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INTERMEDIATE INPUT SUBSTITUTABILITY

ALESSANDRA PETER
Department of Economics, New York University

CIAN RUANE
Irish Economic Analysis Division, Economics and Statistics Department, Central Bank of Ireland

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INTERMEDIATE INPUT SUBSTITUTABILITY

ALESSANDRA PETER
Department of Economics, New York University

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Irish Economic Analysis Division, Economics and Statistics Department, Central Bank of Ireland

We estimate long-run elasticities of substitution between intermediate inputs for Indian manufacturing plants. India's trade liberalization in the early 1990s provides an ideal natural policy experiment, with permanent and heterogeneous tariff reductions inducing changes in relative prices which we use for identification. We find a high degree of substitutability at the plant-level between 8 broad categories of material inputs, significantly above the Cobb–Douglas benchmark of 1. In contrast, when considering shorter time horizons or more transitory shocks to relative prices, we find evidence of much lower elasticities. Using our long-run elasticities in a quantitative model, we find that misallocation of intermediate inputs causes a reduction in aggregate output of 29%–3.5 times larger relative to a standard calibration with complementary inputs.

KEYWORDS: Intermediate inputs, elasticity of substitution, trade liberalization, production networks, misallocation.

1. INTRODUCTION

MODERN PRODUCTION often involves multiple firms operating in complex supply chains. A key characteristic of the production process is the degree of substitutability of inputs. This governs how the economy responds—in both direction and magnitude—to shocks such as technological change or policies such as sectoral subsidies or tariffs. However, as input adjustments take time and may be costly, the degree of substitutability can depend on the time horizon as well as the permanence of the shock. The degree of substitutability of inputs over the long run is, therefore, a crucial ingredient for understanding economic development and the long-run impacts of macroeconomic and trade policies. Despite its importance, there is scant empirical evidence on firms' ability to substitute in response to shocks over longer time horizons.

In this paper, we estimate long-run elasticities of substitution for intermediate inputs of Indian manufacturing plants. Using India's trade liberalization as a natural experiment,

Alessandra Peter: alessandra.peter@nyu.edu
Cian Ruane: cian.ruane@centralbank.ie

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we estimate an elasticity of substitution of 2.5 between eight broad categories of material inputs over a 7-year horizon. What differentiates our setting is that plants faced a *permanent* rather than *transitory* change in relative prices and had up to 7 years to adapt their input mix. In contrast, for both shorter time horizons and more transitory shocks to relative prices, we estimate elasticities below one, consistent with similar short-run estimates in the literature (Atalay (2017), Barrot and Sauvagnat (2016), Boehm, Flaaen, and Pandalai-Nayar (2019), Carvalho, Nirei, Saito, and Tahbaz-Salehi (2020)).

We show that the higher degree of substitutability we estimate over the long run changes the answer to several policy questions substantially. Using a multisector model calibrated to India, we find that the economy is more resilient to sector-specific negative TFP shocks relative to a scenario in which intermediates are complements. On the other hand, input distortions are 3.5 times more damaging, and sectoral subsidies cause losses up to 5 times as high, especially if targeted towards intermediate inputs.

Using rich data on intermediate input use by manufacturing plants from the 1989 and 1996 Indian Annual Survey of Industries (ASI), we estimate how plants' intermediate spending shares changed in response to changes in intermediate input prices. These moments identify the long-run elasticities of substitution between intermediate inputs in a standard constant elasticity of substitution (CES) production function. The main elasticity we estimate is between 8 broad categories of materials, such as Metals, Rubber and Plastics, and Wood and Paper Products.

To overcome the well-known problem of separately identifying elasticities from factor-biased technologies (Diamond and McFadden (1978), Antràs (2004)), we use India's 1991 trade liberalization as a natural policy experiment. India's trade liberalization is an ideal setting because it was large, unexpected, and without much scope for lobbying or political interference (Topalova (2010), Irwin (2025)). Moreover, import tariffs changed heterogeneously across highly disaggregated inputs in an arguably quasirandom way; initial tariffs varied widely but converged to around 30% by the end of the liberalization.

These heterogeneous changes induced large changes in relative prices of domestic inputs. We construct a shift-share instrument at the plant level, exploiting the fact that plants used detailed sub-categories of material inputs with varying intensities and, therefore, saw different price changes for each of the eight broad categories of materials. Our identification assumption relies on the quasirandomness of tariff changes, thereby falling into the "exogeneity of the shifts" category of shift-share IVs (Borusyak, Hull, and Jaravel (2022)). We corroborate this assumption with balance tests, which confirm that tariff changes were uncorrelated with industry characteristics or pretrends.

Our estimate of the plant-level elasticity of substitution between material input categories is 2.5. The 95% confidence interval—[1.5, 3.4]—lies significantly above the Cobb–Douglas benchmark. The OLS estimate of the elasticity of substitution between material inputs, while still significantly larger than one, is lower than the IV estimate, as would be expected due to both simultaneity and attenuation bias. This finding survives a battery of robustness checks concerning the timing of tariff changes, trends in input use, the presence of other reforms (industrial delicensing and FDI), quality upgrading, and many sampling and measurement concerns.

The two notable features of our setting are the long time horizon and the permanence of the shock affecting input prices. These features are especially important in the presence of adjustment costs, which would lead firms to be slow to adjust production processes, especially in response to temporary changes. To gauge whether adjustment costs might explain why existing short-run elasticity estimates tend to be lower than those we estimate, we estimate two additional, short-run elasticities. First, using a subset of inputs whose

tariffs changed early during India's trade liberalization, we estimate the elasticity between materials in response to the same permanent shock for a shorter horizon. We estimate an elasticity below one, consistent with evidence that elasticities increase with the time horizon (Boehm, Levchenko, and Pandalai-Nayar (2023)). Second, we use fluctuations in global commodity prices, arguably more transitory shocks, to estimate the same materials elasticity over a 1-year horizon. Again, we find an elasticity below one. Taken together, these findings are indicative that manufacturing plants face sizeable convex adjustment costs.

India's trade liberalization constitutes an ideal setting to estimate many long-run elasticities of substitution. We estimate two additional elasticities consistent with the KLEMS classification between energy, materials, and services and between a capital-labor (value added) bundle and an intermediate input bundle. In both cases, we estimate elasticities below one. We also consider a range of other long-run material input elasticities, such as materials versus labor and materials versus energy, which we estimate to be close to Cobb–Douglas. Lastly, we estimate the industry-level elasticity of substitution between material inputs, which we find to be slightly higher than the plant-level elasticity.

To gauge the aggregate importance of intermediate input substitutability, we embed our estimates into a canonical multisector model calibrated to the Indian economy. We start by simulating large, sectoral TFP drops. In the short run, when intermediates are complements, such a sectoral shock causes a drop in aggregate output of nearly 4% on average. In contrast, when firms can more easily substitute away from inputs from the affected sector, the economy is more resilient, and aggregate output falls by less than 3% on average. We further show that the gains from India's trade liberalization are 5% larger when intermediates are substitutes.

The flip side is that any policy that introduces distortions to firms' intermediate input use can cause substantial harm. We illustrate this in two counterfactuals. First, we simulate the economy with input distortions that represent, for example, different prices charged by upstream suppliers. This causes GDP losses of 29%—3.5 times as large as in an economy with complementary inputs. Second, we simulate a 30% subsidy to one sector's output. Again, losses are much larger in a more flexible economy, amounting to over 4% of GDP with substitutes versus less than 1% with complements.

Related Literature. Our paper speaks to a broad literature seeking to unbundle the firm production function using external instruments (Griliches and Mairesse (1998)). We focus on the elasticity of substitution between inputs in production, which, as famously pointed out by Diamond and McFadden (1978), cannot be separately identified from technical change using time series data alone.[1] To the best of our knowledge, our paper is the first to estimate *long-run* elasticities of substitution between different categories of material inputs. This is both due to extensive data requirements and because there are few settings with plausibly exogenous, permanent variation in material input prices. Short-run elasticities between material inputs or material suppliers have been estimated at the firm-level (ACCD+ (2022), Barrot and Sauvagnat (2016), Carvalho, Nirei, Saito, and Tahbaz-Salehi (2020), Fujiy, Ghose, and Khanna (2023)) and industry-level (Atalay

[1]There is an extensive literature in macroeconomics and trade using various identification strategies to estimate elasticities of substitution, such as between domestic and imported materials (Boehm, Flaaen, and Pandalai-Nayar (2019), Blaum, Lelarge, and Peters (2018)), capital and labor (Raval (2019), Oberfield and Raval (2021)), and capital/labor and intermediates (Oberfield and Raval (2021), Atalay (2017), Miranda-Pinto and Young (2020), Chan (2023), Doraszelski and Jaumandreu (2018)).

(2017), Miranda-Pinto (2021)).[2] The estimates range between 0 and slightly above 1, in line with our short-run elasticity estimates.

Existing estimates are important inputs for models focused on short-run horizons, such as BBBK+ (2022) who evaluate how the German economy would adjust to a stop of energy imports from Russia.[3] Our estimates of long-run elasticities are needed to analyze a different set of questions, such as the long-run effects of permanent shocks, policies, and frictions on development.[4] Our findings are particularly relevant for the macroeconomic literature evaluating the impact of distortions to intermediate inputs, such as contracting frictions (Boehm (2022), Oberfield and Boehm (2020)), transport costs (Peter and Ruane (2022)), industrial policies (Liu (2019)) and heterogeneous supplier prices (Burstein, Cravino, and Rojas (2024)).

Our paper fits into a literature that emphasizes differences between short-run and long-run adjustments to shocks. Huneeus (2018) and Liu and Tsyvinski (2021) develop models in which firms and sectors may be slow to react to shocks due to adjustment costs—leading to higher long-run relative to short-run elasticities. Ruhl (2008) highlights that shocks of different persistence can also lead to different estimates of short-run vs. long-run trade elasticities. Fitzgerald and Haller (2018) and Boehm, Levchenko, and Pandalai-Nayar (2023) use firm and product-level trade data, respectively, to estimate both short-run and long-run trade elasticities, finding higher elasticities in the long run. In particular, Boehm, Levchenko, and Pandalai-Nayar (2023) estimate that it takes 7–10 years to converge to the long run. Hurst, Kehoe, Pastorino, and Winberry (2022) study the short- and long-run impact of minimum wages—finding larger impacts in the long run as firms are slow to adjust their input mixes. Hassler, Krusell, and Olovsson (2021) model how directed technical change results in higher effective long-run elasticities between energy and other inputs.

