We use the concept of marginal product to explain how the input of an additional unit of a resource contributes to the total output. That ratio—the change in output per unit change in input—is called the marginal product of input. An example should help to clarify the concept. Let us imagine that both Wong and Ghazali are the only unemployed laborers in West Malaysia and that currently all resources are being invested in the pursuit of holiness by building mosques and temples. The total current output of mosques and temples is one hundred per month. Now we put Ghazali to work and 101 new holy buildings are available for prayer the following month—the marginal product of one more laborer (Ghazali) is one holy building. Next we retire Ghazali and Wong goes to work; the
new monthly output is 102 units. The additional contribution to the total output rendered by Wong, his *marginal product of labor*, is double that of Ghazali. On the basis of equal pay for equal work, Wong's wages will be double those of Ghazali.

We can just as easily talk about the *marginal product of land or capital* as about the marginal product of labor. In each case the notion of marginal product allows the producer to calculate precisely the additional output resulting from each additional unit of the resource. With each marginal increment in input (land, material, labor), we can measure the marginal product of output—the increase in output due to the use of additional units of input.

*The Law of Diminishing Returns*

The law of diminishing returns is, again, an assertion about the real world of economic exchange, not a definition or tautology. Economists have simply observed that for many goods, the marginal product will diminish with marginal increments of inputs beyond a certain point. Note that up to now we have been talking about relationships of physical factors of production. We now want to relate these to values and accordingly we speak in terms of prices of marginal products in the market.

Let us go back to the Malaysian countryside. Assume that the pressures of racial politics have forced the authorities to over-invest in rural electrification, despite the acute shortage of qualified electrical engineers. To provide political supporters with jobs and income, thousands of additional workers are hired at appropriate civil service wage rates to build dams, power plants, and other facilities. However, these workers are entirely untrained and unskilled. Although the first few additional workers may actually increase the value of the total output, the costs of additional labor soon surpass the value of the gains in total output. Thousands of workers are receiving wages for their labor, but their output is such that the cost of their wages is greater than the value of their marginal product. Although governments can operate this way for long periods by confiscat-
ing income from the productive segment of the population and subsidizing the unproductive, private business firms in a competitive world soon go bankrupt.

At what point will producers cease adding additional units of inputs? So long as the addition of one worker adds more to revenues than to costs, it is rational to hire another person. At the point where the cost of hiring one more laborer equals the value of his marginal product, a producer will hire no more, since no one hires at $2.00 an hour a fruit picker who picks $1.99 worth of fruit. He stops adding inputs when, in formal terms, the value of the marginal product of input equals its cost.

Thus far we have talked about the relationship of output to inputs when only one input is varied. This relationship is even more complex when all inputs are varied. Under this situation, the producer adopts the rule of minimum cost. Under this rule, he finds the least cost combination of inputs that yields the desired product. He succeeds when the value of the marginal product of each input of production divided by its price is the same for all inputs, no matter how many. That is, inputs are in correct proportion when the ratio of the value of the marginal product of x to the price of x is the same as for inputs y, z, w, etc. Therefore, when the price of one input increases, the rational producer should use less of it thus increasing its marginal product and more of the other inputs, thus decreasing their marginal products until the ratio of the value of marginal product to price is again everywhere equal.

In the absence of competition we might very well have developed a different conception of the rational producer. In the presence of competition, however, the producer sets his output at the point where marginal costs equals price. No businessman cheerfully produces at a loss for any length of time unless he is subsidized by the government out of other businessmen's profits. The rule of minimum cost means the consumer can buy at the lowest possible cost of production.

Keep in mind that throughout this discussion we have assumed the presence of a large number of producers. Thus the
individual seller, much like the individual buyer, does not influence the price of goods by his sales. He produces such a small portion of the total output that none of his merchandise would sell were it to be priced above the average market price. Although it might be extremely rewarding for all sellers to collude in price fixing, the profitability of violation and the windfall gains it would produce makes the enforcement of collusion costly and difficult.

_The Supply Curve_

In Figure 9 we trace out the supply curve for any one producer. From his standpoint, prices are accepted as given since variations in his output have at best only a negligible influence on price. The individual supply curve is the firm's marginal cost curve. We already know that each firm will produce to the point where marginal cost equals price; this level of output is determined by the intersection of the demand curve (the fixed price confronting the seller) and the firm's marginal cost curve (the marginal cost over all prices).

Why does the supply curve slope upward to the right? This is because fixed costs are incurred in the short run whether the firm is closed or operating at any given moment. But an increase in price creates an incentive to increase output. To raise output the firm needs to bid resources away from other uses, thus raising its variable costs. Hence the supply curve slopes upward to the right, showing that marginal costs increase when output is raised.

Examine Figure 9. At a price of $4 per unit item, the point of production at which marginal cost equals price is 250 units. At $6 apiece, the quantity produced is 350 and 500 are produced when the price paid for each is $11. Thus increased output reveals increased marginal cost, as the upward sloping curve illustrates. This marginal cost curve thus determines each firm's output or its supply curve.

Earlier we obtained the total market demand by horizontally adding all of the individual demand schedules. Similarly, the total supply schedule of any industry is obtained by horizontally
adding the marginal cost curves of each of the respective firms. We will see in the next section how the intersection of the supply and demand curves establishes an equilibrium price.

The model of the rational producer is now complete. He is a producer who sets output at the level where marginal costs equal price, using the rule of minimum cost, where he obtains the maximum value of marginal product from each input of production. We have assumed the conditions of a highly competitive world for both consumers and producers; neither is able to have any impact on prices. By combining the rational producer with
the rational consumer, we are able to set forth a model of the perfectly competitive market.

The Marketplace

At the outset we gave an intuitive account of the marketplace: a place where goods and services produced in specialized activities are exchanged through a medium of exchange, most commonly money, subject to scarcity. Now we can sharpen that account using the "rational" producer and consumer. The former is a man or firm that seeks to minimize costs in production; the latter is a buyer who seeks to maximize utility, the subjective satisfaction derived from the purchase of a basket of goods.

The model we develop here is that of the perfectly competitive market. This is a model of an open rather than restricted or closed market: we postulate no legal or arbitrary barriers to market entry by any firm. Neither licensing, nor quotas, nor regulation of any sort restricts competition, that is, adversely affects the right of any producer to sell his wares in the marketplace. In this model we also postulate a large number of buyers and sellers: each take price as given and are unable to influence price by their choices. Neither joint producer action to collude nor joint consumer action to boycott are easy to enforce. We also postulate perfect knowledge among traders. In the perfectly competitive market no buyer pays more than any seller will accept, and no seller accepts less than any buyer will pay. Thus not only are prices taken as given, they are fully known to all traders as well. Additionally, it makes good sense to talk of product homogeneity. Here we really mean that the substitutability of many items for each other allows the large number of buyers and sellers to treat prices as fixed. If each product were unique, then the producer of it could restrict output and, in the absence of suitable substitutes, competition would not exist.

In the world of political choice unanimity is not required. A majority can impose a binding decision on everyone, including the minority opposition, backed up by the use or threat of government force. Market decisions, on the contrary, contain no
such coercive element. Rather, market exchange is voluntary ex-
change. The individual is out to maximize his own self-interest
or utility. He therefore contracts to exchange only if he sub-
jectively feels himself better off after the exchange, which is
directed by his personal valuation of the goods. Unless he feels
better off after exchange, there exist no gains from trade, and
hence no reasons for trade. Thus a unanimity principle is at
work in the marketplace. The allocation of goods after exchange
represents the sum of everyone's desires. No one in a free market is forced to buy or sell when he is made worse off. We thus characterize market decisions by two features: voluntariness and unanimity. Exchange implies a voluntary agreement between buyer and seller and no man is party to an exchange without his consent.

How is the equilibrium price for the goods of any industry determined in the market? Or, put another way, what is the "correct" output for the industry? Using the description of the perfectly competitive market outlined above, we can construct a graphical model of this equilibrium condition. (See Figure 10.)

The demand curve, obtained by horizontally summing all the individual demand schedules, is superimposed on the supply curve, also obtained by adding horizontally the marginal cost curves of each of the respective firms that comprise an industry. The point of intersection is the point where each consumer and producer simultaneously maximizes his gains, either utility from purchase or maximum revenues from lowest cost production.

The equilibrium price of this particular illustration is \( P_1 \), and the correct output, i.e., the level of output where marginal cost equals price, is \( o_0 \). For each consumer the price is the measure of the importance of an increment in the good: a demand price of \( P_1 \), says that the utility each consumer receives from a marginal unit of the good is not less than he can get elsewhere for that amount of money. The price \( P_1 \) is also the marginal cost of the resources needed to produce a marginal unit of the good. If price exceeds marginal cost, producers will expand output until marginal cost rises to equal price. If marginal cost exceeds price, production will decline until marginal cost falls to equal price. \( P_1 \), the price determined by the model of perfect competition, is an equilibrium price.

**Variations from Perfectly Competitive Markets**

Not all markets are perfectly competitive. Sometimes the assumptions of the perfectly competitive market are not met, and hence the marginal unit purchased may not equal the seller's
marginal cost. Also, the model of the perfectly competitive market excludes a number of real costs.

The first cost is that of information. The model assumes perfect knowledge among traders so that no buyer overpays nor any seller underprices. Clearly information in the real world is not free, and hence the price at which a marginal unit is purchased may not equal the seller's marginal cost. A second cost is that of negotiating and enforcing contracts and property rights. Anyone who has tried to collect on a bad debt can confirm that these costs are very real. A third cost is that of money. The model unrealistically assumes that the medium of exchange is costless.  

Often several assumptions of the perfectly competitive market are not met in reality. One frequently unsatisfied is that of large numbers, i.e., many buyers and many sellers. The words monopoly, monopsony, and oligopoly are familiar illustrations of this point. Monopoly and oligopoly signify respectively one seller and a few sellers (with many buyers) for whom competition does not exist to insure an equilibrium or competitive price. Monopsony is the reverse: here one buyer can pick and choose from many sellers. Each of these arrangements is a departure from the model of the perfectly competitive market.

A last variation which is discussed in the next chapter, stems from the existence of public goods, which create a problem of nonappropriability. Ghazali plants flowers around his mosque that Wong finds beautiful to look at. It is difficult for Ghazali to collect payment for this net gain to Wong's utility: he cannot appropriate the benefits of his labors. In this situation the market fails to provide adequate compensation. The presence of uncompensated costs or benefits causes overall social benefits to diverge from social costs, i.e., the marginal unit purchased no longer equals marginal cost. The next chapter develops this

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4 The standard response used to justify the inclusion of ostensibly unrealistic assumptions in a model is that one should judge the worth of assumptions by their implications, not by their purported "truth." Put another way, if the use of abstract simplifying assumptions facilitates accurate explanation and prediction, then their use seems warranted.
argument in detail and explores its implications for the economic behavior of governments.

Welfare Implications

A number of standards can be used for judging the performance of markets. Those most commonly employed—all normative—are allocative efficiency, equal distribution of income, stability of price levels and employment, growth, and personal security. Depending on the standard chosen, and the normative set of values that underlie it, different evaluations of market performance may be reached. For example, the norm of "allocative efficiency" leads one to praise the model of perfectly competitive markets while, conversely, the norm of equal distribution of wealth leads one to scorn it.

An intuitively pleasing standard frequently used to evaluate market performance is that of allocative efficiency, or "pareto-optimality." A market is pareto-optimal when it is impossible for anyone to become better off, without making at least one person worse off. Or conversely, an improvement in everyone's utility, or at least one person's, with no loss in anyone else's utility is seen to improve economic welfare. When no further improvements are possible without some corresponding loss in at least one person's utility, the market is at a pareto-optimal position where it is efficient in resource allocation.

