The economics of equal opportunity

*The **Deputy Governor** of the Bank, Howard Davies, reviews(1) the economic case for equal opportunity and examines the statistical evidence for discrimination in the British labour market. He argues that both economic theory and market logic are working in the right direction, but that there can be a case for targeted intervention by the public sector to overcome market failures.*

The debate about the economics of equal opportunity is fraught with received wisdom, on all sides.

In the reactionary corner, so to speak, there are employers who argue—nowadays rather quietly and behind closed doors—that an equal opportunity policy is bound to cost you money. Women, they say, have a tiresome habit of getting pregnant and having babies, a habit which, despite many technological advances, they find it difficult to shake off. Partly as a result they are less committed to the business in the long term, and the demands of the job often come second to the demands of the family. So they are less useful and flexible employees, and more expensive than the alternative—particularly if they get above themselves and start asking for employer assistance with the costs of childcare. You can also sometimes hear a related case made in relation to disabled people.

Similar, even less printable arguments are advanced on the ethnic minority front where assumptions about educational attainment and work ethic are made which make it look 'risky' to recruit extensively from ethnic minority communities. That is even disregarding more straightforward forms of racial prejudice, which are mercifully rare among employers, at least in my experience.

When it comes to age, the received wisdom is more openly heard. People say that older workers are sicker, more prone to absenteeism and less able to work in demanding jobs. They are less flexible, less adaptable and tiresomely set in their ways. The short work horizons ahead of them make it not worthwhile to invest heavily in their training. You just will not get the needed return on your outlay. And, anyway, older people should have made provision for their retirement; retirement which comes increasingly early. They should not need a job much after the age of 50. They should be digging the garden and revising their wills. Surely it is right, instead, to give youth a chance?

Most of us could make a reasonable stab at demolishing some of these preconceptions and prejudices. But the counterarguments are, I find, often collapsed into an alternative set of received wisdom, more acceptable round dinner tables in N1, but sometimes just as glib.

So the 'seconds' in the progressive corner maintain loftily that equal opportunity recruitment and retention practices are both good ethics and good business. The ethics bit, as they say, goes without saying and therefore isn't often said; the business argument gets an abbreviated outing. Any business which does not recruit a balanced workforce, so the case goes, is not making full use of the range of skills available in the labour market. That any whiff of discrimination in the workplace will damage employee morale across the business: staff of all shades, ages and sexes don't like it these days. And that businesses should wish to recruit a workforce which reflects the balance of its customer base. Only that way will they maximise their appeal to the total potential market.

I have, indeed, advanced such a case myself from time to time on CBI platforms to the evident approval of the assembled multitudes—though one might add that those multitudes are generally self-selected people who are interested in, and enthusiastic about equal opportunities.

Occasionally, as I put these points so, I asked myself just how persuaded I was of its validity. Are all employees quite so committed to increasing the intensity of competition for their jobs? Do all employers really need to tap every conceivable segment of the labour market? Surely at a time of high unemployment it is quite possible to get the people, with the skills you need without working terribly hard? And the unbalanced workforce good for pleasing customers bit? Fine in the hairdressers, perhaps, but do we all know, or care, about the composition of the workforce which assembled our car, or our washing machine? Or, indeed, in my own case, produced the Bank's monetary policy advice, or supervised Barings?

So, afflicted by these wholly non-PC doubts, I decided to go back to first principles in reviewing the economic case for equal opportunity. And I asked the economists at the Bank, an intellectually aggressive and unsentimental bunch of people for the most part, to review the arguments and give me an objective view of the strength of the economic case for equal opportunity policies.

Their response began uncompromisingly, and unpromisingly. 'Discrimination', I read 'is a desirable

(1) In a speech given at the Equal Opportunities Commission Conference on the Economics of Equal Opportunities on Monday, 20 May 1996.

activity for economic agents to engage in'. I began to wish I had not asked the question.

But things began to look up when the author explained that what was meant was discrimination in the sense of seeking to identify the skills and characteristics of the available workforce, in order best to match them to the needs of the job. Discrimination as used in common parlance, is a different matter altogether. Kenneth Arrow, a Nobel Prize winning economist who wrote 25 years ago on the theory of discrimination defined it as 'the valuation in the marketplace of personal characteristics of the worker that are unrelated to productivity'. A somewhat bloodless definition, you may think, but in fact a helpful one if the aim is to identify the economic impact—the costs and benefits—of restricting one's choice of employees, based on factors unrelated to aptitude and ability.

