

Market Structure, Imperfect Tariff Pass-Through, and Household Welfare in Urban China*

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Abstract

This paper investigates the tariff pass-through mechanism and the distributional effects of trade liberalization in urban China. We study how market structure, specifically the size of the private sector, affects tariff pass-through, and how this mechanism influenced the extent to which households benefited from the trade liberalization. Our results suggest that a higher share of private sector in Chinese cities is associated with higher levels of tariff pass-through rates. This effect works both through the distribution sector, and through the production of final goods. By incorporating the changes in consumer prices of tradable and non-tradable goods, we next investigate the impact of WTO accession on household welfare through changes in the cost of consumption. The results show that WTO accession of China was associated with welfare gains to almost every household across the per capita expenditure spectrum, and that the distributional effect is strongly pro-poor. The average welfare gain of WTO accession on Chinese households is estimated to be 7.3 percent. The distributional effect through higher levels of privatization was also pro-poor, indicating that privatization enhanced the pro-poor impact of trade liberalization.

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JEL Classification: D31, D40, F14, O12

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1. Introduction

Trade liberalization affects individual and household welfare through two main channels. Through the income channel, trade liberalization changes the wages and employment of individuals, while through the consumption channel, it influences the prices of goods consumed by households (Deaton, 1989; United Nations, 2012). An individual may experience a decrease in earnings, while simultaneously facing reductions in the prices of consumption items as a result of the trade liberalization. It is also possible that trade liberalization has a regressive distributional effect through the income channel, while having a progressive distributional effect through the consumption channel. Although the income effect has been intensively explored in the literature (i.e., Goldberg and Pavcnik, 2003; Zhu and Trefler, 2005; Hanson, 2007; Verhoogen, 2008; Topalova, 2010; Han, Liu and Zhang, 2012), the consumption effect of trade liberalization through price changes is often overlooked.¹

Recent studies have suggested, however, that the consumption effect might be essential in estimating the welfare gains of trade. Broda and Weinstein (2008) and Broda, Leibtag, and Weinstein (2009) show that, contrary to common beliefs, adjusting income and poverty measures to account for the prices paid by each individual reveals that Americans in every income group are substantially better off than they were before. Faber (2012) finds that access to cheap U.S. inputs reduces the relative price of higher quality products, and thus, leads to a significant increase in Mexican real income inequality. It is therefore crucial to understand the consumption effect of trade liberalization through changes in domestic prices.

The extent to which households benefit from trade liberalization also depends on the structure and the efficiency of the product markets in which the consumption goods are being produced and sold. Reductions in import tariff rates may reduce domestic prices and improve consumer welfare only if markets are able to transmit the price changes from the border to consumers. If domestic industries are

¹ The literature has examined the impact of trade liberalization on labor income (Hanson, 2007), on wage inequality (Zhu and Trefler; 2005; Verhoogen, 2008; Han, Liu, and Zhang, 2012; Helpman, Itskhoki, Muendler and Redding, 2013), on poverty (Hasan, Mitra and Ural, 2007; McCaig, 2011; Topalova, 2010), and on employment (Goldberg and Pavcnik, 2003). See Winters, McCulloch and McKay (2004) and Goldberg and Pavcnik (2007) for surveys of the literature.

imperfectly competitive, changes in tariffs may be absorbed by profit margins or markups (Campa and Goldberg, 2002). In this case, consumer prices may not decrease to reflect the full extent of the tariff reductions, even in the absence of other frictions in the market. Atkin and Donaldson (2012) have further shown how the market power of intermediaries in domestic industries affects the markups, which results in different rates of tariff pass-through within sub-Saharan Africa. In the case of China, a more relevant market imperfection is the share of state-owned enterprises (SOEs) in the domestic industries. A heavily regulated domestic industry that is dominated by the state would have limited flexibility to adjust to the changing cost conditions (Szamosszegi and Kyle, 2011). In contrast, a rising private sector has created markets and accelerated competition in China (Naughton, 1994; Jin and Qian, 1998; Park, Li, and Tse, 2006), which is expected to improve the ability of domestic markets to transfer the tariff reductions to consumers.

China has been consistently opening up its economy since the early 1990s, as exemplified by its World Trade Organization (WTO) accession in 2001. Figure 1 presents the trends in the average tariff rates for major tradable goods in China, namely, Food and Beverage, Clothing and Household Equipment. Each category is shown to have experienced profound tariff cuts from 1992 to 2008. Particularly, the average tariff reduction due to WTO membership was 38 percent from 2000 to 2002. In addition to trade liberalization, China has also been transforming itself from a centrally-planned economy to a market-oriented economy since the early 1990s (Fan and Wei, 2006; Brandt and Rawski, 2008). A unique feature of this transition process in China is the reallocation of resources from SOEs to enterprises outside of the state sector (Brandt, Hsieh and Zhu, 2008; Zhu, 2012). Consequently, the relative size of the private sector in urban China has increased from 22 percent in 1992 to 50 percent in 2008 (see Figure 2). The substantial Chinese trade liberalization, accompanied by the reform of SOEs, provides a unique setting to analyze the role of the private sector in the tariff pass-through and to assess the welfare gains of trade liberalization through price changes.

This paper has several contributions to the literature. It is the first study that estimates welfare gains through changes in consumer prices in urban China using household survey data. The paper also

aims to improve our understanding of the role of domestic markets in the price transmission mechanism. To this end, it adds to the literature by empirically analyzing how the change in market structure, specifically through the size of the private sector, influences tariff pass-through. This allows us to determine whether the rapid expansion in the private sector has enhanced or mitigated the welfare effects of trade liberalization by influencing the ease at which price changes transmit to the consumer. The paper also incorporates the non-tradable goods into the welfare analysis by assessing how the prices of non-tradables respond to the price changes of tradables in general equilibrium. The distributional effect of trade liberalization through these channels, namely through the size of the private sector, tradable goods and non-tradable goods, are then analyzed to assess their relative importance across the per capita expenditure spectrum.

This paper starts with examining how the prices of tradable goods are affected by changes in tariffs using household survey data, and the role of market structure in the tariff pass-through mechanism. The literature has emphasized imperfect competition among foreign exporters and a tariff-induced change in a country's terms of trade as the major reasons for imperfect tariff pass-through on import prices (Feenstra, 1989; 1995). There are only a few papers in the literature that have studied how domestic factors affect the pass-through of tariffs on consumer prices, which focus on the geographic characteristics of localities, such as the distance to the border (Nicita, 2009; Atkin and Donaldson, 2012), or the relative isolation of households from functioning product markets in rural versus urban areas (Ural Marchand, 2012). These papers document the influence of trade policy upon households varies greatly across different regions, even though tariffs are reduced at the national level.² However, there are no

² Nicita (2009) finds that tariff pass-through was significantly higher in the Mexican states closest to the United States border, and thus, households living in these states benefited relatively more from the reductions in tariffs. Atkin and Donaldson (2012) find that intra-national trade costs in Africa are extremely high, which leads to welfare losses for isolated locations. Pass-through estimates for India suggest that reductions in tariffs increased domestic consumer welfare more in urban areas relative to rural areas (Ural Marchand, 2012).

studies that investigate the how market structure at the local level affects the extent to which tariffs are transmitted to consumer prices.³

In order to assess the consumption effects of trade liberalization, this paper follows the empirical approach developed in Deaton (1989) to estimate the negative compensating variation, i.e. the negative of the amount that a household would need in order to maintain their welfare level prior to the policy change. This methodology was followed by Porto (2006), Nicita (2009), Ural Marchand (2012), and Nicita, Olarreaga, and Porto (2014) to study the distributional consequences of trade policies.⁴ A major advantage of this framework is the ability to maintain heterogeneity across households in terms of their consumption baskets and locations, which allows us to investigate the local factors that might affect the welfare impacts of the trade policy.

The results suggest that reductions in tariffs are not perfectly transmitted to consumer prices, and the transmission level varied across cities with different shares of the private sector. The average pass-through rate is found to be 22 percent in a city where all enterprises are state-owned, and a 10 percentage points increase in the size of the private sector is associated with 2 percentage points higher tariff pass-through. A city with an average size of the private sector has an approximate tariff pass-through rate of 31 percent. The share of the private sector among intermediaries, and among the final good producers, are both important factors, while the magnitude of the effect through intermediaries is found to be much higher. In addition, the results suggest that the pass-through level is lower for agricultural goods when compared to manufacturing goods, which is consistent with their relative share of imported goods in the domestic market. The quality of local infrastructure, such as the length of roads and telephone lines, is

³ One exception is that, for exchange rate pass-through on producer prices, Yu (2007a, 2007b) investigates Chinese industries and finds that the producer prices become more sensitive to exchange rate movements as the share of non-state portion of industry increases.

⁴ Porto (2006) studies the welfare impact of the Mercosur free-trade zone on Argentinian households using a similar framework. He concludes that households do not substantially benefit from a reduction in the cost of consumption, but rather they benefit from an increase in their earnings. Studies that incorporate imperfect tariff pass-through (Nicita, 2009; Ural Marchand, 2012), and linkages between production and consumption decisions by households (Seshan, 2005) show that trade liberalization generally increases the real incomes of households and reduces poverty rates. Nicita, Olarreaga, and Porto (2014) analyze the protectionism in Sub-Saharan African countries and show that domestic trade policy tends to favor poor households, with the exception of Ethiopia.

also shown to improve the pass-through mechanism. The results also show that the prices of some non-tradable goods, such as Transportation and Communications, as well as Housing, are significantly affected by the changes in tradable good prices.

Even with the relatively restrictive price transmission, we show that China's accession to the WTO has a pro-poor impact on household welfare. The poorest households at the lower end of the distribution experience a 13.6 percent gain in their welfare relative to their initial welfare. This effect monotonically decreases along the per capita expenditure distribution until it is insignificantly different than zero for better-off households at the upper end of the distribution. The average welfare effect of WTO accession is estimated to be 7.3 percent. Households are affected mainly through the prices of tradable goods, rather than non-tradable goods, as the expenditure shares of these services are relatively low and the response rate of non-tradable prices is relatively small. The results also show that the increasing share of private sector increased the welfare benefits for all households, while the effect was disproportionately higher for poorer households. Privatization therefore enhanced the pro-poor impact of trade liberalization by improving the ability of markets to transmit the tariff reductions to consumers, specifically for products that has a higher expenditure share for poorer households.

The paper is organized as follows. In Section 2, we focus on the tradable goods, and outline the theoretical framework, provide empirical evidence, and explore the possible mechanisms on the role of market structure in tariff pass-through. In Section 3, we estimate the price elasticities of nontradable goods. In Section 4, we assess the consumption effects of trade liberalization, and present distributional analysis of the estimated consumption effects. Section 5 concludes the paper.

