Political favoritism in China’s capital markets and its effect on city sizes

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A B S T R A C T

This paper examines political favoritism of cities in national capital markets and the effect of that favoritism on city sizes. The paper estimates the city-by-city variation in the prices of capital across cities in China from 1998 to 2007. It relates how the prices facing the highest order political units and overall cross-city price dispersion change with changes in national policy and leadership. The effect of capital market favoritism on city growth after the national relaxation of migration restrictions in the early 2000’s is investigated. The elasticity of the city growth rate with respect to the price of capital is estimated to be −0.07 in the OLS approach and −0.12 in the IV approach.

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1. Introduction

Policy bias towards politically favored cities in developing countries is a major policy issue (e.g., Ades and Glaeser, 1995; Davis and Henderson, 2003) in general as well as in specific countries such as China (World Bank, 2014). Simple theoretical models suggest that cities that are favored in national capital markets, in export or import markets or with enhanced transport infrastructure, will attain larger sizes than non-favored cities, increasing inequality in size distributions (Ades and Glaeser, 1995; Duranton, 2007; Henderson, 1988). The empirical work to date has focused on special cases such as favoritism of national capitals (e.g., Ades and Glaeser, 1999; Davis and Henderson, 2003) or favoritism of a national leader’s birthplace (Hodler and Raschky, 2014). For national capitals, the idea is either that national leaders favor the place they live and their relatives may work, or that they garner key political support from the national capital population. Favoritism of one type or another will shift up returns to living or producing in favored cities, potentially drawing in workers and firms, with the advantages of favoritism being dissipated by increased disamenities from increased populations. This literature suggests that unrestrained migration can lead to gross over-population of favored cities and the specter of poor living conditions such as congestion and urban slums. Alternatively, countries can try to restrict in-migration to favored cities, as is China in the 1990’s and even continuing today.

In these analyses, a better articulation, let alone a political economy model of different aspects of favoritism is lacking, beyond just favoritism or not of the national capital. And empirical evidence on political favoritism is limited and indirect. In the literature that focuses on national capitals in Ades and Glaeser (1995) and Davis and Henderson (2003), one must worry that capital cities are, for example, often located in prime geographies and have transport links which make the capital the main hub of the country (as opposed to some other city), in potentially an efficient hub and spoke system. Both factors draw in high numbers of people themselves, and separately identifying the effect of political bias on size is a challenge. A second challenge is to identify degrees of bias. For example, evidence that per capita public expenditures is higher in a capital city is not evidence of bias per se; higher per capita expenditures in larger cities may be efficient if there are greater relative benefits of such expenditures. Or evidence that capital to labor ratios are higher in larger capital cities is not necessarily evidence of bias, since nominal labor costs are higher.

Keeping in mind the above challenges, we utilize the specific institutional and political setting in China to quantify political favoritism directly, and examine its causal relationship to city sizes comprehensively and carefully. While the context is particular, it will inform us about analysis of other contexts. We first articulate a basis
for widespread favoritism in China where it is not just favoritism of one or two political cities versus all others, but shifting favoritism of a wide variety of cities at the expense of the rest, based on the specific and shifting national and local leadership structures, and incentives inherent in that. Secondly, we use data on Chinese capital markets to study political favoritism. This has two key advantages.

In general, defining bias in capital markets is more clear-cut and not confounded with issues of city scale, unlike for analysis of differential per capita public expenditures or capital to labor ratios. Efficiency in capital markets requires equalized marginal returns to capital across cities, regardless of size. The second advantage in looking at capital markets in China is that they can be the key mechanism of political favoritism: banks are still de facto state owned. The state intervenes in capital markets in response to policy initiatives and political pressures, to potentially favor different types of firms and cities.

The final step is to look at the effects of bias on city sizes. There is a cross-section, or long run equilibrium model, where cities with lower costs of capital, ceteris paribus will be larger. While we will examine such a model, estimation is challenged by all the unobservables that might drive differences in city sizes and might be related to the degree of bias, either incidentally or by design. However again, China provides a context where we can construct an empirical framework where inferring the effects of bias is better grounded. We examine the effects of bias on population growth from 2000 to 2010, or how more favored cities grow differentially faster. Looking at growth in a specific context arguably allows us to difference out other fundamentals that affect city sizes. China’s internal migration policies provide variation helpful to identification of effects. Prior to 2000, migration in China was legally and sharply limited (Chan, 2010), curtailing the ability of migrants to move to locations with better wages and job opportunities (Au and Henderson, 2006a, 2006b). Around 2000, legal constraints on migration2 disappear, although migration still faces impediments. This context allows us to argue that there is a regime shift with all cities facing more elastic supply curves of population after 2000, in terms of drawing upon the national reserve of underemployed rural populations. We develop a simple model to show that those favored cities facing a lower price of capital then are likely to respond with larger population increases over the next decade, with the change in supply elasticity.

