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Living Standards Rise Faster than Official Estimates

Measuring living standards is difficult for economists. The usual method is to look at the evolution over time of per capita real income (income adjusted for inflation). But "real income is an imperfect measure of trends in living standards," cautions NBER Faculty Research Fellow **Dora Costa.** One reason is that the Consumer Price Index (CPI) that is used to adjust for inflation overstates the rise in prices. More importantly, "real income does not account for such goods as health that are not purchased in the marketplace, for quality changes, for revolutionary technological change, and for increases in leisure," Costa maintains.

An alternative technique for measuring living standards is to examine spending on recreation. This technique assumes that, after providing for food, clothing, shelter, and other necessities of life, people will use some of whatever income is left over on purchasing recreation. As the proportion of income needed to meet necessities declines, people will have more money for vacations, radios, TVs, CDs, and other recreational goods and activities that strike their fancy. Rising recreational expenditures — "the quintessential luxury goods" — are seen as an indication of rising living standards.

In **American Living Standards: Evidence From Recreational Expenditures** (NBER Working Paper No. 7148), Costa uses consumer expenditure survey data from 1888–90, 1917–9, 1935–6, 1972–3, and 1991 to determine whether trends in real income per capita are consistent with trends in recreational budget shares. She also looks at trends in inequality in recreational spending for those up and down the income ladder. She finds that changes in real total expenditures per capita are likely to underestimate the increase in living standards, particularly during times of innovation in consumer goods and reductions in working hours, such as the 1920s, the 1970s, and the 1980s. In the late 1880s, less than 2 percent of household spending was devoted to recreation; by the mid-1930s, recreation's share had risen to 4 percent, and by 1991 to 6 percent.

Recreational expenditures also tend to rise with income levels. Richer households spend proportionately more on luxuries, including recreation. At the start of this century, pleasure spending was considered a luxury that could not be afforded by low-income households. But by the mid-1930s, low cost recreational activities, such as motoring, movies, and the radio had already spread among the people, especially for those who had jobs.

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The government also invested heavily in recreational facilities. The number of public swimming pools more than tripled and the number of baseball diamonds more than dou-

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bled between 1921 and 1930 alone. There were more parks. And, listening to the radio was a favorite activity of all classes in the 1930s. Today the popular medium is television.

Hours of work also have declined over the decades. Between 1890 and 1940 the average work week fell by 20 hours and retirement rates of men older than 64 rose by almost 30 percentage points. This decline in hours, the spending on recreation suggests, was especially the case for lower income workers. They worked 11-hour days in the 1890s, while the well-to-do worked nine hours. After 1940, paid vacations, holidays, sick days, and personal leave increased; retirement rates continued to rise. But the length of the average work week remained unchanged.

Costa notes that real total expenditures per capita fell by 1.2 percent per year between 1919 and 1935 and rose by 1.8 percent per year between 1972 and 1991. In contrast, trends in the recreational expenditure share of total spending imply that between 1919 and 1935, real per capita total expenditures actually rose by 1.2 percent per year, and between 1972 and 1991 by 3.6 percent per year. So the conventional measures of real per capita total expenditures—used as an indicator of living standards—may be biased downward by 2.4 percentage points per year between 1919 and 1935 and 1.8 percentage points per year between 1972 and 1991. Even in the period that includes the Great Depression, living standards rose by this measure, at least for those with jobs.

"It may therefore be time to reassess the 1920s and 1930s," writes Costa. "Changes in the consumption bundle of households and declines in inequality in recreation suggest that improvements in living standards may have been much more rapid, particularly among lower income households, than suggested by income measures alone. These gains may have been so large that even the income declines of Great Depression were not enough to reverse them."

> "In 1972–91, living standards were rising twice as fast as conventionally measured...the primary beneficiaries of these newly measured gains were lower income households."

Further, in 1972–91, living standards were rising twice as fast as conventionally measured. Costa also finds that the primary beneficiaries of these newly measured gains in per capita total expenditures in both these periods were lower income households.

—David R. Francis

Common Elements in Financial Crises

The two big financial meltdowns of the 1990s—the Mexico or "Tequila" crisis of 1995 and the Asian crisis of 1997—brought with them the notion that in today's global economy, countries can be severely punished merely for the crime of proximity. But in **Common Fundamentals in the Tequila and Asian Crises** (NBER Working Paper No. 7139), NBER Research Associate **Aaron Tornell** argues instead that if one studies the historic record, a pattern emerges: while it's hard to predict which country will be the next Mexico—or, in the case of Asia, the next Thailand—it is possible to forecast which countries are most likely to be targeted when a crisis erupts. He asserts that a crisis is most likely to spread to countries with the following flaws: little in the way of cash reserves to defend their currency, weak banks, and a recent history of sharp currency appreciation. Conversely, Tornell finds that countries with high reserves or with strong banks and only mild currency appreciation are likely to be spared.

