Cities, Heterogeneous Firms, and Trade*

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Abstract

We document a novel stylized fact: Using data for several countries, we show that export activity is disproportionately concentrated in larger cities – even more so than overall economic activity. We account for this fact by marrying elements of international trade and economic geography. We build a model with agglomeration economies where firms with heterogeneous productivity sort across city sizes and select into exporting. The model allows us to study the implications of trade policy for the within-country spatial configuration of economic activity. A central prediction is that within sectors, trade liberalization shifts employment towards larger cities. We structurally estimate the model using data for the universe of Chinese and French manufacturing firms and study the general equilibrium effects of trade liberalization and of urban policies. We find that the effects of these policies are quantitatively different from those predicted by trade models that ignore economic geography, and by economic geography models that omit international trade (both of which are nested in our framework).

JEL: Exporting, Agglomeration, Sorting, Trade, Economic Geography

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1 Introduction

Over the last decades, two mega-trends have shaped economies across the globe: rapid urbanization and a surge in international trade.[1] The simultaneous unfolding of these trends naturally raises the question if they are connected. While the underlying drivers of these trends have traditionally been examined by two separate strands of literature – international trade and economic geography – more recently, a literature at the intersection of these fields has emerged.[2] However, important gaps remain in this nascent strand of research. First, work analyzing the impact of international trade on economic geography has typically focused on heterogeneity in *sectoral* specialization across cities and regions, abstracting from the underlying more granular level, in particular, firms.[3] Second, while the effects of international trade shocks on domestic economic geography have been studied extensively, the converse effects of domestic urban policies and shocks on trade flows across countries have received relatively little attention.

In this paper we study the role played by firm-level heterogeneity in shaping the interactions between economic geography and international trade. We first show – using data for Brazil, China, France, and the United States – that firms located in larger cities systematically export a higher fraction of their output than those in smaller cities, even after controlling for differences in geographic characteristics. More than two-thirds of the association between export intensity and city size can be attributed to variation within industries. We show that the higher within-industry export intensity of larger cities is driven by a higher export participation of firms. This suggests that the sorting and agglomeration of heterogeneous firms has important implications for the spatial configuration of exporting activity within countries.

To explain the stylized facts described above we extend the systems of cities framework of Gaubert (2018) to a multi-country setting and augment it with a mechanism of selection into exporting in the spirit of Melitz (2003). We study a setup with an arbitrary number of symmetric countries, each subject to an identical distribution of potential entrants in each sector. Within countries, cities form endogenously on sites that are ex-ante identical and grow in population as firms choose to locate there, raising local labor demand. For firms, the main benefit of locating in cities is given by agglomeration externalities, such as thick labor markets or knowledge spillovers (Duranton and Puga, 2004). Firms are heterogeneous, drawing their productivity from sector-specific

[1]The average urbanization rate in the world grew from 43 to 55 percent between 1990 and 2010. During the same period, exports as a share of GDP have grown from 30 to 46 percent (https://data.worldbank.org/indicator).

[2]Recent empirical or quantitative contributions to this literature include Autor, Dorn, and Hanson (2013), Dauth, Findeisen, and Suedekum (2014), Redding (2016), Dhingra, Machin, and Overman (2017), Cheng and Potlogea (2020), Lyon and Waugh (2019), and Ducruet, Juhasz, Nagy, and Steinwender (2020). Earlier contributions typically used stylized models to qualitatively explore the effects of trade liberalization on economic geography. These include, for example, Krugman and Livas Elizondo (1996), Monfort and Nicolini (2000),Behrens, Gaigne, Ottaviano, and Thisse (2006b), Behrens, Gaigne, Ottaviano, and Thisse (2006a), Behrens, Gaigne, Ottaviano, and Thisse (2007), and Behrens, Gaigne, Ottaviano, and Thisse (2009).

[3]Notable exceptions include Cosar and Fajgenbaum (2016) and Redding (2016).

distributions.[4] They sort across cities of different sizes within their country.[5] When choosing their location, firms trade off the gains in productivity generated by local externalities in large cities against the higher labor costs prevailing in these cities. Moreover, in line with Combes, Duranton, Gobillon, Puga, and Roux (2012) and Gaubert (2018) we assume that more efficient firms benefit relatively more from these local externalities. This generates positive assortative matching: More efficient firms locate in larger cities, reinforcing their initial productivity advantage. Finally, as in Gaubert (2018), city developers operate within each country and compete to attract firms to their city. They act as a coordinating device in the economy, leading to a unique spatial equilibrium.

The model explains the disproportionate concentration of exporting in larger cities: More productive firms sort into larger cities and further augment their productivity advantage due to local agglomeration economies. As a result, they are more likely to overcome the fixed costs of exporting and sell their products internationally. Consequently, within sectors, a higher fraction of firms in larger cities become exporters.[6] Absent systematic differences in sectoral composition, for any pair of cities, the model predicts that the larger one will have a larger aggregate export intensity, as it will have a higher export intensity in every sector. Similar to Melitz (2003), the model also predicts that – conditional on exporting – export *intensity* at the firm level is unrelated to productivity. This is consistent with our findings.

The model further allows us to study the interaction between international trade and economic geography. We show that trade liberalization, while overall having complex implications for the location of economic activity, tends to shift employment within each sector towards larger cities.

Finally, we structurally estimate the model using Chinese firm-level data. The model can account for the bulk of the correlation between export intensity and city size observed in the data. Furthermore, to explore the quantitative implications of the model, we perform two policy experiments. First, we study the welfare implications of moving to autarky. We benchmark our findings against a similar experiment undertaken in the context of an alternative model that omits domestic geography.[7] We find that the welfare losses associated with shutting down international trade are about 20% smaller in our model relative to the simplified Melitz benchmark. Intuitively, in our model with geography, exporters locate in bigger cities where they face higher input costs than the less productive, domestic firms. This diminishes the effective productivity advantage of exporters and their weight in the economy, leading to relatively smaller welfare gains from trade.

[4]While differentiating between sectors is not necessary to illustrate the main mechanism in our model, it allows us to match the differential export participation across sectors in the data. We keep the structure simple by using Cobb-Douglas utility across sectors, implying constant sectoral shares.

[5]Firms cannot choose the country they enter; they choose a city within a pre-determined country.

[6]An important strand of the trade literature predicts the opposite: A direct implication of the gravity model – and the underlying Armington assumption – is that larger cities (or countries) are *less* open (Anderson and van Wincoop, 2004).

[7]We recalibrate this last model to fit the data, such that both models – our baseline and the model without geography – imply similar trade participation and productivity distributions.

Second, we study the welfare gains associated with increasing housing supply elasticities. We find that the effects on productivity are about 50% larger than in an alternative model that shuts down international trade. Increased housing supply benefits the most productive firms that locate in the largest cities. Trade openness amplifies the corresponding welfare and productivity gains because the most productive firms can also export and grow even larger, increasing their weight in the economy.

Our paper is related to several strands of the literature. First, we document a series of novel stylized facts regarding the economic geography of exporting activity ("exporter facts," as in Bernard, Jensen, Redding, and Schott, 2007). To the traditional stylized facts about exporters (being larger and more productive) we add a new one: Exporters tend to locate disproportionately in large cities. This, in turn, leads to an economic geography of exporting within countries that is even more uneven than that of overall economic activity.

Second, by combining a tractable model of spatial equilibrium featuring heterogeneous firms with a mechanism of selection into exporting à la Melitz (2003), we contribute both to the systems of cities literature (pioneered by Henderson, 1974), and to the international trade literature. From the perspective of the former, our contribution is most closely related to Gaubert (2018), who first proposed the modeling strategy of urban systems that we employ.[8] However, Gaubert's study focuses on the sorting and agglomeration of heterogeneous firms in a single country setting, and it does not feature international trade or selection into exporting. In a related contribution, Behrens, Duranton, and Robert-Nicoud (2014) study the spatial sorting of entrepreneurs who produce non-tradable intermediates.[9] We study the case of producers of goods that are perfectly tradable within countries but subject to transportation frictions across countries.[10]

From the perspective of the trade literature, our contribution is most closely related to the theoretical body of work that analyzes firms' decisions to enter into exporting (Melitz, 2003; Bernard et al., 2007). We show that the same firm-level fundamentals that lead firms to select into exporting may also cause them to locate in large, productive, but expensive cities. This interplay of location choices and exporting decisions allows us to account for the uneven economic geography of exporting. Our paper is also related to an older theoretical literature that analyzes the joint determination of international trade flows and within-country economic geography (Krugman and Livas Elizondo, 1996; Monfort and Nicolini, 2000; Paluzie, 2001; Behrens et al., 2006a,b, 2007).

[8] Some of our modeling assumptions are motivated by the empirical findings of Combes et al. (2012), who show that the productivity advantage of firms in large cities is driven by agglomeration effects, as opposed to tougher competition (and hence stronger selection). They also find that the most efficient firms are disproportionately more productive in large cities, indicating potential complementarities between firm productivity and city size.

[9] Another closely related strand of the literature uses similar conceptual tools, borrowed from the assignment literature, to study how workers rather than firms sort across space (c.f. Eeckhout, Pinheiro, and Schmidheiny, 2014; Davis and Dingel, 2014, 2019).

[10] Our setup is, however, sufficiently tractable to be extended to feature trade costs also within countries.

As in some of these models, in our framework trade policy affects the configuration of economic geography, while spatial policy can affect trade flows. Moreover, as in these models, our framework also captures the fact that domestic policy decisions can have spillovers on other countries via trade channels.[11] We expand this earlier line of research in two dimensions: i) we examine the role of heterogeneous firms, introducing more finely grained dynamics, and ii) unlike these earlier stylized models, our quantitative model can be taken to the data.

Finally, as in Gaubert (2018), Desmet and Rossi-Hansberg (2013) and Behrens et al. (2014), we also use structural estimation of a model of a system of cities to assess the welfare implications of the spatial equilibrium. In doing so, we contribute to the literature that measures agglomeration externalities, as reviewed in Rosenthal and Strange (2004).[12] Moreover, we also employ the model to run policy experiments in order to study the general equilibrium effects of place-based policies. We thus contribute to the strand of literature that quantifies productivity and output losses from policies that distort location decisions, such as restrictive housing policies (Hsieh and Moretti, 2019; Gaubert, 2018; Parkhomenko, 2018). Our paper expands the frontier by assessing the indirect effect of (policy-induced) spatial distortions on productivity, output, and welfare via their implications for the gains from international trade.

The rest of the paper is organized as follows: Section 2 presents the data and Section 3, our stylized facts. Section 4 introduces the model and its equilibrium properties. Section 5 presents the structural estimation of our model, discusses model fit, and provides a counterfactual analysis. Section 6 concludes.

2 Data

Our main empirical analysis uses firm-level data from the 2004 Chinese Economic Census of Manufacturing and from the 2000 French Unified Corporate Statistics System (FICUS). One important advantage of the Chinese and French data is that they provide detailed information on the location of firms. This allows us to study the sorting of firms and exporters across cities. In addition, we use more aggregate information at the city level from the United States (at the MSA level) and Brazil (at the microregion level) for 2012 to confirm the main patterns we derive for China and France. We begin by discussing the Chinese and French data in detail, followed by a description of the U.S. and Brazilian data. For each country, we also discuss what constitutes a "city" in our data.

[11] For example, spatial policies that limit agglomeration in a country can reduce productivity and entry into exporting, thus hurting foreigners consumers.

[12] This literature provides some evidence that sorting across space matters for the understanding of the wage distribution. Some papers in this literature use detailed data on worker characteristics or a fixed-effect approach to control for worker heterogeneity and sorting in a reduced-form analysis (c.f. Combes, Duranton, and Gobillon, 2008; Mion and Naticchioni, 2009; Matano and Naticchioni, 2012). By contrast, we follow Gaubert (2018) in using a structural approach to explicitly account for the sorting of firms when measuring agglomeration economies.

2.1 China

Data for the Chinese Economic Census of Manufacturing are collected by the *National Bureau of Statistics*, covering the universe of firms in China, irrespective of their size. The Chinese data contain detailed information on plant characteristics such as sales, spending on inputs and raw materials, employment, investment, and export value. We use the information from the Census to compute measures of city-, industry-, and firm-level export activity. The reported location of firms reflects the county where their headquarters are based.[13] This feature is unlikely to confound our results because – as Brandt et al. (2014) show – over 90 percent of firms in China are single-plant firms. In Online Appendix B.1, we show that firm-level exports from customs data are highly correlated with our main dataset from the Census, and the corresponding export intensities confirm our stylized facts.[14]

In our main analysis, we define Chinese cities as metropolitan areas with contiguous lights in nighttime satellite images. We use the correspondence constructed by Dingel, Miscio, and Davis (2019) to map counties into metropolitan areas with a threshold for light intensity equal to 30.[15] This value is in the middle of the set of thresholds provided by these authors. Importantly, our results do not depend on the particular threshold of light intensity.[16] For each metropolitan area, we use information on the urban population of the underlying counties, which is provided by the Chinese Population Census of 2010 (i.e., the Chinese Census distinguishes between rural and urban population within each county). We then define 'city size' as the aggregate urban population of the Metropolitan Area.

