

Local leaders' hometown connections and spatial development: The case of intercity investment in China

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General Research Agenda

How to improve the efficiency of the spatial allocation of capital?

Just simply move capital (inter-regional investment) to where it is more productive!

It is, however, not easy in practice.

- ▶ Entrepreneurs need to learn about local productivity (info. frictions)
- ▶ There are physical fixed costs to enter a local market (physical entry frictions)
- ▶ There are local business environment factors (business entry frictions)
- ▶ There are institutional/political entry costs (institutional entry frictions)

This paper argues a channel through local political leaders' hometown connections could help to reduce rather than intensify the frictions.

Shi'23: Overview

- ▶ Empirical analysis connecting various databases:
 - ▶ 1. Hometown connections increase investment inflows into officials' cities.
 - ▶ 2. Such effects only exist in smaller firms. [collusion is not happening (?)]
 - ▶ 3. Such effects only exist in private firms. [reducing info. frictions (?)]
 - ▶ 4. Results on officials: promotion (+) | caught for corruption (n.a.)
 - ▶ 5. Results on firms: exit (+) during / (-) after officials' tenure | innovation (+)
- ▶ Quantitative spatial model:
 - ▶ 1. Location choices of entry firms
 - ▶ 2. Promotion incentives of local officials
 - ▶ 3. Hometown connections \Rightarrow [maybe a little bit ad-hoc (?)]
entry cost (-), info. frictions (-), matching efficiency (+)
 - ▶ 4. Welfare gains.

Comment 1: The incentives are much more complex...

- ▶ Incentive of the officials:
 - ▶ Promotion (Self-interest)
 - ▶ Corruption (Self-interest)
 - ▶ Help Hometown (Hometown-interest)
 - ▶ Help Local GDP (Local-interest)
 - ▶ Benevolent (Too good to be true?)
- ▶ Effects of the incentives:
 - ▶ Promotion-> may reduce info. frictions or attract inv. that should not come
 - ▶ Corruption-> same as above, now even with deadweight losses
 - ▶ Help Hometown-> same as above, now may hurt local firms
 - ▶ Help Local GDP-> same as above, now may hurt hometown firms
- ▶ All the empirical analysis above shows part of the incentive and also only effects on treated firms, but issues outside of these firms are unobserved to us...
- ▶ **As long as the incentive creates friction rather than reduces friction, it would increase misallocation rather than improve efficiency.**

Comment 2: On the Empirical

Main Findings:

- ▶ 1. Hometown connections increase investment inflows into officials' cities.
- ▶ 2. Such effects only exist in smaller firms. [collusion is not happening (?)]
- ▶ 3. Such effects only exist in private firms. [reducing info. frictions (?)]
- ▶ 4. Results on officials: promotion (+) | caught for corruption (n.a.)
- ▶ 5. Results on firms: exit (+)during/(-)after officials' tenure | innovation (+)

Main Concerns:

- ▶ **Reverse Causality:** Simply from the gravity models, cities that have more inv. flows have more appointments of each other's officials (labor flows).
- ▶ **Selection Bias:** Simply from the Melitz model, firms who could enter into a remote market are usually more productive by themselves.
- ▶ **Vague Treatment:** It would be much better if political connections could be measured at firm-level; o/w the treatment effects are quite vague.
- ▶ **Individual's Gain, Economy's Loss (?):** Even though the results above are all valid, it could still be efficiency loss for the reason in the previous slide.

Comment 3: On the Model

Main Concerns: [Assumptions are too ad-hoc]

- ▶ Innovation: $X = n^\alpha (\psi^x l_R(n, X))^{1-\alpha}$, where ψ^x is research productivity
 - ▶ Hometown connections \Rightarrow info. frictions (-) $\Rightarrow \psi^x \times \lambda_1$ which >1
 - ▶ Hometown connections \Rightarrow matching efficiency (+) $\Rightarrow \psi^x \times \lambda_2$ which >1
- ▶ Entry Costs: the leader chooses the entry cost from a set $\{0, \bar{\phi}\}$ for ϕ_{ijt}
 - ▶ Given the above assumption $\lambda_1, \lambda_2 > 1$, always choose hometown $\phi_{ijt} = 0$.
 - ▶ Zero entry cost, of course, attracts small firms.
 - ▶ Promotion is more likely since performance is GDP-based.
 - ▶ These firms grow faster because $\lambda_1, \lambda_2 > 1$.
 - ▶ There is no corruption motive in the model.

Direct Implications:

- ▶ 1. No cities should hire their locals as leaders (really?)
- ▶ 2. Cities should hire leaders only based on productivity match (most gains?)
(high-to-high) \rightarrow (Shanghai-Beijing) | (low-to-low) \rightarrow (Hegang-Beihai)