This normative welfare criterion has the following properties: First, it assumes no interpersonal comparisons of utility since it is impossible in the absence of clairvoyance to know beforehand another's utility. The subjective notion of "better off" is only made public by market choice, when preferences are revealed. Secondly, this standard implies that each individual is a sovereign consumer; he alone is the best judge of his own welfare—a point many are prone to dispute, especially government officials, who are often paternalistic. The test of a beneficial change is consensus; a change that requires one individual to suffer a loss in utility is a sufficient condition for the violation of the pareto-optimality welfare criterion.
We have now arrived at the heart of "welfare" economics: a theorem that relates perfect competition and pareto-optimality or allocative efficiency. It asserts that perfectly competitive markets are allocatively efficient or pareto-optimal. In this market the marginal utility of any item to each consumer is equal to its marginal cost. Any departure from the perfectly competitive market, where resources may no longer be used at their maximum value of marginal product, causes a loss in efficiency.

For example, assume the existence of a market in which there are no stocks of wealth initially and note that an efficient allocation will determine a distribution of wealth according to the value of marginal products. A totally egalitarian society is not compatible with perfect competition unless the values of all marginal products are equal. Otherwise, equality requires discrimination.

Other normative standards may also be used to evaluate market performance. One may dislike perfectly competitive markets because they provide little personal security. Those employed in unproductive industries stand to lose their jobs when resources are shifted to other, more productive activities. The principles of economic growth and stability can also be invoked as normative criteria. Whether one likes perfectly competitive markets, however, depends on the personal utility one has for them. Or, to state the matter somewhat differently, it is one thing to say that competitive markets are efficient; it is another to say that outcomes are undesirable. The former is an analytical judgment; the latter a personal value judgment.

Models, Ethics, and Reality

Models, ethics, and reality are ontologically distinct. Using the model of perfect competition, one can criticize the real world for its market failures. Then, one can turn against the model of perfect competition because it implies inequitable distributions of wealth. Finally, one can criticize both the model and the reality it purports to describe from the standpoint of some other ideal standard or utopia. A model is a model, reality is reality,
and utopia is utopia. A critique of either of the first two must be logically or empirically based to be meaningful. An examination of reality must take into account things as they are, not as someone thinks they ought to be.

Selected References


It was comparatively easy to derive the equilibrium price that describes the perfectly competitive market. It is not so easy to derive the equilibrium conditions of the perfectly "good" government. What constitutes a good government depends on the values one seeks to maximize and the means chosen to do so. But all governments, regardless of their basis of organization, methods of selecting leaders, scope of authority, ideology, or other characteristics, are in the business of supplying such economic goods for their citizens as defense or roads. By focusing upon the economic activities of governments, therefore, we can avoid getting bogged down in the myriads of definitions and descriptions of governments. We can reason about the activities common to all governments and in a later chapter we will try to relate these to the conditions of racial harmony and conflict.

Is there a minimum number of activities that all governments undertake? Empirically, yes. We need merely observe that every government participates in one or more economic activities. Theoretically, the answer is not so clear. Opponents of any kind of government maintain that complete anarchy is both desirable and feasible. Proponents of all-powerful government insist that the good life can only be achieved under an all-embracing authority. Although neither economics nor political science has a monopoly on theory, between the two the framework of economics permits a more reasoned account of public activity.

Let us return to the model of the perfectly competitive market. If all the assumptions and conditions of this model are met, the resulting allocation of resources is said to be efficient, or to satisfy the paretian welfare criterion. However, we have yet to
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specify the conditions under which a perfectly competitive market can exist, wherein all economic activity is based on voluntary exchange. Milton Friedman has suggested several conditions: (1) the maintenance of law and order by government to prevent the coercion of one individual by another, (2) the enforcement of contracts voluntarily entered into, and (3) the definition of the meaning of property rights. The belief that laissez-faire cannot exist in a pure form because the market system could not function without contractual law is echoed by others as well. We thus have an economic justification for at least a minimum government: the maintenance of an institutional framework within which voluntary exchange can take place. Additionally, defense against foreign enemies that seek to destroy those markets is yet another public activity.

How much more government activity is desired depends on (1) the values that individuals want to maximize, and (2) how well (or poorly) purely competitive markets maximize those values. A minimum government seems best suited to maximize each individual's subjective economic freedom. A much larger government may be necessary to bring about an equal distribution of wealth. Keep in mind, though, that all welfare criteria, including the paretinian framework that the model of the perfectly competitive market satisfies, are arbitrary, hence personal and subjective. Nevertheless, we can evaluate the costs and benefits of different amounts and styles of public activity with the paretinian standard and show their effects on race relations. Therefore, let us turn to an exclusively economic interpretation of government.

1 I disagree with Friedman's fourth condition, the provision of a monetary framework. He fails to show that only governments can supply a monetary framework, or conversely, that markets must fail. (In fact, private banks supply the monetary framework in Hong Kong, though they are publicly regulated.) One might also quarrel with any of the other three conditions as well, but they create, if properly applied, an institutional framework in which markets can thrive. See Capitalism and Freedom (Chicago and London: University of Chicago Press, 1962), p. 27.

2 See, for example, Paul Craig Roberts, Alienation and the Soviet Economy (Albuquerque: University of New Mexico Press, 1971), p. 54.
A Theory of Racial Harmony

The Theory of Public Goods

The theory of public goods resembles in two ways the theory of perfectly competitive markets. First, each is developed with the same formal apparatus and secondly each is evaluated with the welfare criterion of pareto-optimality. Although many different topics have been raised in the large and growing literature on public goods, most fall into one of three categories:

1. the normative theory of public goods: a specification of the requirements for pareto-optimal provision of a public good;
2. the theory of market failure in public goods: no decentralized market mechanism can satisfy the pareto-optimal conditions for the provision of a public good, and
3. the political provision of public goods: what are the problems that governments face when they seek to correct market failures.

The first two comprise the welfare economics of public goods and the third the welfare politics of public goods.

This chapter is divided into three sections. The first outlines the characteristics of what we define as public goods. The second examines the economic justification for the state in its role of producer and supplier of public goods. The third lists the political problems which confront those governments that try

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4 The greater portion of the economic literature concerns the first two categories. Economists have shown that under certain logical (assumed) conditions the perfectly competitive, pareto-optimal market does not exist. Moreover, they suggest that government intervention theoretically corrects market failure, thereby increasing efficiency. But, they have yet to show that governments achieve in practice what economists achieve in theory. For these reasons, one finds a vast literature on "the anatomy of market failure" but only a correspondingly small, but growing, literature on "the anatomy of public failure."
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to improve on market performance; here we encounter "the anatomy of public failure."5

Characteristics of Public Goods

Let us begin with a simple example: the Army. For the sake of argument let us suppose that Ghazali, Wong and Ramasamy have just been conscripted into the Malaysian army in the face of an impending crisis. Threatened by invasion from abroad and domestic insurrection from within, the Malaysian Cabinet has taken measures to safeguard the national interest. The army is entrusted with the task of defending the nation's territorial integrity and preserving law and order. With luck and sound strategy, it will succeed.

Law and order, or defense from foreign invasion, is an economic good that is consumed, just like papaya and the transistor radio that are bought in the marketplace. But here the similarity ends. Unlike the papaya which is consumed uniquely by Wong upon his payment to the seller, the defense services, however produced and paid for, are consumed by all—even by those who successfully evade or cheat on their income taxes. There is, in the case of defense, no one-to-one relationship between buyer and seller in the marketplace. Rather, the Malaysian government provides the service for all its citizens and then taxes them to pay for it. This commodity, defense or maintenance of law and order, is perhaps the classic illustration of the "public good."

Another equally popular illustration is the lighthouse. Once built, its services can be supplied to additional consumers at zero additional cost. For this reason, the lighthouse is a commodity that the perfectly competitive market should be theoretically unable to supply. Once its light is turned on, the beams

5 I want to warn the reader that the debate about public goods, and who should provide them, has been controversial and often heated. It is not my intent to enjoin this debate. I hope, rather, to present an interpretation of public goods that most economists would accept and focus, instead, on the racial implications of this treatment in Chapter 5.
are available for the use of all navigators within range. Unless
the producer has some scrambling device or other barrier to the
use of the beam, there is no way to obtain compensation for this
service or to exclude nonpaying consumers. Even Soviet fishing
trawlers get the benefit of lighthouses in Maine!

We can abstract from these two examples the properties of
public goods. The first illustration, defense, suggests the notion
of jointness of supply: once a good is produced, it can be made
available to others at little or no extra cost. The product is in-
divisible; it cannot be divided up and sold on a unit-by-unit
basis to individual consumers. Neither Wong, Ghazali, nor
Ramasamy can each buy one unit of defense, or ten units should
each feel terribly insecure. Each is required to consume the en-
tire defense product. The second illustration, the lighthouse,
identifies what are termed externalities, or more precisely, ex-
ternal economies and diseconomies: those who produce exter-
nalities cannot obtain compensation in the market, nor does the
market properly impose costs. The lighthouse owner, whether a
private individual or a government, cannot collect from each
passing vessel that consumes his light beam. Alternatively, should
a vessel dump garbage in the ocean that is washed up on the
once beautiful private beach which the lighthouse owner uses
in his off duty hours, it will be difficult to collect cleaning costs
from the shipping firm. The former property, jointness of sup-
ply, suggests for some that governments can supply certain goods
more efficiently than private producers. The latter, externalities,
points out the difficulty of imposing costs or collecting compensa-
tion in the market for certain economic activities. Let us ex-
amine each of these in greater detail.

Jointness of Supply

The services of a public good are considered to be in joint
supply, that is, once a unit of the service is made available to

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6 For the original formulation see Paul Samuelson, "The Pure Theory of
1954): 387-9 and "Diagrammatic Exposition of a Theory of Public Ex-
penditure," Ibid. 37, 4 (November 1955): 350-6. For a critique of this
one individual, a service unit of the same quality can be made available to other individuals at no extra cost. It need not, as was originally thought and intensively disputed, require that the service be made available to all others in equal amounts—a concept of equal consumption; instead, for a product to have "public goods" characteristics, the service need only be made available to any other individual.

Some public goods have the property of being available for all, once produced for the use of just one individual. Examples include defense, the overall health of a nation, the symbolic and psychic rewards of putting a man on the moon, and a general nationwide condition of law and order. Other goods, however, are not available in equal units to everyone. Often constraints of area, technology, and time apply. Television waves, for example, are available only to those who live within the technological radius of reception. Baseball games, once produced, are limited by the seating capacity of the stadium. A bridge, once built, cannot handle an unlimited flow of cars during rush hour. However, radio waves, sporting events and engineering monuments possess public goods characteristics (like defense) until the effects of technology or congestion set in. At that point, the public goods characteristics of the item disappear—an identical quality service unit is no longer available to the next person at no extra cost.

Joint supply thus suggests that the decentralized market mechanism cannot efficiently allocate public goods. This is because efficiency, by definition, requires a set of marginal prices that sum to marginal cost. The nature of a public good, up to the point of congestion is such that two or more individuals


7 A footnote discussing the full meaning of jointness of supply as a characteristic of public goods would constitute a chapter of a book by itself. The reader is invited to examine many of the selected references that I list for this chapter.
consume identical units of it, once it is produced. Each person must, for instance, consume the entire Vietnam war equally with his fellow citizens, though their marginal utilities for it may differ. When individuals have differing marginal evaluations or tastes, a set of differential prices is required to achieve efficiency. No decentralized market can satisfy this requirement. The model of the perfectly competitive market, which satisfies the welfare criterion of pareto-optimality, cannot accommodate public goods.

Note that the failure of markets to allocate public goods efficiently does not mean that governments can allocate them efficiently. Until government provision of public goods is demonstrated to improve efficiency for the items in question, no a priori argument recommends for public and against private provision. Where the costs of exclusion are relatively low, the private marketing of public goods, though perhaps not maximally efficient, is certainly feasible: witness turnstiles at ball parks. A proof that markets fail to efficiently allocate public goods should not be construed as a guarantee that government provision will succeed. Very often the costs of government action may offset any gains in efficiency that might arise.

