Misallocation and Product Choice

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NEUDC

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how does heterogeneous product choice affect aggregate misallocation cost?

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  - $\rightarrow$ understate total cost of misallocation

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- Agricultural Misallocation

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  - but mechanisms apply equally to other sectors

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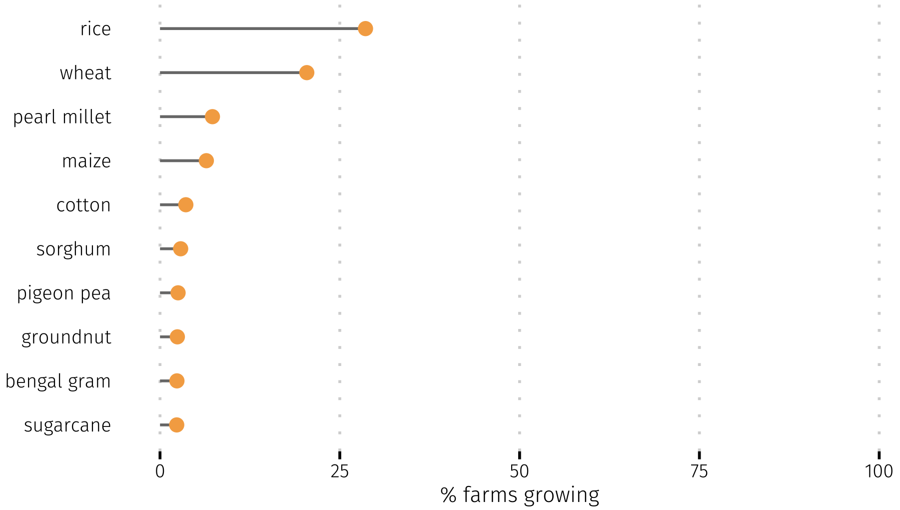
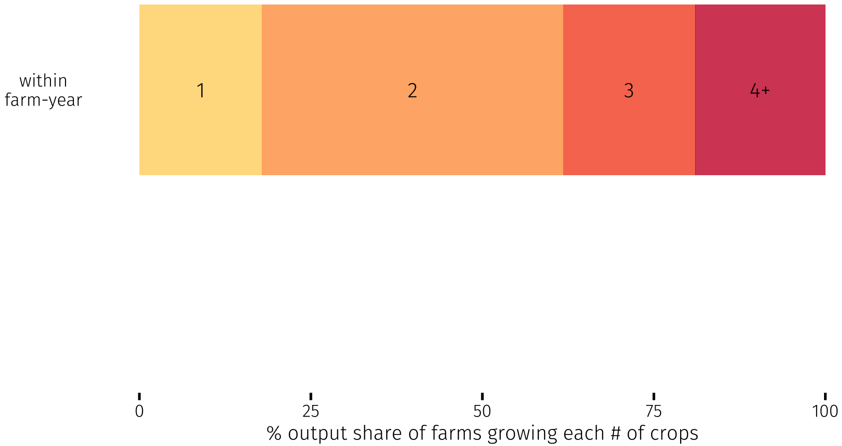
Multi-Product Farms in India

Crop Choice is Heterogeneous



Many Farms Grow Multiple Crops, Mainly Across Seasons



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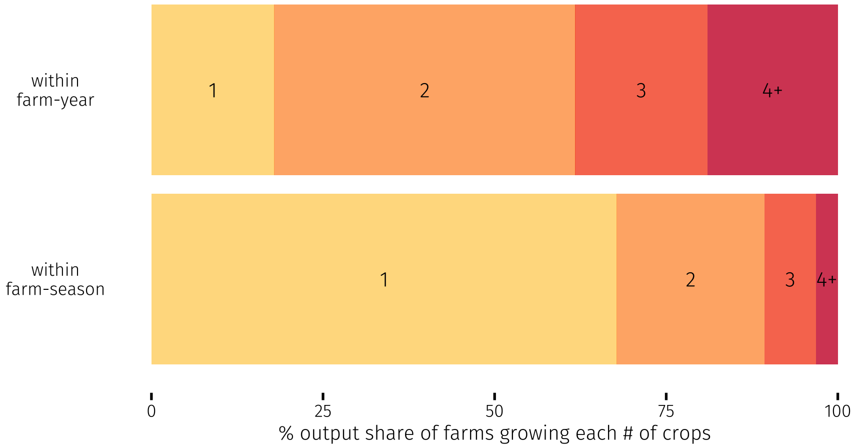

- 3 agricultural seasons: Kharif (monsoon), Rabi (winter/spring), Zaid (summer/dry)

Production Functions

Estimate Crop-Specific Production Functions

- production function:

$$y_{f,i,t} = z_{f,i,t} l_{f,i,t}^{\gamma_i} x_{labor,f,i,t}^{\alpha_{labor,i}} x_{inter,f,i,t}^{\alpha_{inter,i}}$$

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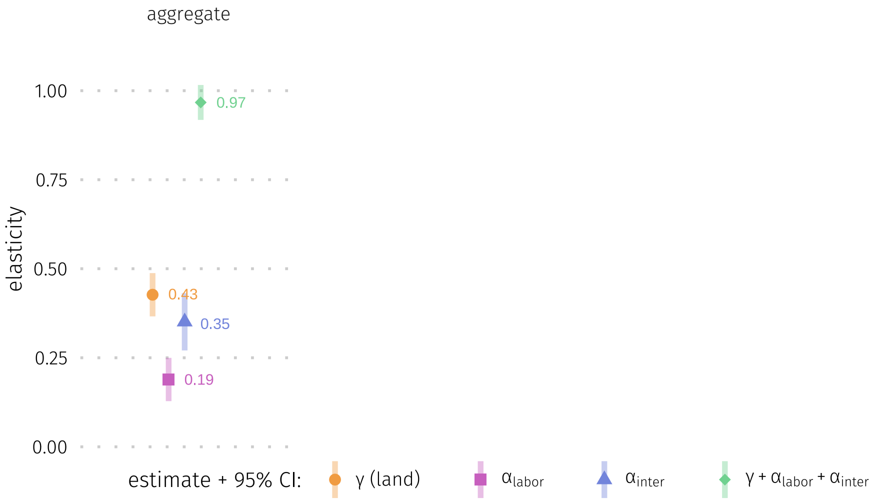

