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“Acting White”

In the United States, the academic achievement of the average black child lags that of the average white child at kindergarten entry and the achievement difference grows throughout the school years. A typical black 17 year old reads at the same level as a typical white 13 year old. On the Scholastic Aptitude Test, the average black student scores more than a standard deviation below the average white student. Crafting effective public policies to address the achievement gap requires understanding its causes. Various possibilities have been advanced, including differences in family structure and poverty, differences in school quality, racial bias in testing or teachers’ perceptions, genetics, and differences in peer culture, socialization, or behavior.

In **An Empirical Analysis of “Acting White”** (NBER Working Paper No. 11334), co-authors **Roland Fryer** and **Paul Torelli** find that black and Hispanic students who earn high grades face social costs in terms of their popularity. Fryer and Torelli define “acting white” as any “statistically significant racial differences in the relationship between [student] popularity and grades.” Participants in student focus groups say that a number of behaviors are condemned as “acting white,” including enrollment in hon-

ors or advanced placement classes, speaking proper English, wearing the wrong clothes from the wrong stores, or wearing shorts in the winter.

To quantify “acting white,” the authors construct a popularity index using data from the Addhealth survey, a nationally representative sample of 90,118 students in grades 7 through 12 in the school year 1994-5. Addhealth interviewed the same students in 1995, 1996, and 2002. Along with collecting information on parental education, socioeco-

nomics, school characteristics, and grade point average, the survey asked students to list up to five friends of each sex, ordered from their best friends to more casual acquaintances. Fryer and Torelli’s popularity index assigns popularity to a student based the number of students who list them as a friend, weighted by the popularity of each student. The weighting scheme ensures that if two students (A and B) have the same number of people who list them as friends, then student A will have a higher popularity index if his friends are more popular, meaning that more people list

them as friends. The resulting popularity indexes demonstrate that “the relationship between social status and achievement is categorically different between racial groups, a difference that is robust to changes in specifications, data sub-samples, and definitions of social status or achievement.” At a GPA of roughly 2.5, racial differences begin to emerge, and Hispanic students lose popularity rapidly. Popularity peaks at a GPA of about 3.5 for black students. Whites continue to gain pop-

“Black and Hispanic students who earn high grades face social costs in terms of their popularity.”

ularity as their grades increase. The social cost of “acting white” is more severe for black males than for black females. It is larger for blacks in public schools, but nonexistent for blacks in private schools, “a finding that may partially explain why black kids in private schools do especially well.” Finally, the burden imposed for “acting white” is greater for students with more interracial contact. Blacks in more segregated schools “incur less of a trade-off between popularity and achievement.” The toll for “acting white” is “particularly salient among high achievers and those in schools with

them as friends. The resulting popularity indexes demonstrate that “the relationship between social status and achievement is categorically different between racial groups, a difference that is robust to changes in specifications, data sub-samples, and definitions of social status or achievement.” At a GPA of roughly 2.5, racial differences begin to emerge, and Hispanic students lose popularity rapidly. Popularity peaks at a GPA of about 3.5 for black students. Whites continue to gain pop-

more interracial contact.”

The authors find that two of the most common explanations for black underachievement — that white society holds talented blacks back so much that they develop coping devices that limit their striv-

ing for academic success, and that blacks sabotage their high achieving peers — fail to explain the fact that academically excellent students of all races retain their popularity at segregated and private schools. Fryer and Torelli conclude that the

patterns in their data accord best with a model in which investments in education are thought to be indicative of an individual’s opportunity costs of peer group loyalty.

— Linda Gorman

The Costs of International Capital Controls

During much of the 1990s it was widely accepted that countries would achieve greater economic growth if they relaxed their “capital controls,” a reference to various laws and regulations that restrict foreign investments in such areas as stock markets, banks and domestic firms. Then, in the late 1990s, the Asian financial crisis hit. And, it seemed that the countries that suffered the most were the ones whose laws recently had been changed to make it easier for foreign investors to move money into and out of their markets. In the aftermath of the crisis, conventional wisdom shifted to embrace a view that maybe some types of capital controls were not so bad after all.

NBER Research Associate **Kristin Forbes** argues, however, that a closer look reveals that capital controls have significant economic costs. She believes policymakers have become increasingly reluctant to criticize controls because they previously lacked clear evidence of their detrimental effects. In **The Microeconomic Evidence on Capital Controls: No Free Lunch** (NBER Working Paper No. 11372), Forbes reinvigorates the argument in favor of financial liberalization by drawing on an abundance of microeconomic analysis showing the many ways in which inhibiting the cross-border flow of money damages domestic economies.