Externalities: External Economies and Diseconomies

Externalities are said to exist when costs are imposed on others that are not compensated (external diseconomies) or when benefits accrue to others for which no payment is received (external economies). Compensation cannot be obtained by nor can costs be imposed on the producers of externalities in the market; in short, there is no market for externalities.

Even Malaysians suffer from air pollution. Since it is impossible to establish a complete system of property rights to the ownership and use of air, how does Ghazali or Wong charge and collect from each passing motorist whose auto exhaust befoils his freshly laundered clothing? Can he individually bargain with each of them? Can he pay them a fee to alter their routes, assuming the winds are predictable? Agreements of this sort could not be reached through voluntary exchange in mar-
kets. Whenever there are imperfections in property titles, i.e., *scarcity is divorced from ownership*, externalities are likely to arise. Only the existence of a fully defined and enforced system of private property rights could permit a person who suffered costs to sue the producer of externalities and collect. But note: whether Ghazali could collect from Wong for the beauty his planted flowers transmit would make for a most interesting court case.

Another way of thinking about the problems of externalities is to examine the problem of excluding nonpayers. For some goods such as defense, healthful environment, living in an educated community whose citizens are allegedly less likely to engage in criminal pursuits, the psychic rewards of having a compatriot tread on the moon, it may be altogether impossible to exclude from consumption those who do not pay. Recall the notion of joint supply, a characteristic of public goods: once produced, the good can be supplied to additional persons at no extra cost. How can the Malaysian government, for example, defend Ghazali from an air raid, charging him for the protection by selling him a specified number of defense units, while simultaneously excluding Wong, who then is not billed at the end of the month? Under such an arrangement Wong will probably benefit at Ghazali’s expense. The *impossibility of exclusion* which characterizes a public good is simply an extreme case of an external economy: once the good is paid for and produced for one person, others can consume it at no cost. A perfectly competitive market will produce little or nothing of those goods which cannot be withheld from the nonpaying consumer. This condition, impossibility of exclusion, illustrates virtually complete market failure in public goods.

A variation on the theme of nonexcludability is the *impossibility of rejection*. Wong is forced to consume the entire defense budget of his government, though he would perhaps prefer less defense and lower taxes. He also consumes, if he lives in Kuala Lumpur, the National Museum, the National Mosque, and the King’s palace. Since these monuments honor Malay traditions, he probably would reject them all if they were mar-
ketable goods. This notion of nonrejectability is the basis for those goods we might call public *bads*. Although Wong can turn off his television when he dislikes the Malay oriented broadcasting, or stay home when the theater shows the latest in Malay drama, he has no choice in matters of defense. Impossibility of rejection becomes an extreme case of external diseconomies.

The presence of externalities does not automatically imply the impossibility of exclusion or rejection. In some cases it may be technologically feasible to exclude nonpayers, but it may cost more to exclude nonpayers than can be collected from them. A number of rock music festivals have recently been cancelled because it was not feasible to exclude those who wished to consume the music without charge. Open fields in the countryside are clearly less conducive to exclusion than athletic stadiums. Of course, the gate-busters might have been kept out, or forced to pay for the privilege of being deafened, if an adequate number of police had been hired, or if the rental fee for a municipal stadium had been paid. In the case of the Malaysian flower garden, Ghazali might have found it too expensive to keep records that counted the number of times Wong and others enjoyed the beauty his labor had produced, assuming a fair price could be reckoned.

The presence of external economies or diseconomies, in a sense the problem of the rights to property and appropriation for its uses, precludes market efficiency: markets cannot achieve pareto-optimality and therefore fail. Moreover, the joint supply characteristic of public goods requires differential pricing that markets cannot achieve. These two characteristics, joint supply and externalities, have caused some economists to suggest an economic role for the state: the production of public goods.

**The Production of Public Goods:**

*An Economic Justification of the State*[^8]

The alleged failure of markets to supply those items with public goods characteristics, jointness of supply and problems

of excludability, has led many to suggest an ever growing economic role for the state and a theory to explain its actions. They assert that not only is the perfectly competitive market unable to allocate efficiently those goods with public goods characteristics, it even fails to produce certain desired or needed goods altogether. Moreover, they insist that if a body of consumers has a strong preference for certain goods not supplied in the market, the provision of these goods by government would, on the face of it, seem to improve their welfare. Let us examine, then, the justification for state production of public goods.

A first and legitimate justification for the existence and economic activities of the state is the creation and maintenance of an institutional framework within which market exchange can flourish. The maintenance of law and order, the enforcement of contracts, and the definition of the meaning of property rights all seem to be legitimate activities of government. Additionally, defense against foreign enemies would stand high on everyone's list of desired government activities.

Two points can be made here. First, is government alone capable of providing the institutional framework for a market system? Presumably individuals could agree to set up an independent agency whose decisions they would accept over disputes of property titles and contracts, and hire their own private police to protect their rights to property. The problem with this arrangement is that difficulties would arise when the party to a contract with the strongest private police force disliked a decision handed down by an independent agency. Government, the agency with a monopoly on the legitimate use of coercion, would be in a stronger position to enforce the decisions of its arbiters, the courts. Intuitively, government, so long as it remains broadly supported and legitimate, seems better suited to maintain markets than an alternative set of individually agreed-upon arrangements that might be more difficult to enforce.

Secondly, is the government alone capable of marshalling the resources necessary to provide an adequate defense? The answer most frequently given is yes: only government can bear the necessary costs and cope with the problem of free-riders.
The cost of modern defense is large, so large that no private entrepreneur is likely to command the resources necessary to supply it in the market. Only government, with its coercive ability to tax, can pay the enormous costs associated with defense and also underwrite the costs of modern military research and technology.

The second aspect, the free-rider problem, is closely intertwined with the first. Since defense is a public good that, once produced for one person, can be supplied to others at no extra cost, there is a strong incentive for each consumer not to pay, since it is difficult to exclude nonpayers. The free-rider problem raises the general question as to whether any completely voluntaristic system of market-type arrangements can ensure an efficient provision of public goods.

Defense is clearly a common end, and it is in each person's self-interest to have an adequate defense against foreign enemies. However, once produced, no individual, not even the nonpayer, can be excluded from consuming it. Whatever amount of resources any one individual might voluntarily contribute for defense is so small that, for practical purposes, he is unable to notice the effect of his contribution on the supply. Thus, under a voluntary arrangement, no single individual has any strong incentive to contribute; if he avoids payment, he will still get by with some help from his friends.

The necessary conditions for the optimal provision of a public good, through completely voluntaristic actions, can be stated very simply. The marginal cost of additional units of the good must be shared in exactly the same proportion as the additional benefits. To repeat, every member of the group must share marginal costs in exactly the same proportion in which he shares marginal benefits. Only if this is done will each individual find that his own marginal costs and benefits are equal, at the same time that the total marginal cost equals the total marginal benefit. Though all of the members of the collectivity have a

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9 An excellent exposition of this concept is found in Mancur Olson, Jr., *The Logic of Collective Action* (Cambridge: Harvard University Press, 1965), Chapter I.
common interest in obtaining defense, they have no common interest in paying for it. Each would prefer that others bear the entire cost, since as a nonpayer he will receive the benefits in any case. The coercive power of government is needed to make these nonpayers contribute.

Another problem arises. Why should any one individual pay the organization costs involved in setting up the voluntaristic arrangements when he might expect someone else to do it for him, unless he gains enormously from it? It is not rational to voluntarily initiate action on an individual basis. Utility maximizing behavior does not dictate that voluntary action towards common ends be independently or privately taken. In a large community in which no single individual's contribution makes a perceptible difference to the group as a whole, no action will be taken to set up the arrangements whereby a public good might be voluntarily provided; instead, coercion is required or some outside inducements to lead the members of a large community to act in their common interest. The existence of organization costs further complicates the voluntary provision of an optimal supply of a public good.

Still a third complication is present. In addition to the organization costs in setting up a voluntaristic arrangement for the supply of public goods, there exist enormous bargaining costs. How difficult it is for 200 million Americans to bargain over the desired scope and price of public goods! It is not surprising that bargaining of this kind is made easier by delegating the authority to bargain to 535 members of Congress. But this is done through government. The bargaining costs for 200 million without some system of delegated authority are prohibitive; clearly the reduction in bargaining costs constitutes a justification for the state. The state has the power and authority to coerce each citizen into paying for the public goods he consumes, and in the process it immensely reduces the bargaining costs. Again, it is hard to imagine a voluntary system of delegated authority that

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can withstand an unhappy recipient of a decision who happens to possess the largest mob!

Not only does the establishment and maintenance of a government solve the bargaining cost problems in the provision of public goods, it also permits a reduction in the bargaining costs associated with multiple source externalities. If only one motorist were responsible for Southern California's smog problem, we could offer him a fee to cease driving. But how can we bargain with 20 million motorists—more than the number found in all of Asia and Eastern Europe put together? Clearly these costs would be prohibitive. Government enforcement of anti-smog legislation eliminates the overwhelming proportion of these bargaining costs. Nevertheless, there are situations where the number of multiple source externalities is small, and where bargaining costs may be less than the costs of governmentally imposed directives.

The potential existence of free-riders thus creates three problems: (1) under a voluntary arrangement, no individual has an incentive to pay for his share of public goods in the absence of the power to coerce that government commands, (2) no individual has an incentive to pay the organization costs in setting up the voluntary arrangements, and (3) once the voluntary arrangements are set up (if this could be done), the bargaining costs are prohibitive. Note that the tax system of the United States and most other countries does not depend on voluntary tax payments by its citizens, thereby suggesting that these problems are very real. In theory, governments are able to cope with these problems because they hold a monopoly on coercion: governments pay the organization costs of setting up a tax system, coerce citizens into paying the designated amount of taxes, and in the process reduce interpersonal bargaining costs to a manageable level. However, governmental provision of public goods is not necessarily either efficient or pareto-optimal, nor, therefore, does it invariably correct the failure of markets to supply these goods. All the theory of public goods claims is that the failure of markets can be attributed to problems of cost, technology and free-riders. Whether optimal provision of defense
is ever possible is an altogether different question! However, unless government uses its coercive powers to divert resources from the private sector into the production of such goods as defense, space exploration, and health, these goods may not be produced.

Additionally, two other justifications for the economic activities of government can be offered. The first concerns what we might term option demand.\(^{11}\) There are many services that consumers would like to be able to use in the future, but for which they are unwilling to commit current resources. Examples of these include hospitals, parks, universities, and trains. Though one may be healthy today, he may require the services of a surgeon tomorrow, and at that time he will be grateful that the hospital exists. When one's child approaches his late teens, a parent will also be grateful that universities exist, and, when air and freeway congestion become unbearable, he will be thankful for the railroads, for which he is presently unwilling to pay. It is difficult in the market to sell such stand-by options as hospitals, universities, and trains, and for that reason it has been suggested that the state should supply these goods. Note an interesting implication of this argument: revealed preferences do not adequately signal full demand. We cannot compute the prospective future consumer's valuation of any good until the option demand arises.

The other justification involves merit goods.\(^{12}\) Some individuals may possess distorted preferences caused by uncertainty or psychological irrationality. But welfare economics takes consumer preferences as given and on that basis identifies efficient allocation. Hence merit goods is somewhat of a departure from the tradition of welfare economics. We can define merit goods as those, due to imperfect knowledge, that individuals choose to consume too little; demerit goods are those like drugs or liquor


of which consumers take too much. Merit goods therefore imply the intervention of government which can reduce uncertainty and thereby correct distorted preferences, as well as care for the psychologically disturbed or immature. Moreover, it can encourage additional consumption of such goods as hot school lunches and education while discouraging drug use. The merit good approach entails activity by government to correct individual preferences; public policy is thereby justified. Bear in mind though, that a recognition of certain merit wants does not prove that the political mechanism can do better than the market mechanism in satisfying them.

