Carbon Taxes and Misallocation in Chile

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June 23, 2025

Abstract

Carbon taxes are subject to a classic free rider problem: the benefits are global but the costs are often local. In an inefficient economy, however, carbon taxes can exacerbate or ameliorate existing domestic distortions. In Chile we find that fossil fuel use is *negatively* correlated with revenue productivity (revenue relative to inputs) across firms. We present evidence suggesting that this pattern may reflect higher price-cost markups at firms that produce higher quality products, with quality being intensive in skilled labor and expensive intermediates but not fossil fuel use. As a result, imposing a unilateral carbon tax may helpfully reallocate inputs away from low-markup, low-quality firms towards high-markup, high-quality firms. We calculate that a unilateral carbon tax in Chile could increase allocative efficiency, consumption, and welfare.

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1. Introduction

Standard logic holds that carbon taxes have global benefits but local costs. The local costs take the form of induced substitution away from fossil fuel inputs, which can reduce local output and consumption. Thus countries may prefer to free ride rather than impose their own carbon tax.

The standard logic may falter, however, if the domestic economy is plagued by distortions other than those related to carbon consumption. Other distortions might stem from government taxes and subsidies, price markups, wage markdowns, financial frictions, government size-dependent policies, and more.[1] If these other distortions are correlated with fossil fuel use across firms, then carbon taxes may amplify or mitigate misallocation of inputs across firms.

To investigate this possibility, we explore firm-level data from Chile on revenue and inputs, prices and quantities, and fossil fuel use from 2015 to 2019. The dataset covers firms in all sectors. We find that revenue productivity (the ratio of revenue to inputs, a common proxy for price-cost markups) is negatively correlated with fossil fuel intensity across firms within industries. Firms with high residual demand (i.e., those who sell more output than one would expect given their relative prices) exhibit higher revenue productivity and lower fossil fuel intensity. We hypothesize that the higher residual demand reflects higher quality, and that firms with higher quality products charge higher markups. Under this interpretation, product quality may be intensive in skilled labor and expensive intermediates, but not fossil fuels.

We write down a static general equilibrium model wherein intermediate good firms are heterogeneous in their fossil fuel intensity within and across industries. They also face heterogeneous revenue "tax" rates (a stand-in for markup dispersion and other distortions). Fossil fuels are entirely imported and financed by exports of the final good. We back out firm-specific production technologies and revenue distortions to fit the firm data on input choices and revenue. Then we impose various carbon taxes to see what they do to output, allocative efficiency, and consumption.

[1] See Restuccia and Rogerson (2017) for a recent survey on sources of misallocation.

We entertain carbon taxes ranging from 20% to 100%, which corresponds to roughly $9 to $46 per ton — within the range implemented in many countries.[2] The carbon tax predictably reduces energy imports and gross output. But it also raises TFP monotonically up through a 100% carbon tax, as it reallocates inputs from low to high revenue-productivity firms. As a consequence, consumption is higher with a carbon tax, at least through a 100% tax. The peak is an increase of over 2% in consumption at around a 20% tax. The increase in consumption is smaller for higher taxes but still positive. The upshot is that, at least in the case of Chile, imposing a carbon tax unilaterally may improve Chilean welfare.

One might wonder why Chile has not pursued policies to eliminate the existing misallocation directly. Misallocation may persist, however, because of barriers to eliminating or mitigating it. For example, there may be political obstacles to subsidizing (or lowering tax rates for) large and highly profitable firms. Or concern that firms will manipulate their financial reporting if subsidies are linked to their profitability. A carbon tax may be comparatively easier to pass and implement.

Our paper relates to several recent efforts. Kim (2023) originated the same idea and arrived at a similar qualitative outcome using U.S. Compustat data. Kim's focus was the interaction of carbon taxes with the allocation of capital due to financial frictions and adjustment costs, and the optimal carbon tax in the presence of those frictions. In contrast, we look at a wider swath of firms in Chile, a small open economy that imports fossil fuels, and analyze the effects of a unilateral carbon tax on the efficiency of input allocation across firms. Moreover, we provide evidence consistent with a distinct mechanism, namely the connection between product quality, markups, and fossil fuel intensity.

Conte, Desmet and Rossi-Hansberg (2023) find that a unilateral carbon tax can be welfare-enhancing for the European Union by concentrating more people and activity in high productivity areas. Aghion, Boppart, Peters, Schwartman and Zilibotti (2025) stress how the shift from agriculture/manufacturing to services reduces fossil-fuel intensity. They also emphasize that, as goods and services improve in quality (e.g., from one iPhone model to another), they may not use proportionately

[2] World Bank (2024).

more fossil fuels. This over-time result is complementary to our cross-firm finding that firms who seem to produce high quality products are less fossil-fuel intensive. Potentially related, Barrows and Ollivier (2018) show that larger firms in India have lower emissions intensity.