Finally, our paper builds on a considerable literature examining the effects of India's trade liberalization on various economic outcomes, including poverty (Topalova (2010)), productivity and reallocation (Krishna and Mitra (1998), Sivadasan (2009), Topalova and Khandelwal (2011)), product range (Goldberg, Khandelwal, Pavcnik, and Topalova (2010)), markups (Loecker, Goldberg, Khandelwal, and Pavcnik (2016)) and investment prices (Johri and Rahman (2022)). It also relates to a broader literature evaluating the gains from trade in intermediate inputs (Amiti and Konings (2007), Blaum, Lelarge, and Peters (2018), Caliendo and Parro (2015), Ossa (2015), and Tintelnot, Kikkawa, Mogstad, and Dhyne (2021)); and in particular Oberfield and Boehm (2020) who analyze the importance of input linkages between Indian manufacturing firms, focusing primarily on the effect of contractual frictions.

Outline. The rest of the paper is structured as follows. In Section 2, we present a model of plant-level production. In Section 3, we discuss our empirical setting and present our data. In Section 4, we show the results from our long-run elasticity estimation. In Section 5, we estimate two short-run elasticities of substitution. Section 6 presents estimates of other important elasticities. Section 7 outlines a quantitative model and presents counterfactual results and Section 8 concludes.

[2]Another related literature identifies elasticities of substitution between suppliers using model-based indirect inference (Huneeus (2018), BDMM+ (2022)).

[3]Baqaee and Farhi (2019, 2020, 2024) derive second-order approximations for the aggregate impact of business cycle shocks, the impact of distortions, and changes in trade barriers. The elasticity of substitution between materials is a key parameter in these approximations.

[4]Jones (2011) explores the importance of complementarities in production for cross-country development.

2. ESTIMATING EQUATIONS

We aim to estimate the causal response of plant intermediate input use to changes in prices of these inputs. The level of aggregation for our main results is broad categories of material inputs, such as plastics or chemicals. We estimate how spending shares on a given material input k relative to material input j change in response to changes in the relative price of k and j. Consider the following log-linear specification:

$$\Delta \ln\left(\frac{E_{ik}}{E_{ij}}\right) = \alpha_m + \beta_m \Delta \ln\left(\frac{P_{ik}}{P_{ij}}\right) + \epsilon_i, \tag{1}$$

where $\Delta \ln(\frac{E_{ik}}{E_{ij}})$ is the log change in plant i's relative expenditure share on material inputs k and j; and $\Delta \ln(\frac{P_{ik}}{P_{ij}})$ is the log change in plant i's relative price for materials k and j.

If input prices vary exogenously, the coefficient β_m in equation (1) identifies the local elasticity of substitution between material inputs k and j. If elasticities are independent of the magnitude of the relative price change, such as in a constant elasticity of substitution (CES) framework, β_m identifies *the* elasticity of substitution between material inputs. To be specific, assume material inputs are aggregated into an input bundle M_{it} given by

$$M_{it} = \left[\sum_{k=1}^{\kappa} \pi_{ikt}^{m} M_{ikt}^{\frac{\theta-1}{\theta}}\right]^{\frac{\theta}{\theta-1}}, \tag{2}$$

θ is the elasticity of substitution between the κ categories of material inputs. The plant-specific technologies π_{ikt}^{m} determine the relative weight of each type of material input in production, reflecting different production "recipes" as in Oberfield and Boehm (2020).

To derive our estimating equations, we only need to assume that plants minimize costs and are input price takers. We impose no assumptions on the demand structure and allow input prices to vary across plants. Taking changes over time from plants' first-order conditions, we have that

$$\Delta \ln\left(\frac{E_{ik}}{E_{i}^{m}}\right) = (1-\theta)\Delta \ln\left(\frac{P_{ik}}{P_{i}^{m}}\right) + \theta \Delta \ln\left(\pi_{ik}^{m}\right), \tag{3}$$

where E_i^m is total expenditures on materials, and P_i^m is plant i's material input price index.[5] In the Cobb–Douglas benchmark where $\theta = 1$, expenditure share changes are independent of price changes. If substitutability is higher (lower) than Cobb–Douglas, price increases cause a decrease (increase) in expenditure shares.

Equation (3) is the structural equation we take to the data. Estimating these parameters requires data on plant-level intermediate input expenditures, data on input prices and plausibly exogenous variation in input prices. OLS estimates are likely to be biased and inconsistent for two main reasons. First, changes in production technologies π_{ki}^{m} may drive changes in prices, creating a simultaneity bias. Second, measurement error in input prices may create attenuation bias. Our estimation strategy, therefore, involves using changes in import tariffs during India's trade liberalization as an instrumental variable when estimating these equations in 2SLS. We discuss the setting and data next.

[5] This is given given by $P_i^m = (\sum_{k=1}^{\kappa} (\pi_{ik}^m)^{\theta} P_{ik}^{1-\theta})^{\frac{1}{1-\theta}}$.

3. EMPIRICAL SETTING AND DATA

In this section, we first describe India's trade liberalization and argue that it constitutes a natural experiment that is uniquely suited to estimating elasticities of substitution between intermediate inputs. We then provide more details about the datasets used in the estimation.

3.1. *India's Trade Liberalization*

Following its independence in 1947, India's government imposed strict controls and restrictions on the manufacture of goods. These industrial policies involved licensing restrictions, FDI restrictions, high import tariffs, and nontariff barriers.[6] While some restrictions started to be gradually relaxed during the 1980s, India still remained a very closed economy in 1990, with average import tariffs around 80%. However, the sudden rise in the price of oil and drop in remittances following the first Gulf War triggered a balance of payments crisis in 1991. The Indian government, therefore, arranged a Stand-By Arrangement with the International Monetary Fund, which was conditional on a program of major structural reforms.

A major component of these reforms was opening up to trade, which was implemented as part of India's Eighth 5-Year Plan between 1992 and 1997. The trade liberalization had two goals: (1) a reduction in average tariff levels and (2) a harmonization of tariff levels across goods. Average Indian import tariffs declined from 80% down to 30% between 1991 and 1997 (Figure 1). At the same time, the dispersion in tariffs fell from 39.4% to 14.5%. Nontariff barriers on intermediate inputs were also reduced rapidly in the first few years of the trade liberalization (Topalova and Khandelwal (2011), Irwin (2025)).

Given the goal of harmonization, the decline of any given tariff is well predicted by its initial level in 1991 (Figure 1). The initial level of tariffs was set during the Second 5-Year Plan (1956–1961). There was significant hysteresis in India's trade policy until the crisis

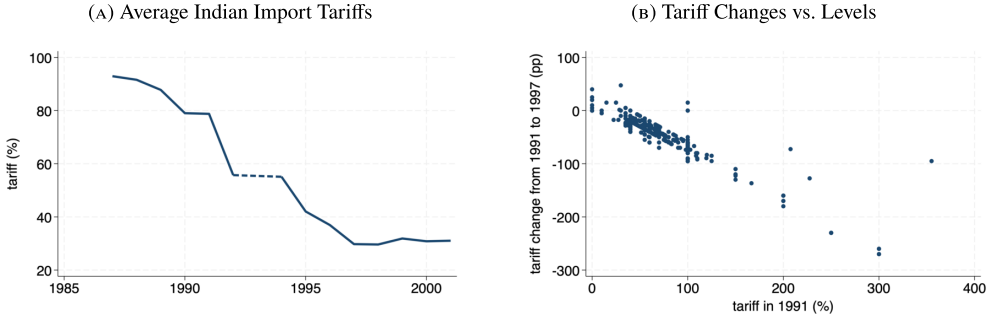

FIGURE 1.—Indian import tariffs. *Note*: Sub-figure (a) shows average Indian import tariffs between 1988 and 2002. We construct average tariffs as the unweighted average of HS4-level tariffs. We omit 1993 because of measurement error concerns. Subfigure (b) plots the percentage point change in Indian import tariffs between 1991 and 1997 against the level of import tariffs in 1991. Each dot corresponds to an HS4 product category. The R-squared from a regression of tariff changes on initial tariff levels is 0.85. We use data on Indian import tariffs from Topalova (2010) for both figures.

[6]See Panagariya (2004) and Sivadasan (2009) for an extensive list of India's industrial policies and World Trade Organization (1997) for a description of nontariff barriers.

in 1991 (Gang and Pandey (1996)); import restrictions remained even as the structure of industry evolved. This feature of India's history renders tariff reductions quasirandom.

Furthermore, the 1991 crisis was both sudden and unexpected. As a result, the trade liberalization was pushed through rapidly and without much scope for industry lobbying (Hasan, Mitra, and Ramaswamy (2003), Goyal (1996), Varshney (2000), Irwin (2025)).[7] This gives us confidence that any remaining heterogeneity in tariffs was not driven by (expected) conditions in individual sectors.

Balance Tests. To further check that the tariff changes constitute a quasirandom shock, we show in Supplemental Appendix Table G.5 (Peter and Ruane (2026)) that neither pre-reform industry characteristics (such as size or capital intensity) nor pre-reform industry trends (in prices, size or TFP) are correlated with the post-reform changes in industry input or output tariffs.[8] We also show in Supplemental Appendix B (Peter and Ruane (2026)) that tariff changes were not correlated with the FDI reforms and industrial delicensing that occurred during the early 1990s. The distribution of tariff changes between 1991 and 1997 is very similar for industries that did and didn't experience other reforms (Supplemental Appendix Figure B.1 (Peter and Ruane (2026))), with the difference in average tariffs both small and statistically insignificant.

3.2. *Datasets*

Our approach to estimating equation (3) requires data on how much Indian plants spend on various types of material inputs, the prices they face for these inputs, and the import tariffs imposed on them. This section describes the main datasets we use.

3.2.1. *Annual Survey of Industries*

We use the Indian Annual Survey of Industries (ASI, Central Statistics Office) for plant-level data on intermediate input expenditures. The ASI is a nationally representative survey of registered (formal) Indian manufacturing plants. Plants with more than 100 workers are surveyed every year, while plants with more than 10 workers are randomly sampled (Supplemental Appendix Table A.1 (Peter and Ruane (2026))). The survey contains many of the standard measures of output and inputs (sales, labor, capital, materials). We use linking factors from a previous release of the ASI to construct a panel (see Bils, Klenow, and Ruane (2021) and Allcott, Collard-Wexler, and O'Connell (2016)). Summary statistics and the distribution of plant-level employment are shown in Supplemental Appendix Table G.1 (Peter and Ruane (2026)) and Supplemental Appendix Figure F.1 (Peter and Ruane (2026)) respectively.