2. Market Structure and Tariff Pass-Through for Tradable Goods

2.1 Theoretical Framework for Tradable Goods

Following Burstein and Gopinath (2014), the change in the consumer prices of a good imported from country i to country n can be decomposed as follows:

$$dlnp_{in}^r = (1 - s_{in}^d) dlnp_{in} + s_{in}^d dlnp_n^d + dln\mu_{in}^r \quad (1)$$

where p_{in}^r is the retail or consumer price, p_{in} is the producer price, s_{in}^d is the share of distribution costs in the pre-markup retail price, p_n^d is the price of distribution services, and μ_{in}^r is the gross retail markup. If we aggregate the prices over all tradable goods:

$$dlnp_n^{tr} = (1 - s_n^d) s_n^m dln(ipi)_n + (1 - s_n^d)(1 - s_n^m) dln(ppi)_n + s_n^d dlnp_n^d + dln\mu_n^r \quad (2)$$

where p_n^{tr} is the average consumer price of tradable goods, s_n^d is the aggregate share of distribution costs, s_n^m is the expenditure share of imported products, ipi_n is the weighted average of import prices, and ppi_n is the producer price.

This equation allows us to navigate through the main mechanisms through which tariffs affect average consumer prices. First, a reduction in tariff rate reduces the import prices at the border, ipi_n . This pass-through rate may be less than unity due to imperfect competition and pricing-to-market behavior among foreign exporters. The imperfect pass-through rate on import prices is widely documented in the exchange-rate pass-through literature (Goldberg and Knetter, 1997; Goldberg and Verboven 2001; Hellerstein, 2008; Gopinath and Ithishoki, 2010; Berman, Martin and Mayer, 2012), and for tariff pass-through (Feenstra, 1989).

Second, the producer prices, ppi_n , may not fully respond to the reduction in import prices. The prices in an imperfectly competitive sector may be less responsive due to higher profit margins, lowering the pass-through rate on consumer prices. This channel has not been empirically studied in the literature for tariff pass-through, and there is little known as to how it operates in price transmission mechanism. In the earlier literature, Dornbush (1987) showed that exchange rate pass-through is smaller in less competitive domestic markets. Lee (1997) later empirically tested this prediction and found that industries with higher concentration have lower exchange rate pass-through rates in Korea. Bernhofen and Xu

(2000) show that significant market power exercised by firms results in an imperfect exchange rate pass-through onto domestic prices. Yu (2007a and 2007b) study exchange rate pass-through on producer prices across Chinese industries, and find that the share of non-state-owned enterprises in Chinese industries enhances exchange rate pass-through. Auer (2012) finds that the transmission from border prices to producer prices in China is imperfect with an elasticity around 0.70 percent.⁵

Third, the market structure among the intermediaries is likely to affect the tariff pass-through rates. The tariff reductions may increase the competition among intermediaries, reducing the response rate of distribution costs, p_n^d , and retail markups, μ_n^r . If the share of distribution cost is a substantial share of the total cost, this channel can significantly dampen the pass-through rates. Burstein, Neves and Rebelo (2003), Campa and Goldberg (2010), and Goldberg and Hellerstein (2013) show that distribution margins are crucial in determining the extent to which exchange rates pass-through on consumer prices.

Fourth, the expenditure share of the imported products (s_n^m) is an important factor. The tariff pass-through is expected to be higher in industries with high import penetration ratios, since the higher share of imported goods in domestic market leads to a more responsive average price in the overall industry.⁶ Finally, other domestic factors, such as the low quality of infrastructure, can also restrict the pass-through rate by leading to an inflexible distribution cost, p_n^d . All of these domestic factors, including imperfect competition among final good producers and intermediaries, the low expenditure share of imported goods, and imperfections in infrastructure, can lead to a pass-through rate that is lower on consumer prices than on import prices.

The link between the private sector share and market competition has often been proposed in the literature. Naughton (1994) finds that the entry of non-state-owned industrial firms play a crucial role in

⁵ However, it is also important to note that, in theory, level of competition does not necessarily affect the degree of pass-through. For example, Atkeson and Burstein (2008) shows that in a CES framework with a continuum of producers, pass-through rate is complete independently of the mark-up levels. The role of competition is therefore an empirical question to be tested with appropriate data.

⁶ Consumer preference towards the imported variety may also lead to higher pass-through rates. A reduction in tariffs may cause consumers to substitute away from the domestic variety towards the imported variety, increasing the expenditure share of the imported products. For more information through this channel, see Broda and Romalis (2008), Faber (2012), and Kothari (2014).

China's reform process by creating markets and competition. Li (1997) finds that the market power of state-owned firms, measured by the market price to marginal cost markup, has substantially decreased during the economic reforms. Jin and Qian (1998) analyze the public and private firms in the rural area. They find that the proportion of public firms (township-village enterprises, or TVEs) to private enterprises is higher when the influence of the central government is larger, the community government power is stronger, and the level of market development is more delayed. Park, Li, and Tse (2006) regard the decentralization of government control and ownership restructuring as important institutional changes to implement market liberalization in China. These considerations suggest that privatization should increase the tariff transmission through increased competition, both affecting the responsiveness of local producer prices, and through more efficient price setting by domestic firms (Li, 1997). As privatization moves the economy towards a relatively more efficient equilibrium, the ability of domestic markets to translate the tariff reductions to the consumers is expected to improve. In this case, the increased market share of private firms is expected to increase the pass-through rate.

In the following empirical analysis, the paper first presents the empirical evidence on the role of market structure in tariff pass-through into consumer prices. Next, using the theoretical framework in Equation (2) as a guide, the paper explores the potential components underlying the pass-through mechanism, including the imperfect tariff pass-through on import prices, market competition among final good producers, market competition among intermediaries, the expenditure share of the imported products, and other factors that influence the pass-through rates such as infrastructure.

2.2 Empirical Approach and Baseline Results for Tradable Goods

This paper presents the first empirical evidence on the role of market structure on tariff pass-through by allowing the pass-through elasticity vary across cities with different levels of privatization. In China, the transition towards a more competitive market-oriented economy did not occur uniformly across the country. There was substantial variation across regions due to the different degrees of reform implementation. The privatization rates, for example, varied between 8.1 percent in Guizhou and 42.2

percent in Jiangsu during 1999 to 2004 (Bai, Lu and Tao, 2009). This finding motivates our approach of incorporating across-city variation to assess the impact of tariff reductions on domestic prices.

We start with the standard pricing equation to estimate the tariff pass-through:

$$\ln p_{ict} = \alpha_0 + \alpha_1 \ln(1 + \tau_{it}) + \alpha_3 \ln p_{it}^w + \delta_{ct} + \gamma_{ic} + \lambda_{it} + \varepsilon_{ict} \quad (3)$$

where p_{ict} is the domestic consumer price of tradable good i in city c at time t ; τ_{it} is the ad-valorem tariff rate of good i and time t ; p_{it}^w is the U.S. export price of good i at time t . δ_{ct} indicates city-year fixed effects that control for city-year level shocks common to all commodities. γ_{ic} indicates product-city fixed effects that control for the unobserved heterogeneity that are specific to each city-good pairs, such as different preferences for certain good in each city. λ_{it} represents product specific trends to account for changes that affect producer cost of each product, such as availability of imported inputs, reduced factor prices or improved technology. We also include industry-year fixed effects in all the regressions to control for unobserved shocks at industry-year level. The industry indicator takes the value of 1 if the product is an agricultural product and 0 if it is a manufacturing product. In this framework, α_1 is the coefficient for the average tariff pass-through elasticity that is uniform across all cities in urban China. α_1 is expected to be positive and less than 1 (Feenstra, 1989; Porto, 2006; Nicita, 2009; and Ural Marchand, 2012).

The current paper differs from the standard pass-through framework by estimating how the changes in the market structure (the relative size of the private sector) at the city level affects the transmission of tariff cuts into local consumption prices. Let κ_{ct} define the fraction of the private sector in each city c at time t . Given our interest in the pass-through coefficients and how κ_{ct} affects these pass-through coefficients, we interact κ_{ct} with tariff rates. Thus, our estimating equation is as follows:

$$\begin{aligned} \ln p_{ict} = & \alpha_0 + \alpha_1 \ln(1 + \tau_{it}) + \alpha_2 (\kappa_{ct} * \ln(1 + \tau_{it})) + \alpha_3 \ln p_{it}^w \\ & + \delta_{ct} + \gamma_{ic} + \lambda_{it} + \varepsilon_{ict} \end{aligned} \quad (4)$$

The estimated pass-through elasticity is:

$$\frac{\partial \ln(p_{ict})}{\partial \ln(1 + \tau_{it})} = \hat{\alpha}_1 + \hat{\alpha}_2 \kappa_{ct} \quad (5)$$

where a positive $\hat{\alpha}_2$ indicates that the higher share of the private sector will enhance the degree of pass-through at the local level.⁷

Domestic consumer prices are calculated as the unit values using the Chinese Urban Household Survey (UHS) which are conducted by the Urban Survey Organization of the National Bureau of Statistics of China (NBS). The data provide detailed information on the consumption patterns of households. The sample of households in UHS is drawn through stratified random sampling to ensure the representativeness of the households in urban China. We are able to obtain the household survey data for five provinces (namely, Liaoning, Guangdong, Shaanxi, Sichuan, and Zhejiang) and one municipality (Beijing) between 1992 and 2008 from the NBS. Beijing is a rapidly growing municipality in North-Central China, while Guangdong and Zhejiang are dynamic economic provinces in the southern coastal region. Liaoning is a northeast province with numerous industries. Shaanxi and Sichuan are less developed provinces in the northwest and southwest of China, respectively. Even though our empirical analysis is limited to the data that are available to us, we believe that the six provinces/municipalities included in our analysis are representative of China's different regions and it should provide a sound base for our empirical study.

⁷ Note that the pass-through level may also vary over time. It may change over time depending on the nature of the shock and the speed at which liberalization and privatization takes place (Burstein and Gopinath, 2014). In this paper, because we are interested in the average welfare impact of trade liberalization, we estimate a single pass-through for each city using data over the liberalization period.

In the UHS, respondents were asked to provide information about expenditures and quantities of 42 commodities, among which 35 can be matched into 4-digit Standard International Trade Classification (SITC) codes in the tariff data.⁸ The ratio of expenditure to quantity is used to measure the unit value for each commodity consumed by each household. Then, the city-level averages of these unit values are used as the dependent variable in our pass-through regression (1) and (2). An important advantage of our specification is to exploit a large variation of the unit prices of 35 tradable goods across cities and years to identify tariff pass-through elasticity. The analyses are conducted with unit values since the domestic prices for each city across years are not available at the level of disaggregation used in this paper. A caveat for using unit values is that they reflect the quality choice as well as the quantity choice for each household. Given their budget, each household faces a trade-off between quality and quantity for each good, and the unit values reflect the outcome of this trade-off. While it is not possible to disentangle the quality choice given the available data, the use of unit values is a standard practice in the literature.⁹

Chinese tariff reduction since the 1990s is part of a broad set of external reforms culminating in WTO accession (Branstetter and Lardy, 2006; Brandt and Morrow, 2013). The tariff reduction thus provides us exogenous variations to estimate the pass-through rate. Tariff data are obtained from the World Integrated Trade Solution (WITS) by 4-digit SITC categories. We hand-matched each 4-digit SITC good category to each category of tradable household consumption good in the UHS data. Details of this match are provided in Appendix Table 1. In the concordance, we have 224 SITC categories matched to 35 consumer goods. When one consumption good is matched to multiple SITC categories, the weighted-average tariff rates are used where the weights are the amount of imports in each industry. For world

⁸ There are 7 categories of goods that cannot be matched into separate SITC codes: bean, duck meat, childwear, sewing machine, electric fan, freezer and video. These goods are excluded in our pass-through regressions and welfare analysis.