To this point we have identified the characteristics of public goods, shown why markets are unable to achieve efficiency in the provision of them, and have enumerated several of the reasons offered for state intervention in economic activity. In the final section of this chapter we turn our attention to an examination of the problems that confront government when it tries to improve on market performance.

**The Anatomy of Public Failure**

Perfect competition is synonymous with efficient allocation, except for those items with public goods characteristics, wherein the model of perfectly competitive markets is said to fail; markets do not and cannot efficiently allocate public goods. Pareto-optimal provision of public goods demands that some means must be found to improve on market performance. The most suitable candidate is government, whose performance we now examine.

The self-interest axiom of market theory stipulates that individuals act in their own best interest. To claim that government corrects market failures is to postulate that government maximizes a social welfare function for the common good. But government is composed of individuals each of whom, if we are to be consistent, must also be concerned with maximizing his own welfare. It is inconsistent with the self-interest view of market

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13 See William A. Niskanen, Jr., *Bureaucracy and Representative Government* (Chicago & New York: Aldine-Atherton, 1971); Gordon Tullock, *The
behavior to suppose that a politically issued paycheck converts an economic individualist into an economic altruist. On the contrary, consistency would postulate that government employees are takers, not givers, with one distinct advantage: they need not earn a profit to stay in business. The coercive power to tax can offset the uneconomic adventures of government.

This view, that government is a taker and not a maximizer of the common good (whatever that means), creates a policing problem: who is to police the policeman? Who is to correct public failure? In democracies, the rascals may be voted out and a new group of social welfare maximizers voted in to correct market failures. Monitoring dictatorships is not quite so easy, but revolutionaries, when successful, can be expected to adjust welfare goals and then select appropriate means to maximize them.

Note here an important distinction between market failure in public goods and public failure in public goods. The former resides in the impersonal world of voluntary exchange; the latter in the direct and personal world of coercion. Which is to be preferred?

Let us examine more specifically the objectives of politicians and bureaucrats. The available evidence points to a concern for power, prestige, status, the building of empires, all characterized by an ever-growing control over the use of economic resources. When political parties, dictators or bureaucracies depart from the economist's welfare objectives of equity, efficiency or growth, how are they reconciled? How does one force public officials to maximize social welfare objectives instead of their own?

Moreover, the concept of a social welfare function is itself troublesome. Remember that groups and communities are nothing more than collections of individuals, each having unique preference orderings. One cannot talk of a correct individual preference, since taste is subjective, nor of a correct group utility

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function. To postulate a given welfare objective is not to say that it is correct, but only that it is preferred by someone. To say, therefore, that government maximizes a social welfare function requires, first, that it postulate the values to be maximized and then obtain unanimous approval; one disapproving vote—the refusal to buy—violates the optimality condition. Social welfare cannot be maximized when one or more individuals determine they are worse off after the implementation of public policy. Only unanimity implies "correct" group utility functions. In the absence of unanimity, political decisions impose externalities on those not in agreement—an illustration of public failure. For many, the political process in fact provides a means through which private gains may be secured at the expense of other citizens.

Forget for a moment that government is a community of takers. Instead consider the public official to be devoted to the common good. Even in this case government may fail in its attempts to improve on market performance.

First, government lacks the knowledge necessary for success. As more and more goods are publicly supplied by government at zero cost or below cost, the political use of these resources reduces the scope of market exchange in which prices signal preference and demand. In the absence of market signals, how do bureaucrats obtain information on consumer preferences and demand? How do they compute the value of foregone options? Information on citizen demand is scarce and very costly to obtain. It is difficult to transmit information about preference orderings of individuals and the technologies of firms to centralized government agencies. Decentralized decisions in the marketplace, on the other hand, make only minimal information demands. As public output increases, thereby reducing the opportunities for individuals to express market valuations, the loss of information becomes greater. For publicly supplied goods provided free of cost, the consumers do not get to vote with their money about the continued output of those items. Information of value is being sacrificed along with the value of the resources used in producing those goods. Even for those
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public goods where the marginal cost to an additional user is zero up to the point of congestion (e.g., bridges), price still serves two functions: (1) it raises the items to their most valuable use, and (2) it yields information about continued production of the items. If the government subsidizes a bridge, there is no way of knowing whether or not consumers value it more than alternative uses of the resources consumed in maintaining the subsidy. How does government compute the costs and benefits of alternatives when markets do not exist to provide information about most preferred use of resources? Virtually the only means are elections which fail to distinguish among the multitude of goods supplied.

Public administrative costs are a second source of public failure; government must consume resources enforcing its edicts. For a social move to be optimal, the costs of government must be less than the total social benefits gained. Although any specific public action may improve social welfare, the expanding and costly public sector intuitively supports the view that public costs are rising more rapidly than the private gains they are designed to realize.

A third source of public failure is the problem of distribution, whether to use marketing or nonmarketing techniques to supply public goods. Nonmarketing techniques often require arbitrary criteria: rationing on the basis of age, income, sex, color, region, influence, or first come-first served. Below cost user-charges must somehow be set—bridge tolls, public hospital fees, state-financed university tuition fees. Government must cope with queues and congestion for below cost goods when the amount consumers demand exceeds the quantity supplied. Some arbitrary bureaucratic device must perform the allocative role of price in markets when public goods are supplied at less than marginal cost. Moreover, in a large organization that does not sell its output

and does not have to compete in the capital market for equity funds, extensive delegation of authority is hazardous since there is no single measure resembling profits by which performance may be appraised. There is no direct competition with other organizations to exert continual pressure for efficiency.\textsuperscript{15} Distribution is especially important when race becomes one of the criteria used for allocating public goods (see Chapter 5). Until it is shown that the public distribution of a specific good is more efficient than private market allocation, i.e., the gains exceed the costs, there is no guarantee that government can improve on market performance.

Additionally, the problem of payment for publicly supplied goods remains. If one pays for a public good on the basis of the utility satisfaction he derives, one will be motivated to hide his true preferences and lead others to believe that he wants less of a public good than he \textit{really} wants. The adoption of such strategies by individuals means that it is not possible for government to devise a benefit system of taxation: it is better for the individual to understate his true preferences and free-ride on the correctly stated and taxed preferences of his more conscientious fellow citizens. Consequently, government will have to impose a nonbenefit system of taxation to pay for the public goods they supply; some individuals will thus overpay while others underpay.\textsuperscript{16} Voting and/or pressure groups are imperfect ways to reveal preferences for public goods. They are certainly imperfect ways to establish tax shares for them. We might term this inability of government to devise a benefit system of taxation the \textit{public failure in public goods}.

A fourth source of public failure, and one that economists discuss only with the greatest of reluctance, is that increased government use of economic resources represents a loss of liberty for each individual who no longer can choose his own private use of those resources given up through taxation. This definition


of liberty is economic: the freedom to use one's own resources as one chooses. Every dollar seized by government is a one-dollar loss in economic freedom.\textsuperscript{17}

\textbf{Summary}

It was suggested at the outset that each individual's preferred level of public activity depends on (1) the values he wants to maximize and (2) how well or poorly competitive markets maximize them. We next examined the theory of public goods, focusing on jointness of supply and externalities due to nonexcludability. These properties, we noted, give rise to an economic theory of the state: (1) the provision of goods that markets fail to supply for reasons of cost or technology; (2) the need to cope with free-riders who would emerge under any purely voluntaristic scheme for the provision of public goods; (3) the reduction of organizational and bargaining costs among large numbers of individuals in the effort to control external diseconomies; and (4) the provision of standby options and merit goods. These activities, we must note, are all additions to the state's minimal role of providing an institutional framework in which market exchange can flourish, \textit{viz.}, law and order, contract enforcement, and the definition of property rights.

It is one thing to demonstrate market failures in theory and another to demonstrate genuine improvement through government intervention; the latter can only be done on a case by case basis. Moreover, once government undertakes any economic action, we find that the anatomy of government reveals a public failure analogous to the theory of market failure: (1) government may decide to maximize its own welfare, not the common good (even granting that such a good could be accurately defined); (2) government lacks the knowledge necessary for suc-

\textsuperscript{17} An excellent discussion of economic freedom is found in Mancur Olson, Jr., op. cit., pp. 91–97. I attribute the general reluctance of economists to discuss freedom to the conceptual and measurement difficulties it poses. What does freedom mean? How is freedom measured? Although economists have not yet developed a metric that quantifies freedom, its loss is nonetheless very real because of an ever encroaching public sector!
cess, since, in the absence of markets and prices, information is scarce and costly; (3) administrative and policing costs often exceed the gains to be had from government intervention; (4) distribution problems complicate the efficient provision of public goods—rationing or other discriminatory criteria are often used that produce congestion when goods are supplied below marginal cost; (5) government is unable to devise an efficient benefit scheme of taxation; and (6) political use of private economic resources invariably gives rise to the expansion of arbitrary, uncontrollable bureaucracies, with a consequent loss of individual liberty.

In the next chapter we examine theoretically the state of race relations in a world of voluntary exchange and then turn in Chapter 5 to an analysis of what happens when government is introduced into the picture. Although it would be exciting to entertain the general conclusion that markets and their imperfections are better than governments and their imperfections, or vice-versa, I limit myself to asking if public intervention improves or harms the welfare of racial communities.

**Selected References**


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IV
MARKETS AND RACIAL HARMONY

Although I claim some measure of originality for the approach used in this book to study race relations, i.e., a political economy of race, a somewhat similar approach was once tried over thirty years ago. J. S. Furnivall, a British economist and colonial administrator in Burma, studied in and described the pre-World War II Netherlands Indies.¹ In this study Furnivall observed that the rulers and the ruled in that tropical dependency of the Netherlands were of different races and lived apart from one another in separate communities; he defined this arrangement as a plural society “comprising two or more elements or social orders which live side by side, yet without mingling, in one political unit.”²

Furnivall noted that the three major races in the Netherlands Indies—Indonesians, Chinese and Europeans—were culturally distinct and that each held values which were generally incompatible with those of the other two. The plural society, in his view, lacked a national cultural consensus that might provide an underlying basis for a range of legitimate public activity. To illustrate this point, Furnivall constructed the following example. The building of cathedrals, he noted, involves an expenditure of resources much like the purchase of groceries. In a racially homogeneous society, the building of a cathedral provides an indivisible public good, i.e., once produced, every citizen can benefit at zero marginal cost (up to the point of congestion). In the multiracial society, however, the publicly financed building of a Chinese temple involves an expenditure

¹ *Netherlands India* (Cambridge: The University Press, 1939).
² Ibid., p. 446. See also *Colonial Policy and Practice* (London: Cambridge University Press, 1948).
that provides no benefits for and in fact represents an opportunity cost to Indonesian Muslims or Christian Europeans. Thus the building of holy places is not a legitimate public activity in the multiracial environment since the separate communities have mutually incompatible demands for public action.

Given the racially distinct demands for public expenditure, there can be no common meeting ground in the public sector; the only common meeting ground is the marketplace. Why is this true? Although persons may differ culturally, Furnivall nonetheless insisted that each is similar in his economic wants insofar as each desires profit. In the absence of a national consensus, the only feasible mutual activity is economic competition. All other mutual social or political activities would be governed by the specific cultural values of the separate communities and probably would give rise to racial conflict. To prevent the values of any one community from being used as a guideline to govern the behavior of the others, their mutual relations must be impersonal and can only take place in a laissez-faire economic process in which the production of material goods is the prime end of social life. The multiracial state cannot be organized for social or normative "ethical" ends, since these differ according to the values of the respective communities.

Political movements, even in those colonies seeking independence from imperial overlords, would, according to Furnivall, end up setting race against race and thereby aggravate social instability. He hinted, indeed at times asserted openly, that external force would be required to prevent racial conflict and hold the multiracial society together. His prime candidate, though rarely acceptable today, was colonial rule.

