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Pass-through, profits and the political economy of regulation

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Abstract Government regulation, such as the pricing of externalities, often raises the unit costs of regulated firms, and its impact on their profits is important to its political economy. We introduce a reduced-form model ("GLM") that nests existing models of imperfect competition under weaker assumptions. We show how a firm's cost pass-through is a sufficient statistic for the profit impact of regulation. We apply the GLM to carbon pricing for US airlines. We find large inter-firm heterogeneity in pass-through, even for a uniform cost shock. The GLM allows us to sidestep estimation of a consumer demand system, firm markups and conduct parameters. We derive the second-best emissions tax including lobbying a government "for sale".

Keywords Cost pass-through, regulation, carbon pricing, airlines, political economy

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