The Census of Manufacturing contains information for approximately 1,272,000 firms with positive output in 2004. We drop firms with zero or missing sales (67,780 observations, corresponding to 5.3% of the sample), with missing industry codes (20,884 observations, 1.7% of the sample), or with export intensity above 100% (6,070 observation, 0.5% of the sample). We also drop processing trade (11,215 observations, defined as firms where processing exports account over 90% of their sales). In addition, to ensure meaningful variation in export intensity at the city-

[13]Counties are the third administrative division in China, below provinces and prefectures – the other administrative division researchers typically use to define cities (e.g., Brandt, Van Biesebroeck, and Zhang, 2014).

[14]Although we also have access to official exports information from the Chinese Customs Agency, we avoid using it for three reasons. First, customs exports only consider direct exports, while Census exports consider both direct and indirect exports through intermediaries. Second, data from customs provides no information on the location of the exporters, and the data cannot be matched in a straightforward way to the Census of manufacturing, leading to poor matching rates. Finally, when computing export intensity with Customs information, many firms have unreliable export intensities – about 10% of the firms identified as exporters using customs data have export intensities above 100%.

[15]For reference, large metropolitan areas (urban population over 1 million) have, on average, about nine counties. In contrast, most small metropolitan areas (population below 100,000) consist of a single county.

[16]A large body of research using information for China defines cities in terms of prefecture-level cities. A prefecture-level city is an integrated political and economic unit, but it often includes rural areas. We avoid defining cities in terms of prefectures because administrative boundaries may fragment economically integrated areas into distinct cities or circumscribe places, including rural areas.

level, we only consider cities with at least 250 firms. Our final sample then consists of 1,035,664 firms located in 655 cities (metropolitan areas). These account for 91% of total non-processing trade sales.

2.2 France

Our analysis for France uses firms from the Unified Corporate Statistics System (FICUS). FICUS is an administrative data set collected by the French National Statistical Institute (*Institut National de la Statistique et des Études Économiques*, INSEE), and covers the universe of private sector firms. It reports information on domestic and export revenue, industry classification, headquarter location, employment, capital, value-added, and production.[17]

As is standard in the literature, we define cities in France in terms of commuting zones. City size reflects the overall commuting zone population, which we obtain by aggregating municipality-level information from the French Population Census of 1999.[18] While FICUS is available for the firms operating in all sectors of the French economy, we restrict our main analysis to the *manufacturing* sector for comparability with the Chinese data. Nevertheless, as we discuss in Appendix B.2, our main results also hold when generalizing the analysis to all sectors.

As in the case of China, we restrict the analysis to firms with strictly positive information on exports and sales, and for cities with at least 250 firms. The final sample consists of 194,688 firms located in 210 cities.

2.3 United States

In the case of the United States, we define cities in terms of Metropolitan Statistical Areas (MSA). MSAs are defined by the United States Office of Management and Budget as one or more adjacent counties with at least one urban area with a population of at least 50,000 inhabitants, and characterized by a high degree of social and economic integration, as measured by commuting flows to work and school.[19] Unlike China, most U.S agencies provide tabulation on key economic accounts at the MSA level. As Dingel et al. (2019) show, MSAs are well-approximated by cities defined in terms of contiguous areas of lights in nighttime satellite images, as we do in the case of China. Our analysis considers 312 U.S. metropolitan areas with a population over 100,000 inhabitants in 2012.

[17] In a robustness check (reported in Appendix B.2), we combine FICUS with establishment-level information from the Annual Declaration of Social Data (DADS). DADS is an employer-employee dataset that contains information on the location of each establishment owned by the firm. In the appendix, we show that our results are qualitatively unchanged when restricting the data to the set of firms for which all establishments are located in a single commuting zone.

[18] We use the definition of commuting zones published by INSEE in 2011 that assigns municipalities (code communes) to commuting zones based on where "most of the labour force lives and works, and in which establishments can find the part of the labour force" (https://www.insee.fr/en/metadonnees/definition/c1361).

[19] Most U.S agencies provide tabulations on key economic accounts at the MSA-level. This contrasts with China, where we aggregate county-level information to derive statistics for metropolitan areas.

To develop our main analysis, we combine data from several sources. Data for exports at the MSA level are provided by the International Trade Administration of the U.S. Department of Commerce and include overall exports.[20] We combine this with establishment-level information of sales and employment aggregated at the MSA level from the 2012 Economic Census.[21] In our baseline analysis we use information for the manufacturing sector (NAICS 31-33), which is closest to our theoretical framework. Consequently, city-level export intensity is constructed as overall exports over manufacturing sales. Finally, we use MSA population from the population projections of the U.S. Census Bureau.[22]

2.4 Brazil

Finally, for the case of Brazil, we consider microregions as the main unit of analysis. Microregions are defined by the Brazilian Institute of Geography and Statistics (IBGE) as urban agglomerations of economically integrated contiguous municipalities with similar geographic and productive characteristics.[23] Although microregions do not directly capture commuting flows (in contrast to U.S. Metropolitan Areas), they are constructed according to information on integration of local economies, which is closely related to the notion of local labor markets. Our sample includes 420 microregions with more than 100,000 inhabitants in 2012.

To construct export intensity, we use overall exports – available at the level of municipalities – from the COMEX Stat database (which is compiled by the Brazilian *Ministry of Industry, Foreign Trade and Services*).[24] We complement this data source with municipal-level GDP from IBGE.[25] We aggregate both exports and GDP at the level of microregions using the correspondence provided by the IBGE, and we compute city-level export intensity as the ratio of overall exports over GDP. Finally, we use population projections from the 2010 population Census.[26]

2.5 Summary Statistics and Export Intensity

Before turning to our empirical results, we show descriptive statistics for the sample of cities considered in the analysis for China, France, the United States, and Brazil. Recall that for each country, our samples include all cities with more than 250 firms. Table 1 shows statistics for the distribution of population and export intensity for the four samples. Average city size varies importantly across the datasets. U.S. cities are larger on average (about 800,000 inhabitants), followed by China (780,000), Brazil (463,000), and France (258,000). These reflect the fact that population

[20]https://www.export.gov/Metropolitan-Trade-Data.

[21]https://www.census.gov/programs-surveys/economic-census/data/datasets.2012.html

[22]https://www.census.gov/data/tables/2012/demo/popproj/2012-summary-tables.html

[23]A number of researchers have used microregions as their main unit of analysis (see Kovak, 2013; Dix-Carneiro and Kovak, 2015, 2017b, 2019; Costa, Garred, and Pessoa, 2016; Chauvin, Glaeser, Ma, and Tobio, 2017).

[24]http://comexstat.mdic.gov.br/en/home

[25]https://www.ibge.gov.br/en/statistics/economic/national-accounts/19567-gross-domestic-product-of-municipalities.html

[26]https://www.ibge.gov.br/en/statistics/social/education/18391-2010-population-census.html?=&t=microdados.

in the U.S. is more concentrated in larger cities. Indeed, as Figure B.2 in the appendix shows, both China and Brazil have a relatively higher density of small cities than the United States.[27] While for the U.S., two-thirds of the cities in our sample have populations above 500,000, in China and Brazil 16 percent of the cities surpass this threshold, and in France, only 9 percent.

We define export intensity as the share of an industry's sales that are exported. Correspondingly, we define the export intensity in city c as follows:

$$EI_c = \left(\frac{\sum_j \sum_i E_{ijc}}{\sum_j \sum_i R_{ijc}} \right) , \tag{1}$$

where E_{ijc} and R_{ijc} denotes the exports and revenues, respectively, of firm i in sector j in city c.[28] The right part of Table 1 reports summary statistics for export intensity. A noteworthy difference between the four countries is the prevalence of zeros. In the U.S. and France, all cities have exporting firms; in contrast, in China and Brazil about 2 and 6 percent of the cities, respectively, record no export activity. We argue that the existence of cities with zero exports does not affect the quantitative implications of our results, because these cities represent a small fraction of output (0.3% and 0.9% of the production in China and Brazil, respectively). The distribution of export intensity is positively skewed for all countries in our sample, with an a substantially fatter tail in Brazil and China than in France and the United States.

3 Stylized Facts

In this section we present our empirical results. We first examine the distribution of export activity across cities. Next, we show to what extent the city-level results reflect differences in sectoral composition. We then show that differences in export intensity within sectors are primarily driven by differences in the extensive margin of exporting. Finally, we provide suggestive evidence for firm productivity as an underlying mechanism, which is positively correlated with both city size and export intensity.

3.1 Export Activity and City Size

Figure 1 presents our main result – the relationship between export intensity and city size. For all countries, we plot log export intensity against city size (log city population), thus reflecting

[27] This is consistent with evidence in Au and Henderson (2006), who show that about half of prefecture-level cities in China are smaller than their optimal size. They argue that this is most likely due to the existence of strong migration restrictions.

[28] Equation (1) can only be directly applied in the case of primary datasets where we have access to firm-level data (i.e., in China and France). For Brazil and the United States, we proxy for the numerator and denominator in (1) using available city-level information. In particular, for Brazil, we compute export intensity as the ratio of city-level exports to GDP (across all sectors). For the United States, we compute export intensity as the ratio of overall city-level exports (across all sectors) to city-level manufacturing sales.

elasticities. Figure 1 shows a strong positive relationship for all countries.[29] Table 2 shows the corresponding point estimates for the elasticity between export intensity and city size. We obtain statistically highly significant estimates for all countries, ranging from 0.20 for France to 0.33 for Brazil and China. Importantly, the coefficient remains positive and highly significant when we include geographical controls for distance to the coast and a categorical variable for cities located on the coast (columns 2, 4, 6 and 8).[30] In all these cases, the estimated elasticities vary between 0.20 and 0.37.

We implement several tests to check the robustness of our main finding for China and France, where we have the most detailed data. First, the Chinese Census of Manufacturing defines firms' locations in terms of the companies' headquarter offices. This may introduce an upward bias if export-intensive companies with production based in small cities locate their headquarters in large cities. As Brandt et al. (2014) show, fewer than 10 percent of firms in the Census of Manufacturing are multi-plant firms, and these tend to be relatively large. We use this feature to indirectly control for the possibility that multi-plant firms drive our results. Table B.3 in the appendix shows that the elasticity estimate remains very similar when we drop relatively large firms. Second, an important body of literature uses prefecture-level Chinese cities as the main unit of analysis (e.g., Au and Henderson, 2006). We show in Table B.4 in the appendix that our main findings are qualitatively unchanged when using prefecture-level cities (in rows 4-8 of the table). The estimated elasticity is actually larger in this case (0.73 for the unconditional correlation and 0.38 once geographical controls are included). Third, a distinctive element of China is the existence of Special Economic Zones (SEZ) and Coastal Development Areas (CDA), which are intended to promote exports and overall economic activity in selected areas. We show in Table B.4 that our main results are not affected by the inclusion of categorical variables for SEC and CDA cities (in row 1 of the table). Finally, we show that defining export intensity using information from the Chinese Customs Service – which only includes direct exports and leads and is limited due to poor matching with the Census of manufacturing – barely affects the baseline correlation (rows 3 and 9 in the table).

The French data allows us to run a number of additional robustness checks, which we report in table B.2 in the appendix. First, city size and export intensity are jointly determined, so that their positive correlation could be driven by a number of different causal mechanisms. We cannot exclude the possibility that unobserved local factors affect both city size and exporting behavior – in fact, many of such candidates are compatible with our mechanism (in particular, factors related to agglomeration).[31] However, we do implement an analysis to exclude the possibility of reverse

[29]While the relationship is somewhat less precisely estimated for Brazil, it is statistically significant.

[30]The former is computed as the shortest straight distance from the center of the city to the nearest port. For France and the US we additionally include distance to the border, as trade across these land borders is quantitatively important (separately for Eastern and Western border in the case of France, and Southern and Northern border in the case of the US).

