Discussion of “Judicial Independence, Local Protectionism, and Economic Integration: Evidence from China” by Liu-Lu-Peng-Wang

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Liu-Lu-Peng-Wang 2022

China's judicial reform: less local government control over local courts

$\downarrow$

Non-local firms more likely to win disputes in court against local firms

$\downarrow$

Entry and investment from non-local firms $\uparrow$

$=$

More economic integration and higher GDP

Roadmap

1. Summary and Overall Assessment
2. Comment #1: Defining Firm Location and Entry
3. Comment #2: What is the Mechanism?
4. Comment #3: Is the Reform Good or Bad?
5. Recap

Some Big Picture Background (1/2)

Two massively influential large strands of literature:

1. Law and finance (e.g., "legal origins theory" of La Porta, Lopez De Silanes, Shleifer, Vishny [LLSV] 1997, 1998, ..., 2008)
   - *legal protection of outside investors limits extent of expropriation [...] and thereby promotes financial development*
   - *common law stands for the strategy of social control that seeks to support private market outcomes, whereas civil law seeks to replace such outcomes with state-desired allocations [...] Civil law is "policy implementing," while common law is "dispute resolving" (Damaska 1986)*
2. Economic effects of trade (e.g., Eaton and Kortum 2002, review by Donaldson 2015)
   - *significant barriers to trade exist both between and within countries*
   - *large potential gains from market integration [...] extremely challenging to estimate empirically*
   - related work on firm-level effects of opening up / globalization

Some Big Picture Background (2/2)

Paper has a clever and creative approach to create a bridge between the literature in law & finance and the one on gains from market integration

- judicial independence and regulation of entry crucial in law & finance work
- reallocation of economic activity central to trade and its consequences on aggregate productivity (e.g., Melitz 2003, Hsieh and Klenow 2009)

Paper puts forward a simple but important observation: local capture of judiciary system may keep local economy from reaping the benefit of opening up

This Paper: Ingredients

Data:

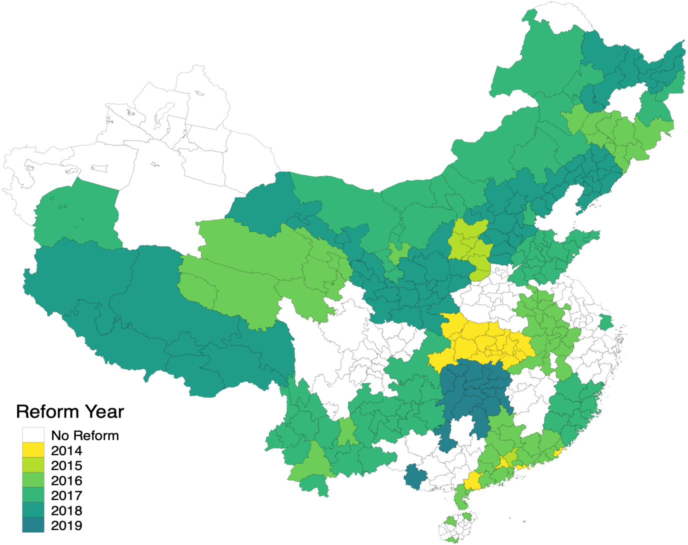
1. Court cases: all 133 million verdicts 2014-2021 + observe winners vs losers in 6 million *firm-vs-firm* cases + measure quality of judicial decisions
2. Firms: 75 million business registration records with ownership network + use these data to observe: new firm entry (*num investment*) and non-local investments (*amount investment*) in local firms

Empirical design:

- Staggered diff-in-diff (at local court / county level) using roll-out of China's judicial reform: about half of the 300+ prefectures in China treated by 2021
  - Note: variation is at prefecture-level
- What does the reform do? Centralize personnel and fiscal control of local courts (3,117 "basic" and 409 "intermediate" People's Courts) into the hands of the provincial party-state apparatus