⁹ See Deaton (1997) for a discussion about using unit values in welfare analysis. Hasan, Mitra and Ural, (2007), Nicita (2009), Ural Marchand (2012) are among the many papers that use unit values as an estimate for domestic prices. However, there are a few important studies in the recent literature that incorporate quality choice using detailed store-level or barcode-level data (Broda, Leibtag, and Weinstein, 2009; Faber, 2012). Such data is not available for China. Our results therefore reflect the quality choice as well as quantity choice by households.

prices, we use U.S. export unit values for each 4-digit SITC categories provided by the USITC.¹⁰ These unit values are then matched to the categories of consumer goods in the UHS data using the same procedure as the tariff rates.

We use the relative size of the private sector to capture the change of the market structure in Chinese cities. This information is readily available in the UHS data. Based on each individual's working status, we calculate the proportion of workers in foreign or privately-owned enterprises, which can be used to evaluate the relative size of the private sector in each city.¹¹ Figure 2 presents the variation of this measure across cities and years, with the fitted line indicating the average city-level shares for each year. The figure shows that while the private sector only comprised 22 percent of the economy in 1992, it constituted a significant part (nearly 50 percent) of the economy in 2008. The relative size of the private sector also varies considerably across cities in our sample. These variations provide sources of identification to estimate the geographical heterogeneity of tariff pass-through within China.

Table 1 presents the benchmark results of the pass-through regression (3) and (4). For each regression, we report two specifications. In columns (1) and (2), we use city fixed effects to control for any city-specific factors that might affect consumer prices, and city-level GDP to control for any time variant demand and cost factors at the city level. In columns (3) and (4), we use city-year fixed effects to control for any time variant factors at the city level that might affect consumer prices. In columns (5) and (6), our preferred specification, we further add the product-city fixed effects to control for any unobserved heterogeneity for each product-city pairs.

First, we find consistent evidence that tariff pass-through is imperfect. According to the column (5), the estimated average elasticity is 0.29, indicating that a 10 percent reduction in tariffs reduces

¹⁰ Although U.S. export prices are widely used as a proxy for world prices, a number of studies directly use world prices if the U.S. is not a major trading partner (Ural Marchand, 2012). We use the U.S. export prices for two reasons. First, after trade liberalization, China started to trade heavily in manufactured products. However, WTO world prices are available mostly for primary products and a disproportionate representation of primary products may lead to biased estimates. Second, the U.S. is the largest trading partner of China, and thus, its export prices are most relevant for Chinese trade. The United States International Trade Commission (USITC)'s FAS Value/First Unit Quantity definition is used as the world price.

¹¹ Brandt, Hsieh and Zhu (2008) and Zhu (2012) use the share of urban employment in domestic private enterprises and foreign-invested enterprises to capture the transition of Chinese economy from central-planning to market orientation.

consumer prices by 2.9 percent. Second, and more importantly, we find that the transmission of tariff reduction depends significantly on the relative size of the private sector at the city level. The estimated coefficient of the interaction term between the tariff reduction and the size of the private sector is significantly positive, and a 10 percentage point increase in the size of the private sector is associated with 2 percentage points higher tariff pass-through (column 6). A city that has an average sized private sector has an approximate tariff pass-through rate of 31 percent.¹² By contrast, a city in which all enterprises are state-owned has a tariff pass-through rate of only 22 percent.¹³ The first two columns of Table 6 further present the city-level pass-through rates and their standard deviations, respectively, where cities are ranked according to their share of the private sector. Due to the differences in the degree of privatization, tariff pass-through rates in our sample vary substantially across cities, ranging from 22 percent to 37 percent. Furthermore, the coefficients of the control variables suggest that the domestic consumer prices of tradable goods are negatively correlated to the size of the private sector, and positively correlated to world prices.

Our estimated pass-through elasticity for consumer price is within the range of those estimated for developing countries. For example, Nicita (2009) finds that the pass-through in Mexico is about 33 percent for agricultural products and about 27 percent for manufacturing. Ural Marchand (2012) finds that consumers in urban India are affected by tariff reductions with a pass-through elasticity that ranges from 64 to 68 percent. Our findings confirm that tariff pass-through elasticity varies considerably within a country. In particular, the degree of pass-through in urban China is affected by the degree of privatization at the local level.

¹² In 2006, the average share of private sector is 45 percent. Given that the data on the share of private sector employment in 2006 cover more cities (the data for 2008 have more missing values), we opt to use the 2006 data as the baseline to calculate the magnitude of the estimates.

¹³ As a robustness check, we include tariffs interacted with city dummies, year dummies, and product specific trends, respectively. The results are robust to these alternative specifications, while the coefficients are slightly lower. In one extra specification, we control for the product-year fixed effects and drop the level effect of tariffs. The estimated coefficient for α_2 is 0.140 (s.e.=0.030; N=15580; R-square=0.96). This specification is not preferred since the identification of α_1 is required for the subsequent welfare analysis, and very little variation is left for identification of α_2 . We have also run the regressions using two way clustering at the city and industry level, which yielded larger standard errors. However, the main coefficients were still significant. These results are available upon request.

2.3 Extended Results on the Pass-Through Mechanism for Tradable Goods

Following Equation (2) as a guide, this section explores the mechanisms through which prices transmit imperfectly on consumer prices. As discussed in Section 2.1, the main potential channels include imperfect transmission at the border, market structure among final good producers and intermediaries, the share of imported goods in the domestic market, and imperfections in the local infrastructure.

We start with estimating the degree of tariff pass-through into import prices, ipi_n , using the transaction-level Chinese Customs data from 2000-2007. The dataset provides the detailed information on the value and quantity for each imported HS 6-digit product at each year, which we use to calculate the unit value for each product. We then use the concordance provided by the World Integrated Trade Solution (WITS) to concord HS 6-digit product codes into SITC Rev3 4-digit product codes that are used in tariff data. The estimated pass-through rate into import prices is reported in column (1) of Table 2. In order to provide a better comparison, we also calculate the national average unit price for each of the 35 products in our sample and run the pass-through regression. The estimated pass-through rate into this national average consumption price is reported in column (2) of Table 2. These results indicate that the average pass-through rate at the border is about 46 percent, which is higher than the estimated pass-through rate into consumer prices, 29 percent. The results show that the tariff pass-through rate into import prices is higher than the tariff pass-through rate into consumer prices, indicating the potential importance of domestic factors such as the private sector in pass-through into consumer prices. This evidence is consistent with previous findings in Frankel, Parsley and Wei (2012) and Burstein and Gopinath (2014) for exchange rate pass-through.

Second, we explore two potential channels through which the private sector affects the pass-through rate of tariffs onto consumer prices. On one hand, the rising share of private sector in production of final goods could increase the competitiveness of domestic producers of final goods, and thus increase the responsiveness of producer prices, ppi_n . As a result, the pass-through rate can be higher as the share of private sector in the final goods production increases in each city. On the other hand, the rising share of

private sector in distribution increases the competitiveness among domestic distributors and thus lead to more flexible prices through lower retail markups and distribution costs of the imported goods. These affect the responsiveness of distribution costs, p_n^d , as well as retail markups, μ_n^r . Therefore, the local pass-through rate at the city level can be higher as the share of private sector in distribution increases.

To study these two channels, we use the UHS data to construct the share of private sector in the production sector and the share of private sector in the distribution sector for each city at each year during 1992-2008. We then interact these two measures with tariff reduction rates to explore the roles of private share in production and distribution sectors in tariff pass-through. The results are presented in columns (4) and (5) in Table 2. The estimated coefficients of both interaction terms are significantly positive, indicating the validity of the two proposed channels. That is, the rising share of private sector in both the manufacturing of final goods and the distribution sectors helps increasing the pass-through of tariff reduction into consumer prices. Specifically, a 10 percentage point increase in the private share in production leads to 0.6 percentage point increase in tariff pass-through, while the same increase in the private share in distribution leads to a much higher increase of 1.5 percentage points in tariff pass-through into consumer prices. This finding highlights the importance of the market structure in the distribution sector in understanding the tariff pass-through mechanism.¹⁴

Third, we explore heterogeneity across products in order to investigate how the expenditure share of imported goods, s_n^m , affect the pass-through rates. The products are categorized as agriculture goods (food and beverages) and manufacturing goods (clothing and household appliances). The mechanics of price transmission mechanism suggest that the pass-through rates should be lower for products with low expenditure share of imports. While the Urban Household Survey does not provide information on the consumption of locally produced and imported goods, the import penetration ratios show that agricultural sector in China has a very low import penetration ratio, 0.04, whereas the manufacturing sector has a

¹⁴ Goldberg and Hellerstein (2013) also finds that about 60 percent of incomplete exchange rate pass-through was due to local non-tradable costs.

relatively high import penetration ratio, 0.25.¹⁵ The results presented in Table 3 suggest that the baseline tariff pass-through rate is in fact much lower in the low import penetration category, i.e., agricultural goods, when compared to the high import penetration category, i.e., manufacturing goods. In addition, the results show suggestive evidence that privatization in the distribution sector plays a larger role in tariff pass-through for goods with higher import penetration such as manufacturing goods.

Last, we provide further empirical evidence in Table 4 to explore other factors of a city that might affect the incomplete tariff pass-through. Specifically, we consider three main factors that are often proposed in the literature (e.g., Atkin and Donaldson, 2012): the level of transportation facilities as measured by the square-meter of roads in each city, the advancement of communication facilities as measured by the number of telephones in each city, and the share of urban sector as measured by the share of urban population in each city. These imperfections in the city-level infrastructure, and the relative isolation in rural areas, may lead to inflexible trade costs, p_d . All the city-level data are collected from Chinese Statistical Yearbooks. As Table 4 indicates, the development of transportation and communication facilities also increase the tariff pass-through rates. More importantly, controlling for these other factors does not affect our main findings, that is, the share of private sectors significantly affects the degree of tariff pass-through in Chinese cities.

