

Does Foreign Direct Investment Lead to Industrial Agglomeration?

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This paper studies the effect of foreign direct investment (FDI) on industrial agglomeration. Using the differential effects of FDI deregulation in 2002 in China on different industries, we find that FDI actually affects industrial agglomeration negatively. This result is somewhat counter-intuitive, as the conventional wisdom tends to suggest that FDI attracts domestic firms to cluster for various agglomeration benefits, in particular technology spillovers. To reconcile our empirical findings and the conventional wisdom, we develop a theory of FDI and agglomeration based on two counter-veiling forces. Technology diffusion from FDI attracts domestic firms to cluster, but fiercer competition drives firms away. Which force dominates depends on the scale of the economy. When the economy is sufficiently large, FDI discourages agglomeration. We find various evidence on this competition mechanism.

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1 Introduction

This paper is concerned with two mechanisms for economic growth. The first is the agglomeration of economic activities (Jacobs 1969, Lucas 1988, Krugman 1991, Glaeser et al. 1992). More specifically, industrialization and urbanization are two salient phenomena which are closely intertwined in the development process for developing countries (see e.g. Henderson 2005 and Michaels, Rauch, and Redding 2012). The second mechanism is technology diffusion (Howitt 2000, Acemoglu, Zilibotti and Aghion 2006), which is fundamentally what underlies the convergence hypothesis. In developing countries, special economic zones are often established as a means to promote economic growth, and the rationales are mainly these two mechanisms: to promote clustering of firms/industries and to facilitate technology diffusion by attracting foreign direct investment (FDI). Manifesting these ideas are the emergence of Shenzhen from a small fishing village to one of the four top-tier cities in China and Iskandar Malaysia, which achieved significant economic growth after its establishment in 2006.¹

The two above-mentioned mechanisms are, however, *not orthogonal*, and we are interested in understanding whether and how FDI affects overall patterns of industrial agglomeration in a country. Firms tend to cluster for various agglomeration benefits.² Foreign firms (and hence FDI) also tend to cluster (Alfaro and Chen 2014). Thus, locations with numerous foreign firms are presumably attractive for domestic firms due to technology diffusion and other agglomeration benefits such as input-output linkages among foreign and domestic firms. Taken together, it is intuitive to conjecture that *more FDI leads to more industrial agglomeration*.³

This paper aims to empirically test the above-mentioned conjecture. Specifically, we explore a particular historical event to empirically examine the effect of FDI on industrial agglomeration. China entered the World Trade Organization (WTO) in the end of 2001.

¹Before 1980, Shenzhen was a small fishing village, with virtually no foreign investment. In May 1980, China's State Council approved establishing the first special economic zone (SEZ) in China, the Shenzhen SEZ. The zone is considered a testing ground for trade and FDI liberalization and tax reforms. To attract foreign investment, the government provided preferential policies for foreign investors, for example, reductions in corporate income tax and land use fees. The annual growth rate averaged between 1980 and 2001 for GDP of Shenzhen was 29.5 percent. The corresponding number for gross industrial output and total exports was 46.4 percent and 39.4 percent, respectively. Regarding the case of Iskandar Malaysia, the Malaysia government established the special economic zone of Iskandar Malaysia in November 2006. After a decade, the zone had created about 700 thousand employment opportunities and the committed cumulative investments reached 52.99 billion US dollars in 2016. The region's GDP grew annually at 4.1 percent from 2006 to 2010, and at about 7 percent after 2011 (Iskandar Regional Development Authority, 2016).

²See the discussion in the literature review below.

³This conjecture would be disproved if foreign firms become more dispersed after the FDI deregulation. As mentioned, earlier empirical evidence shows that foreign firms tend to cluster. Furthermore, we find no empirical evidence on this concern. See Section 5.4 for details.

As a condition of accession, China was required to relax its controls on FDI entry: the extent of deregulation differed across industries. Specifically, China encouraged FDI entries in around one quarter of its manufacturing industries, with the rest remaining mostly status quo. Our data show that such differential deregulation of FDI generated different degrees of influx of foreign capital (hence number of firms) across industries.

These variations in FDI deregulation across industries and time allow us to use a difference-in-differences (DD) estimation approach. Specifically, we compare the degrees of industrial agglomeration in the FDI deregulated industries with those in the status-quo industries before and after the deregulation, which occurred in 2002, not long after the WTO accession. The degree of industrial agglomeration is measured using a widely-used index, the Ellison-Glaeser (EG) index (Ellison and Glaeser 1997). The identifying assumption in estimating the causal effect of FDI deregulation is whether the deregulated industries and the timing of the deregulation are randomly determined or not. The empirical study starts with the check on the parallel pre-trends between the treatment and control groups; it is shown that there is no difference in industrial agglomeration between the treatment and the control group before the FDI deregulations. Second, we control for the nonrandom selection of deregulated industries by carefully examining the determinants of FDI deregulations. Third, we control for other concurrent policy reforms that may affect industrial agglomeration. These policy reforms include tariff reductions, restructuring and privatization of SOEs, place-based policies such as special economic zones, and the Western Development Program. Conditional on a set of controls, the relaxation of FDI regulations is plausibly exogenous. We find a significantly negative effect of FDI deregulation on industrial agglomeration, and this result is robust to a battery of robustness checks (see Section 4 for details).

The results surprised us, as they are contrary to the above-mentioned conjecture. To reconcile the empirical finding and the conventional wisdom behind the conjecture, we develop a theory of FDI and industrial agglomeration based on two counter-veiling forces. On the one hand, FDI brings in foreign firms that are more productive than domestic firms. If domestic firms are located in the same region as the foreign firms, they may receive technological spillover and thus have higher productivities on average than the domestic firms that stay in the other region with fewer or no foreign firms.⁴ On the other hand, the existence of transport cost between regions makes regions with more firms more competitive, which means that the firms there enjoy lesser markups, sales, and profits for the same given productivity. Therefore, FDI deregulation may increase

⁴In fact, technology diffusion in our model can be more broadly interpreted as any external benefit that the presence of foreign firms brings to domestic ones.

competition pressure in locations where foreign firms agglomerate, and this competition pressure may discourage firms from locating there.

Our theory predicts a hump shape in the relation of industrial agglomeration with foreign capital. When the size of the economy is small, technology diffusion attracts domestic firms to where the foreign capital is located. At this stage, competition pressure is small, and thus the competitive effect is dominated by the force of technology diffusion. As the economy grows, competition pressure also grows, and productivity gaps shrink due to the extensive technology diffusion that has already occurred. In this case, a further influx of foreign capital induces dispersion rather than agglomeration. The former case fits the stories of Shenzhen and Iskandar, whereas the latter case explains our empirical results.

To test the mechanism of our theory, we estimate the effect of FDI deregulation on markups, sales, and profits of firms. We do find that after 2002 the markups, sales, and profits of firms in the deregulated industries are significantly lower than their counterparts in the status-quo industries. By repeating our benchmark estimation for the exporter and non-exporter sub-samples separately, we find the effect of FDI deregulation on industrial agglomeration to be much more pronounced for the non-exporters than the exporters. This finding corroborates with our theory as non-exporters face more severe domestic competition than exporters. Our mechanism is undermined if most of the influx of foreign firms export, but we find no evidence of this.

An alternative explanation for our main empirical finding is based on a spatial political competition story. That is, local governments in China have incentive to lure business, and especially foreign firms for their spillover effects, to their regions to help GDP and employment growth. FDI deregulation opens up new opportunities for the local governments to try to attract FDI in these newly deregulated industries. In this spatial political competition, less agglomerated and less developed regions may have stronger incentives to seize this new opportunity. Nevertheless, we do not find empirical support for this story, as the location patterns of foreign firms are largely unaffected by FDI deregulation.

The last part of our empirical investigation is to look directly at the impact of FDI and agglomeration on industrial growth. We find that FDI deregulation increases industrial growth rate, but the dispersion induced by FDI deregulation reduces the positive effect of FDI on growth rate by 16 to 19%. Consistent with our theory and previous empirical findings, combining FDI-promoting and agglomeration-promotion policies (such as SEZs) may be worthwhile because FDI influx may cause dispersion and thereby dampen growth potential.

Our literature review starts with the literature on (industrial) agglomeration. Vari-

ous agglomeration forces operating at the industry level or across industries have been well-understood in recent decades of development of theory and empirics in urban and regional economics. These include knowledge spillover, labor pooling, input-output linkages, and many others. See Marshall (1920) for initial ideas on agglomeration. For modern development of related literature, see Duranton and Puga (2004) for a survey on the theoretical literature, and Rothenthal and Strange (2004) on the empirical counterpart. Less emphasized is the role of international trade and foreign direct investment. A few recent studies point to the positive role of international trade on the agglomeration of economic activities within a country (see, e.g., Rauch 1991; Fajgelbaum and Redding 2014; Tombe and Zhu 2015; Redding 2016), but little work has been done on the role of FDI, which is the focus of our work.

Some empirical literature focuses on the effects of FDI on domestic firms. Using Venezuela data, Aitken and Harrison (1999) find empirical evidence that domestic firms may benefit from foreign firms through channels such as knowledge spillover, input sharing, and labor pooling, but they may lose market share to the more productive foreign multinationals. Their findings generally corroborate our above-mentioned mechanism tests. Alfaro and Chen (2018) decompose the aggregate industry productivity into within-firm productivity effect and between-firm selection and reallocation effect, and find that the selection and reallocation effect account for two-thirds of the effect of multinationals on aggregate industry productivity. Using data from Mexico, Venezuela, and the US, Aitken, Harrison, and Lipsey (1996) study the effect of FDI on local wages. Aitken, Hanson, and Harrison (1997) use Mexican plant-level data to study the effect of FDI on exports by domestic firms. Using data from the Czech Republic, Kosová (2010) studies the effect of FDI on firm selection. To the best of our knowledge, our work is the first attempt to identify the effect of FDI on industrial agglomeration in a country.

On the theory side, we note that our work is specifically on industrial agglomeration as opposed to agglomeration in general. The canonical theories of agglomeration typically model situations when two sides of the markets (buyers and sellers) are both mobile; e.g., when firms and people cluster together to form large regions or cities. See, for examples, Krugman (1991), Helpman (1998), Ottaviano, Tabuchi, and Thisse (2002). However, our focus here, as fits our regression specification and results, is on the location pattern of firms in an industry. Thus, we use the partial-equilibrium framework of Melitz and Ottaviano (2008) and allow only the firms to be mobile, i.e., we assume workers/consumers are immobile. After all, the location pattern of a four-digit industry⁵ is unlikely to affect the location pattern of the population or the overall economy. Our theoretical approach

⁵There are 424 4-digit CIC industries. For details, see Section 2.2.

also fits our empirical measure in the EG index, which takes the spatial distribution of population or overall economic activities as given. To the best of our knowledge, our theory is the first on how FDI affects industrial agglomeration.

A related point is on the role of the competition effect. In the theories of agglomeration, the competition effect may be conducive to agglomeration because consumers enjoy lower prices (e.g., Ottaviano, Tabuchi, and Thisse 2002). But under our setup to study the location pattern of an industry, the competition effect simply discourages agglomeration of firms. Also related is the study by Behrens, Gaigne, Ottaviano, and Thisse (2007) who show geographic dispersion of the industry when trade becomes more open. Our theory differs from theirs as we focus on FDI and incorporate technology diffusion.

The rest of the paper is organized as follows. Section 2 details the data and the background of the FDI deregulation in 2002. Section 3 specifies the estimation strategy. Section 4 presents the empirical results. Section 5 provides a theoretical explanation for the empirical results and conducts mechanism tests. Section 6 investigates the effect of FDI and industrial agglomeration on industrial growth rate. Section 7 concludes.

2 Background and Data

2.1 Regulations of FDI in China

In December 1978, China's then-leader Deng Xiaoping initiated an open door policy intended to promote foreign trade and investment. The policy changed dramatically the situation under the rigid central planning in force before 1978. At that time foreign-invested enterprises were almost completely absent. From the late 1970s to the early 1990s a series of laws on FDI and implementation measures were introduced and revised.

- In July 1979, a "Law on Sino-Foreign Equity Joint Venture" was passed to attract foreign direct investment.
- In September 1983, "Regulations for the Implementation of the Law on Sino-Foreign Equity Joint Ventures" were issued by China's State Council of China. They were revised in January 1986, December 1987, and April 1990.
- In April 1986 the "Law on Foreign Capital Enterprises" was enacted.
- In October 1986, "Policies on Encouragement of Foreign Investment" were issued by the State Council.

Foreign-invested enterprises enjoy preferential policies on taxes, land use, and other matters, often in the form of policies for the special economic zones. They were expected to bring advanced technology and management know-how to China and to promote China's integration into the world economy. As a result of those laws and implementation measures, China experienced rapid growth in FDI inflow from 1979 to 1991. After Deng Xiaoping took a tour of Southern China in the spring of 1992 to revive a slowing economy, the FDI inflows to China grew even faster, reaching US\$ 27.52 billion in 1993.

Most significantly, there were policies designating which industries were permitted to accept foreign direct investment. In June 1995, the central government promulgated a "Catalogue for the Guidance of Foreign Investment Industries" (henceforth, the Catalogue), which, together with the modifications made in 1997, became the government guideline for regulating FDI inflows. Specifically, the Catalogue classified products into four categories in which (i) FDI was supported, (ii) FDI was permitted, (iii) FDI was restricted, or (iv) FDI was prohibited.

After China's entry into the World Trade Organization in November 2001, the central government substantially revised the Catalogue in March 2002, and then made minor revisions in November 2004.⁶ This study exploits the plausibly exogenous relaxation of FDI regulations upon China's WTO accession at the end of 2001 to identify the effect of FDI on industrial agglomeration.

2.2 Data

Panel Data on Industrial Firms.—The main data used in this study are from the Annual Surveys of Industrial Firms (ASIFs) conducted by the National Bureau of Statistics of China during the 1998–2007 period.⁷ These surveys cover all of the state-owned enterprises (SOEs) and all of the non-SOEs firms with annual sales exceeding 5-million Chinese yuan (about US\$827,000). The number of firms covered in the surveys varies from approximately 162,000 to approximately 270,000. The dataset has more than 100 variables, including the basic information for each surveyed firm, such as its identification number, location code, and industry affiliation. It is supplemented with financial and operational information extracted from accounting statements, such as sales, employment, materials, fixed assets, and the total wage bill.