What do we find? By analyzing firm level data in China from 1998 to 2007, we find that, depending on the year, one or two of the four highest level administrative unit cities in China (Beijing, Tianjin, Shanghai, and Chongqing) experience a 20–40% lower price of capital than others. The magnitude of differential in price is similar to the differential in favor of state over private owned firms near the end of our time period. For these four cities, we find that the degree of bias varies overtime in predictable ways as national leadership changes, consistent with our conceptual framework. We then turn to our main analysis which looks at how the price of capital differs city-by-city for the whole set of cities and how these differentials seem to be driven by changing political forces across China as they affect local areas. Finally, we turn to the effects of these differential prices on city sizes and growth rates. The effects on city sizes in a cross-section framework are large. But even in the growth framework where identification is better defended, we find an elasticity on growth of about −0.124. A one standard deviation decrease in the price of capital would increase a city’s growth rate from 2000–2010 by 4% given an average growth rate of 5%.

These findings face a variety of identification issues that we try to resolve. A city’s cost of capital may be driven by non-political factors and capital prices are not randomly allocated across cities. We construct relevant measures to account for varying local economic culture, differences in historical total factor productivity [TFP], national programs promoting investment in specific sectors in which a city has historical employment and built-up comparative advantage, and the like, to shore up our evidence. For city growth analysis, in uncovering causal effects, many other factors may simultaneously affect the cost of capital facing a city and its population growth, including other forms of favoritism such as local infrastructure investments funded from the outside and the assignment of politically favored leaders to faster growing cities. Another issue for this growth analysis involves separating out the positive effects on growth of lower costs of capital from the negative effects of capital market inefficiencies such as allowing inefficient firms to be propped up and to remain in business. We make serious attempts in circumventing these identification issues by the use of specific controls and with two different instrument variables. However, most candidates for an instrument for capital market favoritism are inherently likely to have direct effects on city growth, if only through affecting other forms of favoritism which might also affect city growth. We interpret our instrumental variable estimations cautiously, discussing their validity and limitations.

The rest of the paper is organized as the following. Section 2 discusses a conceptual framework for local favoritism in capital markets in China and reviews the existing literature and Chinese context. In Section 3, models and general econometric specifications are respectively developed for measuring political favoritism in the capital market and its link to city growth. Section 4 details data sources and examines how the descriptive patterns further motivate this paper. Results on capital market bias and its effect on city growth are separately presented and discussed in Section 5. Lastly, Section 6 concludes.

2. Conceptualizing urban political bias in China

2.1. Conceptualizing favoritism

Based in part on work by Li (2001, 2002, 2005, 2013), Li (2005), and Lim et al. (2011), how should we think about spatial favoritism in China’s capital markets? As we will discuss in more detail below, the Communist Party has various well defined factions. People at the top of a faction are patrons to those below within that faction. At the city level, local leaders are evaluated on the basis of economic performance, meaning literally the local GDP growth during their tenure as a local leader. The patrons of a local leader want to make conditions conducive to economic growth in that city, so that leader will get a good evaluation. A simple lever is intervention in local capital markets to ease credit for producers in that city. Next, we will discuss mechanisms for how capital is allocated across cities, discussing, in particular, how provincial leaders influence the allocation of capital across cities, noting that provincial leaders also appoint local leaders. The expectation is that provincial leaders appoint people they prefer as local leaders, and in turn favor the cities governed by their appointees. This is simply patronage politics. Of course these provincial leaders expect a pay-back: backing within the Party by these local officials as these leaders later seek higher office within the Party.

While this is a general framework, we note also that there is an administrative hierarchy among cities in China: provincial level cities (Beijing, Tianjin, Shanghai, and Chongqing), provincial capitals and other prefectures. By place in the hierarchy, cities have different formal degrees of autonomy, different fiscal responsibilities and resources, as well as potentially differential favoritism in the state influenced capital allocation process. Leaders of provincial level cities are like provincial governors and are appointed by national leaders. These leaders are relatively high up in the political hierarchy; and as such we might expect that leaders of higher level cities are overall favored in national politics and capital market allocations. However, as we will explain later, given the specific factions within the party,
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