3. Price Changes of Non-tradable Goods

3.1 Empirical Approach for Non-tradable Goods

To evaluate the overall consumption effects of trade liberalization, we need to understand how the prices of non-tradable goods respond to the price changes of tradable goods. We estimate the following dynamic panel model (Porto, 2006):

¹⁵ The import penetration ratio is calculated as imports/(production-exports+imports), from the 2007 Chinese national Input-Output Table. The products are categorized with respect of broad categories of agriculture and manufacturing since the information is not available for each of the finely defined products. The import penetration ratios for other years, such as 2005, 2002, 2000, are quite consistent.

$$\ln p_{jct}^{NT} = \beta_0 + \beta_1 \ln p_{jc,t-1}^{NT} + \sum_{i=1}^T \beta_{ij} \ln p_{ict} + \gamma_t + \delta_c + \chi_{ct} + \varphi_{jct} \quad (6)$$

where p_{jct}^{NT} is the price of non-tradable good j at city c in year t , p_{ict} is the price of tradable good i at city c in year t , γ_t represents the year fixed effects, δ_c is the city fixed effects, and χ_{ct} is the city-specific trend. β_{ij} are our key coefficients that indicate the elasticities of non-tradable price j to tradable price i . To control for any spurious correlations between the price of non-tradable goods and that of tradable goods, we follow the usual practice of estimating the model in first differences using the Arellano-Bond estimation method (Arellano and Bond, 1991; Mileva, 2007). We utilize two sets of specifications. In the first set of specifications, we treat the lagged price of non-tradable goods and the prices of three tradable goods as endogenous and use the standard Arellano-Bond instruments (the lagged levels of endogenous variables and the first-difference of all the exogenous variables). In the second set of specifications, we further add the interactions between private share and tariffs for three tradable goods as additional instruments in the Arellano-Bond estimation. We focus on presenting the elasticities estimated in the second set of specifications as these estimates are obtained from the actual price changes induced by exogenous tariff reductions, and thus are more relevant to our welfare calculations.

Compared with Porto (2006), the main advantage of our estimation is to explore both time and city variations of price indices to estimate the price changes of non-tradable goods. We extract the Consumer Price Index (CPI) for various categories of tradable and non-tradable goods at the city level from many volumes of provincial statistical yearbooks.¹⁶ Specifically, we have price indices (with the last year as reference year) for three tradable goods: Food and Beverage, Clothing, Household Equipment, and four non-tradable goods: Housing, Transport and Communication, Health and Education for years

¹⁶ We are not able to use UHS data for estimation of price changes of non-tradable services because UHS data only provides total expenditure on non-tradable services, not price information on these services.

1998-2008. The time coverage and the categories of goods are determined solely by the availability of the price index data at the city level from the provincial statistical yearbooks.¹⁷

3.2 Results for Non-tradable Goods

Table 5 presents two sets of estimation results for the elasticities of non-tradable goods. Both sets of specifications are estimated in first differences using Arellano-Bond estimation method. In specifications (1')-(4'), we further add the interactions between private share and tariffs for three tradable goods as additional instruments in the Arellano-Bond estimation. As shown in Table 5, the price of Transport and Communications is negatively related to the price of Food and Beverages, but positively related to the price of Household Equipment. The price of Housing responds positively to the price changes of Food and Beverages. However, evidence suggests that the Health and Education prices do not respond significantly to the price changes of tradable goods induced by tariff reduction.

As pointed out in Porto (2006), these elasticities reflect the complex responses of non-tradable prices to tradable prices in general equilibrium. We offer one possible interpretation of these elasticities based on the classical trade theory, the Stolper-Samuelson Theorem (Dixit and Norman, 1980). That is, different sectors have different intensity in factor usage, such as skilled versus unskilled labor, and thus, the price of one good will affect the price of another good through the factor market. Assume that Food and Beverages are unskilled labor intensive relative to Household Equipment. Similarly, suppose that Health, Transport and Communications, and Education are intensive in skilled labor relative to Housing. As such, increases in the relative prices of Food and Beverages would result in an increase in the relative wages of unskilled labor, and thus, a decrease in the price of Transport and Communication but an increase in the price of Housing. Conversely, an increase in the price of Household Equipment would

¹⁷ Appendix Table 2 provides descriptive statistics of these price indices, averaged across cities for each year during 1998-2008. On average, the overall price levels in urban China demonstrate an upward trend, which varies across different categories. Food and Housing prices increased by about 50 percent during the sample period from 1998 to 2008. Clothing and Household Appliances prices declined primarily because of the large production capacity of Chinese manufacturers. Health and Education price indices fluctuated but did not increase substantially, as the government exerted considerable efforts to subsidize these sectors. The decline in the price of Transport and Communication primarily arose from increased competition in telecommunication services (Loo, 2004).

generate an increase in the relative wage of skilled workers and thus an increase in the price of Transport and Communication. While it is beyond the scope of this paper to empirically test the Stolper-Samuelson Theorem, our findings are generally consistent with its predictions.

4. The Consumption Effects of Trade Liberalization

4.1 Empirical Approach for Consumption Effects Estimation

The empirical results in the previous sections provide us with tariff pass-through estimates for tradable goods, and the price elasticities of non-tradable goods with respect to the prices of tradable goods. In this section, we use these elasticities along with the information in the household survey to estimate the consumption effects of trade liberalization. The consumption effect of the tariff cut for each household h in city c is computed as follows:

$$\widehat{W}_h = - \left(\sum_{i=1}^T Q_{ih} + \sum_{j=1}^{NT} \sum_{i=1}^T Q_{jh} \hat{\beta}_{ij} \right) (\hat{\alpha}_1 + \hat{\alpha}_2 \bar{\kappa}_c) d\ln(1 + \tau_i) \quad (7)$$

where Q_{ih} and Q_{jh} are the expenditure shares of tradable goods i or non-tradable goods j for household h . $\hat{\alpha}_1$ and $\hat{\alpha}_2$ represent the estimated tariff pass-through elasticities from Equation (4). In our baseline estimation, we use the estimates from Column (6) of Table 1.¹⁸ $\hat{\beta}_{ij}$ is the estimated price elasticities of non-tradable goods from Equation (6). In our baseline estimation, we use the estimated elasticities from Column (1')-(4') of Table 5. $\bar{\kappa}_c$ is the average size of the private sector in city c .¹⁹ $d\ln(1 + \tau_i)$ measures the tariff cut due to trade liberalization. In our baseline estimation, we utilize one single exogenous tariff

¹⁸ As a robustness check, we also use the pass-through estimates from Column (1) in Table 4 in the welfare estimation as they represent more conservative estimates for the impact of the private sector. As a result, the estimated welfare effects are slightly smaller than our baseline estimation, while the main implications of the paper remained unchanged. These estimates are available upon request.

¹⁹ In the baseline results we use the share of private sector employment for each city in 2006 as the data from 2006 cover more cities (2008 data has more missing values). However, using data in other years or using average share of private sector does not change the main implications of our findings.

cut due to China's accession into the WTO, i.e., tariff changes between 2000 and 2002. During this period, tariff cuts on tradable goods were approximately 38 percent, on average.²⁰

\widehat{W}_h provides an estimate of the negative compensating variation as a percentage of initial expenditure. In other words, this estimate provides the negative of the amount household h must be compensated to maintain their welfare level prior to the policy change. A reduction in tariffs presumably yields welfare gains, so that \widehat{W}_h will be positive (provided that the pass-through coefficients are positive). Households experience heterogeneous welfare effects through three main variations: each household has different expenditure shares for each of the tradable and non-tradable goods, each good faces a different tariff reduction due to trade liberalization, and these tariff reductions are transmitted differently to the domestic market depending on the extent of privatization in each city.

We use Chinese Urban Household Surveys to estimate the consumption effect of trade liberalization for each household. In these surveys, each household is required to report the amount of expenditure on several categories of goods and services. In 2008, Chinese households spend an average of 47 percent on tradable goods, which comprise 36 percent on Food and Beverage, 7 percent on Clothing, and 4 percent on Household Equipment. They spend about 22 percent on non-tradable goods, which include 6 percent on Health, 3 percent on Transport and Communication, 4 percent on Education, and 9 percent on Housing.²¹ The consumption pattern in urban China is quite similar to other developing countries such as India and Mexico, where households still spend a large portion of their income on food. However, this pattern is less similar to developed countries such as the U.S., where households spend only about 13 percent on food (Bureau of Labor Statistics, 2014).

²⁰ We also experiment with different tariff reductions to estimate the total consumption effects on Chinese households. For example, we experiment with the tariff reduction between 1995 and 2002 because the Chinese government started to cut tariff to commit to the WTO standard in 1995 (Branstetter and Lardy, 2008). We also tried the overall tariff reduction between 1992 and 2008. These sensitivity analyses do not change our baseline findings except that we find an even larger consumption effect of tariff cuts on Chinese households.

²¹ The rest of the 31 percent expenditure include expenditures on other non-tradable services and 7 categories of tradable goods that cannot be matched into SITC codes. These categories of tradable and non-tradable goods are excluded in our pass-through estimation, estimation of elasticities of non-tradable goods, and welfare analysis.

The consumption of non-tradable goods has been growing, and becoming a non-negligible portion of the Chinese household expenditure. It is thus important to incorporate non-tradable consumption in the household welfare analysis. The data suggest that the overall pattern in the consumption of tradable and non-tradable goods is highly heterogeneous across households. Households at the lower end of the per capita expenditure distribution tend to spend more on food and other tradable items. On the other hand, households at the higher end of the distribution tend to spend more on non-tradable services such as health and education.

While the tariffs are reduced at the national level, the previous analyses suggest that the transmission mechanism onto consumer prices varies across cities, and households face different tariff pass-through rates depending on the share of the private sector in their city. A household that is located in a city with higher levels of privatization is able to benefit from the price reductions relatively more than a household in a city dominated by state-owned enterprises. The impact on non-tradable prices also differs across cities since that mechanism works through prices of tradable goods. Using Equation (7), these main sources of heterogeneities are incorporated into the consumption effects of trade liberalization.

4.2 Results for Consumption Effects

To estimate the distributional effects of trade liberalization through the consumption of tradable and non-tradable goods, we estimate a series of nonparametric local linear regressions of the consumption effect across the log per capita expenditure.²² This method obtains a consistent estimator of the average consumption effect by using the information in the neighborhood around each evaluation point across the per capita expenditure distribution.

Figure 3 presents the findings the total consumption effect of WTO accession across the distribution of log per capita expenditure. The figure shows that WTO accession generates welfare gains through the consumption channel for Chinese households across almost the entire distribution. In

²² We also examine the distributional effects of trade liberalization along income percentiles. We find consistent evidence that trade liberalization is pro-poor through the consumption channel.

particular, we find that poorer households experience higher gains from the consumption effect of tariff reduction relative to wealthier households. The average compensating variation for poor households can be as high as 13.6 percent of their initial expenditure level, and it decreases monotonically until it is not significantly different than zero for households at the upper end of the distribution. As poorer households spend a higher proportion of their income on tradable goods, such as food, clothes and household appliances, the tariff reduction passes through to lower consumption costs of these products, which allows poorer households to benefit more from globalization. Overall, our finding indicates that the distributional effect of China's WTO accession through the consumption effect is pro-poor.