⁶The National Development and Reform Commission and the Ministry of Commerce jointly issued the fifth and sixth revised versions of the Catalogue in October 2007 and December 2011, which are outside the period studied.

⁷These data have been widely used by economics researchers in recent years, e.g., Lu, Lu, and Tao (2010), Brandt, Van Biesebroeck, and Zhang (2012), and Lu and Yu (2015).

For our study, we need precise industry and location information about our sample firms. In 2003, a new classification system for industry codes (GB/T 4754-2002) was adopted in China to replace the old classification system (GB/T 4754-1994) that had been used from 1995 to 2002. To achieve consistency in the industry codes over the entire period studied (1998–2007), the concordance table constructed by Brandt, Van Biesebroeck, and Zhang (2012) is exploited to convert all of the data to the GB/T 4754-2002 system.⁸ Meanwhile, during the sample period studied there were several changes in the county or prefecture⁹ codes in the data set, due to changes in administrative boundaries.¹⁰ Using the national standard (GB/T 2260-1999) promulgated at the end of 1998 as the benchmark code, we convert the region codes of all of the firms to that standard to achieve consistency over the entire period studied.

The outcome variable, the degree of industrial agglomeration, is measured by applying the method of Ellison and Glaeser (1997). Ellison and Glaeser’s index (henceforth, the EG index) is constructed as

$$EG_i \equiv \frac{G_i - (1 - \sum_r x_r^2)H_i}{(1 - \sum_r x_r^2)(1 - H_i)},$$

where $G_i \equiv \sum_r (x_r - s_r^i)^2$ with x_r the share of total output of all industries in region r , and s_r^i the share of output of region r in industry i ; and $H_i \equiv \sum_j h_j^2$ is the Herfindahl index of industry i , with h_j the output share of a particular firm j in industry i .

For a given industry, the EG index measures the degree of spatial concentration relative to the case where the firms in that industry are randomly assigned to locations (the metaphor is a dartboard approach). In the main analysis, we measure the EG indexes by using prefectures as the geographic unit. (There are around 380 prefectures in China.) To check whether the findings are sensitive to the geographic unit selected (the so-called

⁸One potential problem with the ASIF data is that, for firms with multiple plants located in regions other than their domiciles, the information about the satellite plants might be aggregated with that of the domicile-based plants. According to Article 14 of China’s Company Law, for a company to set up a plant in a region other than its domicile “it shall file a registration application with the company registration authority, and obtain the business license.” So if a firm has six plants located in different provinces, they are treated as six different observations belonging to six different regions. Thus a firm in this study’s data set is essentially a plant.

⁹The most common form of the prefecture is the so-called “prefectural-level city” (di-ji-shi). Prefectures that are not prefectural-level cities typically cover rural areas. The terminology “prefectural-level city” is the official name for such jurisdictions. This can be confusing, because such prefectures are much larger than a metropolitan area and cover large areas of rural land. In this paper, both types are simply called prefectures.

¹⁰For example, new counties were established, while existing counties were combined into larger ones or even elevated to prefectures.

modifiable area unit problem), the EG indexes are also computed using counties as the geographic unit. (There are around 2,800 counties in China.)

Data on China's FDI Regulations.—In compiling information about changes in FDI regulations upon China's accession to the WTO, the 1997 and 2002 versions of the Catalogue are compared matching the product level in the Catalogue with ASIF industries (Lu, Tao, and Zhu 2017). As has been explained, the Catalogue lists products (i) where foreign direct investment was supported (the supported category), (ii) where foreign direct investment was restricted (the restricted category), and (iii) where foreign direct investment was prohibited (the prohibited category). Products not listed constitute a permitted category. We compare the 1997 and 2002 versions of the Catalogue to identify for each product whether or not there had been a change in the applicable FDI regulations upon China's accession to the WTO. Each product is then assigned to one of three outcomes: (i) FDI became more welcome (FDI encouraged products), (ii) FDI became less welcome (FDI discouraged products) or (iii) No change in FDI regulations between 1997 and 2002.¹¹

The changes in FDI regulations were then aggregated from the product level of the Catalogue to the industry level of the ASIF. This led to four possible outcomes:

1. Encouraged Industries: For all of a 4-digit CIC industry's Catalogue products there was either a relaxation of FDI restrictions or no change.
2. Discouraged Industries: For all of a 4-digit CIC industry's Catalogue products there was either a tightening of FDI regulations or no change.
3. No-change Industries: There was no change in the FDI regulations applicable to any of a 4-digit CIC industry's Catalogue products.
4. Mixed Industries: FDI regulations were tightened for some of a 4-digit CIC industry's Catalogue products but loosened for others.

Among the 424 4-digit CIC industries, 112 are classified as encouraged (the treatment group in the study's regression analyses), 300 are categorized as no-change industries (the control group in the regressions), 7 are considered discouraged, and 5 are mixed. The latter two groups are excluded from the analysis.¹²

One concern here is that regional variation in FDI deregulation might affect the geographic distribution of economic activity. After carefully examining the 2002 Catalogue,

¹¹See Appendix A for more detail about how the 1997 and 2002 catalogues are compared and how Catalogue products are matched with ASIF industries.

¹²The results remain robust when the discouraged industries are included in the control group. See Section 4.3.

however, as well as other policies related to FDI issued in 2002, we do not find any changes in the regional aspects of the FDI entry regulations. Actually, in 1997, the year in which the Catalogue was promulgated, the State Council also issued the “Termination of Unauthorized Local Examination and Approval of Commercial Enterprises with Foreign Investment” which forbid local discretions with respect to FDI.

Descriptive Statistics.—Table 1 reports the EG indexes calculated at the prefecture level across the 2-digit industries over the entire sample period (1998–2007), the pre-WTO period (1998–2001), and the post-WTO period (2002–2007). The three most geographically concentrated industries in the 1998–2007 period are Smelting & Pressing of Nonferrous Metals, Leather, Furs, Down & Related Products, and Food Processing. The industries with the lowest degree of agglomeration are Tobacco Processing, Printing Industry, and Medical & Pharmaceutical Products.

[Insert Table 1 here]

From the pre-WTO period to the post-WTO period there were substantial changes in the degree of agglomeration across the industries. The Chemical Fiber industry witnessed the fastest growth in agglomeration, followed by Instruments, Meters, Cultural & Office Equipment, and then Transport Equipment. Tobacco Processing, Petroleum Processing & Coking, and Medical & Pharmaceutical Products experienced decreased agglomeration.

Table 2 compares the changes in foreign equity share in Panel A, and the changes in the share of number of foreign firms in Panel B, before and after the WTO accession for the treatment and the control group. There were significant increases in both the foreign equity share and the share of number of foreign firms for the treatment industries (in which FDI was encouraged) than for the control industries (where FDI entry regulations were unchanged).

[Insert Table 2 here]

3 Estimation Strategy

3.1 Specification

To identify the effect of changes in FDI regulations on industrial agglomeration, we use variations across industries in the changes in FDI regulations upon China’s WTO accession: a DD estimation framework. Specifically, we compare the degree of agglomeration

in the treatment group (the encouraged industries) with that in the control group (the no-change industries) before and after China’s WTO accession at the end of 2001.

The specification for the DD estimation is

$$y_{it} = \alpha_i + \beta Treatment_i \times Post02_t + \mathbf{X}'_{it} \boldsymbol{\lambda} + \gamma_t + \varepsilon_{it}, \quad (1)$$

where i , and t denote the 4-digit industry, and year, respectively; y_{it} measures the agglomeration (the EG index) of industry i in year t ; α_i is the industry fixed effect controlling for time-invariant industry characteristics; γ_t is the year fixed effect controlling for macroeconomic shocks that affect all industries such as population distribution and labor mobility; and ε_{it} is the error term. To address the potential serial correlation and heteroskedasticity issues, we calculate the standard errors clustered at the industry level (see Bertrand, Duflo, and Mullainathan, 2004).

$Treatment_i \times Post02_t$ is the regressor of interest, capturing the FDI regulation changes in industry i and year t , where $Treatment_i$ indicates whether industry i belongs to the *encouraged industries*; and $Post02_t$ is a dummy indicating the post-WTO period, i.e., $Post02_t = 1$ if $t \geq 2002$, and 0 if $t < 2002$. To isolate the effect of FDI regulation changes, we control for a vector of time-varying industry characteristics \mathbf{X}_{it} (to be explained later) which may be correlated with $Treatment_i \times Post02_t$.

3.2 Identifying Assumption and Checks

The identifying assumption of the DD estimation specification (1) is that, conditional on a list of controls, our regressor of interest ($Treatment_i \times Post02_t$) is uncorrelated with the error term (ε_{it}), i.e., $cov(Treatment_i \times Post02_t, \varepsilon_{it} | \mathbf{W}_{it}) = 0$, where \mathbf{W}_{it} represents all of the controls ($\alpha_i, \mathbf{X}_{it}, \gamma_t$). There are only two possible sources of violation of this identifying assumption; if either $cov(Post02_t, \varepsilon_{it} | \mathbf{W}_{it}) \neq 0$ or $cov(Treatment_i, \varepsilon_{it} | \mathbf{W}_{it}) \neq 0$. We discuss these possible estimation biases in sequence, and also our checks.

Nonrandom Timing of Treatment. If $cov(Post02_t, \varepsilon_{it} | \mathbf{W}_{it}) \neq 0$, the timing of the FDI deregulation was non-random. All of the analyses include year fixed effects that remove all the common differences across years. Nonrandom selection of treatment timing would have biased the estimates if, for example, the Chinese government had chosen to change the FDI regulations in 2002 knowing that treatment and control industries would become different at that moment.

As discussed in the previous subsection, however, the FDI deregulation in 2002 was one of the requirements of China’s WTO accession, the negotiation of which was very

lengthy and rather uncertain prior to 2001. First, it took more than 15 years of exhaustive negotiations with the 150 WTO member countries for China to join the WTO. Second, although China signed a breakthrough agreement with the United States in November 1999 and an agreement with the European Union in May 2000, several remaining issues such as farm subsidies were still unresolved in mid-2001. There could thus have been no anticipation of China's WTO accession by the end of 2001. Nevertheless, a robustness check is performed following Jensen and Oster (2009). Specifically, an additional control— $Treatment_i \times One\ Year\ Before\ WTO\ Accession_t$ —is included in the regression. A significant coefficient for that additional control variable would indicate possible expectation effects.

Another potential bias arising from the treatment timing is that other on-going policy reforms at the time of China's WTO accession might have affected industrial agglomeration, thereby confounding the effect of FDI on industrial agglomeration. At the time of China's WTO accession there were substantial tariff reductions by China and its trading partners which affected the use of imported inputs and access to export markets. To condition out the tariff reduction effects, we include the interactions between year dummies and various tariffs (specifically, China's output and input tariffs, and its export tariffs) in 2001 in X_{it} .¹³ Another important policy reform in the early 2000s was the restructuring and privatization of SOEs. To control for the possibility that the extent of SOE restructuring and privatization differed across industries and affected our outcomes, we add the interaction between the year dummies and industry-level SOE share in 2001 in X_{it} . China's special economic zones were specifically designed to attract foreign direct investments, and to alleviate this concern, we include an additional control, the interaction between the year dummies and the share of industry output from the special economic zones in 2001. China also launched a Western Development Program in 2000 to foster economic growth in its western regions, and we further add in the regressions the interaction between the year dummies and the share of industry output in the western regions in 2001 to control for the effect of that program on industrial agglomeration.¹⁴

¹³The tariff data for HS-6 products are obtained from the World Integrated Trade Solution database. Mapping HS-6 products to ASIF 4-digit industries through the concordance table from China's National Bureau of Statistics allows calculating a simple average output tariff for each industry. The input tariffs are constructed as a weighted average of the output tariffs, using as the weight the share of the inputs in the output value from the China's 2002 input-output table. The export tariff is a weighted average of the destination countries' tariffs on Chinese imports, using China's exports to each destination country as the weight.

¹⁴The Western Development Program covered the provinces of Gansu, Guizhou, Qinghai, Shaanxi, Sichuan, and Yunnan, the autonomous regions of Guangxi, Inner Mongolia, Ningxia, Tibet, and Xinjiang, and the municipality of Chongqing.

Nonrandom Selection of the Treatment Group. If $cov(Treatment_i, \varepsilon_{it} | \mathbf{W}_{it}) \neq 0$, that challenges the comparability of the treatment and control groups. Specifically, the selection of which industries to open up to FDI upon the WTO accession was not random. The *encouraged industries* and the *no-change industries* could have been experiencing different trends before the WTO accession and those differences might have generated different outcome trends across industries in the post-WTO period.

To alleviate the identification concern due to the nonrandom selection of treatment industries, we follow the approach proposed by Gentzkow (2006). First, we carefully characterize the important determinants of the changes in FDI regulations upon the WTO accession. The State Council issued the “Provisions on Guiding the Orientation of Foreign Investment” in 2002 and listed several reasons/criteria for why and how the government modified the Catalogue and relaxed the FDI regulations in 2002. As shown in Lu, Tao, and Zhu (2017), four determinants are identified at the four-digit industry level: new product intensity, export intensity, number of firms, and the average age of firms in the industry.¹⁵

There is also a concern that the choice of industries for FDI deregulation could have been related to the SOE reform during the late 1990s. During the reform, some industries were not deregulated due to political favoritism. FDI deregulation provides the reformers another opportunity to liberalize more industries, and those are likely to be industries associated with politically weaker interest groups. The change in the share of SOEs in an industry between 1998 and 2001 serves as an indicator of the industry-government connection, a potential determinant of FDI deregulation.

