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## Income Declines After Divorce

It is well known that two-parent families fare better financially than one-parent families. That is the reasoning behind the Bush Administration's recent proposal to Congress for \$300 million a year for counseling and other efforts to encourage and support marriage. However, it is not easy to measure the effects of family structure on the economic resources available to children. In **Will You Miss Me When I Am Gone? The Economic Consequences of Absent Parents** (NBER Working Paper No. 8786), authors **Marianne Page** and **Ann Huff Stevens** extend the work of earlier studies on this subject.

One major conclusion of their research is that the family income of children whose parents divorce and remain divorced for at least six years falls by 40 to 45 percent. Food consumption is also reduced by 17 percent. Families respond to the absence of a second parent in a variety of ways that help mitigate some of the costs, the authors note. In the case of children born to single parents who subsequently marry and remain married for at least six years, post-tax family income increases 50 percent and pre-tax income rises 57 percent. But there is no related increase in food consumption. This suggests that children's access to essentials, such as food, may be somewhat better protected than is assumed by focusing on income changes alone.

These different types of measures can be helpful for policymakers considering the skyrocketing number of single-parent families in the United States in the past 50 years. Between 1960 and 1995, the number of children living apart from one of their parents increased from 12 percent to

almost 40 percent, the rate of divorce increased by more than 200 percent, and the fraction of children born out of wedlock rose from about 5 percent to more than 30 percent. Half of all American children today are expected to spend part of their childhood in a family headed by a mother who is divorced, separated, unwed, or widowed.

In the past, studies simply compared the average income among two-parent families to the average income of single-parent families. The wide differences that were observed prompted calls for societal and legal changes to strengthen marriage.

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Some states, including Arizona, Arkansas, and Louisiana, created optional “covenant marriages” that make it harder for couples to divorce. Three quarters of the U.S. states broadened the eligibility for welfare to include two-parent families with Temporary Assistance to Needy Families (TANF); the former welfare program, Aid to Families with Dependent Children, was targeted primarily toward single-parent families. In the wake of TANF, which places a five-year lifetime limit on welfare benefits and requires that participants become members of the labor force within two years of initiating benefits, understanding the relationship between income and family structure factors is particularly important.

But Page and Stevens note that these previous studies — “cross-sectional

comparisons” of family types — are unable to tell us how much of the observed gap in income is actually caused by the absence of a second parent. Other factors may be partly responsible for the income variation. So Page and Stevens use a “dynamic model” that takes into account the usual tendency for family income to grow as parents move up the job ladder; it also incorporates changes in family status over time. (For example, children whose parents divorce may experience a short-term income reduction that is recouped in later years when their mothers remarry or become more

active in the labor market.)

The estimates based on cross-sectional income comparisons that have been presented in other studies are almost 1.8 times bigger than the true losses associated with living in a single-parent family, Page and Stevens find. Similarly, their estimates of the effects of divorce are only 60 to 80 percent as large as estimates based on cross-sectional regressions. Furthermore, divorced parents often remarry. This means that in the years after an initial divorce, income losses average 15 to 20 percent (compared to losses of 40 to 50 percent among those who remain unmarried). Similarly, the typical increase in family income for a child born out of wedlock whose parent marries (28-33 percent) is smaller than the predicted improvement for the child whose parent marries and then stays married (50 to 57 percent).

That's because many of these marriages do not last.

Overall, the authors find that the family-income costs associated with growing up in single-parent families are not temporary, but largely persist until a marriage or remarriage occurs.

These findings, they note, have important implications for public policy. "Time limits recently imposed as part of welfare reform, for example, could result in substantive reductions in the economic well-being of children living in single-parent families." Further,

if family income does play an important role in determining a child's later success in life, then "policies that encourage two-parent families may be justified."

— David R. Francis

## Globalization Reduces Child Labor in Vietnam

In the ongoing debate about the wisdom of deliberately seeking a globalized marketplace, a recurring criticism is that for poor developing countries, integration inevitably will lead to an increase in child labor. The argument holds that globalization, by boosting demands for cheap exports from poor countries, provides an incentive for children to enter the workplace by either increasing their wages or expanding opportunities for their employment.