Next, we investigate whether privatization has contributed or mitigated the pro-poor effect of trade liberalization. To this end, we decompose the consumption effect of trade liberalization into a baseline effect that is associated with $\hat{\alpha}_1$, and a competition effect that is associated with $\hat{\alpha}_2$.²³ The baseline effect reflects heterogeneity across households with different consumption baskets, and the competition effect additionally shows the part of the welfare change stemming from the variation across cities in terms of the share of the private sector. We then run nonparametric regressions across per capita expenditure distribution to understand the distributional effect from these two channels.

Results presented in Figure 4 shows that the distributional effect was pro-poor through both baseline effect and the competition effect. That is, privatization has increased the extent to which households benefit from trade liberalization, and this effect was relatively larger for poor households when compared to the wealthier households. The competition effect was about 4 percent at the low end of the distribution, and decreased monotonically until it was insignificantly different from zero at the high end of the distribution. This suggests that the increased privatization enhanced the pro-poor effect of trade liberalization by improving the mechanism through which tariff reductions affect consumer prices, specifically for goods with higher expenditure shares at the low end of the distribution. The average

²³ The baseline effect is computed as $\{-\hat{\alpha}_1(\sum_{i=1}^T Q_{ih} + \sum_{j=1}^{NT} \sum_{i=1}^T Q_{jh} \hat{\beta}_{ij}) d\ln(1 + \tau_i)\}$ and the competition effect is computed as $\{-\hat{\alpha}_2 \bar{\kappa}_c (\sum_{i=1}^T Q_{ih} + \sum_{j=1}^{NT} \sum_{i=1}^T Q_{jh} \hat{\beta}_{ij}) d\ln(1 + \tau_i)\}$.

welfare gain of trade liberalization through privatization channel was 1.8 percent of the initial household expenditure level, which represents 25 percent of the overall gains from trade liberalization.

Figure 5 decomposes the total consumption effect into the effects of tradable and non-tradable goods.²⁴ The magnitudes of the effects show that almost the entire welfare gain is driven by the direct impact of tariff cuts on the consumption of tradable goods. The welfare effect through the consumption of non-tradable goods is close to zero and always less than 1 percent. This can be explained by two reasons. First, the expenditure shares of these goods are still small, even though it has increased significantly since the early 1990s. Second, the prices of non-tradables, particularly Education and Health, are not very responsive to the changes in tradable prices as shown in Section 3, which could be due to strict government regulations in these sectors (Mok, 2005).

In order to present the city variation of welfare effects, Table 6 shows the average consumption gains across cities computed according to Equation (7). Different sources of the total consumption gains are presented by the city-level tariff pass-through elasticities, average expenditure shares and average consumption effects for both tradable and non-tradable goods. Consistent with the findings in Figure 3, all welfare gains are positive for all cities in the sample. The average welfare gain due to China's accession into WTO is approximately 7.3 percent, and these welfare gains are distributed unevenly across cities. To summarize the geographical distribution of the welfare gains, we categorize the cities according to their share of the private sector, which ranges between 1.4 percent and 75.5 percent with an average of 45.9 percent. The cities in Table 6 are split from the average share of the private sector. We find that households in above-the-mean cities gain more from the WTO accession compared with households in below-the-mean cities. The average welfare gain in cities with relatively high levels of privatization is 7.9 percent, whereas it is about 6.7 percent in cities with relatively low levels of privatization. The expenditure share of tradable and non-tradable goods are very similar across the two groups, indicating that the difference is driven by the variation in tariff pass-through.

²⁴ The consumption effect through tradable goods is computed as $\{-(\sum_{i=1}^T Q_{ih}) (\hat{\alpha}_1 + \hat{\alpha}_2 \bar{\kappa}_c) d\ln(1 + \tau_i)\}$, and the consumption effect through non-tradable goods is computed as $\{-(\sum_{j=1}^{NT} \sum_{i=1}^T Q_{jh} \hat{\beta}_{ij}) (\hat{\alpha}_1 + \hat{\alpha}_2 \bar{\kappa}_c) d\ln(1 + \tau_i)\}$.

Our paper extends the findings from the existing literature on other developing countries. Porto (2006) provides evidence on the pro-poor consumption effects on the tradable goods for Argentinian households, and he finds pro-rich consumption effects on non-tradable goods. Nicita (2009) documents overall pro-rich distributional effects, where these effects are primarily driven by the income channel instead of the consumption channel. Ural Marchand (2012) finds pro-poor distributional effects through the consumption of tradable goods for rural and urban India. Using cross country data, Fajgelbaum and Khandelwal (2015) show that aggregate gains from trade through expenditures of individuals are substantially more at the lower end of the income distribution. Cravino and Levchenko (2015) study the impact of exchange rate devaluation in Mexico and find that relative price changes affects the consumption basket of low income households more than that of high income households. In the case of China, this paper contributes to the literature by showing that the structure of the local economy, in particular the size of the private sector, significantly affects the price transmission mechanism. By estimating the welfare effect of trade liberalization through consumption of both tradable and non-tradable goods, this paper shows that trade liberalization had progressive distributional effect in China, and that privatization enhanced this pro-poor effect across Chinese cities.

5. Conclusion

China's twin policies of liberalizing trade and reforming its state-owned enterprises enhanced the level of competition and efficiency within the domestic economy. However, the existing literature has yet to study how tariff reductions affect households, and more importantly, how trade liberalization interacts with the growth of the private sector. This paper contributes to the literature by documenting that the increased share of private sector enhances the ability of markets to transmit tariff reductions onto domestic consumer prices, and consequently, increases the extent to which households benefit from trade liberalization.

By allowing different pass-through elasticities across Chinese cities, this paper shows that domestic prices decrease more in cities with a higher share of the private sector. When the changes in the

market structure across cities are considered, the increase in household welfare induced by the trade policy at the city level varies between 9.4 and 4.8 percent. Incorporating the price changes of tradable and non-tradable goods, the paper shows that China's WTO accession has reduced the cost of consumption for all households. The distributional effect of WTO accession is highly pro-poor as low-expenditure households experienced the highest welfare gain due to tariff reductions. The increase in the share of the private sector enhanced the pro-poor effect of trade liberalization by inducing larger gains for poor households. These results indicate that geographic variations in domestic market structure can significantly affect the pass-through of tariff rates, and thus the rate at which households benefit from trade liberalization.

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Table 1: Tariff Pass-Through and the Size of the Private Sector

VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)
Tariff	0.289*** (0.009)	0.228*** (0.022)	0.288*** (0.009)	0.210*** (0.024)	0.289*** (0.008)	0.217*** (0.024)
Tariff \times Private Sector		0.167*** (0.047)		0.215*** (0.051)		0.197*** (0.051)
Private Sector		-0.613*** (0.164)				
World Price	0.109*** (0.003)	0.109*** (0.003)	0.109*** (0.003)	0.108*** (0.003)	0.108*** (0.003)	0.108*** (0.003)
City GDP	0.043 (0.032)	0.046 (0.033)				
City Fixed Effects	Yes	Yes				
Year Fixed Effects	Yes	Yes				
Product Trends	Yes	Yes	Yes	Yes	Yes	Yes
City-Year Fixed Effects			Yes	Yes	Yes	Yes
Product-City Fixed Effects					Yes	Yes
Observations	15,393	15,393	15,393	15,393	15,393	15,393
R-squared	0.725	0.725	0.727	0.727	0.732	0.732

Notes: The dependent variable is the logarithm of domestic consumer prices of product i at city c in year t . All the specifications also include industry-year fixed effects. The industry indicator takes the value of 1 if the product is an agricultural product and 0 if it is a manufacturing product. Estimated coefficients are reported with robust standard errors, clustered at the city level, in parentheses. ***, **, * indicates statistical significance at the 10, 5, and 1 percent, respectively.

Table 2: Mechanisms of Tariff Pass-Through and the Size of the Private Sector

VARIABLES	Aggregate Import Price	Aggregate Consumer Price	City-Level Consumer Price		
	(1)	(2)	(3)	(4)	(5)
Tariff	0.458*** (0.039)	0.287*** (0.081)	0.217*** (0.024)	0.278*** (0.014)	0.199*** (0.017)
Tariff × Private Share			0.197*** (0.051)		
Tariff × Private Share in Production				0.056** (0.022)	
Tariff × Private Share in Distribution					0.154*** (0.022)
World Price	0.750*** (0.015)	0.103*** (0.034)	0.108*** (0.003)	0.111*** (0.003)	0.108*** (0.003)
Year Fixed Effects	Yes	Yes			
Product Trends	Yes	Yes	Yes	Yes	Yes
City-Year Fixed Effects			Yes	Yes	Yes
Product-City Fixed Effects			Yes	Yes	Yes
Observations	6,481	508	15,393	13,946	15,281
R-squared	0.560	0.654	0.732	0.744	0.733

Notes: The dependent variable for Columns (1) and (2) is the logarithm of the aggregate import price at SITC 4-digit level and aggregate consumer price at 35 UHS product level, respectively. Specifications (1) and (2) also include industry fixed effects. The industry indicator takes the value of 1 if the product is an agricultural product and 0 if it is a manufacturing product. Estimated coefficients are reported with robust standard errors in parentheses. For Columns (3)-(5), the dependent variable is the logarithm of domestic consumer prices of product i at city c in year t . Specifications (3)-(5) also include industry-year fixed effects. Estimated coefficients are reported with robust standard errors, clustered at the city level, in parentheses. ***, **, * indicates statistical significance at the 10, 5, and 1 percent, respectively.

Table 3: Heterogeneous Tariff Pass-Through across Agricultural and Manufacturing Goods

VARIABLES	Agricultural Goods				Manufacturing Goods			
	(1)	(2)	(3)	(4)	(1')	(2')	(3')	(4')
Tariff	0.192*** (0.009)	0.109*** (0.029)	0.164*** (0.015)	0.106*** (0.019)	0.363*** (0.045)	0.229* (0.131)	0.383*** (0.098)	0.034 (0.098)
Tariff × Private Sector		0.229*** (0.065)				0.344 (0.270)		
Tariff × Private Share in Production			0.089*** (0.026)				0.049 (0.145)	
Tariff × Private Share in Distribution				0.149*** (0.026)				0.500*** (0.118)
World Price	0.038*** (0.005)	0.038*** (0.005)	0.043*** (0.005)	0.038*** (0.005)	0.192*** (0.004)	0.192*** (0.004)	0.191*** (0.004)	0.190*** (0.004)
Product Trends	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
City-Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Product-City Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	10,229	10,229	9,245	10,154	5,164	5,164	4,701	5,127
R-squared	0.147	0.148	0.135	0.149	0.610	0.610	0.638	0.612

Notes: The dependent variable is the logarithm of domestic consumer prices of product i at city c in year t . All the specifications also include industry-year fixed effects. The industry indicator takes the value of 1 if the product is an agricultural product and 0 if it is a manufacturing product. Estimated coefficients are reported with robust standard errors, clustered at the city level, in parentheses. ***, **, * indicates statistical significance at the 10, 5, and 1 percent, respectively.