Although Furnivall was incorrect in the short run—the leaders of the separate communities in multiracial colonies were able to set aside their differences in the cause of a nationalist struggle—he was correct in the long run. See Alvin Rabushka and Kenneth A. Shepsle, *Politics in Plural Societies: A Theory of Democratic Instability* (Columbus, Ohio: Charles E. Merrill, 1972), passim.

British reimposition of direct rule over Northern Ireland, ending a period of home rule exceeding fifty years, suggests that under exceptional circumstances colonial rule may again become fashionable. At this point,
Furnivall's conception of the plural (multiracial) society, introduced in 1939, has given rise to a voluminous literature most of which explored the prospects for stable democracy in the newly or soon-to-be independent multiracial society. However, this literature generally neglected Furnivall's discovery that the races could meet only in the marketplace buying and selling subject to scarcity. His thesis was clear: given the different values of the separate races, the likelihood that each race will try to impose its values over the others means that multiracial societies may be inherently prone to conflict when fighting over control of the public sector. Conflict can be avoided only by the maintenance of a laissez-faire exchange market economy and colonial rule.

Why was Furnivall's point missed for over thirty years? First, postwar intellectuals, whether in Britain or in the colonies, no longer supported the Empire and colonial rule and hence disapproved of his solution: the retention of colonial rule that could provide the institutional framework in which market exchange might thrive. Their aversion to colonial rule most likely led them to overlook the market exchange aspects of race relations. A second and perhaps equally important reason is that most analysts of multiracial societies were sociologists, anthropologists, and political scientists; the number of economists who have applied their skills to the analysis of multiracial environments is, as Becker has written, miniscule. As a result, market exchange in plural societies receives much less attention than such topics as kinship practices, social stratification, cultural practices, education, political parties, and bureaucracies. The disciplinary training of most social scientists predisposed them away from the investigation of economic exchange.

only Bermuda and Gibraltar, each multiracial, remain colonies and, we must note, have been less troubled with racial turmoil than most of those former colonies now independent.

5 This literature is reviewed in Rabushka and Shepsle, op. cit., Chapter 1.
The Logic of Racial Harmony

It is the assertion of this book that racial tensions and conflict are kept to a minimum under conditions of voluntary exchange in free markets. Or, from another standpoint, government intervention in or control over market activities harms racial minorities and exacerbates racial tension and conflict, especially when race is invoked as a political issue. What are the characteristics of market exchange that confirm this conclusion?

1. In free markets, the imposition of costs or the receiving of benefits is largely an individual, and impersonal, affair. Individual labor is rewarded or compensated on the basis of its marginal value of productivity, and the land or capital invested is similarly compensated on the basis of marginal value, rather than on the basis of racial identification. Compensation on the basis of marginal values of productivity is, in the author's opinion, the only equitable, and simultaneously, efficient method of payment. Any other method requires discrimination against productive persons and constitutes theft. Recall the key aspects of market exchange: voluntariness and unanimity. No rational individual voluntarily contracts to make himself worse off. Moreover, in free markets, no individual is coerced into choosing that which he does not wish to buy.

Obviously, an individual's marginal productivity and the overall present distribution of wealth is affected by cultural, genetic, political, or historical circumstances. Some individuals are less able to compete in the free market because they have low marginal productivity. Their lot, some scholars insist, will be wors-

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A Theory of Racial Harmony

ened by free market operations. Considerations of fairness thereby dictate a major compensatory role for government to aid those persons whose lower marginal productivity stems from prior nonmarket causes.

This recommendation poses several problems. Note first that the chief cause of low productivity among select communities has been and still is the nonmarket discrimination practiced by advantaged political majorities in such places as South Africa, Northern Ireland, and the post-Civil War American South. Why should we expect those who control and have used government to their own prior advantage suddenly to become magnanimous? Secondly, will government measures designed to improve the productivity of certain previously hampered groups succeed? The anatomy of public failure suggests the opposite. For example, the raising of the minimum wage rate in the United States, ostensibly to help poor Blacks, raised the unemployment rate of teenage Blacks from 8 percent to just over 20 percent in the mid-fifties. Since Blacks get less schooling on the average than Whites, they are less skilled. The minimum wage law is thus, in fact, an anti-Black measure. Finally, is it ethically correct to tax the present generation of competitively advantaged persons to compensate for prior political discrimination practiced decades ago over which the present generation had no control? Thus, government intervention to assist persons with low marginal productivity need not improve their welfare and may well contribute still further to a lowering of their present well-being in the multiracial society. (See Chapter 5).

Contrast market choice with various political choice devices such as national polls, elections, committees, or legislatures. Political choice, excepting dictatorship, entails a group decision such as a majority vote before an individual is allowed to consume. The group agreement required of political decisions precludes action from being taken individually. And, when we begin to think of individuals in terms of groups, race becomes a natural basis of political appeal and group voting. Political competition requires the aggregation of individuals into winning coalitions; markets do not. In addition, under all less than unan-
imous decisions, some minority will have views enforced upon it that are not its own. This element of coercion violates the Paretian welfare criterion; moreover, it invariably, sooner or later, takes on racial overtones.

2. Markets permit individuals to express intensity of preference. Depending on his resources, a person may consume a variable amount of any given item consonant with his utility for it. In politics, on the other hand, a voter generally has only one vote to cast (if he has any—and many do not) and cannot vary the intensity of his convictions by voting in different quantities on particular issues. Minorities thus have appropriate representation in the marketplace; the number of their votes is related to their proportional productivity. In politics, their votes may always comprise an inefficacious minority; they may be taxed to pay for the wishes of a racial majority receiving, in turn, no benefits of their own.

3. Economic power and choice in markets are distributed thinly among decision makers in most cases, unless wealth is extremely concentrated in a few hands. Each individual is as economically powerful as the amount of resources he commands. In politics, on the contrary, power is extremely concentrated and the power holders, be they dictators or majority assemblies, can forcibly reallocate resources even more to the self-interest of majority communities, without having to compete in the marketplace. Blacks in America, for instance, are often in a minority in any political unit and thus stand the likelihood of losing on political issues in which there is a direct confrontation of racial interests. Blacks have less experience in holding office and in the organizational skills necessary to gain and hold office. Except in those districts in which Blacks constitute a majority, a Black is unlikely to be nominated for political office. Moreover, since political power can be concentrated in the hands of a few political parties or groups, the range of market choice is

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often drastically reduced as a result of this political concentration of power and use of economic resources.

4. Free markets separate economic efficiency from other irrelevant characteristics. A businessman, entrepreneur, or a consumer who expresses preferences that are not related to cost or productive efficiency is at a disadvantage compared to other individuals who do not. These discriminating persons impose higher pecuniary costs on themselves when they discriminate, i.e., maximize some nonpecuniary aspect of utility, than other individuals who do not. The economic incentives of free markets encourage a maximum return on investment; those who choose to discriminate, and in the process fail to meet the competition, will ultimately be forced out of business, unless they can rely upon the power of government to protect them from competition or to enforce discriminatory social custom such as denying the use of hotel facilities to Blacks for fear of losing White customers. Governments, we must note, do not have to meet the competition to stay in business; they just dip into the taxpayer's pocket for their revenues.

The man who discriminates thus pays a price for so doing. The producer will ultimately fail to meet the competition and go out of business; the consumer will pay a higher price for the same goods. The economic incentives in *perfectly competitive markets* should cause these conditions to disappear over time. By and large, discrimination against groups of particular color or religion is least in those areas where there is the greatest freedom of competition.⁹

5. Note also the differences between private firms and government directed or regulated economic activities. In free markets, the right of entry is guaranteed and any individual, regardless of race, can begin production without fear of coercion or restraint, assuming the state performs its minimal tasks of maintaining law and order and protecting his property. The same is not true when government holds economic monopolies, espe-

⁹ See Demsetz, *op. cit.*
cially when the members of one race exclusively dictate public policy. Free entry is then often denied by government.

Additionally, government regulatory commissions, by virtue of their possessing a monopoly over prices, can allow prices to be raised to cover higher costs in regulated industries. One source of higher cost is employers who cater to nonpecuniary racial preferences by discriminating in favor of "their own kind," even though pampering these preferences is costly. A private firm that hires exclusively its own kind must pay the costs of foregone additional profits if its employees have below average marginal values of productivity. Thus, noncompetitive public firms have a distinct advantage over private firms: they can satisfy economic preferences and prejudice against political minorities without the cost of losing out to the competition. Clearly, the most effective market power is that which can be enforced by the police power of government.

But the most important of these characteristics of markets was the first, the fact that individuals and not groups are the key participants. Individuals benefit or lose on the basis of their own marginal values of productivity, not on the basis of a group property such as race. So long as all interpersonal interaction is confined to the marketplace, conflict is purely economic and between private individuals. But when conflict becomes public, the need to form winning coalitions, whether by ballots or by guns, converts communities of individuals into well defined groups: in the multiracial environment these invariably are synonymous with races. Political competition thus becomes racial competition for control over the power that government alone commands. The impersonal market is replaced by a directly coercive political relationship in which race, rather than marginal value of productivity, becomes the basis for resource allocation. This is inequitable and, as the next chapter shows, is illegitimate and unstable as well. In the multiracial society, all attempts to correct market failures by public activity must impose externalities on the race that loses the political competition. It is very unlikely that government in the multiracial
Society can intervene in the economy to correct market failures in a way that is favorable, in a pareto-optimal sense, to all races.

Some Evidence

Students of multiracial societies, in their own research, have sometimes professed bewilderment upon finding a marked difference between the political relationships among communities and all other social and economic relations. Consider, for example, Robert Kearney's description of Ceylon. "... the seeming paradox has existed of amicable relations among members of different communities [Sinhalese and Tamils], readily observable at the lowest levels of interaction in everyday lives of ordinary Ceylonese, at the same time that the communities appear to be locked in mortal struggle in the political sphere."¹⁰ More precisely, Kearney pinpoints the difference between coercive political relationships and those voluntary relations that occur in markets. "Communal competition appeared with the development of the political process and threatened to corrode the tolerant, if not intimate, social relationships which existed between communities."¹¹ In this description, Kearney identifies the harmonious social relationships that characterized Sinhalese-Tamil interaction during the early period of British colonial rule. Such harmony was perhaps only possible under the rule of a foreign colonial power that was regarded as neutral by both races. However, the introduction of competitive electoral politics by the colonial authorities converted the hitherto private economic conflict among Ceylonese individuals of all backgrounds into communal group conflict between Sinhalese and Tamils. Leaders of each community mobilized their supporters in order to win political power, thereby controlling the coercive authority of the state to allocate scarce economic resources. As the economic well-being of these two communities was increasingly affected by political activity, the political struggle between them in-

¹¹ Ibid., p. 40 (emphasis added).
tensified, thereby raising the level of racial tension and conflict. Kearney's observations are not unique. Ivar Oxaal, a perceptive student of Trinidad society, noted in his fine study that "color tended to diminish in actual importance in determining mobility as educational opportunity and achievement increased over the years." For darkskinned Trinidadians of both African and East Indian descent, who had previously lived under a color bar during much of British colonial rule, educational achievement and opportunity had increased the level of social integration as reflected in the growth of the voluntary associations across racial lines. However, politics has become increasingly a racial affair since 1956 with the advent of a new prize over which to fight: independence and its accompanying control over the public purse. As expected, racial voting steadily increased; as more and more economic resources in Trinidad came under political jurisdiction, race relations steadily deteriorated and racial tension and conflict became more prominent.

Note the important feature of Oxaal's results: at the very time that political discord erupted between Africans and East Indians, voluntary relations were improving. To the extent that interracial contacts were confined to market-type situations, racial harmony was fostered. When politics increasingly governed market exchange in those societies where racial issues became paramount, tension and conflict were heightened.

