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One Markup to Rule them All: Taxation by Liquor Pricing Regulation

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Abstract:

Government often chooses simple rules to regulate industry even when firms and consumers are heterogeneous. We evaluate the implications of this practice in the context of alcohol pricing where the regulator uses a single-markup rule which does not vary across products. We estimate an equilibrium model of wholesale liquor pricing and retail demand for horizontally differentiated spirits which allows for heterogeneity in consumer preferences across observable demographics. We show that current policy is consistent with one in which the regulator maximizes tax revenue but is constrained to charging a single markup. In comparison to subsidy-free Ramsey prices, the price distortion introduced by the single-markup rule benefits small local distilleries as well as younger, minority, non-educated, and/or lower income individuals by not overpricing their favored spirits as much as the rest. Welfare increases for only 16% of residents under the current policy but these beneficiaries are aligned politically. These results support the hypothesis that legislators employed a simple policy to garner the favor of these key constituent groups.