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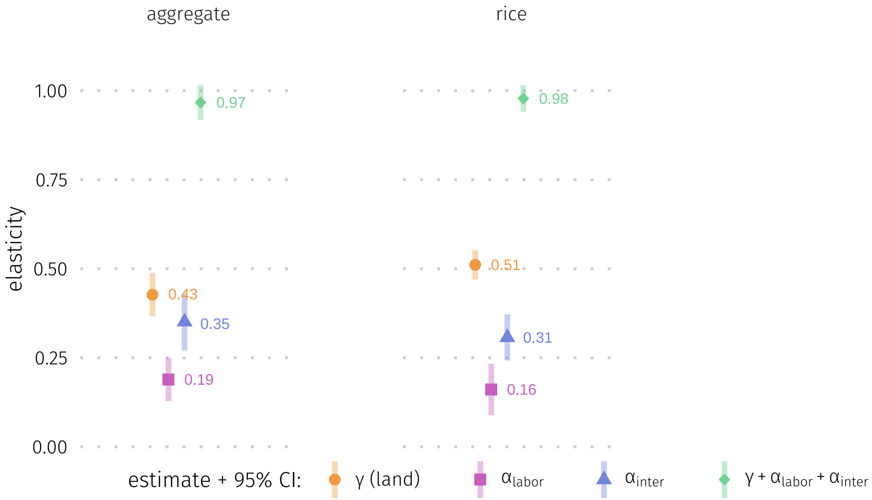

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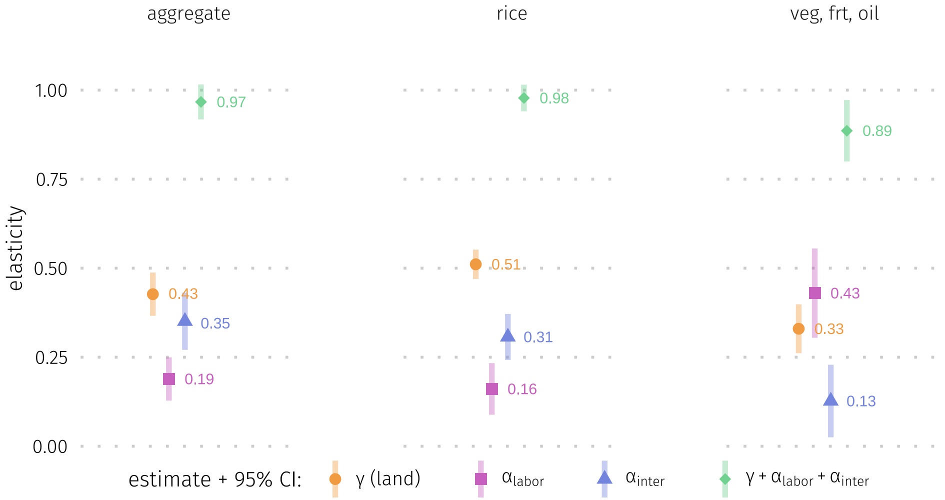

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- flexible inputs g: labor, intermediates
  - quantity $x_{f,g}$ rented at r_g

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$$\text{s.t.} \qquad l_f \qquad = L_f \qquad (\lambda_f)$$

- profit-maximizing farm f: sells output py_f, pays for inputs
- Cobb-Douglas production function with TFP z_f
- flexible inputs g: labor, intermediates
  - quantity $x_{f,g}$ rented at r_g
- land input l is in fixed supply L_f
  - almost no land market in India

Farm: Distortions

$$\max \quad \underbrace{p\,\overbrace{z_f\, l_f^{\gamma} \Pi_g \left(x_{f,g}^{\alpha_g}\right)}^{y_f}}_{\text{revenue}} - \underbrace{\sum_{g=1}^{G} r_g \tau_{f,g} x_{f,g}}_{\text{flex. input costs}}$$

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- distortions extracted from observed input, output choices
  - rationalize all heterogeneity in data ▶ *details*

Farm: Multiple Products

$$\max \underbrace{\sum_{i=1}^{N} p_i \overbrace{z_{f,i} {l_{f,i}}^{\gamma_i} \Pi_g \left({x_{f,g,i}}^{\alpha_{g,i}} \right)}^{y_{f,i}}}_{\text{revenue}} - \underbrace{\sum_{g=1}^{G} r_g \tau_{f,g} \sum_{i=1}^{N} \tau_{f,g,i} x_{f,g,i}}_{\text{flex. input costs}}$$

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- heterogeneous crops $i = 1 \ldots N$
- l in fixed supply $L_f \rightarrow$ interdependent crop production
  - params of crop i change $\rightarrow \lambda_f$ changes $\rightarrow$ inputs and outputs of crops $-i$ change
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- farm-input-crop distortions $\tau_{f,g,i}$, $\tau_{f,l,i}$

  $\rightarrow$ fit observed input ratio heterogeneity across crops within a farm

Farm: Fixed Cost

$$\max \underbrace{\sum_{i=1}^{N} p_i \overbrace{z_{f,i} {l_{f,i}}^{\gamma_i} \Pi_g \left({x_{f,g,i}}^{\alpha_{g,i}} \right)}^{y_{f,i}}}_{\text{revenue}} - \underbrace{\sum_{g=1}^{G} r_g \tau_{f,g} \sum_{i=1}^{N} \tau_{f,g,i} x_{f,g,i}}_{\text{flex. input costs}} - \underbrace{\sum_{i=1}^{N} \omega \cdot 1[y_{f,i} > 0]}_{\text{fixed cost per crop}}$$

$$\text{s.t.} \quad \sum_{i=1}^{N} l_{f,i} \tau_{f,l,i} = L_f \qquad (\lambda_f)$$

- fixed cost ω per produced crop
  - → farms choose **crop set** in addition to **crop mix**
  - – farms don't all produce everything
  - → fit observed heterogeneity in crop sets

Farm: Concavity

$$\max \underbrace{\sum_{i=1}^{N}\left(p_i \overbrace{z_{f,i} {l_{f,i}}^{\gamma_i} \Pi_g \left({x_{f,g,i}}^{\alpha_{g,i}}\right)}^{y_{f,i}}\right)^{\eta}}_{\text{revenue}} - \underbrace{\sum_{g=1}^{G} r_g \tau_{f,g} \sum_{i=1}^{N} \tau_{f,g,i} x_{f,g,i}}_{\text{flex. input costs}} - \underbrace{\sum_{i=1}^{N} \omega \cdot 1[y_{f,i} > 0]}_{\text{fixed cost per crop}}$$

