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Remote markets as shelters for local distortions: Evidence from China

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ABSTRACT

We study how the presence of state-owned enterprises (SOEs) distorts private firms' decision on interprovincial sales in China. Using data from World Bank Investment Climate Survey and Annual Survey of Manufacturing Firms in China, we find evidence that the prevalence of SOEs in a city-industry where private firms reside will affect these firms' decision on the allocation of sales between interprovincial markets versus adjacent market. The direction of the effect on private firms, however, depends crucially on the private firms' access to credit. Specifically, the prevalence of SOEs leads to a higher propensity to sell to remote markets for firms with adequate financial access, whereas the opposite is true for firms who are credit constrained. We build a parsimonious model which links political/market distortion, market access, and credit constraint to explain these patterns, and argue that remote markets can serve as shelters for local distortions resulted from SOEs presence for some private firms.

1. Introduction

While the private sector in China has grown much faster and contributed to most of the economy's growth in the past few decades (Allen, Qian, & Qian, 2005)[1] , for institutional (sometimes even ideological) reasons, political favoritism towards state-owned enterprises (SOEs) still exists in China.[2] This political preference towards different ownership type of firms is translated into biased economic policies and regulatory practices (Huang, 2004). Thus, SOEs may cause distortion in business environment in which private firms operate, through cronyism.[3] As Liu and Shi (2010) have argued, there are two types of efficiency loss

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[1] The private sector absorbs around 80% of employment and produce around 70% of output in 2010 (World Bank, 2012).

[2] See the following papers for the details: Brandt and Li (2003), Che (2002), Clarke, Murrell, and Whiting (2008), Guriev (2004), Johnson, Kaufmann, McMillan, and Woodruff (2000), McMillan (1995), McMillan and Woodruff (1999, 2002); Pearson (1997).

[3] For example, bureaucrats and SOE managers can collude to establish administrative obstacles for private firms in order to ease the competition faced by Bai, Li, Tao, and Wang (2000) document that the financial, legal and other discriminations against the private firms in China are persistent and pervasive.

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resulted from state-ownership. Aside from the well-known fact that SOEs are inefficient *per se*, they also drag down the growth of private sector in the local economy where they reside. Given the presence of such distortion, private firms would try to find ways to mitigate the harm caused. This paper aims to offer the first pieces of evidence that private firms use remote markets as shelters for such local distortions.

Using the Investment Climate Survey in China conducted by the World Bank and the Annual Survey of Manufacturing Firms by the National Bureau of Statistics (NBS) of China,[4] we find that SOE presence at the locality of private firms have a significant impact on private firms' propensity to sell to remote markets (i.e., out-of-province markets). Interestingly, the reaction of private firms to the presence of SOEs nearby differ sharply, depending on their financial conditions. Specifically, if SOEs are more prevalent in a particular industry in a city, then private firms in the same city-industry will sell more intensively to remote markets (i.e., out-of-province) relative to the adjacent markets, only if they have adequate access to credit. If on the contrary, private firms do not have adequate access to financial resources, they will sell relatively less to remote markets when SOEs are more prevalent locally.

To rationalize these findings, we build a parsimonious model linking political distortions resulted from SOE presence, firms' financial conditions, market access and interprovincial export intensity. Distortion is modeled as a multiplier to the marginal cost of private firms similar to Hsieh and Klenow (2009). Firms would like to introduce their products to remote markets since potentially those markets could be much larger than their adjacent market, as the market potential of the later has been fully explored. However, expanding to remote markets entails additional market access costs, which must be paid upfront before sales in those markets were realized. But paying such costs requires adequate financial resources, to which not all firms have access. For firms with/without the required financial resources, their remote markets demand could be much larger/smaller than their adjacent market. Under certain assumptions, this means that firms with/without financial resources are producing at the less/more elastic portion of the demand curve of the remote market. When cost distortion becomes severer, firms face higher marginal costs and optimally have higher price. However, the equilibrium demand in remote markets will be less/more affected, and the sales from these markets change less/more relative to sales in the adjacent market. The moral of this story is that, when cost distortion resulted from SOE presence exist, private firms will be negatively affected. Given this negative effect, firms that have adequate access to finance is partly sheltered, because they have bigger outside markets where sales were less affected by a cost adjustment. On the contrary, financially constrained firms were even more severely harmed as their remote markets are too small to serve as a shelter.

Given these analysis, we argue that exporting to remote markets may be one possible solution for private firms to shelter themselves from the distortion caused by local SOEs. However, we also argue that this solution works only when the remote market is large enough, which in turn only happens when firms have adequate credit access, whose importance has been well-documented in trade literature (Chesnokova, 2007; Chor & Manova, 2012; Manova, 2008, 2013; and Feenstra, Li, & Yu, 2014). Given the underdeveloped and distorted credit market in China, this seems to be a pessimistic conclusion.

However, we then go further to delve into the role played by the development of e-commerce in China, and propose that the utilization of e-commerce reduces the demand for credit in circumstances in which firms want to expand to remote markets. Thus, with e-commerce on the rise, more firms (without adequate access to credit) gain the ability to access to larger remote markets and then use these markets as shelters to mitigate the negative effects caused by local distortions. We provide supportive evidence by using the unique information provided in the aforementioned dataset.

Our paper is related with and contributes to several streams of the literature. First of all, this paper is among the first to show the direct interaction of SOEs and private firms. Most of existing studies focus on the comparison of SOEs versus private firms. For instance, Chen, Sun, Tang, and Donghui (2011) show that investment behavior of Chinese SOE firms is less efficient than that of private firms. Recently, there are a few papers starting to look at the interaction between SOEs and private firms. Li, Liu, and Wang (2012) document a feature of China's state capitalism: the SOEs monopolize the upstream key industries while large number of non-SOE firms competes fiercely in the downstream industries. Our paper contributes to the literature by studying the effects of local SOE presence on private firms' interprovincial sales (export to other provinces).

Secondly, this paper contributes to our understanding about political distortion and intranational trade in China. Previous studies focus exclusively on the negative impact of local protectionism on cross-provincial trade in China, e.g., Young (2000) and Poncet (2005). However, we find that another source of distortion, i.e., local distortion resulted from the presence of SOEs, also plays an important role.

Thirdly, our paper is also related to the literature investigating whether the political connection a private firm has bring any advantage. It has been found that political connections improve trade expansion (Lu, 2011) and firm performance (Fan, Wong, & Zhang, 2007; Li, Meng, Wang, & Zhou, 2008). It has also been found that political connections help firms gain favors in the market, such as advantageous regulatory conditions (Qin, 2004), access to bank loans (Bai, Lu, & Tao, 2006; Claessens, Feijen, & Laeven, 2008; Li et al., 2008), and secure property rights protection (Hellman, Jones, & Kaufmann, 2003; Lu, 2011).

Last but not least, this paper contributes to the vast literature on SOEs in China, and also has something to say about the ongoing debate on whether the phenomenon "Guojin Mintui" (the state advances as the private sector retreats) or the reverse way really exists. Recent years have observed increasing government policies favoring the state sector. In industries such as

[4] These two datasets offer us a good setting to investigate the role of state influence. On the one hand, the Investment Climate Survey offers very detailed information on various aspects of private firms. On the other hand, the Annual Survey of Manufacturing Firms allows us to directly calculate the prevalence of SOEs in almost any city and industry throughout the country.