

# The NBER Digest

NATIONAL BUREAU OF ECONOMIC RESEARCH

September 2000

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## Mothers and Others: Who Invests in Children's Health?

**R**oughly half of all children in the United States grow up with at least one of their birth parents absent. Research has shown that these children tend to have more behavioral, academic, and social problems than other children. In **Mothers and Others: Who Invests in Children's Health?** (NBER Working Paper No. 7691), NBER Research Associates **Anne Case** and **Christina Paxson** investigate whether part of the reason these children face poorer outcomes is because parents invest less in them. They find that children living with stepmothers are significantly less likely to have routine doctor and dentist visits or to receive regular medical care, are less likely to wear seatbelts, and are significantly more likely to be living with a cigarette smoker in the household than other children.

The authors use data from the 1988 Child Health Supplement to the National Health Interview Survey to analyze family composition and

investments in children's healthcare. Children living with foster or adoptive mothers generally have similar experiences in these areas to children living with birth mothers. Also, the nature of the relationship of the child to the father has little effect on the health care investments made in the children. As a rule, fathers appear to know very little about their children's health or health investments.

When the authors control for household income and parental and

the health investments made by birth fathers raising their children alone.

The researchers identify two mechanisms that can mitigate these negative health investments: if the birth mother has regular contact with the child, the child is not less likely to visit the doctor and the dentist. Moreover, if the stepmother has children of her own living in the household, there is more likely to be a doctor's office or clinic that the stepmother can take her stepchild to, if the child is sick. These step children

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"Children living with stepmothers are significantly less likely to have routine doctor and dentist visits or to receive regular medical care and are less likely to wear seatbelts."

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household characteristics, they find that children living with stepmothers and birth fathers appear to be disadvantaged in terms of health investments and behaviors relative to children living with their birth mothers. There appears to be no difference between the health investments in children living with stepmothers and birth fathers as compared with

are still less likely to have been to the doctor or the dentist in the past year, but at least a place for their medical care has been identified.

In general, health investments in children are made by the birth mother. Stepmothers do not appear to be substitutes for birth mothers in this area of child rearing.

—Les Picker

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## Tax Policy Does Not Explain Option Growth

Since 1980, the cash component of CEO compensation has grown at an annual inflation-adjusted rate of 5 percent. The cash-plus-stock-option component has grown at a rate of almost 9 percent per year. The broadest measure of compensation, cash plus stock and stock option appreciation, has grown 11.5 percent per year.

The growth in CEO pay has been propelled by the increasing importance of stock options in executive compensation. Though inflation-

adjusted salary and bonuses nearly doubled, the mean value of stock option grants has increased by 683 percent since 1980.

pen- sation by about \$25,000, but will increase the value of stock and stock option holdings by \$1.25 million. In **The Taxation of Executive Compensation** (NBER Working Paper No. 7596), **Brian Hall** and **Jeffrey Liebman** look at a sample of top executives from the largest publicly traded U.S. firms to determine the importance of tax policy in fueling the overhaul of executive compensation. They note that in 1980, the top personal tax rate was 70 percent; it fell to 50 percent in 1982, and was cut to 28 percent in 1988 following the 1986 tax act.

in top marginal tax rates already has eroded more than half of that advantage. At present, the authors estimate, non-qualified stock options have a moderate tax advantage over cash compensation on the order of \$4 per \$100 of compensation.

Another explanation for the dramatic increase in incentive-based pay is the rise in importance of bottom-line oriented institutional investors. Poor shareholder returns in the 1970s were followed by a wave of corporate takeovers in the 1980s and the percentage of shares owned by large institutional investors rose from 20 percent to almost 50 percent by 1994. This paralleled the increasing importance of stock options in compensation packages.

To separate the effects of taxes from the effects of changes in corporate governance on compensation packages, Hall and Liebman add information on the size and composition of corporate boards of directors and on the share of the firm's stock owned by institutional investors to their data on compensation and tax rates. They conclude that the observable effect of tax policy was modest at best, and that the rise in importance of performance-based pay is primarily attributable to non-tax corporate governance factors.

— Linda Gorman

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“Though inflation-adjusted salary and bonuses nearly doubled, the mean value of stock option grants has increased by 683 percent since 1980.”

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adjusted salary and bonuses nearly doubled, the mean value of stock option grants has increased by 683 percent since 1980. For most top executives, the average stock option grant now exceeds salary and bonus combined. This implies that the link between CEO pay and firm performance is dominated by changes in the value of stock option holdings, not salary and bonus changes. For example, a 10 percent change in the value of a representative firm may change salary and bonus com-

including the 2.9 percent Medicare surcharge, the top personal rate has now risen to 42.5 percent.

The top corporate tax rate was 46 percent before the 1986 tax act, 34 percent after the cut, and was increased to 35 percent in 1993. The same 1993 tax law also prohibited companies from deducting executive compensation in excess of \$1 million unless it was performance related.

Although the 1986 Tax Reform Act sharply increased the tax advantage of stock options, the steady increase

## Tunneling Directs Profits to Controlling Shareholders

For people investing in emerging markets, incidents of corporate managers siphoning off profits and selling assets for personal gain may be considered part of the risk of doing business at the unbridled frontiers of modern capitalism. That individuals are not prosecuted for such brazen “expropriations” usually is attributed

to the fact that the country in question lacks a mature legal system. But what if this sort of behavior, far from being confined to the developing world, routinely occurs in certain developed countries and, furthermore, is essentially sanctioned by a solid, legitimate legal system? Would different laws protect investors from the self-serving interests of a company's controlling shareholders?

