

# Quantitative Spatial Economics I

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March 21, 2025

- 1 Introduction
- 2 Fang et al (2024)
  - Empirical Analysis
  - Building the Model
  - Incorporate Data to Model
  - Calibration
  - Solve for Unobservables
  - Estimation
  - Solve Model Equilibrium
  - Counterfactual Analysis
- 3 Final Conclusion

I will introduce basic methods for quantitative spatial models (QSM) in this course

- Static QSM: model construction, estimation, and solution (Week 1-4)
- Model with Goods Trade (Week 5)
- Diamond style models in urban economics (Week 6-7)
- Dynamic QSM: model construction, estimation, and solution (Week 8-10)
- Student presentation (Week 11)

## Theoretical model vs Structural model vs Design-based regression

- Theoretical model is based on the subjective thoughts of the researcher
- It is purely a deduction
- It is not related to data directly
- But usually it results in testable predictions  $\Rightarrow$  Falsifiability (Karl Popper)
- Example: Traditional Keynesian Model, AMM Model, Principal-Agent Model...

# Introduction

- Design-based regression is the main empirical approach
- Formalized by Angrist, Rubin, Card, and Imbens during 1990s
- It is a pure empirical method: let data speak
- It can be used as tests of theories
- Example: RCT, DID, RDD...
- Sometimes people call it "Reduced-form" analysis, although not so accurate

# Introduction

- RF is a useful framework in tackling causal effects
- But the effect is a black-box
- Can hardly answer two questions
  - What and how important are the mechanisms (channel analysis)
  - What will happen if we impose a complicated new policy, or old policy in a new context (external validity)
- What is the effect of relaxing migrant children's enrollment restriction on the overall human capital in China?
- What is the effect of building a land quota trading system among cities on local and national outputs?

# Introduction: Quantitative Spatial Equilibrium Model

- Structural model is a model directly and closely connected with data
- It is between pure theoretical model and design-based research
- We build a model, then connect to data by estimating model parameters and uncovering model unknowns
- Then we can simulate the counterfactual world in different proposed policies

# Introduction: Quantitative Spatial Equilibrium Model

Quantitative Spatial Equilibrium Model is a powerful tool

- Developed from Eaton and Kortum (2002) model in trade (E-K Model)
- There are many locations, many workers, many goods
- Workers choose locations to live and work, s.t. preference and migration costs
- Goods' flows are determined by productions in each location and trade costs across regions
- There can be some other parts: amenity, land market, housing market etc. (Redding and Rossi-Hansberg, 2017)
- A spatial equilibrium is achieved when labor/goods supply=labor/goods demand in each location



# Introduction: Quantitative Spatial Equilibrium Model

- A key component of spatial model is  
**The cost of moving goods, people and ideas across regions**
- That is why region/geography matters
- If people/goods can move totally freely across regions, then spatial structure does not matter at all
- If I have an Anywhere Door from Doraemon, why do I care where I live and where I work?

# Introduction: Quantitative Spatial Equilibrium Model

- A dilemma: the complexity of the spatial model (structural model)
- If it is too complicated, it is not tractable
- Sometimes impossible to solve a complicated model with equilibria in hundreds of markets simultaneously
- If it is too simplified, it cannot incorporate data well
- Traditional spatial/urban models are only theoretical, e.g. AMM Model (monocentric city), Rosen-Roback Model

# Introduction: Quantitative Spatial Equilibrium Model

- QSEM uses some specific distributional/structural assumptions and results in tractable solutions: Gravity Equations
- Gravity equations describe the spatial movement of goods and people
- This is an extension of simple discrete choice models
- Thus, QSEM can be taken to data!
- We can use it to simulate different policy counterfactuals

# Introduction: Quantitative Spatial Equilibrium Model

- Highly recommend the following:
  - Redding and Rossi-Hansberg(2017) Quantitative Spatial Economics, *Annual Rev. Econ.*
  - 2020 UEA Lecture Series  
<https://urbaneconomics.org/workshops/lectures2020/>

# Introduction: Quantitative Spatial Equilibrium Model

- In the first four weeks, we will introduce Fang et al (2024) to thoroughly investigate the implementation of a QSEM
- The steps of a study with QSEM:
  - 1. Build the model
  - 2. Estimate/calibrate model parameters given data
  - 3. Solve the model equilibrium and check the fitness
  - 4. Implement counterfactuals using the model

Place-based Land Policy and Spatial Misallocation: Theory and Evidence from China  
Min Fang, Libin Han, Zibin Huang, Ming Lu, and Li Zhang

## **Place-based policies are extensively used:**

- Why: to promote balanced development across regions (Neumark and Simpson, 2015)
- How: land supply quotas, wage subsidies, tax subsidies, industrial zones, ...

## **How effective are place-based policies at achieving their targets?**

- What frictions are the policies alleviating (or amplifying)?
- Do they cause efficiency loss through spatial misallocation?
- Are the targets necessarily "place-based"? (versus "people-based")

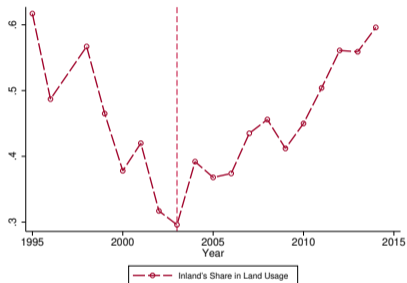
**In this paper, we aim to provide answers by studying a national large-scale place-based land policy implemented by the Chinese government around 2003.**



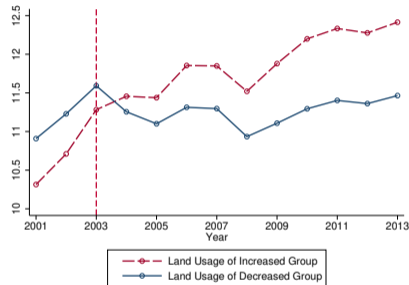
## The Inland-favoring Land Supply Policy around 2003

- **Goal:** to promote convergence of development across regions (Non-East versus East)
- **Tool:** Land Quota System (controls land supply quota in each region)
- **Before 2003:** Mostly based on demand  $\Rightarrow$  **After 2003:** More in Non-East regions

# The Inland-favoring Land Supply Policy around 2003



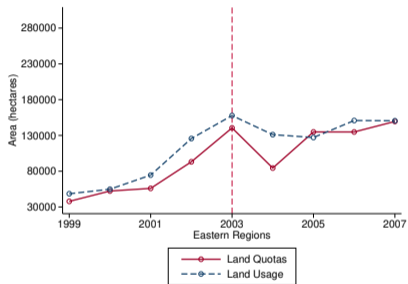
(a) Inland Provinces' Share



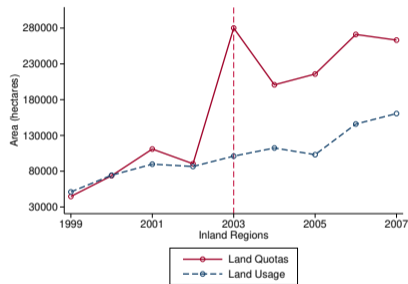
(b) Divergence between Prefecture Groups

Figure: New Urban Land Usage before and after 2003

# The Inland-favoring Land Supply Policy around 2003



(a) Eastern Regions



(b) Inland Regions

Figure: Land Supply and Quota

## **We evaluate such a policy both causally and quantitatively:**

- Using the change of policy in 2003 to find the causal effect on TFP
- Constructing a spatial equilibrium model to evaluate the mechanism and the implications

## **What are our findings?**

- Empirically, it decreased TFP of Eastern cities relative to Inland cities
- It amplified floor space constraints in developed (East) regions, created spatial misallocation, and lowered national TFP, output, and welfare
- How about the targets?
  - It shrank the east-inland geographical output gap. → "place-based"
  - But actually decreases incomes of workers from poorer areas. → "people-based"
- Instead, regional transfer is both more equal and efficient.

# Illustrating the mechanism

## **Consider two regions (East & West):**

- East has high productivity and wages (Opposite for West)
- Massive workers migrate from West to East
- Land as a factor input is much more constrained in East
- Regional divergence (geographically) in total GDP and GDP per capita are observed

## **Now consider a West-favoring land policy to promote regional convergence**

- Regardless of the migration inflow and constrained land supply in East
- Distribute much more new land quotas to West than East

# Illustrating the mechanism

## What happen then?

- More productive East is even more land-constrained:

Land Prices  $\uparrow \Rightarrow$   $\left\{ \begin{array}{l} \text{Residential floor space cost } \uparrow \Rightarrow \text{Labor supply } \downarrow \\ \text{Production floor space cost } \uparrow \Rightarrow \text{Labor demand } \downarrow \end{array} \right. \Rightarrow$

Migrant to East  $\downarrow$

$\Rightarrow$   $\left\{ \begin{array}{l} \text{Workers are locked in the West with lower income} \\ \text{Spatial misallocation in land and labor } \uparrow \text{ Agglomeration effects } \downarrow \\ \text{National TFP, output, and welfare } \downarrow \end{array} \right.$

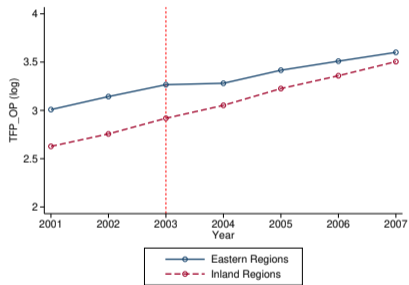
# Empirical Analysis: DID Strategy

For prefecture  $j$  in year  $t$ , we have the following regression:

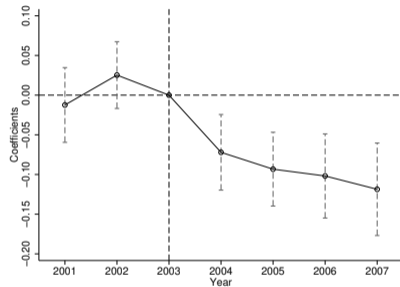
$$\ln(Prod_{jt}) = \alpha + \delta_1 Post2003_t \times East_j + \phi_j + \gamma_t + \epsilon_{jt} \quad (1)$$

- $\ln(Prod_{jt})$ : the prefecture-level average firm TFP;
- $East_j$ : eastern region dummy;
- $Post2003$ : policy time dummy;
- $\phi_j$ : prefecture FE;  $\gamma_t$ : year FE.