For economists, then, the relevant question becomes: if an employer includes other factors in the employment choice, whether based on gender, ethnic status or race, what should one expect the consequences to be? Some people talk about this in terms of the consequences of operating in segregated labour markets. The point is essentially the same.

To try to answer the question, let us take a fairly straightforward example. Suppose that an employer is, for whatever reason, prejudiced against women. Let us assume that this prejudice is not based on pure misogyny, but instead on some version of the argument advanced at the start. The employer believes that the output, the productivity of women, is lower than that of men.

In that case, the employer's response will, if he offers women jobs at all, be to offer them a lower wage. That is a commonsensical outcome, and one we have certainly seen occur in the real world.

Now, if we then assume that the prejudiced employer is wrong, and that the productivity of women is the same as men, or closer to men's than his wage differential suggests, then in only being prepared to pay a lower wage, he is leaving the field open to a competitor to pay more, attract the best women employees, and still undercut the employer who chooses only to employ men at the higher rate. In the end, if there is free entry into whatever market the employer is in, then prejudiced firms will be driven out and wages between men and women will be equalised since competition in the labour market should ensure that women's wages increase until they equal those of men.

This is fairly robust economic theory, and is at the heart of quite a lot of academic literature which maintains that discrimination is an irrational thing to do from an economic point of view. Of course, like many aspects of economic theory it assumes that the world is one in which perfect competition rules and, therefore, that prejudiced employers will be driven out of the market. But we know that the evidence suggests that discrimination between different groups of employees does persist, and is not necessarily removed by market forces.

Why might that be? There are a number of possible reasons. There are still monopolies, or near monopolies, which are in some sense protected from the laws of the market. Not too many at national level, these days, but still a number in local labour markets. There are also monopsonists—employers who are in effect almost the only significant purchasers of certain types of employee in a particular local labour market. There are also firms in which the external market plays a relatively small role in determining pay relativities within the company. They may offer long-term employment and career prospects to reduce their vulnerability to competition for their employees. In such circumstances differentials between men and women can persist for some time. And of course there are cultural stereotypes which push women into certain types of job.

There is also the development of two sorts of employment. Long-term, core employees on the one hand, and short-term or temporary workers on the other where the pay in the two sectors may be determined by rather different considerations. And, as we know, women are particularly significant in the second, if you like, secondary job market.

Lastly, there is the phenomenon known as statistical discrimination. Suppose it is true that, on average, the productivity of a particular group of workers is lower than that of another group. That might conceivably be the case for some ethnic minority groups in the United Kingdom, whose educational attainment, and training, is lower than the average. It might also be true of women. An employer might consider that he should pay in relation to the average productivity of that group. That means that those within it who have higher skills and higher productivity are significantly underpaid, because they are dragged down to the average. This may be rational for the employer; it is tough on the victim. And it is clearly an area in which the work of the Equal Opportunities Conference can be very valuable. They should be arguing for discrimination, in the economist's sense I talked of at the start.

So economic theory can take us a reasonable way in this area. It can show us that, theoretically, discrimination on grounds other than ability and productivity makes no sense and is likely to impose a cost on employers who practice it. At the extreme, they would be driven out of business. And theory also tells us why this does not necessarily happen. It therefore presents us with an interesting agenda of policies which ought, if rigorously pursued, to work against discrimination of the sort we wish to eradicate. We should be outlawing or regulating monopolies and monopsonies, whether national or local. We should be looking for measures which encourage employers to provide training for part-time workers, as well as core long-term employees. We should be trying to increase the employment choices available to people subject to discrimination. We should be trying to increase skill levels in particularly disadvantaged groups, and to offer women better childcare options.

I very much hope that the Commissioner, Padraig Flynn, makes these points strongly to his colleagues in the Commission in debates about opening up markets in

Europe, markets like energy and telecommunications which still remain closed. Market opening measures are likely to contribute to equal opportunities objectives, for the reasons our economists, through me, have explained today.

But before I finish, a few words about what the latest statistics show about discrimination in the British labour market.