In **Tunneling** (NBER Working Paper No. 7523), authors **Simon Johnson**, **Rafael La Porta**, **Florencio Lopez-de-Silanes**, and **Andrei Shleifer** find that, even in developed countries, “the diversion of corporate resources from the corporation (or its minority shareholders) to the controlling shareholder can be substantial.” The title of their study refers to imagery of transition

economies in which corporate assets were spirited away as if through underground tunnels. The term is used by the authors “to describe the transfer of assets and profits out of firms for the benefit of those who control them.”

The authors show that in developed countries that follow the civil law (as opposed to common law) tradition — such as France, Belgium, Germany, and Italy — “tunneling” routinely occurs, not in spite of an evolved legal code governing corporate behavior, but because of it. Courts sanction such deeds “not through neglect or incompetence, but using specific legal logic.”

The authors note that in common law countries, such as the United States and the United Kingdom, laws protecting shareholder rights tend to focus on broad, basic principles, such as fairness, and to offer judges considerable discretion on whether some sort of disputed transaction illegally benefits majority shareholders. By contrast, the civil law coun-

tries are more rigid, emphasizing the “predictability” of their laws toward unscrupulous behaviors. This in turn “may invite (corporate) insiders to creatively structure unfair transactions so as to conform” simply to the “letter of the law.”

The authors point to a case in which a family that was the majority shareholder in one French company established a second company, solely owned by the family members, which then turned around a

family at the expense of other investors. The court’s only concern, the authors said, was that the warehouse seemed to have a “legitimate business purpose” and that it was not created solely to enrich the family.

Johnson et al point out that Germany’s Neuer Markt and France’s Nouveau Marché have succeeded because these civil law countries, through targeted legal reforms, attracted investment for new companies by offering greater protections

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leased warehouse space to the first company. When minority shareholders challenged the relationship, the French court dismissed their claim, showing “no interest” in whether the creation of the warehousing firm and the prices it charged for leasing space were intended to benefit the

to minority shareholders. “For less developed countries, including those that suffered from the Asian crisis, the failure of the legal system may be very costly precisely because it accommodates vast amounts of tunneling,” the authors conclude.

—Matthew Davis

## Do Controls on Capital Inflows Work?

**T**o prevent currency crises such as those that have rocked Asia, Russia, and Brazil, an increasing number of analysts, including experts at the World Bank and International Monetary Fund, have spoken out in favor of restricting capital mobility in emerging markets. **In Controls on Capital Inflow: Do They Work?** (NBER Working Paper 7645), **Jose De Gregorio, Sebastian Edwards,** and **Rodrigo Valdes** examine the efficacy of such controls. They focus their study on Chile, which maintained policies aimed at restricting capital mobility during most of the 1990s and which many analysts point to as the model

for other emerging economies.

Between 1987 and 1997 Chile’s gross domestic product grew in excess of 7.5 percent, inflation was reduced, and the real exchange rate for the peso appreciated on average between 4 and 5 percent. High domestic interest rates, however, attracted foreign funds that put pressure on money creation. In an environment of appreciating real exchange rates and a loss of monetary control, the Chilean authorities in 1991 introduced controls on capital inflow. These controls took the form of unremunerated reserve requirements (URR), essentially a tax or forced loan to Chile’s Central Bank.

This meant that anyone borrowing

money from abroad had to deposit a percentage of the loan in the bank in a non-interest bearing account. At first the deposits were fixed for 90 days, then for a full year. Over the decade the percentage of the loans was adjusted as high as 30 percent before it was reduced and eventually phased out. Other measures to control capital inflows were also attempted, but in their study De Gregorio, Edwards, and Valdes restrict themselves to the impact of the URR.

In the course of their analysis the authors employ a variety of methods, and also consider the interest rate-equivalent cost of the URR for both short- and long-run investment, the currency in which the loans are

denominated, and the impact of loopholes that periodically required adjustment of the URR policy. Bearing in mind that one of the main objectives of the URR was the reduction of the volume of capital coming into the country, the authors initially conclude from their analysis that the Chilean measures had an important effect on short-term capital inflows, but a much less significant effect

policy did result in a temporary if rather small increase in real (indexed) interest rates. This in turn had two consequences: the URR allowed the monetary authorities, at least in the short term, to target interest rates without generating a vicious circle of higher rates, increased inflows, sterilization, even higher rates, and even larger inflows. However, as a result of the URR,

the real exchange rate, but an earlier study they conducted indicated a small appreciation in the rate. More conclusive results, they say, will have to wait for longer time series, although they note that it is unknown at this time if Chile will reimpose capital controls.

Finally, the authors stress that the increase in the domestic cost of capital associated with higher interest rates is an important cost of the URR. Why, they ask, must firms borrow with a tax if the world is willing to lend cheaper? Additionally, since the URR penalizes more short-term credit, the yield curve tends to be inverted. Small firms, which cannot issue long-term bonds in international capital markets, have to borrow at interest rates higher than similar firms can do in other countries. This constitutes a bias, the authors say, against firms that cannot borrow long, which usually means small businesses or start-up operations.

— Matt Nesvisky

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“The increase in the domestic cost of capital associated with higher interest rates is an important cost of these capital controls.”

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on long-term capital inflows. Considering short-and long-term capital inflows together, the authors maintain that the URR had a significant impact on the composition of capital inflows, without affecting overall volume.

The authors then turn to other objectives of the URR, namely independent control of interest rates and of real exchange rates. By examining the data, De Gregorio, Edwards, and Valdes conclude that the URR

there was an increase in the cost of capital in the country.

Maintaining a stable real exchange rate was central to Chile's imposition of the URR, especially since the rate began appreciating substantially in the early 1990s. A reduction in the volume of capital inflows was expected to prevent further appreciation. The authors declare their analysis of the data in this regard is inconclusive. Their study indicates a slight and temporary depreciation in

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