# Empirical Analysis: Parallel Trend



(a) Time Trends of Productivity



(b) Event Study - Productivity

Figure: Parallel Trend Test



# Empirical Analysis: Regression Results on Firm TFP

Table: DID Results on Productivity

	(1)	(2)
Post2003×East	-0.0705*** (0.0267)	-0.0749*** (0.0266)
Province × Time Trend	N	Y
GDP Per Capita × Time Trend	Y	Y
Industry Share × Time Trend	Y	Y
Year FE	Y	Y
Prefecture FE	Y	Y
Observations	1,792	1,792
R-squared	0.7529	0.7537

# Empirical Analysis: Regression Results on Other Outcomes

**Table: Summary of Other Variables on Mechanism**

	Land Price	Housing Price	Average Wage	Migration Inflow
Post2003×East	↑	↑	↓	↓

## The Main Takeaway

- Inland-favoring land policy decreased relative productivity in the developed eastern region
- This is a causal evidence of distortion/misallocation
- We also find increased land and housing prices, and decreased wage and migration in the eastern region
- This offers preliminary empirical evidence for our model mechanism

## The Main Takeaway

- Two crucial questions remain
  - What is the national overall effect on economic efficiency and equality?
  - Can we find a better policy to balance efficiency and equality?
- These are questions cannot be answered by empirical regressions
- That is why we need structural model

## **Spatial allocation of workers:**

- $K$  cities with two sectors: Urban v.s. Rural
- Workers choose city-sector s.t. wages, migration & housing costs
- Urban production combining H/L-skill workers & production floor space
- Agglomeration in urban productivity due to population density

## **Endogenous floor space market s.t. land supply constraints**

- Floor space construction using fixed land supply (policy determined);
- Residential vs. Production floor space
- Endogenous floor space price due to production & residential demand
- Local residents gain all the returns from residential floor space market

# Model I: Worker Preferences

- Worker's Utility:

$$U_{in,jk}^o = \frac{z_{in,jk}^o}{\tau_{in,jk}^s} \left( \frac{c_{in,jk}^o}{\beta} \right)^\beta \left( \frac{S_{in,jk}^o}{1-\beta} \right)^{1-\beta} \quad (2)$$

- Shock ( $z_{in,jk}^o$ ) follows Fréchet Distribution:  $F(z_{in,jk}^o) = e^{-z_{in,jk}^o{}^{-\epsilon}}$ ,  $\epsilon > 1$
- $\epsilon$  is called migration elasticity
- Income: (wage + hometown housing rent)

$$v_{in,jk}^s = w_{jk}^s + \frac{Q_{in} S_{in}^R}{H_{in}^R} \quad (3)$$

$i,j$ : location (home, working);  $n,k$ : sector (rural, urban)  $c$ : goods consumption;  
 $s$ : individual housing consumption;  $S^R$ : location total housing consumption;  
 $H^R$ : hukou population  $\tau$ : migration cost;  
 $z$ : location preference shock;  $Q$ : housing rent;  $v$ : income

## Model I: Worker Preferences

- We assume that migration cost can be decomposed into two parts:

$$\tau_{in,jk}^s = \bar{\tau}_{in}^s d_{in,jk} \quad (4)$$

- $d_{in,jk}$  captures cost specific for migrating from  $in$  to  $jk$
- Physical distance and institutional costs due to the Hukou system
- $\bar{\tau}_{in}^s$  captures cost differences between individuals with different skills
- High skill people can get more public resources in non-Hukou cities

# Model I: Worker Preferences

- We assume this timeline for workers:
  - 1. Observe location taste shock  $z$
  - 2. Decide working location and sector  $j, k$
  - 3. Decide consumption  $c, s$
- Let's go to the bottom layer first: what is the optimal consumption choice given location and sector choices?



## Model I: Worker Preferences

- Optimal consumptions from FOCs (given location choices):

$$c_{in,jk}^o = \beta v_{in,jk}^s \quad (5)$$

$$s_{in,jk}^o = (1 - \beta) \frac{v_{in,jk}^s}{Q_{jk}} \quad (6)$$

- Property of CD utility function
- Workers spend  $\beta$  share of income on final goods and  $1 - \beta$  share on housing
- The property persists when you have more than two goods
- Plug (5) and (6) back to (2), we have indirect Utility:

$$U_{in,jk}^o = \frac{z_{in,jk}^o v_{in,jk}^s Q_{jk}^{\beta-1}}{\tau_{in,jk}^s} \quad (7)$$

# Model I: Migration Flows

- The outer layer is the location choices
- The **individual choice is uncertain** due to taste shock  $z$
- But we can get **certain migration probabilities by aggregating over population**
- This is what we call "**Probabilistic migration**"
- Key: the assumption of Fréchet distribution gives us a closed-form migration flow
- Analogously, we have probabilistic trade (Eaton and Kortum, 2002)
- The idea goes back to Daniel McFadden in 1970s on discrete choice models

## Model I: Migration Flows

- Using the indirect utility equation, we can write the distribution of utility for a worker migrating from  $in$  to  $jk$  as:

$$G_{in,jk}^s(u) = Pr[U \leq u] = F\left(\frac{u\tau_{in,jk}^s Q_{jk}^{1-\beta}}{v_{in,jk}^s}\right) \quad (8)$$

- $F$  is the cdf of a Fréchet distribution
- Using the Fréchet distribution cdf  $F(x) = e^{-x^{-\epsilon}}$ , we have:

$$G_{in,jk}^s(u) = e^{-\Phi_{in,jk}^s u^{-\epsilon}}, \quad \Phi_{in,jk}^s = (\tau_{in,jk}^s Q_{jk}^{1-\beta})^{-\epsilon} (v_{in,jk}^s)^\epsilon \quad (9)$$

$$g_{in,jk}^s(u) = \frac{dG_{in,jk}^s(u)}{du} = e^{-\Phi_{in,jk}^s u^{-\epsilon}} \cdot \Phi_{in,jk}^s \epsilon u^{-\epsilon-1} \quad (10)$$

# Model I: Migration Flows

- Now we calculate the PDF of utility for individual coming from *in* with optimal destination choice
- For individuals from *in*, we can write the following equation:

$$G_{in}^s(u) = \prod_{jk=11}^{JK} e^{-\Phi_{in,jk}^s u^{-\epsilon}} \quad (11)$$

- The left-hand side is the PDF, defined as the probability that a worker from *in* has a utility smaller than *u*
- It means the worker from *in* has a utility less than *u* for all possible destinations *jk*, Which is just the right-hand side

## Model I: Migration Flows

- Thus, for individuals from  $in$ , the CDF and the PDF of utility across all possible destinations are:

$$(11) \Rightarrow G_{in}^s(u) = e^{-\Phi_{in}^s u^{-\epsilon}}, \quad \Phi_{in}^s = \sum_{jk=11}^{JK} \Phi_{in,jk}^s \quad (12)$$

- Watch out the difference!
- Equation (9) shows the CDF of utility for a specific location choice  $jk$  in a feasible choice set  $\{j_1 k_1, j_1 k_2, j_2 k_1, \dots\}$
- Equation (12) shows the CDF of utility for the optimal location choice in the set

## Model I: Migration Flows

- Equation (12) shows a very important property of Fréchet distribution
- The maximum of a sequence of Fréchet r.v. is itself Fréchet distributed
- This kind of distribution is called "extreme value distribution"
- This is "Type II Extreme Value Distribution"

## Model I: Migration Flows

- Another common distribution is "Type I Extreme Value Distribution", which gives us Logit model
- Just as T1EV does for Logit, T2EV here gives us a closed-form migration flow
- T1EV (Logit model) is the log version of T2EV (EK style model)
- Logit model usually gives you a linear utility/production
- EK style model usually gives you a log-linear utility/production
- They are actually isomorphic

## Model I: Migration Flows

- Now let's derive the core gravity equation for migration flows
- For people from  $in$  with skill  $s$
- Proportion to migrate from  $in$  to  $jk$  is:

$$\pi_{in,jk}^s = P[u_{in,jk}^s \geq \max\{u_{in,j'k'}^s, \forall j'k'\}] \quad (13)$$

- We then use Bayes's rule to decompose this probability



# Model I: Migration Flows

- Proportion to migrate from  $in$  to  $jk$  is:

$$\begin{aligned}\pi_{in,jk}^s &= P[u_{in,jk}^s \geq \max\{u_{in,j'k'}^s, \forall j'k'\}] \\ &= \int_u P[u_{in,jk}^s \geq \max\{u_{in,j'k'}^s, \forall j'k'\} | u_{in,jk}^s] \cdot g[u_{in,jk}^s] du\end{aligned}\quad (14)$$

$$= \int_0^\infty \prod_{j'k' \neq jk} G_{in,j'k'}^s(u) g_{in,jk}^s(u) du \quad (15)$$

- $\prod_{j'k' \neq jk} G_{in,j'k'}^s(u)$  means given a fixed utility value  $u$  of choosing  $jk$ , what is the probability to have utility of all other choices ( $j'k'$ ) smaller than  $jk$  choice
- We then integrate over the domain of  $u$  with PDF  $g_{in,jk}^s(u)$ , the prob density of choice  $jk$ 's utility to be  $u$

# Model I: Migration Flows

- Plug in (9) and (10), equation (15) can be written as:

$$\begin{aligned}\pi_{in,jk}^s &= \int_0^\infty \prod_{jk \neq j'k'} e^{-\Phi_{in,j'k'}^s u^{-\epsilon}} \cdot e^{-\Phi_{in,jk}^s u^{-\epsilon}} \cdot \Phi_{in,jk}^s \epsilon u^{-\epsilon-1} du \\ &= \int_0^\infty e^{-\Phi_{in}^s u^{-\epsilon}} \cdot \Phi_{in,jk}^s \epsilon u^{-\epsilon-1} du\end{aligned}\tag{16}$$

- Notice that we have  $\frac{d}{du}[-\frac{1}{\Phi_{in}^s} e^{-\Phi_{in}^s u^{-\epsilon}}] = \epsilon u^{-\epsilon-1} e^{-\Phi_{in}^s u^{-\epsilon}}$
- We can transfer integral (16) to have:

$$\pi_{in,jk}^s = \int_0^\infty \Phi_{in,jk}^s d[-\frac{1}{\Phi_{in}^s} e^{-\Phi_{in}^s u^{-\epsilon}}] = \frac{\Phi_{in,jk}^s}{\Phi_{in}^s}\tag{17}$$