In a statistical examination of thirty-two African nations, Donald Morrison and Hugh Stevenson also concluded that centralization in the form of increasing government spending or taxing increases the likelihood of communal (racial) instability. More specifically, they found that greater control of the economy by central governments, as measured by the percentage of the wage labor force in public sector employment, increases the likelihood of racial instability. In our terms, government's


growing use of national resources converts private market competition among individuals into public group or racial conflict over the authority to allocate public sector jobs for the members of one's own race. As private sector employment declines relative to the growing job opportunities that government represents, economic survival becomes more a matter of seizing control of government than of investing time and energy to raise one's marginal productivity.

My own studies of Malayan race relations disclosed a similar pattern. Using several techniques to identify levels of social toleration and racial interaction, they showed that cultural or racial integration has been steadily increasing since independence in 1957, owing chiefly to the development and expansion of educational opportunities. However, political harmony among Malays, Chinese, and Indians virtually disappeared during that same period as political authority expanded and increased taxation caused a reallocation of wealth from Chinese to Malays. C. T. Edwards shows that by 1965 the public sector, which is controlled by Malays, had become responsible for 24 percent of gross national expenditure. This was more than double the share of total expenditure undertaken by government in 1950.

Present plans to extend further the level of government economic activity should raise the potential for racial conflict, especially as market alternatives are increasingly denied to the Chinese, for example, the Malay-dominated government in seeking to monopolize the distribution of imports from China, formerly in the hands of private business firms.

Similar practices adopted by Ceylon, Trinidad, numerous African nations, and Malaya all illustrate the difference between coercive political relationships and other noncoercive market relationships in societies where racial distinctions assume


importance. But these data do not exhaust the theory this book puts forth. Harold Demsetz, in his analysis of minorities in the marketplace, points to evidence which shows that the proportion of Jews employed in regulated industries and in highly concentrated industries is less than in other, more competitive industries. These regulated and concentrated industries can be expected not to maximize pecuniary profits due to fear of possible antitrust action. Personnel directors, then, are relatively free to discriminate in their hiring patterns in ways that would be uneconomic to the private, unregulated firm, i.e., they can hire persons with low marginal productivity but who otherwise possess desirable social traits. The data concern 352 Harvard MBA graduates selected on the basis of a random sample, of which 224 were non-Jewish and 128 Jewish. These graduates were then classified by ten industry categories: (1) agriculture, forestry, and fisheries, (2) mining, (3) construction, (4) transportation, communication, and other public utilities, (5) manufacturing, (6) wholesale and retail trade, (7) finance, insurance, and real estate, (8) business services, (9) amusement, recreation, and related services, and (10) professional and related services.

Categories (4) and (7) must be regarded as relatively monopolized. Therefore, if the hypothesis presented here is correct, the relative frequency of Jews in these two fields is lower than it is for all fields combined. The relative frequency of Jews in all fields taken together, in the entire sample, is 36 percent. These data show that the frequency of Jews—in all fields taken together, in the entire sample, is 36 percent. These data show that the frequency of Jews—74 MBA’s—in the two monopolized fields is less than 18 percent. If a sample of 352, of whom 36 percent are Jews, is assigned so that 74 are in monopolized and 278 in nonmonopolized fields, the probability that an assignment random with respect to religion will result in as few as 18 percent Jews in the monopolized fields (and over 41 percent in nonmonopolized fields) is less than 0.0005.  

16 Alchian and Kessel, op. cit., p. 171, quoted in Demsetz, op. cit., p. 287.
These data support the view that governmental regulation of profits appears to influence hiring patterns against the interest of social and political minorities.

An overview of multiracial polities discloses that a greater degree of racial harmony prevails in present British colonies or French overseas territories than in those former multiracial colonies now independent. Bermuda and the Bahamas, during its colonial period prior to independence on July 10, 1973, reflect an air of racial harmony so vividly absent from such former British possessions as Pakistan, where a civil war over ethnic issues led to the creation of Bangladesh; Nigeria, which witnessed an abortive Ibo secession movement; Kenya and Uganda, which both expelled massive Indian minorities, the latter having nationalized British interests as well; the Sudan, which underwent a fifteen-year North-South civil war between Arab and African; Cyprus, Zanzibar, Malaya, Ceylon, Burma, Trinidad, and Guyana, all of which have experienced severe interracial conflict.

Two factors encourage racial harmony in the still extant colonial states. The first is that the British still retain ultimate police authority as in Furnivall’s preferred arrangement. Although Whites, Blacks, or other ethnic political leaders may seek to mobilize their respective communities for political ends, none can win enough political power to significantly reduce the economic opportunities of the remaining communities. So long as individuals are afforded ample opportunity to compete in the private sector, there is no economic incentive for racial groups to organize to gain the political power that would be essential to their livelihood if the bulk of the economic opportunities were determined by government.

The second factor is that the still extant British colonies are, by and large, free port societies with low rates of personal taxation. Their resident populations flourish economically: per capita income in Bermuda and in the preindependent Bahamas is among the highest of all the so-called non-Western, non-industrial, underdeveloped nations. However, this favorable portrait of the Bahamas may change shortly. Following the
massive 1972 election victory for Lynden O. Pindling's predominantly Black Progressive Liberal party, Britain agreed to schedule independence for the Bahamas on 10 July 1973. Pindling's past policies, which include restricting the number of foreign workers, presage an even greater regulatory role for government in the economy. He campaigned for that island nation's top office on a platform that called for improving the economic welfare of native Bahamians. One reporter remarked that many whites feared the appeal of Pindling as having unspoken racial overtones in a land where there have been remarkably few racial tensions. If this chapter is correct, the tradition of racial harmony in the Bahamas may be the victim of Pindling's plan to implement a greater economic role for government.

Gibraltar, another British colony, also illustrates interracial cooperation and harmony. A long time resident and analyst of Gibraltar, John Stewart, suggests that Gibraltarians have much to teach the world about interracial goodwill. Once again, the same two factors apply. Gibraltar is governed by an economic policy of laissez-faire, famed for its free port low prices, which produces an exceptionally high standard of living for its residents. In addition, the British retain ultimate police authority and mutual fear of Spanish domination keeps Gibraltarians of all races united in a common cause.

It may be the case, of course, that racial harmony is possible only under the colonial ruling situation. Those societies in which the public economy is limited and the private economy

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allowed to handle resource allocation coincide, in large measure, with colonial rule. It is clear that the presence of colonial power can limit racial discord by acting neutrally between groups to enforce a free enterprise economy upon them. Colonial rule, then, might possibly be a necessary (though not sufficient) condition for a widespread free market, which, in turn, becomes a necessary condition for racial harmony—a position remarkably akin to Furnivall's postwar recommendation for reimposition of colonial rule throughout the empire. Tempers no doubt flare at the suggestion that nations should not be allowed to determine their own destiny, but the fact of relative racial tranquility in the still colonial societies cannot be denied. Nor can one fail to recognize that the few genuine laissez-faire, free market societies are these same colonies.

The present status of Surinam is revealing on this account. The Dutch acquired the country from the British in 1667 and immediately imported slave labor from Africa to work on the Dutch plantations. Slavery was abolished in 1863 and the Dutch brought in contract workers from India and Indonesia to replace the freed Blacks, who, having rejected farming as reminiscent of slavery, had moved into the city of Paramaribo in large numbers.

Immigration patterns thus produced the following racial mosaic: two-fifths of the population are East Indian, two-fifths Creole (African descent), and the remaining one-fifth Javanese (Indonesian). Creoles became urbanized and entered the civil service in disproportionate numbers. They exercised dominance over the Indians as a social and economic middle class. Through most of Surinam's history, they were a numerical majority as well.

The fact that Surinam is ruled as an integral part of the Tripartite Kingdom of the Netherlands kept the Creole majority from converting its numerical supremacy into political

hegemony. Today, the political leaders of the respective communities express attitudes consistent with the argument of this book. Political parties almost exclusively follow racial lines. The United Hindustani Party draws its support from the community of 430,000 East Indians; it wants the Dutch to stay despite the stated Dutch willingness to grant independence. High fertility rates among the East Indians have eliminated majority status for Creoles and the economic position of members of the East Indian community has improved dramatically under the presence of one thousand Dutch troops that give Surinam security against internal disorder.

The Creoles provide the membership and support for the National Progressive party. There is a growing movement among them to seek complete autonomy from the Netherlands, and many East Indians believe that the policy of separation is intended to give Creoles a free hand in opposing them. The East Indians in Surinam appear to have learned from the experiences of their fellow countryman living in Trinidad and Guyana where independence produced Creole (African) controlled governments that steadily encroached upon the economy, denying East Indians economic opportunity. Only continued Dutch presence is likely to forestall a similar fate for Surinamese Indians.

The recent political history of Malaysia and Singapore provides an appropriate note on which to conclude this chapter. Malaya received its independence in 1957. In August 1963, it was joined in a greater Malaysia that included Singapore and the former British Borneo territories of Sabah and Sarawak. This marriage was short-lived. Malaysia and Singapore parted company in August 1965 due to a growing Malay fear that Singapore's ambitious Lee Kuan-yew sought to increase Chinese control over the public sector. Given Chinese predominance in the private sector, these ambitions were totally unacceptable to Malay leaders; Singapore was thus expelled from Malaysia and forced to go it alone as an independent republic.

Initially many voiced the fear that Singapore would be unable to survive economically with its limited land and other
resources, given its high population density. These fears have been unfounded. Singapore's growth rate has exceeded that of Malaysia and her per capita incomes are almost double those of Malaysia, in spite of a 15 percent rate of unemployment. What is important for our purpose, however, is to note that relations between Singapore and Malaysia have steadily improved since the separation. The basis of these improved relations is entirely economic: trade between the two countries is voluntary market exchange. Previous fear of racial competition had strained Chinese-Malay political relations. The separation of politics (coercion) from markets has led to renewed cooperation. Political competition between Chinese and Malays in a broader Malaysia had brought the racial situation to an intolerable level of tension; the separation has permitted economic motives to prevail and relations between the two countries have improved.

**Selected References**


V
GOVERNMENT AND RACIAL CONFLICT

In this chapter we set aside the world of voluntary exchange and return to the world of politics and coercive relationships. Following the format of the previous chapter, we will explore the logic of racial conflict and elaborate upon problems that arise when governments supply public goods in multiracial settings.

The Logic of Racial Conflict

Chapter 3 argued that the model of the perfectly competitive market cannot incorporate for efficient allocation public goods, those items in joint supply, or cope with externalities. That the model of competitive markets does not accommodate the efficient allocation of public goods, therefore, provides a rationale for government to supply them, in part because only government commands the resources required for such expensive goods as defense, and also because only government can cope with potential free-riders who would hamper any purely voluntaristic scheme of supply.

Underlying the notion of state economic activity is the pre-existence of a national value consensus that would enable political leaders to determine the "correct" supply of public goods. The building of national cathedrals, national museums, na-

1 A large literature on the causes of racial conflict can be found in sociology, psychology, social psychology, etc. The welfare economics focus of this book is more narrow, but it allows us to theorize about conflict and harmony without becoming hopelessly enmeshed in a discussion of unique historical or cultural factors. In our view, these unique genetic or historical factors assume importance only insofar as they differentially affect marginal values of productivity.
tional universities, and national parks becomes possible only when there is large scale public demand for these goods.

But members of the separate racial communities possess markedly different values about the level of supply, or even the very provision, of certain public goods including police protection, education, swimming pools, opera companies, and television programming. Moreover, most people prefer that policemen, teachers, and legislators have racial backgrounds similar to their own. When the racial groups are concentrated in different ghetto-like neighborhoods, members of each group will seek different quantities and types of public goods, and, accordingly, different levels of taxation. When people are racially segregated by residential boundaries, a separate jurisdiction for each public good may be required. This would necessitate a multitude of separate government units, each run by members of a different race, a condition not often found in the multiracial society.