[31]Our argument is not that larger city size in itself causes higher export shares. Instead, firm's competitiveness in

causality, i.e., higher exports driving city size.[32] To account for this possibility, we instrument city size with historical population in 1876. The underlying assumption is that population in 1876 was not determined by exporting, in particular not contemporaneous exporting. Given the significant changes in transport technology, industry composition and policy over the last 150 years, French trade pattern are likely to have changed significantly over this period weakening the link between current and past exporting and supporting our assumption. To further support this point, we control for a variety of variables associated with trade costs, such as location on the coast and distance to the border. The 2SLS coefficient displayed in column 1 of Table B.5 in the appendix is positive and statistically significant at the 10% level, suggesting that there is a directional relationship from city size to export intensity. Second, as in the Chinese data, the location of the firm is only defined at the headquarter level in our baseline sample. Complementing the firm-level data with establishment-level employer-employee data allows us to make sure that this does not drive our results. In column 2 of Table B.5 we report results for the sample of firms that are only active in one commuting zone. In column 3, we assume that both domestic and export revenue are distributed proportional to the wage bill across establishments of the firm. In both cases the estimated elasticity is quantitatively similar to our baselines estimates and statistically significant. Furthermore, we show that the positive correlation between export intensity and city size does not just hold within manufacturing but also when including all private sector firms (column 4). In sum, the strong correlation between cities export intensity and city size establishes our first stylized fact:

Stylized Fact 1. *Export intensity increases with city size*

3.2 Within- and Between-Industries Variation

To what extent does the positive correlation between export intensity and city size reflect *within*-industry variation, as opposed to more export-intensive industries locating in larger cities? To answer this question, we decompose city-level export intensity into its variation occurring within and between (i.e., across) industries. We compute the between-industry component as the counterfactual export intensity measure, $EI_c^{Between}$, that would result if city-level export intensity only varied due to differences in city-level industry composition. For each sector j, we first define its national-level export intensity, $\overline{EI}_j$, and then construct the counterfactual city-level export intensity by

export markets is driven by an interplay of firm selection and agglomeration forces, which in turn are also associated with city size.

[32]For example, higher exports for reasons unrelated to our mechanism could lead to firm-level efficiency gains (c.f. Garcia-Marin and Voigtländer, 2019), which in turn drive the growth of cities.

interacting (national-level) industry export intensities with each city's industrial composition:[33]

$$EI_c^{Between} \equiv \left(\sum_j \frac{R_{jc}}{R_c} \times \overline{EI}_j \right) \tag{2}$$

where $R_{jc} = \sum_i R_{icj}$ are total sales revenues of all firms i in sector j in city c, and R_c are total local sales revenues. The within-industry component is then defined simply as the part of the overall variation of export intensity not accounted for by differences in the sectoral composition of cities: $EI_c^{Within} \equiv EI_c / EI_c^{Between}$. In logarithms, we obtain the following decomposition of EI_c:

$$\ln EI_c \; = \; \ln EI_c^{Between} + \ln \underbrace{\left(EI_c / EI_c^{Between} \right)}_{\text{within-sector } (EI_c^{Within})} \tag{3}$$

Table 3 shows the results of the decomposition for our main datasets, China and France.[34] Note that by construction, the within- and between-industry coefficients add up to the overall elasticity between export elasticity and city size from Table 2. We report the share of the overall variation accounted for by the within-industry component. We find that the relationship between export intensity and city size is largely due to variation within industries, accounting for 65% of the overall variation in China, and for almost 70% in France. The evidence from the decomposition exercise leads us to our second stylized fact:

Stylized Fact 2. *About two-thirds of the overall variation in export intensity across city sizes is due to differences within industries, while one-third is due to differences in industry composition across cities.*

This stylized fact can be interpreted as a refinement to Stylized Fact 1. It suggests that the positive elasticity between export intensity and city size we document in section 3.1 for Brazil, China, France and the United States, reflects differences in the exporting behavior across firms *within* the same industry.

3.3 Firm-Level Analysis and Mechanisms

To improve our understanding of the drivers behind our main result (Stylized Fact 1), we study exporting behavior at the firm level for China and France. In particular, we focus on the relationship between city size and the extensive and intensive margin of exporting. Table 4 reports the results, weighting regressions by firms' sales shares within each city. This weighting avoids that the many

[33] For our baseline specification we define industries at the two-digit level to account for differences in comparative advantage, transport costs, etc. across industries, while keeping industries relatively broad so as to have a sufficient number of exporters within each industry.

[34] The decomposition cannot be performed for Brazil and the United States as for these countries we only have access to aggregate city-level exports (i.e., not by sector).

small firms with zero or very small exports dominate our results.[35] In column 1 of Table 4 we examine the extent to which the extensive margin of exporting can account for the higher export intensity of large cities in China. We regress an export dummy for firms with strictly positive exports on the logarithm of city size. The city size coefficient is positive and highly significant. Its magnitude indicates that a doubling in city size is associated with an increase in the proportion of exporting firms by 7.1 percentage points (p.p.), relative to a (weighted) average proportion of exporting firms of 26.2 percent.[36] For France, we also obtain a highly significant relationship between city size and the extensive margin of exporting (column 3 in Table 4). However, the magnitude is smaller – doubling city size is associated with a 1.8 p.p. higher frequency of exporting (compared to a weighted sample mean of 75.1 percent).[37] We stress that these results can only be interpreted as a correlation because, as our model in the next section suggests, firm location is endogenous.

Next, we analyze the intensive margin of exporting, regressing the logarithm of export intensity on city size for the sub-sample of firms with strictly positive exports. In this way, we aim to study if the forces of sorting, selection and agglomeration could lead a more pronounced export orientation in larger cities. Results in columns 2 and 4 in Table 4 suggests that the intensive export margin is relatively weaker than the extensive margin in explaining the positive correlation between city-level export activity and city size. For China, the city size coefficient is *negative* and statistically insignificant, while for France, the city size coefficient is only significant at the 10 percent level and quantitatively small: Doubling city size is associated with an increase in export intensity of exporters by about 0.5 p.p., based on an estimated elasticity of 0.067 and a mean export intensity of 0.290 (weighted by firms' sales shares, as in the regressions in Table 4).

Taken together, these results suggest that the higher within-industry export intensity of large cities is most likely driven by a higher export participation of firms in large cities. We summarize

[35]Small firms (fewer than 25 employees) dominate the Chinese Census of Manufacturing: They account for more than 50 percent of firms in all city sizes, and about one-half of small firms have fewer than 10 employees. At the same time, small firms account for only 6 percent of the aggregate production value, and fewer than 2% of them are exporters. This is in stark contrast to the export activity among medium-sized and large firms, among which more than 20 percent are exporters. While this is consistent with a large literature showing that larger, more productive firms sort into exporting (c.f. Melitz, 2003; Bernard et al., 2007), it gives rise to a downward bias in unweighted regressions: The dominance of small firms in China dilutes the coefficient of interest, because they are distributed relatively homogeneously across all city sizes and have a low unconditional export probability. Weighting by firm-level sales shares has the additional benefit that it is consistent with our city-level analysis (because smaller firms naturally contribute less to overall city-level sales and exports. We could also weight observations by firms' sales. This alternative, however, would implicitly give a higher weight to larger cities.

[36]The unweighted average export participation among Chinese firms is 10.8%.

[37]The unweighted average export participation among French firms is 29.4%. The smaller coefficient for France can be explained by the fact that French firms face lower export costs (both fixed and variable) because of their proximity to the large EU markets, with low regulatory and other frictions. Thus, the export cut-off for France is lower and reached also by firms in smaller cities than in China. In line with this reasoning, we find that there are exporters even in very small French cities. In contrast, in China, there are many cities with no exporters. Consequently, the gradient of export participation with respect to city size is flatter in France.

this in the following stylized fact:

Stylized Fact 3. *The extensive margin of exporting is important: Within industries, firms located in larger cities are significantly more likely to participate in exporting. On the other hand, there is at best mixed evidence on the intensive margin of exporting.*

These suggestive findings provide partial justification for a central pillar in our theoretical framework: firm-level productivity, which is typically higher in larger cities due to firm sorting and agglomeration. Given the importance of the extensive over the intensive margin, our model emphasizes selection into exporting as the key driver of differences in export intensity across city sizes. We turn to the presentation of our model in the next section.

4 Model

To account for the stylized facts documented above, we present a model of sorting and agglomeration of firms across cities, together with selection into exporting. The model combines a multi-country version of the firm location model by Gaubert (2018) with a standard mechanism of selection into exporting as in Melitz (2003).

4.1 Setup

We consider a world economy featuring C symmetric countries. Each country is endowed with N workers and contains a continuum of potential city sites that are ex-ante identical. Each site has a given stock of land γ, which we normalize to one. Cities with different population levels L may emerge endogenously on these sites. Crucially, workers are assumed to be perfectly mobile across cities within countries, but immobile internationally.

Within these countries production takes place in cities in an arbitrary number of sectors, denoted by S. In each country and sector, production is undertaken by heterogeneous firms that produce differentiated varieties in cities, making use of local labor. Land scarcity in cities gives rise to congestion, but cities are also the locus of non-market interactions that generate positive agglomeration economies. Moreover, these agglomeration effects are assumed to be heterogeneous across firms, with more efficient firms benefiting disproportionately from local agglomeration forces. Like workers, firms are also assumed to be mobile within countries but immobile internationally.

Economic geography is primarily driven by the location choices of firms. When choosing which city to locate in, firms trade off the strength of local productivity externalities, the local level of input prices, and the generosity of any local subsidies. Firms can ship their goods costlessly within their home country but need to pay trade costs when shipping internationally. Moreover, all locations within each country have symmetric access to foreign markets. Heterogeneous firms face different incentives, which leads them to make different choices regarding location and export status.

Following Gaubert (2018), we posit that, within countries, each potential city site is administered by a city developer who represents local landowners and competes against other sites to attract firms. These developers play a coordination role in the creation of cities, leading to a unique equilibrium. In what follows we fix a country and describe the rest of the model's setup from the perspective of one "home" country. Given that all other countries are symmetric, the setup would look identical from other countries' perspectives.

With the setup described above, city size is sufficient to characterize the key economic forces at play at the local level. In particular, the distance between two cities plays no role in the model because goods produced in the economy are freely traded within the country, all cities have by assumption equal access to foreign markets, and housing (the only other good in the economy) is non-tradable. Consequently, in what follows we index all relevant city-level parameters by city size L. We now proceed to describe in greater detail the optimization problems faced by the key agents in the model, namely by workers, housebuilders, firms, and city developers.

Preferences Workers live in a city of their choice within their home country. They consume a bundle of goods and housing while being paid the applicable local wage $w(L)$. Crucially, as described in detail below, the wage earned by workers depends on the size of the city they choose as a residence. Workers' preferences are characterized by the utility function:

$$U = \left(\frac{c}{\eta}\right)^{\eta}\left(\frac{h}{1-\eta}\right)^{1-\eta} \tag{4}$$

where h denotes housing and c is a Cobb-Douglas composite of tradable goods across the S sectors of the economy

$$c = \prod_{j=1}^{S} c_j^{\xi_j} \text{ with } \sum_{j=1}^{S} \xi_j = 1 \tag{5}$$

Moreover, within each sector $j \in \{1, \ldots, S\}$ consumers choose varieties i according to the CES aggregator:

$$c_j = \left[\int c_j(i)^{\frac{\sigma_j - 1}{\sigma_j}} di\right]^{\frac{\sigma_j}{\sigma_j - 1}} \tag{6}$$

Housebuilding In each city, housing is built by atomistic local landowners by combining land with local labor according to the technology:

$$h^S = \gamma^b \left(\frac{l}{1-b}\right)^{1-b} \tag{7}$$

where h^S denotes housing supply, γ denotes land, and b denotes the cost share of land in producing housing. Both land and housing markets are assumed to be perfectly competitive at the local level, and landlords take the local wage level $w(L)$ as given. We normalize $\gamma \equiv 1$.

Production Within each country and sector, firms produce differentiated tradable varieties using labor. Firms differ exogenously in their 'raw' efficiency z. For a firm of efficiency z in sector j and city of size L, the production technology is given by

$$y_j(z, L) = \psi(z, L, s_j)\, l \tag{8}$$

where l denotes labor inputs and $\psi(z, L, s_j)$ is a firm-specific productivity shifter. The productivity of a firm $\psi(z, L, s_j)$ increases with its own 'raw' efficiency z and with local agglomeration externalities that depend on city size L. The productivity function is also indexed by a sector-specific parameter s_j, with sectors that benefit from stronger agglomeration economies for each city size being assigned higher values of this parameter. Moreover, the key assumption of the Gaubert (2018) model, which we also adopt, is that the productivity of a firm $\psi(z, L, s_j)$ exhibits a strong complementarity between local externalities and the 'raw' efficiency of the firm. More precisely, we assume that $\psi(z, L, s)$ is twice differentiable, log-supermodular in city size L, firm raw efficiency z, and sectoral characteristic s, and strictly log-supermodular in (z, L). That is,

$$\frac{\partial^2 \log \psi(z, L, s)}{\partial L \partial z} > 0 \quad ; \qquad \frac{\partial^2 \log \psi(z, L, s)}{\partial L \partial s} \geq 0 \quad ; \qquad \frac{\partial^2 \log \psi(z, L, s)}{\partial z \partial s} \geq 0$$

Following Gaubert (2018), we also assume that agglomeration externalities have a decreasing elasticity with respect to city size.[38] On the other hand, our model setup implies that congestion forces increase with city size with a constant elasticity.[39] Together, these features guarantee that the firm's problem is well-defined and concave for all firms, absent any local subsidies. Intuitively, we require that the positive effects of agglomeration externalities are not too strong compared to the congestion forces, so as to preclude a degenerate outcome with complete agglomeration of all firms in the largest city of each country.