Let the four determinants from the Catalogue be measured in 2001 as well as the change in SOE share between 1998 and 2001 denoted as Z_{i2001} . We then add interactions between Z_{i2001} and the year dummies ($Z_{i2001} \times \gamma_t$) in \mathbf{X}_{it} to control flexibly for post-WTO differences in the time paths of the outcomes caused by the endogenous selection of industries for changes in their FDI regulations. Furthermore, we control for time-varying industry characteristics to balance different industries. Specifically, we include in \mathbf{X}_{it} factors which may have affected industrial agglomeration. Included are knowledge spillovers (measured by industrial productivity), input sharing (measured by intermediate inputs as a share of output), labor market pooling (measured by wage premiums), scale economies (measured by average firm size), and a geographic factor (measured by

¹⁵New product intensity is the ratio of new product output to total output. Export intensity is the ratio of total exports to total output. New product intensity and number of firms are statistically positively correlated with the FDI deregulation, while export intensity and industry average age are negatively correlated. The positive correlation of new product intensity indicates that more innovative industries are more likely to be deregulated. Also, infant industries (those with smaller firm ages) and industries with less export intensity are more likely to be deregulated. See Appendix B for a detailed discussion on the selection of the determinants of FDI deregulation.

employment in the coastal area). We further control for the channel of vertical FDI (i.e., backward and forward FDI) to account for potential influences of the FDI in upstream and downstream industries on the agglomeration of own industries.¹⁶

A Placebo Test. We formalize the identification issues and carry out a placebo test with randomly assigned reform status (for similar exercises, see, for example, Chetty, Looney, and Kroft, 2009; La Ferrara, Chong, and Duryea, 2012). We decompose the error term into two parts: $\varepsilon_{it} = \delta\omega_{it} + \tilde{\varepsilon}_{it}$, such that

$$\begin{aligned} \text{cov}(Treatment_i \times Post02_t, \omega_{it} | \mathbf{W}_{it}) &\neq 0 \\ \text{and } \text{cov}(Treatment_i \times Post02_t, \tilde{\varepsilon}_{it} | \mathbf{W}_{it}) &= 0. \end{aligned}$$

All of the identification issues are then confined to omitted variable ω_{it} . Then $\hat{\beta}$ is such that

$$\text{plim}\hat{\beta} = \beta + \delta\kappa, \quad (2)$$

where $\kappa \equiv \frac{\text{cov}(Treatment_i \times Post02_t, \omega_{it} | \mathbf{W}_{it})}{\text{var}(Treatment_i \times Post02_t | \mathbf{W}_{it})}$. And $\hat{\beta} \neq \beta$ if $\delta\kappa \neq 0$. To check whether the results are biased due to the omitted variable ω_{it} , we conduct a placebo test by randomly generating the industry and time variations in the changes in FDI entry regulations. Specifically, 112 industries are first selected randomly from the total of 412 industries in the regression sample and assigned as *encouraged industries*. A year between 1999 and 2006 is then randomly chosen (to ensure at least one year before the treatment and one year after WTO accession is included for the DD analysis). Then, we create *false* treatment groups and *false* implementation years from these two randomizations, i.e., $Treatment_i^{false} \times Post_t^{false}$. The randomization ensures that $Treatment_i^{false} \times Post_t^{false}$ should have no effect on industrial agglomeration (i.e., $\beta^{false} = 0$); otherwise, it indicates the existence of the omitted variable ω_{it} . This random data generation process is repeated 500 times to avoid contamination by any rare events and to improve the power of the test.¹⁷

Colombia Instruments. Despite of all these validity exercises, one may still be concerned about the endogeneity that remains in this research setting. The validity checks may not have exhausted all the determinants of FDI deregulation, and remaining uncontrolled selection variables may generate post-treatment differences between the treated and control

¹⁶Following Javorcik (2004), backward FDI is $\sum_{k \text{ if } k \neq i} \alpha_{ik} \times Treatment_k \times \gamma_t$, and forward FDI is $\sum_{m \text{ if } m \neq i} \beta_{im} \times Treatment_m \times \gamma_t$. Here, α_{ik} is the ratio of industry i 's output supplied to sector k , and β_{im} is the ratio of inputs purchased by industry i from industry m . Information on α_{ik} and β_{im} is compiled from China's 2002 input-output table.

¹⁷To be specific, we conduct the placebo test by estimating the following equation: $y_{it} = +\beta^{false} Treatment_i^{false} \times Post_t^{false} + \mathbf{X}'_{it}\boldsymbol{\lambda} + \gamma_t + \nu_{it}$. The controls ($\alpha_i, \mathbf{X}'_{it}, \gamma_t$) are the same as those in the benchmark estimation (1).

industries, biasing the estimates. To further address such concerns, we adopt an instrumental variable estimation in the spirit of Ellison, Glaeser, and Kerr (2011) to identify the effect of FDI liberalization on industrial agglomeration. The instruments are Colombian industry-level characteristics, i.e., export intensity, industry age, and number of firms corresponding to the determinants of China’s FDI regulation changes, interacted with $Post02_t$. For the construction of the Colombia instruments, the industry-level measures of export intensity, age and number of firms are calculated based on Colombian plant-level data from the Departamento Administrativo Nacional de Estadística. The measures are averaged over 1981 to 1991 for the median firm in each industry.¹⁸ The instruments are potentially correlated with the FDI deregulation in China because they reflect relatively similar industry characteristics of the corresponding Chinese industries. We test the relevance condition by examining the significance of the instruments in the first-stage of the IV estimation. The instruments are unlikely to be correlated with the error term because bilateral trade and FDI between China and Colombia in the 1980s were very small, indicating that there are no close international comovement relationships between Chinese and Colombian industries.¹⁹

4 Empirical Findings

4.1 Graphical Results

To illustrate the validity of our identification strategy, we plot, in Figure 1, the time trends in the difference in industrial agglomeration (measured by the EG index) between the *encouraged industries* and *no-change industries*, conditional on a set of controls in (1). It is clear that in the pre-treatment period the treatment and control groups show quite similar trends. This alleviates the concern that our treatment and control groups are systematically different *ex ante*, which lends support to the idea that the DD identifying assumption is satisfied.

Meanwhile, in the post-treatment period, the treatment group experienced a significant decline in the degree of agglomeration compared with the control group, indicating that the relaxation of FDI regulations had a negative effect on industrial agglomeration.

¹⁸Note that the lack of information on Colombian firm-level new products and R&D investments prevent using new product ratio as an instrument for the regressor of interest. Also, the industry classifications of the Colombian data (ISIC revision 2) and Chinese data (the Chinese Industry Classification, as mentioned earlier) are different. To obtain consistency in industry classification, the ISIC revision 2 data are first converted to revision 3 using a concordance from the UN Nations Statistics Division, and then converted to the Chinese Industry Classification using a concordance published by Judith and Lovely (2010).

¹⁹Colombia’s exports to China from 1981 to 1991 averaged 0.07% of those from the U.S.

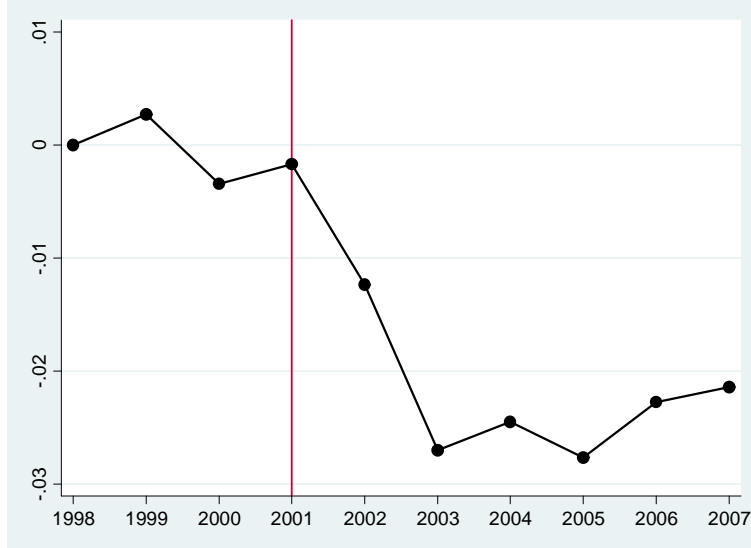


Figure 1: Effects of FDI regulation changes on industrial agglomeration

4.2 Main Results

The DD estimation results are reported in Table 3. We start with a DD specification that includes only the industry and year fixed effects in Column 1. Then, we stepwisely include a set of controls as elaborated in the previous section. The inclusion of the controls allows isolating the effect of FDI from other confounding factors such as the endogenous selection of industries for changes in FDI regulations upon the WTO accession and other on-going policy reforms (tariff reductions, SOE reform, special economic zones, and the Western Development Program) occurring around the same period. Specifically, interactions between the year dummies and potential determinants of changes in FDI regulations are reported in Column 2. Interactions between year dummies and tariff reductions, and between year dummies and SOE share are included in Columns 3 and 4, respectively. Column 5 adds the interaction between between the year dummies and the share of industry output from the special economic zones in 2001. Column 6 adds the interaction between between year dummies and the share of industry output from the western regions in 2001. Time-varying industry characteristics are added in Column 7. The extent of backward and forward FDI is added as a control in Column 8.

We consistently find that our regressor of interest, $Treatment_i \times Post02_t$, is statistically significant and negative, implying that FDI liberalization has a negative effect on industrial agglomeration. This also echoes the message in Figure 1.

[Insert Table 3 here]

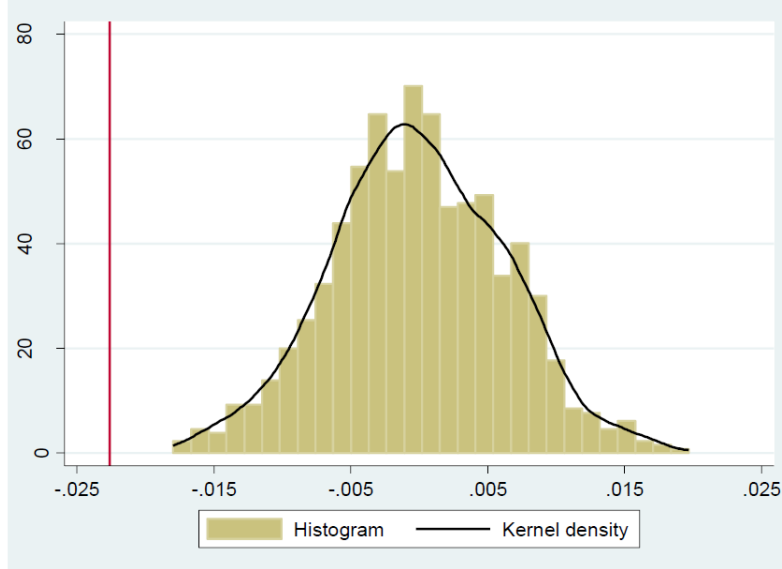


Figure 2: Distribution of estimated coefficients in the placebo test

4.3 Robustness Checks

Randomly Assigned Policy Reform.—As discussed in the previous section, we conduct a placebo test by randomly generating the industry and time variations in the changes in FDI entry regulations. Figure 2 shows a histogram and the kernel density of the distribution of the estimates from the 500 randomized assignments. The distribution of the estimates is centered around zero (mean value -0.00008) with a standard deviation of 0.006. In addition, the true estimate (i.e., -0.023) lies below all 500 estimates. Combined, these observations suggest that the negative and significant effect of FDI on industrial agglomeration is unlikely to be driven by unobserved variables.

IV Estimation. The IV estimation result is presented in Table 4, with the first-stage estimates in Column 1 and the second-stage estimates in Column 2. The first-stage estimation result shows that the Colombia instruments are statistically significant with the changes in FDI regulations. The Anderson-Rubin Wald test and the Stock-Wright LM S statistic, which offer reliable statistical inferences in a weak instrument setting, are both significant. These results confirm the relevance condition of the instruments. Furthermore, the Hansen J statistic fails to be significant, confirming the joint validity of the full instrument set. Turning to our regressor of interest, $Treatment_i \times Post02_t$, the coefficient remains negative and statistically significant, indicating that FDI has a negative effect on

industrial agglomeration.²⁰

[Insert Table 4 here]

Discouraged Industries Included in the Control Group.—In Column 1 of Table 5, we enlarge the control group by including the discouraged industries. The results remain similar to the benchmark results.

[Insert Table 5 here]

Alternative Measures of Agglomeration.—In Column 2 of Table 5, we repeat our analysis using an alternative measure of agglomeration—an EG index calculated using the county as the geographic unit. Consistently, we find that $Treatment_i \times Post02_t$ is negative and statistically significant, implying that the benchmark results are not driven by the specific measure of industrial agglomeration.

Expectation Effect.—In Columns 3 and 4 of Table 5, we add to the regression an additional control, $Treatment_i \times One\ Year\ Before\ WTO\ Accession$, to check whether or not the degree of industrial agglomeration changes in anticipation of the changes in the FDI regulations upon WTO accession. The coefficient of the regressor of interest remains negative and statistically significant, whereas the coefficient of the $Treatment_i \times One\ Year\ Before\ WTO\ Accession$ term is statistically insignificant, with magnitude close to 0. These results indicate that the treatment and control groups are comparable in the pre-treatment period and there is no expectation effect.

5 A Theory of Foreign Direct Investment and Industrial Agglomeration

This section provides a theory to comprehend our empirical results. The conventional expectation of a positive relationship between FDI and industrial agglomeration is intimately linked with ideas about technology spillovers and various examples of successful SEZ stories. Such expectation can be reconciled with these empirical results by considering more closely the interplay between technology diffusion and competition.²¹

²⁰Note that the IV estimator has the same direction as the DD estimator, but they differ in magnitude. Essentially, the IV estimator identifies the local average treatment effect while the DD estimator captures the average treatment effect. To assess the external validity and gauge the economic magnitude of the results, the DD estimator is used as the benchmark.

²¹The competition here is product market competition. We choose to focus on product markets rather than competition in factor markets because that is how industries are defined. Also, factor market competition is generally across the board among industries within a region. The overall pattern of factor market competition across regions in a given year should already be taken care of by the year fixed effect.

Note first that technology diffusion can be interpreted more generally. There are various benefits that domestic firms can receive from the presence of foreign firms. Apart from technology spillovers, there are input-output linkage and labor pooling. We take a simple approach to model these various benefits to domestic firms by technology diffusion, i.e., the domestic firms become more productive when locating near foreign firms. On the other hand, whereas FDI deregulation implies more FDI inflows, the number of firms increases, and this brings fiercer competition which also affects firms' location choices.

When the scale of the industry (or the entire economy) is small, which is often the case for developing countries in the early stage of development, firm productivities tend to be low and competition is not fierce. In that situation, domestic firms can benefit tremendously from FDI, and FDI deregulation fosters industrial agglomeration. However, once the industry has grown sufficiently large, the productivity gap may have already narrowed and competition is fiercer. The benefits that domestic firms might hope to receive from foreign firms then become small, while the already fierce competition encourages dispersion of firms in the face of an influx of foreign capital.