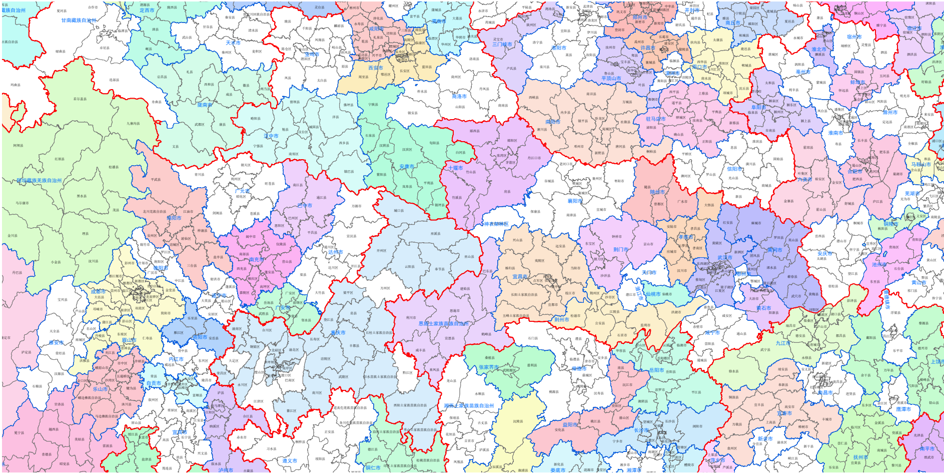
Model: a simple version of Melitz 2003 where judicial reform lowers entry cost for non-local investors → allows for suggestive back-of-envelope quantifications

This Paper: Visual Illustration



Sources: Yearbook of Judicial Reform of Chinese Courts (2013-2020)

This Paper: Visual Illustration



This Paper: Results

Result #1: Win rate ↓ by 7% for local defendants

- note: ex-ante local vs non-local win rate about 50-50
- win rate of local defendants drops the most against non-local firms *in same province*
- local firms' win rate still drops (but less) against non-local firms *from outside the province*
- win rate goes down (a) most for local firms connected to local gov, (b) a bit for unconnected local firms, (c) not at all for local firms connected to provincial or central gov
- effects mostly driven by intensive margin of change in judge behavior (rather than differential selection of firms into suing other firms)

Result #2: Quality of judicial decisions ↑

- more appeals from non-local firms, more evidence examinations and expert witnesses, longer judicial reasoning for verdicts, less discretionary tools

Result #3: Non-local investment in treated counties ↑ by about 8%

- Effect mostly driven by entry of new non-local firms, rather than acquisitions of shares of existing local firms
- Investment response coming mostly from firms in other counties in same prefecture

Is Narrative Credible?

Yes!

Many interesting anecdotes from **Young (QJE 2000)** "*The Razor's Edge: Distortions and Incremental Reform in the People's Republic of China*"

- **The central proposition of this paper is, seemingly, unbelievable**. **One is asked to accept that twenty years of economic reform in the People's Republic, which have brought extraordinary economic growth and burgeoning international openness, have resulted in a fragmented internal market with fiefdoms controlled by local officials** *whose economic and political ties to protected industry resemble those of the Latin American economies of past decades. It seems plausible that the endogenous response of actors to the rent-seeking opportunities created by gradualist reform could give rise to new distortions, whose lifespan far exceeds that of the rents which motivated their arrival. Nevertheless, it seems hard to believe that this paper, drawing its inspiration from a broad reading of popular Chinese media, has hit upon a creditable example.* **The central proposition of this paper is, surprisingly, supported by a wide variety of data**.

Is Narrative Credible?

Pressed by the complexity of directing the growing number of small local enterprises, and probably dislocated by the political events of the time, **the central planning apparatus during the Cultural Revolution (1966-1976) increasingly relinquished control of detailed planning to provincial authorities***, focusing, instead, on managing the interprovincial transfer of key materials and products.*

From almost the very beginning, the central government sought to improve the efficiency of industrial production and public administration by hardening the budget constraints of both state enterprises and local governments. **Beginning in 1979, the historical system of full remission of enterprise surpluses (and central coverage of losses) was replaced with contracts specifying the division of profits between the government and enterprises, with incentives for exceeding historical values. Consequently, contracts had to be negotiated on an enterprise-by-enterprise basis, with opportunities for renegotiation and renegement (by both sides).**

Is Narrative Credible?

For all its imperfections, **the contracting system** *undoubtedly hardened local and enterprise budget constraints and improved fiscal and industrial efficiency by providing an objective function (albeit moving) with marginal rates of central taxation well below 100 percent. In the process, however, it* **inadvertently devolved power to local authorities and strengthened the ties between local governments and state enterprises***.*

Enterprise contracting shifted power from the center to local governments since these, with their historical tax and administrative ties with enterprises and detailed knowledge of local circumstances, were best positioned to negotiate and monitor contracts for themselves and the central government. The hardening of local budgets increased the interest of local authorities in industrial enterprises, where the main revenue surpluses were to be found. *Local governments could control input prices and costs, minimizing reported "profits" (which might have to be shared with the center), while still maximizing the surpluses available for local coffers. While local governments could draw revenue from industry, their broader interest centered around the financial well being of state enterprises as these traditionally provided housing and a wide variety of social services (e.g., health, retirement, disability, burial, recreation, etc.) to their workers.*

Is Narrative Credible?