The rest of the paper is organized as follows. In Section 2 we describe the Chilean data, and document correlates with fossil fuel intensity. Section 3 lays out a model of firms with differing production technologies and revenue productivity. In Section 4 we calculate what imposing a carbon tax would do in our model when it is calibrated to match the Chilean data. Section 5 concludes.

2. Dataset and Empirical Patterns

2.1 Dataset

We use merged confidential administrative data on the universe of firms in Chile. The sample is yearly, starts in 2015, and we end with 2019 to avoid the COVID episode. The data includes prices and quantities for firm-to-firm transactions from VAT invoices, prices and quantities of firm imports from customs data, and firm employment, physical capital, sales, and intermediates from annual tax reports.[3] Firms are placed into 2-digit sectors according to their registered main economic activity. We drop firms with less than 10 employees, non-positive value added, or fixed assets below 10,000 Chilean pesos (about $15 U.S. dollars), and those belonging to "public administration" or sectors with fewer than five firms. The resulting yearly sample varies from about 21,000 to 26,000 firms across 70 2-digit sectors.

To identify transactions of fossil fuel products in VAT invoices, we benefit from a word embedding model used to classify products into the Central Product Classification (CPC) v.2 at six digits.[4] Table 1 displays the codes and descriptions of products we consider "fossil fuel".[5] Fossil fuel products in customs data are classified in

[3] We have access to this data through the Central Bank of Chile.

[4] The CPC v.2 is available here:
https://unstats.un.org/unsd/classifications/Econ/Download/In%20Text/CPC_Ver_2_English.pdf

[5] Firms have no incentive to under-report purchases of intermediate inputs, including fossil fuel products, as by doing so they obtain VAT claims deductible from taxes.

chapter 27 in the 2007 HS Nomenclature.[6]

2.2 Measures of fossil fuel intensity

Firms in year t are indexed by $i = 1, ..., J_t$, each of them belonging to a sector $s = 1, ..., S$, where J_t is the total number of firms in year t and S is the total number of sectors. To shorten notation, we sometimes simply refer to a firm as "firm si".[7] We postulate two measures of a firm's fossil fuel intensity of use. We start with a "direct" measure denoted by λ_{sit} for firm si at year t, and defined as

$$\lambda_{sit} \equiv \frac{\sum_{j=1}^{J_t} \left(ff_{sij't} + M_{sit}^{ff} \right)}{Cost_{sit}}. \tag{1}$$

which is the fossil fuel share in costs of a given firm si in year t, where $ff_{si't}$ is its total purchases of fossil fuel products from an arbitrary firm j in year t recorded in VAT invoices (i.e., involved in domestic transactions), and M_{sit}^{ff} is total imports of fossil fuel products by firm j in year t recorded in customs data and denominated in local currency. In turn, $Cost_{sit}$ includes firm si's wage bill, total purchases of intermediate inputs, total imports denominated in local currency, and an imputation for the cost of capital, all in year t, as reported in firm annual tax reports. Capital costs are simply a 15% assumed user cost of capital multiplied by a firm's reported fixed assets.[8]

We also measure a firm's "total" fossil fuel intensity, denoted by Λ_{sit}, which encompasses direct and indirect use contained in all intermediate inputs they buy from domestic firms:

$$\Lambda_{sit} \equiv \lambda_{sit} + \eta_{sit} \sum_{j=1}^{J_t} \omega_{jt}^{si} \Lambda_{j,t} \tag{2}$$

where η_{sit} denotes the share in firm si's costs of its total purchases in year t of non-

[6] Constructued by the World Customs Organization, the 2007 HS classification is available here: https://www.wcoomd.org/en/topics/nomenclature/instrument-and-tools/hs_nomenclature_previous _editions/hs_nomenclature_table_2007.aspx

[7] As firms' indices are unique, the sectoral index is redundant but added to facilitate exposition.

[8] The 15% user cost is chosen to reflect interest, depreciation, and taxes. The result are not too sensitive to this choice relative to 10% or 20%. We also compute results excluding the cost of capital and arrive at similar empirical patterns.

