

Trade Liberalization, Roads and Firm Productivity*

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November 25, 2019

Abstract

We examine the role of road infrastructure in determining the impact of a reduction in input tariffs on firm productivity. We combine new geo-spatial data on road improvements in Ethiopia with establishment level data on manufacturing firms that allow us to estimate physical productivity. Results show that an input tariff reduction is associated with a larger increase in firm productivity in areas where better roads improve access to other intranational markets. Roads magnify pass-through of tariff reductions to imported input prices and also incentivize firms to exploit this cost advantage to enhance productivity. Road infrastructure hence complements trade liberalization.

Keywords: Input tariffs; transport infrastructure; roads; firms; productivity; Ethiopia

JEL Classification: F14; O14; O18

* We are grateful to Francesco Amodio, Andrew Bernard, Cosimo Beverelli, Maarten Bosker, Lorenzo Caliendo, Davin Chor, Simona Fabrizi, Pablo Fajgelbaum, Michele Imbruno, Andualem Mengistu, Christian Meyer, Niclas Moneke, Steven Poelhekke, Georg Schaur, Meredith Startz, Joel Stieble, Frederic Warzynski, Jens Wrona and participants to DEGIT Paris, ETSG Florence, ICEG Naples, FIW Vienna, SIEPI Ferrara, CSAE Oxford, ATW in Auckland, GLAD in Göttingen, the 13th Timbergen Institute Conference in Amsterdam, the ABCA Conference at Stanford, the EEA Annual conference in Cologne, the IGC/PEDL workshop at LSE, and to seminars at EDRI in Addis Ababa, SALDRU in Cape Town, IOB in Antwerp, Roma Tre, University of Michigan, UNU-Merit, DICE in Düsseldorf for helpful comments and conversations. We acknowledge support by Fitsum Mulugeta, Tewodros Gebrewolde and the Ethiopian Economic Association for facilitating the collection of census data from CSA. We thank Girum Abebe, Margaret McMillan and Michel Serafinelli for sharing their survey data on FDI in Ethiopia. We are grateful to officials in the Ethiopian Central Statistical Agency; the Ethiopian custom authority; and the Ethiopian Road Authority for providing precious insights and feedback in face to face interviews during a field trip in November 2018. We also thank members of the Galbino Project for hospitality during the initial stages of the project. Sanfilippo and Sundaram gratefully acknowledge financial support by the IGC (project n. 32403) and thank SALDRU, University of Cape Town for grant administration. Fiorini received funding from the European Union's Horizon 2020 grant agreement No 770680 ("RESPECT"). The views expressed in this paper are those of the authors. They are not meant to represent the positions or opinions of IGC. All errors are our own.

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1 Introduction

Trade liberalization has been shown to benefit economies in numerous ways. Increased competition and better access to intermediate inputs resulting from trade liberalization can spur innovation and lead to productivity enhancements (Topalova and Khandelwal, 2011; Bigsten et al., 2016; Bloom et al., 2016; De Loecker, 2011), while lower product prices can generate welfare improvements for consumers (Ural Marchand, 2012). However, the distribution of gains from trade liberalization is far from uniform within countries and depends on complementary domestic conditions, including the flexibility of labor and credit markets, quality of institutions and provision of public goods and infrastructure (Pavcnik, 2017). Identifying and understanding these complementary conditions and the channels through which they shape the effects of trade liberalization is crucial to inform policy and ensure that trade works for all.

In this study, we examine the complementary role of road infrastructure in determining the impact of input tariff (the tariff on intermediate inputs) liberalization on firm productivity. We argue that roads matter for productivity gains from input tariff liberalization. Specifically, we propose that improved roads amplify the impact of a reduction in input tariffs on firm productivity by boosting firms' connectivity to intranational markets. Increased intranational connectivity can not only magnify the pass-through of a tariff reduction to input prices, but also incentivize firms to undertake actions that enhance physical total factor productivity by improving market access. Such productivity-enhancing actions may include investing in new imported inputs and/or superior technology. Our empirical analysis combines newly constructed geo-spatial data from Ethiopia on road improvements under the Ethiopian Road Sector Development Program (RSDP) with detailed establishment level data on manufacturing firms.

Overlapping trade and road infrastructure reforms make Ethiopia an excellent case study for our purpose. Tariffs were reduced progressively starting in the early 1990s and continuing into our sample period, as part of a trade liberalization agenda initiated externally. Tariff changes were hence largely exogenous to domestic firms. Next, Ethiopia embarked on extensive improvements to roads via the RSDP, aimed at improving connectivity throughout the country. Significant enhancements in road infrastructure were undertaken under this program, including projects to rehabilitate and upgrade the quality of existing roads and to build new ones.

To study the impact of roads, we utilize raw data on the evolution of the Ethiopian road network over time, sourced from the Ethiopian Road Authority (ERA). For each point in time during our sample period, we observe the set of existing road segments, their surface type and their condition. We identify urban areas (towns) using contiguous lit spatial units from high resolution nocturnal satellite images. Road improvements under the RSDP result in differential changes in the quality of road infrastructure across Ethiopian towns over time, either through increases in the quality of the existing road network or through an expansion of the existing network with the construction of new roads. Our primary measure of roads for each Ethiopian town in a given year is its market access, determined by the road network (hereafter referred to simply as market

access). This variable captures the intensity of possible road connections between the urban area (town) in which a firm is located and other markets in the country. Furthermore, we employ an additional measure of roads that captures the travel time from each town to Galafi, the last Ethiopian town en route to Ethiopia’s primary port in Djibouti¹. This second measure (hereafter referred to as Galafi) is intended to capture the impact of road infrastructure improvements on the cost of transporting imported inputs intranationally, from port to destination.

We exploit census data on Ethiopian manufacturing establishments from 1998 through 2009 to construct measures of firm productivity.² In addition to information on revenues, the Ethiopian manufacturing census records data on quantities, allowing us to compute unit-values at the firm level. This allows us to build quantity-based physical productivity measures that are not affected by the usual caveats undermining the application of revenue-based productivity in studies of trade liberalization and firm performance. As highlighted by a burgeoning literature, focusing on revenue-based productivity introduces biases in the estimation of production function coefficients and may confound the effects of trade liberalization on physical productivity and firm markups (see for instance De Loecker, 2011; De Loecker et al., 2016).

Our empirical strategy relates firm productivity to input tariffs, roads and an interaction of the two to explore the complementary effect of roads on the relationship between input tariffs and firm productivity. We find strong complementarity between market access and input tariff liberalization. A one percentage point decrease in the input tariff is associated with a 3.1 percentage point larger increase in productivity for a firm with median market access relative to a firm with market access at the 5th percentile. A one percentage point decrease in the input tariff is associated with a 0.4 percentage point larger increase in productivity for a firm with market access at the 95th percentile relative to a firm with median market access. We find no evidence for complementarity between input tariff liberalization and travel time to Galafi.

Results survive a battery of robustness checks, including the introduction of control variables for local road infrastructure improvements that account for the endogeneity of road investments, and for the presence of multinationals. Our findings are further confirmed with alternative measures of productivity, roads, tariffs and in various cuts of the data. Finally, results endure after we control for the effect of a reduction in output tariffs (the tariff on the final good produced by the firm) on firm productivity that operates by increasing competition.

We explore the mechanisms through which roads complement the relationship between input tariff liberalization and firm productivity. We find that with a fall in the input tariff, firms in towns with better market access are more likely to employ newly imported intermediate inputs and a higher capital-labor ratio. Both these findings provide support for our argument that better market access increases the incentive for firms to invest in total factor productivity enhancements. Additionally, an input tariff reduction is associated with greater pass-through to input prices for firms in areas with better market access. In an extension of our empirical analysis, we look at revenue-based firm productivity and the markup charged as additional dependent variables. We

¹About 93% of total Ethiopian trade is estimated to transit through the port of Djibouti, according to the World Bank (World Bank, 2013).

²The data, collected by the Ethiopian Central Statistical Agency (CSA), include detailed information at the establishment level on location (town), labor and capital use, usage of imported inputs and exports.

find some evidence for complementarity between market access and the impact of input tariff liberalization on revenue-based productivity. However, our results on the markup charged by firms reveal no such complementarity. We argue that two contrasting forces are potentially at work. While amplified gains from an input tariff reduction for firms in towns with better market access mean larger markups, increased competitive pressures from better market access can exert an opposing influence.

Our paper makes several contributions. First, we contribute to the literature studying infrastructure development in the context of international trade. This literature has embedded intranational trade costs into models of international trade to emphasize that better transport infrastructure can impact interregional and international trade (Donaldson, 2018), shape the pattern of comparative advantage among sub-national entities (Coşar and Fajgelbaum, 2016) and determine the intranational distribution of gains from falling international trade barriers (Atkin and Donaldson, 2015; Allen and Atkin, 2016; Ramondo et al., 2016). However, to date, there has been no formal assessment of the role played by roads in determining the impacts of trade liberalization on physical firm productivity, specifically through firm decisions to import new inputs or upgrade technology. We aim to fill this gap by underscoring the role for transport infrastructure in ensuring productivity gains from better access to intermediate inputs for domestic firms.

Second, our study contributes to the literature demonstrating that lower input tariffs and the resulting access to cheaper, better quality and a wider variety of intermediate inputs is associated with greater firm productivity (Topalova and Khandelwal, 2011; Bigsten et al., 2016), higher markups (Brandt et al., 2017), product quality improvements (Amiti and Khandelwal, 2012) and greater product scope (Goldberg et al., 2010). In this context, we argue that the positive effects of an input tariff reduction are augmented when firms are better connected to markets intranationally by quality transport infrastructure. In fact, firms in less connected regions may lose out on gains from trade liberalization.

Third, our study broadly relates to the literature emphasizing road infrastructure improvements as crucial for economic development in low-income countries (Storeygard, 2016; Donaldson, 2018). Policy makers have long touted the potential for roads to generate growth and alleviate poverty.³ While studies have found that good roads are associated with increases in firm activity (Shiferaw et al., 2015), exports (Volpe Martincus and Blyde, 2013; Coşar and Demir, 2016) and employment (Volpe Martincus et al., 2017), recent work casts doubt on the ability of road improvements to substantially transform rural economies in developing countries (Asher and Novosad, 2018). By focussing on inputs and firm productivity, we highlight an important role for roads in ensuring gains from trade liberalization. Our results suggest that initial road investments bring the largest productivity gains for firms, echoing existing work on investment in railroads in Africa (Jedwab and Moradi, 2016).

The remainder of the paper is organized as follows. Section 2 presents our conceptual

³ The World Bank identified "widespread poverty ... linked to, among others, the constraint imposed by the poor road network on economic and social development and the creation of local employment opportunities" as a concern for Ethiopia (World Bank, 2018).

framework. Section 3 focuses on the empirical analysis. We describe our measures of tariffs and road infrastructure, the data and estimation of physical total factor productivity. We further discuss the empirical specification, identification issues and estimation strategy. Section 4 presents results, robustness checks and extensions to the baseline analysis. Section 5 concludes.

2 Conceptual Framework

The main goal of our study is to analyze the role played by road improvements in determining the impact of an input tariff reduction on physical total factor productivity of firms. In this section, we discuss the channels through which road improvements shape the productivity impacts of trade liberalization. We begin by noting that a reduction in the input tariff can lead to a decrease in input prices, generating a cost advantage for firms. As pointed out by Atkin and Donaldson (2015), the transmission of input tariff reductions to reductions in input prices can be a complex function of the quality of transportation infrastructure. Specifically, the quality of roads can lead to differential pass-through of tariff reductions to input prices, both through its impact on the marginal cost for intermediaries transporting inputs domestically and the demand conditions they face.⁴ However, an important point we make in this paper is that this differential pass-through following a reduction in input tariffs alone is neither necessary nor sufficient for road improvements to generate differential effects of input tariff liberalization on firm productivity.

We posit that an increase in physical productivity results from specific actions firms take, following a reduction in input tariffs (hereinafter referred to as productivity-enhancing actions). For instance, a firm might respond to a decrease in the price of imported inputs by introducing a new input. It might simultaneously adopt a new technology that relies on this revised input mix, which increases total factor productivity (Topalova and Khandelwal, 2011). Other mechanisms that explain how the introduction of a new imported input can lead to an increase in productivity include: (i) adopting imported intermediates that are imperfectly substitutable with domestic inputs and that, through higher price-adjusted quality, improve firm productivity (Halpern et al., 2015); (ii) adopting a larger variety of imported intermediates under a production technology that displays love-of-variety, generating greater efficiency from greater specialization of resources (Colantone and Crinò, 2014). (iii) adopting imported capital inputs that embody superior technology (Xu and Wang, 1999; Eaton and Kortum, 2001; Yasar and Paul, 2007).