An important feature of the ASI is that plants report expenditures on highly disaggregated categories of material inputs in certain years. Imports and domestic material expenditures are also reported separately for each input category. During our period of

[7] Irwin (2025) describes how the extent of the reforms largely came as a surprise: "Congress's 1991 election manifesto gave little hint that sweeping reforms were in store, let alone a dismantling of Nehruvian socialism." Due to the crisis and political circumstances, the trade reform was implemented in a matter of hours rather than weeks or months. Given that import liberalization was only one component of a broader package of reforms that were more politically charged (such as cuts in fuel and fertilizer subsidies, as well as industrial delicensing), they received surprisingly little pushback (Irwin (2025)). Tariff reductions were also largely at the discretion of the finance minister and did not require public debate.

[8] This is consistent with similar findings in Topalova (2010) and Topalova and Khandelwal (2011).

interest, this detailed breakdown of material inputs is available for the years 1989, 1993, 1994, and 1996. The data quality unfortunately worsens in the 1997 and 1998 surveys before improving again from 1999 onwards.[9] We, therefore, use the 1989 survey to measure pre-reform material expenditure shares, the 1996 survey to measure post-reform material expenditure shares, and the 1993/1994 surveys to explore transition dynamics from the short to medium-run.

The classification used for the reporting of material input expenditures and quantities in 1996 is the Annual Survey of Industries Commodities Classification (ASICC). The ASICC classifies all materials into 9 different 1-digit categories: "1. Animal and Vegetable Products," "2. Ores and Minerals," "3. Chemicals," "4. Rubber, Plastics and Leather," "5. Wood, Cork and Paper," "6. Textiles," "7. Metals," "8. Transport Equipment," and "9. Other Manufactured Articles." These are further disaggregated into 250 3-digit categories and 5,500 5-digit categories. Supplemental Appendix Table A.2 (Peter and Ruane (2026)) shows the most commonly used material inputs within each 1-digit category. Before 1996, plants report their materials according to the ASI Item Code classification. To link input expenditures between the earlier (1989, 1993, 1994) and later (1996–) waves, we construct a concordance between the ASI Item Code classification and the ASICC at the 5-digit, 3-digit level and 1-digit level. Supplemental Appendix A (Peter and Ruane (2026)) provides additional summary statistics and details about the data and concordance.

3.2.2. *Tariffs and Prices*

We obtain the official Indian import tariffs from Topalova (2010). These are available for 5,000 HS6 good categories. We use India's Wholesale Price Index (WPI, Office of the Economic Adviser) to measure prices for domestically produced inputs. The WPI contains yearly prices for 450 product categories covering the main agricultural and mining commodities and the main manufactured products. We complement the WPI with service and fuel price indices from India KLEMS (Das, Erumban, Aggarwal, and Das (2015)).

We construct a concordance linking our price and tariff data to the ASICC classification at the 5-digit level (see examples in Supplemental Appendix Table A.4 (Peter and Ruane (2026))). We keep only inputs for which both prices and tariffs are available from 1989 to 1997 and drop a set of goods (mostly cereal grains, oil seeds and derived agricultural products) where imports and exports were restricted to the public sector (canalization). As a result, we obtain price and tariff measures for 495 5-digit ASICC categories.

4. ESTIMATION OF ELASTICITY OF SUBSTITUTION BETWEEN MATERIAL INPUTS

In this section, we describe the estimation of the plant-level elasticity of substitution between material inputs and present our main results.

4.1. *Empirical Specification*

OLS estimates of elasticities of substitution might suffer from attenuation and simultaneity bias. Classical measurement error in input prices biases the estimate of θ towards 1. Simultaneity bias could arise from shifts in the demand for materials. For example, the adoption of a new cotton-intensive weaving machine might increase the demand

[9]The main issues are that the size threshold for inclusion in the survey was doubled, while the number of material inputs plants were required to report was capped at 5. In addition, there is a sharp increase in 1998 in the share of materials classified as "Other." See Supplemental Appendix A.1 (Peter and Ruane (2026)) for more details.

for cotton and thereby lead to an increase in both the expenditure share on cotton and the price of cotton—the latter will be true as long as the supply curve of cotton is upward sloping. The resulting positive correlation between prices and expenditure shares would bias OLS estimates of θ towards 0.

We overcome both of these concerns by instrumenting input price changes with tariff changes. Our empirical specification to estimate the elasticity of substitution between material inputs follows from equation (3):

$$\text{First stage: } \Delta \ln(P_{ik}) = \rho_m \Delta \tau_{ik} + \lambda_i + \eta_{ik}, \tag{4}$$

$$\text{Second stage: } \Delta \ln\left(\frac{E_{ik}}{E_i^m}\right) = \beta_m \Delta \ln(P_{ik}) + \lambda_i + \epsilon_{ik}, \tag{5}$$

where i denotes a plant, k is a 1-digit material input category (e.g., Textiles), and Δ stands for changes between 1989 and 1996. E_{ik}/E_i^m are expenditures by plant i on material input k as a share of total material expenditures. $\Delta \ln(P_{ik})$ is the change in plant i's price index for material input k. $\Delta \tau_{ik}$ is the change in the import tariff measure for plant i's material input k. λ_i is a plant fixed effect. ρ_m is the elasticity of domestic input prices with respect to import tariffs; the pro-competitive effects of tariff reductions. β_m is one minus the estimate of the elasticity of substitution between materials.

4.2. *Variable Construction*

We measure aggregate import tariffs and input prices at a granular level, allowing us to use plant-level spending shares to construct *plant-specific* input prices and tariffs at the 1-digit material input level. We now describe this approach.

Input Prices. We construct plant-specific changes in 1-digit material input (k) prices as the weighted average change in 5-digit material input (l) prices used by plant i:

$$\Delta \ln(P_{ik}) = \sum_l \bar{w}_{ikl} \Delta \ln(P_{kl}). \tag{6}$$

The weights $\bar{w}_{ikl}$ are average (Tornqvist) expenditure shares over the initial and end-period. In particular, for the change in the price index between 1989 and 1996, we construct $\bar{w}_{ikl} = (w_{ikl}^{1989} + w_{ikl}^{1996})/2$. This allows for an extensive margin at the 5-digit level, as the weights can equal 0. The advantage of using a Tornqvist price index over a Laspeyres price index (which uses initial period weights) is that the resulting price index $\Delta \ln(P_{ik})$ is a second-order approximation to the change in the true price index for any constant elasticity production function between 5-digit inputs. We, therefore, do not need to take a stand on how much substitutability there is *within* each 1-digit material input category.

Import Tariffs. We construct plant-specific import tariffs at the 1-digit material input level using the same approach as for prices, except that the 5-digit tariff changes are weighted by 1989, rather than average, expenditure shares w_{ikl}^{1989}:

$$\Delta \tau_{ik} = \sum_l w_{ikl}^{1989} \Delta \tau_{kl}. \tag{7}$$

We weight using initial period shares when constructing the import tariff to avoid post-liberalization expenditures on materials (which we treat as endogenous) entering the instrument (see, e.g., Borusyak, Hull, and Jaravel (2024)). The weights w_{ikl}^{1989} sum to one within each k.

Measurement Challenges. We face two measurement challenges. First, we do not have prices and tariffs for all 5-digit ASICC inputs (P_{kl} and τ_{kl}). Second, we rely on a concordance to the ASICC classification to construct the weights (w_{ikl}) on each 5-digit material input for the 1989–1994 ASI surveys.

Due to these two issues, we lose 17% of plant × 1-digit input observations. However, these observations account for only 6% of aggregate material expenditures, so our coverage remains high. We provide more detail on how we construct the price and tariff variables in Supplemental Appendix A.2 (Peter and Ruane (2026)).

Estimation Sample. The estimation sample consists of plants we observe in the ASI in both 1989 and 1996 and which use at least two categories of 1-digit material inputs in both years. The latter restriction comes from the fact that our specification identifies $\hat{\theta}$ from changes in *relative* expenditure shares within the plant. We drop the 1-digit input category "Transport Equipment" as it corresponds more closely to capital than to material inputs. We drop plants that import in either 1989 or 1996 because our identification relies on how import tariffs affect *domestic* input prices. We drop plants that change 4-digit industry as these plants likely changed which products they make. We trim the 1% tails of spending share changes ($\Delta \ln(E_{ik}/E_i^m)$) and price changes ($\Delta \ln(P_{ik})$), as well as the 5% tail of tariff changes ($\Delta\tau_{ik}$). We choose a higher cut-off for tariff changes since their distribution is left-skewed, and these outliers can have a disproportionate weight in the IV estimation.[10] Supplemental Appendix Tables G.2 and G.1 (Peter and Ruane (2026)) report summary statistics for the estimation and full samples.

4.3. *Identification*

Our IV falls into the category of shift-share (Bartik) instruments (Bartik (1991), Borusyak, Hull, and Jaravel (2024)). Our identifying argument stems from the exogeneity of the many shifts (Borusyak, Hull, and Jaravel (2022)) rather than exogeneity of the shares (Goldsmith-Pinkham, Sorkin, and Swift (2020)). In other words, we assume that the variation in tariffs across 5-digit material inputs is quasirandom. We outlined the institutional features of India's trade liberalization, which make the tariff variation plausibly quasirandom in Section 3.1. We also described the balance tests we have run, which show that tariff changes are uncorrelated with various other factors potentially leading to shifts in the demand for material inputs.[11] This is a sufficient condition for identification, provided that the shocks are dispersed, large in number, and with sufficiently small average exposure at the plant level.

[10] This sets the largest tariff decline at the plant-level to −160pp. In contrast to tariff changes, the distribution of price changes and spending share changes is symmetric. The IV estimates are similar in magnitude with 1% trimming (Supplemental Appendix Table G.7 (Peter and Ruane (2026))).

[11] In Supplemental Appendix Table G.6 (Peter and Ruane (2026)), we also check that the import tariff instrument is uncorrelated with other observables at the plant-input level in 1989, including the average price of a plant's inputs in 1989 relative to the industry median, the number of 5-digit inputs used by the plant (within a 1-digit input category), and the share of inputs concorded across classifications.