Yet in **Does Globalization Increase Child Labor? Evidence from Vietnam** (NBER Working Paper No. 8760), authors **Eric Edmonds** and **Nina Pavcnik** show that globalization in fact may be having the opposite effect. They conclude that Vietnam's efforts to become a significant player in global rice markets are linked directly to a decrease in child labor. Furthermore, their findings suggest that using trade sanctions to combat child labor in developing countries could be counter-productive.

Edmonds and Pavcnik focus on the impact of Vietnam's decision in 1993 to begin lifting export restrictions that, in the interest of domestic food security and suppressing domestic prices, had constrained the ability of rice farmers to sell their crop abroad. This liberalization allowed Vietnamese rice exports to more than double between 1993 and 1998, with the demand from global markets contributing to a 30 percent rise in the price of Vietnamese rice.

Given that so many Vietnamese households are involved in rice production, rather than inducing more parents to put their children to work,

the extra income produced by the price increase appears to have provided them with the means to take them off the job. Edmonds and Pavcnik discovered that a 30 percent increase in the price of rice was associated with a 9 percent drop in child labor. Overall, the authors note that between 1993 and 1998, 2.2 million children stopped working in Vietnam. They assert that almost half of that decline, the exit from the labor mar-

ket of about 1 million children, can be attributed to the export-fueled rise in rice prices. "Greater integration into international markets, at least in this case, is associated with less child labor," they conclude.

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"Households appear to have taken advantage of higher income after the rice price increase to reduce child labor despite increased earning opportunities for children."

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The positive effects of rice price increases were most pronounced for those children who bore the largest burden of household work: older girls. For girls 14 to 15, the 30 percent price hike resulted in a dramatic increase in school attendance. However, overall child labor rates actually increased in urban areas where the higher cost of rice placed additional burdens on household incomes without providing any benefits.

By linking trade liberalization with such a large overall decline in child labor, Edmonds and Pavcnik say their study has "several implications for the policy debate on globalization and child labor." First, they point out that while globalization's critics generally assume that in developing countries, an increase in earning opportunities

to use trade sanctions to pressure poor countries. "These trade measures are likely to lower the price of the exported good, so our results suggest that sanctions could instigate more rather than less child labor," they write.

Finally, Edmonds and Pavcnik acknowledge that trade liberalization could have "different implications for child labor" if the result is cheaper imports flowing into developing countries that displace domestic products and the household incomes they generate. However, the authors assert that in "poor, relatively unskilled, labor abundant economies" such as Vietnam, most people work in either nontraded sectors or export-oriented sectors.

And "integration leads to higher prices in the export sectors," they note, which in Vietnam produced additional household income that "appears to be associated with a substantial reduction in child labor."

— Matthew Davis

## Looting Mexican Banks

In many countries, banks typically provide loans to so-called “related parties,” that is, to shareholders of the lending bank, their family members, or the firms they control. In the past, some economists argued that related lending improves credit efficiency — bankers know more about related borrowers than unrelated ones and therefore can better assess risk and sidestep bad investment projects. This view is sometimes referred to as the “information view” on related lending. Past studies of long-term bank lending in Germany and keiretsu groups in Japan have supported this optimistic perspective.

But, in countries with weak corporate governance, related lending may create more problems than it solves, according to a recent study by economists **Rafael La Porta, Florencio López-de-Silanes, and Guillermo Zamarripa**. In **Related Lending** (NBER Working Paper No. 8848), the authors examine the extent and impact of related lending in the Mexican financial system. They assert that cozy connections between lenders and borrowers “may allow insiders to divert resources from depositors and/or minority shareholders to themselves.” For instance, lenders have the incentive to divert funds to the companies they control, as long as their interest in the company exceeds their interest in the bank. In addition, deposit insurance may induce banks to assume inordinate risks and lend to the related parties on non-market terms, aware that the state will bear the costs. In sum, related lending may be very attractive to the borrower but may bankrupt the bank. La Porta, López-de-Silanes, and Zamarripa refer to this pessimistic perspective of related lending as the “looting view”.

In direct contrast to ownership structures in Germany and Japan uncovered in previous studies, the Mexican banks typically were controlled by non-financial firms rather than the other way around. The

Mexican banking setup is similar not only to that of many developing countries, but also can be seen in the early stages of development in England, Japan, and the United States. Another important feature of banks in Mexico during the sample period is that related lending was largely unregulated and that banking supervision was lax.