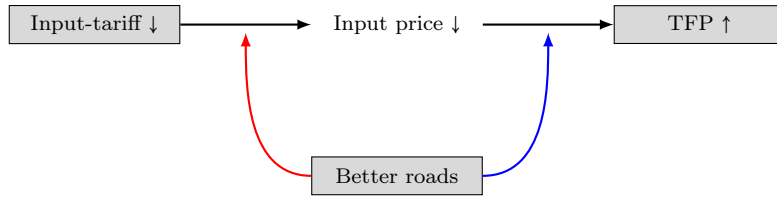
We argue that roads differentially affects firms' incentives to take productivity-enhancing actions in response to the cost advantage generated by an input tariff reduction. The quality of roads determines the degree of market access in the firm's area (town). Better connectivity to intranational markets means that, on the one hand, firms can access larger demand. Jensen and Miller (2018) show how, when consumers learn about non-local producers, firms gain market share and grow. On the other hand, firms compete more intensively with other final good producers, given that an increase in market access allows consumers to access goods

⁴ We discuss intermediaries and pass-through of input tariff reductions to domestic prices in Appendix A.

produced by firms in other locations. Greater demand and more competition increase the potential gains for firms from improving total factor productivity (Lommerud et al., 2009), increasing incentives to use the cost advantage implied by a reduction in input tariffs to undertake productivity enhancements. Thus, we argue that firms in locations with better roads will have a greater incentive to increase physical productivity with an input tariff reduction.

To summarize, roads determine the overall effect of input tariffs on firm productivity in two ways, as illustrated in Figure 1. First, roads shape the pass-through of an input tariff reduction to a decrease in input prices for firms (the red arrow in Figure 1). Second, they influence the incentives faced by firms to take productivity-enhancing decisions in response to the cost advantage generated by these lower input prices (the blue arrow in Figure 1). We wish to reiterate here that the first channel alone only impacts how an input tariff reduction impacts firm profitability, not firm productivity. In other words, the differential pass-through from input tariffs to input prices generated by roads is not sufficient to establish that roads play a role in determining the effects of input tariff liberalization on firm productivity. Moreover, it is not a necessary condition either. Even if pass-through does not vary with roads, the incentives to take productivity-enhancing actions in response to an input tariff reduction can vary, leading to a differential effect of input tariff liberalization on productivity. This emphasis on the role played by roads in enhancing physical firm productivity is a crucial contribution of our paper.

Figure 1: The two channels of roads' impact in shaping the effect of input tariffs on productivity



In the empirical analysis that follows, we will estimate the differential effect of an input tariff reduction on the productivity of firms located across urban areas (towns) with varying quality of roads. We will also aim to disentangle the mechanisms through which roads shape the impact of a reduction in input tariffs on firm productivity. Particularly, we will explore differential pass-through of input tariff reductions to input prices. We will also examine evidence for potential productivity-enhancing actions that firms take in response to an input tariff reduction, and ask if they vary with road quality.

Finally, we will exploit rich geo-spatial information on the Ethiopian road network to identify whether road improvements matter because they increase connectivity along specific intra-national trade routes (the route from each location to Galafi) and/or because they enhance the overall degree of market access for firms in an area. We can thus throw light on how new and better roads play a role in determining the productivity impacts of trade liberalization.

3 Empirical Framework

This section presents the ingredients of our empirical framework. Section 3.1 discusses Ethiopian infrastructure and tariff reforms and related measures used in the analysis. Section 3.2 describes the database of Ethiopian firms and the methodology we adopt to estimate total factor productivity. Our preferred approach accounts for both output price and input price biases in addition to the standard endogeneity concerns due to simultaneity in input choices. Section 3.3 introduces the empirical specification used to analyze the role of infrastructure in determining the effect of a reduction in input tariffs on firm productivity and discusses our identification strategy. Finally, Section 3.4 introduces the estimation sample and reports summary statistics.

3.1 Infrastructure and Tariffs in Ethiopia: Reforms and Related Measures

3.1.1 Road infrastructure

Being a landlocked country with a poorly developed railway system, Ethiopian road transport represents the dominant mode for intranational movement of people and goods (Imi et al., 2017).⁵ At the end of the nineties, the deteriorated condition of the existing road network spurred the Ethiopian Government to launch a major infrastructural reform program: the Road Sector Development Programme (RSDP). The first three phases of the program, from July 1997 to June 2010 involved construction, rehabilitation, upgrading and maintenance of federal and regional roads by the Ethiopian Roads Authority (ERA) and the Regional Roads Authorities (RRAs).

The official assessment of the first three phases of the program (Ethiopian Roads Authority, 2011) reveals substantial improvements in road infrastructure along multiple dimensions between 1997 and 2010 (see Table 1).

Table 1: Improvements in road infrastructures during the RSDP

Indicators	1997	2010
Proportion of Asphalt roads in Good Condition	17%	73%
Proportion of Total Road network in Good Condition	22%	56%
Road Density/ 1000 sq. km	24.1	44.4

Notes: Raw data sourced from Ethiopian Roads Authority (2011).

The main source of information on Ethiopian road infrastructure we draw upon in this paper is a proprietary geo-spatial database consisting of coded documents by the ERA and the RRAs reporting on all road construction sites that were opened in the context of the first three phases of the RSDP. The resulting database is a time series of shapefiles of the Ethiopian road network, where for each geo-localized road segment, two main attributes are registered: the type of road

⁵ The railway connecting Addis to the port of Djibouti was ceased in 2007 in the section between Addis and Dire Dawa. The new railway connecting Addis to Djibouti has been financed by a Chinese concessional loan project and was inaugurated in early 2017, almost ten years after the sample period analyzed in this paper.

surface and the road's condition. There are four types of road surfaces in the data: earth surface, minor gravel (which identifies regional rural roads with a gravel surface), major gravel (federal gravel roads) and asphalt. As for road conditions, the database distinguishes between two categories: (i) not rehabilitated and (ii) new or rehabilitated.⁶

Figure 2a presents the network of federal and regional roads in 1996 by type of surface and the cities that are covered in our empirical analysis. Figure 2b shows the network of federal and regional roads in 2010, distinguishing between road segments which existed in 1996 and were not rehabilitated by 2010 (light grey segments on the map) and roads that were either newly constructed or rehabilitated during the first three phases of the RSDP. A visual inspection of the two maps shows a substantial expansion of the road network between 1996 and 2010. This data on road improvements can be aggregated to compute the average travel speed for each road segment at each point in time. This is done in accordance with the speed matrix proposed by the ERA and reported in Table 2.⁷

Figure 2: Federal roads, regional roads and the RSDP

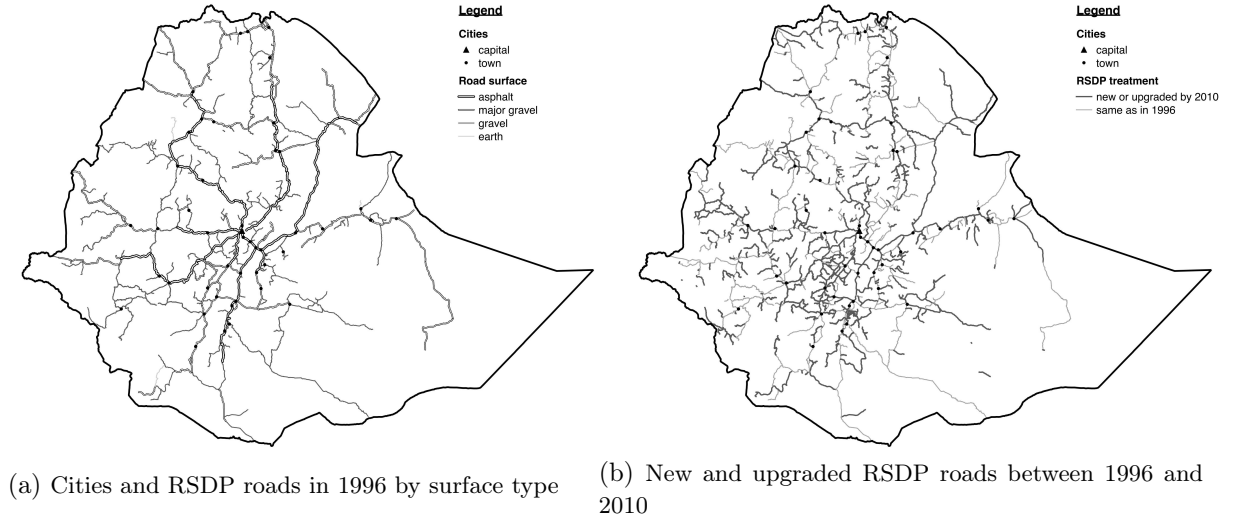


Table 2: The ERA travel speed matrix

Surface	Condition	
	Not rehabilitated	Rehabilitated or new
Asphalt	50	70
Major gravel	35	50
Minor gravel	25	45
Earth	20	30

Notes: The table reports average travel speed as a function of the surface and condition of the road segment. Speed is measured in kilometers per hour.

To identify the role of road improvements in determining the relationship between a reduction in

⁶ Information on road surface and condition are recorded every two years from 1996 to 2010. The raw data were compiled by a local consultant. The consistency and accuracy of the original documents used for the coding exercise were checked by the authors during a field trip in 2017.

⁷ The same speed matrix has been used by Shiferaw et al. (2015) and Storeygard and Jedwab (2018).

input tariffs and firm performance, we employ two measures of the quality of roads. The first one is an indicator of market access à la Harris (1954). This and alternative versions of the market access indicator have been used by Donaldson and Hornbeck (2016) to measure the economic effects of infrastructural developments in the context of a formal structural gravity trade model. In our context, and similarly to Storeygard (2016), market access captures the structure of road connections between a geographically defined urban area (city or town) where a firm is located and all other urban markets in the country weighted by the intensity of their economic activity.⁸

Formally, we define the indicator Market access_{*rt*} for each town *r* at time *t* as follows:

$$\text{Market access}_{rt} = \log \left(\sum_{z \neq r} D_{rz,t}^{-1} L_z \right) \quad (3.1)$$

where $D_{rz,t}$ is the minimum distance in hours of travel between town *r* and town *z* given the road network in place at *t*, and L_z is an indicator of economic activity based on night-light intensity in *z* in the pre-sample period (1996).⁹ Bilateral distances in travel hours are computed applying the Dijkstra algorithm on the network of Ethiopian urban areas (nodes) connected by federal and regional Ethiopian roads (links).¹⁰ Each link is characterized by its average travel speed, a function of the surface type and condition of the road segment(s) in the link (see Table 2). Hence, the variable Market access_{*rt*} captures the intensity of the road infrastructure reform treatment received by town *r* at time *t* as the capacity of such treatment to affect *r*'s contact with intranational markets in the country.

Following Henderson et al. (2011, 2012) we measure town-level economic activity with night light data. More precisely, L_z is given by the sum of the beginning of sample (1996) night light intensity scores provided by NOAA National Geophysical Data Center (2018) over 0.86km² grid cells within the urban area corresponding to town *z*.¹¹ Urban areas are defined as contiguous lit areas between 1996 and 2010 intersecting with, or situated within a 5 kilometer-ray buffer centered on the town coordinates as reported in the road network database.¹² Note that since

⁸ In the computation of market access, we consider all cities recorded as hosting firms in the Ethiopian Census of Large and Medium Manufacturing Firms.

⁹ While many papers including Donaldson and Hornbeck (2016) use population data in the computation of market access, we employ night light intensity data as in Storeygard (2016). This is particularly appropriate, given our interest in supply-side economic activity.

¹⁰ Starting from the shapefiles with road segments, we create additional ancillary nodes to allow for turns at every intersection between road segments. We have no information on the direction of travel allowed on each road segment. Hence, links are set so that they are not directed, reflecting the underlying assumption that each road segment can be travelled on in both directions. This is a reasonable assumption, given the focus on regional and federal roads which represent the majority of road infrastructure in the country. A road (link) is connected to a town node when it enters the corresponding urban area (definition follows in the main text). Unlike Ethiopian regions (the first level of administrative division in the country), city or town areas are small and relatively homogeneous. For this reason, we assume zero distance for connections between roads and town nodes. Alternative assumptions do not change the resulting market access indicator.

¹¹ Following Eberhard-Ruiz and Moradi (2018), we use scores from raw satellite images, instead of processed images with stable nightlights, as more reliable proxies of economic activity in small and medium African towns.

¹² This definition of urban areas follows the approach in other studies, as in Henderson et al. (2017) and Eberhard-Ruiz and Moradi (2018). We thus identify urban areas starting from town coordinates as reported in the Ethiopian Census of Large and Medium Manufacturing Firms. For 6 town, we do not find any corresponding lit area and we exclude their coordinates from our analysis. Also, the contiguous lit area associated with Addis, the capital city, is associated with 8 town coordinates: Addis, Burayu, Sululta, Sendafa, Akaki, Sebeta, Bishoftu, Modjo. We partition this area into 7 sub-areas consisting of the Voronoi polygons defined around town coordinates.