These conditions are met in our setting. We observe tariffs for 495 material input categories at the 5-digit level, though this falls to 297 tariffs once we restrict to inputs used by plants in 1989. Supplemental Appendix Figure F.3 (Peter and Ruane (2026)) plots the distribution of 1989–1996 tariff changes at the 5-digit level, with and without residualizing on 1-digit fixed effects. It shows that the shocks are dispersed—the standard deviation of tariff changes is 41pp in the raw data and 40pp after residualizing. Regarding the third condition, the need for small average exposure at the plant level implies that there must be sufficient heterogeneity in plants' material input expenditures within 1-digit ASICC categories.[12] A notable feature of plant-level data, and the Indian ASI in particular, is the significant dispersion in expenditures on material inputs even within narrowly-defined industries (see, e.g., Supplemental Appendix Figure F.2 (Peter and Ruane (2026)) and Oberfield and Boehm (2020)). To see how the distribution of plant exposures affects our estimation, we follow Borusyak, Hull, and Jaravel (2022) and report summary statistics of tariff changes weighted by their respective importance weights.[13] The importance-weighted standard deviation of tariff changes is 36pp, only slightly down from the unweighted dispersion (see kernel density plots in Supplemental Appendix Figure F.4 (Peter and Ruane (2026))). The inverse of the Herfindahl Index of importance weights—the "effective number of shifts"—is 33. This is significantly smaller than the total number of tariffs because some general-purpose inputs are used by many plants across industries (e.g., "gunny bags" has the largest importance weight). In summary, while the effective number of tariffs is lower than the total number of tariffs, there remains substantial dispersion in tariff changes underpinning our estimation strategy.

4.4. *Estimation*

We estimate the first stage regression following equation (4) and report results in the lower panel of Table I. For all our first and second-stage IV results, we report exposure-robust standard errors from the equivalent tariff-level instrumental variable regression, following Borusyak, Hull, and Jaravel (2022). We estimate that a 10 pp (relative) reduction in tariffs reduces (relative) domestic prices by 1.59%. Coincidentally, this is almost identical to Loecker, Goldberg, Khandelwal, and Pavcnik (2016) using a different measure of prices from Prowess and pooling together all years between 1989 and 1997. The first stage is strong, with an F-statistic of 18.0, above the conventional threshold of 10. We plot the relationship between tariff changes and input prices nonparametrically in Figure 2. There is no clear evidence of nonlinearities in the relationship between tariff changes and price changes.

Why do tariff reductions on imported inputs lead to price falls for the same domestically produced inputs? The main explanation is that tariff reductions increased competition facing domestic producers. As a result, domestic producers reduced their markups or found ways to improve production efficiency. Loecker, Goldberg, Khandelwal, and Pavcnik (2016) find that markup declines were an important explanation for the pro-competitive effects of India's trade liberalization.

The top panel of Table I presents the baseline OLS and IV estimation results. The OLS estimate of θ is 1.3 with a standard error of 0.17. As mentioned previously, both attenuation bias and simultaneity bias should lead to downward biased estimates of θ

[12]Our exposure measures sum to 1 by construction, and therefore we do not need to include the "incomplete share" control from Borusyak, Hull, and Jaravel (2022).

[13]The importance weights are proportional to the exposure share of that "shift" for an average observation.

TABLE I

BASELINE ESTIMATE OF θ.

	OLS	IV
$\Delta \ln(\text{prices})$	−0.30	−1.47
	(0.17)	(0.48)
$\widehat{\theta}$	1.30	2.47
95% CI	[0.96, 1.64]	[1.54, 3.40]
First Stage		
Δ tariffs	0.16	
	(0.038)	
F-stat	18.0	
Observations	10,144	10,144
# plants	3,943	3,943
# 5-digit ASICC inputs	297	297

Note: This table shows estimation results from the specifications in equations (4) and (5). An observation is a plant × 1-digit material input category. The dependent variable in the OLS and IV specifications are the change in plant spending shares between 1989 and 1996. The dependent variable in the first stage is the change in material input prices at the 1-digit ASICC input level. All regressions include plant fixed effects. Regressions are weighted by the inverse of the number of inputs used by the plant; that is, each plant is weighted equally. OLS standard errors are clustered at the 4-digit industry level. We report exposure-robust standard errors from the equivalent tariff-level instrumental variable regressions for the first-stage and IV specifications. The inverse of the Herfindahl index of the exposure weights is 33.3, and the largest weight is 0.101.

(the former assuming that $\theta > 1$). In addition, the OLS estimate picks up short-run price fluctuations and the long-run changes induced by tariff reductions. Given that we expect short-run substitution elasticities to be lower than long-run elasticities, this is another reason why the OLS estimate may lie below the IV estimate.

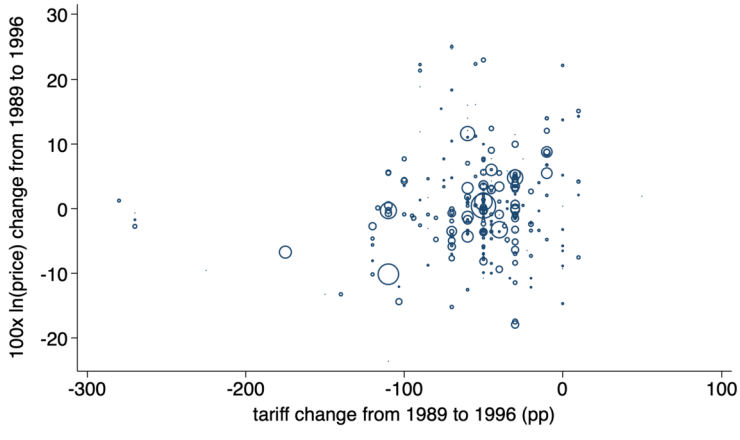

FIGURE 2.—Pro-competitive effects of tariff reductions (nonparametric first stage). *Note*: This figure plots the exposure-share weighted change in Indian input prices against the change in Indian import tariffs between 1989 and 1996, following equation (4). Each circle corresponds to a 5-digit ASICC product category, weighted using the importance weights from Borusyak, Hull, and Jaravel (2022). The estimate from the corresponding linear regression is 0.159, with a standard error of 0.038 (also reported in Table I). See Sections 3.2.2 for details on underlying data sources and variable construction.

TABLE II

PRODUCTION ELASTICITIES IN THE LITERATURE.

Paper	Elasticity	Aggregation	Country and Time Period	Horizon	Value
ACCD+ (2022)	b/w suppliers	Firm	Ecuador 2009–2015	1–5 year[a]	1.36
Atalay (2017)	b/w materials	Industry	U.S. 1997–2013	1 year	−0.1
Barrot and Sauvagnat (2016)	b/w suppliers	Firm	U.S. 1978–2013	1 year	≈ 0
Carvalho, Nirei, Saito, and Tahbaz-Salehi (2020)	b/w suppliers	Firm	Japan, 2010–2012	1 year	1.2
Fujiy, Ghose, and Khanna (2023)	b/w suppliers	Firm	India 2019–2020	1 Month	0.55
Miranda-Pinto (2021)	b/w materials	Industry	U.S. 1997–2018	1 year	−0.1

Note: This table lists papers estimating the elasticity of substitution between material inputs, or between suppliers of material inputs. The second column specifies whether the elasticity is between supplying firms or between material input categories. The third column specifies if the unit of production considered is the firm or the industry. The fourth column specifies the country and time period considered. The fourth column specifies the time horizon over which the elasticity is estimated. The fifth column reports the point estimate of the elasticity.

[a]We report a 1–5 year horizon for ACCD+ (2022) because their specification pools together both short-run and medium-run variation.

Consistent with a downward bias for OLS, the IV estimate of θ is higher, 2.5, with a standard error of 0.48. This is economically and statistically significantly higher than the Cobb–Douglas benchmark of 1. The 95% confidence interval lies between 1.5 and 3.4. To interpret the magnitude of the IV coefficient, consider a plant that uses two inputs, each with an initial spending share of 50%. The IV estimate implies that a 10% change in relative prices will lead to the relatively more expensive input's share declining to 47% over time and the relatively cheaper input's share increasing to 53%.

Our estimate of the elasticity of substitution between materials is significantly higher than existing estimates from the literature. We report the closest other estimates of θ in Table II, alongside the level of aggregation, country and time period, and time horizon over which they are estimated.[14] These estimates vary considerably in the levels of aggregation they consider; Barrot and Sauvagnat (2016), Carvalho, Nirei, Saito, and Tahbaz-Salehi (2020), Fujiy, Ghose, and Khanna (2023), and ACCD+ (2022) estimate a firm-level elasticity of substitution between suppliers while Atalay (2017) and Miranda-Pinto (2021) estimate an industry elasticity of substitution between broad material input categories. The values estimated range from strong complementarities to slightly above Cobb–Douglas. While the countries and time periods vary, the common factor across these estimates is that almost all focus on short time horizons of up to 1 year.[15] In contrast, we estimate the long-run elasticity between materials for a time horizon of 7 years in response to a permanent shock to prices. We also provide estimates of short-run elasticities in our setting in Section 5, which we estimate to be more in line with the papers in Table II.

[14]While also important, we do not include in this list papers estimating elasticities of substitution between imported and domestic intermediates (such as Boehm, Flaaen, and Pandalai-Nayar (2019) or Blaum, Lelarge, and Peters (2018)).

[15]In addition, these papers cover most sectors of the economy, while our paper focuses on manufacturing. Miranda-Pinto (2021) estimates a higher short-run elasticity between material inputs for service sectors relative to manufacturing.

4.5. *Robustness*

We perform a variety of robustness checks, which we summarize below.

Timing of Tariff Changes. The ideal scenario in which to estimate the long-run elasticity of substitution between material inputs would be for all tariffs to change simultaneously once and for all. This did not occur during India's trade liberalization. While most products saw their tariffs fall early, a minority of products had large tariff changes late in the liberalization period. This staggered timing introduces potential issues both with the power of the instrument (if pro-competitive effects take time) and with the interpretation of our estimate as a long-run elasticity.

To gauge the importance of this concern, we re-estimate θ under additional sampling restrictions. First, we drop plant-inputs-pairs that experienced relatively large and late tariff changes, defined as a decline in tariffs greater than 20pp between 1994 and 1996 that accounted for at least 50% of the overall tariff decline from 1989 to 1996. Second, we also restrict our attention to plants that saw large (relative) tariff changes in the very first years of the liberalization; plants with above median standard deviations of 1989–1992 tariff changes across their inputs. Reassuringly, we find very similar results to our baseline (Supplemental Appendix Table G.7 (Peter and Ruane (2026))).

Trends in Input Use. The balance tests in Supplemental Appendix Table G.5 (Peter and Ruane (2026)) indicate that tariff changes were not correlated with industry trends prior to the liberalization. We can go further and control for any trends in input use occurring at the 1-digit ASICC level during the liberalization by adding 1-digit ASICC fixed effects to equation (4) and equation (5). This rules out the possibility that our results are driven by trends in input use or input prices that happened to be correlated with tariff changes. We report the results in Supplemental Appendix Table G.7 (Peter and Ruane (2026)). The first-stage estimates are very similar, while the IV estimates are somewhat larger in magnitude (above 3) and have larger standard errors but remain statistically significantly different from 1 at the 10% level.