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  - risk

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▶ *solution* ▶ *GE*

Reallocation Exercises

Benchmark Exercise

reallocation gain

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▶ *reallocation exercise details* ▶ *sensitivity to concavity* ▶ *role of states, seasons*

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▶ *mechanisms* ▶ *benchmark decomposition* ▶ *“least-distorted state” decomposition*

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  - *in progress*

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  $\rightarrow$ input choices may appear inefficient statically but be optimal dynamically

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- **agriculture** is the perfect setting to study **endogenous product choice**
  - firm-product (farm-crop) inputs and outputs are feasible to measure
  - products (crops) are $\sim$homogeneous across firms (farms)
- but mechanism applies to **non-agricultural** settings too
  - $\rightarrow$ relevant for *more* developed countries too

back

Farm Solution Expressions

$$\sum_{i\in I_f}\left(\lambda_f^{\frac{\eta\sum_g \alpha_{g,i}-1}{1-\eta\sum_g \alpha_{g,i}-\eta\gamma_i}}\right)\left(\left(p_i z_{f,i}\right)^{\eta}\eta\left(\frac{\gamma_i}{\tau_{f,l,i}}\right)^{1-\eta\sum_g \alpha_{g,i}}\Pi_g\left(\frac{\alpha_{g,i}}{r_g\tau_{f,g}\tau_{f,g,i}}\right)^{\eta\alpha_{g,i}}\right)^{\frac{1}{1-\eta\sum_g \alpha_{g,i}-\eta\gamma_i}}\tau_{f,l,i}=L_f$$

$$x_{f,g,i}=\frac{\alpha_{g,i}}{r_g\tau_{f,g}\tau_{f,g,i}}\left(\frac{\gamma_i}{\lambda_f\tau_{f,l,i}}\right)^{\frac{\eta\gamma_i}{1-\eta\sum_g \alpha_{g,i}-\eta\gamma_i}}\left(\left(p_i z_{f,i}\right)^{\eta}\eta\Pi_h\left(\frac{\alpha_{h,i}}{r_h\tau_{f,h}\tau_{f,h,i}}\right)^{\eta\alpha_{h,i}}\right)^{\frac{1}{1-\eta\sum_h \alpha_{h,i}-\eta\gamma_i}}$$

$$l_{f,i}=\left(\left(p_i z_{f,i}\right)^{\eta}\eta\left(\frac{\gamma_i}{\lambda_f\tau_{f,l,i}}\right)^{1-\eta\sum_g \alpha_{g,i}}\Pi_g\left(\frac{\alpha_{g,i}}{r_g\tau_{f,g}\tau_{f,g,i}}\right)^{\eta\alpha_{g,i}}\right)^{\frac{1}{1-\eta\sum_g \alpha_{g,i}-\eta\gamma_i}}$$

back

List of crops

Crop list

Rice	Wheat	Other Cereals	Pulses	Oilseeds, Fruits and Vegetables		
				Oilseeds	**Vegetables**	**Fruits /Condiments**
		Barley	Black gram	Sesame	Ash gourd	Mango
		Maize	Green peas	Groundnut	Beet root	Papaya
		Sorghum	Pigeon peas	Castor	Bitter gourd	Grapes
		Pearl millet	Horse gram	Sunflower	Bottle gourd	Plum
		Finger millet	Cowpea	Niger	Eggplant	Cardamom
		Others	Kidney bean	Soybean	Board bean	Chilli
			Lentil	Safflower	Cabbage	Cumin
			Chickpeas	Rapseed	Cauliflower	Dill seed
			Others	Linseed	Carrot	Indian mustard
				Others	Potato	Other
					Cucumber	
					Peas	

back

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- **2SLS first stage**:

$$M_{j,i,t} = Z_{k \neq j,i,t} + \mu_{j,i,t}$$

  - M = land, labor, intermediates
  - $Z_{k \neq j,i,t}$: instruments **from other plots within farm**
    - > agricultural shocks interacted with plot characteristics
    - > household, community characteristics & shocks interacted with plot characteristics

back

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▶ *details*

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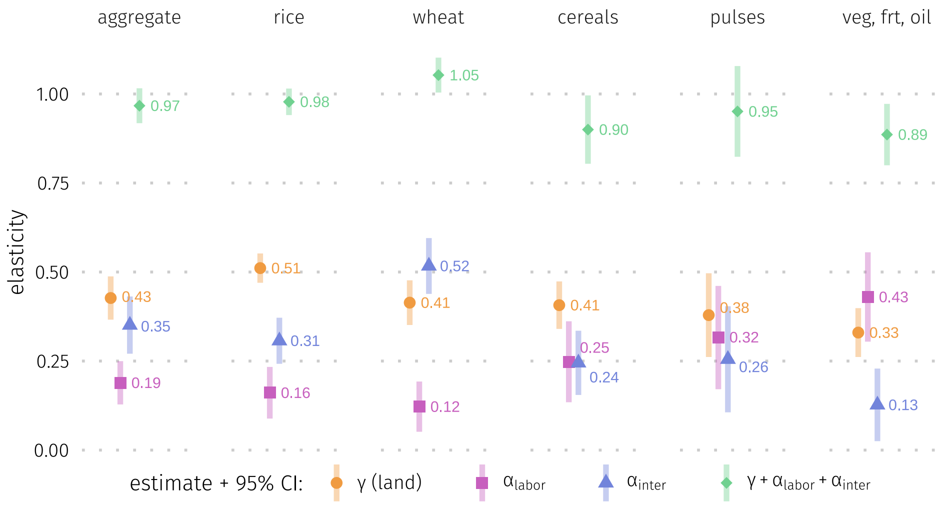
- quality-adjusted land = quality index $\times$ plot area