Taking gender discrimination, first, the bald statistics suggest that women earn around 20% less than men, per hour of full-time work. On the other hand, they are less likely to be unemployed though almost twice as likely to be economically inactive. It is reasonable to suggest, however, that more of women's inactivity is voluntary than is men's.

It is fair to say, too, that some of the earnings differential can be explained by differences in skill levels or educational attainment. For example, although the proportion of women in the university population is now close to a half, in the workforce as a whole just under 10% of women have a degree, compared to over 14% of men. And, at the other extreme, 24.5% of women have no qualifications at all, compared to 17% of men. In quoting these figures, I do not mean to imply that we should be happy with them, merely that they may be part of the explanation for a continued earnings differential when average salaries in the economy as a whole are compared.

But even after making such adjustments it still seems that there is a residual element that cannot be explained in that way and can only be ascribed to continued discrimination—discrimination of the sort our economists disapprove of, not the sort they like. And of course, some of the lower attainment levels may be attributable not to free choice, but to what one might call pre-market discrimination, in that women may be channelled into jobs which offer less in the way of personal development opportunity.

The position of ethnic minorities is more complex. Looking at ethnic minorities as a whole, their wage rates are perhaps 8.3%, on average, below those of the white population. But their unemployment rate is significantly higher.

This average figure is, however, somewhat misleading since it conceals very different positions in the different types of ethnic community. Inactivity rates are particularly high among people of Pakistani or Bangladeshi origin (especially among women, for cultural and religious reasons), and particularly low among blacks. The educational attainment of people of Indian origin is higher than that of the average of the white population, though the community is more polarised in that both the percentage with degrees and the percentage with no qualification at all are higher than for the white population.

In these circumstances it is important to look at trends to try to understand what is going on. Until the last recession they were painting a slightly more optimistic picture, in that unemployment rates between the different ethnic communities in this country were gradually converging. By 1990 unemployment in the ethnic communities was 'only' one and two-thirds times the figure for whites.

Unfortunately, unemployment rates in ethnic communities have recently risen again relative to the rest and are now two and one-third times the rate for whites. The implications are not entirely clear. Perhaps, on average, people from ethnic communities were more recent employees, and some form of 'last in first out' rule was applying. But, whatever the reason, it would appear that the employment status of people from ethnic minorities remains more fragile and vulnerable than for the white population as a whole. That is a continuing source of concern.

The problem of age-based discrimination remains rather different in character. And the statistical analysis needed is also different. Unemployment declines with age and inactivity rises as people retire. So, while the unemployment rate for men and women at retirement age, (ie 59 for women and 64 for men) is only around 7%, the inactivity rate is 32%. Some of this inactivity is undoubtedly voluntary as people consider that they have adequately secured their future incomes and prefer to increase their leisure time or, perhaps, to spend more time in a caring role. But there is nonetheless some persuasive evidence of age discrimination. That is to be found in the duration of periods of unemployment among older workers. Although older workers are less likely to be unemployed than younger people, once they are unemployed they tend to experience longer periods out of work. So while 40% of the unemployed in their 20s and 30s are long-term unemployed that figure rises to 45% for workers in their 50s and 52% for people over 60. Once older workers become unemployed, they find it harder to get another job. And, indeed, some of what is categorised as early retirement should more properly be regarded as unemployment. The proportion of discouraged workers, in other words people who would like a job but who are not looking because they believe none are available for people like them, increases with age.

It seems likely, therefore, that employers are to some degree at least discriminating against older workers. They do appear to believe that older workers are more difficult to train, or that it is simply not worth doing so because of their short time left in the workforce. That, even though the average life of acquired skills has, by one measure, reduced by a half in the last 15 years, from 14 to 7 years. In other words, skilled workers need retraining every seven years now to keep them competitive and productive. That means the traditional calculations about the over 50s may need to be revised. And at the same time, of course, people are living longer, and more healthily, lengthening their potential participation time in the workforce.

I conclude, therefore, that there remains a considerable agenda for those who are committed to equal opportunities to pursue. My thesis is that both economic theory and market logic are working in the right direction and that market forces will, if they are properly supported, tend to deliver a positive outcome. But, that is not to say that there is no case for targeted intervention by the public sector to overcome the market failures which undoubtedly still exist. The market needs a lot of support to achieve a desirable outcome. I hope that, today, I have presented the beginnings of an agenda of such interventions, and provided a discriminating set of arguments to support it.