For this study the researchers collected data for all banks in Mexico on the identity of each bank’s top 300 borrowers by total loan size in 1995.

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“The default rate on loans to related parties was 77.4 percent, compared to 32.1 percent for unrelated parties, while recovery rates were \$0.30 per dollar lower for related borrowers than unrelated ones.”

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For each bank, they then gathered information on the borrowing terms of a random sample of 90 loans from the top 300 loans outstanding at the end of 1995 and tracked their performance through December of 1999. (The random sample encompassed more than 1,500 loans.)

The authors find that related lending represented a large fraction of the banking business in Mexico in 1995 (20 percent of all loans outstanding as of year-end 1995 were made to related parties). Moreover, when the economy slipped into a recession and the value of the insiders’ equity in the banks declined, the fraction of related lending almost doubled for the banks that subsequently went bankrupt and increased only slightly for the banks that survived the crisis.

The borrowing terms offered to related parties were substantially better than those available to unrelated ones, even after controlling for observable financial characteristics. For example, interest rates on related loans were 4 percentage points lower than on unrelated ones. Similarly, 84 percent of unrelated loans posted collateral assets, compared to only 53

percent of related loans.

Of course, these findings are still consistent with information-view proponents, who would argue that advantageous terms to related parties are justified by the low expected default rates and more efficient allocation of capital. However, La Porta, López-de-Silanes, and Zamarripa find that related loans had much higher default rates and lower recovery rates than unrelated ones. The default rate on loans to related parties was 77.4 percent, compared to 32.1 percent for

unrelated parties, while recovery rates were \$0.30 per dollar lower for related borrowers than unrelated ones. Perhaps most interestingly, the worst-performing loans were those made to persons and companies closest to the controllers of banks. In fact, in most cases, a dollar lent to a related person or a related privately-held company turned out to be a dollar lost. On the other hand, related borrowers emerged from the crisis relatively unscathed — bank owners lost control over their banks but not their industrial assets.

La Porta, López-de-Silanes, and Zamarripa conclude that all their principal findings are consistent with the “looting view” rather than the more halcyon “information view” of related lending. They suggest that the best way to reduce the fragility of financial systems might be by scaling back on related lending. Such an effort could be achieved “by explicit regulation of related lending as well as by enhanced reporting requirements, better investor protection... and closer supervision.”

— Carlos Lozada

## Do Cigarette Taxes Make Smokers Happier?

Eight out of ten smokers in America say they want to quit their habit.

This type of response is consistent with descriptions of behavior suggesting that individuals have “self-control problems” and are not able to make long-term plans (such as quitting smoking) and consistently carry them out. At the same time, there is clear evidence that higher cigarette prices deter smoking. Thus, government actions to raise the price of cigarettes may serve as “commitment devices” that help smokers to achieve the outcome they want, which is to reduce their consumption of this addictive good.

In **Do Cigarette Taxes Make Smokers Happier?** (NBER Working Paper No. 8872), authors **Jonathan Gruber** and **Sendhil Mullainathan** ask whether cigarette taxes actually can make smokers better off. They do this by directly examining the impact of cigarette taxes on individuals’

reports of their subjective well being. Using data from long-running surveys in both the United States and Canada, the authors assess what happens to self-reported well being among those likely to be smokers when state or provincial governments increase the taxes on cigarettes.

The authors find that higher cigarette taxes are in fact associated with

happiness through reduced smoking and not simply through changes in the size of government.

These findings imply that smokers do have self-control problems with their habit, and as such can be made better off by government policies to raise the price of cigarettes. Given that the damage that smokers do to themselves through shortening

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“The authors find that higher cigarette taxes are in fact associated with a large increase in self-reported well-being in both the United States and Canada.”

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a large increase in self-reported well-being in both the United States and Canada, among those likely to be smokers. Furthermore, they find that this increase is not present for other excise taxes, such as those on beer and alcohol, illustrating that this finding represents an effect of taxes on

their lives is valued at roughly \$35 per pack, high taxes on cigarettes may be justified. The authors also suggest that self-reported well being data may have broader value as a tool for economists to understand the welfare impacts of government policies.

— Les Picker

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