L_z is fixed over time, the time variation in Market access $_{rt}$ solely reflects the rehabilitation, upgrading and construction of new roads undertaken during the first three phases of the RSDP.

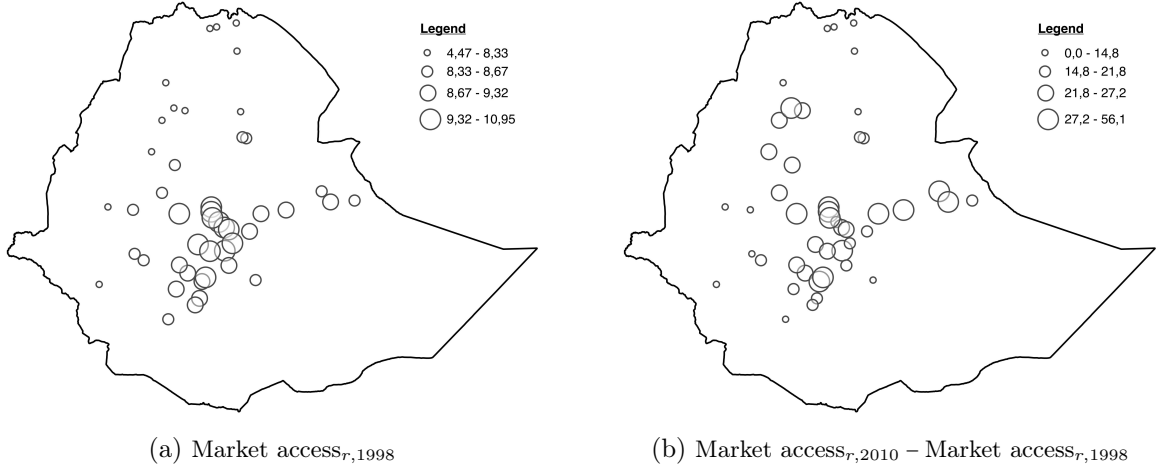
The market access indicator, Market access $_{rt}$, captures several dimensions of connectivity that are consistent with the mechanisms identified in our conceptual framework. First, it reflects the ease with which intermediate inputs can be transported to Ethiopian firms. As more remote towns are better connected to regional and central economic hubs via the road network, the cost for intermediaries to transport inputs to them is likely to decline. Second, the measure accounts for both increases in market size and competition faced by firms. As discussed in Section 2, we expect market access to play a role in shaping the productivity effect of an input tariff reduction via two channels. First (channel one), market access can affect the pass-through from input tariffs to input prices. Second (channel two), it may influence the incentives of firms across urban areas to take productivity-enhancing decisions. Relevant for the pass-through channel (channel one) is the reduced travel cost from intranational markets implied by an increase in market access, and the higher demand and competition faced by intermediaries serving a local market. The combination of these forces leads to a theoretical ambiguity in how Market access $_{rt}$ affects pass-through, and thereby productivity. We derive and discuss this theoretical ambiguity in Appendix A. The role of Market access $_{rt}$ in determining how liberalization affects productivity via channel two is unambiguous. The higher demand and competition faced by firms with an increase in market access boost firm incentives to enhance productivity, magnifying the impact of input tariff liberalization on firm productivity.

Figure 3a plots the value of the market access indicator at the beginning of our baseline estimation sample (1998) for the 46 towns that are covered in the econometric analysis. Figure 3b shows the change in market access between 2010 and 1998 for each town, formally Market access $_{r,2010}$ – Market access $_{r,1998}$. Focusing on Figure 3a, bigger circles near the center of the country close to Addis reveal higher market access in this area of the country. Smaller circles away from the center indicate lower market access for these towns. Figure 3b shows a larger increase in market access for less connected towns away from the center, suggesting that they saw improvements in road infrastructure over the time period of our analysis.

The second measure that we use to identify the role of road improvements in determining the relationship between a reduction in input tariffs and firm performance is the travel time to Galafi. Galafi is the first Ethiopian node to the border with Djibouti. To reiterate, almost 93% of Ethiopian trade passes through the port of Djibouti and up until the re-establishment of the Djibouti-Addis railway in 2018, all of this trade took place via roads (see World Bank, 2013, for more details). For our empirical analysis we take the log of the minimum travel time in hours from each urban area r to Galafi given the road network in place at time t . Assuming that the resulting variable - Galafi $_{rt}$ - captures the decrease in transport cost incurred by firms importing intermediate inputs more closely than market access, we expect this variable to better pick up the effect of roads on pass-through of input tariff reductions to input prices. On the contrary, we

This requires merging Addis and Burayu, whose coordinates are too close to each other to allow for the application of the Voronoi partition. Figure B-1 provides a graphical representation of this partition for Addis (including Burayu), Sululta, Akaki, Bishoftu and Modjo, the towns within the contiguous lit area covered in our estimation sample.

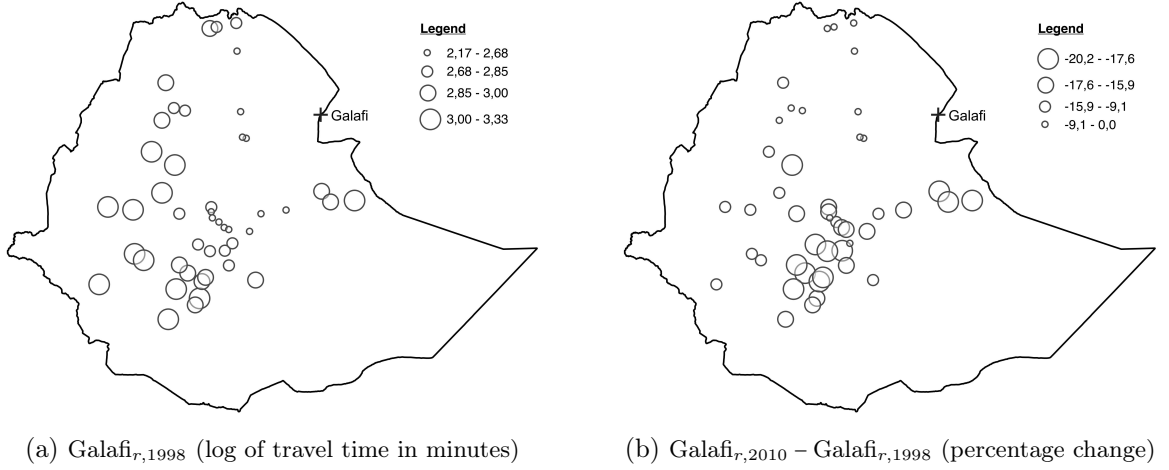
Figure 3: Market access ($\text{Market access}_{rt}$)



do not expect any impact of Galafi_{rt} on firms' incentives to take productivity-enhancing actions once we control for market access.

Figure 4a plots the value of Galafi_{rt} across the 46 urban areas covered in the estimation sample and for $t = 1998$. Figure 4b instead plots $\text{Galafi}_{r,2010} - \text{Galafi}_{r,1998}$. Note that bigger circles in Figure 4b report negative values since they are associated with larger reduction in travel time.

Figure 4: Travel time to Galafi (Galafi_{rt})



In Table C-1, we conduct a descriptive analysis of the relationship between market access and relevant firm outcomes measured at the town level. We find that roads are positively correlated with a range of indicators of economic performance and global engagement in manufacturing, like the total number of firms, labor productivity, capital intensity, total sales, import-intensity (defined as the ratio of imports to sales) and the ratio of skilled to unskilled labor. These correlations are consistent with roads broadly benefiting the manufacturing sector in Ethiopia.

3.1.2 Tariffs

Starting in 1993, the Ethiopian government implemented six rounds of trade reforms, which ended in 2003 with the adoption of a six-band tariff structure with bands now ranging from 0 to 35% (more details are available in World Bank, 2004). We collect data on tariffs from the World Bank’s WITS database, which uses the UN’s TRAINS database as its source. Data on tariffs for Ethiopia are publicly available for the period 1995-2015, but they report some gaps in coverage, especially for the pre-2000 period. In light of this, we replace missing tariff values with values obtained by linear interpolation.

We construct input tariffs with information on the use of raw materials to construct industry weights. First, we match the code attributed by the CSA to each raw material used by the firm with a (4-digit) HS code. Second, we aggregate the information at the industry level (4 digit ISIC Rev. 3). Third, we compute the share of each input in each industry’s total input expenditure: we denote as α_{jzt} the share of expenditure on input z in total input expenditures of sector j at time t .¹³ Fourth, we use these shares as industry-specific coefficients to weight output tariffs using the standard approach:

$$\text{Input-tariff}_{jt} = \sum_z \alpha_{jzt} \text{Output-tariff}_{zt} \quad (3.2)$$

Figure 5 traces changes in the (sector) average input tariff for the period of our estimation sample (from 1998 to 2009). With trade liberalization, input tariffs dropped sharply up to 2003 and more gradually thereafter.

3.2 Firm-level Data and the Estimation of Total Factor Productivity

3.2.1 Firm level Data

We use establishment level data from the annual census of Large and Medium Manufacturing Firms, published by the Central Statistical Agency (CSA) of Ethiopia.¹⁴ Data cover all firms with at least 10 persons engaged and that use electricity in their production process.¹⁵ All firms need to comply with CSA requirements, and the census is therefore representative of more structured and formal firms in the country.¹⁶ The dataset includes detailed information on the characteristics of each establishment that are needed to estimate production functions, including

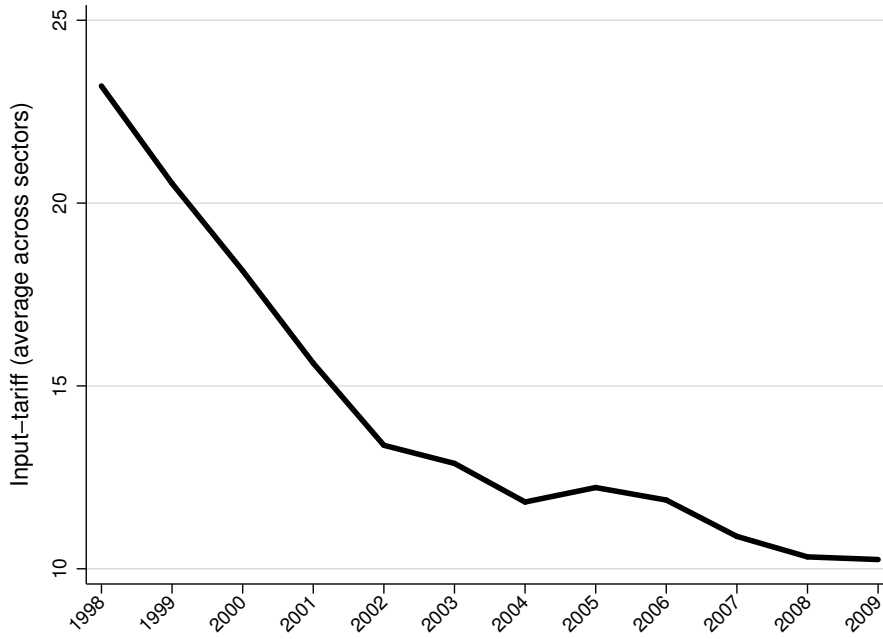
¹³ We construct these cost shares on the basis of total input purchases, including both domestic and imported inputs to avoid endogeneity bias (see discussion in Amiti and Konings, 2007).

¹⁴ The census data includes information at the level of the single productive establishment. We use the terms establishment and firms interchangeably in the paper.

¹⁵ The number of persons engaged refer to employees as well as working owners.

¹⁶ In 2005, a representative survey of firms was conducted instead of a census. This does not represent a critical bias for our analysis, since we do not focus explicitly on entry and exit rates (except when adjusting our TFP estimates for attrition), or on generating aggregate figures. Yet, we make an adjustment for those firms that are in the data in both 2004 and 2006, but not in 2005, filling in information for all variables as the simple average of the closest years. Results remain robust when dropping 2005 from our data.

Figure 5: Input tariff reduction



Notes: Authors' calculations from World Bank's WITS data.

output, employment, capital and inputs. Firms belong to the manufacturing sector, and their industry is defined at the 4-digit level according to the ISIC Rev. 3 classification.

Information on sales values and physical quantities is given for (up to eight) specific products produced by each firm. Products are recorded according to a CSA (Ethiopian Statistical Agency) classification and information available includes the value and quantity produced for the domestic and export markets for each product.¹⁷ As discussed earlier in the section on input tariffs, our data also allow us to identify raw materials used at the firm level, sourced domestically and imported, and their share in total firm expenditure.

Finally, and crucially for our focus on roads, we have information on the region, woreda (district) and town for each firm. While firms are located in about 80 towns in the country, their growth is geographically divergent over time. Nevertheless, we register a strong concentration in the capital, Addis Ababa, which hosts 47% of the firms and 54.3% of total observations in our data respectively.