Table 1: CPC v.2 items included in fossil fuel

11010	Coal, not agglomerated
11020	Briquettes and similar solid fuels manufactured from coal
11030	Lignite, not agglomerated
11040	Lignite, agglomerated
12010	Petroleum oils and oils obtained from bituminous minerals, crude
12020	Natural gas, liquefied or in the gaseous state
12030	Bituminous or oil shale and tar sands
33100	Coke and semi-coke of coal, of lignite or of pear; retort carbon
33200	Tar distilled from coal, from lignite or from pear, and other mineral tars
33310	Motor spirit (gasoline), including aviation spirit
33330	Other light petroleum oils and light oils obtained from bituminous minerals (other than crude); light preparations n.e.c. containing not less than 70% by weight of petroleum oils or oils obtained from bituminous minerals (other than crude), these oils being the basic constituents
33341	Kerosene
33342	Kerosene type jet fuel
33350	Other medium petroleum oils and medium oils obtained from bituminous minerals (not kerosene), other than crude; medium preparations n.e.c containing not less than 70% by weight of petroleum oils or oils obtained from bituminous minerals (other than crude), these oils these oils being the basic constituents of the preparations
33360	Gas oils
33370	Fuel oils n.e.c.
33410	Propanes and butanes, liquefied
33420	Ethylene, propylene, butylene, butadiene and other petroleum gases or gaseous hydrocarbons, except natural gas
33500	Petroleum jelly; paraffin wax, micro-crystalline petroleum wax, slack wax, ozokerite, lignite wax, peat wax, other mineral waxes, and similar products; petroleum coke, petroleum bitumen and other residues of petroleum oils or of oils obtained from bituminous materials
69120	gas distribution through mains (on own account)

fossil fuel intermediate inputs recorded in VAT invoices (domestic transactions), and ω_{jt}^{si} is the input-output link of firm si with an arbitrary firm j, defined as the share of firm si's purchases of intermediate inputs from firm j in year t over its total purchases of intermediate inputs from domestic firms. By construction, $\eta_{sit} \in [0,1]$ and $\sum_{j=1}^{J_t} \omega_{jt}^{si} = 1$ for any firm j. In matrix form, this expression becomes

$$\Lambda_t \equiv \lambda_t + \Delta_t \Omega_t \Lambda_t = [\mathbf{I}_{J_t} - \Delta_t \Omega_t]^{-1} \lambda_t$$

where $\mathbf{I}_{J_t}$ is the identity matrix of dimension J_t, Δ_t is a diagonal matrix with the vector $[\eta_{sit}]$ in its diagonal, $\Omega_t \equiv [\omega_{jt}^{si}]$ is the input-output matrix at the firm level, and λ_t is the vector of firm direct fossil fuel intensities in year t.

A few comments on Λ_t are due. First, we do not include each firm's indirect use of fossil fuel via its imports of intermediate inputs in the computation of Λ_t. This is because the experiment we are interested in is the implementation of a local carbon tax for which, besides direct fossil fuel intensity, the indirect use of fossil fuel contained in the domestic production network is most informative. Second, our data is at the firm level. Therefore, in spite of its richness, we must assume that all products sold by a given supplier contain the same fossil fuel intensity. Third, indirect fossil fuel intensity through the domestic production network is captured by $\Delta_t \Omega_t \Lambda_t$. To independently assess its incidence in total fossil fuel intensity, we conveniently define it as

$$\tilde{\lambda}_t \equiv \Delta_t \Omega_t \Lambda_t \tag{3}$$

such that $\Lambda_t \equiv \lambda_t + \tilde{\lambda}_t$. Finally, notice that both measures of a firm's fossil fuel intensity are constructed from nominal data. We also produce measures that adjust each type of fossil fuel in Table 1 by a CO2 emission factor.[9] Results are robust to this adjustment so, for simplicity, we keep the measurements computed on value for the baseline analysis. Details of the computation of CO2 emission factors and robustness results are reported in Appendix X.

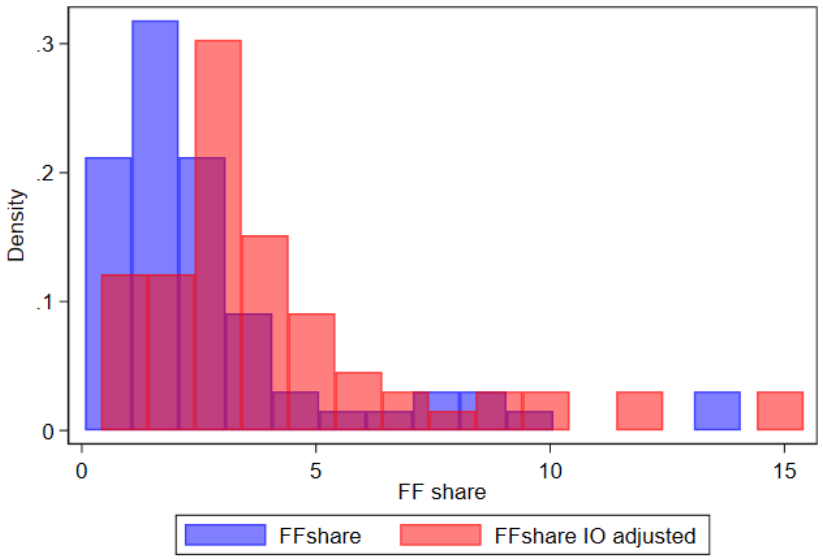
[9] These factors are computed from the estimation of tonCO2/TJ reported in the 2022 Energy Balance published by Chile's Ministry of the Environment.