Other Reforms. We reported in Section 3.1 that both industrial delicensing and FDI reforms were uncorrelated with tariff changes. Still, plants in industries experiencing other large reforms may have had different responses to tariff changes, which could have implications for external validity. To test whether this is the case, we report in Supplemental Appendix Table G.8 (Peter and Ruane (2026)) the elasticity estimates separately for industries that underwent other reforms between 1991 and 1997 and those that did not. As before, we consider two of the other major sets of reforms that occurred during this period: industrial delicensing reforms and FDI reforms. We find that point estimates tend to be larger for plants in industries that did *not* undergo simultaneous reforms, while standard errors are considerably larger for plants that did undergo other reforms. One explanation for this is that delicensing may have significantly changed the products plants produced, introducing measurement error through changes to the input bundles that were not related to tariff changes. Reassuringly, this suggests that our estimates would also be applicable to other empirical settings where plants only faced changes in relative prices.

Import Substitution and Quality Upgrading. There may be a concern that reductions in import tariffs may induce domestic producers to improve the quality of their products (Verhoogen (2008), Goldberg, Khandelwal, Pavcnik, and Topalova (2010), Bas and Strauss-Kahn (2015)). To the extent that these quality changes are not perfectly captured

by the Wholesale Price Index (as discussed in Section 3.2.2), they might introduce a bias in the IV estimates. While India's statistical authorities designed the WPI to track goods of constant quality, it is well known that variety and quality biases continue to complicate inflation measurement even in the U.S. (BDGG+ (1996)).[16] We evaluate the potential direction and magnitude of this bias in Supplemental Appendix C (Peter and Ruane (2026)). We show that, if tariff reductions induce quality upgrading, this would result in our IV estimate being upward biased. Using simulated regressions, we quantify the potential magnitude of this bias. We find that if the unmeasured quality response to tariffs amounts to 10% of the observed price response, the true elasticity of substitution would be 2.3, declining to 2.0 if the unmeasured quality upgrades are as high as 50% of observed price responses. These results suggest that, even for very large unmeasured quality changes induced by tariff changes, the true elasticity of substitution remains high.

Sampling and Firm Exit. Our estimation strategy limits us to plants that we observe both in 1989 and 1996. Because only plants with more than 100 workers are sampled with certainty, and because smaller plants typically have higher exit rates, large formal manufacturing plants are over-represented in our estimation sample relative to smaller ones (see Supplemental Appendix Figure F.1 (Peter and Ruane (2026)) and Supplemental Appendix Table G.1 (Peter and Ruane (2026))).[17]

Plants of different sizes could have different elasticities of substitution for several reasons. On the one hand, production flexibility could reflect good management and, therefore, be correlated with productivity and size. On the other hand, large plants could face larger adjustment costs, making it more difficult to change their input mix. Large plants might also produce a broader array of products and use a wider range of inputs, enabling substitution both between inputs and between products. We explore this directly by estimating θ separately for small and large plants. We estimate somewhat higher elasticities for smaller plants, 2.9 vs. 2.2, though the difference is not statistically significant (Supplemental Appendix Table G.10 (Peter and Ruane (2026))).

Further, in order to be in our estimation sample, a 1-digit input must be used by the plant in both 1989 and 1996. Our baseline estimation strategy, therefore, does not capture extensive margin changes at the 1-digit level. For example, plants could switch from cardboard/paper to plastic containers and drop the 1-digit category "Wood, Cork and Paper" entirely. However, the 1-digit inputs that get dropped or added typically account for a very small share of plant expenditures. At this level of aggregation, the median value-share of inputs dropped (added) is 1.6% (1.1%) (Supplemental Appendix Table G.3 (Peter and Ruane (2026))). We also conduct a robustness check in estimating θ for plants where there is no extensive margin change in the set of 1-digit inputs used between 1989 and 1996 (Supplemental Appendix Table G.9 (Peter and Ruane (2026))). We estimate an elasticity very similar to the baseline.

The last concern is that the trade liberalization led to differential plant exit. For instance, one may think that plants with less flexible production processes were less well able to adapt to import competition and shut down as a result. If this is the case, our estimation sample consist of firms with higher elasticities of substitution. While our setting

[16] According to the documentation, statistical authorities were well aware of issues related to quality and variety changes over time. See https://eaindustry.nic.in/archive_data/archive/wpi_technical_report.pdf for additional details on the data collection and construction of the price index.

[17] In addition, our sample does not include any *informal* manufacturing plants; these account for roughly 35% of manufacturing value-added during the 1990s (Bollard, Klenow, and Sharma (2012)).

offers limited possibilities to address this directly, we can gauge the importance of this channel by comparing our plant-level estimates to the *industry-level* elasticity of substitution between material inputs, which we estimate in Section 6.3. This elasticity, which captures the effects of plant entry and exit on changes in industry expenditure shares, is broadly in line with our baseline estimate of θ.

Measurement. Lastly, we show that our results are robust to the way we clean and trim the data, as well as alternative methods of constructing the price and tariff measures (Supplemental Appendix Table G.11 (Peter and Ruane (2026))).[18] We also consider additional robustness exercises in Supplemental Appendix Table G.9 (Peter and Ruane (2026)). We find similar results to the baseline when we use a Laspeyres price index (using 1989 shares as weights) when restricting the sample to each plant's top three inputs or restricting the set of inputs to those that account for at least 1% of plant expenditures (averaged between 1989 and 1996).

5. SHORT-RUN VS. LONG-RUN ELASTICITY ESTIMATES

The high elasticity of substitution we estimate contrasts significantly with existing, much lower estimates (Atalay (2017), Barrot and Sauvagnat (2016), Boehm, Flaaen, and Pandalai-Nayar (2019), Carvalho, Nirei, Saito, and Tahbaz-Salehi (2020)). There are three aspects that are unique to our setting. First, we estimate elasticities over a longer horizon, 7 years, rather than quarter on quarter or year on year. Second, the trade liberalization constitutes a permanent shock to relative prices rather than a change that is likely to be temporary, such as supply chain disruptions. Both of these differences are especially important in the presence of adjustment costs, which would lead firms to be reluctant to adjust production processes quickly or in response to temporary changes. Third, we estimate elasticities for Indian firms rather than firms in advanced economies such as the U.S. or Japan.

To gauge the importance of the time horizon and the perceived permanence of the price change, we estimate two additional, short-run, elasticities in this section. First, using the subset of inputs whose tariffs changed early, we estimate the elasticity between materials for a shorter horizon. While standard errors are large, we find suggestive evidence that elasticities increase with the time horizon, consistent with (Boehm, Levchenko, and Pandalai-Nayar (2023)). Second, we use transitory shocks (fluctuations in global commodity prices) to estimate the same elasticity over a 1-year horizon. We find much lower elasticities, closer to the conventional wisdom in the literature.

5.1. *Dynamics Effects of Trade Liberalization*

We use the 1993 and 1994 waves of the ASI to estimate the short-run elasticity of substitution between material inputs and contrast the results with the long-run estimates from the 1996 wave of the ASI.

[18] We consider the following robustness checks: (1) only trimming the 1% tails of tariff changes, (2) trimming the 2% tails of prices, tariffs, and shares, (3) using average industry value shares to construct the price and tariff variables instead of plant-specific shares, (4) constructing prices and tariffs using plant-specific 3-digit expenditure shares but aggregate 5-digit expenditure shares within each 3-digit category, (5) restricting the sample to plants where more than 95% of inputs in 1989 are concorded to the ASICC classification, (6) constructing tariff changes as $\ln(1+\tau_{ik})$. The only case where the IV estimate is not significantly greater than 1 is when we use average industry value shares to construct prices and tariffs. The lower precision is not surprising as we use less of the available variation in the data.

The reductions in tariffs across product lines were staggered between 1991 and 1997; some products saw their tariffs fall earlier than others. Tariff rates were at the discretion of the minister for finance, and so did not require public debate (Irwin (2025)), and beyond a gradual lowering of the maximum tariff rate (Singh (2017)), it is not entirely clear how policymakers determined the sequencing of tariff reductions. While the sequencing of tariff reductions could in principle reflect strategic industry considerations or lobbying, Dr. Raja Chelliah, Chairman of the Indian Tax Reforms Committee between 1991 and 1993, stated in a 2004 interview: *"When we started economic reforms in 1991, we concentrated on the most urgent things that anyhow had to be done […]. We didn't have the time to sit down and think exactly what kind of a development model we needed."*[19] This suggests that the sequencing of tariff changes throughout the trade liberalization was not driven by a development strategy or lobbying linked to trends in material input use. Corroborating this, we rerun balance tests in Supplemental Appendix Table G.4 (Peter and Ruane (2026)) and confirm that the tariff changes from 1989 to 1992 are not statistically significantly associated with industry characteristics in 1988 or pre-trends from 1985 to 1988.

The short-run estimation sample comprises plant-inputs from our baseline estimation in Section 4 that also are sampled in either 1993 or 1994. This ensures that differences between our short-run and long-run estimates are not driven by plant exit or changes in the extensive margin of input use. We also make the same sampling restrictions as for our robustness check in Section 4.5; we only keep plants that experienced large relative tariff changes in the first year of the liberalization, and drop any plant-inputs where there were large tariff changes between 1994 and 1996.[20] This ensures that plants in the short-run estimation sample already experienced meaningful tariff changes by 1993/1994.

The identifying assumptions remain the same as described in Section 4, though the estimation sample and period are now different. To check that the sample restrictions are not meaningfully changing the composition of the sample, we show in Supplemental Appendix Figure F.5 (Peter and Ruane (2026)) that the distribution of plant sizes and material expenditure shares in 1989 are similar for plants that are in the short-run estimation sample and those that are only in the long-run estimation sample.

The estimation equations are similar to those for our baseline specification, except they are now indexed by a year subscript t, given that we pool together 1993 and 1994:

$$\text{First stage: } \Delta \ln(P_{ikt}) = \rho_m \Delta \tau_{ikt} + \lambda_{it} + \eta_{ikt}, \tag{8}$$

$$\text{Second stage: } \Delta \ln\left(\frac{E_{ikt}}{E^m_{it}}\right) = \beta_m \Delta \ln(P_{ikt}) + \lambda_{it} + \epsilon_{ikt}. \tag{9}$$

Because we are pooling 2 years of data, the plant fixed effects are replaced with plant × year fixed effects. As before, we report exposure-robust standard errors from the equivalent tariff-year level IV regression, clustered at the 5-digit ASICC level.

We present short-run results in Table III. We also present the long-run estimates under the same sampling restrictions for comparison. The short-run first stage is somewhat weaker than for the corresponding long-run estimation; the F-stat is 17. We also find lower pro-competitive effects of tariff reductions on domestic input prices relative to the

[19] Topalova (2010), with full interview available here: https://www.rediff.com/money/2004/jul/05inter.htm).