As fitting to our empirical results from industry-level regressions, labor is assumed to be immobile as each particular industry has only negligible influence on the overall distribution of labor force or population. We thus focus on "industrial agglomeration" rather than "agglomeration" of both population and firms. Without mobility of workers or consumers, competition entails negative incentives for firms' location choices, as firms typically choose to go to places with less fierce competition.²²

5.1 Model

To incorporate competition effect in an analytically tractable way, our model builds on Melitz and Ottaviano's (2008) modeling of heterogeneous firms and variable markups. Consider a country with two regions, indexed by $i = 1, 2$. A mass of immobile workers \bar{L}_i live and work in region i such that $\bar{L}_1 + \bar{L}_2 = \bar{L}$. Suppose for some reason that there are more foreign firms in region 1. That may attract domestic firms to locate in region 1 in hopes of technology diffusion, but region 1 may also become more competitive, and some firms may want to leave. To highlight the tradeoff between technology diffusion and competitive effects, assume foreign firms can only be located in region 1. We can think of this assumption as SEZs or broader policy restrictions/incentives targeting foreign firms.

²²When labor is mobile, pro-competitive effects can be an agglomeration force, as more firms in a location can lower product prices and thus attract consumers and workers to move to that location, too. See, e.g., Ottaviano, Tabuchi, and Thisse (2002).

We assume that domestic firms are freely mobile. Empirically, we find no evidence that the location pattern of foreign firms become more dispersed due to FDI deregulation. See Section 5.4 for details.²³

5.1.1 Consumption

Assume that any worker living in region i consumes a set of differentiated products indexed by ω and a homogeneous good, which is set to be the numeraire. She solves the following utility maximization problem:

$$\begin{aligned} \max_{q_0, q_{ji}(\omega)} U_i &= q_0 + \alpha \sum_j \int_{\omega \in \Omega_j} q_{ji}(\omega) d\omega - \frac{\gamma}{2} \sum_j \int_{\omega \in \Omega_j} q_{ji}^2(\omega) d\omega - \frac{\eta}{2} \left(\sum_j \int_{\omega \in \Omega_j} q_{ji}(\omega) d\omega \right)^2 \\ \text{s.t. } q_0 + \sum_j \int_{\omega \in \Omega_j} p_{ji}(\omega) q_{ji}(\omega) d\omega &= y_i + \bar{q}_0, \end{aligned}$$

where Ω_j is the set of differentiated products produced in region j , $q_{ji}(\omega)$ is her demand for the goods produced in region j with price $p_{ji}(\omega)$, q_0 is the amount of the numeraire good consumed, and \bar{q}_0 is the per person endowment of the numeraire good. The positive parameters α and η capture the substitution between the differentiated products and the numeraire: A larger α or a smaller η indicates greater willingness to pay for any differentiated product in terms of the numeraire. The parameter $\gamma > 0$ captures the degree of product differentiation between the varieties: the larger γ , the more differentiated the products are. When $\gamma = 0$, they are perfect substitutes.

Each worker is endowed with a unit of labor, which is supplied inelastically to the firms in the region where she resides. Assume \bar{q}_0 is sufficiently large so that the consumption q_0 is always positive. Each worker also owns an equal share of all the domestic capital K^H (H stands for home). Thus, her total income is $y_i = w_i + \frac{K^H}{L} r_i$, where r_i is the rental rate of capital in region i and is endogenously determined.

As shown in Melitz and Ottaviano (2008), there exist choke prices p_i^m such that the individual demand is

$$q_{ji}^c = \begin{cases} \frac{1}{\gamma} (p_i^m - p_{ji}) & p_{ji} \leq p_i^m \\ 0 & p_{ji} > p_i^m \end{cases}. \quad (3)$$

²³If one were to assume the foreign firms to be mobile, the resulting equilibrium would be one in which the numbers of foreign and domestic firms are proportional to the population's distribution. That is because our model has no built-in agglomeration force. One can nevertheless incorporate standard agglomeration economies to generate an innate agglomeration, but all of the results should still hold, because an uneven distribution of foreign firms entails more technology diffusion in region 1. Such a model would, however, be much more complicated while offering little new insight.

Following a procedure similar to that of Melitz and Ottaviano (2008), the choke price here is given by

$$p_i^m = \frac{\gamma\alpha + \eta P_i}{\gamma + \eta N_i},$$

where

$$P_i \equiv \sum_j \int_{\omega \in \Omega_{ji}^c} p_{ji}(\omega) d\omega. \quad (4)$$

The price elasticity of demand for positive q_{ji}^c is $\varepsilon_{ji} = -\frac{\partial q_{ji}^c}{\partial p_{ji}} \frac{p_{ji}}{q_{ji}^c} = \left(\frac{p_i^m}{p_{ji}} - 1\right)^{-1}$. For a given price p_{ji} , a larger number of competing firms N_i lowers the choke price and induces an increase in ε_{ji} , indicating fiercer competition.

5.1.2 Production

The numeraire goods q_0 are produced using one-to-one constant-returns technology, and freely traded between the two regions. Thus $w_1 = w_2 = 1$. For the differentiated sector, ϕ units of capital are required to set up a firm in any region. Upon hiring ϕ units of capital, each entrant in region i generates a distinct product and draws its unit labor requirement c (i.e., the marginal cost or the inverse of productivity) from a given distribution $G_i^s(c)$, $s = H, F$. As in Melitz and Ottaviano (2008), the choke price in a region i determines the selection cutoff c_i such that entrants in i with $c > c_i$ will exit.

The standard iceberg trade cost assumption is also made: for each good ω , τ_{ji} units must be shipped in order to deliver 1 unit to region i from region j . For simplicity, we assume symmetric trade costs, and that trading locally is free. Thus, $\tau_{ji} = \tau > 1$ if $j \neq i$, and $\tau_{ji} = 1$ if $j = i$.

The total capital \bar{K} in this country consists of domestic capital K^H and foreign capital (FDI) K^F . We assume that K^F is entirely located in region 1 and is immobile. K^H is mobile. Denote the number of entrant firms in region i as N_i^E . The total number of entrants nationwide is then $\bar{N}^E \equiv N_1^E + N_2^E = \frac{K^F + K_1^H}{\phi} + \frac{K_2^H}{\phi} = \frac{\bar{K}}{\phi}$. By choosing units for capital, we can normalize ϕ to 1. Define the fraction of surviving firms in region 1 as

$$f \equiv \frac{K^F G_1^F(c_1^D) + K_1^H G_1^H(c_1^D)}{K^F G_1^F(c_1^D) + K_1^H G_1^H(c_1^D) + K_2^H G_2^H(c_2^D)}.$$

It is actually easier to work with the ratio of surviving firms between the two regions:

$$\lambda \equiv \frac{K^F G_1^F(c_1^D) + K_1^H G_1^H(c_1^D)}{K_2^H G_2^H(c_2^D)}, \quad (5)$$

which has a one-to-one mapping with f such that $f = \frac{\lambda}{1+\lambda}$ and is increasing in λ . We are interested in how FDI affects the spatial distribution of firms in the two regions, or equivalently, how the equilibrium value of λ , denoted as λ^e , responds to changes in the amount of capital.

If there is no technology diffusion, then regardless of the location, a firm of type s draws its cost c from a distribution given by

$$\bar{G}^s(c) = \left(\frac{c}{c^{M,s}} \right)^\theta, \quad c \in [0, c^{M,s}], \quad s \in \{H, F\}.$$

We assume $c^{M,F} \leq c^{M,H}$ to reflect the technological advantage of foreign firms over home firms. With technology diffusion in region 1, the domestic firms in region 1 draw from

$$G_1^H(c) = \left(\frac{c}{c_1^{M,H}} \right)^\theta, \quad c \in [0, c_1^{M,H}],$$

where

$$c_1^{M,H} = c^{M,F} + e^{-\beta K^F} (c^{M,H} - c^{M,F}), \quad \beta > 0.$$

Therefore, if $K^F = 0$, $c_1^{M,H} = c^{M,H}$, and if $K_1^F \rightarrow \infty$, $c_1^{M,H} = c^{M,F}$. That is, more FDI improves the productivity of domestic firms in region 1, but still leaves it lower than that of the foreign firms. Meanwhile, foreign firms still draw from the distribution with $c^{M,F}$, and the home firms in region 2 draw from the distribution with $c_2^{M,H} = c^{M,H}$.

Aggregating the individual demand (3), the aggregate demand (that is, the demand facing a firm) is $q_{ij} \equiv \bar{L}_j q_{ij}^c$. With trade cost $\tau > 1$, firms price-discriminate between the regions. Thus, maximizing $\pi_i = \pi_{ii} + \pi_{ij}$ is equivalent to

$$\max_{p_{ij}} \pi_{ij} = (p_{ij} - \tau_{ij}c) q_{ij} \quad \text{for } j = 1, 2.$$

Therefore,

$$\begin{aligned} p_{ij} &= \frac{\varepsilon_{ij}}{\varepsilon_{ij} - 1} \tau_{ij}c = \frac{p_{ij}}{2p_{ij} - p_j^m} \tau_{ij}c = \frac{1}{2} (p_j^m + \tau_{ij}c) \\ q_{ij} &= \bar{L}_j \left(\frac{p_j^m}{\gamma} - \frac{p_{ij}}{\gamma} \right) = \frac{\bar{L}_j}{2\gamma} (p_j^m - \tau_{ij}c). \end{aligned} \tag{6}$$

Let c_i^D and c_i^X denote cutoff cost levels in the local market and the export market for firms in region i . Note that those cutoffs are independent of firm types. Then, $c_i^D = p_i^m$ and $\tau_{ij}c_i^X = p_j^m$. So $c_i^X \tau_{ij} = c_j^D$. The equilibrium profit and revenue for a firm from i with

c in market j (if it sells there) are

$$\pi_{ij} = \frac{\bar{L}_j}{4\gamma} (c_j^D - \tau_{ij}c)^2 \quad (7)$$

$$s_{ij}(c) = \frac{\bar{L}_j}{4\gamma} \left((c_j^D)^2 - (\tau_{ij}c)^2 \right). \quad (8)$$

Moreover, the firm's mark-up in market j (if any) is

$$\mu_{ij}(c) = p_{ij}(c) - \tau_{ij}c = \frac{1}{2} (p_j^m - \tau_{ij}c). \quad (9)$$

5.1.3 Entry

The products available in region i consist of those locally produced and those imported:

$$\sum_{s \in \{H, F\}} N_i^{E,s} G_i^s(c_i^D) + \sum_{s \in \{H, F\}} N_j^{E,s} G_j^s(c_j^X) = N_i. \quad (10)$$

By (4) and (10), we have

$$P_i = N_i \frac{2\theta + 1}{2(\theta + 1)} c_i^D. \quad (11)$$

Combining the expression for the choke price with (11), we can solve for the number of products available in region i :

$$N_i = \frac{2(\theta + 1)\gamma\alpha - c_i^D}{\eta c_i^D}. \quad (12)$$

Let $\rho \equiv \tau^{-\theta}$, and thus ρ is a measure of trade openness. Using (10) and (12), the numbers of entrants are

$$N_1^{E,H} = \frac{2(\theta + 1)\gamma (c_1^{M,H})^\theta}{\eta(1 - \rho^2)} \left(\frac{\alpha - c_1^D}{(c_1^D)^{\theta+1}} - \rho \frac{\alpha - c_2^D}{(c_2^D)^{\theta+1}} \right) - K^F \left(\frac{c_1^{M,H}}{c^{M,F}} \right)^\theta \quad (13)$$

$$N_2^{E,H} = \frac{2(\theta + 1)\gamma (c_2^{M,H})^\theta}{\eta(1 - \rho^2)} \left(\frac{\alpha - c_2^D}{(c_2^D)^{\theta+1}} - \rho \frac{\alpha - c_1^D}{(c_1^D)^{\theta+1}} \right). \quad (14)$$

Together with $c_i^X \tau_{ij} = c_j^D$, each firm's expected profit gross on their capital rental is

$$E(\pi_i^s) = \int_0^{c_i^D} \pi_{ii}^s(c) dG_i^s(c) + \int_0^{c_i^X} \pi_{ij}^s(c) dG_i^s(c) = \frac{\bar{L}_i (c_i^D)^{\theta+2} + \rho \bar{L}_j (c_j^D)^{\theta+2}}{2\gamma(\theta + 1)(\theta + 2) (c_i^{M,s})^\theta}. \quad (15)$$

Competition for capital equates the capital rental rate to that expected profit. That is, $r_i^H = E(\pi_i^H)$ and $r_1^F = E(\pi_1^F)$.

5.2 Equilibrium Analysis

5.2.1 Equilibrium with fixed spatial distribution of firms

Before the analysis of equilibrium spatial distribution of firms, we first express the equilibrium conditions when the spatial distribution is fixed, that is, when λ is fixed. Equation (5) and $N_1^{E,H} + N_2^{E,H} = K^H$ together imply that

$$N_1^{E,H} = \frac{K^H \lambda G_2^H(c_2^D) - K^F G_1^F(c_1^D)}{\lambda G_2^H(c_2^D) + G_1^H(c_1^D)} = \frac{K^H \lambda \left(\frac{c_2^D}{c_2^{M,H}}\right)^\theta - K^F \left(\frac{c_1^D}{c_1^{M,F}}\right)^\theta}{\lambda \left(\frac{c_2^D}{c_2^{M,H}}\right)^\theta + \left(\frac{c_1^D}{c_1^{M,H}}\right)^\theta} \quad (16)$$

$$N_2^{E,H} = \frac{K^F G_1^F(c_1^D) + K^H G_1^H(c_1^D)}{\lambda G_2^H(c_2^D) + G_1^H(c_1^D)} = \frac{K^F \left(\frac{c_1^D}{c_1^{M,F}}\right)^\theta + K^H \left(\frac{c_1^D}{c_1^{M,H}}\right)^\theta}{\lambda \left(\frac{c_2^D}{c_2^{M,H}}\right)^\theta + \left(\frac{c_1^D}{c_1^{M,H}}\right)^\theta}. \quad (17)$$

Equating (13) and (16), as well as (14) and (17), we obtain

$$\frac{\alpha - c_1^D}{(c_1^D)^{\theta+1}} = \frac{\left[\rho (c_1^D)^\theta + \lambda (c_2^D)^\theta\right] \left[K^F \left(\frac{c_1^{M,H}}{c_1^{M,F}}\right)^\theta + K^H\right]}{\lambda \left(c_2^D c_1^{M,H}\right)^\theta + \left(c_1^D c_2^{M,H}\right)^\theta} \frac{\eta}{2(\theta+1)\gamma} \quad (18)$$

$$\frac{\alpha - c_2^D}{(c_2^D)^{\theta+1}} = \frac{\left[(c_1^D)^\theta + \lambda \rho (c_2^D)^\theta\right] \left[K^F \left(\frac{c_1^{M,H}}{c_1^{M,F}}\right)^\theta + K^H\right]}{\lambda \left(c_2^D c_1^{M,H}\right)^\theta + \left(c_1^D c_2^{M,H}\right)^\theta} \frac{\eta}{2(\theta+1)\gamma}. \quad (19)$$

For a given λ , the two cutoffs c_1^D and c_2^D are determined by the above two equilibrium conditions.