2.3 Empirical patterns

2.3.1 Dispersion in fossil fuel intensity across and within 2-digits sectors

In order for a carbon tax to affect the allocation of inputs across firms, a necessary condition is that firms and sectors differ in their fossil fuel intensity. Figure 1 displays the density of direct and total fossil fuel intensity across 2-digit sectors. Both measures are averaged across firms in each sector and year, and then averaged over time. When aggregating firm fossil fuel shares up to the sector level in each year, the firm's share of aggregate costs is used as a weight.

Figure 1: Fossil Fuel Shares Across Sectors

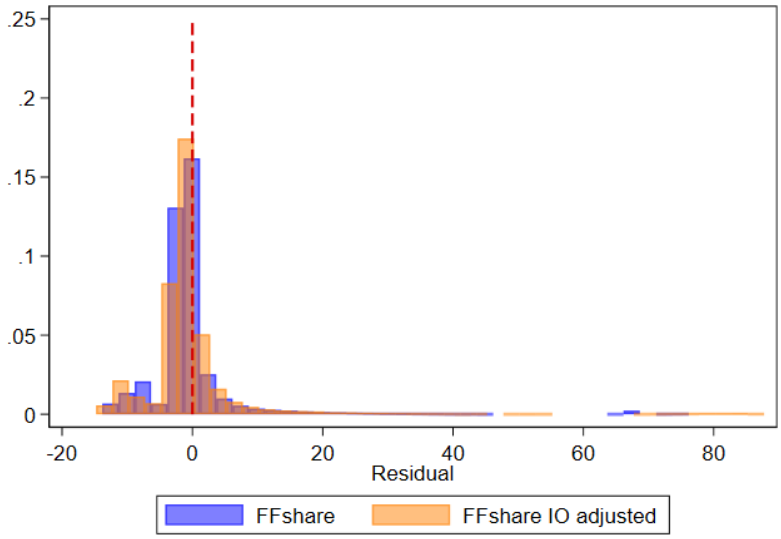


Note: We exclude sectors with less than 25 firms to comply with the Central Bank of Chile's disclosure policy.

Direct fossil fuel intensity (in blue in Figure 1) represents less than 5% of costs in most sectors, though higher in a few sectors. Perhaps unsurprisingly, the sectors with the highest direct fossil fuel intensity are "gas distribution" (code 52), "air transportation" (code 68), and "other passengers transportation" (code 65). Total fossil fuel intensity (in red in Figure 1) is on higher and more dispersed, with the same three sectors accounting for the highest total intensity. However, the sectors

with the highest indirect fossil fuel intensity, as defined in equation (3), are different: "electricity distribution" (code 51), "basic chemical industries" (code 35), and "manufacturing from other non-metallic minerals" (code 41).