[20] For the first restriction, we regress the 1989–1992 tariff changes at the plant-input level on a plant-fixed effect, and construct the standard deviation of the residuals. We only keep plants with above median standard deviation of the residuals. For the second restriction, we drop plants that experienced a decline in tariffs greater than 20pp between 1994 and 1996 that accounted for at least 50% of the overall tariff change.

TABLE III

SHORT-RUN VS. LONG-RUN ELASTICITY ESTIMATES.

	Short-Run		Long-Run	
	OLS (1)	IV (2)	OLS (3)	IV (4)
Δ(prices)	0.26	0.31	−0.69	−1.32
	(0.27)	(0.61)	(0.26)	(0.49)
Elasticity	0.74	0.69	1.69	2.32
	[0.21, 1.27]	[−0.52, 1.89]	[1.18, 2.19]	[1.35, 3.29]
First Stage				
Δ tariffs	0.12		0.17	
	(0.029)		(0.032)	
F-stat	16.6		26.8	
Observations	3,676	3,676	3,118	3,118
# plants	1,008	1,008	1,334	1,334
# 5-d inputs	272	272	280	280

Note: This table shows our short-run estimation results from the specifications shown in equations (8) and (9), as well as our long-run estimation results from the specifications in equations (4) and (5). In columns (1)–(2), an observation is a plant × year × 1-digit material input category. In columns (3)–(4), an observation is a plant × 1-digit material input category. The sample for all columns only includes plants that experienced large relative tariff changes in the first year of the liberalization, and excludes any plant inputs where there were large tariff changes between 1994 and 1996. The dependent variable in columns (1)–(2) are the change in plant spending shares between 1989 and either 1993 or 1994. The dependent variable in columns (3)–(4) are the change in plant spending shares between 1989 and 1996. The dependent variable in the first stage is the change in material input prices at the 1-digit ASICC input level. All regressions include plant fixed effects. Columns (1)–(4) include plant × year fixed effects. Regressions are weighted by the inverse of the number of inputs used by the plant; each plant is weighted equally. The OLS standard errors are clustered at the 4-digit industry level. We report exposure-robust standard errors from the equivalent tariff-level instrumental variable regressions for the first-stage and IV specifications. For the short-run (long-run) horizon results, the inverse of the Herfindahl index of the exposure weights is 23.3 (23.1), and the largest weight is 0.147 (0.153).

longer time horizon. Our interpretation is that the pro-competitive effects of trade also take time to materialize; low-productivity firms may not immediately exit, and it may take time for imported inputs to penetrate all markets. The OLS and IV estimates of the short-run elasticity of substitution are all less than one. We cannot reject Cobb–Douglas, and in the case of the IV estimates, we can neither reject Leontief or elasticities as high as 1.9 with 95% statistical confidence. In contrast, the long-run estimates are all greater than one, and the 95% confidence intervals for the IV estimates lie above 1.[21]

Discussion. The difference in the short-run and long-run elasticity estimates indicates that the dynamic response of plants' input mixes to relative price changes takes time, even when the shocks are large and permanent. This supports a role for convex adjustment costs. Our results also highlight that quite long time horizons are required to estimate long-run elasticities of substitution when using variation in prices over time, similar to Boehm, Levchenko, and Pandalai-Nayar (2023).

5.2. *Short-Run Elasticity Estimates Using Commodity Prices*

In this subsection, we estimate the elasticity of substitution between material inputs using price changes induced by global commodity price shocks. We estimate these in the

[21] We find similar results if we include 1-digit input fixed effects (Supplemental Appendix Table G.12 (Peter and Ruane (2026))).

same setting, Indian manufacturing, in order to show that our previous larger estimates are not driven by Indian plants reacting more to changes in material input prices than firms in other countries.

For this exercise, we need a relatively long panel with consecutive years of data on plant material input usage. We therefore use the Annual Survey of Industries waves from 1999 to 2013. We use official concordances and panel identifiers to construct a panel at the plant × 1-digit ASICC input level.[22] As before, we construct plant-specific input prices for each 1-digit ASICC input by weighting changes in India's wholesale price index using Tornqvist expenditure shares (averages between t and $t+h$):

$$\Delta_h \ln(P_{ikt}) = \sum_l \bar{w}^h_{iklt} \Delta_h \ln(P_{klt}). \tag{10}$$

We identify a set of commodities at the HS 6-digit level using the classification from Fally and Sayre (2019). We manually concord these commodities to 5-digit ASICC codes.[23] We construct annual global prices for each commodity as the ratio of global import values and global import quantities reported in Fally and Sayre (2019) who use the BACI trade database (Gaulier and Zignago (2010)). We construct the commodity price instrument analogously to the tariff instrument:

$$\Delta_h \ln\left(P^C_{ikt}\right) = \sum_l \left(\frac{E^C_{iklt}}{E^m_{ikt}}\right) \Delta_h \ln\left(P^C_{klt}\right). \tag{11}$$

We weight ln-changes in the global price of commodity l from t to $t+h$ using period t plant-specific shares of expenditure on commodity l over total material expenditures in input category k. Our specification is analogous to that in equations (4) and (5):

$$\text{First stage: } \Delta_h \ln(P_{ikt}) = \rho^h_m \Delta_h P^C_{ikt} + \lambda^h_{it} + \sum_t \delta_t \left(\frac{E^C_{ikt}}{E^m_{ikt}}\right) + \eta^h_{ikt}, \tag{12}$$

$$\text{Second stage: } \Delta_h \ln\left(\frac{E_{ikt}}{E^m_{it}}\right) = \beta^h_m \Delta_h \ln(P_{ikt}) + \lambda^h_{it} + \sum_t \delta_t \left(\frac{E^C_{ikt}}{E^m_{ikt}}\right) + \epsilon^h_{ikt}. \tag{13}$$

The first main difference is that we now index the changes by the horizon h and pool across years t from 1999 to 2013, We consider 1-year and 2-year horizons. Because the commodity exposure weights do not sum to one, we fall into the "incomplete shares" case of Borusyak, Hull, and Jaravel (2022).[24] We, therefore, control for each firm's total share of expenditure on commodities within each 1-digit category (E^C_{ikt}/E^m_{ikt}). Intuitively, we only exploit the composition of each firm's commodity bundle for identification, not total exposure to commodities. We report exposure-robust standard errors clustered at the 5-digit ASICC level.

[22] We start the panel in 1999 because we need a long sample period, and the data quality in 1997 and 1998 is poor. See Supplemental Appendix A.1 (Peter and Ruane (2026)) for more details on the 1999–2013 waves of the ASI and concordances.

[23] Commodities are concentrated in the following 1-digit ASICC categories: "1. Animal and Vegetable Products," "2. Ores and Minerals," "3. Textiles," and "7. Metals." Averaging from 1999 to 2013, they account for 22% of 5-digit inputs used, 41% of total material expenditures, and 48% of expenditure on imported materials.

[24] To be specific, it is not necessarily the case that for all i and k $\sum_l E^C_{iklt}/E^m_{ikt} = 1$.

TABLE IV

SHORT-RUN ELASTICITY ESTIMATES WITH COMMODITY PRICE IV.

	1-Year Horizon		2-Year Horizon	
	OLS (1)	IV (2)	OLS (3)	IV (4)
Δ ln(prices)	0.09	0.57	0.05	0.61
	(0.05)	(0.28)	(0.05)	(0.34)
Elasticity	0.91	0.43	0.95	0.39
	[0.81, 1.00]	[−0.12, 0.98]	[0.87, 1.04]	[−0.29, 1.06]
First Stage				
Δ commodity price		0.22		0.29
		(0.059)		(0.107)
F-stat		13.6		7.5
Observations	77,130	77,130	42,092	42,092
# plants	18,584	18,584	10,649	10,649
# 5-digit inputs	94	94	92	92

Note: This table shows our short-run estimation results using global commodity price fluctuations as an instrument, from the specifications shown in equations (12) and (13). An observation is a plant × year × 1-digit material input category. The sample includes plant in the ASI survey waves from 1999 to 2013. The dependent variable is the log-change in plant spending shares. The dependent variable in the first stage is the change in plant material input price at the 1-digit ASICC input level. All regressions include plant × year fixed effects and controls for plant expenditure share on commodities within each 1-digit ASICC category, interacted with year fixed effects. Regressions are weighted by the inverse of the number of inputs used by the plant; each plant is weighted equally. The OLS standard errors are clustered at the 4-digit industry level. We report exposure-robust standard errors from the equivalent year × 5-digit input level instrumental variable regressions for the first-stage and IV specifications, clustered at the 5-digit ASICC input level. For the 1-year (2-year) horizon results, the inverse of the Herfindahl index of the exposure weights is 85.4 (76.4), and the largest weight is 0.041 (0.038).

The key identification assumption is that fluctuations in relative global prices of commodities are uncorrelated with other determinants of material input demand for manufacturing plants in India. This is plausible given that the main feature of commodities is that they are traded on global markets and we use the average global price as our instrument. Even a comparatively large economy such as India accounted for only 2.9% of global commodity imports, averaging across commodities and years from 1999 to 2013.

We report the estimation results in Table IV. There is a reasonably strong first stage at the 1-year horizon, with the F-statistic equal to 13.6, though this is somewhat weaker at the 2-year horizon. At the 1-year horizon, we estimate that a 10% increase in global commodity prices leads to a 2% increase in domestic Indian input prices over a 1-year horizon. Consistent with typical findings in the literature, the OLS estimate of the elasticity of substitution is below but very close to 1. Our baseline IV estimate is 0.43, with 0 in the 95% confidence interval. Extending to the 2-year horizon (columns (3) and (4) of Table IV) and including 1-digit input fixed effects (Supplemental Appendix Table G.13 (Peter and Ruane (2026))) leads to similar, albeit somewhat noisier, estimates.

Discussion. Our estimates of short-run complementarities between material inputs in response to transitory shocks to input prices are consistent with similar estimates in the literature. In particular, Atalay (2017) estimates an elasticity between material inputs very close to 0 using U.S. industry data and military spending shocks for identification. This suggests that our findings of *long-run* substitutability between materials in response to tariff shocks are not due to the particular setting of Indian manufacturing but rather due to the long time horizon and permanency of the price shock.