back

Production Functions: All Crops



back

Production Functions: Table

	Aggregate	Rice	Wheat	Other Cereals	Pulses	Veg, Frt, Oil
Land	0.427	0.511	0.414	0.407	0.379	0.330
	(0.031)	(0.021)	(0.032)	(0.034)	(0.060)	(0.035)
Labor	0.189	0.161	0.122	0.248	0.316	0.430
	(0.031)	(0.037)	(0.036)	(0.058)	(0.074)	(0.064)
Intermediates	0.351	0.307	0.517	0.245	0.255	0.127
	(0.041)	(0.033)	(0.040)	(0.046)	(0.076)	(0.052)
Observations	14,705	4,807	3,566	2,779	1,128	2,338
R^2	0.624	0.742	0.713	0.590	0.417	0.572
Village FEs	Y	Y	Y	Y	Y	Y
Season FEs	Y	Y	Y	Y	Y	Y
			First Stage: F statistics			
Land	77.0	62.0	40.3	37.8	15.7	19.3
Labor	49.3	34.7	17.7	25.2	12.9	14.8
Intermediates	35.8	31.7	21.5	19.9	8.9	11.8
K-Paap Wald F statistic	51.1	40.4	16.0	30.8	12.4	12.7

back

Production Functions: Pairwise Equality Test P-Values

γ

	rice	wheat	cereals	pulses
veg, frt, oil	<0.01	0.95	0.62	0.73
pulses	0.05	0.7	1	
cereals	<0.01	0.57		
wheat	<0.01			

α_{labor}

	rice	wheat	cereals	pulses
veg, frt, oil	<0.01	<0.01	0.08	0.43
pulses	0.01	0.03	0.3	
cereals	0.17	0.33		
wheat	0.65			

α_{inter}

	rice	wheat	cereals	pulses
veg, frt, oil	<0.01	<0.01	0.08	0.27
pulses	0.53	<0.01	0.94	
cereals	0.35	<0.01		
wheat	<0.01			

back

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     - *expressions*
- for each farm, pick profit-maximizing crop set

back

Potential Sources of Concavity

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back

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  - but the appropriate way to define GE may be different

back

Extracting Distortions

- unobserved **distortions** map to observed **marginal revenue products**:

$$r_g \tau_{f,g} \tau_{f,g,i} = \frac{\alpha_{g,i} \eta \left(p_i y_{f,i}\right)^{\eta}}{x_{f,g,i}} = mrpg_{f,i}$$

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distorted economy $\Leftrightarrow$ heterog. $\tau_{f,g} \tau_{f,g,i}$

Extracting Distortions

- unobserved **distortions** map to observed **marginal revenue products**:

$$r_g \tau_{f,g} \tau_{f,g,i} = \frac{\alpha_{g,i} \eta \left(p_i y_{f,i}\right)^{\eta}}{x_{f,g,i}} = mrpg_{f,i}$$

$$\lambda_f \tau_{f,l,i} = \frac{\gamma_i \eta \left(p_i y_{f,i}\right)^{\eta}}{l_{f,i}} = mrpl_{f,i}$$

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$$z_{f,i} = \frac{y_{f,i}}{l_{f,i}^{\gamma_i} \Pi_g \left(x_{f,g,i}^{\alpha_{g,i}}\right)}$$

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▶ *splitting distortions*

back

Splitting Distortions

- splitting $r_g \tau_{f,g} \tau_{f,g,i}$ into 3 terms is arbitrary from farm f's POV

back

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  - and **does not** matter for aggregate misallocation estimate

back

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  - but will matter for *partial* reallocation exercises $\rightarrow$ come up with a sensible split

back

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- split $r_g \tau_{f,g}$ from $\tau_{f,g,i}$:

back

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- likewise restrict $\tau_{f,l,i}$:
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  $\rightarrow$ $L_f = \sum_i l_{f,i} = \sum_i \tau_{f,l,i} l_{f,i}$

back

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  $\rightarrow$ $L_f = \sum_i l_{f,i} = \sum_i \tau_{f,l,i} l_{f,i}$
- split of r_g from $\tau_{f,g}$ imposed by GE

back

Estimate the Elasticity of Substitution

- from consumption FOC:

$$\log\left(\frac{p_i C_i}{\sum_j p_j C_j}\right) = -\log\left(\sum_j \varphi_j^{\sigma} p_j^{1-\sigma}\right) + (1-\sigma)\log p_i + \sigma \log \varphi_i$$

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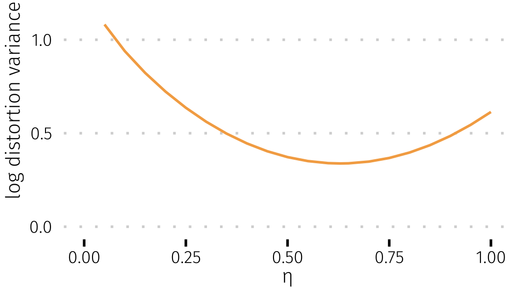
	$\log s_{h,i}$
σ	1.699
$\log p_{h,i}$	-0.699
	(0.067)
Observations	40,833
Kleibergen-Paap F stat	230.9

Village-level instruments: Elevation × rain, ruggedness × rain, pucca roads availability

back

Choose η That Minimizes Implied Dispersion

- τs reproducing data need to be extreme if η is too high or too low



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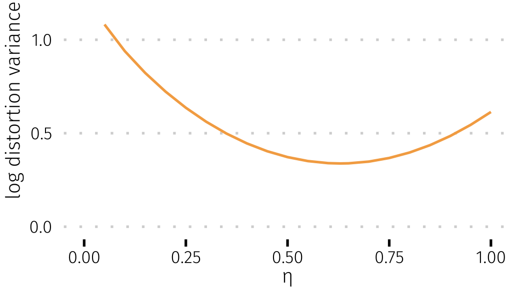

- **low** η: farm, farm-crop output more uniformly distributed in efficient allocation
  $\rightarrow$ data farm size **“too varied”**, farms mix crops **“too little”** $\rightarrow$ extreme distortions

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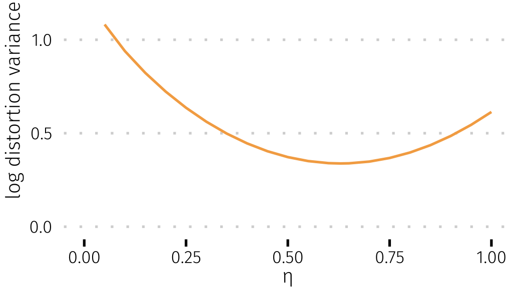