Table 4: Other City-Level Factors in Tariff Pass-Through

VARIABLES	(1)	(2)	(3)
Tariff	0.218*** (0.023)	0.215*** (0.024)	0.245*** (0.030)
Tariff \times Private Sector	0.124** (0.052)	0.169*** (0.049)	0.218*** (0.053)
World Price	0.108*** (0.003)	0.108*** (0.003)	0.108*** (0.003)
Tariff \times Road	0.021*** (0.005)		
Tariff \times Telephone		0.001*** (0.000)	
Tariff \times Urban Sector			-0.060 (0.039)
Product Trends	Yes	Yes	Yes
City-Year Fixed Effects	Yes	Yes	Yes
Product-City Fixed Effects	Yes	Yes	Yes
Observations	15,393	15,393	15,393
R-squared	0.733	0.732	0.732

Notes: The dependent variable is the logarithm of domestic consumer prices of product i at city c in year t . All the specifications also include industry-year fixed effects. The industry indicator takes the value of 1 if the product is an agricultural product and 0 if it is a manufacturing product. Estimated coefficients are reported with robust standard errors, clustered at the city level, in parentheses. ***, **, * indicates statistical significance at the 10, 5, and 1 percent, respectively.

Table 5: The Responses of the Prices of Nontradable Goods

	Health		Transport and Communications		Education		Housing	
	(1)	(1')	(2)	(2')	(3)	(3')	(4)	(4')
Food and Beverages	-0.136*	-0.133	-0.101**	-0.129***	0.087	0.090	0.312***	0.266***
	(0.074)	(0.086)	(0.042)	(0.043)	(0.073)	(0.085)	(0.036)	(0.041)
Clothing	0.092	0.121	0.005	0.038	-0.039	-0.004	-0.031	-0.045
	(0.076)	(0.098)	(0.037)	(0.054)	(0.064)	(0.073)	(0.032)	(0.035)
Household Equipment	0.113	0.136	0.160***	0.149*	0.022	0.020	0.010	0.042
	(0.082)	(0.103)	(0.050)	(0.078)	(0.086)	(0.099)	(0.043)	(0.050)
L.Dependent Variable	0.598***	0.522***	0.302***	0.292***	0.418***	0.448***	0.088***	0.141***
	(0.044)	(0.043)	(0.038)	(0.072)	(0.048)	(0.048)	(0.033)	(0.049)
Year Fixed Effects	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
City Trend	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Observations	504	334	504	334	504	334	504	334
Wald χ^2 Test	1640.10	968.69	407.59	260.27	371.31	330.70	252.85	161.75

Notes: The dependent variable is the logarithm of the price index for each category of four non-tradable goods j at city c in year t . All the specifications are estimated in first differences using Arellano-Bond estimation method. In specifications (1)-(4), we treat the lagged price of non-tradable goods and the prices of three tradable goods as endogenous and use the standard AB instruments (the lagged levels of endogenous variables and the first-difference of all the exogenous variables). In specifications (1')-(4'), we further add the interactions between private share and tariffs for three tradable goods as additional instruments. Estimated coefficients are reported with robust standard errors, clustered at the city level, in parentheses. ***, **, * indicates statistical significance at the 10, 5, and 1 percent, respectively.

Table 6: The Consumption Effects of WTO Accession at the City Level

Cities	Tradable Goods						Non-tradable Goods				Total Consumption Effects	
	Tariff Pass-Through		Expenditure Shares		Consumption Effects		Expenditure Shares		Consumption Effects			
	Mean	SD	Mean	SD	Mean	SD	Mean	SD	Mean	SD	Mean	SD
<i>Above-the-mean Private Share</i>	0.333		0.461		0.075		0.220		0.004		0.079	
Zhuhai	0.371	0.085	0.398	0.123	0.073	0.024	0.259	0.123	0.004	0.004	0.077	0.026
Jiaxing	0.369	0.110	0.431	0.148	0.078	0.029	0.229	0.131	0.003	0.004	0.081	0.029
Foshan	0.365	0.096	0.378	0.134	0.069	0.025	0.249	0.133	0.004	0.004	0.073	0.026
Shaoxing	0.360	0.102	0.421	0.155	0.073	0.028	0.210	0.131	0.003	0.004	0.076	0.029
Ningbo	0.355	0.105	0.450	0.153	0.078	0.029	0.195	0.122	0.003	0.003	0.081	0.030
Zhoushan	0.353	0.097	0.438	0.152	0.075	0.028	0.197	0.114	0.003	0.003	0.079	0.029
Dongguan	0.351	0.097	0.409	0.137	0.070	0.025	0.280	0.150	0.003	0.004	0.073	0.026
Huzhou	0.349	0.112	0.457	0.157	0.077	0.029	0.199	0.113	0.003	0.003	0.080	0.030
Zigong	0.348	0.073	0.502	0.149	0.087	0.028	0.183	0.102	0.004	0.003	0.091	0.028
Zhaoqing	0.343	0.086	0.499	0.138	0.088	0.026	0.256	0.105	0.006	0.003	0.094	0.027
Yingkou	0.343	0.119	0.479	0.135	0.081	0.024	0.237	0.126	0.005	0.004	0.086	0.024
Taizhou	0.341	0.100	0.456	0.153	0.075	0.027	0.250	0.145	0.003	0.004	0.079	0.028
Shangluo	0.232	0.038	0.448	0.161	0.049	0.019	0.175	0.108	0.002	0.002	0.050	0.019
Huizhou	0.339	0.123	0.411	0.126	0.069	0.023	0.252	0.119	0.004	0.004	0.073	0.024
Hangzhou	0.339	0.113	0.462	0.151	0.076	0.027	0.208	0.125	0.003	0.004	0.079	0.027
Fuxin	0.333	0.129	0.467	0.140	0.077	0.025	0.241	0.128	0.004	0.003	0.081	0.025
Leshan	0.332	0.083	0.508	0.161	0.083	0.028	0.184	0.109	0.004	0.003	0.086	0.029
Dalian	0.330	0.135	0.495	0.153	0.080	0.026	0.206	0.120	0.003	0.003	0.083	0.026
Liaoyang	0.328	0.121	0.498	0.152	0.080	0.026	0.193	0.115	0.003	0.003	0.083	0.026
Dandong	0.326	0.133	0.473	0.143	0.077	0.024	0.266	0.128	0.005	0.003	0.083	0.025
Neijiang	0.325	0.077	0.481	0.144	0.077	0.024	0.213	0.106	0.003	0.002	0.081	0.025
Shenyang	0.324	0.120	0.503	0.159	0.079	0.027	0.217	0.124	0.003	0.003	0.083	0.027
Chengdu	0.322	0.084	0.521	0.168	0.083	0.029	0.197	0.123	0.003	0.003	0.086	0.029
Jinhua	0.320	0.108	0.435	0.154	0.067	0.025	0.215	0.133	0.003	0.003	0.070	0.026
Anshan	0.317	0.149	0.492	0.152	0.075	0.024	0.231	0.128	0.004	0.003	0.079	0.024
Shenzhen	0.317	0.091	0.402	0.149	0.062	0.024	0.238	0.145	0.004	0.004	0.066	0.024
Wenzhou	0.317	0.097	0.470	0.159	0.074	0.027	0.216	0.125	0.003	0.004	0.078	0.027

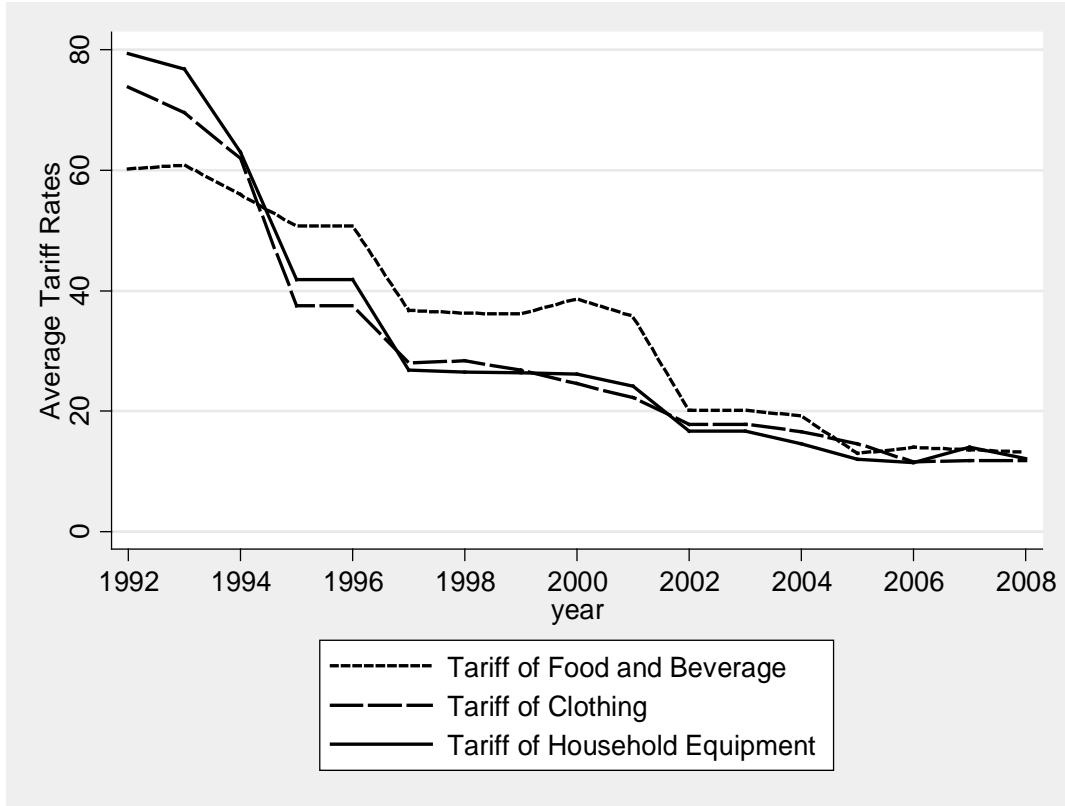
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Nanchong	0.316	0.078	0.506	0.162	0.078	0.027	0.181	0.107	0.003	0.003	0.081	0.028
Guangzhou	0.316	0.096	0.451	0.159	0.072	0.027	0.186	0.100	0.003	0.003	0.075	0.027
Jinzhou	0.314	0.123	0.508	0.155	0.078	0.025	0.206	0.119	0.004	0.003	0.082	0.026
Quzhou	0.314	0.104	0.440	0.154	0.067	0.025	0.243	0.131	0.003	0.004	0.070	0.026
Below-the-mean Private Share	0.282		0.466		0.064		0.224		0.003		0.067	
Benxi	0.312	0.145	0.454	0.127	0.069	0.021	0.209	0.106	0.003	0.003	0.072	0.021
Chaoyang	0.311	0.140	0.491	0.141	0.074	0.023	0.268	0.129	0.005	0.004	0.078	0.023
Fushun	0.310	0.131	0.477	0.148	0.072	0.024	0.191	0.118	0.003	0.002	0.075	0.024
Guangyuan	0.306	0.084	0.512	0.143	0.077	0.023	0.232	0.111	0.004	0.003	0.081	0.024
Meizhou	0.305	0.094	0.480	0.124	0.074	0.020	0.245	0.106	0.005	0.003	0.079	0.021
Lishui	0.304	0.106	0.424	0.142	0.061	0.023	0.242	0.129	0.003	0.003	0.064	0.024
Yulin	0.304	0.003	0.450	0.155	0.065	0.024	0.226	0.145	0.003	0.004	0.068	0.024
Zhanjiang	0.303	0.090	0.490	0.153	0.076	0.025	0.200	0.103	0.003	0.003	0.079	0.026
Luzhou	0.303	0.069	0.487	0.151	0.073	0.025	0.200	0.114	0.003	0.003	0.076	0.026
Shantou	0.298	0.094	0.473	0.135	0.072	0.022	0.235	0.091	0.004	0.002	0.076	0.023
Huludao	0.297	0.128	0.454	0.150	0.066	0.023	0.195	0.113	0.003	0.003	0.069	0.023
Mianyang	0.294	0.083	0.481	0.139	0.068	0.021	0.230	0.117	0.003	0.003	0.071	0.022
Beijing	0.293	0.151	0.452	0.155	0.064	0.023	0.217	0.136	0.002	0.003	0.066	0.023
Shaoguan	0.289	0.092	0.469	0.143	0.068	0.022	0.231	0.115	0.004	0.003	0.072	0.023
Xian	0.285	0.023	0.458	0.141	0.064	0.020	0.234	0.136	0.003	0.003	0.067	0.021
Panzhuhua	0.272	0.074	0.493	0.138	0.066	0.020	0.207	0.110	0.002	0.003	0.068	0.020
Ankang	0.264	0.065	0.460	0.136	0.058	0.019	0.201	0.114	0.003	0.002	0.061	0.019
Hanzhong	0.258	0.044	0.505	0.143	0.063	0.019	0.190	0.101	0.003	0.002	0.066	0.020
Tieling	0.257	0.119	0.476	0.159	0.059	0.021	0.212	0.120	0.003	0.003	0.062	0.022
Baoji	0.252	0.052	0.429	0.132	0.043	0.132	0.241	0.115	0.003	0.003	0.054	0.017
Yanan	0.243	0.018	0.397	0.136	0.044	0.016	0.266	0.162	0.003	0.003	0.048	0.016
Xianyang	0.240	0.020	0.441	0.142	0.050	0.017	0.230	0.132	0.002	0.003	0.053	0.017
Tongchuan	0.238	0.037	0.479	0.135	0.055	0.016	0.252	0.126	0.003	0.002	0.058	0.017
Weinan	0.223	0.032	0.455	0.133	0.047	0.014	0.233	0.115	0.002	0.002	0.049	0.015
All Cities	0.310		0.463		0.070		0.222		0.003		0.073	