- $\Phi_{in,jk}^s$  is not a function of  $u$ , which can be taken out of the integral

# Model I: Migration Flows

- Then we have the **Gravity Equation of Migration Flow**:

$$\pi_{in,jk}^s = \frac{(\tau_{in,jk}^s Q_{jk}^{1-\beta})^{-\epsilon} (v_{in,jk}^s)^\epsilon}{\sum_{j'k'=11}^{JK} (\tau_{in,j'k'}^s Q_{j'k'}^{1-\beta})^{-\epsilon} (v_{in,j'k'}^s)^\epsilon} \quad (18)$$

- Proportion of people with skill  $s$  from  $in$  to migrate to  $jk$
- Positively affected by destination income  $v$
- Negatively affected by destination housing price  $Q$  and migration cost  $\tau$
- The denominator is a normalization
- This is the key to connect model with data

[▶ Back to Main](#)

# Model I: Logit versus EK

- In a choice problem with individual  $n$  choosing alternatives  $j$
- We have two ways of setting up the model
- Logit Model
  - Linear utility with T1EV error:  $U_{nj} = V_{nj} + z_{nj}$
  - For T1EV error, we have:  $F(z_{nj}) = e^{-e^{-z_{nj}}}$
  - Closed-form choice probability function:  $P_{ni} = \frac{e^{V_{ni}}}{\sum_j e^{V_{nj}}}$
- EK Model
  - Log-linear utility with T2EV error:  $U_{nj} = V_{nj} \cdot z_{nj}$
  - For T2EV error, we have:  $F(z_{nj}) = e^{-z_{nj}}$
  - Closed-form choice probability function:  $P_{ni} = \frac{V_{ni}}{\sum_j V_{nj}}$

# Model I: Logit versus EK

- When to use Logit and when to use EK?
- They are isomorphic  $\Rightarrow$  no difference in model
- Really depends on the convenience of calculation
- It is also a historical tradition that labor economists use Logit more but trade economists use EK more
- Just an observation, I don't know why

[▶ Back to Main](#)

## Model II: Production

- In rural region  $r$  of prefecture  $j$ , we have rural production:

$$Y_{jr} = A_{jr}H_{jr} \quad (19)$$

- Depends only on fundamental productivity  $A$
- And total labor  $H_{jr} = H_{jr}^h + H_{jr}^l$

## Model II: Production

- In urban region  $u$  of prefecture  $j$ , we have urban production:

$$Y_{ju} = (X_{ju})^\alpha (S_{ju}^M)^{1-\alpha}, \text{ where } X_{ju} = [(A_{ju}^h H_{ju}^h)^{\frac{\sigma-1}{\sigma}} + (A_{ju}^l H_{ju}^l)^{\frac{\sigma-1}{\sigma}}]^{\frac{\sigma}{\sigma-1}} \quad (20)$$

- $X_{ju}$  is a CES aggregated input of high skill labor  $H^h$  and low skill labor  $H^l$
- $S_{ju}^M$  is the production floor space
- $A_{ju}^h, A_{ju}^l$  are skill-specific productivity
- $H_{ju}^h, H_{ju}^l$  are high/low skill labors

## Model II: Production

- First Order Conditions:

$$w_{ju}^l = \alpha X_{ju}^{\alpha-1} S_{ju}^M{}^{1-\alpha} A_{ju}^l{}^{\frac{\sigma-1}{\sigma}} X_{ju}^{\frac{1}{\sigma}} H_{ju}^l{}^{-\frac{1}{\sigma}} \quad (21)$$

$$w_{ju}^h = \alpha X_{ju}^{\alpha-1} S_{ju}^M{}^{1-\alpha} A_{ju}^h{}^{\frac{\sigma-1}{\sigma}} X_{ju}^{\frac{1}{\sigma}} H_{ju}^h{}^{-\frac{1}{\sigma}} \quad (22)$$

$$S_{ju}^M = \left( \frac{1-\alpha}{q_{ju}} \right)^{\frac{1}{\alpha}} X_{ju} \quad (23)$$

FOC gives us a measure of skill premium  $\omega$  of city  $j$ :

$$\omega_{ju} = \frac{w_{ju}^h}{w_{ju}^l} = \left( \frac{A_{ju}^h}{A_{ju}^l} \right)^{\frac{\sigma-1}{\sigma}} \left( \frac{H_{ju}^h}{H_{ju}^l} \right)^{-\frac{1}{\sigma}} \quad (24)$$



## Model II: Production

- Assume that final good can be traded without cost and the market is perfectly competitive
- Price of final goods is normalized to 1: numeraire
- We have zero profit condition:

$$(X_{ju})^\alpha (S_{ju}^M)^{1-\alpha} - W_{ju}X_{ju} - q_{ju}S_{ju}^M = 0 \quad (25)$$

where  $W_{ju}X_{ju} = w_{ju}^l H_{ju}^l + w_{ju}^h H_{ju}^h$

- $w_{ju}^h, w_{ju}^l$  are wages,  $q_{ju}$  is production floor space price
- FOC (23) + Zero profit (25) gives us production floor space price at equilibrium:

$$q_{ju} = (1 - \alpha) \left( \frac{\alpha}{W_{ju}} \right)^{\frac{\alpha}{1-\alpha}} \quad (26)$$

## Model II: Production

- We assume to have economy of scale in urban region
- **Agglomeration is very important in spatial economics**
- For productivity of workers with skill  $s$  in urban region of prefecture  $j$ :

$$A_{ju}^s = a_{ju}^s \times (D_{ju})^\gamma, \quad D_{ju} = \frac{H_{ju}^h + H_{ju}^l}{\bar{L}_j} \quad (27)$$

- $a_{ju}^s$  is the fundamental productivity
- $D_{ju}$  is the urban population density,  $\bar{L}_j$  is the total constructed land
- We will discuss the agglomeration issue in more details

## Model III: Floor Space Market Clearing

- Housing market in rural area is simple
- In general, there is no commodity housing market in rural China
- Houses can only be leased informally from "zhai ji di"
- For simplicity, we assume rural floor space price is a proportion of  $\tau$  of urban floor space price/rental rate in the same prefecture:

$$Q_{jr} = \tau Q_{ju}$$

## Model III: Floor Space Market Clearing

- Floor space market in urban area is much more complicated
- We have two kinds of floor space: production vs residential
- There is a production & residential price difference

$$q_{ju} = \eta_j Q_{ju} \quad (28)$$

- $\eta_j$  is city-level tax equivalent of land use regulations
- It is an exogenous parameter determined by the government
- This captures the fact that Chinese local governments are more willing to allocate land for manufacturing sector but not housing (Lu et al., 2024)

## Model III: Floor Space Market Clearing

- Assume a simple linear technology to convert land  $L$  to floor space  $S$  for real estate firms:

$$S_{ju} = \phi_j L_j \quad (29)$$

- Urban land supply is monopolistic in China (only by government)
- Thus,  $L_j$  is exogenous and the main policy parameter
- Urban floor space market clearing: supply = demand

$$\text{Production: } S_{ju}^M = \theta_j S_{ju} = \left( \frac{(1 - \alpha)}{q_{ju}} \right)^{\frac{1}{\alpha}} X_{ju} \quad (30)$$

$$\text{Residential: } S_{ju}^R = (1 - \theta_j) S_{ju} = E[s_{ju}] H_{ju} = (1 - \beta) \frac{E[v_{ju}] H_j}{Q_{ju}} \quad (31)$$

- $\theta$  is the share of floor space allocated to production

# Model: Spatial Equilibrium

A **Spatial General Equilibrium** for this economy is defined by a set of *exogenous economic conditions*  $\{\tau_{in,jk}^s, a_j^s, \eta_j, \phi_j, L_j, H_{in}^s\}$ , a list of *endogenous prices*  $\{Q_{ju}, q_{ju}, w_{jk}^s\}$ , *quantities*  $\{v_{in,jk}^s, Y_{jk}, H_{jk}^s, S_{ju}\}$ , and *proportions*  $\{\pi_{in,jk}^s, \theta_j\}$  that solve firms' problem, workers' problem, floor space producers' problem, and market clearing such that:

(i). **[Worker Optimization]** Taking the exogenous economic conditions  $\{\tau_{in,jk}^s, A_{jk}^s\}$  and the aggregate prices  $\{Q_{ju}, w_{jk}^s\}$  as given, workers' optimal choices of migration pin down the equilibrium labor supply in each city  $H_{jk}^s$  and the migration flow between each city pairs  $\pi_{in,jk}^s$ .

(ii). **[Firm Optimization]** Taking the exogenous economic conditions  $\{A_{jk}^s\}$  and the aggregate prices  $\{q_{ju}, w_{jk}^s\}$  as given, firms' optimal choices of production pin down the equilibrium labor demand  $H_j^s$ , equilibrium production floor space demand  $\theta_j S_{ju}$  in each city.

(iv). **[Market Clearing]** For all prefectures, labor supply equals labor demand, floor space supply equals floor space demand, and final good supply equals final goods demand. This pins down the equilibrium aggregate prices  $\{Q_{ju}, q_{ju}, w_{jk}^s\}$ , equilibrium floor space  $S_{ju}$ , and equilibrium output  $Y_{ju}$ .