The previous two empirical results confirm that the likely difference between our estimate and existing ones is that plants in our sample faced a permanent change in relative prices to which they adjusted over an extended period of time. Taken together, this is indicative of manufacturing plants facing sizeable adjustment costs. If it is costly for firms to adjust their production process, they are less likely to do so if they can reasonably expect relative prices to return to baseline within a quarter or a year. The fact that plants' responses to a permanent change takes time to materialize—as we find evidence for in Section 5.1—suggests that these adjustment costs are convex.[25]

6. OTHER LONG-RUN INPUT ELASTICITIES

The tariff changes during India's trade liberalization caused changes in relative prices of material inputs, constituting an ideal setting to estimate the elasticity of substitution between these. However, the trade liberalization also reduced the cost of materials overall compared to other inputs such as energy, services, or capital and labor.

In this section, we estimate a set of other elasticities. First, we use the standard KLEMS classification of nesting and estimate the elasticity between energy, materials, and services, as well as between a capital-labor bundle and an intermediates bundle. Second, we estimate several alternative nesting structures guided by models of firm production used in the literature. We conclude this section by estimating the between-materials elasticity at the industry—rather than the plant level, which accounts for reallocation of production across firms.

6.1. *Nested CES Production Function*

The first set of elasticities we estimate is the one corresponding to a standard nested CES production function, where the nests follow the KLEMS accounting framework. This production function is commonly used in macroeconomic models due to its tractability in aggregation. The main inputs in this framework are capital (K), labor (L), energy (E), materials (M), and services (S).

6.1.1. *Nesting Structure*

Plant i produces output Q_{it} in period t using a CES composite of a capital-labor bundle $F(L_{it}, K_{it})$ and an intermediate input bundle X_{it}. ε is the elasticity of substitution between the capital-labor bundle and the intermediate input bundle. γ_{it} determines the relative importance of value-added in production:

$$Q_{it} = A_{it}\left(\gamma_{it}F(L_{it}, K_{it})^{\frac{\varepsilon-1}{\varepsilon}} + (1-\gamma_{it})X_{it}^{\frac{\varepsilon-1}{\varepsilon}}\right)^{\frac{\varepsilon}{\varepsilon-1}}.$$

The intermediate input bundle X_{it} itself has a CES structure across energy (E_{it}), materials (M_{it}), and services (S_{it}):

$$X_{it} = \left[\pi_{it}^{e}E_{it}^{\frac{\theta^X-1}{\theta^X}} + \pi_{it}^{m}M_{it}^{\frac{\theta^X-1}{\theta^X}} + \pi_{it}^{s}S_{it}^{\frac{\theta^X-1}{\theta^X}}\right]^{\frac{\theta^X}{\theta^X-1}},$$

θ^X is the elasticity of substitution between energy, materials, and fuels. π_{it}^{e}, π_{it}^{m}, and π_{it}^{s} are input-biased technological shifters. M_{it} is in turn given by equation (2).

[25] Huneeus (2018) and Liu and Tsyvinski (2021) propose models of production networks with adjustment costs that result in larger long-run compared to short-run elasticities of substitution.

TABLE V

UPPER CES NEST ELASTICITY ESTIMATES.

	θ^X		ε	
	OLS (1)	IV (2)	OLS (3)	IV (4)
Δ(prices)	0.36	0.13	0.45	0.03
	(0.19)	(0.17)	(0.14)	(0.29)
Elasticity	0.64	0.87	0.55	0.97
	[0.26, 1.02]	[0.53, 1.21]	[0.27, 0.83]	[0.41, 1.54]
First Stage				
Δ tariffs	0.24		0.20	
	(0.082)		(0.070)	
F-stat	8.6		7.9	
Observations	13,373	13,373	6,692	6,692
# plants	6,798	6,798	6,692	6,692
# 5-d inputs	309	309	309	309

Note: This table shows our estimation results from the specifications shown in equations (8) and (9) (columns (1) and (2), and (10) and (11) (columns (3) and (4)). An observation in column (1) and (2) is a plant × input (energy or services). An observation in columns (3) and (4) is a plant. The dependent variable in the OLS and IV specifications in columns (1) and (2) are the change in plant relative spending shares on materials vs. energy or materials vs. services between 1989 and 1996. The dependent variable in the OLS and IV specifications in columns (3) and (4) are the change in plant relative spending shares on intermediates vs. capital and labor between 1989 and 1996. The dependent variable in the first stage is the change in relative input prices at the 1-digit ASICC input level. Regressions are weighted by the inverse of the number of inputs used by the plant; each plant is weighted equally. The OLS standard errors are clustered at the 4-digit industry level. We report exposure-robust standard errors from the equivalent tariff-level instrumental variable regressions for the first-stage and IV specifications. For the θ^X (ε) results, the inverse of the Herfindahl index of the exposure weights is 46.3 (46.2), and the largest weight is 0.084 (0.084).

6.1.2. *Estimation*

The empirical specifications for estimating θ^X and ε, as well as the approaches to constructing the tariff instrument and input prices, are analogous to what we describe in Section 4 for the estimation of θ. Similarly, the identifying assumptions remain that the variation in tariffs across 5-digit material inputs is quasi-random. We, therefore, relegate the details to Supplemental Appendix D (Peter and Ruane (2026)) and only present the results in the main text.

Table V presents the estimates of θ^X and ε. The IV point estimates (standard errors) of θ^X and ε are less than but close to one; 0.87 (0.17) and 0.97 (0.29), respectively. The 95% confidence intervals include Cobb–Douglas for both elasticities. We can reject Leontief for both elasticities. We find similar results for a number of robustness checks, which we report in Supplemental Appendix Tables G.14 and G.15 (Peter and Ruane (2026)).

These estimates, therefore, suggest that inputs are less substitutable at higher levels of aggregation. While we find high elasticities between different material inputs, it seems that materials, energy, and services, as well as intermediate inputs and value-added, are not very substitutable even in the longer run.

6.2. *Alternative Nesting Structures*

The nesting structure we estimated in the previous subsection is commonly used, yet only one of many possible nesting structures. In what follows, we consider alternative nesting structures that have also been considered in the literature for which our setting

allows us to estimate the relevant elasticities. We briefly discuss these below; Supplemental Appendix Table G.16 (Peter and Ruane (2026)) contains all estimation results.

Alternative Levels of Aggregation of Materials. Our baseline results estimate the elasticity of substitution across 8 categories of materials, as classified by the ASI. Alternatively, we can estimate the same elasticity across more disaggregated categories. We follow the level of aggregation used in Atalay (2017), which corresponds to a combination of 2-digit and 3-digit NAICS codes. The elasticity across these finer 14 material input categories is very similar at 2.5.

Materials vs. Labor and/or Capital. Following the KLEMS classification, our baseline nesting structure imposes a constant elasticity between a bundle of capital and labor and a bundle of materials, energy, and services. Alternatively, one can imagine that firms first combine labor and materials, such as typically considered in the literature on outsourcing (Chan (2023), Oberfield and Boehm (2022)), or materials and a capital-labor bundle (Oberfield and Raval (2021), Castro-Vincenzi and Kleinman (2024)).

We estimate the elasticity between labor and materials as well as between a capital-labor bundle and materials.[26] We estimate elasticities close to or below one. The point estimates for the materials-labor elasticity are 0.78 (OLS) and 1.13 (IV). The elasticity between materials and value-added is even lower than between labor and materials, with point estimates of 0.53 (OLS) and 0.69 (IV).

Materials vs. Energy / Services. Our baseline nesting structure imposes a common elasticity between energy, materials, and services. Alternatively, we could estimate the elasticity separately between materials and energy or materials and services.[27] The importance of the substitutability of energy in production has been highlighted in recent years, given the hike in energy prices in Europe following Russia's invasion of Ukraine. We estimate gross complementarities between energy and materials using OLS regressions, but very close to Cobb–Douglas with the IV. The point estimates are 0.70 (OLS) and 1.17 (IV), with the latter statistically different from 0 but not from 1. Interestingly, our point estimates suggest that energy and materials are more substitutable than services and materials.

6.3. *Plants vs. Industries*

The plant-level elasticities in Tables I and V are the key structural parameters for the macroeconomic model we present in Section 7. However, the macroeconomics and trade literature have mostly used models with industry production functions, that is, without an explicit nesting of plants within each industry. In these models, the *industry*-level elasticities of substitution are the key structural—constant—parameters.[28]

The key difference between plant and industry elasticities of substitution is that the latter captures the contribution of entrants, exiters, and reallocation across plants to changes in industry input shares. As discussed in Oberfield and Raval (2021), even with constant plant-level elasticities, industry-level elasticities of substitution are not constant if plants

[26]For completeness, we also estimate an elasticity between materials and capital. The specifications are analogous to those described in Section 4 and Supplemental Appendix D (Peter and Ruane (2026)).

[27]Since we only have an instrument for materials prices, we cannot estimate the elasticity between energy and services.

[28]Caliendo and Parro (2015) and Caliendo, Parro, and Tsyvinski (2022) are recent examples.

are heterogeneous in their spending shares: changes in relative prices lead to a reallocation of inputs across plants. As a result, the local industry-level elasticity of substitution between two inputs is a convex combination of the elasticity of substitution across inputs and the elasticity of demand faced by plants.

To speak to this literature, we estimate the industry-level elasticity of substitution between 1-digit materials. The specifications are identical to the plant-level specifications in equations (4)–(5), except that the unit of production is the 4-digit industry rather than the plant. We construct industry-level expenditure shares on each intermediate input category as the sum of all expenditures by plants in that industry in a given year. We also construct industry price indices and tariff instruments in the same way as we do for plants, weighting 5-digit prices and tariffs by industry expenditure shares.[29]

The estimation results are presented in the last column of Supplemental Appendix Table G.16 (Peter and Ruane (2026)). We estimate an elasticity of 3.2 between different categories of materials. However, the industry estimates are less precise than the plant estimates, and the difference is not statistically significant. The higher industry elasticity than plant elasticity suggests that *total* inputs are being reallocated towards plants that experienced greater decreases in tariffs. This is consistent with the elasticity of demand facing firms being greater than our estimated elasticity of substitution between materials (Oberfield and Raval (2021)).

7. THE AGGREGATE IMPORTANCE OF INTERMEDIATE INPUT SUBSTITUTABILITY

The fact that we estimate a high degree of substitutability between materials in the long run has two important consequences. On the one hand, the economy is more resilient to negative productivity shocks than previously thought. On the other hand, distortions, such as those arising from market power, contracting frictions, or direct government policy, are even more harmful than previous estimates suggest. This is particularly true if such frictions apply directly to intermediate inputs.

To quantify this, we embed the model of plant-level production from Sections 2 and 6 into a general equilibrium framework calibrated to the Indian economy. We briefly outline the model and calibration strategy below and relegate details to Supplemental Appendix E (Peter and Ruane (2026)). We use the model to run a set of counterfactuals using three possible values for the elasticity of substitution between materials: the substitutes case (our estimated $\theta = 2.5$), the standard Cobb–Douglas case ($\theta = 1$), and a complements case ($\theta = 0.1$), and compare the predicted effects on aggregate output.