The firm census dataset is an unbalanced panel of 3,551 establishments covering the period 1998-2009, totalling 12,672 observations. Table 3 reports the number of firms for each year, showing strong dynamism in the private sector,¹⁸ which is consistent with the overall pattern of economic growth experienced by the country over the last decade (Moller, 2015).

¹⁷The product code necessary to identify products is missing in some cases. On average, across firms and years in our estimation sample, non-identifiable products account for 21% of total firm sales. We therefore opt to conduct our analysis at the firm, rather than at the product level.

¹⁸ The sector has experienced rapid growth, with an annual average of 10% over the period considered.

Table 3: Number of firms in census years

Year	Firms	Share (%)
1998	701	5.53
1999	712	5.62
2000	704	5.56
2001	732	5.78
2002	866	6.83
2003	923	7.28
2004	980	7.73
2005	978	7.72
2006	1,131	8.93
2007	1,301	10.27
2008	1,696	13.38
2009	1,948	15.37
Total	12,672	100

Notes: Authors' summary of Ethiopian Census Data on firms.

3.2.2 TFP Estimation

To construct our dependent variable, we follow the existing literature and use a measure of firm performance based on estimated Total Factor Productivity (TFP). A large body of research on the nexus between trade liberalization and firm performance has been unable to distinguish improvements in physical efficiency from gains in profitability due to lack of information on firm specific prices. In our study, we exploit information on values and physical quantities to construct a measure of physical productivity at the firm level in the spirit of Eslava et al. (2004) and Smeets and Warzynski (2013).

We start from a basic production function linking the output produced by firm i to inputs adopted in the production process:

$$y_{ijrt} = \beta_1 k_{ijrt} + \beta_2 l_{ijrt} + \beta_3 m_{ijrt} + \omega_{ijrt} + \epsilon_{ijrt} \quad (3.3)$$

where y_{ijrt} denotes the output of firm i producing in sector j , located in town r at time t . k_{ijrt} denotes capital, l_{ijrt} labor and m_{ijrt} intermediate inputs respectively. The random component ω_{ijrt} is unobservable productivity or technical efficiency and ϵ_{ijrt} is an idiosyncratic output shock.

Standard approaches adopt industry price deflators, when available, to adjust both output and inputs for price variation common to all firms in a given industry j . This introduces a so-called output price bias, resulting in a possible downward bias on the input coefficients, which is due to the likely correlation between firm specific variation in output prices and expenditure on inputs (De Loecker and Goldberg, 2014; De Loecker, 2011). For instance, firms producing products of high quality are likely to use high quality inputs that are priced higher. Similarly, lack of information on firm specific variation in input prices can introduce a downward bias in the estimated coefficients, given that higher input prices will raise input expenditure, while not increasing physical output (De Loecker et al., 2016).

Our data allow us to eliminate the output price bias given that we can calculate firm level price indices from information on the quantity and value of a firm’s product. We aggregate product-level unit values at the firm level to calculate a firm-level price index P_{it} , using the approach suggested by Eslava et al. (2004) and Smeets and Warzynski (2013). The steps followed to calculate P_{it} are described in Appendix D.¹⁹

While deflating output with firm specific prices eliminates the output price bias, we follow a simplified version of the approach developed by De Loecker et al. (2016) to address input price bias. The assumption here is that the source of input price variation at the firm level can be captured by the quality of inputs adopted in the production process. Another assumption is that output quality is complementary to input quality and therefore, the quality of inputs is a function of the quality of output. This assumption allows us to control for the input price bias by including the output price index in the control function to account for unobserved input price variation.

We estimate production functions at the sector level (aggregating sectors at the 2 digit of the ISIC classification, and combining sectors sharing similar technologies when sample sizes are too small). Since OLS coefficients will be biased in equation (3.3) due to simultaneity and selection biases, we apply the approach by Levinsohn and Petrin (2003) (LP) that uses the costs of raw material as a proxy for unobservable productivity shocks to correct for simultaneity bias. We also address potential collinearity in the first stage due to simultaneity bias in the labor coefficient by adopting the correction suggested by Akerberg et al. (2015). Finally, we adjust our estimates for attrition in the second stage of our productivity estimation. Physical output is total production at the level of the firm deflated using the index P_{it} described in Appendix D. We use the book value of fixed assets at the beginning of the year to measure capital stock, the total number of permanent employees to measure labor and the total cost of materials to measure intermediate inputs. Table E-1 in Appendix E reports production function coefficients at the industry level.

3.3 Econometric Specification and Identification Strategy

The basic empirical strategy used in this paper consists of a standard interaction model. The main regressors of interest are: (i) the product of the input tariff and the market access indicator; and (ii) the product of the input tariff and the measure of travel time to Galafi. The empirical model is given by

$$\begin{aligned} \log \text{TFP}_{ijrt} = & \beta \text{Input-tariff}_{jt} + \gamma \text{Input-tariff}_{jt} \times \text{Market access}_{rt} + \\ & + \delta \text{Input-tariff}_{jt} \times \text{Galafi}_{rt} + \boldsymbol{\eta}' \mathbf{z}_{ijrt} + \mu_i + \nu_{rt} + \varepsilon_{ijrt} \end{aligned} \quad (3.4)$$

The dependent variable is the natural logarithm of TFP estimated for firm i active in sector j , town r at time t . Input tariffs in equation (3.4) vary at the industry-year level. The second regressor consists of the interaction between the input tariff and the measure of market access

¹⁹ This comes with measurement issues, given that product-level prices are measured by unit values. In addition, we make assumptions concerning product homogeneity or the way products are aggregated across firms. See Appendix D for details.

determined by the road network as described in Section 3.1. The latter varies at the town level and over time. The third regressor is the interaction between the input tariff and the rt -specific travel time to Galafi. The model includes a vector of firm-specific characteristics varying over time (\mathbf{z}_{ijrt}): this includes a control for the firm's age (age_{ijrt}), a dummy for exporter status (Exporter dummy $_{ijrt}$) and one for foreign ownership (Foreign ownership dummy $_{ijrt}$). The baseline specification also contains firm fixed effects (μ_i), town-year fixed effects (ν_{rt}) and the idiosyncratic error term (ε_{ijrt}). Standard errors are clustered at the level of the (four-digit) industry-town pair.

Consistent with the large literature on the productivity effects of tariff liberalization, lower tariffs are expected to have a positive impact on TFP at the average quality of roads. This would be reflected in a negative sign for the coefficient β when the moderator variables Market access $_{rt}$ and Galafi $_{rt}$ are demeaned. By construction, the proposed specification allows the productivity effect of the input tariff to vary linearly with the quality of roads as reflected in the two metrics of market access and travel time to Galafi. The role of roads in shaping the effect of tariff liberalization is identified by the coefficients γ and δ . A negative sign for γ would indicate that the negative relationship between input tariffs and TFP is magnified for firms in towns where better roads generate a higher market access. Similarly, a positive sign for δ would reveal that the linkage from lower input tariffs to higher productivity is amplified for firms where better roads imply a lower travel time to Galafi.

Identification in this empirical setting requires the policy treatment (input tariffs in our case) to be as good as randomly assigned. The included battery of fixed effects account for any confounding heterogeneity originating from firm specific as well as town and year specific shocks/characteristics. In sections below, we address further concerns pertaining to endogeneity.

3.3.1 Endogeneity of Tariffs

A standard argument in the literature has to do with the potential endogeneity of trade policy. Mechanisms related to political economy (Grossman and Helpman, 1994), including the targeting of more (or less) productive industries for protection or lobbying by firms and industries might influence both the timing and the size of trade protection, introducing a bias in our estimates. In the case of Ethiopia, trade reforms were largely exogenous, shaped by international institutions under liberalization programs implemented beginning in the early '90s (Jones et al., 2011; Bigsten et al., 2016). Nevertheless, we tackle this potential concern in two main ways.

First, as in Topalova and Khandelwal (2011), Ahsan (2013) for India and Bas (2012) for Argentina, we aggregate our firm data at the industry level to test for the political protection argument. Specifically, we construct aggregates of production, employment, exports, capital intensity and agglomeration for each 4-digit industry and test the correlation among pre-sample levels (1996) of these variables and changes in the input tariff between 1996 and 2003.²⁰

²⁰ For this exercise we use the change in input tariffs between 1996 and 2003, since this is the year of the latest trade reform. Results do not change if we replicate the same exercise using the change in tariffs from 1996 to

Results from these regressions are reported in Appendix F and show that there is hardly any correlation between changes in input tariffs and pre-sample industry characteristics, bolstering our argument that tariff reform in Ethiopia was largely exogenous to firm outcomes.

Second, following Topalova and Khandelwal (2011) and Brandt et al. (2017), we check whether input tariff adjustments were made in response to productivity levels. To do this we regress input tariffs at time $t + 1$ on firm productivity at t , controlling for firm and year fixed effects. We repeat the same exercise using levels of productivity at $t - 5$. Results of these exercises show that changes in input tariffs were not correlated with previous levels of firm productivity, implying that policy makers did not adjust trade policy in response to observed productivity levels. Due to space considerations, we present and discuss results from these exercises in Appendix F. Overall, we find strong empirical support against endogeneity of input tariff liberalization in Ethiopia.

3.3.2 Endogeneity of Roads

In this section, we address potential endogeneity of the moderator variables, Market access $_{rt}$ and Galafi $_{rt}$. It is possible that investments in road improvements were allocated systematically across towns. The high costs and potential benefits of road improvements can lead policy makers to select locations in which they will have the biggest economic impact (Coşar and Demir, 2016; Duflo and Pande, 2007; Asher and Novosad, 2018). In our specific context, a concern is that road improvement decisions were related to the time-contingent activities of more/less productive firms if they systematically lobbied for local infrastructure development. A mitigating factor in the Ethiopian context, as argued by Shiferaw et al. (2015), is that road improvement plans under the program were made on a 5-year basis. It is hence unlikely that they were affected by annual changes in firm performance.

Nevertheless, we proceed to address this concern in three steps. First, we regress town-specific changes (log differences) in Market access $_{rt}$ and Galafi $_{rt}$ during each phase of the RSDP against town-level average productivity at the beginning of each phase and we find no significant relationship between the two variables. We replicate the exercise after replacing average TFPQ with the town-level proxy for economic activity based on night-light data (L_{rt} defined above). Again, there is no strong evidence that suggests that towns with higher economic performance as captured by night light intensity receive disproportionate infrastructure investments in the context of the RSDP. Results of these exercises are reported in Appendix G.

Second, we check whether investments in roads are correlated with government decisions regarding provision of incentives to foreign investors (multinational firms) to locate in specific areas. In some cases, when negotiating new FDI projects, the Ethiopian Government assigned land to new entrants. An ad-hoc survey run by Abebe et al. (2019) asks foreign investors if their location was allocated by the authorities. This choice is clearly not random and likely reflects local political-economy forces. Knowing whether an FDI location was targeted by the government allows us to identify areas where factors capable of shaping government decisions (including lobbying) were more likely to be present. We hence test whether FDI allocation

correlates with improvements in roads. To do this, we regress the increase in market access between 1996 and 2014 on an indicator variable that equals one if the location was selected by the government to host an FDI project.²¹ We do not find a statistically significant difference in road investments across locations receiving government-supported FDI (the coefficient on the FDI indicator is -0.033 with a standard error of 0.0289).

Finally, as in Donaldson and Hornbeck (2016), we exploit the fact that variation in each town's market access ($Roads_{rt}$) is determined by improvements to the whole road network in the country. Therefore we can partial out the moderating role of changes in local roads, the source of the endogeneity concern. We do this by augmenting the baseline model (3.4) with an additional interaction between $Input-tariff_{jrt}$ and a measure of the quality of local road infrastructure at the town level. We present the results of these exercises after a discussion of our baseline estimates.²²

3.4 Estimation Sample

We assemble data from the sources described to obtain our final estimation sample. The final sample consists of an unbalanced panel covering up to 1544 establishments located in 46 towns and observed across the period 1998-2009, yielding a total of 7740 observations. Summary statistics for the variables used to obtain baseline results are reported in Table 4.

²¹ We conduct this analysis for 174 districts, rather than at the town level, since our data on FDI, sourced from Abebe et al. (2019), are at the district level. Furthermore, given that most FDI projects covered in Abebe et al. (2019) are in more recent years, we extend this analysis to the year 2014, for which we have road information.

²² As a final note to this section, we argue that endogeneity of $Roads_{rt}$ can actually be irrelevant for the consistent estimation of our parameter of interest - the coefficient of the interaction between roads and tariffs. To do so we appeal to an econometric result recently highlighted by Nizalova and Murtazashvili (2016). These authors show that in estimating the coefficient of an interaction between an exogenous treatment (in our case input tariff reduction) and an endogenous moderator (market access and/or travel time to Galafi), consistent OLS estimates are obtained when the moderator and the unobservable omitted variable determining the endogeneity of the moderator (firms' lobbying capacity, for instance) are jointly independent of the treatment. Given exogeneity of tariffs discussed above, the absence of any correlation between roads and tariffs would guarantee consistent estimates for γ (as well as for β). This is strongly the case in our exercise, where exogenous tariff policy action at the national level is independent of town level infrastructure improvements. Indeed, in our setting, the correlation between roads and tariffs is very close to zero. Computed on firm-year observations, the correlation between Market access and Input-tariff is equal to -0.032 on the estimation sample defined below, and equal to -0.005 on all available observations. Similarly, the correlation between Galafi and Input-tariff is .14 on the estimation sample and 0.096 on the whole data. Finally, this is confirmed by the robustness of our results to the various checks proposed in this section and further discussed in Section 4.2.1. A similar application of Nizalova and Murtazashvili (2016) can be found in Beverelli et al. (2018).

