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WHY THE POOR PAY MORE: AN ALTERNATIVE EXPLANATION*

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AT NO TIME IN UNITED STATES HISTORY HAS THERE BEEN AS MUCH CONCERN over the plight of the poor as in the sixties. Part of this concern has been directed not only to poverty itself but to the way the poor are treated by the marketplace. Poor people *qua* consumers were brought into national focus by the research of Caplovitz,¹ and the wide scale civil disturbances of the last decade. Since that time, major government investigations and numerous articles have been written focusing attention on the low-income area marketplace.

One aspect of the literature on the plight of the low-income consumer has to do with the market for consumer durables and credit. Several authors, namely Sturdivant, Wilhelm, Hanselman and Kangun, have performed empirical analyses of the consumer durable market.² These articles conclude that the poor pay more as a result of their income status and, in addition, Sturdivant *et al.* conclude that the market problems of the low-income consumer, who is also a member of a minority group, are exacerbated by the racial preferences of merchants. The hypothesis presented to explain the behavior of the merchants is essentially the "exploitation" hypothesis, i.e., merchants use excessive markups and usurious interest charges to exercise economic and/or racial discrimination against the poor. The analysis and conclusions of these authors are worthless on at least two counts: (1) they fail to suggest a behavioral model of the observed merchant behavior, and (2) their analysis and conclusions fail to suggest effective policy measures to modify the behavior of the merchants.

Though discussion will focus mainly on the experiment and analysis done by Sturdivant *et al.*, the same criticism, in general, can be made about similar studies. Turning to the theoretical underpinning of their analysis several flaws appear. Sturdivant and Hanselman attempt to measure the effect of race on the total price (cash plus credit price) that people pay and suggest the following hypothesis: "Price discrimination occurs for the minority shopper when buying a major consumer durable and the discrim-

* The opinions expressed in this article are those of the author and do not necessarily represent the views of The Urban Institute.

¹ David Caplovitz, *The Poor Pay More* (New York: The Free Press, 1963).

² See Frederick D. Sturdivant and Walter T. Wilhelm, "Poverty, Minorities, and Consumer Exploitation," *Social Science Quarterly*, 49 (Dec. 1968), pp. 643-650; Frederick D. Sturdivant and William Hanselman, "Discrimination in the Marketplace: Another Dimension," *Social Science Quarterly*, 52 (Dec., 1971), pp. 625-630; Norman Kangun, "Race and Price Discrimination in the Market Place: A Further Study," *Mississippi Valley Journal of Business and Economics*, 5 (Spring, 1970), pp. 66-75.

ination is a function of racial affiliation.”³ Therefore, if the merchant charges a higher total price to a nonwhite shopper than that charged a white shopper for an identical item, the authors assert that racial preferences account for the merchant’s behavior.

To test this hypothesis, the authors carefully selected four couples, two black and two white. One couple from each race had a low income but identical credit profiles and similarly one couple from each race had higher income and identical credit profiles. The importance Sturdivant and Hanselman attach to controlling credit profiles is to control for risk differences.⁴ The authors admit that, “. . . differentials based on economic status are justified on the assumption that the merchant accepts a higher risk on non-payment in offering credit to low-income shoppers.”⁵ They assert that this issue is neutralized since the economic status of the couples is held constant.

The experiment design consisted of shopping trips by couples for a specified television set. The finding of the experiment was that merchants charged black couples higher credit prices than white couples. The study concluded that merchants use credit charges to discriminate against minority shoppers. The authors’ confidence that whatever differences in price charged the couples, since their creditworthiness was controlled, was due to non-sampling variation is unwarranted.⁶ It is just this point that will be taken up in the next few paragraphs.

The crucial theoretical weakness of the experiments done by Sturdivant and Hanselman, as well as similar studies, is the assumption that, since creditworthiness was controlled in the experiment, *creditworthiness played no role in the merchant’s behavior*. At this point explicit recognition of an important aspect of human behavior, often ignored, should be made. People do not base decisions on the true nature of things; instead, people base their decisions on what they perceive as the true nature of things. For example, an individual often runs when he hears a rustling in the bushes *not* because imminent danger is in fact, but he *perceives* or *translates* the rustling of the bushes as imminent danger. Decision-making made on the basis of incomplete information is a fact of life and must always be taken into account.

It is obvious to most of us that minorities, in general, face longer and more frequent unemployment, have higher residential mobility and lower income than the majority population; these are factors which influence the creditworthiness of a borrower. Thus the mere knowledge that a prospective borrower is a member of a minority group is enough information, at least to the Bayesians among us, to assign differential default probabili-

³ Sturdivant and Hanselman, “Discrimination in the Marketplace.”

⁴ Sturdivant and Hanselman differentiated couples by income to test another hypothesis as part of the experiment. See *Ibid.*, Table 1, p. 626.

⁵ *Ibid.*, p. 628.

⁶ The statistical validity of the experiment is questioned due to the very limited sample size. The findings may easily represent random variations that are neither racial nor determined by income.

ties based on the racial attributes of the customer. Therefore, given the appearance of black and white couples, who appear to the merchant to be a random sample of their ethnic groups, it is rational for the merchant to assign higher conditional probability of default to the black couples.

Such an expectation (or guess) and behavior based on the expectation is consistent with wealth-maximization behavior of merchants *independent* of the merchant's own personal feelings about particular ethnic groups. Having knowledge of the history of minorities in the United States, and no other information, one does not have to be "racist" to use race as an average indicator of some other variable (in Sturdivant and Hanselman's study: default probability) any more than he has to be a racist to assign a higher probability that a black or Mexican American randomly selected from society is poor or a high school drop-out. Race and ethnicity are correlated with many other factors and poverty and higher probability of default are among them.