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  $\rightarrow$ data farm size **"too uniform"**, farms mix crops **"too much"** $\rightarrow$ extreme distortions

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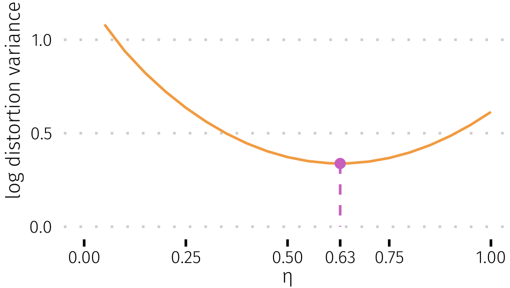

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$\rightarrow$ pick η that minimizes distortions required to explain observed output distribution

$\rightarrow$ conservative misallocation estimates

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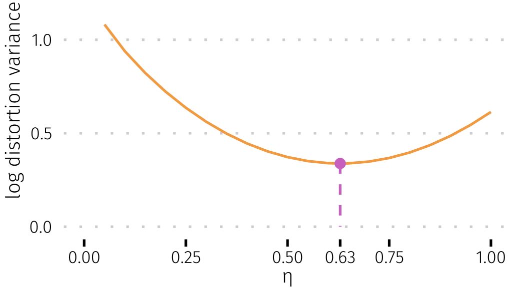

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▶ *details*

back

General Equilibrium

- representative consumer buys crops, sells inputs, receives profit from owned farms

$$\max_{\{C_i\}_{i=1}^N} \left(\sum_i \varphi_i C_i^{\frac{\sigma-1}{\sigma}} \right)^{\frac{\sigma}{\sigma-1}}$$

s.t.

$$\sum_i p_i C_i = \sum_g r_g X_g^{agg} + \Pi$$

back

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▶ *profits details*

Choose η That Minimizes Implied Dispersion

- farm-crop revenue:

$$p_i y_{f,i} = \underbrace{\left(\left(\frac{1}{\lambda_f \tau_{f,m,i}} \right)^{\gamma_i} \Pi_g \left(\frac{1}{\tau_{f,g} \tau_{f,g,i}} \right)^{\alpha_{g,i}} \right)^{\frac{1}{1-\eta(\sum_g \alpha_{g,i}+\gamma_i)}}}_{\text{composite distortion, } dist_{f,i}} \underbrace{\left(p_i z_{f,i} \gamma_i^{\gamma_i} \eta^{\sum_g \alpha_{g,i}+\gamma_i} \Pi \left(\frac{\alpha_{g,i}}{r_g} \right)^{\alpha_{g,i}} \right)^{\frac{1}{1-\eta(\sum_g \alpha_{g,i}+\gamma_i)}}}_{\text{“objective” factors}}$$

back

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- $Var(\log dist_{f,i})$ needed to match observed output dispersion depends on chosen η

back

GE Profits

$$\Pi = \sum_f \left[\sum_{i=1}^{N} p_i y_{f,i} - \sum_{g=1}^{G} r_g \sum_{i=1}^{N} x_{f,g,i} \right]$$

- distortions τ, fixed costs ω, concavity η are not reflected in dividends sent to consumer
  - farmers act *as if* frictions they face had monetary representations
  - but these are non-monetary and not added/subtracted from dividends
- equivalent formulation: τs, ωs are monetary taxes/subsidies, administered by consumer
  - show up in dividends and consumer's BC as government revenue/expense
- choice is arbitrary: both formulations (or any mixture) produce identical equilibrium conditions

back

Reallocation

- to quantify **aggregate cost** of distortions, conduct **counterfactual reallocations**

back

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  - to prevent double-booking of inputs in a single season
  - sum aggregate output across seasons

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  - farm-level TFPs are fixed $\rightarrow$ aggregate TFP $\uparrow$ reflects pure **reallocation gain** or **misallocation cost**

back

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  - farm-level TFPs are fixed $\rightarrow$ aggregate TFP $\uparrow$ reflects pure **reallocation gain** or **misallocation cost**
- compare **reallocation gain** between **multi-product** model and **1-product** model

▶ *reallocation exercise details*

back

Reallocation Exercise Details

- **reallocation 1**: equalize land and labor distortions, crop sets fixed

back

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  - farms can't change crop sets, but can change crop ratios

back

Reallocation Exercise Details

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  - crop sets fixed $\rightarrow$ extract all needed fundamentals from data

back

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back

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  - solve for market-clearing $\{p_i\}_i, \{r_g\}_g, \bar{\lambda}$

back

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back

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- **reallocation 2**: equalize land and labor distortions, allow crop set changes
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back

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  $\rightarrow$ need to parameterize **unconditional** z, τ distributions and calibrate to match observed **conditional** distributions

back

Benchmark Exercise Sensitivity

η \ σ	1.1	1.3	1.5	1.7	1.9	2.1	2.3
0.93	1588	1781	1961	2123	2267	2393	2503
0.83	1300	1472	1635	1787	1924	2047	2157
0.73	762	837	909	977	1040	1098	1152
0.63	277	284	289	*294*	299	303	306
0.53	139	140	140	141	141	142	142
0.43	99	99	99	99	99	100	100
0.33	79	79	80	80	80	80	80

(a) reallocation gain, %

back

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(a) reallocation gain, %

- misallocation estimates are always sensitive to calibrated concavity
  - firms can expand grow more easily in reallocation $\rightarrow$ greater gain

back

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0.33	79	79	80	80	80	80	80

(a) reallocation gain, %

η \ σ	1.1	1.3	1.5	1.7	1.9	2.1	2.3
0.93	+6	-6	-14	-21	-26	-30	-33
0.83	+3	-9	-18	-25	-30	-34	-38
0.73	-38	-43	-48	-52	-55	-57	-59
0.63	-23	-25	-27	*-28*	-29	-30	-31
0.53	-2	-3	-3	-4	-4	-4	-5
0.43	+2	+2	+2	+2	+2	+1	+1
0.33	+2	+2	+2	+2	+2	+2	+2