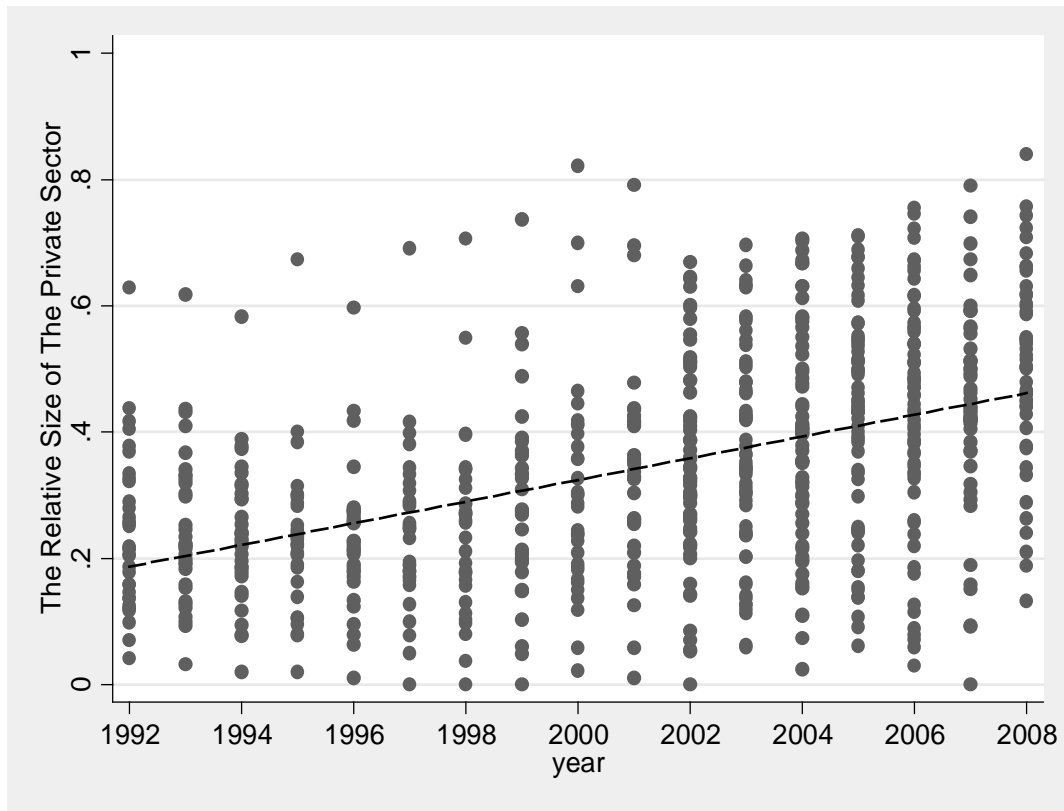
Notes: This table presents the pass-through elasticities, the average expenditure share, and the average consumption effects of trade liberalization - tariff cuts due to the WTO accession - for each of the cities in our sample. The pass-through elasticities are estimated based on Equation (5), and the consumption effects are estimated based on Equation (7). The expenditure shares are based on 2006 Chinese Urban Household Survey.

Figure 1: Average Tariff Rates for Major Tradable Goods



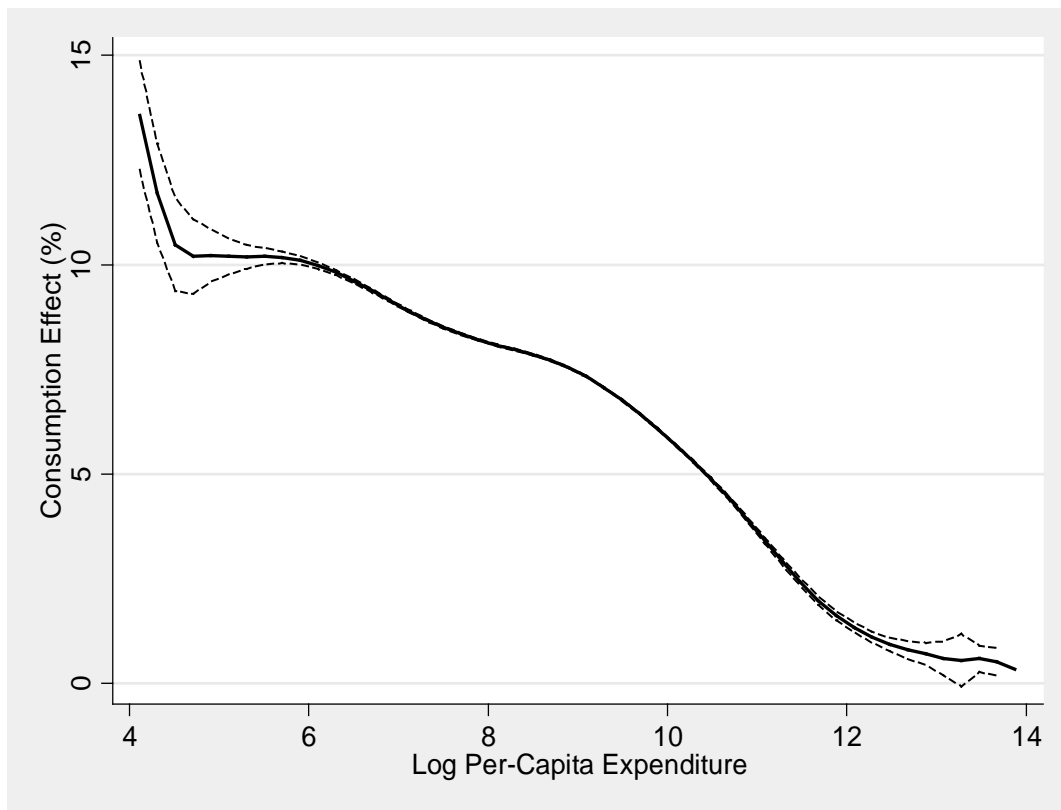
Notes: This figure presents the average Chinese effective tariff rates for three major tradable goods for years 1992-2008. Tariff rates at the 4-digit SITC level are extracted from WITS and aggregated to the three major categories of tradable goods using the concordance provided in Appendix Table 1. Import values are used as the weight for the aggregation.