Forbes said the problem with previous efforts to justify the lifting

of capital controls is that they looked for evidence of large effects on the entire country — a “macroeconomic” approach — rather than looking at a variety of “individual experiences and specific effects” or a “microeconomic approach.” So, instead of focusing on how capital controls affect entire economies, such as in their growth rates, Forbes

“These widespread effects of capital controls suggest that even though they may yield limited benefits in certain circumstances, they also have substantial and often unexpected economic costs,” Forbes concludes. “Capital controls are no free lunch.”

In fact, Forbes found that if there is a downside to lifting the

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looked for evidence of more discrete impacts, such as on certain types of companies or groups of investors.

What she found was a host of economic studies demonstrating the many ways that capital controls can weaken economies and how lifting them leads to substantial improvements. Forbes observes that, among other things, restricting foreign investment increases financing costs by reducing the amount of capital available to domestic firms. Controls also prompt corporations to engage in a variety of market-distorting behaviors designed to minimize the costs of the controls or to evade them altogether. In addition, capital controls encourage inefficiency by insulating markets from competition. And, they can be difficult and costly to enforce, even in countries with strong government institutions.

restrictions, it may be attributable to the perverse effect of the controls themselves. Liberalization can make life more difficult for companies that enjoyed preferential treatment under the old protectionist schemes or for companies that already had found various ways to evade the controls.

But liberalization appears to be a clear win for small companies. For example, Forbes points to a study finding that when publicly listed domestic firms become eligible for foreign ownership, their stock prices improve dramatically. She also cites evidence that lifting capital controls makes it much easier for small firms to get the investment they need to expand their operations. “This impact of capital controls on small firms can be particularly important for some emerging markets in which small and new firms are often important sources of job creation

and economic growth,” she writes.

Studies looking at the effect of capital controls in particular countries and at the company level also support the idea that they are bad for business. For example, capital controls enacted in Chile in the 1990s, often cited as protecting the country from the jarring impacts of globalization, had a considerable downside. Forbes points out that when capital controls were in place in Chile, smaller firms paid a steep price as the evidence indicates that “investment growth” flowing to small companies “plummeted.”

Capital controls also tend to skew corporate behavior in ways that ultimately stymie investment. One study found that as U.S.-based multinational firms try to avoid being penalized by capital controls, the net effect of such behavior is to shrink investments in foreign markets by 13 to 16 percent. Meanwhile, in Russia, capital controls have prompted domestic firms to embrace a variety of evasive tactics, such as creating fictitious enterprises and import contracts to disguise transactions, which, Forbes notes, have “increased corruption and lowered economic

efficiency.”

Forbes acknowledges that since this paper focuses “on individual experiences and/or specific effects of capital controls,” it’s fair to question whether her analysis can be the basis of a generalized argument in favor of financial market liberalization. But she considers the cumulative weight of the evidence to “present a series of convincing results on the effect of capital controls and the benefits from capital account liberalizations.”

— Matthew Davis

Why South African Incomes Declined

South Africans are worse off than they were before the end of apartheid, at least as measured by real incomes. In **Incomes in South Africa Since the Fall of Apartheid** (NBER Working Paper No. 11384), co-authors **Murray Leibbrandt, James Levinsohn, and Justin McCrary** document that decline and attempt to explain what has happened. They show that average incomes of South African men and women fell by about 40 percent between 1995 and 2000, and note that there has been little improvement since then. These researchers explore income patterns in the South African economy overall and in specific groups, such as men and women, older and younger workers, and whites and blacks. Their focus is on economic well being as measured by income, rather than on other ways of evaluating social welfare, including measurement of political freedom.

The change in income is most pronounced in the lower half of the income distribution and has disproportionately affected younger workers, women, and blacks. For men in

the bottom 5 percent of the income distribution, total real income in 2000 was about half the level of 1995. In the tenth through the seventy-fifth percentile, incomes were about one third lower than in 1995. For those in the top 10 percent, incomes declined by about one-seventh. For women, the results are very similar, although above the ninetieth percentile, women fare slightly better than men, with roughly constant real incomes. In 1995, white South African men were paid 98 percent more than black

sources, they show that rather than a change in the “endowments” of workers, such as education and skills, it was the change in returns on these endowments that provides the underlying explanation for declining income.

Skill-biased technical change is generally thought to have contributed to stagnation of real wages for lower skilled workers in other countries around the world in the past decade. But a 40 percent decline in real incomes in such a short span of time

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men. By 2000, this discrepancy had grown to 118 percent — a difference of 20 percentage points. Black and white women saw the analogous gap grow by 40 percentage points.