## Model: Conclusion

Now let's briefly conclude the building blocks of the model

- This is a Quantitative Spatial General Equilibrium model
- Two markets: labor + land
- N prefectures, each has two regions, urban + rural
- Labor supply is determined by migration flows
- Workers choose working locations based on wages, housing prices, migration costs, and taste shocks
- With a Fréchet distributed taste shock, we derive closed-form migration flows  $\Rightarrow$  Gravity Equation (Probabilistic Migration)

## Model: Conclusion

- Labor demand is determined by firms
- They maximize their profits by choosing optimal labor and production floor space inputs
- Urban land is exogenously controlled by government and can be used to produce floor space
- Floor space is used as either production or residential
- A Spatial GE is achieved by a series of wages and floor space prices when
  - Workers maximize utility; Firms maximize profit
  - In each location, labor supply = labor demand
  - In each location, floor space supply = floor space demand



## Model: Conclusion

- Next, we introduce how to incorporate data to this model
- Given data, we need to
  - Recover the parameters (Calibration + Estimation)
  - Recover unknown variables (Solve unobservables)
- Then, we introduce the algorithm to solve model equilibrium
- Last, we discuss the implementation of policy counterfactuals

# Incorporate Data to Model

- Now we start to incorporate data to the model
- To transfer a theoretical model to a quantitative one
- We will separate all parameters and variables to three parts:
  - Observed variables
  - Estimable (or calibrated) parameters from data
  - Unobserved variables: productivity, migration cost, floor space
- We need to estimate/calibrate parameters (except agglomeration) given data
- Then recover the unobserved variables given data and parameters
- Then estimate the agglomeration parameter using data and recovered variables (productivity)

## Incorporate Data to Model: Data

Data Used (233 cities with 2 sectors in both 2005 and 2010)

1. City-sector-level Hukou/working population and city-sector-pair migration flow from *Census*:  $\pi, H_{in}^s, H_{jk}^s$
2. City-sector-level average residential housing cost from *Census*:  $Q_{ju}$
3. City-sector-level high/low-skill wages from various *City Statistic Yearbooks* of each city:  $w_{jk}^s$
4. Land usage and other aggregate city-sector-level data from *Urban Statistic Yearbooks*:  $L_j$
5. Land price gap between production and residence from China Land Market Website:  $\eta_j$

## Unobservables and Parameters to be Solved or Estimated

1. Preference, Production, Friction Parameters:  $\{ \beta, \alpha, \sigma, \epsilon, \tau, \eta_j, \phi_j \}$
2. Unobserved Productivities and Agglomeration Parameter:  $\{ A_{ju}^h, A_{ju}^l, \gamma \}$
3. Unobserved Floor Space Market Variables:  $\{ S_{ju}^R, S_{ju}^M, q_{ju} \}$
4. Migration Costs:  $\tau_{in,jk}^s$

# Incorporate Data to Model: Calibration and Estimation

- Let's consider parameters first
- Two ways to incorporate data: Calibration, Estimation
- Calibration is simple, using widely accepted values
- The basic idea is that you have a one-to-one mapping from model parameter to data/literature without uncertainty
- Then just match it, done
- This is a standard process to make your model comparable to other models
- Especially for more macro models and parameters

# Incorporate Data to Model: Calibration and Estimation

- Estimation is more complicated, requiring you to directly use your data
- The main idea relies on how to add uncertainty to your model to capture data
- A model without uncertainty will give deterministic results
- All firms choose same FOC, all workers choose same consumption
- However, this is definitely not true in data
- Because models are limited, there are always something you cannot capture
- Also, there are always measurement errors in data

# Incorporate Data to Model: Calibration and Estimation

- Thus, the key to connect data to model is to know how to add uncertainty in model
- Then with uncertainty, we "estimate" parameters
- On the contrary, calibration does not care about uncertainty at all
- It just simply matches a parameter with a single aggregated moment from data or previous literature
- This aggregation ignores all uncertainty in micro data

# Incorporate Data to Model: Calibration and Estimation

- For instance, consider when you have a C-D utility function:

$$U = x_1^\beta x_2^{1-\beta} \quad (32)$$

- You want to pin down the C-D utility parameter  $\beta$
- In calibration, you directly equal it as the average final consumption share of good 1 in UHS data
- Though you know there are heterogeneity and uncertainty here:
  - Each family may have different consumption shares
  - UHS is a small sample of Chinese households
  - There are measurement errors for each family's consumption composition
- You just ignore them to make your life easier



# Incorporate Data to Model: Calibration and Estimation

- But if you want to consider these heterogeneity and uncertainty, you have to make utility parameters to be **random coefficients**
- What are random coefficients? Coefficients that are random variables
- By replacing constant  $\beta$  to be a random variable

$$U = x_1^{\beta_i} x_2^{1-\beta_i} \quad (33)$$

$$\beta_i \sim N(\mu_\beta, \sigma_\beta^2) \quad (34)$$

- Now  $\beta_i$  is different across families
- It can capture heterogeneity, sampling errors, and measurement errors we just mention
- But then, you have to estimate  $\mu_\beta$  and  $\sigma_\beta^2$  using methods like simulated method of moments

## Incorporate Data to Model: Calibration and Estimation

- Except for parameters, we need to pin down other unobserved variables
- In our case, floor space, migration cost, and local productivity
- In many spatial models, we have 1-1 mapping from model to unobservables
- Then we can simply invert the model to solve them
- You can consider it as a process of calibration
- If not, we have to estimate them like parameters using the methods we will introduce

# Incorporate Data to Model: Calibration and Estimation

- Now let's go through the process in our model
- To see how to estimate and pin down parameters and unobservables

Step 1: Calibrated Fixed Parameters:  $\{ \beta, \alpha, \eta_j, \sigma, \epsilon, \tau \}$

**Table: Fixed Parameters**

<b>Parameter</b>	<b>Description</b>	<b>Value</b>	<b>Source</b>
$\beta$	share of consumption in utility	0.77	<i>Urban Household Survey</i>
$\alpha$	share of labor in production	0.88	<i>Enterprise Surveys</i>
$\eta_j$	relative cost of production to residential land	city-specific	China Land Market Website
$\sigma$	elasticity of substitution between H/L-skills	1.4	Katz and Murphy (1992)
$\epsilon$	migration elasticity	1.9	Fang and Huang (2022)
$\tau$	relative cost of rural housing	0.34	<i>Census</i>

- When can we calibrate parameters?
  - Very common parameters widely used in other literature  $\sigma$
  - Parameters that have been estimated in almost the same context in other paper  $\epsilon$
  - Parameters that clearly and exactly match one specific data pattern  $\alpha, \beta, \eta, \tau$
  - Parameters that are not central to your model
- Use calibration to make your life much easier
- High-dimensional optimization in estimation is computationally intensive

## Solve for Unobservables

Step 2: Solve Unobserved Productivities, Floor Space, and Migration Costs from "Data Used".

- **Unobserved Productivities:** (from the FOCs of the firm)

$$A_{ju}^l = \frac{q_{ju}^{\frac{1-\alpha}{\alpha}} w_{ju}^l (\Xi_{ju}^l)^{\frac{1}{\sigma-1}}}{\alpha(1-\alpha)^{\frac{1-\alpha}{\alpha}}}, \quad A_{ju}^h = \frac{q_{ju}^{\frac{1-\alpha}{\alpha}} w_{ju}^h (\Xi_{ju}^h)^{\frac{1}{\sigma-1}}}{\alpha(1-\alpha)^{\frac{1-\alpha}{\alpha}}} \quad (35)$$

where  $\Xi_{ju}^s = \frac{w_{ju}^s H_{ju}^s}{w_{ju}^h H_{ju}^h + w_{ju}^l H_{ju}^l}$  is the share of labor income distributed to low skill workers.

- Intuitively, observed higher production floor prices, higher wages, and a higher share of skill  $s$  in total payroll in "Data Used" all require higher skill  $s$  productivity at equilibrium.

## Solve for Unobservables

Step 2: Solve Unobserved Productivities, Floor Space, and Migration Costs from "Data Used".

- **Land Market Clearing:** (from the FOCs of firm and HHs)

$$S_{ju}^R = \frac{1-\beta}{\beta Q_{ju}} [w_{ju}^l H_{ju}^l + w_{ju}^h H_{ju}^h], \quad S_{ju}^M = \left( \frac{(1-\alpha)}{q_{ju}} \right)^{\frac{1}{\alpha}} X_{ju}, \quad S_{jr}^R = \frac{1-\beta}{\beta Q_{jr}} [w_{jr} H_{jr}]$$

We are then able to calculate the total amount of urban floor space  $S_{ju} = S_{ju}^R + S_{ju}^M$  and finally back out the implied construction intensity  $\phi_j = S_{ju}/L_j$ .

- **Migration Costs:** (from the HHs' income  $v_{in,jk}^s = w_{jk}^s + \frac{Q_{jn} S_{jn}^R}{H_{in}^R}$  and migration flows)

$$\tau_{in,jk}^s = \frac{v_{in,jk}^s}{Q_{jk}^{1-\beta} (\pi_{in,jk}^s \phi_{in}^s)^{1/\epsilon}}, \quad \text{for } i \neq j \quad (36)$$

- Agglomeration parameter  $\gamma$  is one of the most important parameters we have in our model
- What is the effect of population density on productivity?
- It controls the strength of the main channel
- It is also not estimated in other literature in China
- We will use a method called indirect inference



# Estimation

- Before we go to the estimation of this paper
- Let's take a detour to introduce four main methods of estimation commonly used in structural works:
  - Regression derived from model
  - Generalized Method of Moments/Simulated Method of Moments
  - Maximum Likelihood Estimation/Simulated Maximum Likelihood
  - Indirect Inference
- GMM/SMM and MLE/SML are not used in this paper
- We will not discuss GMM/SMM and MLE/SML in very details
- Rather, we will focus on the basic ideas
- A full and long structural course is required to learn it:  
Professor Junjian Yi has a great course

# Estimation: Method Introduction - Regression

- The first estimation method is simple
- We can linearize equations in the model, add error terms, and run regressions to estimate the parameters
- Specifically, this is widely used in estimating gravity equations
- Now let's see how to implement it in this model

## Estimation: Method Introduction - Regression

- Let's implement log linearization for equation (18):

$$\ln \pi_{in,jk}^s = -\epsilon \ln(\tau_{in,jk}^s) - \epsilon(1 - \beta) \ln(Q_{jk}) + \epsilon \ln(v_{in,jk}^s) - \ln\left(\sum_{j'k'=11}^{JK} (\tau_{in,j'k'}^s Q_{j'k'}^{1-\beta})^{-\epsilon} (v_{in,j'k'}^s)^\epsilon\right) \quad (37)$$

- The denominator is a constant for each  $s - in$ , which is exogenous
- We can replace it by FE of  $s - in$
- Migration cost can be decomposed by equation (4):  $\tau_{in,jk}^s = \bar{\tau}_{in}^s d_{in,jk}$
- Which can be absorbed in a  $s - in$  level FE and  $in - jk$  level FE