5.2.2 Equilibrium spatial distribution of firms

Let $\Delta^H(\lambda) \equiv E(\pi_1^H(\lambda)) - E(\pi_2^H(\lambda))$, where $\lambda \in [\underline{\lambda}, \infty)$ with $\underline{\lambda} \equiv \frac{K^F G_1^F(c_1^D)}{K^H G_2^H(c_2^D)}$, as the lower and upper bounds, correspond to the cases where all domestic firms are in region 2 and

in region 1, respectively.²⁴ We define equilibria following the standard approach (e.g., Krugman 1991; Ottaviano, Tabuchi and Thisse 2002). That is, an interior equilibrium λ , λ^e , must satisfy $\Delta^H(\lambda^e) = 0$. A corner equilibrium $\lambda^e \rightarrow \infty$ ($f^e = 1$) exists if $\lim_{\lambda \rightarrow \infty} \Delta^H(\lambda) > 0$. Similarly, a corner equilibrium $\lambda^e = \underline{\lambda}$ exists if $\Delta^H(\underline{\lambda}) < 0$.

From (15), we have

$$\Delta^H(\lambda) = \frac{\left[\left(\frac{c_1^{M,H}}{c_2^{M,H}} \right)^{-\theta} - \rho \right] \bar{L}_1 (c_1^D)^{\theta+2} + \left[\left(\frac{c_1^{M,H}}{c_2^{M,H}} \right)^{-\theta} \rho - 1 \right] \bar{L}_2 (c_2^D)^{\theta+2}}{2\gamma(\theta+1)(\theta+2) \left(c_2^{M,H} \right)^\theta}.$$

First recall that $\frac{c_1^{M,H}}{c_2^{M,H}} < 1$ due to technology diffusion. If $\frac{c_1^{M,H}}{c_2^{M,H}} \leq \rho^{\frac{1}{\theta}}$, then $\left(\frac{c_1^{M,H}}{c_2^{M,H}} \right)^{-\theta} \rho \geq 1$ and $\Delta^H(\lambda) > 0$ for all λ . Hence, full agglomeration ($f^e = 1$) occurs when $\frac{c_1^{M,H}}{c_2^{M,H}} \leq \rho^{\frac{1}{\theta}}$. Any interior equilibrium λ^e must satisfy $\Delta^H(\lambda^e) = 0$. Note that this also implies equal rental rates for domestic capital: $r_1^H = r_2^H \equiv r^H$. The condition $\Delta^H = 0$ implies that

$$\frac{c_2^D}{c_1^D} = \left(\frac{\left(c_2^{M,H} \right)^\theta - \rho \left(c_1^{M,H} \right)^\theta \bar{L}_1}{\left(c_1^{M,H} \right)^\theta - \rho \left(c_2^{M,H} \right)^\theta \bar{L}_2} \right)^{\frac{1}{\theta+2}} \equiv h > \left(\frac{\bar{L}_1}{\bar{L}_2} \right)^{\frac{1}{\theta+2}}. \quad (20)$$

Note that for a given K^F , h is exogenously determined. Suppose the two regions' populations are the same. Then, (20) implies that $c_2^D > c_1^D$. Because foreign firms are more productive, the domestic firms in region 1 are also more productive due to technology diffusion. Together with positive trade cost ($\tau > 1$; $\rho < 1$), firms in region 1 being more productive ensures that competition and selection are both more fierce in region 1, resulting in $c_1^D < c_2^D$. Observe that h is strictly decreasing in $c_1^{M,H}$, which is strictly decreasing in K^F ; so h is strictly increasing in K^F . FDI deregulation (an increase in K^F) therefore widens the difference between the two selection cutoffs, as the market in region 1 becomes more competitive. When the population sizes are different, the larger the population ra-

²⁴When all domestic firms are in region 2, the levels of c_1^D and c_2^D are determined by

$$\begin{aligned} \frac{2(\theta+1)\gamma \left(c_1^{M,H} \right)^\theta}{\eta(1-\rho^2)} \left(\frac{\alpha - c_1^D}{(c_1^D)^{\theta+1}} - \rho \frac{\alpha - c_2^D}{(c_2^D)^{\theta+1}} \right) - K^F \left(\frac{c_1^{M,H}}{c_1^{M,F}} \right)^\theta &= 0 \\ \frac{2(\theta+1)\gamma \left(c_2^{M,H} \right)^\theta}{\eta(1-\rho^2)} \left(\frac{\alpha - c_2^D}{(c_2^D)^{\theta+1}} - \rho \frac{\alpha - c_1^D}{(c_1^D)^{\theta+1}} \right) &= K^H, \end{aligned}$$

which are derived from (13) and (14). It can be shown that this occurs when \bar{L}_1/\bar{L}_2 is below a certain level, causing $\Delta^H(\lambda) < 0$.

tio \bar{L}_1/\bar{L}_2 , the larger the gap between the two cutoffs. Also, the greater the technology diffusion, the larger the gap.

Letting $\bar{\ell} \equiv \frac{\bar{L}_2}{\bar{L}_1}$, and using $N_1^{E,H} + N_2^{E,H} = K^H$, (13), (14), and (20), we have

$$\frac{\alpha(1 + \bar{\ell}h) - c_1^D(1 + \bar{\ell}h^2)}{(c_1^D)^{\theta+1}} = \frac{(1 - \rho^2)}{\left(c_1^{M,H}\right)^\theta - \rho\left(c_2^{M,H}\right)^\theta} \frac{\eta \left[K^H + K^F \left(\frac{c_1^{M,H}}{c_1^{M,F}} \right)^\theta \right]}{2(\theta + 1)\gamma}. \quad (21)$$

The selection cutoff c_1^D is the only endogenous variable in (21), which allows the following characterization.

Proposition 1. *When $\frac{c_1^{M,H}}{c_2^{M,H}} \leq \rho^{\frac{1}{\theta}}$, the equilibrium where all firms agglomerate in region 1 ($f^e = 1$) is the only equilibrium. Let h be defined by (20). When $\rho^{\frac{1}{\theta}} < \frac{c_1^{M,H}}{c_2^{M,H}} < 1$ and*

$$\frac{K^H + K^F \left(\frac{c_1^{M,H}}{c_1^{M,F}} \right)^\theta}{\left(c_1^{M,H}\right)^\theta - \rho\left(c_2^{M,H}\right)^\theta} \frac{\eta(1 - \rho^2)}{2(\theta + 1)\gamma} > \frac{(h - 1)h^\theta}{\alpha^\theta}, \quad (22)$$

there exists a unique interior equilibrium. Moreover, $f^e \geq 1/2$ if and only if $h \geq 1$.

Proof. The proposition is already proven for the full-agglomeration case. Define $F(c) \equiv \frac{\alpha(1 + \bar{\ell}h) - c(1 + \bar{\ell}h^2)}{c^{\theta+1}}$, where $c \in (0, \frac{\alpha}{h})$. The domain is $(0, \frac{\alpha}{h})$ because $0 < c_1^D < \alpha$ and $c_2^D = hc_1^D < \alpha$. It can be shown that $F(c)$ is strictly decreasing on $(0, \frac{\alpha}{h})$. Thus, the left-hand side of (21) strictly decreases from infinity to $\frac{(h-1)h^\theta}{\alpha^\theta} > 0$. Observe that $\left(c_1^{M,H}\right)^\theta - \rho\left(c_2^{M,H}\right)^\theta > 0$ if and only if $\frac{c_1^{M,H}}{c_2^{M,H}} > \rho^{\frac{1}{\theta}}$. Thus, if $\frac{c_1^{M,H}}{c_2^{M,H}} > \rho^{\frac{1}{\theta}}$ and (22) holds, then there exists a unique equilibrium c_1^D that satisfies (21), which is a condition for interior equilibrium. If $\frac{c_1^{M,H}}{c_2^{M,H}} > \rho^{\frac{1}{\theta}}$ but (22) fails, then no interior equilibrium exists. Observe that

$$\begin{aligned} \lambda^e &= \frac{K^F G_1^F(c_1^D) + N_1^{E,H} G_1^H(c_1^D)}{N_2^{E,H} G_2^H(c_2^D)} = \frac{\frac{\alpha - c_1^D}{(c_1^D)^{\theta+1}} - \rho \frac{\alpha - c_2^D}{(c_2^D)^{\theta+1}}}{\frac{\alpha - c_2^D}{(c_2^D)^{\theta+1}} - \rho \frac{\alpha - c_1^D}{(c_1^D)^{\theta+1}}} h^{-\theta} \\ &= \left(\frac{(1 - \rho^2)}{\frac{\alpha - c_2^D}{\alpha - c_1^D} h^{-\theta-1} - \rho} - \rho \right) h^{-\theta} = \frac{(1 - \rho^2)h}{\frac{\alpha - h\alpha}{\alpha - c_1^D} + h - \rho h^{\theta+1}} - \rho \left(\frac{1}{h} \right)^\theta. \end{aligned} \quad (23)$$

We know that $c_1^D < \alpha$ and $c_2^D = hc_1^D < \alpha$, and thus $c_1^D < \min\{\alpha, \frac{\alpha}{h}\}$. If $h > 1$,

$$\lambda^e = \left(\frac{1 - \rho^2}{\left(\frac{1}{h}\right)^{\theta+1} \frac{\alpha - c_2^D}{\alpha - c_1^D} - \rho} - \rho \right) h^{-\theta} > \frac{(1 - \rho^2)}{h^{-1} - \rho h^\theta} - h^{-\theta} \rho \equiv H(h),$$

where the inequality follows from the fact that $c_1^D < c_2^D < \alpha$ in equilibrium and that $H(h)$ is increasing in h over the domain $(1, \rho^{-\frac{1}{\theta+1}})$. Note here that $h \geq \rho^{-\frac{1}{\theta+1}}$ is not permissible because the term $\left(\frac{1}{h}\right)^{\theta+1} \frac{(\alpha - c_2^D)}{(\alpha - c_1^D)} - \rho$ in (23) must be positive, and $c_1^D < c_2^D$ when $h > 1$. Hence, $\lambda^e > H(1) = 1$ and $f^e = \frac{\lambda^e}{1 + \lambda^e} > \frac{1}{2}$. Similarly, if $h < 1$, we have $c_1^D > c_2^D$, and thus $\lambda^e = \left(\frac{1 - \rho^2}{\left(\frac{1}{h}\right)^{\theta+1} \frac{\alpha - c_2^D}{\alpha - c_1^D} - \rho} - \rho \right) \left(\frac{1}{h}\right)^\theta < \left(\frac{(1 - \rho^2)}{\left(\frac{1}{h}\right)^{\theta+1} - \rho} - \rho \right) \left(\frac{1}{h}\right)^\theta \equiv H(h)$, which is increasing in $(0, 1)$, and thus $\lambda^e < H(1) = 1$ and $f^e = \frac{\lambda^e}{1 + \lambda^e} < \frac{1}{2}$. Also, if $h = 1$, then $\lambda^e = 1$ and $f^e = 1/2$. ■

Note that condition (22) serves as a regularity condition that guarantees the existence of an interior equilibrium. Two key observations are in order. First, the ratio $\frac{c_1^{M,H}}{c_2^{M,H}}$ inversely measures technology diffusion as it is negatively affected by K^F . Thus, given $\rho \in (0, 1)$, for an initial K^F such that $\rho^{\frac{1}{\theta}} < \frac{c_1^{M,H}}{c_2^{M,H}}$, increasing K^F from the initial level will eventually cause $\frac{c_1^{M,H}}{c_2^{M,H}}$ switch from larger than $\rho^{\frac{1}{\theta}}$ to smaller than $\rho^{\frac{1}{\theta}}$, and hence switch the equilibrium from partial to full agglomeration. This demonstrates that FDI can encourage agglomeration by attracting domestic firms to region 1.

Note too, that if $\rho = 1$ ($\tau = 1$), the competition pressure a firm faces is the same regardless of where the firm is located. Thus, transport cost τ measures the degree in which locations matter in terms of competition pressure. Given K^F (hence given $\frac{c_1^{M,H}}{c_2^{M,H}}$), increasing the transport cost between the two regions (reducing ρ) may switch the equilibrium from full to partial agglomeration. When τ is high, location matters for competition pressure, and firms tend to spread themselves among the locations.

Even though Proposition 1 shows the importance of the composite parameter h in determining the location pattern f^e , we still lack an analysis on the comparative statics of K^F on f^e in a continuous range, say, when $h > 1$. Due to the complexity of the model, no analytical result is available and we resort to numerical analysis for such comparative statics.

We consider three cases based on the relative amounts of foreign and domestic capital. In all the cases, we let $\bar{L}_1 = \bar{L}_2$.

