

Factor Market Distortions across Time, Space and Sectors in China

Loren Brandt
University of Toronto

and

Trevor Tombe
University of Calgary

and

Xiaodong Zhu
University of Toronto
Hong Kong Institute for Monetary Research

November 2012

Summary

In this paper, we measure TFP losses in China's non-agricultural economy associated with labour and capital misallocation across provinces and sectors between 1985 and 2007. We also decompose the overall loss into factor market distortions within provinces (between state and non-state sectors) and distortions between provinces (within sectors). Over the entire period, misallocation lowers aggregate non-agricultural TFP by an average of twenty percent. However, after initially declining, these losses increased appreciably beginning in the mid-1990s. This reversal can be attributed almost exclusively to increasing misallocation of capital between state and non-state sectors within provinces, while losses from between province misallocation remained fairly constant. We argue that the recent increase in capital market distortions is related to government policies that encourage investments in the state sector at the expense of investments in the more productive non-state sector.