Firms engage in monopolistic competition and aim to maximize profits by their choice of location and pricing. In doing so, they take the sectoral price index (which by symmetry is the same across countries) as given. Moreover, there is an infinite supply of potential entrants in each country and sector. Firms pay a sector-specific sunk cost f_j in terms of the final good in order to enter.

[38] That is, $\frac{\partial}{\partial L}\left(\frac{\partial \psi(\cdot)}{\partial L}\frac{L}{\psi(\cdot)}\right) < 0$.

[39] Congestion costs are endogenous and are associated with the higher wages that have to be paid in larger cities to compensate workers for the higher cost of housing in these locations (due to scarce land) and keep them in spatial equilibrium. As can be seen in equation (10), in spatial equilibrium wage rates increase with city size with constant elasticity $b\frac{1-\eta}{\eta}$.

They then draw a 'raw' productivity level z from a distribution given by $F_j(\cdot)$. Once firms discover their raw efficiency, they choose the size of the city where they want to produce and whether they want to export to other countries.

City developers Within countries, each potential city site is administered by a city developer. Each city developer i announces a city size L and competes with other city developers to attract firms to their city by subsidizing firms' operational profits (defined as total revenues minus variable costs of production, which equals profits gross of any fixed production costs in the model). Thus city developers also announce the level of subsidies to local firms' operational profits in sector j, which may vary with the firm's 'raw' productivity z, $T_j^i(L, z)$.[40] Developers are funded by fully taxing the profits made by landlords on the housing market. City developers are therefore the residual claimants on local land value and their objective is to maximize land rents net of the cost of the policies they put in place to attract firms.[41] There is perfect competition and free entry among city developers, which drives their profits to zero in equilibrium.

4.2 International Trade Costs and Selection Into Exporting

To complete the link between our multi-country version of the Gaubert (2018) model and our subsequent analysis of the economic geography of exporting, we now specify the international trade frictions faced by firms that aim to ship their goods internationally. In order to export to other countries, firms need to pay a sector-specific fixed export cost f_j^e in terms of the final good for each foreign country that it wants to export to. In addition, firms' exports are subject to iceberg transportation costs τ. Importantly, these costs are symmetric for all locations within the source country (i.e., a firm locating in any city in the source country will face the same international trade costs) and across all destination countries (the same trade costs apply to all country pairs). This setup yields a standard mechanism of selection into exporting, with firms above a certain sector-specific threshold of 'realized' productivity $\underline{\psi}_j$ selecting to export, while firms below that threshold remain domestic. Moreover, given the symmetry of the problem, firms will either find it optimal to be purely domestic or to export to all countries (if it is profitable for a firm to export to one country, it is profitable to export to all countries).

With the above setup in place, we now proceed to describe the key spatial equilibrium conditions, i.e., those characterizing workers and firms.

[40] In principle, developers could set different subsidies by variety i, firm efficiency z, sector j and target city size L. In equilibrium, however, developers will choose a constant subsidy as is shown below.

[41] As is standard in the literature (e.g. Henderson (1974)), the role of these developers is to solve a coordination failure: atomistic agents such as firms, workers, or landowners alone cannot create new cities. This results in multiple equilibria in which cities of suboptimal size persist due to the failure of atomistic agents to coordinate on creating new cities. City developers are, in contrast, large players at the city level and act as a coordinating device that allows a unique equilibrium to emerge in terms of the city-size distribution.

Spatial Equilibrium: Workers and Firms We begin our discussion of the key spatial equilibrium conditions with an analysis of workers. We denote by P the aggregate price index for the composite tradable good in the home country, and by $c(L)$ and $h(L)$ the consumption of the tradable composite good and housing, respectively, for a worker residing in a city of size L. We can then write the budget constraint for such a worker as:

$$Pc(L) + p_H(L)h(L) = w(L).$$

Since goods are freely tradable within countries, all cities have symmetric access to foreign markets, and countries are symmetric, the price indices denoted by P are the same across all cities in all countries. Moreover, given the housebuilding technology in equation (7) and the housing market clearing condition, the quantity of housing consumed in equilibrium by each worker in a city of size L is given by:

$$h(L) = (1-\eta)^{1-b} L^{-b} \tag{9}$$

Intuitively, housing consumption is lower in larger cities because cities are land constrained. This yields a congestion force that counterbalances the positive production externalities that occur in cities and thus precludes the complete agglomeration of each country's economy into only one city.

The free mobility of workers and the symmetry of countries guarantees that in equilibrium worker utility must be equalized across all inhabited locations within each country. We denote this common level of utility $\bar{U}$. As a result, wages must increase with city size to compensate workers for the higher cost of housing in these locations:

$$w(L) = \bar{w}\left(\left(1-\eta\right)L\right)^{b\frac{1-\eta}{\eta}} \tag{10}$$

where following Gaubert (2018) $\bar{w} = \bar{U}^{\frac{1}{\eta}} P$ denotes a country-wide constant that is determined in general equilibrium. However, this constant will be the same in all countries due to symmetry.

We can now proceed to characterize the spatial equilibrium condition for firms, whose location choices are the main driver of economic geography in the model. Firms choose city size based on three factors. First, the price of labor varies by city size. Second, firm productivity increases with city size, as a result of stronger agglomeration externalities. Third, firms stand to benefit from subsidies to operational profits (profits gross of any fixed exporting costs paid) offered by local city developers. The firm's problem can thus be solved recursively. For a given city size, the problem of the firm is to hire labor and set prices to maximize profits, taking as given the size of the city (and hence the size of the externality term), input prices, and subsidies. Then, firms choose location to maximize this optimized profit. When maximizing profits, firms treat local productivity as exogenous, so that the agglomeration economies take the form of external economies of scale.

Consider a firm of efficiency z producing in sector j and in a city of size L. Denoting by P_j the price index in sector j (which again by symmetry will be the same in all countries) and given CES preferences, firms face demand curves of the type:

$$c_j(i) = p_j(i)^{-\sigma_j} P_j^{\sigma_j - 1} E_j \tag{11}$$

Where E_j represents total expenditure in sector j in the (home) country (by symmetry this will be the same in all countries). Given monopolistic competition, firms set constant mark-ups over marginal costs yielding profits before subsidies on the domestic market:

$$\pi_j^D(z, L) = \frac{1}{\sigma_j^{\sigma_j}} (\sigma_j - 1)^{\sigma_j - 1} \left[\frac{\psi(z, L, s_j)}{w(L)}\right]^{\sigma_j - 1} E_j P_j^{\sigma_j - 1} \tag{12}$$

Moreover, for each foreign country c', a firm may make profits from exporting given by the expression

$$\pi_j^{Exp\ c'}(z, L) = \begin{cases} \frac{\pi_j^D(z,L)}{\tau^{\sigma_j - 1}} - P f_j^e & \text{if } \frac{\pi_j^D(z,L)}{\tau^{\sigma_j - 1}} >= P f_j^e \\ 0 & \text{if } \frac{\pi_j^D(z,L)}{\tau^{\sigma_j - 1}} < P f_j^e \end{cases} \tag{13}$$

Given that in equilibrium each firm will either export to no foreign countries or to all foreign countries, a firm's total profits from exporting will be given by

$$\pi_j^{Exp}(z, L) = \begin{cases} \frac{(C-1)\pi_j^D(z,L)}{\tau^{\sigma_j - 1}} - (C-1) P f_j^e & \text{if } \frac{\pi_j^D(z,L)}{\tau^{\sigma_j - 1}} >= P f_j^e \\ 0 & \text{if } \frac{\pi_j^D(z,L)}{\tau^{\sigma_j - 1}} < P f_j^e \end{cases} \tag{14}$$

It is straightforward to show that domestic profits given by (12) are increasing in z when holding L constant. As a result, for each sector and city size there may exist a $z_j^*(L)$ such that a firm remains domestic if $z < z_j^*(L)$ and exports to all countries if $z \geq z_j^*(L)$[42]. As a result we can write a firm's operational profits as

$$\pi_j^o(z, L) = \begin{cases} \pi_j^D(z, L) & \text{if } z < z_j^*(L) \\ \left[1 + \frac{(C-1)}{\tau^{\sigma_j - 1}}\right] \pi_j^D(z, L) & \text{if } z \geq z_j^*(L) \end{cases} \tag{15}$$

[42]This $z_j^*(L)$ satisfies the condition $\pi_j^D(z_j^*(L), L) = P f_j^e$. If for a certain sector j and city size L such a $z_j^*(L)$ does not exist, it means that in that sector and at that size level we either have that firms of all productivities would be domestic, or firms irrespective of productivity would be exporters. In this case the relevant expressions for profits would prevail.

While a firm's total profits before subsidies are given by

$$\pi_j^T(z,L) = \begin{cases} \pi_j^D(z,L) & \text{if } z < z_j^*(L) \\ \left[1 + \frac{(C-1)}{\tau^{\sigma_j - 1}}\right] \pi_j^D(z,L) - (C-1)Pf_j^e & \text{if } z \geq z_j^*(L) \end{cases} \tag{16}$$

Finally, firms receive subsidies to operational profits (profits gross of any fixed costs of exporting paid) from the city developers, which yields total profits after subsidies

$$\pi_{Sub,j}^T(z,L) = \begin{cases} (1 + T_j(z,L))\, \pi_j^D(z,L) & \text{if } z < z_j^*(L) \\ (1 + T_j(z,L)) \left[1 + \frac{(C-1)}{\tau^{\sigma_j - 1}}\right] \pi_j^D(z,L) - (C-1)Pf_j^e & \text{if } z \geq z_j^*(L) \end{cases} \tag{17}$$

The problem of the firm thus is to choose the city size L to maximize (17).

4.3 Equilibrium Existence, Uniqueness and Stability

With the setup outlined in the previous two sections, we can define a spatial equilibrium of the world economy as follows:

Definition 1. *An equilibrium is, for each country, a set of cities $\mathcal{L}$ characterized by a city-size distribution $f_L(.)$, a wage schedule $w(L)$, a housing-price schedule $p_H(L)$ and for each sector $j = 1, ..., S$ a location function $L_j(z)$, an employment function $l_j(z)$, a production function $y_j(z)$, a price index P_j and a mass of firms M_j such that:*

1. *workers maximize utility given $w(L)$,$p_H(L)$ and P_j,*
2. *utility is equalized across all inhabited cities,*
3. *firms maximize profits given $w(L)$ and P_j, and choose whether to participate in export markets,*
4. *landowners maximize profits given $w(L)$ and $p_H(L)$*
5. *city developers choose $T_j(L,z)$ to maximize profits given $w(L)$ and the firm problem,*
6. *labor, goods and housing markets clear; in particular, the labor market clears in each city,*
7. *firms and city developers earn zero profits.*

Building on the work of Gaubert (2018) it is possible to show that the there exists an unique equilibrium of the model (proofs are relegated to Appendix A). Moreover this equilibrium is stable.[43] Intuitively, our assumptions guarantee that, within each sector and country, for each firm type there exists a unique optimal city size that maximizes profits. Moreover, due to the assumed

[43] The equilibrium is said to be stable if no deviation of any small mass of individuals or firms from a given city to another city or empty site enhances their utility. This definition of stability is commonly used in the literature (see Behrens et al. (2014) for example).

complementarity between intrinsic productivity z and city size, the optimal city size is increasing in the firm's intrinsic productivity. The presence of competitive city developers ensures that, within countries, the optimal city size of each firm type and sector, is provided in equilibrium. As a result, the assignment of firms to city sizes can be uniquely pinned down in equilibrium for all countries and sectors, which in turn uniquely pins down the realized productivity of all firms. This in turn allows us to recover the values of general equilibrium quantities: total expenditure for each country, the mass of firms by sector in each country, the sectoral price indices in each country and sector, the export productivity threshold in each country and sector. Finally, the mass (or 'number') of cities of each type endogenously adjusts in equilibrium such that labor markets clear.