(b) single-product model error, %

- misallocation estimates are always sensitive to calibrated concavity
  - firms can expand grow more easily in reallocation → greater gain
- sign and magnitude of single-product model's error also depends on calibration

back

Reallocation: Role of States and Seasons

	main	within state	no split by season
multi-product:	294%	107%	314%
1-product:	212%	124%	260%

back

Mechanism I: Product Heterogeneity as Frictions

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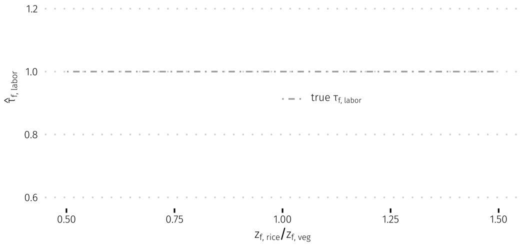

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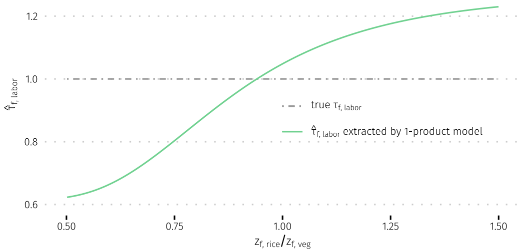

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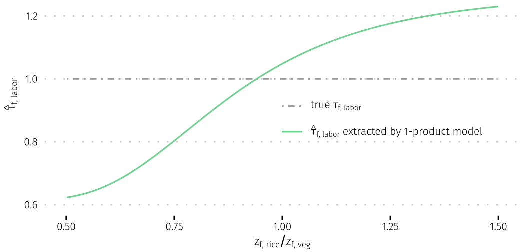

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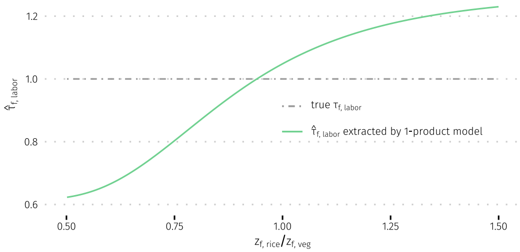

- **exercise to isolate**: apply 1-product model to counterfactual reallocation data generated by multi-product model

Mechanism II: TFP Dispersion

- 1-product model understates TFP dispersion

back

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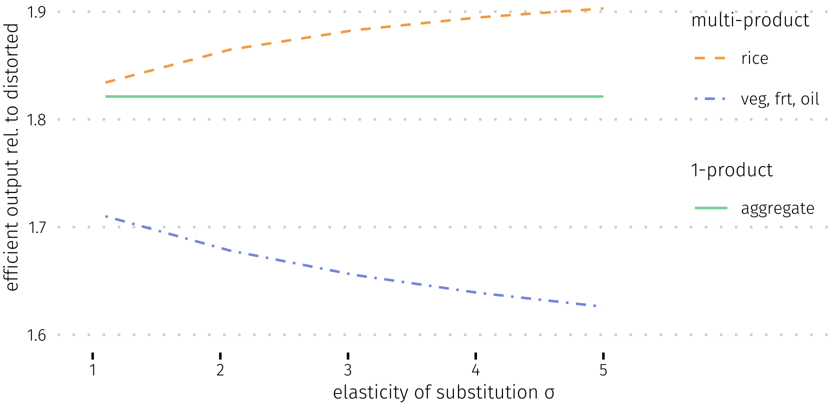
  - $\rightarrow$ 1-product model **understates misallocation**
- **exercise to isolate**: treat farm-crops as separate farms for 1-product model

back

Mechanism III: Returns to Scale

- some products have higher returns to scale → some farms grow more in reallocation



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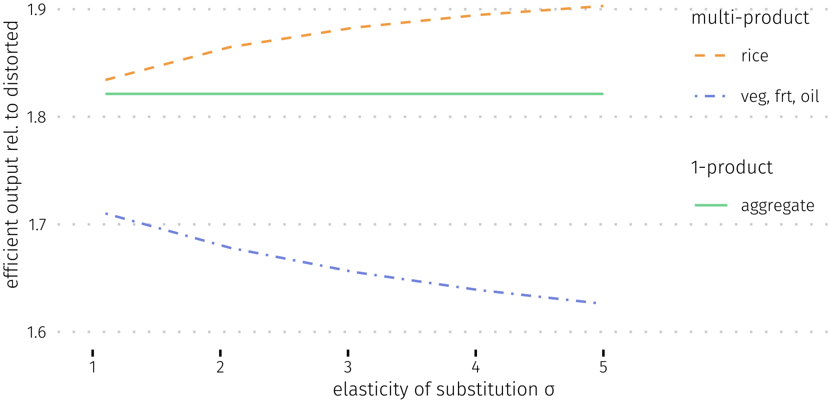
- some products have higher returns to scale → some farms grow more in reallocation
- → consumer can substitute toward high-RS products to take advantage



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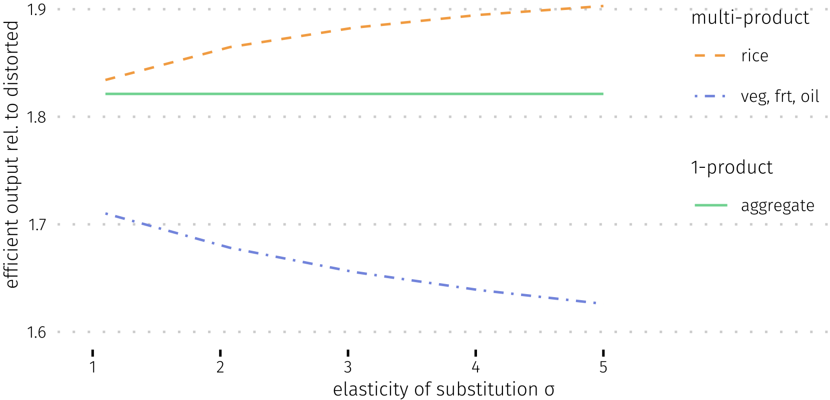