## Estimation: Method Introduction - Regression

- Thus, we can simplify the linear regression as:

$$\ln \pi_{in,jk}^s = \epsilon \ln(v_{in,jk}^s) + FE_{in,jk} + FE_{in}^s + error_{in,jk}^s \quad (38)$$

- $error_{in,jk}^s$  is the measurement error we add to capture the uncertainty in data
- This regression can be easily estimated using OLS to get  $\epsilon$
- We can see from the regression that the meaning of  $\epsilon$  is the elasticity of migration on income
- If considering endogeneity of income  $v$ , we can also use IV
- We will discuss more about using shift-share IV to estimate regressions like this in later classes

# Estimation: Method Introduction - GMM/SMM

- The second method is GMM/SMM
- This is also widely used since it is simple and clear
- The basic idea is to match moments from data to moments from model
  - Step 1: Calculate some data moments (say, average test scores of different groups of students)
  - Step 2: Given a set of parameters, simulate the model moments many times
  - Step 3: Find the parameters that can generate the most similar model moments compared with data moments

## Estimation: Method Introduction - GMM/SMM

- Assume that we want to estimate  $\theta$  in a model  $y_i = r(err_i; \theta_0)$
- $err$  is error,  $\theta_0$  is the true value of the parameter in DGP
- $i$  is individual, we have  $n$  people in the sample
- Define a set of moments in data:

$$E[K(y_i)] = E[K(r(err_i; \theta_0))]$$

- $K(y_i)$  can be some endogenous outcome you can find in data
- RHS of this equation means that data comes from the "true model"
- $E[K(y_i)]$  is the mean outcome in the real world
- If you know  $\theta_0$ , you can exactly match  $E[K(y_i)]$  by your model results  $E[K(r(err_i; \theta_0))]$

## Estimation: Method Introduction - GMM/SMM

- Given a guess of parameter  $\tilde{\theta}$ , define a set of moments simulated from your model:

$$\tilde{k}(err_i^s; \tilde{\theta}) = K(r(err_i^s; \tilde{\theta}))$$

- Superscript  $s$  means this is the  $s$ -th simulation
- We simulate this outcome  $\tilde{k}$  for each individual  $i$  for  $S$  times
- Then for one guess of  $\theta$ , the simulated outcome for individual  $i$  is  $\frac{1}{S} \sum_s \tilde{k}(err_i^s; \theta)$

## Estimation: Method Introduction - GMM/SMM

- At last, we minimize the following function to find the best  $\theta$ :

$$\Phi(\theta) = \left\{ \sum_i^N \left[ K(y_i) - \frac{1}{S} \sum_s \tilde{k}(\text{err}_i^s; \theta) \right] \right\}' \Omega \left\{ \sum_i^N \left[ K(y_i) - \frac{1}{S} \sum_s \tilde{k}(\text{err}_i^s; \theta) \right] \right\}$$

- $\Omega$  is some weighting matrix
- $\Phi(\theta)$  is a weighted euclidean distance between data moments and simulated moments



## Estimation: Method Introduction - GMM/SMM

- Let's give an example in this model
- Say we want to estimate migration elasticity  $\epsilon$  in this model
- We can choose the set of data moments as migrants' shares in each city
- Then we simulate our model for different guesses of  $\epsilon$  and get a series of model moments  $\Rightarrow$  simulated migrants' shares from the model for each guess
- We minimize the distance between real and simulated migrants' shares to get an estimation of  $\epsilon^*$

# Estimation: Method Introduction - GMM/SMM

- GMM/SMM is still the most commonly used method
- The advantage of GMM/SMM is that it is relatively simple to implement
  - Sometimes no complicated distributional assumptions
  - No need to write likelihood function: in complicated models, usually we cannot derive a closed-form likelihood function
- The disadvantage of GMM/SMM is that we do not use full information
- We match several moments, rather than the whole distribution
- Moreover, the identification is always a question
- Do we have enough moments for our parameters?
- Hard to prove it rigorously

## Estimation: Method Introduction - MLE/SML

- The third common estimation method is MLE/SML
- This is the most efficient estimation method
- Because it requires you to write the likelihood function of the endogenous variables and make full use of the information
- GMM/SMM matches only some moments; MLE/SML matches the full distribution
- There are three steps:
  - We make full distributional assumptions for all uncertainty in a model
  - Then we directly calculate the likelihood for this model to generate the observed endogenous variables
  - We maximize this likelihood function by optimizing parameters

## Estimation: Method Introduction - MLE/SML

- Although MLE is efficient
- It is the most complicated estimation method of all these four
- When you have a complicated model, say Dynamic GE
- The likelihood function can be very hard to write
- Even if you write it down, the simulation process can also be a disaster
- It may take a whole semester of classes to learn this

## Estimation: Method Introduction - Indirect Inference

- The last method we introduce is called Indirect Inference
- The basic idea is as simple as follows
- First, we create an "auxiliary model" from the main one
- This auxiliary model can be a regression (like DID) with parameter  $\beta$
- Then we implement the following three steps:
  - Run this regression with real data to get  $\hat{\beta}^{data}$
  - Simulate all needed variables from main model, then run this regression with simulated (S times) data and get  $\hat{\beta}^s$
  - Choosing  $\theta$  in main model to minimize the distance between  $\hat{\beta}^s$  and  $\hat{\beta}^{data}$

## Estimation: Method Introduction - Indirect Inference

- The key point is to differentiate between  $\theta$  and  $\beta$
- $\theta$  is the target parameter we want to estimate in the main model
- $\beta$  is the parameter generated in an auxiliary model
- $\beta \neq \theta$ , but  $\beta$  gives us information of  $\theta$
- That is, in our model, with some  $\theta$ , we can generate the simulated data, which can give us same  $\beta$  as in the real data
- To match model simulated "coefficient" with data "coefficient"
- This is used to estimate the agglomeration parameter in this paper

## Estimation: Method Introduction - Indirect Inference

- Therefore, indirect inference looks like GMM/SMM
- What you do is to match something generated from model to the corresponding thing from data
- In indirect inference, you match regression coefficients
- Something like a treatment effect, a policy effect
- It is a great way to combine design-based and structural approaches
- In GMM/SMM, you match moments
- But if you consider regression coefficients as some special moments, then they are the same thing

# Estimation: Agglomeration Parameter

- OK we have already learned four important estimation methods
- Now let's go back to the model
- Let me show you what methods do we use to estimate the agglomeration parameter in this paper



## Estimation: Agglomeration Parameter

- We have the decomposition of productivity as:

$$A_{ju}^s = a_{ju}^s \times (D_{ju})^\gamma, \quad D_{ju} = \frac{H_{ju}^h + H_{ju}^l}{\bar{L}_j} \quad (39)$$

- $a_{ju}^s$  is the fundamental productivity
- $D_{ju}$  is the urban population density
- Now, what is the simplest way to estimate  $\gamma$ ?
- Log linearize it and run a reg, right?

## Estimation: Agglomeration Parameter

- We can have a regression as follows:

$$\log(A_{ju}^s) = \gamma \log(D_{ju}) + \log(a_{ju}^s)$$

- We already calculate  $A_{ju}^s$ , and know  $D_{ju}$  from data
- Can we estimate  $\gamma$  by running  $A_{ju}^s$  on  $D_{ju}$  and treat  $a_{ju}^s$  as error term?
- No! Because  $\log(a_{ju}^s)$  is unobserved and endogenous
- Based on our model, fundamental productivity affects wages and housing prices, thus, migration flows
- Which is surely correlated with  $\log(D_{ju})$

## Estimation: Agglomeration Parameter

- This goes back to a very traditional identification issue in urban economics
- How to distinguish agglomeration from fundamental productivity?
- Several methods are available (Combes and Gobillon, 2015)
  - Find IV, such as geographic conditions or population in ancient times (Ciccone and Hall, 1996)
  - Use a natural experiment (Ahlfeldt et al., 2015)
  - Model the mechanism of agglomeration and estimate (Baum-Snow and Pavan, 2012)
- IV is very hard to find in China due to data limitation
- Fortunately, we have a natural experiment: Inland-favoring land policy

## Estimation: Agglomeration Parameter

- The identification idea is that this policy will only change productivity through changing agglomeration
- The reallocation of land quota will not affect fundamental productivity in different locations  $\Rightarrow a_{ju}^s$  is exogenous in the model
- Thus, given  $\gamma$ , we can simulate the model with/without inland-favoring policy
- Then, we use simulated data to run the same DID regression as in our empirical part
- We find the best  $\gamma$  to match these two coefficients

# Estimation: Agglomeration Parameter

## Step 3: Estimate Agglomeration Elasticity using Indirect Inference

- First calculate real world equilibrium city-urban TFP:  $\ln(\widetilde{TFP}_{ju}) = \ln\left(\frac{Y_{ju}}{(H_{ju}^h + H_{ju}^l)^\alpha}\right)$
- Second, choose agglomeration elasticity  $\gamma_0$  (and correspondingly,  $a_j^{s,0}$ ), simulate a counterfactual equilibrium of 2005 without inland-favoring policy, then calculate:  $\ln(\widetilde{TFP}_{ju}^0)$
- Third, run pooled reg. of "real world" ( $Post2003 = 1$ ) and counterfactual ( $Post2003 = 0$ ):

$$\ln(\widetilde{TFP}_{ju}^0) = \alpha + \delta_1^0 Post2003 \times East_{ju} + \phi_j + \gamma_t + \epsilon_{jut}$$

## Estimation: Agglomeration Parameter

- We have the following results:

Data Estimation of $\hat{\delta}_1$		
	(1) OP	(2) LP
Post2003×East	-0.0749*** (0.0241)	-0.0516* (0.0268)
Trend Variables	Y	Y
Year FE	Y	Y
Prefecture FE	Y	Y
Observations	1,788	1,788
R-squared	0.7537	0.6351

# Estimation: Agglomeration Parameter

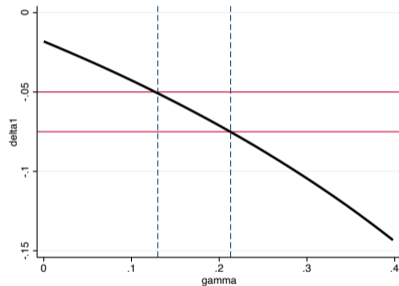


Figure: Relation between  $\gamma$  and  $\delta$

# Estimation: Agglomeration Parameter

- $\gamma$  and  $\delta$  are positively correlated
- Why?  
Because agglomeration effect amplifies the impact of the inland-favoring policy
- The inland-favoring land policy  $\Rightarrow$  migration from inland to east  $\downarrow \Rightarrow$   
Agglomeration in east  $\downarrow$



