Misallocation in the Market for Inputs*

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Abstract

How costly is weak contract enforcement? Using microdata on Indian manufacturing plants, we show that in states with weaker enforcement, as measured by judicial lags, production and sourcing decisions appear systematically distorted. We document that in those states, plants' expenditure shares on intermediate inputs tend to be lower, with the effect concentrated in industries rely more heavily on inputs that require customization. To quantify the impact of these distortions on aggregate productivity, we construct a model in which plants have several ways of producing, each with different bundles of inputs. Weak enforcement exacerbates a holdup problem that arises when using inputs that require customization, distorting both the intensive and extensive margins of input use. The distortions accumulate along supply chains.

KEYWORDS: Intermediate Inputs, Misallocation, Productivity, Contract Enforcement
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