Figure 2: Fossil Fuel Shares Across Firms Within Sectors

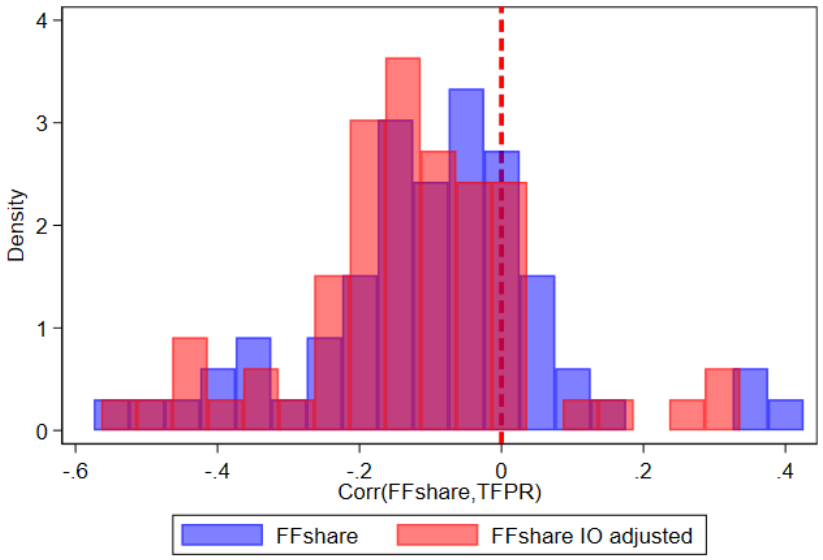


In turn, Figure 2 displays the density of direct and total fossil fuel intensity across firms within 2-digit sectors. The industry-year mean is removed, and firm deviations are averaged across years before plotting. Most of the intra-sector dispersion of direct fossil fuel intensity (in blue in Figure 2) lies within 5 percentage points of the industry-year mean. The distribution of intra-sector dispersion of total fossil fuel dispersion (in yellow in Figure 2) is not so different — other than more mass on the negative side of the support, indicating a higher mean at the sectoral level. Both distributions have a long positive tail; few firms have much higher fossil fuel intensity than their sectoral mean. In part this is due to two-digits of disaggregation being too coarse. There is less dispersion across firms within sectors than across sectors, but firm output is also presumably more substitutable within sectors. Hsieh and Klenow (2009) and Baqaee and Farhi (2020) stress that input reallocation is more sensitive to differences within than across sectors for this reason.

2.3.2 Correlation of fossil fuel intensity with TFPR and TFPQ

A carbon tax may affect allocative efficiency if fossil fuel intensity is correlated with revenue productivity across firms. Figure 3 provides the distribution of the correlation of TFPR (the ratio of revenue to input costs) with direct and total fossil fuel intensity across firms within each sector. For both measures, the correlation is negative in the vast majority of industries. Thus firms who use fossil fuel more intensively tend to have lower ratios of revenue to inputs. There is higher mass on negative correlations for total fossil fuel intensity, indicating that high revenue productivity firms tend to use non-fossil fuel inputs which themselves are produced with low fossil fuel intensity. We will return to this when we present more systematic empirical results and when we turn into a model for counterfactual exercises.

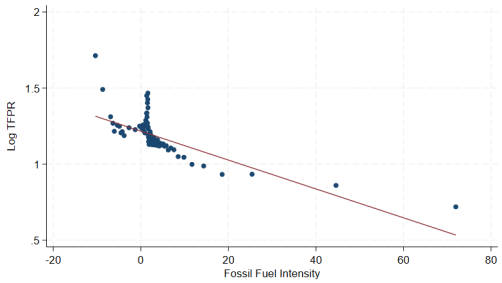
Figure 3: TFPR vs. Fossil Fuel Intensity



To provide a sense of the shape of the relationship, we calculate average TFPR across firms within 100 bins of fossil fuel intensity in Figure 4, with panels A and B for direct and total fossil fuel intensity, respectively. Both panels show that some highly fuel-intensive firms have very low TFPR, and a negative relationship holds through most of the range of fossil fuel use.

Figure 4: TFPR vs. Fossil Fuel Intensity

(A) Direct fossil fuel intensity



(B) Total fossil fuel intensity

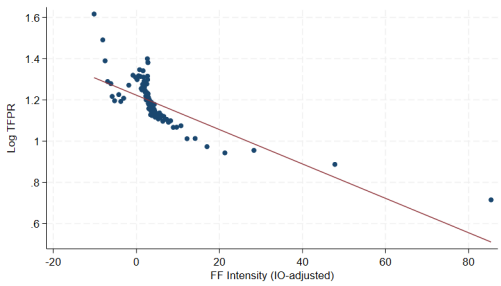


Table 2 provides the related regressions of log TFPR on fossil fuel intensity across firms. Sector fixed effects are included, so the coefficients reflect differences across firms within industries. Columns (1), (3), and (5) show results for direct fossil fuel intensity for years 2015, 2017, and 2019. The relationship is negative and significant at the one percent level: a one percentage point higher direct fossil fuel intensity is associated with 0.8 percent lower TFPR. The magnitude of the coefficient is fairly stable across the three years.

Columns (2), (4), and (6) show results for 2015, 2017, and 2019 that distinguish between direct and indirect fossil fuel intensity as regressors. The coefficients on direct fossil fuel intensity are almost identical to those reported in columns (1), (3), and (5). The coefficients on indirect fossil fuel intensity are likewise stable across the three years, significant at the one percent level, and larger: a one percentage point higher indirect fossil fuel intensity is associated with about 1.2 percent lower TPFR. However, comparing to columns (1), (3), and (5) shows that the contribution of indirect fossil fuel intensity to R^2 is very small. This also shows up in the 0.36 correlation between direct and *indirect* fossil fuel intensity in our whole sample, whereas the correlation is 0.97 percent between direct and *total* fossil fuel intensity, the latter encompassing both direct and indirect fossil fuel intensity.