## Estimation: Agglomeration Parameter

- We have a range of coefficient  $\hat{\delta}_1^* \in [-0.075, -0.05]$
- It corresponds to  $\gamma \in [0.13, 0.21]$
- This is larger than the agglomeration effect estimated in developed countries
- There can be several reasons:
  - Supply chain integration is more profitable when trade cost is high in China
  - Knowledge spillover is strong within regions relative to across regions in China

## Solve Model Equilibrium: Overfitting

- We have all parameters and variables in our hands
- It is time for us to calculate the equilibrium using our model
- We solve the model Eq separately in 2005 and 2010
- Usually equilibrium fitness is very good in QSGE models
- Since we impose a large set of free parameters for migration cost and productivity
- There are criticism about over-fitting here (Dingel and Tintelnot, 2020)

## Solve Model Equilibrium: Overfitting

- Especially when the geographical setting is very "granular"
- When we have one migration cost for each pair of cities, we are trying to match migration flows for all city pairs
- The geographical dimension can be very high
- If we have 3000 counties in China, then we have  $3,000 \times 3,000 = 9,000,000$  county pairs

## Solve Model Equilibrium: Overfitting

- Even if we have Census data, it usually covers only 1 million people
- But we have 9 million pairs!! There will be a lot of pairs with no people at all
- Then, you will have infinitely large migration cost for these pairs
- However, are there really no people in these pairs? Not necessarily. We have only a small sample of all people in China
- The small sample issue naturally create a measurement error problem

## Solve Model Equilibrium: Overfitting

- If we have too many migration cost parameters, we are not only fitting signals, but also these measurement errors
- That is why you may have many infinitely large migration costs
- This is a very typical bias-variance tradeoff
- We are making this model too complicated to capture all data pattern, including noises
- Perfect within sample prediction means poor out-of-sample prediction

# Solve Model Equilibrium: Overfitting



Remember this?

## Solve Model Equilibrium: Overfitting

- A fix to this problem is to parameterize migration cost
- We assume that migration cost is a function of distance
- Rather than consider it as a series of fixed effects
- We will further discuss this issue later in the dynamic model part

# Solve Model Equilibrium: Algorithm

- Now we show how to solve the equilibrium
- The main target of the equilibrium solving process is to calculate endogenous variables using parameters and exogenous variables
- It is used to calculate: Original Eq + Counterfactual Eq
- This is a reverse process of estimation/calibration
- Estimation/calibration:  
Endogenous and exogenous variables in data  $\Rightarrow$  parameter
- Solving model equilibrium:  
Parameter and exogenous variables in data  $\Rightarrow$  Endogenous variables from model
- Then compare endogenous variables solved from model to data/facts (fitness)



# Solve Model Equilibrium: Algorithm

- Exogenous variables:  $\{\tau_{ij}^s, a_j^s, \eta_j, \phi_j, L_j, H_{in}^s\}$
- Endogenous variables:  $\{Q_{ju}, q_{ju}, w_{jk}^s, S_{ju}^R, S_{ju}^M, v_{in,jk}^s, \pi_{in,jk}^s, Y_{jk}\}$
- Three blocks of this model:
  - Migration Block: worker income and gravity equations
  - Production Block: production, wage, and floor space price equations
  - Housing Block: construction equations and market clearing equations

# Solve Model Equilibrium: Algorithm

- There are two ways to solve the equilibrium in QSGE models
- The first is the "hat-algebra", which solves the model in "change" but not level
- Anyone who is interested in it can go to Prof Deng's course
- We will discuss it a little bit in the dynamic model part
- Today, we introduce a more traditional and general method
- Using contraction algorithm, we solve the model in level
- This method can be used in any structural model

# Solve Model Equilibrium: Algorithm

- There are two reasons why we need to solve the equilibrium
- First, we want to evaluate the fitness of the model
- We want to see how similar it is for equilibrium values in the model, compared with those in data
- Here is the process:
  - We start from one block using some variable value (data value in the first iteration)
  - We solve the variables in other blocks using model equations and update them with these values
  - We solve the variables in the starting block by model equations and *updated* values of other variables
  - We iterate this process until all endogenous variables converge

# Solve Model Equilibrium: Algorithm

- Second, we need to solve the variables in the model under counterfactuals
- To calculate the counterfactuals following policy changes
- The process is similar
- We start with **the block where the changes happen**
- Then iterate block by block to update the endogenous variables
- The iteration ends until all endogenous variables converge
- Example: An increase in land supply

# Solve Model Equilibrium: Algorithm

- There are two layers of loops: inner and outer
- Suppose a land reallocation policy is  $\hat{L}_j = \Delta_j \times L_j$  for every city  $j$
- $L_j$  is the land supply in the real world, and  $\Delta_j$  is the proportional change in the counterfactual policy
- $\{\hat{x}_{jk}\}^{OI}$  indicates the  $OI^{th}$  iteration of variable  $x$
- $O$  is the iteration time of outer loop
- $I$  is the iteration time of inner loop

# Solve Model Equilibrium: Algorithm

- In the outer loop, we update the residential and production floor space in urban region according to their inner loop equilibrium
- In the inner loop, we update the migration, production decisions, and floor space prices given the residential and production floor space
- Inner loop converge first, then feed back to outer loop to get it converged
- Generally, you can also update everything together in one loop
- The design of the convergence algorithm can determine the efficiency

# Solve Model Equilibrium: Algorithm

## Outer loop

Step 1: Initiation (ensuring non-zero floor space supply)

Change in land supply  $\Rightarrow$  Change in urban floor space supply

$$\{\hat{S}_{ju}\}^* = \phi_j \hat{L}_j$$

$$\{\hat{S}_{ju}^R\}^1 = S_{ju}^R \times (\{\hat{S}_{ju}\}^* / S_{ju})$$

$$\{\hat{S}_{ju}^M\}^1 = S_{ju}^M \times (\{\hat{S}_{ju}\}^* / S_{ju})$$

# Solve Model Equilibrium: Algorithm

## Outer loop

Step 2:

- Given outer loop value  $S$  and  $L$ , calculate all other endogenous variables in the inner loop
- $x^{1*}$  means the convergence outcome of  $x$  from the inner Loop

$$\{\hat{Q}_{ju}\}^{1*} = \frac{1 - \beta}{\beta} \frac{\{w_{ju}^l H_{ju}^l + w_{ju}^h H_{ju}^h\}^{1*}}{\{\hat{S}_{ju}^R\}^1}$$

$$\{\hat{q}_{ju}\}^{1*} = (1 - \alpha) \left( \frac{\alpha}{\{\hat{W}_{ju}\}^{1*}} \right)^{\frac{\alpha}{1-\alpha}}$$

- $\{\hat{Q}_{ju}\}^{1*}$  and  $\{\hat{q}_{ju}\}^{1*}$  are results from the inner loop
- We will show latter what is the inner loop



## Solve Model Equilibrium: Algorithm

- Now we have to adjust  $S_{ju}^R, S_{ju}^M$  according to  $\{\hat{Q}_{ju}\}^{1*}$  and  $\{\hat{q}_{ju}\}^{1*}$

- **Outer loop**

Step 3: Compare floor space prices and generate excess demand for residential space. If  $\{\hat{Q}_{ju}\}^{1*} > \frac{\{\hat{q}_{ju}\}^{1*}}{\eta_j}$ , residential floor space is smaller than equilibrium and production floor space is larger than equilibrium, so we need to redistribute more residential floor space to production floor space, until  $\{\hat{Q}_{ju}\}^{1*} = \frac{\{\hat{q}_{ju}\}^{1*}}{\eta_j}$ . We update partially with step size  $\gamma$ .

$$\{ED_j^R\}^1 = \gamma \left( \frac{\{\hat{Q}_{ju}\}^{1*} - \frac{\{\hat{q}_{ju}\}^{1*}}{\eta_j}}{\{\hat{Q}_{ju}\}^{1*} + \frac{\{\hat{q}_{ju}\}^{1*}}{\eta_j}} \right) \times \{\hat{S}_{ju}^R\}^1$$

- The updating rule is usually arbitrary. Try to find an efficient one.

# Solve Model Equilibrium: Algorithm

## Outer loop

Step 4: Update floor space

$$\{\hat{S}_{ju}^R\}^2 = \{\hat{S}_{ju}^R\}^1 + \{ED_j^R\}^1$$

$$\{\hat{S}_{ju}^M\}^2 = \{\hat{S}_{ju}^M\}^1 - \{ED_j^R\}^1$$

we repeat Step 2 to Step 4 until the market clearing condition holds:  $\{\hat{Q}_{ju}\}^{**} = \frac{\{\hat{q}_{ju}\}^{**}}{\eta_j}$ .