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Tornell concludes "that the Tequila and Asian crises did not spread across emerging markets in a purely random way...a crisis will spread to countries that are vulnerable. A country is vulnerable to an attack if it has had an appreciated real exchange rate for the past few years, or it has experienced a lending boom, thus increasing the likelihood that its banking system is laden with bad loans."

Tornell does not completely discount an emotional element to the currency attacks. He sees the initial crisis as something that makes investors generally pessimistic, prompting them to be more suspicious of other countries' weaknesses. He also believes that investors exhibit a certain amount of herd behavior, with individual money managers initiating an attack in part because they expect their colleagues around the world to do the same.

But while investors may be somewhat motivated by fear, their attacks are rational events, Tornell believes. As a crisis unfolds, money managers

merely look at the same economic data and reach identical—and sound—conclusions. In certain countries, the banks are so weak, reserves so low, and the exchange rate so high that a run on the currency would leave the government with almost no choice but to devalue.

For example, Tornell observes that in the four years preceding the Tequila crisis, Peru experienced a similar appreciation and a greater lending boom than Mexico. But it suffered far less during the crisis because it had the currency reserves required to deter an attack.

—Matthew Davis

Bribery Does Not Reduce Bureaucracy

There is a well-established school of thought that holds that a little corruption isn't such a terrible thing. "In terms of economic growth, the only thing worse than a society with a rigid, over-centralized, dishonest bureaucracy is one with a rigid, over-centralized and honest bureaucracy," wrote noted political scientist Samuel P. Huntington in 1968. The thinking is that bribery "greases the wheels" of commerce, allowing entrepreneurs and corporations to go about their business without being entirely stifled by bureaucratic meddling.

In **Does "Grease Money" Speed up the Wheels of Commerce?** (NBER Working Paper No. 7093), **Daniel Kaufmann** and NBER Faculty Research Fellow **Shang-Jin Wei** challenge this hypothesis. They use firm-level survey data from the World Economic Forum's Global Competitiveness Report and the World Bank's World Development Report; for these, corporate managers in different countries were asked about the level of corruption they had to contend with, the amount of time they spent dealing with government bureaucracy, and the overall regulatory burden. The authors find that far from greasing the wheels of commerce, more corruption means even more red tape.

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The grease-the-wheels theory comes down to the assumption that a corrupt government official will use harassment or bureaucratic delay to force a bigger bribe. Kaufmann and Wei find that if corruption is rampant, time spent with bureaucrats and regulatory burden are high. They also ask if the East Asian countries, known for both corruption and economic dynamism, are an exception. They find that in fact the correlation between corruption and bureaucratic burden is even stronger in those countries.

None of this means that an individual firm can't profit from making a bribe, Kaufmann and Wei caution. But the business community as whole is better off with less bribery, and with international laws that strengthen firms' ability to commit to not paying bribes. —Justin Fox

Direct Investment is a Steady Source of Foreign Capital

In recent years, direct investment—which occurs when a company in one country obtains a "lasting interest" in an enterprise in another country—has acquired a reputation as the tortoise of international finance: a reliable standby in a world of hot money and recurrent financial crises. This popular perception, it turns out, is pretty much on the mark. In **The Role of Foreign Direct Investment in International Capital Flows** (NBER Working Paper No. 7094), NBER Research Associate **Robert Lipsey** examines data from 1969 through the 1990s and finds that direct investment flows to and from major world areas have been markedly less volatile than portfolio investment, bank loans, or other investment flows. There is one glaring exception to this rule: the United States, where net direct investment flows have actually been more volatile than portfolio or short-term investment flows.

That high U.S. volatility reflects the events of the 1980s when the United States switched from its traditional role as the world's dominant supplier of direct investment to become the world's largest recipient of direct investment. It returned to its supplier role in the 1990s, but no longer in a

dominant way. In crisis-beset developing areas such as Latin America and developing Asia, in contrast, direct investment clearly has been the most dependable, steady source of foreign investment, with an upward trend and no reversals of direction over five-year periods.

Lipsey finds that, relative to other forms of international investment, direct investment grew from 1970 to 1994, when it reached 31 percent of world investment flows. Then direct investment declined for a few years relative to other forms of international investment, but it still remained well above its 1970s levels.

While the United States was the main source of direct investment outflows through the 1970s, first Europe and then Japan became major sources of gross direct investment outflows in the 1980s. As of 1996 Europe was by far the leading source of gross direct investment outflows, trailed by the United States, Japan, and the Asian tigers of Hong Kong, Taiwan, and Southeast Asia.

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Much of Europe's total, however, consists of intra-European investment, and much of the U.S. gross outflow is matched by a corresponding inflow. Since there is little inflow into Japan, that country is much more important as a net supplier of direct investment than as a gross supplier. Latin America has been the region with the largest net inflows from outside, although developing Asia has at times received larger gross inflows, particularly in the 1990s. Much of the Asian inflow is from Asian countries, while little of the Latin American investment comes from within the region.

—Justin Fox

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