The equilibrium is unique in terms of distribution of outcomes within countries, such as firm-size distribution, city-size distribution and matching functions between firms and city sizes within countries. It is not unique in terms of which site is occupied by a city of a given size, as all sites are identical ex ante.

4.4 Equilibrium Properties: Matching the Stylized Facts

In what follows we highlight the main characteristics of the equilibrium, with a focus on describing how the model matches the stylized facts we've documented above. To set the stage for presenting our main results, it is helpful to note that as in Gaubert (2018), the equilibrium is characterized by strict ranking of firms in terms of productivity, profits and revenues vis a vis city size. We restate this result, already present in Gaubert (2018), more formally in the lemma below

Lemma 1. *In equilibrium, within each country and sector, firm revenues, profits and productivity increase with city size in the following sense. For any $L_H, L_L \in \mathcal{L}$ such that $L_H > L_L$, take z_H such that $L_j^*(z_H) = L_H$ and $L_j^*(z_L) = L_L$. Then $r^*(z_H) > r^*(z_L), \pi^*(z_H) > \pi^*(z_L), \psi^*(z_H) > \psi^*(z_L)$.*

These strong predictions are a direct consequence of the perfect sorting of firms, which naturally yields a ranking of firm productivity with respect to city size. In turn this productivity ranking is reflected in an identical ranking in terms of firm profits and firm size by revenues (as the mapping from firm productivity to revenues and profits is a monotonic bijection in equilibrium). Notably, Lemma 1 is silent on the association between employment and city size. This is because the relationship between (average) firm employment and city size is ambiguous: firm employment can be either positively or negatively associated with city size due to the effect of wages. More precisely within a sector, it is straightforward to see that $l^*(z) \propto r^*(z)/w(L^*(z))$, where both firm revenues and wages increase with city size. Firms may thus have lower employment in larger cities, even though they are more productive and profitable.

We now proceed to describe the properties of the equilibrium concerning the distribution of exporting activity across space. These properties speak directly to the stylized facts we have documented and are described in the following proposition:

Proposition 1. *In equilibrium, within each country and sector, firm exports and export intensity (i.e. exports/sales) weakly increase with city size in the following sense. For any* $L_H, L_L \in \mathcal{L}$ *such that* $L_H > L_L$*, take* z_H *such that* $L_j^*(z_H) = L_H$ *and* $L_j^*(z_L) = L_L$*. Then* $Exp^*(z_H) \geq Exp^*(z_L), Expint^*(z_H) \geq Expint^*(z_L)$*.*

Corollary 1. *For any pair of cities that feature no differences in their sectoral composition, the larger one will be characterized by weakly larger overall export intensity.*

As intrinsically more productive firms sort into bigger cities, they become even more productive as they benefit from agglomeration economies. The resulting productivity differences imply that firms in larger cities are more likely to jump over the 'Melitz barrier" and engage in exporting. This produces a positive correlation between export intensity and city size within sectors. However, it is important to note that within sectors, larger cities only export strictly more than smaller cities for pairs of cities that are "on the opposite sides" of the sector-specific exporting threshold z_j^*. Above and below the exporting threshold export intensities for a given sector are constant with city size - export intensity is zero for all cities hosting firms with intrinsic productivity $z < z_j^*$ and given by $\frac{C-1}{\tau^{\sigma_j - 1}}$ for all cities hosting firms with intrinsic productivity $z > z_j^*$. This result is an artefact of the perfect sorting predicted by the model, with each city having a degenerate firm productivity (and hence firm size) distribution within sectors, coupled with the standard Melitz (2003) prediction that the export intensity of exporters does not vary with firm productivity. Model extensions allowing for imperfect sorting would predict a smooth, monotonically increasing relationship between export intensity and city size.[44].

The result in Corollary 1 can be established via a two step aggregation. In the first step, we aggregate the exporting result from the firm level to the level of city-sector cells. This is trivial, given that in the model each city size bin only hosts a single type of firm, so city-sector cells preserve all the properties of the unique firm size that they host. In a second step we note that export intensity at the city level is given by:

$$Expint_c = \frac{Exports_c}{Output_c} = \frac{\sum_{j=1}^{S} Exports_{cj}}{Output_c} = \frac{\sum_{j=1}^{S} Expint_{cj} Output_{cj}}{Output_c} \tag{18}$$

Which can be rewritten as

$$Expint_c = \sum_{j=1}^{S} Expint_{cj} \frac{Output_{cj}}{Output_c} \tag{19}$$

[44] Indeed, in the quantitative section of the paper, we present a stochastic extension of the model that allows for imperfect sorting of firms across cities of different sizes. In this extended model the results on exporting are stronger. If we allow firm productivity to be given by a deterministic component given by $\psi(.,.,.)$ and stochastic multiplicative shock distributed independently of city size, then we obtain the result that average export intensity strictly increase with city size, at least beyond a certain city size threshold.

In the last equation, if the sectoral shares $\frac{Output_{cj}}{Output_c}$ (i.e. the sectoral composition) are identical for two cities of different sizes, then the relative export intensity of the two cities will be driven by the within-sector export intensity terms (i.e. the $Expint_{cj}$ terms), which the main proposition has shown to be weakly higher in larger cities.

It is important to note that the results outlined in Proposition 1 do not depend on our assumptions regarding the presence of city developers. While the presence of city developers ensures the uniqueness of equilibria, the properties outlined in Proposition 1 would apply to any equilibrium (in other words, in the absence of city developers the model will have multiple equilibria, but all equilibria will satisfy the properties outlined in Proposition 1).

All in all, the results outlined in Proposition 1 and Corollary 1 indicate that the model is able to qualitatively match all the key stylised facts outlined in the previous section. In line with the evidence presented, the model predicts a positive association between export intensity and city size (Fact 1) driven by within sector variation (Fact 2). Moreover, in line with Fact 3, the model predicts that the within sector positive association between export intensity and city size is driven by the extensive margin of firm selection into exporting, with the export intensity of exporters being unrelated to city size.

Finally, as in Gaubert (2018), the model is able to match the observed city size distribution. In particular, the model predicts that the city size distribution will obey Zipf's law (i.e. the city size distribution follows a power law, more precisely a Pareto distribution with exponent -1). This feature of the model is captured in the next proposition:

Proposition 2. *If the firm size distribution in domestic revenues within countries follows Zipf's law, a sufficient condition for the upper tail of the city size distribution to follow Zipf's law is that domestic revenues increase with constant elasticity with respect to city size in equilibrium.*

4.5 Welfare Analysis

The competitive equilibrium derived in section 4.3 can be shown to be inefficient, as firms tend to locate in cities that are too small. The intuition for this result is as follows. The social marginal benefit of choosing a larger city is higher than the private benefit perceived by firms through their profit function. There are two related benefits of choosing a larger city that are not fully internalized by firms: (1) first, choosing a larger city increases the productivity of the economy which lowers the entry cost of firms into a sector (Pf_j); (2) second, the same productivity effect of choosing larger cities lowers the entry cost into exporting (Pf_j^e). The latter is a new effect that appears in our open-economy, multi-country model and was absent in existing work. Fostering entry and entry into exporting increases welfare, by the love of variety effect. Firms ignore the effect of their choice of city size on the cost of entry and the cost of entry into exporting, and therefore choose cities that are too small compared to the social optimum. This general equilibrium cross-city and cross-country effect is not internalized by firms nor by city developers who, despite being large local players, are still atomistic at the national and international levels.

4.6 Comparative Statics

One of the key features of the the model is that allows us to study the joint determination of international trade and economic geography. In this section we briefly outline some of the comparative static properties of the model. In particular we highlight how the model allows us to study the impact of trade policy on within country economic geography.

Let us consider the implications of opening up to international trade on internal geography. Within sectors, the spatial reallocation of employment associated with trade liberalization is straightforward to characterise and is outlined in the proposition below

Proposition 3. *Within sectors, opening up to international trade leads to a shift in employment to larger cities in the following sense: for any city size L in the support of the city size distribution we have that*

$$\left(\frac{\int_{z_j(L)}^{\infty} Emp_j(z_j)dz_j}{\int_0^{z_j(L)} Emp_j(z_j)dz_j}\right)_{open} \geq \left(\frac{\int_{z_j(L)}^{\infty} Emp_j(z_j)dz_j}{\int_0^{z_j(L)} Emp_j(z_j)dz_j}\right)_{closed} \tag{20}$$

It can easily be seen from equation (A.8) that opening up to trade has no impact on the matching function between firms and cities in any sector, and hence no impact on realized firm productivities. Moreover, under the assumption of the presence of city developers this in turn implies that the support of the city size distribution does not change when trade costs change.

What opening up to trade does is increase the size of the more productive firms, who become exporters, relative to less productive firms. This shift takes place within all sectors. In response, the mass of cities accommodating the workers of these new exporting firms need to grow for labor markets to clear. Since these new exporters are located in larger cities relative to non-exporters the cumulative employment share of the relatively larger cities will increase.

On the other hand, the overall implications of trade openness on the city size distribution are highly complex, as we need to keep track of which sectors are most affected by opening up to trade and where these sectors tend to locate. If the sectors that tend to locate in large cities have low fixed exporting costs, opening up to trade will tend to shift population towards the largest cities. If, on the other hand, the sectors that benefit most from trade openness (because of low fixed costs of exporting) tend to locate in medium sized or even small cities we may see the largest shifts in population towards cities in these size bins.

5 Quantitative Analysis

In this section we take the model to the data. We first present the main features of the estimation procedure. We then show how the model fits our main stylized fact for the Chinese economy.

Finally, we provide quantitative results for the effect of (i) trade liberalization and (ii) spatial policies on welfare and productivity.

5.1 Structural Estimation

Functional Forms

The first step to estimate the model is to specify the productivity process. In the model, firms sort perfectly into cities and into exporting according to their raw efficiency z. This produces the stark prediction that small cities have no productive firms nor exporters. Yet, in the data, small cities feature both productive and unproductive firms, and they may produce for the domestic or foreign markets. To accommodate these facts, we modify the baseline model in two ways. First, we introduce a disturbance term in ex-post productivity that varies across firms and cities. This reflects the fact that firms may be more productive in certain locations, for example because they have better knowledge of the local culture and can organize production in a more efficient way. The resulting productivity process features two sources of randomness: raw productivity (z), and a idiosyncratic productivity shock ($\varepsilon_{i,L}$) that varies across firms and cities. In this way, we allow firms to sort imperfectly into cities of different sizes.

We specify the same functional form for ex-post productivity ψ (including agglomeration economies related to the firm's optimal city choice) as Gaubert (2018):

$$\log(\psi_j(z_i, L, s_j)) \quad = \quad a_j \log L + \log(z_i) \left[1 + \log \frac{L}{L_0}\right]^{s_j} + \varepsilon_{i,L} \tag{21}$$

where L_0 denotes the size of the smallest city, and $\{a_j, s_j\}$ are sectoral parameters. Equation (21) shows that ex-post (log) productivity ψ is composed by three terms. The first term ($a_j \log L$) represents the classical agglomeration mechanism: Firms are more efficient when they locate in larger cities. The second term represents the log-modularity between firms' raw efficiency z and (normalized) city size (L/L_0). According to this, firms' raw productivity z and city size L are complementary: Initially more productive (high z) firms benefit relatively more from locating in larger cities (provided that s is greater than zero). Finally, the last term $\varepsilon_{i,L}$ is an idiosyncratic term that varies across firms and cities. Importantly, this term is distributed independently of firm's raw productivity z. Thus, regardless of the level of raw productivity z, firms can still find optimal to locate in smaller cities.

We assume that raw productivity z follows a log-normal distribution with mean zero and variance σ_Z. We restrict the process for $\log z$ to be non-negative to ensure that ex-post productivity ψ increases with city size. Consequently, the distribution for $\log z$ is truncated at zero. Regarding the idiosyncratic term $\varepsilon_{i,L}$, we assume that it is distributed type-I extreme value. We restrict the parameters so that the mean of the process is equal to zero. With this restriction, the distribution is determined solely by the scale parameter β_ε.[45]

In the model, firms become exporters with probability one after the surpass the export productivity threshold. Yet, in the data, not all highly productive firms are exporters. To accommodate this stark prediction of the model, we specify a Pareto distribution for the probability of becoming exporters, as an increasing function of the relative distance of firms' ex-post productivity from the export productivity threshold in each city, $\psi_j^*(L)$:

$$\text{Pr(Export>0)} = \begin{cases} 1 - \left(\frac{\psi_j(z_i,L,s_j)}{\psi_j^*(L)}\right)^{-\theta}, \text{ with } \theta > 0 & \text{if } \psi_j(z_i,L,s_j) \geq \psi_j^*(L) \\ 0 & \text{otherwise} \end{cases} \tag{22}$$

Note that this parametrization is consistent with more productive firms having a higher probability of becoming exporters. At the same time, this specification relaxes the step-function for export probability by the canonical Melitz's (2003) model. Firms with productivity just above the export productivity threshold have an export probability marginally above zero. The export probability increases continuously until eventually reaching one for high enough productivity levels.