Table 4: Summary statistics

Variable	mean	median	sd	min	max
$\log \text{TFP}_{ijrt}$	2.484	2.267	1.518	-4.999	9.081
$\text{Input-tariff}_{jrt}$	14.376	10.032	9.480	0	60.236
$\text{Market Access}_{rt}$	9.188	9.463	1.060	4.470	11.004
Galafi_{rt}	2.647	2.667	0.154	0	3.425
$\text{Night light intensity}_{rt}$	8.802	9.669	1.461	3.807	10.035
$\log(\text{age}_{ijrt} + 1)$	2.436	2.398	0.891	0	4.736
$\text{Exporter dummy}_{ijrt}$	0.045	0	0.208	0	1
$\text{Foreign ownership dummy}_{ijrt}$	0.040	0	0.196	0	1

Notes: The table reports summary statistics for the main variables used in the analysis as described in equation 3.4.

4 Results

4.1 Baseline Results

Section 2 outlines our hypothesis that road infrastructure, by improving connectivity, shapes the relationship between input tariff reductions and firm productivity. We examine this hypothesis in our empirical analysis. We report our main estimation results in Table 5. Column (1) presents a simple relationship between the input tariff and firm productivity. Column (2) includes our road variables - market access and travel time to Galafi - and their interactions with the input tariff. Models in columns (1) and (2) do not control for potentially confounding heterogeneity across towns, but only for firm and year fixed effects. Column (3) reports estimates for the specification in column (2) with town-year fixed effects introduced to account for unobserved time-contingent, town-specific shocks correlated with firm productivity. Note that in this case we cannot estimate the impact of market access and travel time to Galafi on firm productivity, since these effects are subsumed by the town-year effects. Column (3) is our preferred specification and we employ it for all subsequent estimations.

Column (1) shows a negative relationship between the input tariff and firm productivity, however, this effect is not statistically significant. In column (2), we find that the interaction term between the input tariff and market access is negative and statistically significant. A decrease in the input tariff is associated with a larger increase in productivity in firms located in towns with better market access. The interaction between the input tariff and travel time to Galafi is negative, but not statistically different from zero. Put together, these results highlight two aspects related to the role of road infrastructure improvements in the context of trade liberalization. First, without quality roads, there is no evidence that a reduction in the input tariff is associated with gains in total factor productivity for Ethiopian firms. Next, road improvements complement an input tariff reduction not primarily by lowering the cost of transporting intermediate inputs from port to destination regions, but by endowing firms with greater intranational market access. Results continue to hold in column (3), which includes town-year fixed effects to account for time-varying town-specific heterogeneity. Overall, these results emphasize the role for roads in determining the effects of a reduction in the input tariff on firm productivity.

Figure 6 uses estimates from column (3) to plot the effect of the input tariff on firm

Table 5: Main Estimation Results

Dependent variable:	log TFP _{ijrt}		
	(1)	(2)	(3)
Input-tariff _{jt}	-0.008 (0.007)	-0.008 (0.007)	-0.008 (0.007)
Input-tariff _{jt} ×Market access _{rt}		-0.007** (0.003)	-0.009** (0.004)
Input-tariff _{jt} ×Galafi _{rt}		-0.006 (0.020)	-0.025 (0.023)
Market access _{rt}		0.408*** (0.115)	
Galafi _{rt}		0.513 (0.770)	
Observations	7740	7740	7740
Adjusted R^2	0.664	0.664	0.663
Firm FE	✓	✓	✓
Year FE	✓	✓	
Town-year FE			✓
Firm-year controls	✓	✓	✓

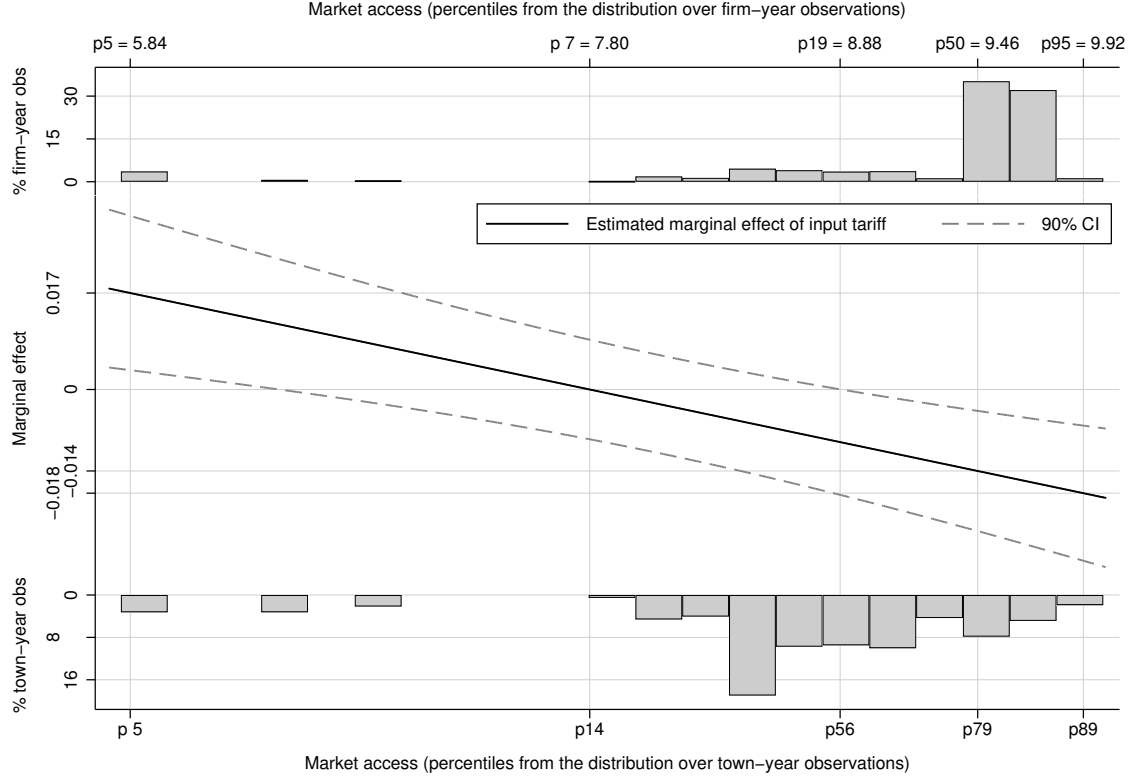
Notes: Market access_{rt} and Galafi_{rt} are demeaned using the mean computed on the estimation sample. Firm-time controls include exporter and FDI dummies and firm age. Standard errors in parentheses are clustered at the town-sector level. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

productivity at various levels of market access with 90 percent confidence intervals on each side. The horizontal axis presents percentiles of market access in the data based on firm-year and town-year observations.

We make the following observations from Figure 6. First, the downward sloping line at the center of the figure shows that the coefficient on the input tariff is more negative for larger values of market access. In other words, a fall in the input tariff is associated with a larger increase in firm productivity as market access from better roads improves. From the figure, a one percentage point decrease in the input tariff is associated with a 3.1 percentage point larger increase in productivity for a firm with median market access relative to a firm with market access at the 5th percentile. A one percentage point decrease in the input tariff is associated with a 0.4 percentage point larger increase in productivity for a firm with market access at the 95th percentile relative to a firm with median market access. Note from the confidence intervals in Figure 6 that moving from roads at the 5th percentile to the median level of market access results in a statistically larger effect of an input tariff reduction on firm productivity. This is not true for moving from the median to the 95th percentile of market access.

Our results hence suggest that roads built to increase market access of towns at the left tail of the distribution can bring larger gains to firm productivity from input tariff liberalization. Second, the estimated marginal effect of the input tariff is negative and statistically significant for 81% of firm-year observations and 44% of town-year observations. This suggests that for a majority of firms in our data (but not for all firms), a fall in the input tariff is associated with

Figure 6: The effect of input tariffs moderated by road infrastructures (market access)



Notes: The central panel in this figure plots the estimated marginal effect of input tariffs on $\log TFP_{ijrt}$ from column (3) of Table 5 (on the vertical axis) as a function of $Market\ access_{rt}$ (on the horizontal axis) and fixing the value of $Galafi_{rt}$ at its sample median level denoted by \overline{Galafi} . Considering the regression equation (3.4), the point estimate plotted as a solid black line in the figure is given by $\hat{\beta} + \hat{\gamma} \times Market\ access_{rt} + \hat{\eta} \times \overline{Galafi}$. The upper and lower panel of the figure plot the distribution of $Market\ access_{rt}$ over firm-year observations and town-year observations respectively. Point estimates for the marginal effect of the input tariff are negative for values of $Market\ access_{rt}$ bigger than 7.8. 93% (86%) of firm-years (town-years) covered in the estimation sample score a value of $Market\ access_{rt}$ bigger than that threshold. After the 19th (56th) percentile of the distribution of $Market\ access_{rt}$ over firm-years (town-years), the estimated marginal effect is negative and also statistically different from zero.

an increase in productivity since they are located in urban areas with adequate market access.

4.2 Identification and Robustness

In this section, we address several empirical concerns. First, we present results from the various exercises to tackle endogeneity of roads discussed in Section 3.3.2. Next, we test for robustness of our results to alternative productivity, road and tariff measures. Finally, we ask if our results are robust to cuts of the sample and controlling for the effect of the output tariff (the tariff on the final good produced by the firm) on productivity and its complementarity with road infrastructure. We find that our baseline results endure qualitatively across all of these tests.

4.2.1 Addressing Endogeneity of Road Infrastructure

The quality of road infrastructure might be endogenous to firm productivity. Even though descriptive evidence discussed in Section 3.3.2 suggests that this is unlikely in our empirical setting, we present results from a number of additional exercises to address endogeneity of roads in Table 6.

Table 6: Additional interactions

Dependent variable:	log TFP _{ijrt}	
	(1)	(2)
Input-tariff _{jt}	-0.007 (0.007)	-0.009 (0.007)
Input-tariff _{jt} ×Market access _{rt}	-0.008** (0.003)	-0.010*** (0.003)
Input-tariff _{jt} ×Galafi _{rt}	-0.009 (0.022)	-0.009 (0.023)
Input-tariff _{jt} ×Local roads _{rt}	0.013 (0.009)	0.009 (0.017)
Input-tariff _{jt} ×Night light intensity _{rt}		0.013 (0.010)
Input-tariff _{jt} ×Log number of firms _{rt}		-0.012 (0.011)
Input-tariff _{jt} ×Production _{rt}		0.004 (0.005)
Input-tariff _{jt} ×FDI town _{rt}		0.002 (0.008)
Input-tariff _{jt} ×Export town _{rt}		0.011* (0.007)
Observations	7740	7740
Adjusted R ²	0.663	0.664
Firm FE	✓	✓
Town-time FE	✓	✓
Firm-time controls	✓	✓

Notes: Local roads_{rt} measures the sum of all distances that can be travelled in an hour from a town node over all possible road links connected to that node; Night light intensity_{rt} is the average light intensity within a circle of a 10 kilometer ray centered around the point coordinate associated with each town in our sample; Log number of firms_{rt} is the log number of firms in town r at time t; Production_{rt} is the (log) total value of real production of firms based in town r at time t; FDI town_{rt} is a dummy that equals one if the town hosts a foreign-owned firm in year t; Export town_{rt} is a dummy that equals one if the town hosts at least one exporting firm at time t. All variables, except the last two, are demeaned using the mean over the estimation sample. Firm-time controls include exporter and FDI dummies and firm age. Standard errors in parentheses are clustered at the town-sector level. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

In Column (1) of Table 6 we augment the baseline model with an additional interaction between input tariffs and a measure of the quality of local (town-level) roads denoted as Local roads_{rt}. We construct this variable as the sum of all distances that can be travelled in an hour from a town node over all possible road links connected to that node. As argued by Donaldson and Hornbeck (2016) in their seminal contribution, partialling out the local component of the market

access measure would not undermine its variability, which crucially depends on the whole road network. However, it will help to purge it of local variation that is the source of endogeneity. We find that after partialling out the moderating role of improvements to local road infrastructure, the market access indicator capturing road infrastructure retains its role in shaping the effect of an input tariff reduction on firm productivity.

