# When Trade Discourages Political Favoritism: Evidence from China

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**Abstract**

Developing country governments often distort resource allocation by protecting politically favored firms. If trade liberalization increases the cost of protection, it may discourage political favoritism and thereby improve allocative efficiency. China's WTO accession is studied to investigate whether or not trade liberalization leads to the reallocation of market share from politically favored but less productive state-owned enterprises (SOEs) to more productive non-SOEs. Trade liberalization is found to have induced a 12.25 percentage-point decline in the employment share of SOEs. The decline was driven by an increase in import competition and took place at the intensive margin and through intra-industry reallocation of production. Interestingly, the decline was linked to political affiliation: SOEs affiliated with city, county and township governments were the worst hit, while those affiliated with the central and provincial governments were less affected. These results suggest that apart from the familiar sources of gains from trade, trade can also deliver welfare gains by reducing inefficiencies arising from the political distortions.

**Keywords:** Political Favoritism; Trade liberalization; WTO; Difference-in-differences; State-owned enterprises

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