



Fallacy of Automatic Pass Thru of Costs

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Fallacy of automatic pass-through of costs

There is a common fallacy that higher costs are automatically passed through to consumers. Actually, only marginal production is shut down by a rise of variable costs; other production continues. Pass-through is not needed to keep things moving.

Where producer surplus is high, ϵ of production is low. That means the % cutback of output is much less than the % cutback of the variable input.

Individuals who just bought into an industry at high prices may go bankrupt, but that need not remove the resources from production. Bankruptcy is a personal question, not a supply question. The creditors who foreclose keep the resources producing in order to minimize their losses of the past -- more positively, to maximize their gains in the future.

Where prices are determined in world markets, local taxes or other charges are not shifted forward at all. They cannot be, demand is totally elastic.

Example 1: severance tax on coal by N.D. Commonwealth Edison case, N.D. won the judgment, consumers had no case.

Example 2: Reduction in Calif. property taxes was not passed on to renters, 1978. Imposts on new housing in California are alleged to raise prices of housing to consumer, but probably are borne by sellers of raw land to builders. Any builder who thinks he can automatically pass on any cost increase is in for a rude shock. He had better bid less for raw land.