1. Hold K^H fixed and increase K^F only. This is numerical comparative statics of an

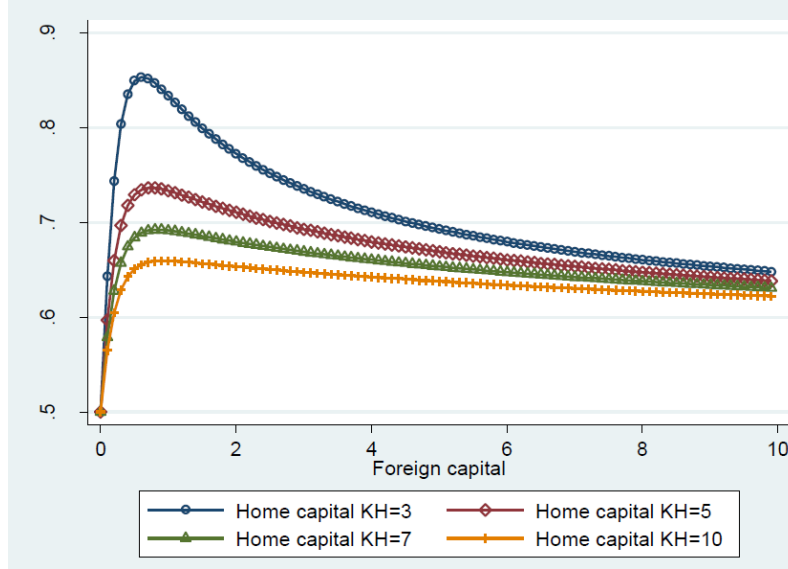


Figure 3: Comparative statics of K^F on f^e

influx of foreign capital (Shenzhen and Iskandar vs 2002 FDI deregulation).

2. Increase K^H and K^F at the same rate. This is numerical comparative statics of the overall scale of the industry.
3. Increase K^H faster than K^F . Numerical comparative statics of the overall scale of the industry when domestic capital increases faster than foreign investment.

Figure 3 shows that f^e first increases with K^F and then decreases, and that this is true for different levels of K^H .²⁵ Such non-monotonic patterns demonstrate a key intuition: the increasing part corresponds to the case where K^F is small but its increase promotes agglomeration sharply because of technology diffusion. The decreasing part shows up eventually when K^F becomes even larger as the competition becomes more intense and there are diminishing returns to technology diffusion. The curves with small K^H can be thought of as mimicking the case where the economy is small overall (e.g., China in 1979). In such a case, the slope of the increasing part is particularly steep as technology diffusion plays a large role. The curves with large K^H can be thought of as mimicking the case where the overall scale of the economy has grown large. In such a case when K^F is also large, we still see a negative effect of FDI on agglomeration of firms even when the slope is flatter than the cases where K^H is small. This corresponds to our empirical findings.

²⁵The parameters used for plotting Figure 4 are $L_1 = L_2 = 1$, $\theta = 5$, $\alpha = 2$, $\beta = 5$, $\eta = 10$, $\gamma = 1$, $\tau = 2.2$, $c^{M,H} = 2$, $c^{M,F} = 1.75$. Here, K^F increases from 0 to 10, and there are four values of K^H : 3, 5, 7 and 10.

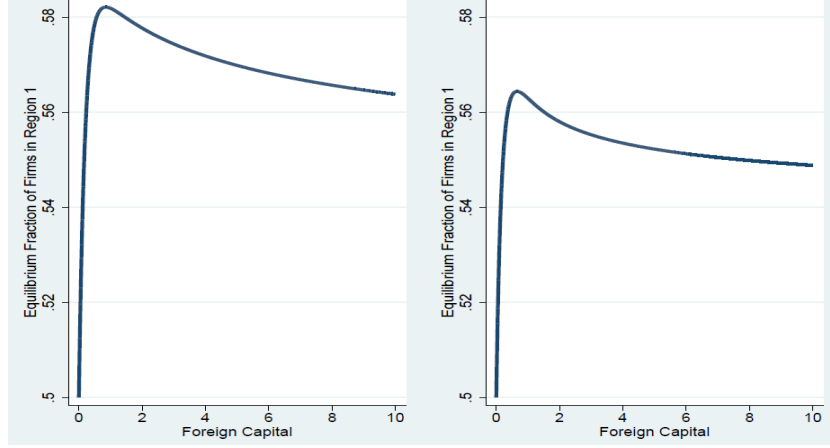


Figure 4: Comparative statics on f^e when K^F and K^H both grow

The left and right panels of Figure 4 plot the second and third cases.²⁶ They show what would occur if the effect of FDI deregulation were to increase not only the foreign firms but also the domestic firms (through various complementary channels). These patterns are robust. Note also that the reactions are smaller in the right panel than in the left because the amount of foreign capital is relatively less in the right panel, mitigating the effect of technology diffusion.

5.3 Evidence on Competition Effect

As competition is the main mechanism explaining our empirical findings, it is crucial to test this mechanism empirically. In all of our numerical comparative statics in the above theoretical model, c_1^D and c_2^D both decrease in response to FDI deregulation (increase in K^F). Consequently, according to (7), (8), and (9), firms' mark-ups, profits, and revenues decrease in both regions and for both types of firms. These are natural reflections of increased competitive pressure. Thus, our first mechanism test is to examine whether there are negative effects of FDI deregulation on markups, profits, and sales.

Firm sales and profits can be extracted directly from the data. Firm markups are estimated using the methodology developed by De Loecker and Warzynski (2012).²⁷ The estimation uses the following DD specification:

²⁶Except for the amount of capital, the parameters used in both panels are same: $\bar{L}_1 = \bar{L}_2 = 1$, $\theta = 5$, $\alpha = 2$, $\beta = 5$, $\eta = 10$, $\gamma = 1$, $\tau = 2.2$, $c^{M,H} = 2$, $c^{M,F} = 1.75$. Initial home capital $K_0^H = 5$ and initial foreign capital $K_0^F = 0$ in both panels. In the left panel, home and foreign capital increase at the same rate, that is: $K_t^s = K_0^s + t$, where $s \in \{H, F\}$, and time $t \in (0, 10)$. In the right panel, home capital increases faster than foreign capital: $K_t^F = K_0^F + t$, and $K_t^H = K_0^H + 20t$ with time $t \in (0, 10)$.

²⁷See Appendix C for details of the firm markup estimation.

$$y_{fit} = \alpha_f + \beta Treatment_i \times Post02_t + \mathbf{X}'_{it}\boldsymbol{\theta} + \boldsymbol{\Psi}'_{ft}\boldsymbol{\phi} + \gamma_t + \varepsilon_{fit}, \quad (24)$$

where f , i , and t here denote the firm, 4-digit industry, and year, respectively. y_{fit} measures the performance (markups, profits or sales) of firm f in industry i in year t ; α_f and γ_t are firm and year fixed effects, respectively; and ε_{fit} is the error term. We control for the time-varying industry characteristics X_{it} as in the benchmark estimation (1). The vector of time-varying firm characteristics Ψ_{ft} includes firm size (measured by firm employment), capital intensity (measured by the ratio of capital to labor), intermediate inputs, and firm ownership (measured by a state-owned enterprise dummy and a foreign-invested enterprise dummy). To address the potential serial correlation and heteroskedasticity, we cluster the standard errors at the industry level.

The estimation results are presented in Table 6, with Panel A for the sample of all firms and Panel B for the sample of domestic firms only.²⁸ Consistently, we find that FDI deregulation has a negative and statistically significant effect on firm markups, profits, and sales. These results are consistent with our model predictions, lending strong empirical support to the theoretical model.

[Insert Table 6 here]

Our theory focuses on China with the rest of the world appearing only as the exogenous source of foreign capital. It has emphasized as a mechanism that an influx of foreign capital intensifies domestic competition. Another way to look into such a mechanism is to distinguish exporting firms from non-exporters. The non-exporters face predominantly domestic competition, whereas the exporters also face competition on foreign turf. Any competitive impact of FDI deregulation should thus be more pronounced for the non-exporters than for exporters.

Estimation results testing this conjecture are presented in Table 7, with Column 1 for non-exporters and Column 2 for exporters. With the non-exporters sample the effect of FDI on industrial agglomeration is statistically negative, and slightly larger in magnitude than in the benchmark estimation result shown in Column 8 of Table 3. The FDI deregulation effect on industrial agglomeration using the sample of exporting firms is negative with much smaller magnitude and statistically insignificant.

[Insert Table 7 here]

²⁸Similar to the empirical literature on FDI, we also look at the impacts of FDI on domestic firms. Competition may have a stronger impact on domestic firms than on foreign firms because domestic firms are more mobile within China.

Another concern about the mechanism is what if the foreign firms mostly produce for export instead of selling on the domestic market and thus do not actually impose competitive pressure on domestic firms. The proposed mechanism would also be undermined if FDI deregulation induces more export-oriented foreign firms to enter China or encourages incumbent foreign firms to export more. To examine these possibilities, we consider the changes in export intensity of the foreign firms in both the treatment and control groups. The following table reports the export intensity in each group before and after 2002.

	Before 2002	After 2002
Treatment Group	0.327	0.348
Control Group	0.398	0.400

The first observation is that foreign firms' domestic sales account for between 60 and 70% of their revenue during the entire period of the data. Second, the export intensity of the foreign firms in the control group hardly changes after the FDI deregulation; the increase in export intensity in the treatment group is also quite slight. That is, the foreign firms in the deregulated industries still sell mainly to the domestic market after deregulation.

We turn to the effect of the FDI deregulation on the foreign firms' export intensity, reported in Column 3 of Table 7 using the same benchmark specification as in Column 8 of Table 3: here is no statistically significant effect. These results and those in Table 2 indicate that FDI deregulation results in fiercer competition pressure on the domestic firms.

5.4 An Alternative Explanation: Spatial Political Competition?

An alternative explanation for the finding of the negative effect of FDI deregulation on industrial agglomeration arises from a political-economy perspective. Local governments have an incentive to lure business to help increase GDP and employment. The incentive to attract foreign firms could be particularly strong because of the potential for spillovers. FDI deregulation opens up new opportunities for the local governments to try to get FDI in the newly-deregulated industries. In this spatial political competition, less-agglomerated and less-developed regions may be particularly keen to seize this new opportunity. Once the foreign firms become more dispersed because of this, domestic firms may follow them in search of technology diffusion. To test whether this story is plausible, we focus on the location pattern of foreign firms. In particular, we calculate the EG index for the foreign firms in each industry, and regress using the same benchmark specification (Column 8 of Table 3). If political competition is a factor, there should be more dispersion in the

deregulated industries. The result is reported in Column 4 of Table 7. The coefficient is insignificant, so the estimation results do not support the political competition explanation.

6 The Effect of FDI and Industrial Agglomeration on Industrial Growth

Our aforementioned analyses show a significant negative effect of FDI deregulation on industrial agglomeration. As mentioned in the introduction, one fundamental reason of investigating FDI and industrial agglomeration is their implications for economic growth. Thus, we are interested in knowing whether or not industrial growth rate is affected by these two factors, which, as we have shown, are not orthogonal. The technology diffusion assumption implies that FDI is conducive to industrial growth. The deregulated industries may also grow faster because the deregulation allows more foreign capital to enter, which may also attract domestic capital to accumulate. Moreover, even though the competition channel may induce firms to disperse spatially, the accompanying stronger selection implies higher average productivity, which is also conducive to industrial agglomeration. The various agglomeration economies (even though they are not explicitly modeled here) are positive externalities, and thus they are by definition conducive to growth as well. We thus expect that both FDI and industrial agglomeration would enhance industrial growth.

The FDI deregulation event allows exploring this using a decomposition framework in the spirit of Heckman, Pinto, and Savelyev (2013). The decomposition exercise involves three steps. First, we regress the industrial growth (measured by the growth rate of industry value-added, i.e., the difference in the logarithm of value-added between t and $t - 1$ for a one-year growth rate, and the difference in value-added between t and $t - 3$ for a three-year growth rate) on the FDI regulation changes using the same specification as in the baseline estimation (1). This regression produces an estimated coefficient $\hat{\beta}^{total}$ for the total effect of FDI deregulation. In the second step, industrial agglomeration (measured by the EG index) is added to the previous regression, yielding an estimate $\hat{\beta}^{net}$ of the total FDI deregulation effect net of the changes in economic growth induced by FDI deregulation via industrial agglomeration. Lastly, we calculate the relative contribution of the industrial agglomeration to the total effect of FDI deregulation on economic growth as

$$\frac{\hat{\beta}^{total} - \hat{\beta}^{net}}{\hat{\beta}^{total}} \times 100 \text{ percent.}$$

Table 8 presents the estimation results. Note that the estimated coefficients of $Treatment_i \times$

$Post02_t$ are positive and significant, indicating that FDI does promote industrial growth. The facts that the estimated coefficients are smaller when the EG index is not controlled than those when the EG index is controlled and that FDI deregulation induces dispersion imply that industrial agglomeration is conducive to industrial growth, confirming our hypothesis. The decomposition further indicates that 16 to 19% of industrial growth rate is lost due to the dispersion caused by FDI deregulation. We discuss related policy implications in the conclusion.

[Insert Table 8 here]

7 Conclusion

By using a DD estimation, this paper finds that the FDI deregulation in 2002 in China on average caused geographic dispersion of industries. We propose a theory based on the interaction of technology diffusion and competition effect to explain when such a finding may arise and also the situation when the influx of foreign capital can encourage agglomeration. Empirical evidence supports the mechanism in the theory.

Our empirical and theoretical findings render some policy implications, especially in designing industrial districts and when coupled with trade policy, such as various special economic zones in China and similar place-based policies elsewhere. FDI is often thought of as having technology spillover effect on domestic firms, and this should foster agglomeration of firms and make the place-based policy successful. Our findings suggest that whether this is true or not depends on the stage of development. It may likely be true in early stages of development, but it may turn out to be against firms' incentive in later stages.

Our empirical investigation on industrial growth echoes our main empirical findings and the theory. We find that FDI deregulation increases industrial growth rate, but the dispersion induced by FDI de-regulation reduces the positive effect of FDI on growth rate by 16 to 19%. This suggests that combining FDI-promoting and agglomeration-promotion policies (such as SEZs) may be worthwhile because FDI influx may cause dispersion and thereby dampen growth potentials. Of course, we are not taking any stance on any specific place-based policy, but it is also important to note the possibility that an agglomeration stimulated in a few places may induce an overall dispersion of the industry.

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Appendix

A Data on FDI Regulations in China

The 1997 and 2002 versions of the Catalogue for the Guidance of Foreign Investment Industries are compared to obtain information about changes in FDI regulations upon China's accession to the WTO. The 2002 version rather than the 2004, 2007, or 2011 version is used because the 2002 revision of the Catalogue was substantial and in strict accordance with the commitments made in China's WTO accession. There were very few changes in 2004, and the 2007 and 2011 modifications are beyond the period studied.