Therefore, merchant behavior in the management of credit transactions is inextricably tied to the search for information and the cost of information. Information, like any other economic good requires that resources be sacrificed for its acquisition. The amount of resources sacrificed by the individual in the acquisition of information will, on the margin, be determined by information search costs and expected benefits from search. The utility maximizing individual will seek to economize resources allocated to information search.

There are many ways to economize on information cost. One way is to use physical attributes (cheaply observed attributes) as an average indicator of some other attribute (in the merchant's case, the probability of default). The very fact that a customer is a woman, a hippie, a criminal or a member of a minority is sufficient information, *on the average*, to make some statement about creditworthiness. While the indicator (individual attributes) may be sufficient on the average, it is by no means completely reliable for specific cases.⁷ For example, while life insurance companies know that, on the average, smoking will reduce the life expectancy of an individual five or more years, they in no way can predict the life of a *given* individual. Nonetheless, some life insurance companies charge lower premiums for non-smokers, i.e., "price discrimination against smokers." With such a policy they discriminate against those smokers who *ex post* live just as long and maybe longer than the non-smoker.

Thus an alternative hypothesis has been given for the merchant behavior observed by Sturdivant *et al.* That is, discrimination, on the basis of superficial (cheaply observed) attributes is consistent with the wealth-maximization model of merchant behavior. Furthermore, choice based on physical attributes implies *nothing* certain about the utility or disutility caused by

⁷ That the race of an individual customer is not a completely reliable predictor of credit worthiness is amply demonstrated by the shopping experiment. A more adequate test of merchant racial preferences would have been to formulate an experiment whereby the merchant had complete information on all couples.

these attributes. In other words, the fact that a merchant uses race as a crude proxy for creditworthiness or the fact that life insurance companies use smoking as a crude proxy for longevity says *nothing* about the merchant's personal feelings about Negroes or the life insurance company's personal feelings about people who smoke.

To argue that the merchant behavior described by Sturdivant and others may be rational economic behavior consistent with wealth-maximization does not constitute a commitment to or justification of the status quo. However, the discernment of behavioral relationships, as opposed to mere characterization, provides insight into the kinds of policy that will be effective in modifying aspects of merchant behavior.

All studies which argue that merchant exploitation accounts for observed differences between high- and low-income areas have a basic weakness. They fail to tell us how price differentials and what is implied—supra-normal profits—can persist in *open* markets.

An open market is a market where there are no legal barriers to entry. Closed markets are markets having entry barriers; examples are utility companies, medical practitioners, etc. A characteristic of open markets is that entry occurs whenever there are supra-normal profits—food stores and many other retailers are in this kind of market. Entry continues until all firms are earning “normal” profits. The source of supra-normal profits in ghettos, according to the critics of the ghetto market, is higher prices. However, entry into the ghetto market is not occurring. In fact, as every student of urban areas knows, *exit* of firms from the inner city is the case. This behavior, at the very least, seems to refute the exploitation hypothesis.

In the presence of higher cost circumstances, higher prices are consistent with “normal” or below normal rates of return. Indeed, the Federal Trade Commission's study of merchant practices in Washington, D. C., concluded:

It does not appear, however, that low-income market retailers made profits which were substantially higher on the average than general market retailers. The higher prices charged by low-income market retailers must have been accompanied in many instances by substantially higher costs arising from their method of doing business. Some of these costs probably arose from greater losses on credit sales. To some extent, costs may have been higher because of smaller volume and generally more costly and less efficient store operation.⁸

The realization that peculiarities of ghetto markets are a result of complex socioeconomic forces and merchant accommodative responses to customer attributes and the market conditions is very important for effective policy formulation. On the other hand, the identification of higher prices or higher credit costs as merchant exploitation is apt to lead to ineffective and perhaps harmful policy. For example, attributing higher prices and credit

⁸ U. S. Federal Trade Commission, *Economic Report on Installment Credit and Retail Sales Practices of District of Columbia Retailers* (Washington, D. C.: Government Printing Office, 1968), p. 21.

terms charged to Negro customers to merchant racial preferences seems to suggest that the remedy is to change the color of the merchants, cancel licenses or control prices. All of these measures are likely to be ineffective or injurious.

However, if merchant behavior observed by Sturdivant and others, in part, represents efforts to economize on information costs, then an effective government policy would be to lower information costs, i.e., subsidize credit information. Such a subsidy would take the form of reimbursement to the merchant for part or all of any costs associated with determining the creditworthiness of low-income customers. Under this program, it is inconceivable that the wealth-maximizing merchant would charge different credit terms solely on the basis of race. Nor would there be redistribution among the poor such as that occurring now. That is, the poor who do pay their bills transfer income to the poor who do not pay the bills to the extent that the merchant charges prices that account for some sort of average risk of non-payment.

Another cost related differential between high-income and low-income areas has to do with the differential crime rate. Crime costs, as a percent of total sales, is twice, sometimes thrice, that found elsewhere.⁹ This observation, often ignored by the critics of the low-income market, naturally suggests that consumer welfare in ghettos can be improved by increased resources toward property rights protection.

In conclusion, the first thing that researchers and policymakers must insure, when dealing with the problems of poverty, is that they do no harm. To insure against doing harm requires dispassionate analysis that avoids the mere characterization of behavior. This paper has offered an alternative hypothesis of merchant behavior that suggests effective policy measures.

⁹ Small Business Administration, *Crime Against Small Business*, Report, Transmitted to the Select Committee on Small Business, U. S. Senate (Washington, D. C.: Government Printing Office, 1969).