Table 2: Regressions of TFPR on Fossil Fuel Intensity

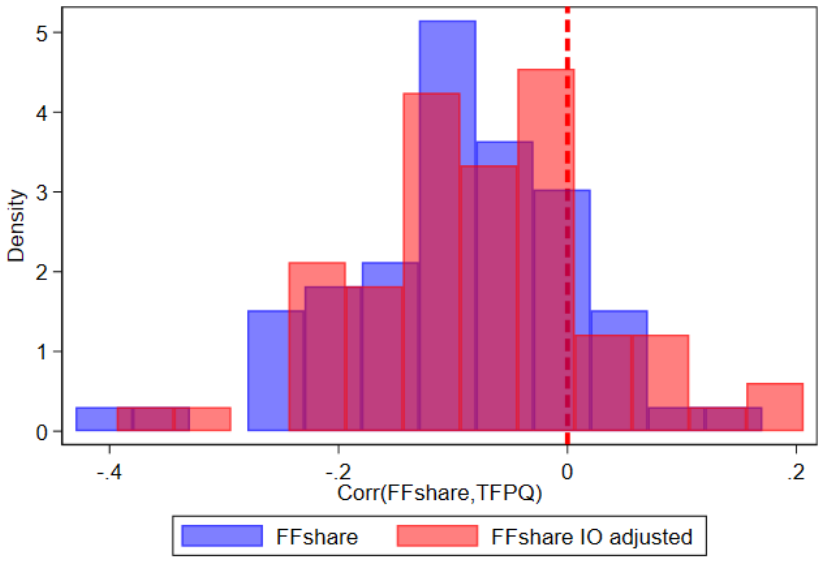
	(1)	(2)	(3)	(4)	(5)	(6)
VARIABLES	$\log(TFPR)$	$\log(TFPR)$	$\log(TFPR)$	$\log(TFPR)$	$\log(TFPR)$	$\log(TFPR)$
λ	-0.797***	-0.806***	-0.876***	-0.870***	-0.837***	-0.835***
	(0.023)	(0.022)	(0.024)	(0.024)	(0.024)	(0.023)
$\tilde{\lambda}$		-1.469***		-0.553***		-1.073***
		(0.177)		(0.087)		(0.101)
Constant	1.291***	1.310***	1.175***	1.180***	1.151***	1.173***
	(0.290)	(0.368)	(0.263)	(0.275)	(0.268)	(0.347)
Observations	25,611	25,611	28,931	28,931	26,257	26,257
Adjusted R-squared	0.371	0.374	0.399	0.400	0.407	0.410
Sector FE	YES	YES	YES	YES	YES	YES
Year	2015	2015	2017	2017	2019	2019

Clustered Standard Errors at firm level in parenthesis

*p<.05; **p<.01; ***p<.001

A related question is whether a firm's underlying productivity is correlated with its fossil fuel intensity. Here we use TFPQ, which captures both process efficiency and residual demand (e.g. product quality).[10] Figure 5 plots the histogram of within-industry correlations of TFPQ and fossil fuel intensity across firms within industries. Almost all industries feature a negative correlation. Thus, firms with better technology seem to be able to economize on fossil fuel by both directly using less for production and by using inputs which themselves use less fossil fuel. However, this latter channel seems to be less prevalent given the higher mass of positive correlation between TFPQ and total fossil fuel intensity (in red in Figure 5) than with direct fossil fuel intensity (in blue in Figure 5).

Figure 5: TFPQ vs. Fossil Fuel Intensity



[10] TFPQ is a measure of quality-adjusted real output relative to inputs. See Hsieh and Klenow (2009). More on TFPQ in the model below.

2.3.3 Inspecting the mechanism

To delve into the potential mechanism further, we run pooled regressions of TFPQ and its components on fossil fuel intensity. We do this across firms within industries by controlling for sector-year fixed effects. A firm's relative price is $p_{it} \equiv P_{it}/P_{st}$, its process efficiency $PE_{it} \equiv \text{TFPR}_{it}/P_{it}$, and its residual demand (TFPQ relative to process efficiency) is $RD_{it} \equiv \text{TFPQ}_{it}/PE_{it}$.

As shown in Table 3, one percentage point higher fossil fuel share goes along with 0.9 percent lower TFPQ. Moreover, it is associated with 3.9% lower relative prices. Process efficiency is 3 percent higher. So the lower TFPQ does *not* reflect lower process efficiency. On the contrary, such firms have lower TFPQ despite higher process efficiency. Combining the price and process efficiency results suggests that price-cost markups may be about 1% lower for firms with one percent higher fossil fuel share — consistent with the TFPR regressions in Table 2.