The decline in income may reflect a slack labor market and skill-biased technical change, the authors explain. Using a variety of statistical techniques and a range of data

is a highly unusual event. In South Africa’s case, the effect has been exacerbated by the economy’s poor economic performance and the large amount of slack in the labor market, which has put downward pressure on real wages. Unemployment was already high in South Africa in 1994. In 1995-2000, while the number of job seekers rose by 5-6 million, net

job creation was only in the range of 1.5 to 2 million. Labor, and particularly lower-skilled labor, has been entering the market faster than it could be absorbed, putting downward pressure on wages. Blacks have suffered because their education levels are lower following the discrimination of the apartheid era.

South Africa's reengagement with the world economy, after relative isolation during the period of anti-apartheid trade sanctions, may have added to the downward pressure on

the incomes of lower skilled workers. Younger workers — from 18 to their early 30s — and women have suffered because of lower skill levels and less-established positions in the workforce than older workers and men.

The researchers emphasize that, in spite of these plausible explanations, the drop in South African incomes is not fully understood. But there are some implausible explanations that they can dismiss. They include the notion that high-skilled

and high-earning white workers left the country after the African National Congress came to power in 1994, or that the data are somehow faulty. Nor was it the case that the most able workers were no longer among those reporting positive incomes. The controversial nature of the paper's claims emphasizes the need for more research to better understand the declines documented, the authors stress.

— Andrew Balls

The Happiness of Nations

Traditionally, economists and others measure a nation's progress and prosperity by looking at Gross Domestic Product (GDP), that is, the total output of good and services a country produces for its own inhabitants or for sale to other nations. There is a growing tendency, however, for economists to consider another measure, Gross National Happiness.

"For the wealthy countries of the world, though not the developing countries, our instinct is that it would be a mistake in the twenty-first century to focus excessively on ways to raise the level or growth rate of GDP," write **David Blanchflower** and **Andrew Oswald** in **Happiness and the Human Development Index: The Paradox of Australia** (NBER Working Paper No. 11416). "The industrialized countries should ... use a broader conception of well-being than the height of a pile of dollars." As economies get richer, they can afford to question the need for further riches. In a country where people are starving, economic growth remains regarded as a vital objective to overcome hunger and other poverty problems.

One of the best-known attempts to move away from a simple reliance

on GDP as a measure of welfare is the Human Development Index (HDI) of the United Nations. Published every year, the HDI is a score that amalgamates three indicators: lifespan, educational attainment, and adjusted real income.

In this paper, Blanchflower and Oswald question the soundness of this measure when the 2004 Human Development Report places Australia at third in the world, ahead of all the other English-speaking countries. The top-ten countries, in order according to that index, are: Norway, Sweden, Australia, Canada, Netherlands, Belgium, Iceland, United States, Japan, and Ireland.

The HDI, the authors note, is a mechanical criterion. "It does not capture the contentment or psycho-

incorrect. Rather, their stated goal is to improve upon the traditional narrow economic focus on real income and growth. In that regard, they draw on recent academic literature exploring the "economics of happiness," studies that make use of how people in different countries rate their own happiness or well being. The authors suspect that HDI data and subjective well-being data could play complementary roles.

Using new data on approximately 50,000 randomly sampled individuals from 35 nations in 2002, Blanchflower and Oswald show that Australians have some of the lowest levels of job satisfaction in the world. Only Japan, Taiwan, and six East European nations (including Russia) do worse in this regard.

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logical state of individuals," that is, their mental well being. "Emotion surely ought to play a role in a measure of human well being," they write. Their goal is not to establish that the HDI measure of human well being is

Moreover, in a sub-sample of English-speaking nations where the common language should help such subjective measures to be more reliable, Australia performs poorly on a range of four other happiness indi-

cators. The authors note that comparisons of people's answers regarding happiness in one country to answers to the same questions in another country is "probably hazardous" because of different languages and cultures that may cause biases in such happiness surveys.

In the "world league table" on happiness, Australia performs respectably in these four categories outside of job satisfaction. Ranking the 35 nations by all five categories, Australians place their happiness level at 5.39 on a scale that runs from a low of one to a high of seven, making it the twelfth happiest country in this sample. By comparison, Austria has a value of 5.54, Brazil 5.42, Switzerland 5.51, and the United States 5.52.

Happiness measures, Blanchflower and Oswald add, "can tell politicians and others how citizens value the different effects upon well-being of diverse influences such as

unemployment, the divorce rate, real income, friendship, traffic jams, crime, health, and much else. If we can learn to exploit the power of statistical happiness equations, it should be possible to make public policy choices in a more coherent way than before."