[...] led to the development of interregional trade barriers.

To protect their industrial interests, **provincial, county and, even, city governments found it expedient to erect barriers to trade** *so as to maintain high local final industrial goods prices.*

Aside from tariff barriers (i.e., special charges levied at roadblocks), **non-tariff methods such as physical barriers, outright prohibition, low interest, loans, and other financial benefits for commercial establishments marketing local goods, fines for commercial establishments marketing non-local goods, legal restrictions on price differences between local and non-local goods sold in commercial establishments, local purchasing quotas, and administrative trivia** *(e.g.medical, sanitation, epidemic prevention, product quality, measurement and other such licenses and certificates)* **were used to hamper trade** *in products as varied as textiles, automobiles, trucks, perfumes, beverages, plastics, matches, household electrical appliances, electrical machinery, bicycles, pens, alcohol, washing powders and soaps, tires, tractors, engines, processed foods, and food flavourings.*

The legal system was also subverted, as enterprises were encouraged not to pay non-local bills, the courts ignored non-local pleas, rulings and fines were issued against non-local producers, and judges who ruled in favour of non-local firms were punished.

Is Narrative Credible?

Since centrally mandated price distortions are gradually disappearing, what force, one might wonder, serves to prevent local governments from reverting to free market principles? The answer to this question is as old as the history of protectionism itself: **local governments now find their financial and political interests embedded in a particular industrial structure.**

These interests can be defended using a variety of mechanisms. In raw-material-producing areas, export barriers convert processing factories into monopsony buyers and, thereby, maintain the price distortions of the pre-reform era. Elsewhere, import barriers, while impoverishing the local economy as a whole, can induce artificially high returns in particular industrial sectors (just as in the import substitution industries of so many other countries).

Finally, when trade barriers cannot be fruitfully enforced, or are viewed as being too costly to other local interests, there is always the banking system which can be repeatedly pressured into extending credit to enterprises, providing local revenue and employment at the expense of national inflation.

Thus, **while it is probably the case that efficiency considerations, the demands of other social and political groups, and interregional competition for factors of production all place constraints on the distortionary activities of local governments, it is also not unreasonable to argue that there is considerable hysteresis in public finance and political relations.**

Why Is This Paper Important?

1. Big Question

- Huge, important topic. Yet, extremely limited empirical evidence.
- Implications for law & finance, gains from trade, but also personnel economics of the state, political connections, decentralization and corruption, and of course, China's model of economic growth

2. Extraordinary Measurement

- Truly impressive data effort. You don't see many papers identifying firm-to-firm disputes, judicial quality, etc. at such granular level.
- Main challenge will be deciding which new papers to write next!

3. Good Identification

- Judicial independence hard to isolate. Most work has focused on cross-country analyses.
- While identification not bullet-proof, paper is extremely rigorous and transparent, and results are absolutely credible. See also Yang-Wang 2022
- Joins recent work on within-country local economic effects of better rule of law (e.g., Ponticelli-Alencar 2016, Colonnelli-Prem 2022)

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What is the "Location" of a Firm?

Paper strongly grounded on the *county* of the firm as a measure of firm's location.

- Conceptually, this implies that local governments want to protect firms in their counties
- Empirically, this implies firms can be local or non-local, and that local firms suffer after the reform

Perfect measurement seems crucial. A few questions:

- "The trial is heard in the defendant's jurisdiction by default": in the US, firms forum-shop when filing for bankruptcy, and location is a fuzzy concept (HQ or most of econ activity etc). What is the legal definition in China?
- What is the location of multi-establishment firms?
- Many shareholders for many firms. What if some are from different counties?
- SOEs are often large and span many counties. Provincial/Central SOEs likely connected to local governments in many ways other than physical location.
- Is county the ideal administrative unit where incentives of local govmts and local firms are aligned?

What is a "New" Firm?

The welfare quantification and most of the economic outcomes rely on an effect on new firm creation in the treated counties.

Some sources of confusion and related questions:

- If a new firm is created, is this counted as non-local? Most new firms are typically created by individuals in the same local economy. Hence, I think the correct answer should be No.
- If you only count (as outside investment) new firms created by firms or individuals who were already operating elsewhere, how much of the action are we missing? My speculative guess is we are missing the bulk of the action.
- If a firm (which is operational elsewhere) enters in year 0 in a given county, it is considered *non-local*. Should this firm become *local* in year 1 (it should be, from the perspective of local protectionism incentives of local govmts)?