In the spirit of Ahsan (2013), column (2) augments the specification with additional interactions between the input tariff and measures of economic performance at the town level, in particular the number of firms and total production. We also include measures of multinational and export presence at the local level. Note that the two latter variables will also account for state support for special industrial zones to a certain extent, since multinationals in Ethiopia are incentivized to locate in them (Abebe et al., 2019). This exercise reinforces our interpretation of γ as the productivity premium due to better road connectivity with intra-national markets, given that it controls for a host of other town-level factors that might generate differential effects of input tariff liberalization.

4.2.2 Robustness Checks

Finally, we undertake a series of checks to ensure the robustness of our results to (1) an alternative measure of the dependent variable; (2) an alternative measure of market access; (3) a firm-level, instead of an industry-level tariff and (4) alternative sub-samples.

First, we calculate an alternative measure of firm productivity, to check if results are affected by the TFP estimation method used and described in Section 3.2. In column (1) of Table 7, we present results for the baseline model with productivity estimated after accounting for a range of variables in the control function.²³

Second, results may be affected by the manner in which we construct the market access variable measuring roads. We use an alternative measure of market access that draws upon the model-based formula derived in Donaldson and Hornbeck (2016) and applied to the East African context by Eberhard-Ruiz and Moradi (2018) (henceforth ERM). Using the night-light intensity variable L and bilateral travel times D , the model-based formula of market access for town r can be written as $\sum_{z \neq r} L_z / \exp\{\sigma D_{rz,t}\}$, where σ is a distance decay parameter and captures the non-linear impact of distance on trade. We follow the parametrization in ERM where σ is the product of trade elasticity - fixed at 8.4 - and the average per unit cost of transporting a good for one hour over the road network relative to the good's overall value. The value of this latter parameter has been estimated by ERM at 0.005 using monthly petrol prices for seven Ugandan cities. We plug the resulting value (0.042) of the distance decay parameter σ in the market access formula, take the log and denote it as Roads(ERM)_{rt} . We present results in column (2) of Table 8.

Results from columns (1) and (2) confirm our baseline patterns. A reduction in the input tariff is associated with a larger increase in firm productivity for firms in regions with better market

²³ The control function approach is based on the methodology proposed by De Loecker et al. (2016), and consists of augmenting the set of variables affecting a firm's demand for materials. We do this by adding the input tariff as well as the export status of the firm in the control function.

Table 7: Robustness checks

Exercise:	Control F	Alt Mkt Acc	Firm tariff	Balanced
	(1)	(2)	(3)	(4)
Input-tariff _{jt}	-0.008 (0.007)	-0.008 (0.007)		-0.008 (0.010)
Input-tariff _{jt} ×Market access _{rt}	-0.008** (0.003)			-0.015** (0.007)
Input-tariff _{jt} ×Market access (ERM) _{rt}		-0.009** (0.004)		
Input-tariff _{jt} ×Galafi _{rt}	-0.026 (0.023)	-0.013 (0.022)		-0.015 (0.037)
Input-tariff _{ijrt}			-0.005 (0.004)	
Input-tariff _{ijrt} ×Market access _{rt}			-0.005* (0.003)	
Input-tariff _{ijrt} ×Galafi _{rt}			-0.002 (0.020)	
Observations	7740	7740	7202	2263
Adjusted R^2	0.635	0.663	0.669	0.654
Firm FE	✓	✓	✓	✓
Town-time FE	✓	✓	✓	✓
Firm-time controls	✓	✓	✓	✓

Notes: Market access_{rt} and Galafi_{rt} are demeaned using the mean over the estimation sample. The dependent variable in column (1) is TFP estimated with a modified control function; in column (2) we use a definition of market access based on the approach by Eberhard-Ruiz and Moradi (2018); column (3) reports our baseline estimates using input tariffs calculated at the firm level, rather than at the sector level. The number of observations in this column drops slightly since some firms do not report product codes to identify products. Finally, column (4) reports estimates based on a balanced panel of firms appearing in all years of our sample. Firm-time controls include exporter and FDI dummies and firm age. Standard errors in parentheses are clustered at the town-sector level. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

access. The coefficient on the interaction term between the input tariff and travel time to Galafi is negative but not statistically significant.

In column (3), we use firm-level input tariffs instead of industry-level tariffs²⁴. In column (4), we restrict our sample to a balanced panel of firms observed in all years of our sample period. Again, results in both columns are qualitatively similar to baseline results.

As a final step, we include output tariffs in our estimation. In fact, it is conceivable that the output tariff (the tariff on the final product produced by firms) is correlated with the input tariff and independently affects firm productivity by spurring firms to improve efficiency in the face of competition. If this is true, our estimates of the effect of the input tariff on firm productivity and its complementarity with roads will not be consistently estimated without accounting for output tariff effects. In addition, some of the mechanisms linking infrastructure development to trade liberalization could also work through changes in the output tariff. We thus introduce controls for the output tariff and its interaction with roads in our baseline regression. Results

²⁴Firm level tariffs are calculated as described in Section 3.1.2 with the only difference that weights are firm, and not industry, specific.

are presented in Table 8. The qualitative story on the input tariff remains. However, we do not find a significant interaction effect between the output tariff and road variables.

Table 8: Output tariff

Dependent variable:	log TFP _{ijrt}	
	(1)	(2)
Input-tariff _{jt}		-0.007 (0.006)
Input-tariff _{jt} ×Market access _{rt}		-0.007** (0.003)
Input-tariff _{jt} ×Galafi _{rt}		-0.043 (0.028)
Output-tariff _{jt}	-0.009 (0.010)	-0.006 (0.010)
Output-tariff _{jt} ×Market access _{rt}	-0.012* (0.006)	-0.010 (0.007)
Output-tariff _{jt} ×Galafi _{rt}	0.023 (0.042)	0.043 (0.043)
Observations	7740	7740
Adjusted R ²	0.662	0.662
Firm FE	✓	✓
Town-time FE	✓	✓
Firm-time controls	✓	✓

Notes: Market access_{rt} and Galafi_{rt} are demeaned using the mean over the estimation sample. Firm-time controls include exporter and FDI dummies and firm age. Standard errors in parentheses are clustered at the town-sector level.
* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

Overall, our analyses in this section show that our results are robust to a range of checks, boosting confidence in our baseline finding.

4.3 Mechanisms

We have so far established a significant moderating role for roads in determining the impact of input tariff reductions on firm productivity. In this section, we explore evidence for potential mechanisms by leveraging the strength of our data that allows us to differentiate between domestic and intermediate inputs, calculate the price (unit-value) of imported inputs and track their use over time.²⁵

Our key argument is that better market access resulting from road improvements provides incentives for firms to undertake productivity-enhancing actions that increase their physical total factor productivity. One of the main channels we emphasize in our conceptual framework is that a reduction in the input tariff allows firms to use imported intermediate inputs that imperfectly substitute domestic ones. To explore this idea, we study the relationship between

²⁵ A limitation of our data is that firms are asked to report their seven most important intermediate inputs. This means that we are unable to accurately capture changes in the scope or variety of intermediate inputs used by firms following input tariff liberalization.

input tariffs and the likelihood that a firm employs a new imported input in production in column (1) of Table 9. We find a negative and statistically significant coefficient on the interaction between market access and the likelihood of a firm using a new imported input. This provides strong support for the idea that roads differentially afford firms with the opportunity to utilize new imported inputs following a reduction in input tariffs. In a framework where imported intermediates imperfectly substitute domestic inputs, improved access to foreign intermediate inputs is a plausible explanation for the differential gains in total factor productivity from input tariff liberalization experienced by firms in towns with better market access from roads.

Next, we ask if an input tariff reduction is associated with differential use of production techniques by firms in areas with better roads. Columns (2) focuses on the capital-labor ratio, while columns (3) looks at the employment of non-production workers. Both these variables can also signal a shift in technology²⁶. From column (2), we find that a reduction in the input tariff is associated with greater capital-intensity among firms in areas with better market access. From column (3), we see a negative coefficient on the interaction between the input tariff and market access, though this result is not statistically significant. Broadly, results from columns (1) - (3) offer support for our proposition that market access incentivizes firms to undertake actions that improve physical productivity, including adopting new inputs and production technology.

Finally, we ask whether there is differential pass-through of a reduction in the input tariff to imported input prices for firms across areas with varying quality of roads. The dependent variable here is the price (unit-value) of imported intermediate inputs at the firm level. Note that the role of roads in determining the relationship between input tariffs and input prices is nuanced. Consider for instance a framework of intranational trade with imperfectly competitive intermediaries importing intermediate inputs at the world price and transporting them to firms across locations (Atkin and Donaldson, 2015). Prices that firms pay for their inputs in each location are a function of intermediaries' markups, which in turn depend on their marginal costs (including the cost of acquiring the input and intranational transport costs), competition faced (like the number of intermediaries serving the same location with the same intermediate input) and local demand conditions. All these elements depend upon road infrastructure quality. For instance, intermediaries' marginal costs should respond negatively to the quality of roads connecting economic hubs such as dry ports or border towns with locations where firms (demand) are located. Furthermore, the number of intermediaries serving a local market, and therefore competition among them, should increase with the quality of road infrastructure. Finally, location specific demand conditions (number of firms demanding a particular intermediate input and its quantity) may be a positive function of the extent of market access from better roads.

A priori, it is ambiguous whether roads magnify or attenuate pass-through of input tariff reductions to local input prices. Appendix A offers a simple model à la Atkin and Donaldson (2015) that illustrates this point. The role of roads in determining the relationship between

²⁶Note however that owing to the lack of information on the specific functions of non-production workers within the firm, their share in the total is only a rough proxy for skill intensity. This category is open enough to include both high skilled managers and technicians as well as less skilled administrative assistants.

input tariffs and input prices for firms is thus an empirical question that we explore in column (4). We find that a reduction in the input tariff is associated with lower input prices for firms in regions with better market access. Thus, pass-through of input tariff reductions to input prices is magnified by better market access from good roads. Though it is not essential that such magnified pass-through of input tariff reductions to input prices for firms yields physical productivity enhancements, our results in columns (1) through (3) indicate that improved market access also motivates firms to undertake productivity enhancements. To conclude, our results in this section underscore the complementary role played by roads in ensuring productivity gains for firms from input tariff liberalization.

Table 9: Mechanisms

Dependent variable:	firms' actions			pass-through
	new input	K/L	non-prod wks	input price
	(1)	(2)	(3)	(4)
Input-tariff _{jt}	-0.031 (0.021)	-0.013 (0.013)	-0.010 (0.006)	0.019 (0.013)
Input-tariff _{jt} ×Market access _{rt}	-0.020* (0.011)	-0.016*** (0.006)	-0.006 (0.007)	0.049*** (0.017)
Input-tariff _{jt} ×Galafi _{rt}	0.011 (0.070)	-0.041 (0.043)	-0.015 (0.019)	0.123 (0.117)
Galafi _{rt}	-0.991 (2.325)			
Market access _{rt}	0.274 (0.439)			
Observations	5043	7740	7423	1755
Adjusted R^2		0.607	0.478	0.297
Firm FE	✓	✓	✓	✓
Year FE	✓			
Town-year FE		✓	✓	✓
Firm-year controls	✓	✓	✓	✓

Notes: Market access_{rt} and Galafi_{rt} are demeaned using the sample mean over the estimation sample. The dependent variable in column (1) is a dummy variable that equals one each time a new variety of an imported input is reported by the firm. The model is estimated using a conditional logit and only includes firms that switch status between importing a new input and not, across years. The dependent variable in column (2) is the log of the capital labour ratio, measured as the book value of fixed assets divided by the number of employees. The dependent variable in column (3) measures the ratio of non-production workers to production workers. The dependent variable in column (4) is the price index of imported inputs. Column (4) only includes firms that employ imported inputs. Firm-time controls include exporter and FDI dummies and firm age. Standard errors in parentheses are clustered at the town-sector level. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

4.4 Extensions

A key contribution of this study is our ability to analyze gains in physical total factor productivity (denoted as TFP in our paper but often called TFPQ in the literature) from input tariff liberalization. A growing body of research has emphasized the need to focus on physical total factor productivity as opposed to revenue-based total factor productivity (TFPR), which conflates impacts on productivity and the markup. Furthermore, there is rising interest in looking at the how firms' pricing strategies respond to trade liberalization, including via input

tariff reductions (Brandt et al., 2017; Fan et al., 2018). In an extension of our analysis, we probe the effects of input tariff liberalization and the complementary role of roads on the markup charged by firms and on TFPR.²⁷

We hypothesize that by reducing marginal cost, an input tariff reduction will *ceteris paribus* result in an increase in the markup charged by firms (as found, for instance, by De Loecker et al., 2016). Whether this increase in the markup resulting from input tariff liberalization is exacerbated or attenuated in areas with better road infrastructure is less clear. On the one hand, a reduction in marginal cost from the input tariff reduction is likely to result in a smaller increase in the markup in areas with better roads due to stronger competitive pressures. On the other hand, the fact that these firms can also access a larger market and have a greater incentive to employ imported inputs and increase TFPQ may influence markups in the opposite direction. The direction in which roads affect the impact of input tariff liberalization on markups will depend on the effect that dominates, with the possibility of observing no role for roads if these effects play out equally.