Some recent findings from statistical happiness research include the following, the authors note in their paper:

1. For a person, money does buy a reasonable amount of happiness. But it is useful to keep this in perspective. Very loosely, for the typical individual, a doubling of salary makes a lot less difference than life events like marriage.
2. Nations as a whole, at least in the West, do not seem to get happier as they get richer.
3. Happiness is U-shaped in age — that is, it falls off for a while, then stabilizes, and rises later in

life. Women report higher well-being than men. Two of the biggest negatives in life are unemployment and divorce. More educated people report higher levels of happiness, even after taking account of income.

4. At least in industrial countries such as France, Britain, and Australia, the structure of a happiness equation looks the same.
5. There is adaptation. Good and bad life events wear off — at least partially — as people get used to them.
6. Comparisons matter a great deal. Reported well being depends on a person's wage relative to an average or "comparison" wage. Wage inequality depresses reported happiness in a region or nation. But the effect is not large.

— David R. Francis

Bank Supervision and Corruption in Lending

Although banks provide a substantial proportion of external finance to enterprises around the globe, there had been no studies of whether international differences in bank supervision influence the obstacles that corporations face in raising external finance. International financial institutions — such as the Basel Committee, International Monetary Fund, and World Bank — promote the development of powerful bank supervisory agencies with the authority to monitor and discipline banks. Yet, there is no cross-country evidence to support these recommendations, nor is there evidence on the general question of which bank supervisory policies will facilitate efficient corporate finance.

In **Bank Supervision and**

Corruption in Lending (NBER Working Paper No. 11498), co-authors **Thorsten Beck, Asli Demirgüç-Kunt, and Ross Levine** provide the first assessment of the relationship between bank supervisory policies and the degree to which corruption in lending impedes the ability of firms to raise external finance. Three general theories of government regulation provide a natural framework for understanding the findings of the authors' research.

The first theory holds that strong official supervision of banks can improve their corporate governance. Known as the "supervisory power view," this theory holds that private agents frequently lack the incentives and capabilities to monitor powerful banks. It assumes that

governments have both the expertise and the incentives to ameliorate market imperfections and improve the governance of banks.

An alternative theory, the "political/regulatory capture view," argues that politicians and supervisors do not maximize social welfare; they instead maximize their own private welfare. Thus, if bank supervisory agencies have the power to discipline non-compliant banks, then politicians and supervisors may use this power to induce banks to divert the flow of credit to politically connected firms.

Finally, the "private empowerment view" argues that bank supervisory policies should focus on enhancing the ability and incentives of private agents to overcome information and transaction costs,

so that private investors can exert effective governance over banks.

The authors' data strongly refutes the view that powerful supervisory agencies with the authority to directly monitor and discipline banks can facilitate efficient corporate finance. Countries with stronger supervisory agencies tend to have firms that face greater obstacles to obtaining bank loans because of corrupt bank officials than firms in countries where the supervisory agency is less powerful.

The results provide some support for the political/regulatory capture view, which emphasizes that powerful supervisory agencies are prone to capture and manipulation by politicians, regulators, or both. Specifically, the authors find that powerful supervisory agencies tend to lower the integrity of bank lending. However, the authors caution that this conclusion needs to be tempered. Powerful supervision is so strongly correlated with poor national institutions (government ineffectiveness, the absence of the rule of law, high national corruption) that it is difficult to identify an

independent relationship between supervisory power and bank corruption when controlling for these institutional traits.

Finally, the authors' findings are consistent with the private monitoring view. In particular, bank super-

bureaucratic institutions.

The authors use firm-level data from the World Business Environmental Survey on more than 2,500 firms across 37 countries to examine the impact of bank supervision on the obstacles firms encounter in

“Bank supervisory strategies that focus on forcing accurate information disclosure and not distorting the incentives of private creditors to monitor banks facilitate efficient corporate finance.”

visory strategies that focus on forcing accurate information disclosure and not distorting the incentives of private creditors to monitor banks facilitate efficient corporate finance. These findings are consistent with approaches that simultaneously recognize that private agents face substantive information and enforcement costs when monitoring banks, while also recognizing that politicians and regulators will act in their own interests and not necessarily act to reduce market frictions. Private monitoring exerts a particularly beneficial effect on the integrity of bank lending in countries with sound legal and

raising external capital. As they point out, bank supervision clearly matters. Bank supervisory policies that ameliorate market failures by forcing the accurate disclosure of information reduce the obstacles that firms face in raising external finance. Active bank supervision can help ease information costs and improve the integrity of bank lending. However, the authors' findings suggest that powerful supervisory agencies too frequently do not act in the best interests of society.

— Les Picker

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