What is the Mechanism? (1/2)

Reforms like the one paper studies are always a bit of a **black-box**, mostly because they are a bundle of changes and affect many outcomes simultaneously

- Crucial to pin down specific economic forces at play

Authors' preferred interpretation: interconnectedness of "judicial independence" (hard to measure empirically) and "local protectionism" (Barwick et al 2021: preferential policies and practices that protect local firms against competition from non-local firms) → this focus should drive analysis of mechanisms!

- non-local firms fight local firms + local politicians have an interest in helping local firms (that bring economic value to local govmt) win + local politicians force judges to rule in favor of local firms

Alternative mechanisms:

1. Quid-pro-quo & corruption
2. Judiciary becomes more efficient

What is the Mechanism? (2/2)

Empirical results very interesting, but some are puzzling to reconcile with main story

- Why would firms in same province now lose to firms from other provinces?
- Most results on politically connected firms more consistent with a corruption story, not one of local protectionism.
- For it to be about local protectionism, effects should be stronger in industries from which local govmt can extract more tax revenues or generate more employment. SOE results in part consistent with this.
- Paper shows large improvements in judicial quality! Many results seem consistent with a story of better management practices in local courts. Easy to come up with story for why non-local firms worse off with inefficient judiciary (higher costs of gathering info, more complex cases, less fear of repercussions, ...)
- Other: formalization/reporting of firms/outside investors easier with better courts? Bureaucratic costs (and uncertainty) of dealing with inefficient courts go down?

Paper already does excellent job. Maybe try to: have a sharper (sector-agnostic) measure of pol. con.; use data on cases unrelated to firm-firm disputes; embrace additional stories at play (all very interesting!)

Who Wins and Who Loses?

Paper's (likely correct) interpretation is that reform was good.

But let's play devil's advocate: maybe reform simply led to a reallocation of preferential treatment away from locally connected firms to centrally connected ones

Crucial to say more about who wins and who loses, as reallocation key in any shock to market integration, and because reallocation here can be good or bad:

- Evidence from firm-to-firm disputes necessarily implies there are winners and losers. Paper shows local firms lose more often, and some (i.e., pol. con. firms) suffer considerably.
- But then analysis of economic outcomes suggests there are only winners, i.e., non-local firms able to enter new markets and no effect on local firms. What would rationalize this?

One worry is that level of analysis and data structure do not allow to pin down economic effects as precisely as we would like

Measuring Aggregate Effects (1/2)

Quantification exercise is useful, as magnitudes from reduced-form analysis difficult to interpret. But the model in the paper shuts down lots of interesting forces

- Effect on incumbents is assumed away, motivated by lack of effects on new investments by local firms
- But is this enough? What about firm exit? What about intensive margin of firm growth?

Alternative model that might fit the context better

- Melitz model with firm-level corruption wedge $\tau \rightarrow$ some firms (e.g., local firms) receive a subsidy, some firms (e.g., non-local firms) pay a tax
- Judicial reform means $|\tau| \downarrow$
- We should see reallocation of economic activity away from local firms (esp. if pol. con.) to non-local firms, in intensive (firm growth, investment) and extensive (entry, exit) margin

Measuring Aggregate Effects (2/2)

In short, hard to know if reform was good or bad without aggregate outcomes

- Higher dynamism implied by results on new firms / investment indicates effects are positive.
- But results don't take us all the way there. That requires an implicit assumption that reallocation and market integration is good (as suggested by the literature on trade).

Some suggestions:

- Reform is staggered at prefecture-level: why not run analysis at that level aggregating the county-level data?
- Nearly all of the analysis can be replicated at that level, and we can have broader measures of economic outcomes: num of firms, entries and exits, employment, investment, ...
- Ideally split by sector, local vs non-local, connected vs unconnected, ...
- Similarly, you can run an analysis at firm level to better understand if firms lose or win on net in courts. Right now it may well be that firms lose more in their court but win more outside.

Recap

This is a polished, extremely well-executed paper.

Unique combination of very important question, incredible data, and solid execution
→ Paper deserves to be published well as is and I am sure it will be highly influential

In future work or if more data become available, I'd love to see the authors push even further on:

- the detailed economic channels of how a judicial system capture by local governments creates distortions;
- putting more structure on the analysis of economic effects and firm dynamics

Really great work. This is a paper I wish I'd have written.