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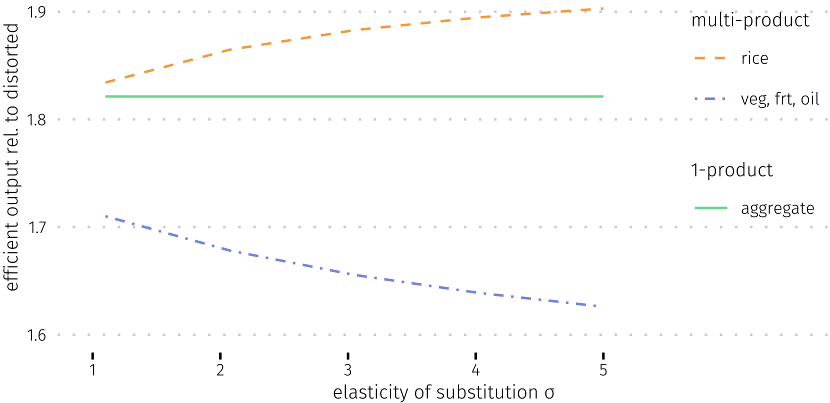
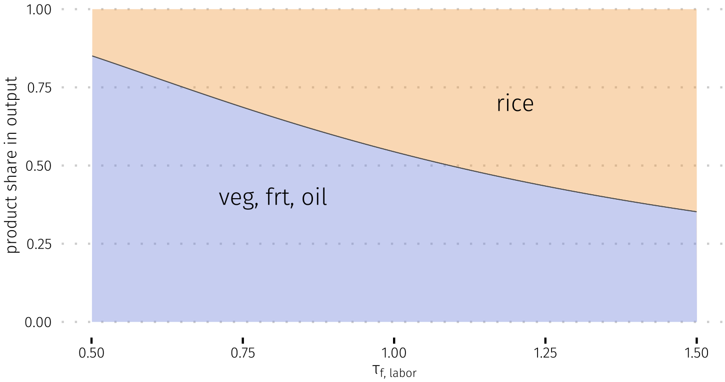


Mechanism IV: Endogenous Product Choice

- simulated multi-product farm as labor distortion $\tau_{f,labor}$ is varied:

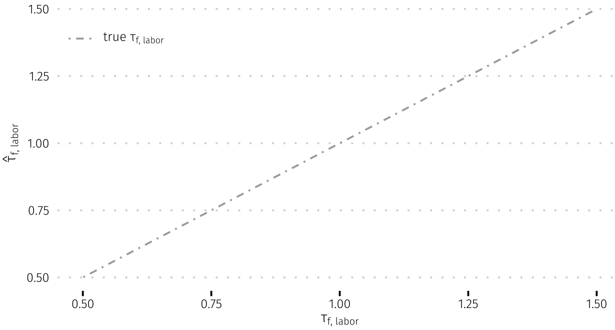


- $\tau_{f,labor} \uparrow \rightarrow$ shift from labor-intensive vegetables to land-intensive rice

back

Mechanism IV: Endogenous Product Choice

- apply **single**-product model to extract frictions from simulated **multi**-product data



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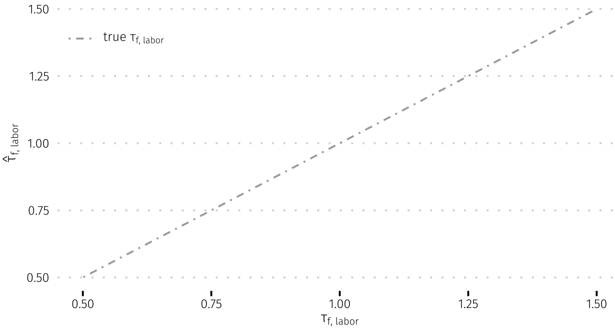

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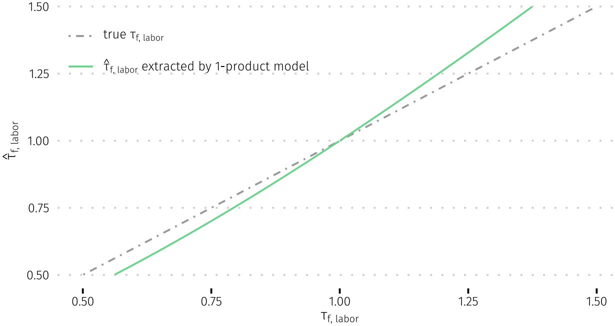

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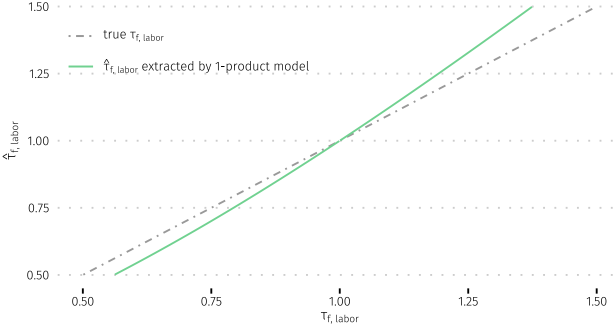


back

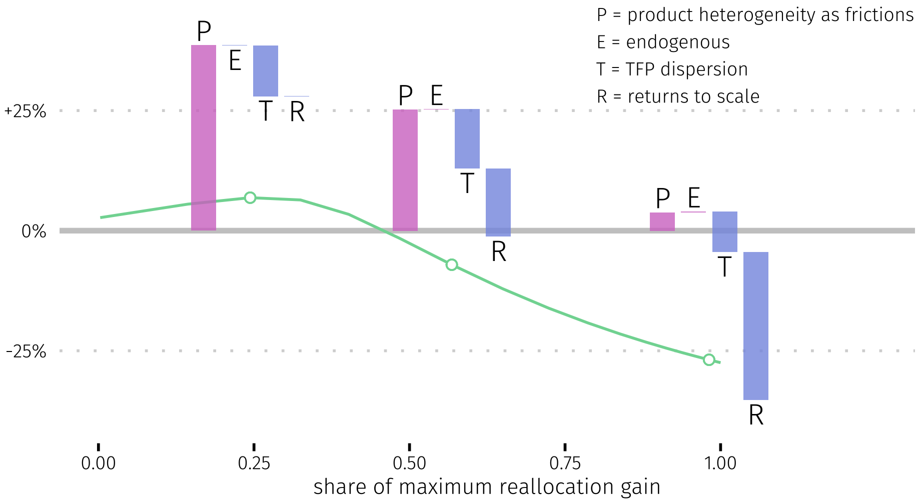
Mechanism IV: Endogenous Product Choice

- **exercise to isolate**: prohibit farms in multi-product model to change product choice in counterfactuals
  - keep product sets fixed
  - keep input allocation across crops fixed: farm can choose $\sum_i x_{f,g,i}$ but $x_{f,g,i}$ gets a fixed share of total

back

Remove More Distortions → 1-Product Model Overstates

- 1-product error when conducting increasingly expansive reallocations:



back

Mechanisms Contributing to 1-Product Model Error

- Product Heterogeneity as Frictions ▶ *details*

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Mechanisms Decomposition: Benchmark Reallocation