We present results for TFP, TFPR and the markup (μ) in Table 10. All columns estimate the baseline specification with firm and town-year fixed effects and firm controls. Columns (1) and (4) replicate columns (1) and (3) of our baseline table Table 5²⁸. Columns (2) and (5) and columns (3) and (6) look at the relationship between the input tariff and TFPR and the markup and the moderating role of roads in each instance, respectively. As hypothesized, from column (3), we confirm that a reduction in the input tariff is associated with higher markups charged by firms. From column (6), we find no moderating role for roads in determining the relationship between the input tariff and the markup. This is consistent with the two forces in areas with better road infrastructure acting in opposite directions - more competition in connected regions exerts downward pressure on the markup, while better market access and efficiency gains from physical productivity (TFP) enhancements work the other way. Finally, columns (2) and (4) focus on revenue productivity (TFPR) and show that a reduction in the input tariff is associated with an increase in TFPR, driven by the reduction in marginal cost for firms. The increase is magnified in cities with better road infrastructure, driven primarily by gains in TFP.

Overall, our results in this section are consistent with the idea that while input tariff liberalization is associated with greater improvements in efficiency in areas with better roads, it is not associated with equivalent increases in the markup charged by firms. The latter finding can be explained by the presence of competitive pressures from economic dynamism spurred by better roads. The

²⁷ We calculate price-cost margin following the approach by De Loecker and Warzynski (2012), which rests on the idea that markups generate a wedge between an input's elasticity and revenue share. The markup μ_{it} is calculated as the ratio of price to marginal cost, $\mu_{it} = \frac{P_{it}}{\lambda_{it}}$, where P_{it} is the firm's output price. We can derive an expression for markup as:

$$\mu_{it} = \beta_{it}^m (\alpha_{it}^m)^{-1},$$

in which $\beta_{it}^m = \frac{\partial Q_{it}(\cdot)}{\partial M_{it}} \frac{M_{it}}{Q_{it}}$ is the output elasticity of material inputs and $\alpha_{it}^m = \frac{P_{it}^m M_{it}}{P_{it} Q_{it}}$ is the share of expenditure in materials in total revenue. We recover the output elasticity of materials β_{it}^m directly from the production function estimated in equation (3.3) and then adjust the share of expenditure on materials, α_{it}^m to account for productivity shocks to revenue, $\alpha_{it}^m = \frac{\exp(m_{it})}{\exp(r_{it} - \hat{\epsilon}_{it})}$.

²⁸ The minor difference between column (1) of Table 10 and column (1) of Table 5 is due to the inclusion of town-year fixed effects (instead of year fixed effects only)

Table 10: Extentions - Revenue productivity and markups

Dependent variable:	log TFP	log TFPR	μ	log TFP	log TFPR	μ
	(1)	(2)	(3)	(4)	(5)	(6)
Input-tariff _{jt}	-0.009 (0.007)	-0.024* (0.014)	-0.010*** (0.003)	-0.008 (0.007)	-0.025* (0.014)	-0.010*** (0.003)
Input-tariff _{jt} ×Market access _{rt}				-0.009** (0.004)	-0.011** (0.005)	-0.001 (0.002)
Input-tariff _{jt} ×Galafi _{rt}				-0.025 (0.023)	-0.003 (0.055)	-0.008 (0.011)
Observations	7740	7740	7567	7740	7740	7567
Adjusted R^2	0.663	0.704	0.390	0.663	0.705	0.390
Firm FE	✓	✓	✓	✓	✓	✓
Town-year FE	✓	✓	✓	✓	✓	✓
Firm-year controls	✓	✓	✓	✓	✓	✓

Notes: Market access_{rt} and Galafi_{rt} are demeaned using the sample mean over the estimation sample. TFPR is computed following the procedure described in Section 3.2.2, the only difference being that output is now deflated using the country-wide deflator (sourced from the IMF). Markups (μ) are estimated following the approach by De Loecker and Warzynski (2012), which is described earlier in this Section, and are expressed in logs. Firm-time controls include exporter and FDI dummies and firm age. Standard errors in parentheses are clustered at the town-sector level. * $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$.

flavour of these results underscores the important role for improved roads in delivering gains from trade liberalization to local firms.

5 Conclusion

In this paper, we examine the role of roads in determining the effect of a reduction in input tariffs on the productivity of Ethiopian firms. We find that a reduction in input tariffs is associated with a larger increase in productivity for firms in towns with better market access from roads that connect them to other intranational markets. We find supportive evidence that road improvements facilitate adoption of new imported intermediate inputs and capital-intensive production techniques from a reduction in input tariffs. We observe greater pass-through of input tariff reductions to input prices for firms in locations with better market access. Finally, results suggest that increased competition from better connectivity to other markets can ensure that increases in firm markups are not differentially larger in towns with better roads.

We believe that our analysis has implications for both trade and infrastructure policy in developing economies. While trade liberalization can improve firm performance by affording domestic firms better access to intermediate inputs, poor infrastructure can mitigate these gains from trade, particularly for very remote regions. This may exacerbate regional inequality with trade liberalization. We highlight that road improvements can complement the beneficial effects of trade liberalization on firm performance.

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Appendices

A Roads and the pass-through from input tariffs to input prices

In this Appendix we propose a stylized model to analyze the differential impact of a decrease in the input tariff on input prices in towns with varying quality of road infrastructure. Our theory draws from the model introduced by (Atkin and Donaldson, 2015).

Suppose that intermediaries transport an imported product from the border (or dry port) to the final destination (Ethiopian towns, indexed by r).²⁹ Intermediaries obtain the product at the port for a price of $p^w + t$ where t is a specific tariff on imports of the product. They incur a transport cost to transport the product from the origin to the destination market. For simplicity, we assume that this transport cost is a per-unit cost $\tau(x_r)$ that is related to x_r , the quality of road infrastructure in town r . Better roads lead to a lower transport cost and hence, $\tau'(x_r) < 0$. Intermediaries then sell the product to firms to be used as an intermediate input in production at a price p_r . We conceptualize Ethiopian towns as local markets. This is consistent with anecdotal evidence from the ground, which documents how firms operate in local markets given high intranational transport costs.

We assume that the number of intermediaries competing in each town r is given by n_r and it is a positive function of the quality of local infrastructure x_r . Formally, $n'_r(x_r) > 0$, capturing the fact that better infrastructure induces greater competition among intermediaries. The number of intermediaries in each town is fixed (we rule out entry), which is plausible in the Ethiopian context (Atkin and Donaldson, 2015).

Consider the location specific demand function

$$Q_r = a(x_r) - bp_r \quad (\text{A-1})$$

Demand in the town depends on roads via $a(x_r)$, with $a'(x_r) > 0$. This is a core assumption, unique to our framework. The rationale behind is that low cost conditions generated by better access to roads might generate firm entry (or at least reduce firm exit), generate agglomeration economies and more economic dynamism that increases demand for intermediate inputs from firms.

Denote with q_{kr} the quantity sold by intermediary k in location r . The profit function of intermediary k in location r is given by

$$\Pi_{kr}(q_1, \dots, q_{n_r}) = q_{kr}p_r \left(\sum_{i=1}^{n_r} q_{ir} \right) - c_{jr}(q_{jr}) \quad (\text{A-2})$$

where $\sum_{i=1}^{n_r} q_{ir}$ can be denoted as q_r . Location specific marginal cost is given by

$$c'_r(q_{kr}) = p^w + t + \tau(x_r) \quad (\text{A-3})$$

Necessary conditions for the Cournot-Nash equilibrium can be identified in the following system of first order conditions (FOCs):³⁰

$$p_r(Q_r) - \frac{1}{b}q_{kr} - p^w - t - \tau(x_r) = 0 \quad \forall j = 1 \dots n_r(x_r) \quad (\text{A-4})$$

²⁹ The relevance of different types of intermediaries - from companies managing international and domestic transport, to agents dealing with customs clearance procedures - is high in the context of Ethiopia. This has been confirmed in a series of field interviews with various officials at the Ethiopian Customs Authority and with experts of the trade facilitation and logistics division at the Ethiopian office of the World Bank.

³⁰ Functions' differentiability and concavity of the payoff functions make FOCs also sufficient.

Summing FOCs across intermediaries, we get

$$n_r(x_r)p_r(Q_r) - \frac{1}{b}q_r - n_r(x_r)(p^w + t + \tau(x_r)) = 0 \quad (\text{A-5})$$

Imposing market clearing $Q_r = q_r$ and using the expression for demand, (A-5) can be rewritten as an expression in p_r . That expression can be solved to obtain the location-specific equilibrium price

$$p_r^* = \frac{a(x_r)}{b(n_r(x_r) + 1)} + \frac{n_r(x_r)}{(n_r(x_r) + 1)}(p^w + t + \tau(x_r)) \quad (\text{A-6})$$

We can now derive a workable expression for $\partial\left(\frac{\partial p}{\partial t} \frac{1}{p}\right)/\partial x$ where, for the sake of simplicity, we ignore the r subscript since everything is now intended to be location-specific. We also write p^* as p . This expression tells us how does the proportionate change in the equilibrium price associated with a change in tariffs varies with the quality of road infrastructure. In other words, it is the moderating effect of roads on the transmission of tariff changes to price changes.

$$\frac{\partial\left(\frac{\partial p}{\partial t} \frac{1}{p}\right)}{\partial x} = \frac{b}{[a + bn(p^w + t + \tau)]^2}(an' - bn^2\tau' - na') \quad (\text{A-7})$$

The sign of this expression is determined by the term in the numerator in brackets.

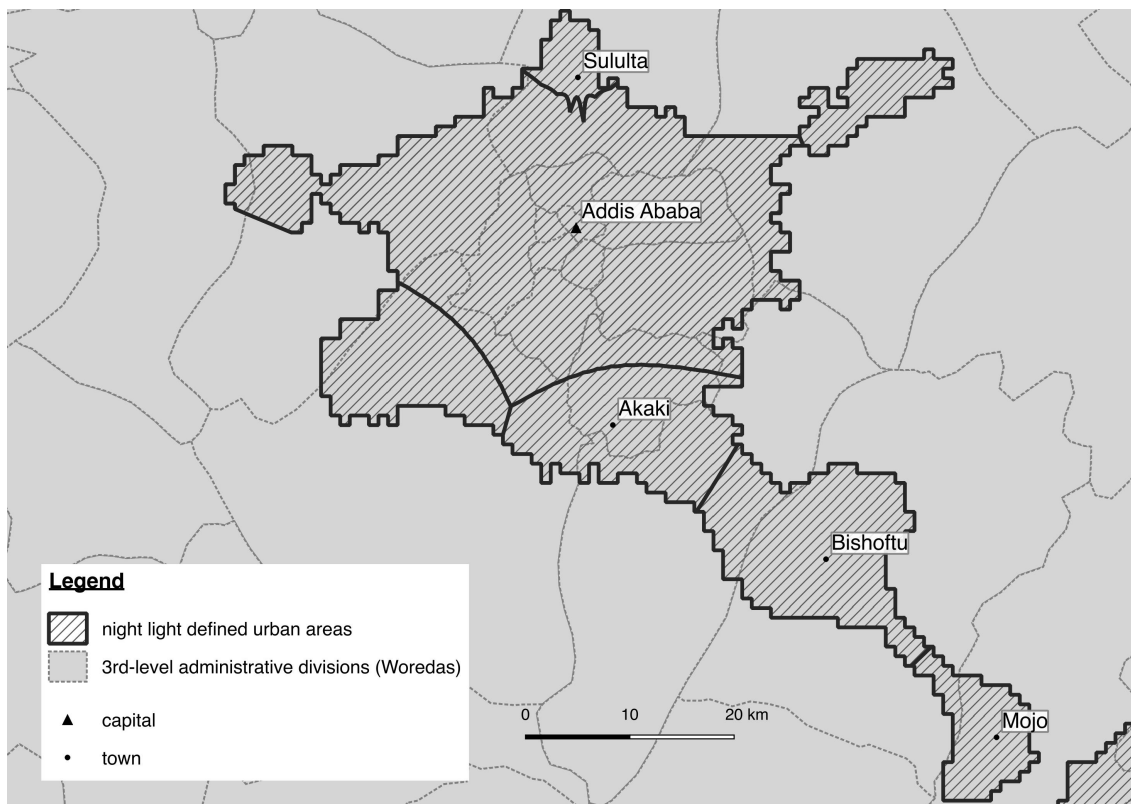
$$\frac{\partial\left(\frac{\partial p}{\partial t} \frac{1}{p}\right)}{\partial x} < 0 \iff an' - bn^2\tau' - na' < 0 \iff \frac{n'}{n} - \frac{b}{a}n\tau' < \frac{a'}{a} \quad (\text{A-8})$$

Hence, for a large enough proportional shift in demand due to better roads, $\partial\left(\frac{\partial p}{\partial t} \frac{1}{p}\right)/\partial x < 0$, suggesting that towns with better roads may see a weaker transmission of tariff declines to price declines. On the other hand, a larger competition effect among intermediaries captured by n'/n , or a larger effect of roads on the transport cost captured by $-(b/a)n\tau'$ will result in $\partial\left(\frac{\partial p}{\partial t} \frac{1}{p}\right)/\partial x > 0$ so that towns with better roads will see a stronger transmission of tariff declines to price declines. Finally, if these various effects offset each other, we may observe no moderating effect of roads on the impact of a tariff decrease on the destination price.