In the Catalogue, products are classified into four categories: (i) products where foreign direct investment was supported (the supported category), (ii) products (not listed in the Catalogue) where foreign direct investment was permitted (the permitted category), (iii) products where foreign direct investment was restricted (the restricted category), and finally, (iv) products where foreign direct investment was prohibited (the prohibited category).

Comparing the 1997 and 2002 versions of the Catalogue allowed identifying for each product whether there had been a change in the FDI regulations upon China's accession to the WTO. Each product could then be assigned to a category:

- FDI became more welcome (the encouraged products). For example, "dairy products" was listed in the supported category in the 2002 Catalogue, but listed in the permitted category in the 1997 Catalogue, so FDI in "dairy products" was encouraged.
- FDI became less welcome (the discouraged products). For example, "ethylene propylene rubber" was listed as supported in the 1997 Catalogue, but listed as permitted in 2002, so FDI in "ethylene propylene rubber" was discouraged.
- No change in FDI regulations between 1997 and 2002. For example, "Casting and forging roughcasts for automobiles and motorcycles" was listed in the supported category in both the 1997 and 2002 Catalogues, so there is no change in FDI in this product.

Table A1 lists a matrix of all of the possible changes in product categories (supported, restricted, prohibited, and permitted) between 1997 and 2002 with the corresponding classifications in the changes in FDI regulations (encouraged, discouraged, or no change).

Then, we aggregate the changes in FDI regulations from the Catalogue product level to the ASIF industry level. As the product classifications used by the Catalogue are different

from the industry classifications used in the ASIF data, we convert the product classifications of the Catalogue for the Guidance of Foreign Investment Industries into the 4-digit Chinese Industry Classification (CIC) of 2003 using the Industrial Product Catalogue from the National Bureau of Statistics of China.²⁹ As the Chinese industry classification was revised in 2003, we use a concordance table from Brandt, Van Biesebroeck, and Zhang (2012) to create a harmonized Chinese Industry Classification that is consistent over the entire 1998–2007 period. As the product classifications of the Catalogue are generally more disaggregated than the 4-digit Chinese Industry Classifications of the ASIF, it is possible that two or more products from the Catalogue are sorted into the same 4-digit CIC industry of the ASIF. The aggregation process leads to four possible scenarios:

1. (FDI) Encouraged Industries: For all of the possible Catalogue products in a 4-digit CIC industry, there was either an improvement in the FDI regulations or no change. For example, four sub-categories under “Synthetic Fiber Monomer (Polymerization)” (CIC code: 2653) experienced improvements in FDI regulations (listed in the restricted category in the 1997 Catalogue, but the supported category in the 2002 Catalogue): “Pure Terephthalic Acid (PTA)” (CIC sub-code: 26530101), “Acrylonitrile” (26530103), “Caprolactam” (26530104), and “Nylon 66 Salt” (26530299); and there was no change in FDI regulations for the other sub-categories. “Synthetic fiber monomer (polymerization)” is thus an (FDI) encouraged industry.
2. (FDI) Discouraged Industries: For all of the possible Catalogue products in a 4-digit CIC industry, there was either a deterioration in FDI regulations or no change. For example, one sub-category in “Food Additives” (CIC code: 1494) experienced a deterioration in FDI regulations (listed in the permitted category in the 1997 Catalogue but listed in the restricted category in the 2002 Catalogue): “Synthetic Sweeteners” (CIC sub-code: 14940103), but there were no changes in FDI regulations for the other sub-categories. “Food Additives” is thus an (FDI) discouraged industry.
3. No-Change Industries: There was no change in FDI regulations for any of the possible Catalogue products under a 4-digit CIC industry. “Edible Vegetable Oil” (CIC code: 1331) is one example. All of the sub-categories were permitted in both the 1997 Catalogue and the 2002 Catalogue. “Edible Vegetable Oil” is thus a no-change industry.
4. Mixed Industries: Some of the products in a 4-digit CIC industry experienced an

²⁹The Industrial Product Catalogue lists each CIC 4-digit industry and its sub-categories at the 8-digit disaggregated product level.

improvement in FDI regulations, but some had tighter FDI regulation. For example, under “Crude Chemical Medicine” (CIC code: 2710), the FDI regulations for one sub-category (“Vitamin B6” (CIC sub-code: 27100404)) improved (listed in the restricted category in the 1997 Catalogue, but the permitted category in the 2002 Catalogue), but the FDI regulations for one sub-category (“Vitamin E” (CIC sub-code: 27100408)) deteriorated (listed in the permitted category in the 1997 Catalogue, but in the restricted category in the 2002 Catalogue). “Crude Chemical Medicine” is thus a mixed industry.

B Determinants of Changes in FDI Regulations¹

As mentioned in the main text, the changes in FDI regulations upon China’s WTO accession in 2002 may not be randomly determined. In this appendix, we carefully examine the determinants of the changes in FDI regulations upon China’s WTO accession. According to the “Provisions on Guiding the Orientation of Foreign Investment” issued by the State Council, there are several reasons why the government chose to modify the Catalogue and relaxed the FDI regulations in 2002. The government sought to make its domestic firms competitive in the era of globalization and promote industry upgrades and exports. Meanwhile, the government aimed to protect infant industries in their early stages and encourage industrial clustering so as to boost development in those industries. Finally, the government also cared about the impact of FDI deregulations on the domestic labor market, for instance current employment and wages, which are critical for maintaining social stability in the country.

To account for the above possible considerations of China’s government in relaxing its FDI regulations, we include seven variables: new product intensity (the ratio of new products in total output), export intensity (the ratio of exports to total output), number of firms, industrial clustering (the Ellison–Glaeser index), average age of firms, average employment, and average wage per worker.

We regress the changes in FDI regulations (a dummy variable taking value 1 if FDI in an industry became more welcome, and 0 otherwise) on the aforementioned FDI determinants and found that four variables are statistically significant: (1) new product intensity is found to have a positive effect; (2) export intensity is found to have a negative effect; (3) number of firms is found to have a positive effect; and (4) average age of firms is found to have a negative effect.

¹This appendix was reproduced with modifications from Appendix A in Lu, Tao, and Zhu (2017).

C Estimation of Markups

Estimation Framework.—To recover firm-level markups, we follow the approach developed by De Loecker and Warzynski (2012). Consider that a firm f at time t produces output using the following production technology:

$$Q_{ft} = Q_t(L_{ft}, K_{ft}, M_{ft}, \omega_{ft}), \quad (\text{C.1})$$

where Q_{ft} is the firm's physical output and L_{ft}, K_{ft}, M_{ft} are the firm's physical inputs of labor, capital, and intermediate input, respectively. ω_{ft} denotes firm productivity. $Q_t(\cdot)$ is assumed to be continuous and twice differentiable with respect to all of its elements.

Consider a firm's cost minimization problem and the associated Lagrangian function for firm f at time t :

$$\begin{aligned} \mathcal{L}(L_{ft}, K_{ft}, M_{ft}, \lambda_{ft}) &= w_{ft}L_{ft} + r_{ft}K_{ft} + p_{ft}^m M_{ft} \\ &+ \lambda_{ft}(Q_{ft} - Q_t(L_{ft}, K_{ft}, M_{ft}, \omega_{ft})), \end{aligned} \quad (\text{C.2})$$

where w_{ft}, r_{ft} , and p_{ft}^m denote the firm's wage rate, the rental price of capital, and the price of intermediate input, respectively. The estimation of markup hinges on the factor that the firm can freely adjust. China's capital and labor markets are heavily regulated and resource misallocations are severe, so intermediate input is taken as the optimal input free of any adjustment costs (Lu and Yu 2015). Thus, the first-order condition for intermediate input is

$$\frac{\partial \mathcal{L}}{\partial M_{ft}} = p_{ft}^m - \lambda_{ft} \frac{\partial Q_{ft}}{\partial M_{ft}} = 0, \quad (\text{C.3})$$

where $\lambda_{ft} = \frac{\partial \mathcal{L}_{ft}}{\partial Q_{ft}}$ is the marginal cost of production at a given level of output.

Rearranging equation (C.3) and multiplying both sides by $\frac{M_{ft}}{Q_{ft}}$, we obtain

$$\frac{\partial Q_{ft}}{\partial M_{ft}} \frac{M_{ft}}{Q_{ft}} = \frac{1}{\lambda_{ft}} \frac{p_{ft}^m M_{ft}}{Q_{ft}}. \quad (\text{C.4})$$

The firm markup is defined as price divided by marginal cost, that is, $\mu_{ft} \equiv \frac{P_{ft}}{\lambda_{ft}}$. Using equation (C.4), the firm-level markup can be expressed as

$$\mu_{ft} = \alpha_{ft}^m \frac{p_{ft}^m M_{ft}}{P_{ft} Q_{ft}} = \alpha_{ft}^m (\theta_{ft}^m)^{-1}, \quad (\text{C.5})$$

where α_{ft}^m is the output elasticity of the intermediate input and θ_{ft}^m is the share of expenditure on intermediate input. The share of expenditure on intermediate input is available

from the firm-level data. Computing firm-level markup then requires an estimate of the production function to obtain the output elasticity of the intermediate input.

Production Function Estimation.—Consider the following translog production function (in logarithmic form):

$$y_{ft} = \beta_l l_{ft} + \beta_k k_{ft} + \beta_m m_{ft} + \beta_{ll} l_{ft}^2 + \beta_{kk} k_{ft}^2 + \beta_{mm} m_{ft}^2 + \beta_{lk} l_{ft} k_{ft} \quad (\text{A1})$$

$$+ \beta_{lm} l_{ft} m_{ft} + \beta_{km} k_{ft} m_{ft} + \beta_{klm} l_{ft} k_{ft} m_{ft} + \omega_{ft} + \epsilon_{ft}, \quad (\text{C.6})$$

where y_{ft} is the logarithm of firm output, l_{ft} , k_{ft} , and m_{ft} are the logarithms of the inputs employment, capital, and materials. ω_{ft} is firm productivity, and ϵ_{ft} is measurement error and any unanticipated shocks to output.

Obtaining consistent production function estimates $\beta = (\beta_l, \beta_k, \beta_m, \beta_{ll}, \beta_{kk}, \beta_{mm}, \beta_{lk}, \beta_{lm}, \beta_{km}, \beta_{klm})$ requires controlling for unobserved productivity shocks potentially leading to simultaneity and selection biases. A control function based on a static input demand function is used as a proxy for the unobserved productivity.

The control function approach proposed by Olley and Pakes (1996) and extended by Levinsohn and Petrin (2003) is applied. The following material demand function is used as a proxy for the unobserved productivity:

$$m_{ft} = m_t(\omega_{ft}, l_{ft}, k_{ft}). \quad (\text{A2})$$

Inverting (A2) yields the control function for productivity:

$$\omega_{ft} = h_t(l_{ft}, k_{ft}, m_{ft}).$$

In the first stage, unanticipated shocks and measurement errors (ϵ_{ft}) are purged by estimating the following equation:

$$y_{ft} = \phi_t(l_{ft}, k_{ft}, m_{ft}) + \epsilon_{ft}. \quad (\text{A3})$$

That yields a predicted output ($\hat{\phi}_{ft}$).

(A1) and (A3) from the first stage estimation can then be used to express productivity:

$$\omega_{ft}(\beta) = \hat{\phi}_{ft} - \beta_l l_{ft} - \beta_k k_{ft} - \beta_m m_{ft} - \beta_{ll} l_{ft}^2 - \beta_{kk} k_{ft}^2 - \beta_{mm} m_{ft}^2 \quad (\text{A4})$$

$$- \beta_{lk} l_{ft} k_{ft} - \beta_{lm} l_{ft} m_{ft} - \beta_{km} k_{ft} m_{ft} - \beta_{klm} l_{ft} k_{ft} m_{ft}. \quad (\text{C.7})$$

To estimate the production function coefficients β , the technique of Akerberg, Caves,

and Frazer (2015) is applied and moments are formed based on innovation in the productivity shock ξ_{ft} in law of motion for productivity:

$$\omega_{ft} = g(\omega_{ft-1}) + \xi_{ft}.$$

Using (A4), $\omega_{ft}(\boldsymbol{\beta})$ is non-parametrically regressed against $g(\omega_{ft-1})$ to obtain the innovation term $\xi_{ft}(\boldsymbol{\beta}) = \omega_{ft}(\boldsymbol{\beta}) - E(\omega_{ft}(\boldsymbol{\beta}) | \omega_{ft-1}(\boldsymbol{\beta}))$.

The moment conditions used to estimate the production function coefficients are

$$E(\xi_{ft}(\boldsymbol{\beta}) \mathbf{Y}_{ft}) = 0,$$

where \mathbf{Y}_{ft} contains lagged labor and materials, current capital, and their interactions.³⁰

Once the production function coefficients $\hat{\boldsymbol{\beta}} = (\hat{\beta}_l, \hat{\beta}_k, \hat{\beta}_m, \hat{\beta}_{ll}, \hat{\beta}_{kk}, \hat{\beta}_{mm}, \hat{\beta}_{lk}, \hat{\beta}_{lm}, \hat{\beta}_{km}, \hat{\beta}_{lkm})$ have been estimated, the output elasticity of intermediate input is measured as $\hat{\alpha}_{ft}^m = \hat{\beta}_m + 2\hat{\beta}_{mm}\tilde{m}_{ft} + \hat{\beta}_{lm}\tilde{l}_{ft} + \hat{\beta}_{km}\tilde{k}_{ft} + \hat{\beta}_{lkm}\tilde{l}_{ft}\tilde{k}_{ft}$.

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³⁰Following the lead of previous scholarship, labor and materials are treated as flexible inputs and their lagged values are used to construct moments. As capital is considered a dynamic input with adjustment costs, its current value is used to form moments.