Column 4 of Table 3 indicates that higher fossil fuel use is accompanied by 3.8 percent lower residual demand. This is consistent with fossil fuel intensive firms producing lower quality products. If producing higher quality involves non-fuel inputs intensively, and higher product quality is associated with higher markups, then the negative relation we find between TFPR and fossil fuel use may be systematic rather than coincidental. The last column provides a different perspective for this result: one percent higher direct fossil fuel intensity is associated with 2 percent lower intermediate inputs prices, which presumably are lower quality than intermediate inputs at less fossil fuel intensive firms.

3. A Model of Fossil Fuel Use and Misallocation

Here we lay out of a static, small open economy model of firms with heterogeneous production technologies — including fossil fuel intensity. Given our focus on a small open economy, our model does not feature environmental externalities from fossil fuel use.

Table 3: Evidence of Mechanisms

	$TFPQ$	P	PE	RD	$\tilde{P}$
λ	-0.874***	-3.900***	2.962***	-3.836***	-2.181***
	(0.030)	(0.137)	(0.139)	(0.139)	(0.102)
FE_{kt}	Yes	Yes	Yes	Yes	Yes
Obs.	115,590	115,590	115,590	115,590	115,590
Firms	41010	41010	41010	41010	41010
R^2_{adj}	0.334	0.435	0.411	0.410	0.156

Clustered Standard Errors at firm level in parenthesis.
*p<.05; **p<.01; ***p<.001

Endowments The aggregate endowments of labor L and physical capital K are exogenously fixed. Labor and capital are both homogeneous. Gross output Q can be devoted to either "value added" Y or non-energy intermediate goods M:

$$Q = Y + M$$

Households A representative household has discounted utility

$$U_t = \sum_{t=0}^{\infty} \beta^t \, L \, u(c_t)$$

where per capita consumption is $c_t \equiv C_t/L$ and flow utility is $u(c_t) = \ln(c_t)$. The household's intertemporal budget constraint is

$$A_{t+1} = w_t \cdot L + (R_t - \delta) \cdot A_t - C_t + T_t$$

where A are assets, w is the wage, R is the rental price of capital, δ is the depreciation rate on physical capital, and T_t are lump sum taxes or transfers. Note that $R_t \equiv r_t + \delta$, where r is the real interest rate. Here we implicitly normalize the price of the final good (and consumption) to 1.

Household utility maximization leads to the usual Euler equation:[11]

$$c_{t+1}/c_t = \beta(1 + r_t)$$

Production Technology Aggregate gross output is the geometric average of gross output in S sectors:

$$Q = \prod_{s=1}^{S} Q_s^{\theta_s}$$

where θ_s is the geometric weight on sector s. Sectoral output, in turn, is a CES aggregate of firm-level gross output:

$$Q_s = \left(\sum_i^{N_s} Q_{si}^{1-\frac{1}{\sigma}} \right)^{\frac{1}{1-\frac{1}{\sigma}}}$$

where $\sigma > 1$ is the elasticity of substitution across firms.

The production technology for firm i is a Cobb-Douglas aggregate of inputs

$$Q_{si} = A_{si}(K_{si}^{\alpha_{si}} L_{si}^{1-\alpha_{si}})^{\gamma_{si}} M_{si}^{\eta_{si}} E_{si}^{1-\gamma_{si}-\eta_{si}} \tag{4}$$

where A_{si} is factor-neutral technology, K_{si} is physical capital rented by the firm, L_{si} is labor input, M_{si} are non-energy intermediate inputs, and E_{si} are energy inputs. Firm-specific exponents will allow firms to differ in their fossil-fuel intensity, even within sectors.

Trade Firms take the global price of energy P^E as given and choose how much energy E to import.[12] Imports are financed by exports of the final good, so the balanced trade condition is

$$P^E E = P \cdot (Q - M - C)$$

where P is the price of the final good (which we normalize to 1).

[11] We also assume the usual no Ponzi condition.

[12] In 2020, the share of imports is 98.9% for crude oil, 79.5% for natural gas, and 96% for coal.

Taxes and Transfers Energy purchases are tax at the *ad valorem* rate τ_C. We relate this to the typical carbon tax below. There is also a revenue tax rate τ_{si} that is specific to firm i in sector s. This is a stand-in for not only firm-specific taxes and subsidies but also price-cost markups and size-dependent regulations. The resulting tax "revenue" is rebated lump sum as

$$T_t = \left(\tau_C P_E E + \sum_s \sum_i \tau_{si} P_{si} Q_{si} \right) / P$$

We divide by the price of the final output good (which is normalized to 1) to make it explicit that the energy and intermediate good prices should be interpreted as relative to the price of the final good.