Estimation Procedure

To estimate the model, we use the data from the Chinese Census of Manufacturing (see Section 2, for details). To match the relative size of China in the world economy in 2004, we consider a world with 20 symmetric countries. The estimation is carried out sector-by-sector for each 2-digit manufacturing ISIC industry.[46]

The estimation strategy proceeds in two steps and follows Gaubert (2018). We first calibrate all parameters that can be directly linked to the data $\{\sigma_j, \xi_j, b(1-\eta)/\eta, \tau_j\}$. The elasticity of substitution σ_j is set to match the average 2-digit markup, computed at the the establishment-level using the procedure outlined by De Loecker and Warzynski (2012). The Cobb-Douglas sectoral share ξ_j is computed as the share of each sector's value added within the manufacturing sector. The composite parameter $b(1-\eta)/\eta$ corresponds in the model to the elasticity of wages to city size. This elasticity is equal to the difference between the elasticity of average value-added to city size minus the elasticity of average employment to city size.[47] Thus, we run regressions for the logarithm of average city-level value-added, and the logarithm of average city-level employment as dependent variables, against the logarithm of urban population of the city size, and then subtract the coefficient on log city size from the former regression to the corresponding coefficient on the

[45] The location parameter λ can be recovered explicitly as a function of the scale parameter β_ε. In particular, the restriction $\mathbb{E}(\varepsilon) = 0$ implies that $\lambda = -\gamma\beta_\varepsilon$, where γ is the Euler-Mascheroni constant.

[46] We consider a total of 19 industries. We exclude manufactures of Tobacco products, and merge (i) manufactures of coke, refined petroleum products and nuclear fuel with manufactures of chemicals and chemical products, and (ii) office, accounting and computing machinery with manufactures of electrical machinery.

[47] To see why this is the the case, note that $w(L)l_j(z,L) = (\sigma_j - 1)/\sigma_j r_j(z,L)$, where r represents firm revenues.

latter regression. Finally, the iceberg variable trade cost τ_j is set to match the average export intensity within exporting firms.[48]

In the second stage, we estimate the remaining parameters $\{a_j, s_j, \sigma_Z, \beta_\varepsilon, f_j^e, \theta\}$ through simulated method of moments (SMM). This method compares the objective moments in the data to the moments derived from a simulated economy, for candidate values of the parameters to be estimated. The vector of estimated parameters $\hat{\theta}_{SMM}$ are such that they minimize the weighted distance between the moments in the data ($\mathbf{m}_j$) and the simulated economy ($\hat{\mathbf{m}}_j(\theta_j)$):

$$\hat{\theta}_{j,SMM} = \arg\min_{\theta_j} (\hat{\mathbf{m}}_j(\theta_j) - \mathbf{m}_j)^T W_j (\hat{\mathbf{m}}_j(\theta_j) - \mathbf{m}_j) \tag{23}$$

In equation (23), the matrix W_T weights the vector of moments. We set this matrix to be equal to the inverse of the variance-covariance matrix of the moments. To compute this matrix, we follow Eaton, Kortum, and Kramarz (2011) and compute bootstrapped standard errors of the moments resampling within industry-cities (with replacement) 5,000 artificial economies with the same number of firms as in the Chinese Census of Manufacturing in 2004.

Choice of Moments and Identification

We now discuss the moments we choose to target in the SMM estimation. Table 5 summarizes these moments, together with the parameter each moment aims to identify. The first set of moments relate to $\{a_j\}$. This parameter summarizes classical agglomeration forces: as a_j gets larger, productivity and revenues increase with city size. Accordingly, we define the target moment as the share of value added produced by firms located in cities of different sizes. We construct the moment in the following way. For each sector, we sort cities in terms of population, and define city groups in terms of quartiles of cumulative population (e.g., the first group contains all smallest cities in the economy, until that their population add up to 25 percent of the overall population). Then, we compute four moments as the share of value-added produced by firms located in each of the population quartiles. Thus, the first set of moments match by how much the share of sectoral value added increases with the size of the cities.

The second set of moments relates to $\{s_j\}$, which determines the strength of the complementarity between raw productivity z and city size. To identify this parameter, we seek to match the average value added of firms in relatively large cities. Intuitively, for a given productivity z, the higher is the value of s_j, the stronger is the increase of firm productivity and revenues in city size. Formally, we divide cities in four quartiles by size, and then compute the average value-added of the firms locating in each quartile. We emphasize the top quartile of the city size distribution: differences in s_j will affect relatively more the slope of average value added in relatively large cities,

[48] In the model, the average export intensity conditional on exporting is equal to $\left(1 + \frac{\tau^{\sigma_j - 1}}{(C-1)}\right)^{-1}$.

while it will tend to have a more modest impact in relatively smaller cities.

The third set of moments relate to the scale parameter of the idiosyncratic productivity shock (β_ε). This parameter varies by firm and city size, and it accounts for relatively productive firms locating in small cities. To identify this parameter, we target the average value added of firms in small cities. Through the lens of the model, if average value added in small cities is high, it must be because some highly productive firms are choosing to locate in these cities. Thus, as β_ε increases, we expect the average value added of firms locating in small cities to increase. Formally, this moment is defined analogously to the second set of moments, but with an emphasis on the bottom quartile of the city size distribution.

The fourth set of moments relate to the variance of the truncated log-normal distribution of raw productivity, σ_z. To identify this parameter, we target the top decile of normalized sales across all cities.

Finally, to identify the fixed export cost and the Pareto shape parameter θ, we target the national-level export-related moments. First, to identify the fixed export cost, we target the fraction of firms that are exporters in the data. Intuitively, a higher fixed export cost affects the extensive margin of exporting. As this cost increases, fewer firms will be sufficiently profitable to pay the fixed export cost and participate in export markets. Second, to identify θ, we target the industry-level export intensity, defined as overall exports over sales across all city sizes. Conditional on the fixed export cost, a higher export intensity requires a less disperse exporting probability distribution, leading to a higher level of the shape parameter θ.

Model Fit

The model generally matches the moments in the data well. Table B.6 shows the estimated coefficient for each 2-digit sector, and Table B.7-B.8 compares each data moment to the corresponding moment of the simulated model. Notably, the model replicates the average firm size and the distribution of economic activity across city sizes. Average value-added increases with city size in most sectors (Figure B.4), which in the model occurs due to agglomeration economies and the sorting of most productive firms into larger cities. Similarly, the model fits quite closely the distribution of total employment across quartiles of city size (Figure B.5). Note that the model does not directly target this last moment. Finally, the model fits well the distribution of overall firm-size distribution for most sectors (Figure B.6), which is quite surprising given that the estimation of the model only targets the top decile of the firm size distribution.

To get a sense of how the model fits export-related moments, we estimate the export-size premium implied by the simulated model. This is a non-target statistic that combines information about the estimated productivity distribution and fixed and variable trade costs.[49]

[49]To compute this statistic in the model, we simulate the model using the estimated sectoral parameters. After obtaining draws for intrinsic (z) and idiosyncratic productivity ($\varepsilon_{i,L}$), we solve the firms' location and export decisions

Table 6 shows results for the export-size premium, using the Chinese Census of Manufacturing (columns 1-3) and the simulated model (columns 4-6). Specifically, we estimate a linear regression of firm-employment (in logarithm) against a dummy taking the value one for exporters, controlling for industry (columns 2 and 5) or industry-city fixed effects (columns 3 and 6).[50] Quite remarkably, we obtain similar export-size premiums in the model and data, even though the model does not directly match this moment. Across specifications, the model slightly underestimates the export-size premium, in about 8-11 percent of the premium observed in the data.

5.2 Export Intensity and City Size

We now discuss the model's fit to our main stylized fact, related to the positive relationship between export intensity. This pattern is not directly targeted by our estimation strategy. Thus, our results in this section can be used to evaluate the mechanisms highlighted by the model – firm sorting and agglomeration, plus selection into exporting.

We simulate an economy with 200 equally-spaced city size bins. The support of the city size distribution in the simulated economy resembles the Chinese data described in section 3. Note that although the grid of city sizes is fixed, the effective city size distribution is determined endogenously in the model as a result of sorting and agglomeration forces. For each sector, we draw 20,000 realizations of raw productivity z and 20,000$\times$200 realization of idiosyncratic productivity shocks (one for each potential city size). Then, we solve the firms' problem and determine: (i) optimal city size and (ii) export participation.[51] Conditional on these choices, we solve the general equilibrium problem, taking the effective number of firms in each sector as the equilibrium mass of firms $\{M_j\}$ of the economy. This leads us to the equilibrium values for sectoral prices $\{P_j\}$, aggregate revenues $\{R\}$ and the export productivy threshold $\{\psi^*(L)\}$.[52] Once we obtain these values, we compute revenues and export value, and construct city-level export intensity as the share of aggregate exports to revenues, both defined at the level of city sizes.

Figure 2 shows the main result. It plots (log) export intensity against (log) city size for the model (red-squared symbols) and data (blue-dotted symbols). For both, model and data we plot a

and the general equilibrium problem. Finally, we use the equilibrium objects and parameters to compute employment, revenues, and exports for each firm.

[50]We do not directly include geographical controls because market access does not vary with city size in the model. Nevertheless, in our most restrictive specification, the industry-city fixed effects account for the average impact of market access on optimal firm size.

[51]In the model, these decisions are independent from each other. Firms' location choice weights the strength of agglomeration economies over ex-post productivity ψ against congestion forces leading to more expensive labor costs. Thus, once firms choose their optimal city, the export decision affects the level of revenues and employment demand.

[52]Unlike the theoretical model, in the empirical model the export productivity thresholds varies with city size. This is directly related to the fact that in the theoretical model, firms sort perfectly into city sizes. As a consequence, there is only one city size featuring both domestic firms and exporters. This city defines the only relevant export productivity threshold. In contrast, in the model with imperfect sorting, all cities may feature exporters. Since labor costs vary across cities, exporting requires a higher productivity threshold in larger cities.

solid line represent the regression line that best fits the data.[53] The model produces a remarkable positive relationship between city size and export intensity: In the model – as in the data – bigger cities are more export-intensive. The regression coefficient is very precisely estimated at a value 0.167 (robust standard error 0.020), accounting for a large portion of the data variation.[54]

One explanation for the weaker relationship estimated by the model compared to the data relates to how the selection-into-exporting mechanism operates. Conditional on productivity, the probability that a firm exports in the model decreases with city size. Firms in larger cities have to pay higher labor costs, which ultimately reduces the probability of generating enough profits to pay the fixed export costs.[55] In contrast, export activity in the data increases with city size, even after controlling for firm-productivity (see columns 2 and 4 in Table 4). Then, unless we introduce an additional force, the model's ability to perfectly fit this dimension of the data is limited.[56]

5.3 Counterfactual Analysis

This section analyzes the general equilibrium effect of trade and spatial policies. Our goal is to illustrate how economic geography and international trade interact in the model. We first explore the quantitative relevance of economic geography for the computation of gains from trade in terms of productivity and welfare. We then discuss how international trade affects the effectiveness of spatial policies.

5.3.1 Economic Geography and the Effect of Trade Liberalization

We begin comparing the welfare and productivity gains associated with trade openness in our baseline model to a model without geography (e.g. Melitz, 2003). We implement this counterfactual exercise as a symmetrical decline in the variable trade cost τ from prohibitive levels to levels consistent with observed trade flows in all C countries. As τ decreases, firms with realized productivity (i.e., including the effect of agglomeration economies) above the export productivity threshold increase their exports and their share of production sold in foreign markets. Importantly, the decrease in the variable trade cost allows exporters to offer their production at a lower cost in all destination markets, lowering aggregate prices in all countries given the symmetry assumption. This, in turn, induces entry into export markets, as the lower aggregate prices decreases the value

[53] In the case of the model, the regression weights each city-size by the number of cities in each bin.

[54] The model overestimates cities' export intensity, particularly for small cities (less than 500 thousand inhabitants). In these cities, the observed average export intensity is 3.3 percent – 40 percent of the value predicted by the model (8.2 percent). In contrast, in large cities (over 5 million inhabitants), the difference between data and model closes to only 1.6 percentage points (12.8 vs. 14.4 percent).