We directly use the estimated long-run elasticity and do not take a stand on the exact mechanism by which substitution is higher in the long run than in the short run. Our quantitative model is thus a reduced form for a variety of such mechanisms that have been proposed by the literature, such as adjustment costs (Boehm, Levchenko, and Pandalai-Nayar (2023)), putty-clay production (Gilchrist and Williams (2000)), or the fact that it may take time to find new suppliers (Huneeus (2018)).

[29] As before, we drop inputs whose expenditure share in the industry is less than 0.1%, trim the 1% tails of price changes, spending share changes, and tariff changes, and for the estimation of θ trim the 5% left tail of tariff changes. We also drop industries with fewer than 10 plants on average. One difference relative to the plant-level specification is that we do not drop industries with positive imports, as this would dramatically reduce the sample size.

7.1. *Model and Calibration*

For the sake of maximum transparency, we choose a standard model of a static, small open economy with multiple sectors, building on Long and Plosser (1983). In each sector, there is a large, exogenous number of perfectly competitive firms that use labor and intermediate inputs in production. Each intermediate input has a domestic and an imported variety; otherwise inputs are aggregated as in Sections 2 and 6.[30] Firm output is aggregated to a sectoral good using a standard CES aggregator. The sectoral good is used as intermediate input or further aggregated to a single consumption good, which is used domestically and exported to pay for imported inputs.

We calibrate the model to sectoral input–output shares from the World Input-Output Database (WIOD, TDLS+ (2015, 2013)) as well as plant-level moments—such as the distribution of firm-level productivity and technologies—from the ASI. We calibrate the model to 1996, which is the earliest year for which both the WIOD and the ASI are available. We use our estimates from this paper for the elasticities of substitution between materials, energy, and services as well as between value-added and intermediates.[31] The corresponding cross-sector elasticities on the consumption side are set to 2.6, as estimated by Hobijn and Nechio (2019). That is, goods from different sectors are substitutes in consumption, irrespective of the calibration on the input side.

7.2. *Resilience to TFP Shocks*

What happens to the economy when a sector suffers a negative TFP shock? Typically, the multi-sector models used to explore such questions share a similar underlying structure to the one in this paper, albeit focusing on transitory shocks and a short time horizon.[32] With most of the literature pointing to short-run complementarities in production, a low value of the elasticity of substitution is generally used. This, in turn, results in relatively larger aggregate impacts of negative sectoral shocks.

In contrast, our findings suggest that in response to a permanent TFP shock over the long run, an economy would be able to adjust and dampen some of these negative effects. For example, in the complements calibration, a 50% productivity shock to one sector of the Indian economy would, on average, lead to a more than 60% reduction in output from that sector, as well as a 3.7% decline in aggregate output. Using the elasticities we estimate, the same sectoral productivity shock would, on average, lead to only a 2.9% drop in aggregate output. In a more substitutable economy, the affected sector contracts by more—82% on average—, dampening the resulting fall in aggregate output.

7.3. *Input Distortions*

The flip side of the economy's increased flexibility in dampening negative TFP shocks is that distortions and taxes can have more detrimental effects. Such distortions are likely

[30] Our baseline estimation in Section 4 uses only plants that do not use imported intermediates. In the model, these would be plants with a zero weight on the imported variety in that new lower nest.

[31] We use our baseline estimate of $\theta = 2.5$ also for the elasticity of substitution between energy inputs and between services inputs. The conclusions of the following section are not sensitive to this assumption as we get similar results when setting these two elasticities to 1.

[32] Many studies have applied the framework of Baqaee and Farhi (2019) and Baqaee and Farhi (2024) to various countries and settings. For example, BBBK+ (2022) estimate the effect of a German embargo on Russian gas imports.

TABLE VI

GDP LOSSES FROM INPUT DISTORTIONS.

Substitutes	Cobb–Douglas	Complements
−28.7%	−13.5%	−7.7%

Note: The table shows the change in aggregate GDP from adding firm-level distortions to material inputs. The distortions are drawn from a log-normal distribution with mean zero and a standard deviation of 0.5. Each column corresponds to a different calibration of the elasticity of substitution between materials, θ.

to be ubiquitous, especially in developing countries. Examples include contracting frictions (Boehm (2022), Oberfield and Boehm (2020)), transportation cost (Peter and Ruane (2022)), or different prices charged by input suppliers (Burstein, Cravino, and Rojas (2024)).

To gauge how big such distortions may be in our context, we use the detailed plant-level data from the ASI. Even within industries, there is significant heterogeneity in input spending shares across plants. In the baseline model, we assumed that all heterogeneity in plant spending shares is a result of different technologies used. If, instead, one were to interpret heterogeneity in spending shares as resulting from distortions, their implied log standard deviation equals 1.46.

Starting from our undistorted initial calibration, we consider a counterfactual in which we introduce firm-level distortions to material inputs with variance equal to 1/3 of the observed dispersion in the data.[33] We choose 1/3 so as to not overstate the degree of input distortions, since some of the observed heterogeneity is likely due to differences in technology or measurement error (Bils, Klenow, and Ruane (2021)).

Table VI reports the results. When material inputs are substitutes, distorting input choices leads to a 28% drop in GDP. In contrast, in an economy where material inputs are complements, the same level of, say, contracting frictions with suppliers would only cost around 8% of output. The fact that losses are over 4 times higher in the longer run is due to the economy's greater flexibility: the more firms adjust their input choices in response to the frictions, the more they distort production allocations relative to the first best.

7.4. *Sectoral Subsidies*

The input distortions we considered above generate inefficient dispersion in input use across firms but do not directly favor one sector over another. However, many governments around the world have adopted industrial policies favoring particular sectors (Liu (2019)), often targeting upstream sectors producing intermediate inputs (Lane (2025)). While there may be various reasons in favor of industrial policies, such as offsetting existing distortions, they also have the potential to cause significant welfare losses if badly targeted.

To illustrate this point, we simulate two sets of counterfactuals. First, we consider a permanent uniform 30% revenue subsidy to all firms in a sector.[34] If material inputs are complements, this policy would lead to a 1.5% drop in aggregate output on average (Table VII). With our estimated elasticities, the drop in GDP is 2.5%–67% larger.

[33]The distortions are drawn from a log-normal distribution with mean zero.

[34]All policies we consider are paid for by a lump-sum tax to the household.

TABLE VII

GDP LOSSES FROM A 30% SECTORAL SUBSIDY.

	Substitutes	Cobb–Douglas	Complements
Subsidy to one sector's output	−2.5%	−1.8%	−1.5%
Subsidy to inputs from one sector	−4.3%	−1.7%	−0.8%

Note: Table VII shows the average change in aggregate GDP from subsidizing one of the economy's sectors by 30%. The first row corresponds to a uniform output subsidy to all firms in a given sector. The second row corresponds to a subsidy to inputs used from a given sector.

Second, we consider a policy subsidizing purchases of domestic intermediate goods or services from a sector. This would be a prime example of import substitution.[35]

We implement the policy as a subsidy paid to all firms in proportion to their input use. In an economy in which material inputs are complements, this policy causes less of a decline in aggregate TFP than subsidizing the entire sector's output. As the subsidy only affects intermediates and not consumption—where goods are substitutes—sectoral subsidies cause less distortion overall. However, when intermediates are substitutes, subsidizing inputs from one sector has much larger distortionary effects on firms' production choices. As firms tilt their intermediates bundle more towards the subsidized input, this sector's share of the aggregate intermediate good increases by 2% on average, compared to 0.3% when materials are complements. As a result of the distortion between consumption and intermediate use of the subsidized sector, aggregate losses are large, amounting to over 4% of GDP on average.

7.5. *Trade Liberalization*

Last, we use the quantitative model to assess the gains from India's trade liberalization. Since the WIOD does not go back to 1989, we first use the model to generate calibration targets. That is, we feed the tariff *increases* from 1996 to 1989 into the model with our estimated elasticity and use the resulting pre-liberalization equilibrium as calibration targets for all three versions of the model for 1989.

Starting from the constructed 1989 baseline, we then simulate the observed decline in tariffs from 1989 to 1996 and compare the pre- and post-liberalization equilibria in the three calibrations. Since we model India as a small open economy, the tariff changes have no effect on world prices, and there is full pass-through to the price of imported goods.

Table VIII shows the results. If intermediate inputs were complements, GDP would have increased by just below 3.2% as a result of the observed tariff declines. With our estimated elasticity, that number is 5% larger. The reason this particular counterfactual is less sensitive to the elasticity of substitution between intermediate inputs is that the trade liberalization acts in a manner akin to a sectoral productivity shock. Tariffs declined, on average, by about 30%. Coupled with an average import share of intermediates of less than 15% in 1989, the trade liberalization constitutes a shock that is small enough for Hulten's theorem to hold approximately.

[35]That said, we have also run counterfactuals in which all inputs from a certain sector, domestic or imported, are subsidized and find similar aggregate effects.

TABLE VIII

GAINS FROM THE TRADE LIBERALIZATION.

	Substitutes	Cobb–Douglas	Complements
Change in GDP	3.4%	3.3%	3.2%

Note: Table VIII shows the effects on aggregate output of the tariff declines during India's trade liberalization. The pre-liberalization equilibrium is constructed by feeding the tariff changes from 1996 to 1989 into the 1996 model with $\theta = 2.5$. All three models are then calibrated to the model-implied 1989 equilibrium, and the same tariff decline from 1989 to 1996 is then simulated to obtain the GDP response.

8. CONCLUSION

In this paper, we provide the first estimates of long-run elasticities of substitution between intermediate inputs at the plant level. The empirical setting—the manufacturing sector during India's trade liberalization—provides us with the unique combination of detailed data and quasiexogenous variation necessary for estimation. We find an elasticity of substitution between broad categories of materials around 2.5—a significant departure from existing short-run estimates, which are close to 0.

We argue that the elasticity of substitution is sensitive both to the time horizon it is estimated over and to the nature of the shock. We find evidence that it takes plants time to adjust to the permanent price change over the trade liberalization—elasticities are lower over four instead of seven years. Further, intermediate inputs appear to be complements when estimated in response to temporary shocks such as those induced by commodity price fluctuations.

The value of the elasticity of substitution between intermediate inputs is crucial for a range of questions in macroeconomics. Most prominently, we find that permanent distortions to intermediate inputs, such as those caused by a poor contracting environment, may lead to aggregate losses on the order of 30%—3.5 times larger than in the short run when intermediates are complements.

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