Table 1: Calculated EG Indexes by Industry

Industry	(1)	(2)	(3)
	1998–2007	1998–2001	2002–2007
Food processing	0.0506	0.0531	0.0490
Food manufacturing	0.0186	0.0181	0.0189
Beverage manufacturing	0.0396	0.0428	0.0375
Tobacco processing	−0.0001	0.0007	−0.0006
Textile industry	0.0476	0.0392	0.0532
Garments & other fiber products	0.0136	0.0109	0.0154
Leather, furs, down & related products	0.0640	0.0427	0.0781
Timber processing, bamboo, cane, palm fiber & straw products	0.0235	0.0229	0.0239
Furniture manufacturing	0.0122	0.0084	0.0145
Papermaking & paper products	0.0499	0.0989	0.0173
Printing industry	0.0145	0.0205	0.0105
Cultural, educational & sports goods	0.0211	0.0153	0.0249
Petroleum processing & coking	0.0065	−0.0113	0.0184
Raw chemical materials & chemical products	0.0348	0.0294	0.0384
Medical & pharmaceutical products	0.0069	0.0050	0.0081
Chemical fiber	0.0220	−0.0044	0.0396
Rubber products	0.0147	0.0073	0.0195
Plastic products	0.0294	0.0230	0.0336
Nonmetal mineral products	0.0403	0.0297	0.0473
Smelting & pressing of ferrous metals	0.0157	0.0122	0.0181
Smelting & pressing of nonferrous metals	0.0654	0.0551	0.0723
Metal products	0.0347	0.0288	0.0387
Ordinary machinery	0.0122	0.0099	0.0137
Special purpose equipment	0.0220	0.0009	0.0360
Transport equipment	0.0316	0.0126	0.0434
Electric equipment & machinery	0.0271	0.0195	0.0321
Electronic & telecommunications equipment	0.0417	0.0234	0.0528
Instruments, meters, cultural & office equipment	0.0259	0.0197	0.0300

Note: An EG index for each 2-digit industry is calculated over the 1998-2007 period, the pre-WTO 1998-2001 period, and the post-WTO 2002-2007 period.

Table 2: FDI Inflows Before and After WTO Accession

	(1)	(2)	(3)
	1998–2001	2002–2007	Percentage change (%)
<i>Panel A. Foreign equity share for the treatment and control groups</i>			
Treatment	0.244	0.312	27.99
Control	0.217	0.250	15.46
<i>Panel B. Share of number of foreign firms for the treatment and control groups</i>			
Treatment	0.131	0.161	22.78
Control	0.192	0.208	8.48

Note: Foreign equity share in Panel A and share of foreign firms in Panel B, in the treatment and control groups, calculated over the pre-WTO 1998–2001 period, the post-WTO 2002–2007 period, and their percentage changes.

Table 3: Main Results

	Dependent variable: industrial agglomeration (EG index, prefecture level)							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
<i>Treatment</i> × <i>Post02</i>	−0.020**	−0.018**	−0.019**	−0.020**	−0.021**	−0.021**	−0.022***	−0.023***
	(0.008)	(0.009)	(0.009)	(0.009)	(0.009)	(0.009)	(0.009)	(0.009)
Observations	4,076	4,076	4,076	4,076	4,076	4,076	4,076	4,076
Additional controls:								
Industry fixed effects	yes	yes	yes	yes	yes	yes	yes	yes
Year fixed effects	yes	yes	yes	yes	yes	yes	yes	yes
Control for determinants of FDI regulation changes	no	yes	yes	yes	yes	yes	yes	yes
Control for tariff reductions	no	no	yes	yes	yes	yes	yes	yes
Control for SOE reforms	no	no	no	yes	yes	yes	yes	yes
Control for special economic zones	no	no	no	no	yes	yes	yes	yes
Control for western development program	no	no	no	no	no	yes	yes	yes
Control for time-varying industry characteristics	no	no	no	no	no	no	yes	yes
Control for vertical FDI	no	no	no	no	no	no	yes	yes

Note: Standard errors are clustered at the industry level and shown in parentheses. Determinants of FDI regulation changes include interactions of the year dummies with new product intensity, export intensity, number of firms, industry age, and changes in the output share of state-owned enterprises between 1998 and 2001. Tariff reductions include interactions of the year dummies with output tariff, input tariff, and export tariff. SOE reforms include interactions of the year dummies with the output of state-owned enterprises as a share of total output. Special economic zones include interactions of the year dummies with the output of SEZ firms as a proportion of total output. Western development program include interactions of the year dummies with the output of firms in the western region as a proportion of the total output. The time-varying industry characteristics are industrial productivity, the ratio of intermediate inputs to output, the wage premium, average firm size, and the fraction of employment in coastal areas. Vertical FDI includes backward and forward FDI. ***, ** and * denote significance at the 1, 5 and 10% level respectively.

Table 4: Robustness Checks

	Dependent variable: industrial agglomeration				
	EG index (prefecture level); Columbia instruments	Discouraged industries included in the control group	EG index (county level)	EG index (prefecture level)	EG index (county level)
	(1)	(2)	(3)	(4)	(5)
<i>Treatment × Post02</i>	-0.143** (0.063)	-0.022** (0.009)	-0.014** (0.007)	-0.023*** (0.008)	-0.014** (0.007)
<i>Treatment × One Year Before WTO Accession</i>				-0.001 (0.005)	0.001 (0.004)
Observations	4,066	4,136	4,076	4,076	4,076
Anderson-Rubin Wald test	8.40**	–	–	–	–
Stock-Wright LM S statistic	91.75***	–	–	–	–
Hansen's J statistic	3.90	–	–	–	–
p-value of Hansen J statistic	0.14	–	–	–	–
Additional controls:					
Industry fixed effects	yes	yes	yes	yes	yes
Year fixed effects	yes	yes	yes	yes	yes
Control for determinants of FDI regulation changes	yes	yes	yes	yes	yes
Control for tariff reductions	yes	yes	yes	yes	yes
Control for SOE reforms	yes	yes	yes	yes	yes
Control for special economic zones	yes	yes	yes	yes	yes
Control for western development program	yes	yes	yes	yes	yes
Control for time-varying industry characteristics	yes	yes	yes	yes	yes
Control for vertical FDI	yes	yes	yes	yes	yes

Note: Standard errors are clustered at the industry level and shown in parentheses. Determinants of FDI regulation changes include interactions of the year dummies with new product intensity, export intensity, number of firms, industry age, and changes in the output share of state-owned enterprises between 1998 and 2001. Tariff reductions include interactions of the year dummies with output tariff, input tariff, and export tariff. SOE reforms include interactions of the year dummies with the output of state-owned enterprises as a share of total output. Special economic zones include interactions of the year dummies with the output of SEZ firms as a proportion of total output. Western development program include interactions of the year dummies with the output of firms in the western region as a proportion of the total output. The time-varying industry characteristics are industrial productivity, the ratio of intermediate inputs to output, the wage premium, average firm size, and the fraction of employment in coastal areas. Vertical FDI includes backward and forward FDI. In column 1, a post-WTO dummy interacted with industry-level export intensity, number of firms and age calculated from Columbian firms sample 1981 to 1991 are used as instruments for FDI regulation changes. ***, ** and * denote significance at the 1, 5 and 10% level respectively.

Table 5: Mechanism Test I

	(1)	(2)	(3)
Dependent variable:	Log markups	Log profits	Log sales
<i>Panel A. Full sample</i>			
<i>Treatment × Post02</i>	−0.041*** (0.014)	−0.034*** (0.012)	−0.023*** (0.006)
Observations	1,724,823	1,429,489	1,761,629
<i>Panel B. Domestic firms sample</i>			
<i>Treatment × Post02</i>	−0.037*** (0.013)	−0.035*** (0.012)	−0.025*** (0.006)
Observations	1,363,524	1,152,490	1,395,898
Additional controls:			
Firm fixed effects	yes	yes	yes
Year fixed effects	yes	yes	yes
Control for determinants of FDI regulation changes	yes	yes	yes
Control for tariff reductions	yes	yes	yes
Control for SOE reforms	yes	yes	yes
Control for special economic zones	yes	yes	yes
Control for western development program	yes	yes	yes
Control for time-varying industry characteristics	yes	yes	yes
Control for vertical FDI	yes	yes	yes
Control for time-varying firm characteristics	yes	yes	yes

Note: Standard errors are clustered at the industry level and shown in parentheses. Determinants of FDI regulation changes include interactions of the year dummies with new product intensity, export intensity, number of firms, industry age, and changes in the output share of state-owned enterprises between 1998 and 2001. Tariff reductions include interactions of the year dummies with output tariff, input tariff, and export tariff. SOE reforms include interactions of the year dummies with the output of state-owned enterprises as a share of total output. Special economic zones include interactions of the year dummies with the output of SEZ firms as a proportion of total output. Western development program include interactions of the year dummies with the output of firms in the western region as a proportion of the total output. The time-varying industry characteristics are industrial productivity, the ratio of intermediate inputs to output, the wage premium, average firm size, and the fraction of employment in coastal areas. Vertical FDI includes backward and forward FDI. The time-varying firm characteristics include firm size, capital-labor ratio, intermediate inputs, a state-owned enterprise dummy, and a foreign-invested enterprise dummy. ***, ** and * denote significance at the 1, 5 and 10% level respectively.

Table 6: Mechanism Test II

Dependent variable:	Industrial agglomeration (EG index)		Export intensity (foreign firms)	Industrial agglomeration (EG index)
	Non-exporters	Exporters		Foreign firms
	(1)	(2)	(3)	(4)
<i>Treatment × Post02</i>	−0.025*** (0.009)	−0.011 (0.012)	0.011 (0.019)	−0.003 (0.010)
Observations	4,057	3,851	3,995	3,653
Additional controls:				
Industry fixed effects	yes	yes	yes	yes
Year fixed effects	yes	yes	yes	yes
Control for determinants of FDI regulation changes	yes	yes	yes	yes
Control for tariff reductions	yes	yes	yes	yes
Control for SOE reforms	yes	yes	yes	yes
Control for special economic zones	yes	yes	yes	yes
Control for western development program	yes	yes	yes	yes
Control for time-varying industry characteristics	yes	yes	yes	yes
Control for vertical FDI	yes	yes	yes	yes

Note: Standard errors are clustered at the industry level and shown in parentheses. Determinants of FDI regulation changes include interactions of the year dummies with new product intensity, export intensity, number of firms, industry age, and changes in the output share of state-owned enterprises between 1998 and 2001. Tariff reductions include interactions of the year dummies with output tariff, input tariff, and export tariff. SOE reforms include interactions of the year dummies with the output of state-owned enterprises as a share of total output. Special economic zones include interactions of the year dummies with the output of SEZ firms as a proportion of total output. Western development program include interactions of the year dummies with the output of firms in the western region as a proportion of the total output. The time-varying industry characteristics are industrial productivity, the ratio of intermediate inputs to output, the wage premium, average firm size, and the fraction of employment in coastal areas. Vertical FDI includes backward and forward FDI. ***, ** and * denote significance at the 1, 5 and 10% level respectively.

Table 7: Role of Industrial Agglomeration in Industrial Growth

	Estimated coefficient of <i>Treatment</i> \times <i>Post02</i>		Implied relative contribution
	EG index not included	EG index included	
Dependent variable:			
Growth rate of industry value-added (difference in the logarithm of value-added between t and $t-1$)	0.041* (0.021)	0.049** (0.022)	-19.27%
Growth rate of industry value-added (difference in the logarithm of value-added between t and $t-3$)	0.107* (0.057)	0.124** (0.059)	-16.62%
Additional controls:			
Industry fixed effects	yes	yes	-
Year fixed effects	yes	yes	-
Control for determinants of FDI regulation changes	yes	yes	-
Control for tariff reductions	yes	yes	-
Control for SOE reforms	yes	yes	-
Control for special economic zones	yes	yes	-
Control for western development program	yes	yes	-
Control for time-varying industry characteristics	yes	yes	-
Control for vertical FDI	yes	yes	-

Note: Standard errors are clustered at the industry level and shown in parentheses. The implied relative contribution is the relative contribution of industrial agglomeration to the total effect of FDI deregulation on industrial growth. Determinants of FDI regulation changes include interactions of the year dummies with new product intensity, export intensity, number of firms, industry age, and changes in the output share of state-owned enterprises between 1998 and 2001. Tariff reductions include interactions of the year dummies with output tariff, input tariff, and export tariff. SOE reforms include interactions of the year dummies with the output of state-owned enterprises as a share of total output. Special economic zones include interactions of the year dummies with the output of SEZ firms as a proportion of total output. Western development program include interactions of the year dummies with the output of firms in the western region as a proportion of the total output. The time-varying industry characteristics are industrial productivity, the ratio of intermediate inputs to output, the wage premium, average firm size, and the fraction of employment in coastal areas. Vertical FDI includes backward and forward FDI. ***, ** and * denote significance at the 1, 5 and 10% level respectively.

Table A1: Changes in FDI regulations (product level) between 1997 and 2002

		2002			
		(1) <i>Supported Category</i>	(2) <i>Permitted Category</i>	(3) <i>Restricted Category</i>	(4) <i>Prohibited Category</i>
1997	(1) <i>Supported Category</i>	No change	Less welcome	Less welcome	Less welcome
	(2) <i>Permitted Category</i>	More welcome	No change	Less welcome	Less welcome
	(3) <i>Restricted Category</i>	More welcome	More welcome	No Change	Less welcome
	(4) <i>Prohibited Category</i>	More welcome	More welcome	More welcome	No Change

Appendix Table 2: First-Stage of IV Estimation

Dependent variable: FDI regulation changes	
<i>Export intensity</i>	1.034*** (0.384)
<i>Industry age</i>	0.016** (0.006)
<i>Number of firms</i>	0.019 (0.021)
Observations	4,066
Anderson-Rubin Wald test	8.40**
Stock-Wright LM S statistic	91.75***
Additional controls:	
Industry fixed effects	yes
Year fixed effects	yes
Control for determinants of FDI regulation changes	yes
Control for tariff reductions	yes
Control for SOE reforms	yes
Control for special economic zones	yes
Control for western development program	yes
Control for time-varying industry characteristics	yes
Control for vertical FDI	yes

Note: Standard errors are clustered at the industry level and shown in parentheses. Determinants of FDI regulation changes include interactions of the year dummies with new product intensity, export intensity, number of firms, industry age, and changes in the output share of state-owned enterprises between 1998 and 2001. Tariff reductions include interactions of the year dummies with output tariff, input tariff, and export tariff. SOE reforms include interactions of the year dummies with the output of state-owned enterprises as a share of total output. Special economic zones include interactions of the year dummies with the output of SEZ firms as a proportion of total output. Western development program include interactions of the year dummies with the output of firms in the western region as a proportion of the total output. The time-varying industry characteristics are industrial productivity, the ratio of intermediate inputs to output, the wage premium, average firm size, and the fraction of employment in coastal areas. Vertical FDI includes backward and forward FDI. ***, ** and * denote significance at the 1, 5 and 10% level respectively.