[55] In the statistical model, this holds in expected values because the conditional idiosyncratic productivity shocks $\varepsilon_{i,L}$ are distributed independently of firms' raw productivity z. As a consequence, two firms with the same z may draw very different $\varepsilon_{i,L}$ in large and small cities, leading them to have higher or lower export probability. However, because $\varepsilon_{i,L}$ has mean zero, it will still be true in expectation that – conditional on z – export participation decreases with city size.

[56] One easy way to improve the fit of the model to the data would be to allow the fixed export cost to fall with city size, perhaps reflecting the existence of better productive amenities – such as infrastructure – in larger cities.

of the entry into exporting. All in all, trade liberalization leads to a reallocation of economic activity towards most productive firms, which grow as a result, leading to an increase in aggregate productivity. Welfare also increases as real incomes grow as the aggregate price index decreases.

An important feature of the model is that the matching function between firms and cities does not depend on the degree of openness to trade of the economy. Indeed, optimal city choice only depends on the strength of agglomeration economies compared to congestion costs. Thus, trade liberalization does not induce additional within-firm efficiency gains due to firms moving to larger cities to profit from agglomeration economies. Differences in aggregate productivity will only arise due to reallocation of resources across existing city size bins.

Relative to the model without geography, the magnitude of the effects of trade openness on welfare and productivity in our baseline model may be smaller or larger. In both models, exporters grow relative to non-exporters by the same scaling factor when the economy is opened to trade, such that the relative gains from trade in the two models are driven by the share of firms that become exporters. In turn this is driven by the relative wages (benchmarked against the national average) faced by the firms on the margin of exporting in the two models. If these are higher in our model, then the gains from opening up to trade are smaller in our model (as a smaller fraction of firms become exporters in our model) while if they are lower the converse is true.

To analyze the effect of trade liberalization, we proceed in four steps. First, we compute general equilibrium quantities and values in the full model with geography. For this, we calibrate the land intensity parameter b as in Gaubert (2018), setting the parameter to match the median housing supply elasticity across U.S. cities (see Saiz, 2010). Second, we simulate the baseline economy following the same steps as in section 5.2. Third, we simulate the counterfactual closed economy, where we set τ to a prohibitively high value. This involves recomputing general equilibrium objects, given that in the counterfactual economy, no firm exports. Finally, we compute aggregate TFP and welfare.[57]

Table 7 computes the aggregate productivity and welfare gains from trade liberalization, both in the baseline model and in the model without geography. To simplify comparisons, we normalize productivity and welfare in both models relative to actual open economy. We find that for both, welfare and aggregate productivity, economic geography considerations substantially dampens the effect of trade liberalization policies. Opening the Chinese economy to trade in the model without geography leads to productivity and welfare gains of 30 and 31%, respectively. In contrast, the gains in our model are about one-third lower: Trade liberalization leads to gains of 23 and 24%

[57]For the economy without geography, we proceed in a similar way, but re-estimating a restricted version of the model with the agglomeration parameters, a and s, and the idiosyncratic productivity term $\varepsilon_{i,L}$ equal to zero. We estimate the parameters $\{\sigma_z, f_x, \theta\}$ targeting the top decile of the firm size distribution, the aggregate fraction of exporters and export intensity in each sector. We show the estimated parameters and discuss how this model fits the data in Appendix C.

in welfare and productivity, respectively. This is consistent with exporters locating in relatively larger cities, where operational profits are smaller relative to a model without geography, where firms face a flat wage schedule across cities.

Note that the gains from trade reported in Table 7 most likely overestimate actual gains, because our economy does not consider non-tradable sectors. Nevertheless, to the extent that the non-tradable sector enters aggregate consumption with a Cobb-Douglas weight, mapping our results to a model with a non-tradable sector is straightforward. In this case, the welfare gains from trade can be easily scaled using the expenditure shares of manufacturing and housing. Using the share of manufacturing and housing in 2004 Chinese real GDP leads to welfare gains of 8.8% in the model with geography and 11.6% in the model without geography. This numbers closely match results in Ossa (2015), who estimates gains from trade for China in a multi-sectoral model using a modified version of the sufficient statistic approach by Arkolakis, Costinot, and Rodriguez-Clare (2012).

5.3.2 International Trade and the Effect of Spatial Policies

Our second counterfactual exercise studies the productivity and welfare effect of the reduction in land-use restrictions studied by Gaubert (2018). We compare the response in the open and closed economy cases. We implement this policy as a (multilateral) reduction in the parameter b, which measures the intensity of land use in the housing production function.[58] Changing this parameter affects both housing supply and the cost of labor across cities. In particular, a reduction in the value of b increases the housing supply elasticity, and flattens the wage schedule across city sizes.

In the model, a less restrictive spatial policy lead to a higher level of aggregate productivity. As b decreases, firms have incentives to move (in average) to larger cities. Ultimately, this relocation process generates improvements in aggregate total factor productivity, due to within-firm efficiency gains, and gains from reallocation of resources. On the one side, firms that move to larger cities benefit of larger agglomeration economies, leading to within-firm efficiency gains. On the other side, these firms become larger, and hire relatively more workers. This produces a reallocation of resources within the economy, which reinforces the within-firm effect and leads to additional gains in efficiency.

Relative to the closed economy case, we expect the reduction in land use restrictions to generate a larger effect on aggregate productivity when the economy is open. Most productive firms have a greater weight in the open economy case, because they can export and increase their revenues. This amplifies the impact of the within-firm gains from the closed economy case. In addition, as we discuss in section 4.6, the model predicts that weakening housing supply restrictions increases the fraction of firms that are exporters. This leads to additional gains – relative to a closed economy

[58]More generally, policies in the open economy case may lead to cross-country spillovers when they are not applied symmetrically in all countries. While this may lead to interesting quantitative results, for now we focus on the the case of multilateral policies to emphasize the different responses of the economies in the open and closed economy cases.

– in the form of reallocation of resources from domestic firms to new exporters.

The property of predetermined city sizes, although convenient analytically for solving the equilibrium of the model, is somehow unrealistic. At least in the short-run, cities grow when the they face increased housing demand. This, in turn, reinforces the within-firm gains and amplifies the overall productivity gains. Thus, when analyzing the general equilibrium effect of policies, we report results a less restrictive interpretation of the model where we allow cities to grow (but the number of cities of each size is fixed).[59]

We proceed in three steps to analyze the effect of changes in b. First, we calibrate the land intensity parameter b. As in Gaubert (2018), we set this parameter to match the median housing supply elasticity across US cities (see Saiz, 2010). Second, we simulate the baseline economy as in section 5.2. Finally, we simulate the various counterfactual economies, where we change the value of b. This involves recomputing: (i) firms' optimal location, (ii) export decision, and (iii) general equilibrium objects. In particular, we vary b so that the housing supply elasticity varies between the 25th and the 75th percentile of the housing supply elasticity across U.S. cities (as defined by Saiz, 2010). Finally, we compute aggregate TFP for all economies. For the closed economy, we proceed in a similar way, but we set the variable trade cost equal to a large number, while we keep the rest of parameters fixed at their open economy values.

Figure 3 plots aggregate TFP against various levels of the housing supply elasticity. In order to simplify comparisons, we compute productivity relative to the level in the baseline economy. Accordingly, when the housing supply elasticity takes the value of the baseline economy (1.75), the value for normalized aggregate TFP is zero. In each panel, we plot the productivity trajectories for the closed (dashed line) and open (solid line) economy cases. Both cases show relatively large changes in aggregate productivity. Taking the economy from the first to the fourth quartile of the housing supply distribution increases aggregate productivity in approximately 10 percent relative to the baseline in the closed economy case. When we compute the same statistic for the open economy, the productivity gains scale up to almost 15 percent. Thus, open economy considerations increases the estimated effectiveness of spatial substantially. In our particular exercise, the effectiveness increases in about 50 percent.[60]

[59]Operationally, the counterfactual exercise involves solving a fixed-point problem: A reduction in b leads firms to move to larger cities. This increases the size of these cities, and their attractiveness in terms of agglomeration economies. This leads to subsequent waves of firms moving to larger cities. This process continues up to the point that congestion costs counterbalance the benefits from agglomeration.

[60]Our estimates are significantly larger than the values estimated by Gaubert (2018) for a closed economy version of the model estimated for France. We note that our estimates are not directly comparable to hers: Gaubert (2018) solves the strict interpretation of the model, with predetermined city sizes. This dampens significantly the productivity response of the economy, as it misses agglomeration gains due to changes in the size of the cities.

6 Conclusion

Trade policy has received renewed interest in recent years, as globalization has been blamed for widening spatial disparities in many developed countries (Ezcurra and Pose, 2013; Dix-Carneiro and Kovak, 2017a; Potlogea, 2018)). In response to this interest, a nascent literature has begun to analyze the interplay between trade and economic geography within countries.

In this paper, we contribute to this literature in three ways. First, using information from three major trading nations – China, the United States and Brazil – we have documented a novel and highly robust stylized fact: Exporting is more unevenly distributed than overall economic activity, and in particular, it is disproportionately concentrated in larger cities. Second, we show that a relatively simple framework can explain this stylized fact, by marrying sorting and agglomeration of heterogeneous firms across space (à la Gaubert, 2018) with an open economy setting and selection into exporting in the spirit of Melitz (2003). The intuition of the model is straightforward: Due to both selection and agglomeration, larger cities feature more productive firms that are more likely to select into exporting. As a result, large and productive cities feature high aggregate export intensities in all sectors. Third, we structurally estimate the model using Chinese firm-level data to recover the shape of agglomeration externalities and the magnitude of fixed exporting costs. We then use the model to undertake counterfactual policy analyses.

Our model is designed to assess the effects of both trade policies and (domestic) spatial policies, giving rise to novel interactions between these two levers. We find that the corresponding welfare implications are richer and differ from those in the more parsimonious standard models that are nested in our framework: a standard trade model that ignores within-country geography, and an economic geography model that shuts down international trade.

Our theoretical framework opens the door for fascinating future work that exploits the interplay of international trade and domestic economic geography. For example, our model naturally lends itself to exploring the rich interactions between local agglomeration forces and (domestic and international) trade costs that are at the core of a variety of policies.

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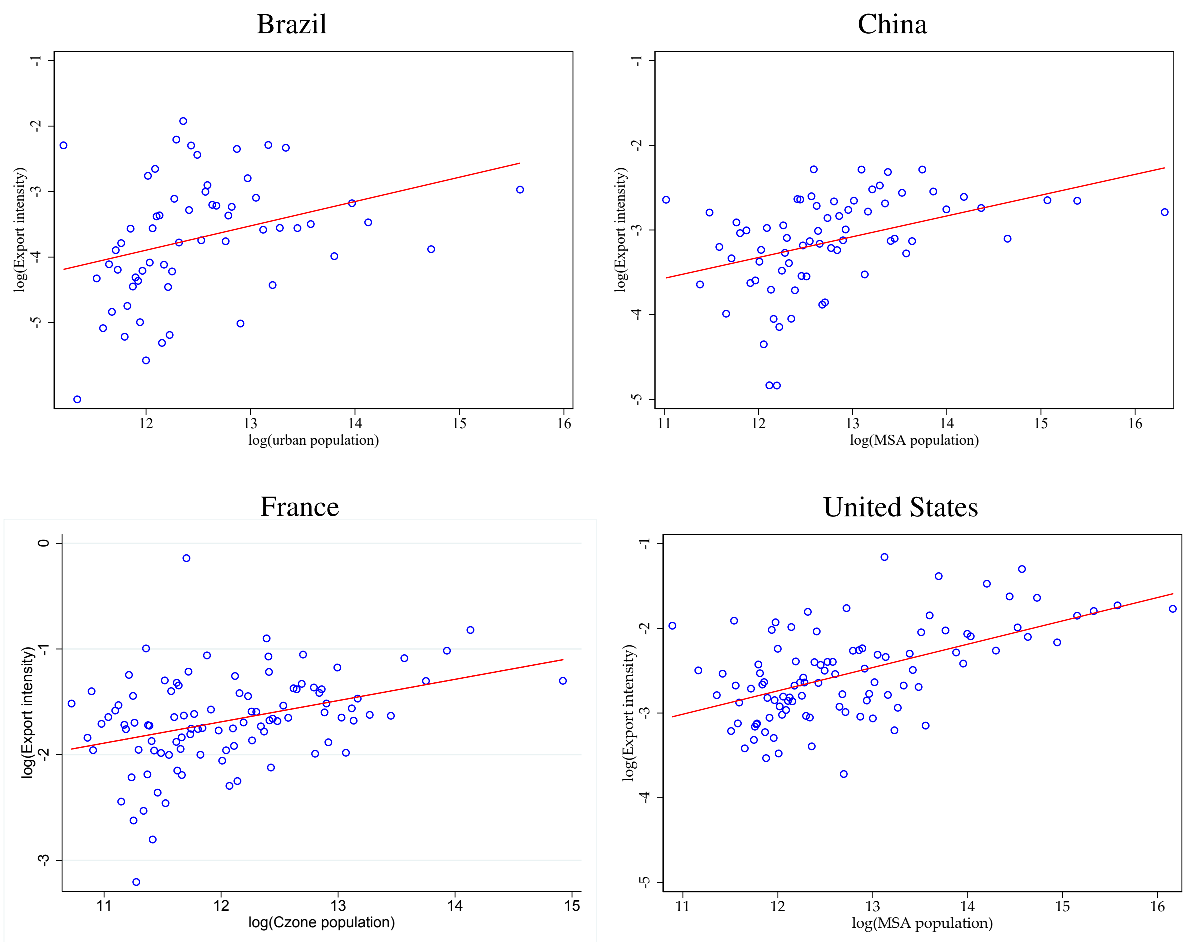
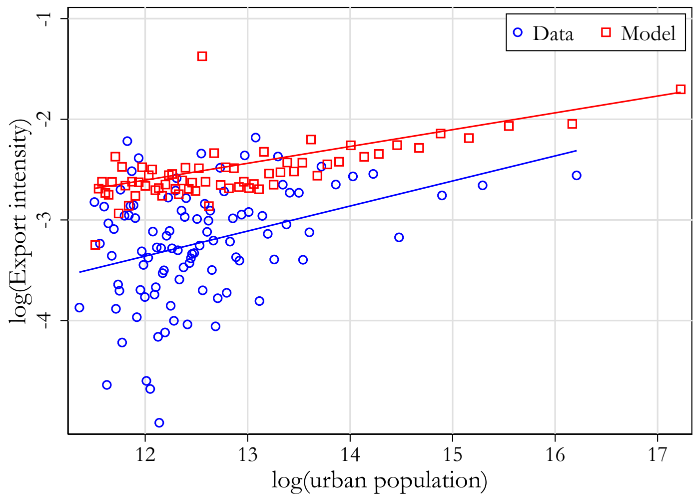
FIGURES