- **benchmark**: single-product model understates gain by **82 pp** (28%)

back

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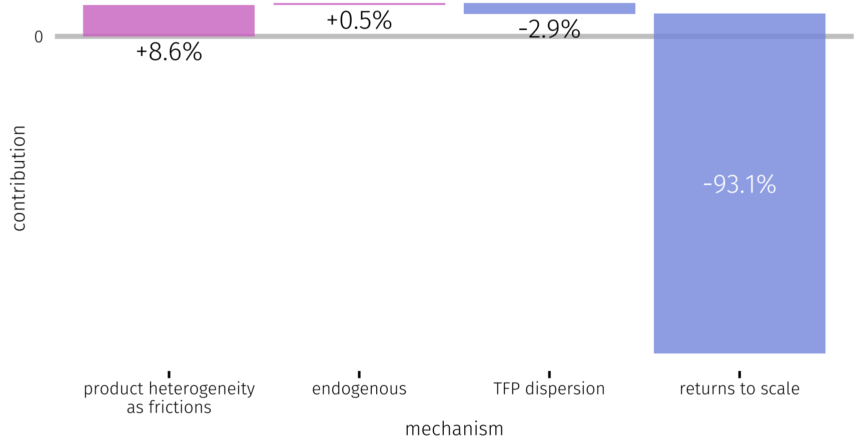

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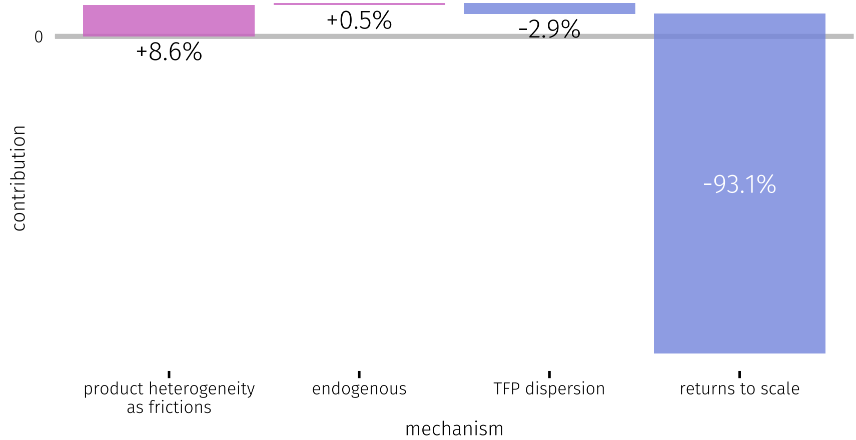

- assess total drag of misallocation → firms' ability to expand matters most
  → single-product model understates **misallocation**

back

Mechanisms Decomposition: "Least-Distorted State" Reallocation

- **"least-distorted state"**: single-product model overstates gain by **10 pp** (26%)

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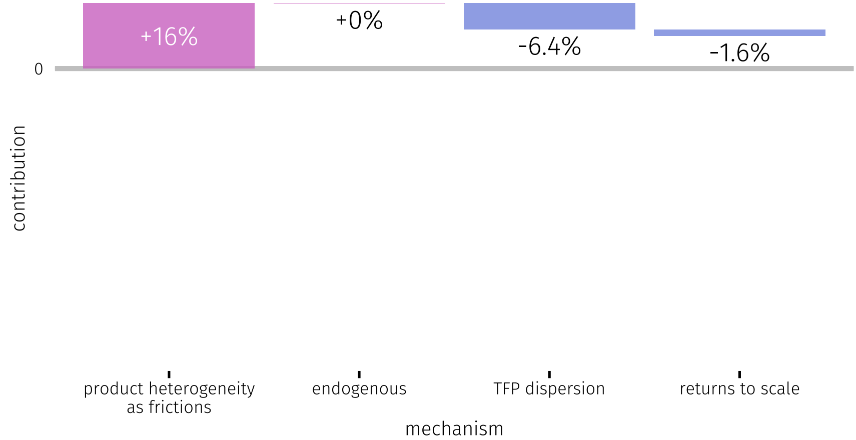

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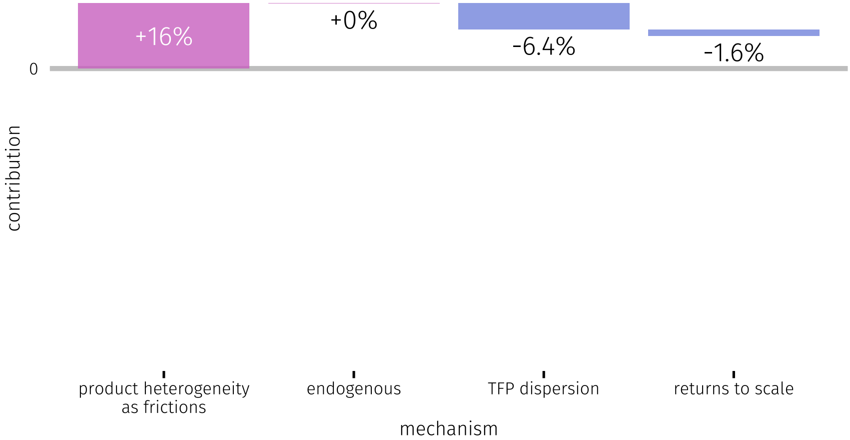

- consider partial reallocations → estimation of frictions matters most
  - → single-product model overstates **misallocation** ▶ *details*

back

Reallocation

- to quantify **aggregate cost** of distortions, conduct **counterfactual reallocations**

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  - equalize (or reduce) distortions between farms
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  - treat each season as a separate economy
- compute counterfactual Δoutput: **reallocation gain**
  - reflects aggr. TFP gain from better input allocation between farms
  - captures **misallocation cost**
- compare **reallocation gain** between multi-product model and 1-product model

  ▶ *details*

back