# Solve Model Equilibrium: Algorithm

- What is the inner loop? We sequentially update all endogenous variables  
Break Step 2 of **Inner loop**  
Step 2-1: Update the housing block

$$\{\hat{Q}_{ju}\}^{11} = \frac{1 - \beta}{\beta} \frac{w_{ju}^l H_{ju}^l + w_{ju}^h H_{ju}^h}{\{\hat{S}_{ju}^R\}^1}$$

$$\{\hat{Q}_{jr}\}^{11} = \tau \{\hat{Q}_{ju}\}^{11}$$

$$\{\hat{S}_{jr}^R\}^{11} = \frac{1 - \beta}{\beta} \frac{w_{jr} H_{jr}}{\{\hat{Q}_{jr}\}^{11}}$$

# Solve Model Equilibrium: Algorithm

## Inner loop

Step 2-2: Update the migration block

$$\{\hat{v}_{in,jk}^s\}^{11} = w_{jk}^s + \frac{\{\hat{Q}_{in}\}^{11} \{\hat{S}_{in}^R\}^{11}}{H_{in}^R} \quad \text{from eq.(3)}$$

$$\{\hat{\pi}_{in,jk}^s\}^{11} = \frac{(\tau_{in,jk}^s \{\hat{Q}_{jk}\}^{11})^{1-\beta} (\{\hat{v}_{in,jk}^s\}^{11})^\epsilon}{\sum_{j'k'=11}^{JK} (\tau_{in,j'k'}^s \{\hat{Q}_{j'k'}\}^{11})^{1-\beta} (\{\hat{v}_{in,j'k'}^s\}^{11})^\epsilon} \quad \text{from eq.(18)}$$

Population distribution  $H_{jk}^s$  is then updated accordingly

# Solve Model Equilibrium: Algorithm

## Inner loop

Step 2-3: Update the production block

$$\{\hat{X}_{ju}\}^{11} = [(\{A_{ju}^h\}^{11} \{\hat{H}_{ju}^h\}^{11})^{\frac{\sigma-1}{\sigma}} + (\{A_{ju}^l\}^{11} \{\hat{H}_{ju}^l\}^{11})^{\frac{\sigma-1}{\sigma}}]^{\frac{\sigma}{\sigma-1}} \text{ from eq.(20)}$$

$$\{\hat{w}_{ju}^l\}^{11} = \alpha(\{\hat{X}_{ju}\}^{11})^{\alpha-1} (\{\hat{S}_{ju}^M\}^1)^{1-\alpha} (\{A_{ju}^l\}^{11})^{\frac{\sigma-1}{\sigma}} (\{\hat{X}_{ju}\}^{11})^{\frac{1}{\sigma}} (\{\hat{H}_{ju}^l\}^{11})^{-\frac{1}{\sigma}} \text{ from eq.(21)}$$

$$\{\hat{w}_{ju}^h\}^{11} = \alpha(\{\hat{X}_{ju}\}^{11})^{\alpha-1} (\{\hat{S}_{ju}^M\}^1)^{1-\alpha} (\{A_{ju}^h\}^{11})^{\frac{\sigma-1}{\sigma}} (\{\hat{X}_{ju}\}^{11})^{\frac{1}{\sigma}} (\{\hat{H}_{ju}^h\}^{11})^{-\frac{1}{\sigma}} \text{ from eq.(22)}$$

# Solve Model Equilibrium: Algorithm

## Inner loop

Step 2-4: Update floor space prices, which is the input of step 2-1

$$\{\hat{Q}_{ju}\}^{12} = \frac{1 - \beta}{\beta} \frac{\{w_{ju}^l H_{ju}^l + w_{ju}^h H_{ju}^h\}^{11}}{\{\hat{S}_{ju}^R\}^1}$$

# Solve Model Equilibrium: Algorithm

## Inner loop

We repeat Step 2-1 to Step 2-4 until residential floor space prices  $\{\hat{Q}_{ju}\}^{1t}$  converge to  $\{\hat{Q}_{ju}\}^{1*}$ . We then output  $\{\hat{Q}_{ju}\}^{1*}$  and  $\{\hat{q}_{ju}\}^{1*}$  for the use in outer loop.

$$\{\hat{Q}_{ju}\}^{1*} = \frac{1 - \beta \{w_{ju}^l H_{ju}^l + w_{ju}^h H_{ju}^h\}^{1*}}{\beta \{\hat{S}_{ju}^R\}^1}$$

$$\{\hat{W}_{ju}\}^{11} = \frac{\{\hat{w}_{ju}^h\}^{11} \{\hat{H}_{ju}^h\}^{11} + \{\hat{w}_{ju}^l\}^{11} \{\hat{H}_{ju}^l\}^{11}}{\{\hat{X}_{ju}\}^{11}}$$

$$\{\hat{q}_{ju}\}^{1*} = (1 - \alpha) \left( \frac{\alpha}{\{\hat{W}_{ju}\}^{1*}} \right)^{\frac{\alpha}{1-\alpha}}$$

# Solve Model Equilibrium

- The order of the algorithm is as follows:
  - 1. Outer loop step 1  $\Rightarrow$
  - 2. Outer loop step 2  $\Rightarrow$
  - 3. Inner loop step 2-1 to 2-4 Until converge  $\Rightarrow$
  - 4. Outer loop step 3  $\Rightarrow$
  - 5. Outer loop step 4
- Implement 1-5 until converge
- We can also design an algorithm to update everything together in one loop



# Solve Model Equilibrium

- Using this algorithm, we can calculate model responses when some policy is implemented
- We compare the original Eq with the changed Eq
- We can then evaluate the policy effect

## Solve Model Equilibrium: Analysis

- Before we go to the results of the counterfactuals
- Let's first analyze the original equilibrium solved from the data
- We solve the model separately for data in 2005 and 2010
- Let's see what is going on in reality in China in 2005 and 2010

# Solve Model Equilibrium: Analysis

- First, we investigate the spatial distribution of the productivity
- The measured productivity in our model is  $\ln(\widetilde{Prod}_{ju}) = \ln\left(\frac{Y_{ju}}{(H_{ju}^h + H_{ju}^l)^\alpha}\right)$
- We can decompose the labor productivity as follows:

$$\begin{aligned}
 \ln(\widetilde{Prod}_{ju}) &= (1 - \alpha)\ln(S_{ju}^M) + \alpha \ln\left(\frac{[(A_{ju}^h H_{ju}^h)^{\frac{\sigma-1}{\sigma}} + (A_{ju}^l H_{ju}^l)^{\frac{\sigma-1}{\sigma}}]^{\frac{\sigma}{\sigma-1}}}{H_{ju}^h + H_{ju}^l}\right) \\
 &= \underbrace{(1 - \alpha)\ln(S_{ju}^M)}_{\text{land scale premium}} + \frac{\alpha\sigma}{\sigma - 1} \left( \underbrace{\ln\left(\frac{(A_{ju}^h \Gamma_{ju}^h)^{\frac{\sigma-1}{\sigma}} + (\Gamma_{ju}^l)^{\frac{\sigma-1}{\sigma}}}{A_{ju}^l}\right)}_{\text{skill premium}} + \underbrace{\ln(a_{ju}^l)}_{\text{fundamental}} + \underbrace{\gamma \ln(D_{ju})}_{\text{agglomeration}} \right)
 \end{aligned}
 \tag{40}$$

## Solve Model Equilibrium: Analysis

- We calculate each component of this productivity for six groups of prefectures in 2005 and 2010
- The six groups are categorized as follows:
  - Divide by development level  $\{high, mid, low\}$   
Based on  $\{10\%, 45\%, 45\%\}$  of the distribution of GDP per capita.
  - Divide by region: East vs Inland

# Solve Model Equilibrium: Analysis

Table: Spatial Distribution of Measured Productivity and Land Tightness

Regions (loc., dev.)	No. of prefectures	Measured Productivity										Land Tightness	
		Total	LSP	2005			2010				2005	2010	
				SP	Fund	Agg	Total	LSP	SP	Fund	Agg	Land/Worker	
National	225	33.84	2.19	0.59	31.06	-0.01	35.86	2.22	0.62	32.92	0.11	0.093	0.083
(east, high)	21	35.21	2.24	0.67	32.07	0.22	36.81	2.29	0.67	33.51	0.33	0.077	0.068
(east, mid)	51	33.84	2.25	0.49	31.06	0.04	35.75	2.24	0.57	32.76	0.17	0.084	0.082
(east, low)	25	32.61	2.13	0.50	30.00	-0.02	34.84	2.06	0.50	32.57	-0.30	0.080	0.108
(inland, high)	2	33.69	2.06	0.59	31.44	-0.40	35.24	2.13	0.77	32.65	-0.33	0.127	0.130
(inland, mid)	50	32.97	2.11	0.69	30.34	-0.17	35.35	2.17	0.69	32.40	0.09	0.140	0.101
(inland, low)	76	32.50	2.09	0.56	30.21	-0.37	35.10	2.14	0.52	32.74	-0.30	0.104	0.086

## Solve Model Equilibrium: Analysis

- Fundamentals and agglomeration effects drive the spatial dispersion of productivity
- Fundamentals and agglomeration effects also drive the growth of productivity
- Eastern and more developed prefectures have 30% to 50% less land per worker
- Land tightness in Eastern and more developed prefectures is worsening from 2005 to 2010

# Solve Model Equilibrium: Analysis

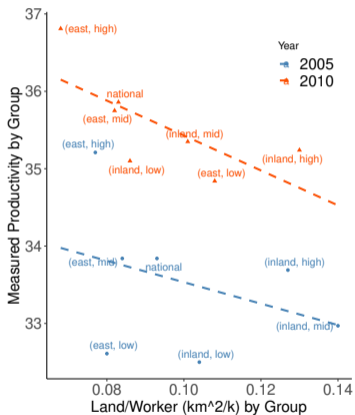


Figure: Correlation between Productivity and Land Tightness

## Counterfactual Analysis: No Inland-favoring Policy

- Now let's go to the main counterfactual
- What will happen if we get rid of this inland-favoring land supply policy in 2003?
- In the model, we keep the land growth rate before 2003 unchanged
- For prefecture  $j$  in year  $t$ , we have the following allocation rule:

$$\widehat{L_j(t)} = L_j(2003) + \underbrace{\sum_j [L_j(t) - L_j(2003)]}_{\text{actual total increment of land}} \times \underbrace{\frac{L_j(2003)(1 + g_{L_j})^{t-2003}}{\sum_j L_j(2003)(1 + g_{L_j})^{t-2003}}}_{\text{prefecture } j\text{'s share if no inland-favoring}}$$

- $L_j(2003)$ : Urban land stock in 2003
- $\sum_j [L_j(t) - L_j(2003)]$ : Actual national total increment of land
- $g_{L_j}$ : Average land supply growth rate before 2003



# Counterfactual Analysis: No Inland-favoring Policy

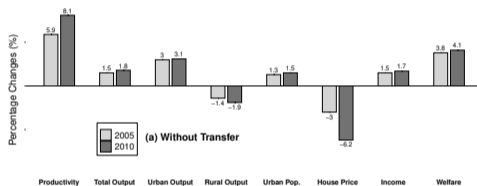
Table: Counterfactual Total Land Supply ( $km^2$ )

Regions (loc., dev.)	No. of prefectures	Reality		Counterfactual	
		2005	2010	$\widehat{2005}$	$\widehat{2010}$
National	225	22268	28336	22268	28336
(east, high)	21	5838	7272	6597	10958
(east, mid)	51	5875	7832	5734	6551
(east, low)	25	1418	1681	1472	1596
(inland, high)	2	169	206	169	169
(inland, mid)	50	5131	6578	4537	4819
(inland, low)	76	3837	4767	3760	4244