Figure 2: The Relative Size of the Private Sector in Chinese Cities



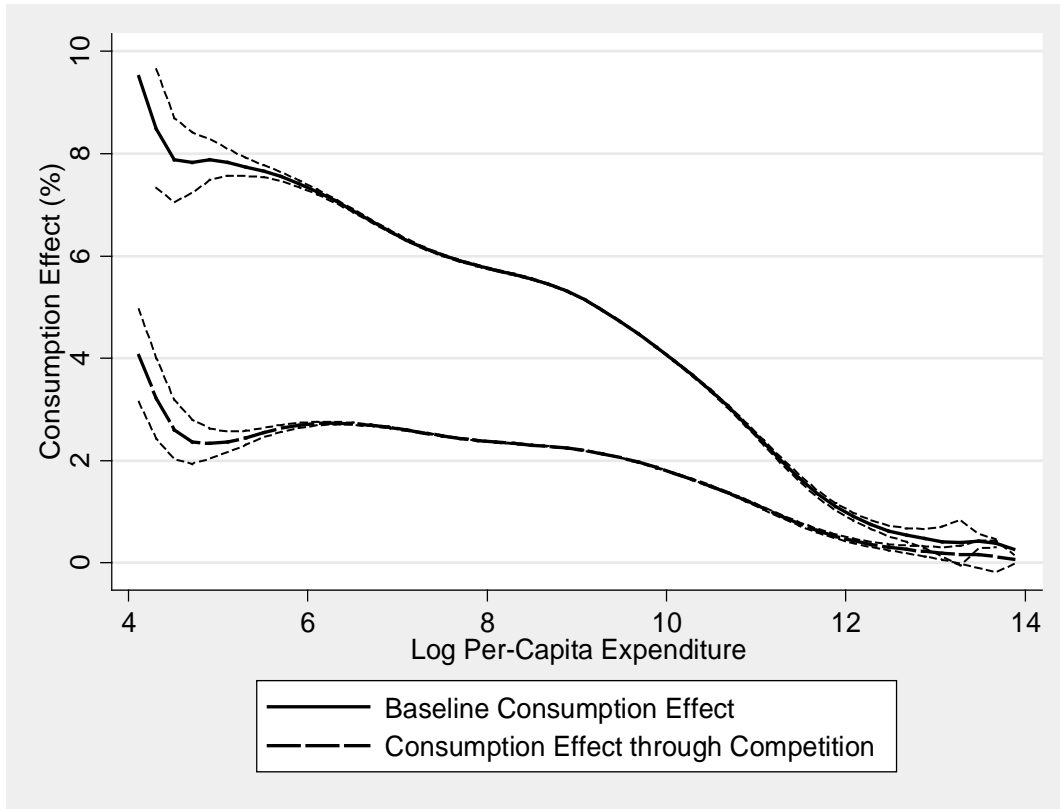
Notes: This figure presents the relative size of the private sector in urban China for years 1992-2008. The share of the private sector employment is calculated at the city-year level using the Chinese Urban Household Survey data. Scatter points represent the values for each city. The dashed line represents the linear fit over time.

Figure 3: The Consumption Effect of WTO Accession on Household Welfare



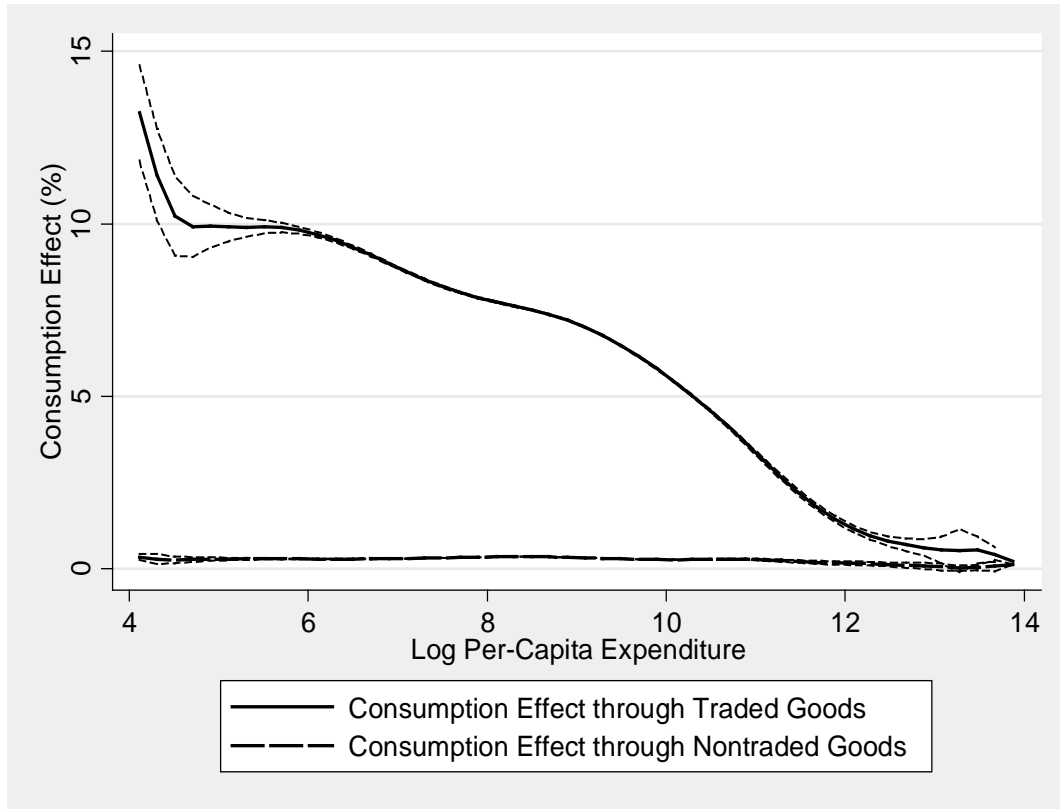
Notes: The figure shows the results of the local linear regression of consumption effect, \widehat{W}_h , across the per capita expenditure distribution. The Epanechnikov kernel function and the rule-of-thumb bandwidth used in the estimation.

Figure 4: Decomposing Competition Effect on Household Welfare



Notes: The figure shows the results of the local linear regression of the baseline consumption effect, and the consumption effect through competition across the per capita expenditure distribution. The baseline effect is computed as $\{-\hat{\alpha}_1(\sum_{i=1}^T Q_{ih} + \sum_{j=1}^{NT} \sum_{i=1}^T Q_{jh} \hat{\beta}_{ij}) d\ln(1 + \tau_i)\}$ and the competition effect is computed as $\{-\hat{\alpha}_2 \bar{\kappa}_c (\sum_{i=1}^T Q_{ih} + \sum_{j=1}^{NT} \sum_{i=1}^T Q_{jh} \hat{\beta}_{ij}) d\ln(1 + \tau_i)\}$. The Epanechnikov kernel function and the rule-of-thumb bandwidth used in the estimation.

Figure 5: Household Welfare Effect Through Tradable and Nontradable Goods



Notes: The figure shows the results of the local linear regression of consumption effect through tradable and nontradable goods across the per capita expenditure distribution. The consumption effect through tradable goods is computed as $\{-(\sum_{i=1}^T Q_{ih}) (\hat{\alpha}_1 + \hat{\alpha}_2 \bar{\kappa}_c) d\ln(1 + \tau_i)\}$, and the consumption effect through non-tradable goods is computed as $\{-(\sum_{j=1}^{NT} \sum_{i=1}^T Q_{jh} \hat{\beta}_{ij}) (\hat{\alpha}_1 + \hat{\alpha}_2 \bar{\kappa}_c) d\ln(1 + \tau_i)\}$. The Epanechnikov kernel function and the rule-of-thumb bandwidth used in the estimation.

Appendix Table 1: Concordance between UHS consumption categories and SITC

UHS Consumption Items	4-Digit SITC 3rd Revision Categories
Rice and Grain	411; 412; 421; 422; 423; 430; 441; 449; 451; 452; 453; 459
Edible Oil	4113; 4211; 4212; 4213; 4214; 4215; 4216; 4217; 4218; 4221; 4222; 4223
Pork	13; 122; 161; 175
Beef	11; 111; 112; 176; 179
Lamb	12; 121
Chicken	14
Egg	251; 252; 253
Fish	341; 342; 344; 345; 351; 352
Vegetable	541; 542; 544; 545; 546; 547; 548; 561; 564; 566; 567
Seasoning	751; 752; 984
Sugar	611; 612
Cigarette	1211; 1212; 1213; 1222; 1223
White Wine	1124
Fruit Wine	1122; 1121
Beer	1123
Cola	1110
Tea	741; 743
Coffee	711; 712; 713
Fruit	571; 572; 573; 574; 575; 576; 579
Nuts	577
Cake	484; 485
Milk	221; 222
Menswear	8411; 8412; 8413; 8414; 8415; 8416; 8431; 8432; 8437; 8438
Women wear	8421; 8422; 8423; 8424; 8425; 8426; 8427; 8428; 8441; 8442; 8447; 8448
Cloth	2613-2682; 6511-6574
Shoes	8511; 8512; 8513; 8514; 8515; 8517; 8519
Furniture	8211; 8212; 8213; 8215; 8218
Washing Machine	7751
Refrigerator	7752
Air Conditioner	7758
Television	7611; 7612
Radio	7621; 7622; 7628; 7633
Record	7638
Camera	8811; 8812; 8813
Watch	8853; 8854; 8855

Notes: This table reports the household consumption items in Chinese Urban Household Survey that can be matched to SITC codes. There are 7 additional categories of goods that cannot be matched into separate SITC codes: bean, duck meat, child wear, sewing machine, electric fan, freezer and video. These goods are excluded in our pass-through regressions and welfare analysis.

Appendix Table 2: Average Price Indices in Urban China

Year	Tradable				Non-tradable			
	All	Food and Beverage	Clothing	Household Equipment	Health	Transport and Communication	Education	Housing
1998	99.3 (1.249)	97.0 (1.953)	100.1 (2.339)	98.4 (1.461)	102.5 (3.426)	95.5 (3.752)	97.8 (3.662)	104.6 (6.840)
1999	98.9 (1.815)	97.9 (4.116)	96.9 (5.230)	96.3 (3.580)	98.1 (7.868)	94.1 (4.767)	99.0 (3.979)	103.1 (3.329)
2000	100.5 (1.956)	98.9 (3.819)	97.6 (5.346)	96.8 (3.407)	98.1 (8.011)	94.4 (4.515)	99.4 (4.246)	106.1 (4.035)
2001	99.7 (1.712)	101.0 (3.174)	97.1 (5.636)	97.0 (3.454)	95.7 (6.588)	98.6 (3.308)	101.2 (4.463)	101.8 (3.164)
2002	99.9 (1.687)	101.8 (2.825)	96.7 (5.561)	96.7 (3.361)	95.8 (6.562)	98.2 (3.282)	100.3 (4.530)	102.4 (2.979)
2003	101.0 (1.717)	104.3 (3.932)	95.6 (7.315)	95.9 (5.224)	98.5 (6.342)	97.1 (3.112)	100.6 (4.854)	103.7 (4.003)
2004	102.8 (1.240)	107.6 (3.314)	98.1 (3.674)	98.2 (2.670)	99.3 (3.098)	98.3 (1.947)	100.6 (2.450)	103.0 (2.247)
2005	101.4 (0.821)	103.0 (1.830)	97.6 (3.780)	99.5 (2.236)	99.3 (1.651)	98.8 (1.563)	101.4 (3.393)	103.7 (2.380)
2006	102.2 (1.864)	104.6 (4.760)	99.1 (2.906)	101.4 (2.225)	101.7 (2.112)	99.7 (1.858)	99.1 (1.634)	103.1 (3.156)
2007	104.7 (1.316)	111.9 (3.192)	98.6 (2.733)	101.8 (1.965)	101.9 (2.018)	99.2 (1.492)	99.2 (1.454)	104.7 (1.961)
2008	105.0 (0.843)	113.0 (2.154)	96.1 (4.480)	102.5 (2.119)	103.4 (2.359)	98.3 (2.006)	99.3 (1.548)	104.5 (2.045)

Notes: This table reports the average Consumer Price Indices of the main categories of consumption goods (both tradable and non-tradable goods) across 56 cities in our sample. The reference year for calculating price indices is last year (i.e., last year=100). The price index data are extracted from various volumes of provincial statistical yearbooks.