From our analysis above we conclude that the effect of road infrastructure in shaping the pass-through from input tariffs to input prices faced by the firms in different areas of the national market is ambiguous and depends on the relative strength of the three channels (demand, competition and transport cost) discussed above. If the latter two forces dominate, $\partial\left(\frac{\partial p}{\partial t} \frac{1}{p}\right)/\partial > 0$. If instead the “demand” force dominates, we would expect $\partial\left(\frac{\partial p}{\partial t} \frac{1}{p}\right)/\partial x < 0$. This theoretical ambiguity generates the empirical question of what the net moderating role of road infrastructure on input prices actually is. The empirical analysis conducted in the paper contributes to answer this question for the case of Ethiopia. We discuss results from the empirical estimation in Table 9

B Ethiopian towns within a contiguous lit area

Figure B-1: Voronoi partition of the contiguous lit area



Notes: The figure plots urban areas defined by night-lights corresponding to Addis (including Burayu), Sululta, Akaki, Bishoftu and Modjo, all lying within a contiguous lit area. We partition the area into sub-areas consisting of the Voronoi polygons defined around town coordinates.

C Roads and aggregate firm performance

Table C-1: Correlation between roads and town-level aggregate firm performance

Dep var:	N firms_{rt}	Lab prod_{rt}	$\text{Capital intensity}_{rt}$	Sales_{rt}	Import/sales_{rt}	Skill ratio_{rt}
	(1)	(2)	(3)	(4)	(5)	(6)
Roads _{rt}	0.019 (0.011)	0.108 (0.028)	0.143 (0.021)	0.127 (0.038)	0.011 (0.004)	0.050 (0.013)
Observations	638	591	624	638	635	615
R^2	0.903	0.490	0.568	0.719	0.416	0.383
Town FE	✓	✓	✓	✓	✓	✓
Year FE	✓	✓	✓	✓	✓	✓

Notes: The dependent variables are constructed by adding up firm level information at the town and year level. N firms_{rt} is the log number of firms; Lab prod_{rt} is the log of labor productivity, constructed as total value added divided by total number of employees; $\text{Capital intensity}_{rt}$ is the log of the share of total fixed assets in total number of employees; Sales_{rt} is the log of total sales; Import/sales_{rt} measures the value of imported raw materials as a share of total sales; and the Skill ratio_{rt} is the share of the total number of administrative (and other non-production) workers in the total number of production workers. Robust standard errors in parenthesis.

D Firm-level price index

The estimation of firm level productivity in the present paper builds on Eslava et al. (2004) and Smeets and Warzynski (2013). These two studies propose an empirical model of the production function where, instead of deflating revenues with the standard vector of sector-level price indices, a firm-level price index P_{it} is used. This Appendix discusses the procedure to adapt the methodology applied in Eslava et al. (2004) and Smeets and Warzynski (2013) to the specificities of our data.

Step 1

First, we account for the fact that in the Ethiopian firm census data, many products within firms are not consistently identifiable across time due to the lack of a product category as identifier. Second, multiple line entries within a firm-year record the same product code and unit measure. The solution we adopt is as follows. All products with missing product code are grouped in an aggregate product category (denoted with *nim* ‘non identifiable missing’). Products within a firm-year that have the same values for both product code and unit measure are grouped in aggregate product categories depending on their product code (*onih* ‘other non identifiable with product code h ’).

Next, we derive a product-level price index as a weighted average of the prices of domestic sales and exports:

$$P_{hit} = \sum_{\nu=d,x} s_{hit}^{\nu} P_{hit}^{\nu} \quad (\text{D-1})$$

where the superscripts d and x stand respectively for the domestic and export market, and s_{hit}^{ν} is the share of market ν in the total sales of product h by firm i at time t .

We deal with missing information in line with Eslava et al. (2004). In a nutshell: we compute sector-year level averages of P_{hit}^{ν} for $\nu \in \{d, x\}$ and we replace missing values of P_{hit}^{ν} with the respective sector-year average in case of a zero or missing value for sales or export quantity (value) and a non-missing, strictly positive value for sales or export value (quantity). Notice that when the value is missing (this is actually a minority of cases) the shares s_{hit}^{ν} cannot be computed. We correct for this by replacing the missing value of domestic and/or export sales for a product-firm-time level observation with the average value of domestic and/or export sales across available observations of the same product in the same firm but in alternate years.

Finally, we compute $P_{nim,it}$ and $P_{onih,it}$ as the weighted average of P_{hit} for all h belonging to the respective group of non-identifiable products, with weights computed as the h share of the total value (sales value plus export value) in the group. In this newly created database, these product-aggregates will be treated as individual products.

Step 2

We focus on product-level observations with perfectly identifiable products. We compute P_{hit} as before and append the results to the database created in Step 1. Then, we apply a Tornqvist formula to obtain firm-level prices. Notice that the dynamic structure of the Tornqvist formula requires that each product h is perfectly identifiable across time.

$$\Delta \log(P_{it}) = \sum_h \frac{s_{hit} + s_{hi(t-1)}}{2} \times [\log(P_{hit}) - \log(P_{hi(t-1)})] \quad (\text{D-2})$$

where s_{hit} is the share of product h total (both domestic and export) sales value over total sales value of the firm i at time t .

Finally, we select 2009 as our base year (the number of active firms is at its maximum in this year) and set $P_{i,2009} = 1$. We then proceed recursively (backward) to retrieve firm-level prices:

$$\log(P_{i(t-1)}) = \log(P_{it}) - \Delta\log(P_{it}) \quad \forall t \leq 2009 \quad (\text{D-3})$$

We first apply (D-3) only for those firm-year pairs (i, t) such that, for every year $t \leq k \leq 2009$, $\Delta\log(P_{it})$ is non missing.

There are two potential computational caveats that we address following the approach laid out by Eslava et al. (2004). First, a firm might not be observed in the base year. Consider the following example which illustrates the proposed solution. Take firm i and assume that the last year where it is observed is 2006. In that case the last $\Delta\log(P_{it})$ that we can compute using (D-2) is $\Delta\log(P_{i2006})$. We will set $\log(P_{i2006})$ as the sector-level average for 2006, i.e. $\sum_j \log(P_{j2006}) / |J^{S(i)2006}|$, where $|\cdot|$ is a cardinality operator, J^{k_t} is the set of firms j belonging to sector k for which we were able to retrieve $\log(P_{jt})$, and $S(i)$ is the sector to which firm i belongs. Second, a firm i might have a missing value for $\Delta\log(P_{it})$ at a certain time t in between two time intervals where it is potentially possible to apply the recursive formula (D-3). This would cause a break in the formula (this is the case for year 2004 and panel_id 6 for instance). Again, we solve this issue by replacing the missing observation of $\log(P_{i(t-1)})$ with the sector-level average for that year. The result is a series of firm-level price indices P_{it} which will be used to deflate firm-level revenues.

E TFP coefficients

Table E-1: TFP coefficients

Sector	Labor	Capital	Materials
15	0.4126489	0.0486334	0.8142029
17	0.0830094	0.0317496	0.6806585
18	0.1221208	-0.0289049	0.9153442
19	0.0679566	0.0752514	0.8331738
20	0.4058325	0.0115141	0.7583169
22	0.4919236	-0.010469	0.5968748
24	0.0809411	0.1088803	0.8244199
25	0.4396779	0.0269117	0.7720901
26	0.3447249	0.0431832	0.6823554
28	0.1844413	0.1293488	0.7633256
34	0.3015625	0.0996745	0.7081328
36	0.1963425	0.038197	0.8051757

Notes: The table reports coefficients of the production function estimated for each 2-digit industry following the methodology described in Section 3.2.2. Sectors are specified as 2-digit ISIC Rev 3 categories.

F Addressing potential endogeneity of tariff reforms

In this section, we ensure that input tariff changes are largely exogenous to initial industry characteristics. If input tariff changes are endogenous to initial industry characteristics, it is possible that our results on the impact of input tariff reductions on firm productivity are inconsistently estimated. To do this, we estimate relationships between initial sector characteristics in 1996 including production, employment, exports, capital intensity and agglomeration and input tariff changes at the sector level between 1996 and 2003. Results are presented in Table F-1. Across columns, we find no statistically significant relationship between initial sector characteristics and input tariff changes, assuring us that tariff changes are plausibly exogenous.

Table F-1: Correlation between initial sectoral characteristics and trade policy change

Dependent variable:	Production	Employment	Export	Capital intensity	Agglomeration
	(1)	(2)	(3)	(4)	(5)
Δ Input-tariff	-1.005 (1.243)	-1.093 (0.547)	-1.085 (3.219)	0.514 (0.811)	0.008 (0.025)
Observations	36	41	41	41	41
R^2	0.020	0.081	0.003	0.015	0.005

Notes: The dependent variables are constructed by aggregating firm level data at the 4-digit sector and year level and using pre-sample information from the census year 1996. Variables "Production", "Employment" and "Export" are the sum of the values of output, employees and exports of the firm by sector and year; "Capital Intensity" is constructed as the sum of fixed asset divided by the total employment by sector and year; "Agglomeration" is given by the number of firms in each sector and year. After aggregation, all variables have then been transformed in logs. Input tariffs are computed at the 4-digit sector level and the variable report their changes between 1996 and 2003. Robust standard errors in parenthesis.

Next, we ask if input tariff changes are related to initial performance, measured by productivity. If they are, then the relationship we estimate between reductions in input tariffs and firm productivity might be driven by how tariff reforms were targeted across sectors. In Table F-2, we estimate correlations between lagged values of productivity and input tariff changes in each year in our sample period. Again, we find no evidence of a strong correlation between initial performance and subsequent changes in input tariffs, lending further credence to our claim that input tariff changes are exogenous to firm performance.

Table F-2: Correlation between initial sectoral performance and trade policy change

Dependent variable:	Input-tariff _{jt}	
	(1)	(2)
log TFP _{ijt-1}	-0.038 (0.063)	
log TFP _{ijt-5}		-0.024 (0.055)
Observations	7367	3107
R^2	0.456	0.055
Firm FE	✓	✓
Year FE	✓	✓

Notes: The dependent variable in both regressions is the input tariff computed at the industry level. The regressors are firm productivity lagged one and five years respectively. All regressions include firm and year fixed effects. Robust standard errors clustered at the sector level are reported in parenthesis.

G Addressing potential endogeneity of roads

Table G-1: Correlation between town-level economic outcomes and change in roads

Panel A:	Dep var: $\Delta \text{Market access}_{rp}$					
	(1)	(2)	(3)	(4)	(5)	(6)
$\log \text{TFP}_{rp}$	0.016 (0.010)		0.016 (0.010)	-0.004 (0.013)		-0.004 (0.013)
Night light intensity $_{rp}$		0.007 (0.009)	0.003 (0.011)		0.013 (0.073)	-0.007 (0.080)
Observations	117	138	117	109	138	109
Adjusted R^2	0.012	-0.003	0.004	0.350	0.328	0.341
Town FE				✓	✓	✓
RSDP phase FE				✓	✓	✓
Panel B:	Dep var: $\Delta \text{Galafi}_{rp}$					
	(1)	(2)	(3)	(4)	(5)	(6)
$\log \text{TFP}_{rp}$	-0.009 (0.007)		-0.009 (0.007)	0.003 (0.007)		0.002 (0.008)
Night light intensity $_{rp}$		0.002 (0.006)	0.003 (0.006)		0.093 (0.047)	0.097 (0.049)
Observations	112	115	112	103	109	103
Adjusted R^2	0.007	-0.008	0.000	0.413	0.444	0.439
Town FE				✓	✓	✓
RSDP phase FE				✓	✓	✓

Notes: The dependent variables $\Delta \text{Market access}_{rp}$ and $\Delta \text{Galafi}_{rp}$ are constructed as the difference between the value of $\text{Market access}_{rt}$ and Galafi_{rt} at the end and beginning of each of the three phases (indexed by p) of the RSDP covered in our sample. $\log \text{TFP}_{rp}$ is constructed by averaging firm level data at the town level for the year at the beginning of each RSDP phase. Night light intensity $_{rp}$ is also measured at the town level for the year at the beginning of each RSDP phase. Robust standard errors in parenthesis.