Figure 1: Log Export intensity and Log City size in China, Brazil, France and the United States



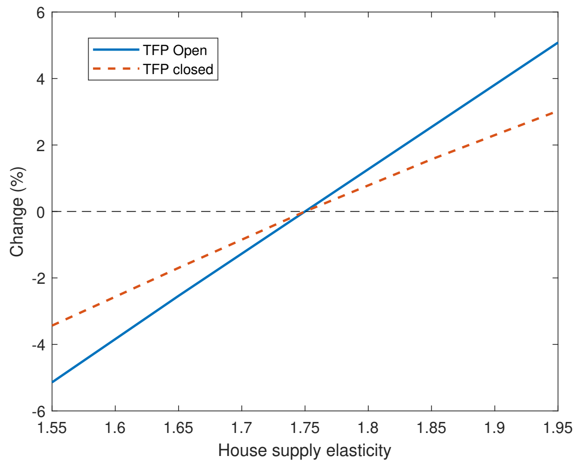
Notes: The figure shows the relationship between city size and export intensity. Cities are defined in terms of metropolitan areas in the cases of China and the United States, and in terms of microregions for the case of Brazil. For all countries, the analysis only considers cities with positive exports and population over 100,000 inhabitants. City-level export intensity is defined as manufacturing exports over manufacturing sales for China; overall exports over manufacturing sales for the United States, and as overall exports over GDP for the case of Brazil.

Figure 2: Export Intensity and City Size in the Baseline Model



Notes: The figure shows the relationship between city size and export intensity predicted by the model. It simulates an economy with 200 city size bins, and 20,000 firms in each sector 2-digit sector. In the simulated economy, we define a log-linear grid over 200 equally spaced city-size bins. The support of the grid of city sizes in the simulated economy resembles the distribution of city sizes in the data. The size of each bubble denotes the number of cities in each city size. The actual number of cities of each size are determined endogenously within the model as a consequence of firms sorting into cities.

Figure 3: Aggregate Productivity Effect of a Reduction in Land Use Restrictions



Notes: The Figure shows the aggregate of aggregate productivity of reducing land-use restrictions. The horizontal shows the housing supply elasticity of the economy, while the vertical axis shows the aggregate TFP response relative to baseline economy. In the model, a less restrictive land use policy is mapped to an increase in the housing supply elasticity. The dashed line shows the closed economy response of aggregate TFP, while the solid line shows the open economy.

TABLES

Table 1: Descriptive Statistics for City Size and Export Intensity Across Datasets

	Population ('000s)				Export Intensity			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Brazil	China	France	U.S.	Brazil	China	France	U.S.
Observations	317	655	210	312	317	655	210	312
Mean	463.0	780.2	258.1	798.8	.0684	.0853	.218	.1131
25th percentile	141.1	185.0	94.6	157.5	.0071	.0228	.136	.0445
50th percentile	203.1	293.4	148.6	277.5	.0358	.0541	.203	.0853
75th percentile	360.7	542.2	287.1	636.6	.0742	.1107	.282	.1370
90th percentile	811.9	1,088.6	490.1	1,929.2	.1845	.2084	.355	.2250
95th percentile	1,469.3	2,214.8	740.5	3,176.1	.2724	.3023	.410	.3292
Cities without exports	—	—	—	—	20	13	0	0

Notes: The Table analyzes the relationship between city size and export intensity. Cities are defined in terms Microregions for Brazil, Metropolitan Areas for China (as defined by Dingel et al., 2019, using lights at night with a threshold equal to 30 to define metropolitan areas) and the United States; and Commuting Zones for France. For all countries, the analysis only considers cities with positive exports and population over 100,000 inhabitants. City-level export intensity is defined as manufacturing exports over manufacturing sales for China; overall exports over manufacturing sales for the United States, and as overall exports over GDP for the case of Brazil.

Table 2: Export intensity and City size in Brazil, China, France, and the United States

Dependent Variable: City-Level Export Intensity

	Brazil		China		France		United States	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
log City Size	.327***	.371***	.326***	.249***	.198***	.197***	.323***	.305***
	(.1210)	(.1424)	(.0490)	(.0452)	(.0467)	(.0493)	(.0351)	(.0366)
Geog. Controls	No	Yes	No	Yes	No	Yes	No	Yes
Mean Dep. Var.:	-3.65	-3.65	-3.14	-3.14	-1.67	-1.67	-2.52	-2.52
R^2	.013	.021	.042	.190	.060	.300	.158	.166
Observations	297	297	642	642	210	210	312	312

Notes: The Table analyzes the relationship between city size and export intensity. Cities are defined in terms of Metropolitan Areas for China and the United States, commuting zones for France, and Microregions for Brazil. For China and France, the analysis considers cities with positive exports and at least 250 manufacturing firms. For Brazil and the United States, the analysis considers cities with a population above 100,000 inhabitants. City-level export intensity is defined as manufacturing exports over manufacturing sales for China and France; overall exports over manufacturing sales for the United States, and overall exports over GDP for the case of Brazil. Geographical controls for Brazil, China, and the United States include a dummy variable for cities located in coastal areas, and the log of the linear distance between the city center and the nearest port. Geographical controls for France include the average distance to other domestic commuting zones, distance to the Western and the Spanish border, dummies for individual country borders, and a dummy for the Atlantic and the Mediterranean coast. Robust standard errors in parentheses. Key: ** significant at 1%; ** 5%; * 10%.

Table 3: Within-Between Sectoral Decomposition

Dep. Var.: Within- and Between Components of City-Level Export Intensity

	China			France		
	(1)	(2)	(3)	(4)	(5)	(6)
Specification:	Within	Between	% Within	Within	Between	% Within
log(City Size)	.183**	.067***	65.0%	.137**	.060**	69.5%
	(.0441)	(.0135)		(.0421)	(.0180)	
Geog. Controls	Yes	Yes	—	Yes	Yes	—
Mean Dep. Var.:	-2.65	-0.49	—	-1.36	-0.31	—
R^2	.140	0.09	—	.171	.179	—
Observations	642	642	—	210	210	—

Notes: The Table decomposes the overall elasticity between city-level export intensity (total exports over sales) and city size into its across and within industry variation. To compute the across-industry component, we first calculate city-industry export intensities at the national average for each industry and then interact them with the sales share of the industry in each city. The within-industry component is computed as the difference between the logarithm of the overall export intensity and the across component (which is also expressed in logs). The sample includes all Chinese metropolitan areas and French commuting zones with at least 250 manufacturing firms. Geographical controls for China and France are described in the notes to Table 2. Robust standard errors in parentheses. Key: *** significant at 1%; ** 5%; * 10%.

Table 4: Export Activity and City Size: Firm-Level Regressions

Dependent Variable: As indicated in table header

	China		France	
	(1)	(2)	(3)	(4)
Dependent Variable:	$\mathbb{I}$(Exports>0)	log(Export Intensity)	$\mathbb{I}$(Exports>0)	log(Export Intensity)
log(City Size)	.0715***	-.0658	.0178**	.0668*
	(.0061)	(.0426)	(.0071)	(.0384)
Geog. Controls	Yes	Yes	Yes	Yes
4-digit Industry FE	Yes	Yes	Yes	Yes
Mean Dep. Var.:	0.262	-2.25	0.751	-2.08
Observations	1,035,664	103,202	194,688	44,276

Notes: The Table analyzes the relationship between city size and firm-level export activity for China and France. Columns 1 and 3 use a categorical variable that takes the value one for firms with strictly positive exports as the dependent variable. Columns 2 and 4 use the logarithm of export intensity as the dependent variable. All regressions are weighted by the sale share of each firm in city-level sales. Cities are defined in terms of metropolitan areas in China and commuting zones for the case of France. The analysis only considers cities with at least 250 manufacturing firms. Geographical controls for China and France are described in the notes to Table 2. Regressions are weighted by firms' total sales shares (within their cities). Standard errors are clustered at the city level. Key: *** significant at 1%; ** 5%; * 10%.

Table 5: Parameters and Target Moments

Parameter	Moment
I. Calibrated Parameters	
σ_j	Average sectoral markup (De Loecker & Warzinsky, 2012)
ξ_j	Sectoral value added share
$\frac{b(1-\eta)}{\eta}$	Elasticity of wages to city size
τ_j	Average export intensity across exporting firms
II. Estimated Parameters	
a_j	Share of value added across city sizes
s_j	Average value added across city size (top quartile)
$\nu_{j,Z}$	Top decile firm size distribution
$\nu_{j,R}$	Average value added across city size (bottom quartile)
f_j^e	National Export probability
θ	National export intensity

Notes: The Table summarizes the target moments we use when taking the model to the data. With the exception of the composite parameter $b(1-\eta)/\eta$, all parameters are computed at the level of 2-digit ISIC sectors (revision 3). The quantitative analysis considers a mixed strategy, calibrating parameters that can be directly mapped to particular moments of the data (upper panel), and estimating the remaining parameters (bottom panel) through simulated method of moments.

Table 6: Export size premium

Dependent Variable: Firm Size (log employment)

	Data			Model		
	(1)	(2)	(3)	(4)	(5)	(6)
Export dummy	1.295***	1.225***	1.232***	1.159***	1.134***	1.123***
	(.0038)	(.0039)	(.0040)	(.0024)	(.0023)	(.0024)
Industry FE	no	yes	yes	no	yes	yes
Industry-City FE	no	no	yes	no	no	yes
Observations	947,185	947,185	947,185	948,788	948,788	948,788

Notes: The Table shows the results of estimating an OLS regression of firm size, in terms of the logarithm of labor, against an export dummy variable. All regressions are estimated at the firm-level. Columns 1-3 uses information from the Chinese Census of Manufacturing of 2004, while columns 4-6 uses simulated data from our structural model. We winsorize the top and bottom percentiles of the dependent variable in the data and model to avoid the influence of outliers. Robust standard errors in parentheses. Key: *** significant at 1%; ** 5%; * 10%.

Table 7: Welfare and Productivity Gains from Trade Liberalization

	Model with Geography		Model without Geography	
	Welfare	TFP	Welfare	TFP
Open Economy	1.000	1.000	1.000	1.000
Closed Economy	0.763	0.769	0.686	0.701
Gains from Trade (%)	23.7%	23.1%	31.4%	29.9%

Notes: The Table shows the estimated gains from trade in terms of aggregate welfare and measured total factor productivity (TFP). The model with geography corresponds to the baseline model introduced in section 4. The model without geography corresponds to an constrained version of the baseline model where agglomeration parameters and firm-city specific productivity are restricted to be equal to zero. This alternative model is estimated to match the relevant data moments.