On the other hand, it has been argued that in the long run social unity may be increased by forcing different races to consume the same public goods. For example, in the hope of encouraging a sense of national unity, the Malaysian government has imposed Malay as the medium of instruction in all government-aided schools replacing the former option of Malay, Chinese, Tamil, or English. Such policies, however, invariably evoke intense hostility in the short run and are nearly always detrimental to social and political stability in the long run. It is common knowledge that different communities have different desires. Therefore, they do not demand equal consumption of all public goods. Chinese do not benefit equally with Malays from state provision of a national mosque.

It is, therefore, nearly impossible for government to insure equitable provision of public goods in the multiracial society. A fundamentally unalterable reason is that race constitutes an obvious and inflexible basis for exclusion from publicly supplied goods. For those goods available equally to every citizen in a society, such as defense, the psychic rewards of space exploration, public health, and contract enforcement, it is difficult for
government to discriminate against subgroups. However, many public goods facilitate discriminatory levels of service among subgroups: fire protection, crime prevention, highway and street construction and maintenance, flood control and drainage, education, waste removal, medical care, and services from cultural and recreational facilities. It is clear that public supply of these goods is *not* legitimate from the standpoint of those minorities who fail to receive a fair share, despite their being taxed to pay for them.²

It is easy to supply different levels of fire protection to racial minorities that are clustered geographically. We often hear that police display favoritism for certain races and that police protection varies from area to area. In fact, a lower level of crime prevention service for certain color groups is a criterion often followed in some communities, although it is scarcely ever explicit in laws or regulations. The fact that we possess little data describing the discriminatory racial distribution of government services testifies to government's social propensity to discriminate covertly in ways that are not tolerable in taxation. A pattern of racial discrimination from differential tax rates would be more obvious.

It is commonplace to observe poor street service maintained in slum areas, especially in those depressed ghetto neighborhoods through which other more affluent residents of a city do not frequently pass. The amount of education supplied per child by government also varies along racial lines. Since education is supplied free of charge by government, it can be arbitrarily distributed along racial lines, especially when this pattern of distribution helps maintain political power for those in authority.

Similarly, sewage, medical care, and cultural and recreational facilities can be rationed using racial criteria. Whenever tax financed goods are supplied free of charge, the amount de-

manded equals that which would be supplied at zero price. Excess demand is thereby created that the available supply cannot satisfy; hence, some arbitrary device for rationing must be found. In a multiracial society, race invariably is the most obvious and simple rationing criterion.

Exploitation by one group over another accounts for much of government's activity in many times and places. Such exploitative activity can be viewed as a means whereby one special group treats government as its own private producer of consumer goods, though paid for by all. Whenever goods are supplied below marginal cost, shortages develop that create queues and congestion. Some criterion other than willingness to pay must be invoked. In multiracial societies, the most salient characteristic is race, hence it is an obvious rationing criterion. Furthermore, increasing levels of government spending impair minority group freedom of choice by reducing through heavier taxes their ability to buy what they prefer in the marketplace.

Now we take the argument one step further. Distinctions that permit planned government discrimination against subgroups and those which do not, evaporate when race becomes the exclusive basis of political activity in the multiracial society. This change occurred in most of the world's newly created independent multiracial societies. Defense, the most basic public good, is almost invariably the prerogative of one racial group; in Guyana, for example, the army and police are virtually all African in composition. An International Commission of Jurists visiting Guyana in 1968 found that 73.5 percent of its police force was of African descent and only 19.9 percent of Indian background, even though Indians comprise a majority of all Guyanese. East Indians thus view the army and police forces as objects of domestic terror rather than as a source of protection against lawlessness or foreign enemies.

When legislatures and courts are monopolized by one race, law and order, contract enforcement, and protection of property very often benefit the ruling race and harm the politically disadvantaged races. An analysis of the racial composition of the police forces in twenty-six American central cities disclosed
that in all cases Blacks are vastly underrepresented at all ranks, and especially so at higher ranks. Small wonder that some Blacks question the legitimacy of disproportionately White police forces. East Indians in Trinidad do not consider African control over the public sector, the army, and the police as legitimate or desirable. Elsewhere, Chinese see Malay political and police authority as illegitimate, and the same is true for Catholics in Northern Ireland, Turks in Cyprus, Muslims in Zanzibar, Blacks in South Africa and Rhodesia, Tamils in Ceylon, and Indians (when there were some) in Uganda.

Thus, even basic public services that preclude planned government discrimination against subgroups are not equally and fairly consumed by all in the multiracial society because political power and the authority to allocate economic resources is, with rare exception, the private preserve of one race. Political power is used to exploit the property of political minority members. Almost without exception, therefore, public economic activity in the multiracial setting violates the requirement of nonexcludability. Accordingly, the economic rationale for the state to supply public goods, on the grounds that markets cannot supply them efficiently for reasons of nonexcludability, entirely disappears in the context of the multiracial society. This point cannot be overemphasized. Since the justification for state supply of public goods disappears, we should expect to find that the government is not accorded legitimacy by minorities that are subject to official discrimination. These communities are taxed to finance the police who, in turn, oppress and discriminate against them. This is not conducive to racial harmony as the recent history of about twenty multiracial societies documents.

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We also confront the problem of nonrejectability. Political minorities must consume such goods as national mosques and museums that exclusively reflect the values of the dominant community. This is an extreme case of external diseconomies; political action in the multiracial state, therefore, necessarily imposes external costs on racial minorities.

Government provision of public goods in the multiracial society insures public failure in public goods. Governmental interference with free markets or public provision of economic goods violates the conditions of nonexcludability and non-rejectability. These were initially the conditions inherent in market failure that government intervention is theoretically postulated to correct. But, in the multiracial society, governmental activity itself brings about those very conditions, thereby insuring public failure. The rationale for state action is invalid in the eyes of racial minorities, and from the standpoint of the theory of market failure as well. It becomes a basis that allows communities which have low marginal values of productivity to gain political control over the use of private economic resources. Or, alternatively those with high values of productivity to benefit themselves still further by control over the public purse.

Once members of a racial group accede to power, whether in the form of a junta, dictator, or popularly elected majority in a legislature, they normally proceed to redistribute wealth in their own favor, employ police and court authority to influence contract conditions for their own benefit, and create permanent privileges that deviate from perfect competition, again to their own benefit. Although state supply, even in a homogeneous society, precludes individual evaluations of goods and services due to an absence of markets and the price mechanism, which is in itself a cause of public failure in public goods, the problem is aggravated when the desires of racial minorities are openly flaunted.

Gary Becker neatly summarizes the actions of many governments that have effectively harmed minority communities.

The most important and pervasive influence on the employment of minorities has clearly been government action. Early in the twentieth century the government of South Africa already restricted the employment of blacks in mines—largely, it should be added, at the urging of the union of white miners. One need only note further the government harrassment of Chinese merchants in Indonesia and Southeast Asia, the expulsion of Indian merchants from parts of Africa, the confiscation of some property of Japanese Americans in the United States during World War II, the restrictions legislated against Negroes in various southern states, the limited amount of public education available to Jews in eastern Europe for several centuries, or the government-imposed Apartheid in South Africa.⁶

In an excellent study of South Africa, William H. Hutt argues that the development of a liberal economy by the English in South Africa would have prevented or ameliorated racial tensions. Hutt contends that the restrictionist policies arising from the racialist doctrines of the Nationalist Government and the efforts of the White Afrikaner workers to protect their privileged positions in the labor markets against Blacks would not have been possible had the economy been run on competitive lines. In short, White Afrikaner workers gained by legislating and enforcing restrictive labor opportunities on Blacks. This occurred because investors and managements were intimidated by politicians who wielded the coercive planning powers of the state.⁷

This theme is echoed by other analysts of South Africa. "The legislative history of much of South Africa (and of the post-bellum deep South) consists in attempts by higher priced white labor to ward off undercutting by cheaper groups, and to entrench its exclusive control of certain jobs."⁸

It is an informative exercise to list many of the measures enacted by the White Afrikaner government, to show how far members of one race are prepared to go to restrict competition in their own favor. Among the most important provisions are the Group Areas Act of 1950, amended in 1952, 1955, and 1957, which established segregated residential areas for each race. It restricts physical movement and area of residence, and places a significant bar on Indian as well as African economic opportunities. A variety of labor and educational legislation places all non-Whites at a serious disadvantage both in employment and in universities by prohibiting African workers from competing with Whites in many occupations and forbidding non-Whites from attending English speaking universities. A number of other laws give the government wide powers of perquisition, confiscation of property, banning of organizations, exile, extradition, arrest, and detention without trial. The most dramatic of these restrictive measures is the "pass laws" that require all adult African males to carry "reference books," thereby enabling the police to restrict African migration and keep control over the mass of Africans. Collectively, these measures protect White Afrikaners from the potential competition of Black labor.

Correspondingly, the economic position of the American Negro is attributable to White political discrimination, and not market discrimination. Carl Degler writes that "... the rising political power of the mass of whites is related to the development of local segregation. It is surely not accidental that the removal of Negroes from jobs in southern cities after 1830 coincides with the growing participation in politics by the ordinary white man." Following the abolition of slavery in the South, Degler notes that "... many Negro skilled workers lost their jobs or customers to whites, who used their political and social power to obtain the Negroes' jobs. As slaves Negroes had enjoyed the protection of their masters—out of self-interest, if nothing else—in their right to work as carpenters, coachmen, barbers, bricklayers, and so forth. As freedmen, however, they

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had few powerful friends and were often prevented from using the ballot for self-protection. Thus, using the powers of government, the ordinary White citizen was able to have his concerns about status and mobility translated into laws as well as practice.

Another recent publication confirms Degler's explanation. "Thus many one-time crusaders against slavery sat idly by or even collaborated in passing various laws which served to improve the economic position of Whites at the expense of Blacks. Licensure laws helped to squeeze Blacks out of some crafts. Educational restrictions helped to exclude them from others. Meanwhile taxation and fiscal policies were used to transfer income from Blacks to Whites, perhaps more effectively, certainly more elegantly, than had been possible under slavery."

Still yet another version of the same phenomenon.

... With the demise of these Bourbon regimes and the rise of Herrenvolk democracy in the South, a whole set of new mechanisms for the repression of Negroes was instituted. Among the first measures were a number of state laws aimed at nullifying the effect of the Fifteenth Amendment. Since Negroes could not be deprived of the right to vote on grounds of race, a whole battery of literacy and educational tests, poll taxes, 'white primaries,' and 'grandfather clauses' was developed to achieve the same result. In a few years the overwhelming mass of Southern Negroes had lost its franchise rights and was not to begin regaining them until after World War II. Indeed, we have yet fully to regain the achievements of Reconstruction in Negro voting and representation.

A further illustration is found in the work of Richard Freeman who reports that expenditures per enrolled child were

10 Ibid., p. 259.
Government and Racial Conflict

roughly the same for Blacks and Whites in the South until disenfranchisement of Blacks virtually eliminated their political power. White control of southern state and county governments led to a change in public school expenditures at the expense of Blacks during the disenfranchisement period. The \textit{loss of voting rights for Blacks} underlies reduced school expenditures for them. The lack of relative improvement in Black economic status from 1910 to 1940 does not reflect market discrimination; rather, the condition of low occupational advancement for Blacks reflects the politically enforced educational discrimination.\textsuperscript{13} Curiously, it was industrialization that reduced the relative expenditure differentials in education owing to the demand for more educated Black labor in industry.

All of these cases call into question the economic rationale for public economic activity: in the multiracial society the government itself (1) violates the requirement of nonexcludability, and (2) imposes external costs on minorities not in agreement with majority policy. When we re-examine the anatomy of public failure first presented in Chapter 3, we find that each cause of public failure is even more applicable in the multiracial setting.

1. Governments take resources from the public but use them to maximize their own welfare. In the multiracial society this means the welfare of the controlling racial group, not the "common good" of all the citizens.