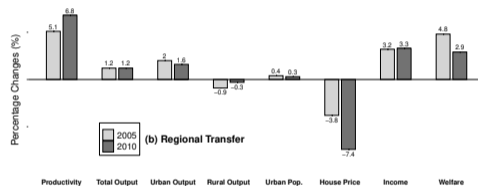
## Counterfactual Analysis: No Inland-favoring Policy

- We know that the target of inland-favoring land policy is to encourage the development of underdeveloped regions
- Can we have other options to achieve it?
- A policy of replacement is a regional transfer program
- We allocate land as before 2003, but transfer additional income in developed cities to underdeveloped ones
- It mimics a regional land quota trading system
- Inland cities can sell land quota to eastern cities

# Counterfactual Analysis: No Inland-favoring Policy



(a) No Transfer



(b) With Transfer

Figure: National Results of Main Counterfactual

# Counterfactual Analysis: No Inland-favoring Policy

## Conclusions at national level

- Removing inland-favoring land policy can
  - Increase national productivity by 5.9% (8.1%)
  - Increase total output by 1.5% (1.8%)
  - Increase urban population by 1.3% (1.5%)
  - Increase Welfare by 3.8% (4.1%)
- Adding regional transfer may distort the market a little
- But much smaller than the original inland-favoring policy

## Counterfactual Analysis: No Inland-favoring Policy

- Inland-favoring land policy affected China's economy by distorting both land and labor markets
- We further decompose the impact of the inland-favoring policy in three channels:
  - Direct effect from production floor space input changes
  - Indirect effect from induced labor demand and supply changes
  - Agglomeration effect from induced population density changes
- We can shut down channels by fixing different variables

# Counterfactual Analysis: No Inland-favoring Policy

Table: Aggregate Effects Decomposition

Decomp.	$\Delta \widehat{\text{Productivity}}$		$\Delta \widehat{\text{Urban Output}}$		$\Delta \widehat{\text{Rural Output}}$		$\Delta \widehat{\text{Urban Pop.}}$	
	2005	2010	2005	2010	2005	2010	2005	2010
	(a) Without Transfer							
Total	5.9%	8.1%	3.0%	3.1%	-1.4%	-1.9%	1.3%	1.5%
Direct	0.3%	-0.8%	0.3%	-0.8%	0.0%	0.0%	0.0%	0.0%
Indirect	3.2%	5.8%	1.6%	3.2%	-1.4%	-1.7%	1.3%	1.2%
Agglomeration	2.4%	3.1%	1.0%	0.8%	0.0%	-0.3%	0.0%	0.3%
	(b) Regional Transfer							
Total	5.1%	6.8%	2.0%	1.6%	-0.9%	-0.3%	0.4%	0.3%
Direct	0.3%	-0.8%	0.3%	-0.8%	0.0%	0.0%	0.0%	0.0%
Indirect	2.9%	5.3%	1.1%	2.4%	-0.9%	-0.6%	0.4%	0.3%
Agglomeration	1.9%	2.3%	0.6%	0.0%	0.0%	0.3%	0.0%	0.0%

## Counterfactual Analysis: No Inland-favoring Policy

- Indirect channel and agglomeration effects accounts for most productivity/output reductions
- The distortion effect of the inland-favoring land policy on labor markets is very important
- The general equilibrium effect is very important

## Counterfactual Analysis: No Inland-favoring Policy

- We have investigated the national effect
- Now let's go to the spatial effect
- This is crucial since it directly points to the main target of the policy
- Can inland-favoring land policy achieve its original goal to promote regional balanced development?



# Counterfactual Analysis: No Inland-favoring Policy

Table: Spatial Effects on Economic Development

Regions (loc., dev.)	No. of prefectures	$\Delta$ Productivity		$\Delta$ Urban Output		$\Delta$ Rural Output		$\Delta$ Urban Pop.		$\Delta$ House Price	
		$\widehat{2005}$	$\widehat{2010}$	$\widehat{2005}$	$\widehat{2010}$	$\widehat{2005}$	$\widehat{2010}$	$\widehat{2005}$	$\widehat{2010}$	$\widehat{2005}$	$\widehat{2010}$
National	225	5.9%	8.1%	3.0%	3.1%	-1.4%	-1.9%	1.3%	1.5%	-3.0%	-6.2%
(east, high)	21	7.4%	14.9%	8.1%	17.8%	0.0%	3.3%	6.9%	13.9%	-17.4%	-32.4%
(east, mid)	51	-0.3%	-2.3%	-0.7%	-4.4%	-0.4%	0.0%	-0.7%	-3.0%	1.4%	11.9%
(east, low)	25	-0.6%	-2.7%	-0.8%	-4.6%	-1.4%	-3.5%	-0.6%	-3.2%	-3.3%	2.8%
(inland, high)	2	-0.1%	-2.6%	0.0%	-3.2%	0.0%	1.7%	0.1%	-1.0%	1.6%	18.5%
(inland, mid)	50	-0.7%	-7.8%	-2.6%	-11.8%	-1.5%	-2.9%	-1.9%	-7.5%	1.6%	9.6%
(inland, low)	76	-0.4%	-4.9%	-1.7%	-6.7%	-1.9%	-3.2%	-1.6%	-5.1%	-3.8%	-1.7%

# Counterfactual Analysis: No Inland-favoring Policy

Table: Spatial Effects on Income and Welfare

Regions (loc., dev.)	No. of prefectures	Without Transfer				Regional Transfer			
		$\widehat{\Delta \text{ Income}}$		$\widehat{\Delta \text{ Welfare}}$		$\widehat{\Delta \text{ Income}}$		$\widehat{\Delta \text{ Welfare}}$	
		2005	2010	2005	2010	2005	2010	2005	2010
National	225	1.46%	1.74%	3.8%	4.1%	3.18%	3.26%	4.8%	2.9%
(east, high)	21	2.69%	7.43%	10.8%	14.5%	-10.3%	-10.9%	7.7%	2.5%
(east, mid)	51	0.28%	-0.08%	-0.2%	-4.0%	0.49%	5.03%	1.2%	2.1%
(east, low)	25	1.10%	1.92%	-1.5%	1.2%	0.72%	6.49%	1.9%	6.3%
(inland, high)	2	0.01%	-1.61%	-0.6%	-5.3%	2.30%	5.63%	2.0%	3.1%
(inland, mid)	50	0.95%	-0.91%	-0.1%	-5.1%	20.0%	6.94%	5.8%	4.2%
(inland, low)	76	2.24%	1.92%	2.7%	-3.5%	6.49%	7.05%	5.0%	4.0%

## Counterfactual Analysis: No Inland-favoring Policy

- By removing the inland-favoring land policy, we can
  - Increase population, productivity and output in developed regions
  - But decrease population, productivity and output in underdeveloped regions
  - Housing prices are dramatically reduced in developed regions
- Thus, the inland-favoring land policy shrank the regional development gap
- But did it really help people from there?

## Counterfactual Analysis: No Inland-favoring Policy

- We increase incomes for workers from underdeveloped regions by removing the policy
- The welfare effect is at best mixed
- Thus, inland-favoring policy helped region, but not necessarily people there
- Since it prevented people from migrating to developed regions
- Replace it with a regional transfer can help people from poor areas with minimal spacial misallocation

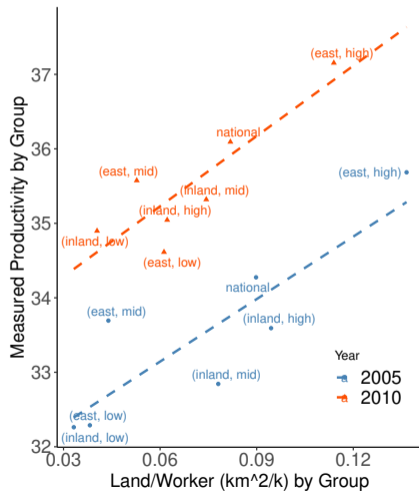
## Counterfactual Analysis: Optimal Policy

- In the main counterfactual, we investigate removing the inland-favoring policy in 2003
- But land allocation before 2003 is not necessarily efficient
- What will happen if we eliminate all frictions in land market?
- How much did the inland-favoring land policy account for in the overall misallocation?
- It then goes to finding an optimal land allocation

# Counterfactual Analysis: Optimal Policy

- In total, there are three layers of misallocation
  - National total land supply cap
  - Land supply allocation across prefectures
  - Production & residential land allocation within prefecture
- We ignore the first one and focus on the second and the third ones
- Optimal policy construction: We find the land allocation rule  $\{L_j, \eta_j\}$  such that:
  - (1) Marginal production output of land is equalized across regions  
 $\partial Y_{ju} / \partial S_{ju}^M = \partial Y_{iu} / \partial S_{iu}^M, (q_{ju} = q_{iu}),$  for any  $i, j$
  - (2) Price gap between production and residential floor space is eliminated  
 $\eta_j = 1, (q_{ju} = Q_{ju}),$  for any  $j$

# Counterfactual Analysis: Optimal Policy



# Counterfactual Analysis: Optimal Policy

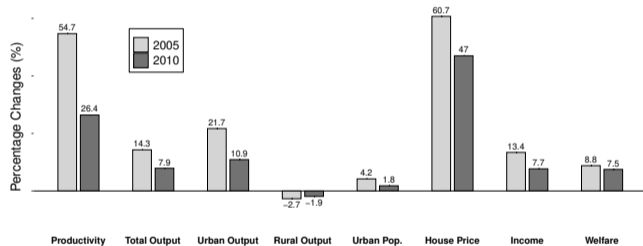


Figure: Results of the Optimal Policy



# Counterfactual Analysis: Optimal Policy

- The optimal policy can increase
  - Productivity by 55% (26%)
  - Output by 14% (8%)
  - Welfare by 8.8% (7.5%)
- The overall spatial misallocation in China is large
- But it reduced across time from 2005 to 2010
- Inland-favoring land policy contributed a sizable part of it

# Final Conclusion

- QSGE Model is interesting and important
- The crucial part is how to combine data with model
- This is the key to all structural methods
- We have introduced it in details using one paper as the example
- Let's continue our journey with more contents in the following weeks!

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