2. Government lacks the knowledge necessary for success (to achieve efficient allocation of public goods) because information is scarce and costly in the absence of markets. But in multiracial societies, government is not even interested in obtaining this knowledge; rather, government openly disregards the preferences of racial minorities and forcibly oppresses minorities by the use of its police power.

3. Administrative and policing costs often exceed the gains to be had from government intervention. In the multiracial so-

ciety, political minorities bear the costs of administration and policing, receiving few or no benefits. Indeed, it is tragic that they are oppressed by the very group they finance.

4. Distribution problems prevent efficient provision of public goods. In the multiracial society, rationing criteria are almost exclusively racial; public goods thus become the private preserve of the politically advantaged community.

5. Government cannot devise an efficient benefit scheme of taxation. In the multiracial society, taxes are collected from members of all communities, but political minorities can be excluded from consuming all the public goods their funds pay for.

6. Liberty is lost when government consumes private economic resources. Its loss is all the greater from the standpoint of racial minorities, who forego their private resources via taxation and are then later excluded from consuming public goods on racial grounds.

A Critical Test

The theory put forth here may strike some as utopian, divorced from any real world considerations that might confirm or falsify its chief tenets. What, for example, would constitute a critical test? The following illustration may help. Consider the case of a multiracial society in which one race, politically dominant, uses its power to consume and allocate scarce resources for its own behalf. The claim advanced here is that a reduction in the scope of public activity, and a concomitantly greater dependence on markets, would promote racial harmony. But this same theory also posits that groups with low marginal values of productivity which fare poorly in competitive markets are motivated to seize and use political power to improve their material welfare. Or, that individuals with high marginal values of productivity will seek to further entrench their advantaged position by monopolizing political power. How, therefore, do we persuade those groups in control to reduce public activity, thereby expanding private exchange? The answer is intuitively
evident! Those who seize political power to offset a position of competitive disadvantage in the market, or to legalize a monopoly position, whether by historical, electoral, or violent means, have little incentive to surrender their power voluntarily in the interests of harmony; their cost may be a return to reduced compensation determined by low marginal values of productivity, or the loss of additional advantage.

A direct test of the theory seems on intuitive grounds, most likely to emerge in countries where the rulers also have higher average marginal values of productivity than the political minorities, e.g., Singapore and the United States. The former country relies chiefly on private enterprise and is, relatively speaking, racially harmonious. The Chinese are the dominant economic and political community. They comprise about 75 percent of the population and have a per capita income well in excess of the resident Malays and Indians. The Chinese thus have little to gain from legislating restrictions against the minority communities. Private enterprise in Singapore is conducive both to individual welfare and racial harmony. In this instance it is clearly not the presence of a neutral occupying (colonial) power that accounts for the comparative absence of racial discord.

The situation in the United States is less encouraging. Here Whites gain by excluding Blacks, which historically has been accomplished via White control over local and state governments. It seems unlikely that Whites will forego the economic advantages which control over government provides in the interests of racial harmony. The economic welfare of Blacks will suffer, in the long run, as public control and regulation increase. And, it is not in the self-interest of those working class Whites who have lower than average marginal productivity to surrender that control.

An evaluation of the theory put forth here, then, rests on two sets of data: multiracial societies that rely chiefly on market exchange, and those with substantial public economic activity. A list of the former includes Hong Kong, Singapore, Gibraltar, the Bahamas (until 1973), and Bermuda. A list of the latter
includes Cyprus, Nigeria, the Congo, Zanzibar, Kenya, Uganda, South Africa, Rhodesia, Northern Ireland, Belgium, Yugoslavia, Trinidad, Guyana, and increasingly Malaysia. Most, if not all, of this latter set have been the scene of extensive racial or ethnic conflict, ranging from chronic riots to full-scale civil war.

Selected References


VI
CONCLUSION

Let us briefly review the arguments advanced in this brief study. First, we saw that the model of the perfectly competitive market insures an efficient—pareto-optimal—allocation of resources, in which the marginal utility derived from the last dollar spent on any good equals its marginal cost. This is the beauty and heart of modern welfare economics: perfectly competitive markets satisfy the intuitively desirable Paretian welfare criterion. No individual is forced, in an efficient economic world, to consume that which he does not wish to buy.

Second, we qualified this model somewhat by examining goods that are in joint supply or individual economic behavior that generates externalities: this is the world of public goods. The model of perfectly competitive markets cannot accommodate public goods, hence, the state is called upon to assume an economic role. However, at no time has it been proven empirically that government is more efficient than private producers, or that government can and does allocate public goods according to the Paretian criterion of efficiency. On the contrary, in fact, a careful scrutiny of public economic activity uncovers what has been called “the anatomy of public failure.” Government may take from the private individual, will invariably impose administrative, information and policing costs upon him, and is likely to use arbitrary or politically attractive criteria for rationing goods, since the amount demanded will be that which would be desired at zero cost and thus exceed the public supply.

Third, we refocused on market exchange in the multiracial setting. What emerged from that inquiry was the importance accorded to the individual in a competitive market; individuals are compensated on the basis of their marginal values of pro-
ductivity. This appears to be the most equitable basis for payment since it varies directly with an individual’s productivity. Therefore, race does not become a salient concern in the marketplace; moreover, any consumer or producer who displays a desire to discriminate in the market pays a price for so doing. The consumer pays more for an identical quality service unit of any good while the producer will fail to meet the competition and ultimately be forced out of business, unless he is subsidized or compensated by government.

Finally, our analysis of the effect of government action in the multiracial society was both revealing and discouraging. Discouraging to those who believe that government has the capacity to achieve racial harmony. Revealing for all because it can now be clearly seen that government itself violates the conditions for efficient provision of public goods. Indeed, government officials, by conscious choice, exclude from consumption of public goods members of minorities or politically dispossessed communities, and government actions directly impose external costs upon minority community members who are not in agreement with majority policy. Only the marketplace, with its conditions of voluntary and unanimous exchange, can satisfy the efficiency criterion. Government in general does not and in the multiracial society cannot.

Hence, the closer any society approximates a purely competitive, laissez-faire economic community, the more likely are its different racial communities to live together in a condition of harmony. The more government intervenes in economic activity, whether at local, regional, or national levels, the more likely is racial tension, discord, and conflict to develop. This is the “positive” theory of racial harmony and conflict.

Now we remove our hat of “positive theory” and enter the world of “normative” thinking. Two policy implications immediately follow from the positive theory of race relations.

1. Those who desire racial harmony should support the development and expansion of a free market economy in which government’s role is restricted exclusively to providing the institutional framework within which market exchange can take
place, and to defend that market system from those who seek to
destroy it.

2. Or, those who seek to expand the role of the state, for
whatever reasons, and strive to reduce the freedom of choice
individuals possess in the private sector may, in the process,
aggravate racial tension and conflict in the multiracial society.

Is this theoretical solution to racial discord feasible or prac­
ticable in the modern world? Assume, for the moment, the
existence of a free market, multiracial society in which govern­
ment plays only the very limited role of providing both defense
and the institutional framework that permits orderly market
exchange. Now, what is to stop members of communities who
have, on the whole, low marginal values of productivity from
seizing control of the government by violent or peaceful means
and then rapidly increasing the economic and redistributive
activities of the public sector for their own self-serving interest?

It may just be the case, therefore, that racially harmonious
free market societies exist only where members of those com­
munities with high marginal values of productivity also control
the public sector, and do not need to use their political power to
seek additional material gain not secured in the marketplace,
e.g., Singapore. Or, that racially harmonious free market so­
cieties exist in those few remaining British multiracial colonies
where the colonial officials are relatively free from local, racially
motivated political pressures invariably found in independent
countries and, therefore, can enforce free markets upon the en­
tire society. It might be possible to maintain an image of racial
harmony by using the iron sledge of ruthless suppression, as
the Soviet Union has done, for example; but these societies do
not even begin to resemble free market economies or free
societies.

The example of Switzerland, an apparently harmonious, multi­
lingual country, suggests another possible solution—decentralization. For a series of unique historical reasons, Switzerland
is a highly decentralized polity that did not originate as a nation
state; instead, the Swiss Confederation grew out of a mutual
alliance of Swiss cantons in their common struggle against
feudal rulers and the German emperor. The confederation did not possess a constitution, central government, national army, or a capital city. Throughout Swiss history, the Swiss cantons retained a high degree of sovereign independence, even after the constitution of 1848 transformed the confederation into a modern federal state. The crucial fact about Switzerland is that eighteen of its twenty-two cantons are unilingual. Municipal and canton politics do not revolve around ethnic differences for most of the country. What is it that keeps language unimportant in national politics? "Based on the heritage of many centuries of sovereign independence, the Swiss Cantons retain today important political powers, and they remain sharply differentiated in customs, dialect and outlook. . . . regional and local variations still persist and the cantons remain viable political units as well as the focus of emotional loyalties. Specifically, all educational, religious, intellectual, and artistic matters remain subject to cantonal, not federal jurisdiction."1 In effect, canton governments provide the bulk of Swiss government-origin goods. And, since eighteen of the twenty-two cantons are unilingual, there is no ethnic basis for political competition to control the distribution of public goods that the canton governments produce in most of Switzerland.

However, in the multilingual canton of Berne, a long standing separatist movement among French speaking Bernese flared up in 1947. Concentrated in the Northern Jura section of Berne, French speaking Jurassians make up about one-seventh of the canton's population. When the German-majority in the Berne legislative assembly refused to ratify the appointment of a French speaking Jurassian to the important post of Director of Public Works and Railways—an office in the canton that bears a primary responsibility for the provision of government goods—a storm of protest was ignited which has since led to a separatist movement among Jurassians demanding the creation of a new Jura canton.

Even in tranquil Switzerland, the right to allocate publicly

supplied goods invokes ethnic quarrels in the multilingual canton. In the United States, by comparison, racial minorities are widely dispersed, and not regionally concentrated as in Switzerland. Decentralization of government need not, therefore, improve racial harmony in America—after all, it was local and state governments that first disenfranchised Blacks in the South. If the separate races were each uniquely concentrated into separate regions, then political decentralization could allow each group to determine its own preferred level of public output. This condition does not hold, thus the Swiss example is not applicable to the American experience.

But, on the view put forth in this book, the policy of growing public participation that has been advocated and followed by virtually all but a few governments in multiracial societies will steadily worsen rather than promote racial cooperation and goodwill. Market discrimination, however extensive, is invariably less harmful to minorities than political discrimination. Nevertheless, there remains the feasibility question: can governments be persuaded to reduce their economic role and expand the private sector? At this point it seems unlikely, but, if this theory of racial harmony is right, the future state of the world will be more wrong.
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A Theory of Racial Harmony

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Fifty-five-pound Warren's University Text, an acid-free paper noted for its longevity. The paper was expressly watermarked for the University of South Carolina Press with the Press colophon
Originality can be reasonably expected when a political scientist applies the tools of modern welfare economics to what is generally a subject for sociologists—namely, racial harmony and conflict. Professor Rabushka's conclusions do not disappoint. His thesis that "racial tensions and conflicts are kept to a minimum under conditions of voluntary exchange in free markets" undermines accepted theories and posits new guidelines for efforts to improve race relations throughout the world.

This study focuses on the extent to which the political use of economic resources affects race relations. Rabushka argues that in multiracial environments racial groups of individuals with low marginal values of productivity attempt to compensate by gaining public control over resources. Consequent governmental activities in effect convert private economic conflict among individuals in markets into group conflict between races: the greater the public use of resources to promote racial aims, the greater the likelihood of racial conflict. Hence, governments should be seen as a chief cause of racial conflict, not as a sponsor of racial harmony.

The alternative to state intervention rests with the creation of a purely competitive, laissez-faire economic community. Only in the marketplace is race minimized, for whoever discriminates must pay a price for so doing. In the multiracial society, competition in the marketplace erodes prejudice.