Market Structure We assume perfect competition in the final goods sector. A representative final goods firm maximizes

$$\Pi = P \prod_{s=1}^{S} \left[\left(\sum_i^{N_s} Q_{si}^{1-\frac{1}{\sigma}} \right)^{\frac{1}{1-\frac{1}{\sigma}}} \right]^{\theta_s} - \sum_s \sum_i P_{si} Q_{si}$$

where P_{si} is the price of intermediate good i in sector s. The final good firm is a price taker in terms of both output and inputs, so it's first order condition for intermediate good i from sector s is

$$\frac{Q_{si}}{Q_s} = \left(\frac{P_{si}}{P_s} \right)^{-\sigma}. \tag{5}$$

Here the ideal price index for sector s is

$$P_s = \left(\sum_i^{N_s} P_{si}^{1-\sigma} \right)^{\frac{1}{1-\sigma}}$$

and the ideal price index for the final good is

$$P = \prod_{s=1}^{S} \left(\frac{P_s}{\theta_s} \right)^{\theta_s}.$$

We assume the intermediate goods sector is monopolistically competitive. Each firm chooses P_{si} to maximize its current profits

$$\Pi_{si} = (1-\tau_{si})P_{si}Q_{si} - wL_{si} - RK_{si} - P^M M_{si} - (1+\tau^C)P^E E_{si}$$

given its production technology (4) and residual demand (5), and taking P_s, Q_s, w, R, P_M and P_E as given.[13]

The profit-maximizing price of each intermediate good is the function

$$P_{si} = \frac{\sigma}{\sigma-1}\frac{(1+\tau^C)^{1-\gamma_{si}-\eta_{si}}}{(1-\tau_{si})}\frac{1}{A_{si}}\widetilde{P}_{si}$$

where $\widetilde{P}_{si}$ is firm-specific input cost index:

$$\widetilde{P}_{si} = \left[\left(\frac{w}{1-\alpha_{si}}\right)^{1-\alpha_{si}}\left(\frac{R}{\alpha_{si}}\right)^{\alpha_{si}}\frac{1}{\gamma_{si}}\right]^{\gamma_{si}}\left[\frac{P^M}{\eta_{si}}\right]^{\eta_{si}}\left[\frac{P^E}{1-\gamma_{si}-\eta_{si}}\right]^{1-\gamma_{si}-\eta_{si}}$$

Notice that the carbon tax τ_C will have a differential effect on prices of different intermediate goods producers to to the extent that $\gamma_{si}+\eta_{si}$ differ across firms. That is, to the extent that fossil-fuel intensity differs across firms, they will be differentially affected by a common carbon tax.

Equilibrium An equilibrium is a set of prices $w, r, \{P_{si}\}$ such that:

- Households maximize discounted utility
- Firms maximize current profits
- Output and input markets clear:
  - $\sum_s \sum_i L_{si} = L$
  - $\sum_s \sum_i K_{si} = K$

[13] Non-energy intermediate inputs M are produced directly from the final good, therefore $P^M = P$. We include P^M for clarity of exposition.

  - $\sum_s \sum_i M_{si} = M$
  - $Q = Y + M$

- Trade is balanced: $Y - C = \sum_s \sum_i P^E E_{si}$

Allocative Efficiency The impact of a carbon tax on allocative efficiency depends on how its differential impact across firms relates to the other distortion those firms face. This can be seen by looking at the market share of firm i within sector s:

$$\frac{P_{si}Q_{si}}{P_sQ_s} \propto \left(\frac{(1-\tau_{si})}{(1+\tau^C)^{(1-\gamma_{si}-\eta_{si})}} \cdot \frac{A_{si}}{\widetilde{P}_{si}} \right)^{\sigma-1}$$

As emphasized by Hsieh and Klenow (2009), economies such as this one are allocatively efficient (ignoring any negative externalities from carbon consumption) if $\tau_{si} = 0$ for all firms. The variation in market shares due to dispersion in production technologies is efficient, but the variation due to idiosyncratic revenue taxes τ_{si} is inefficient. These taxes are sand in the gears of the market allocation. A higher τ_{si} causes a firm to raise its relative price and hence lower its market share.

Carbon taxes can affect allocative efficiency to the extent that their differential effect is correlated with the revenue tax rates. A positive correlation between the firm's fossil fuel intensity and its revenue distortion means a carbon tax would lower allocative efficiency. A negative correlation means a carbon tax may increase allocative efficiency.

Another way to frame the effect of carbon taxes on allocative efficiency is by looking at the variance of market shares within a sector. For exposition purposes, suppose $A_{si}/\widetilde{P}_{si}$ is uncorrelated with τ_{si} and $1 - \gamma_{si} - \eta_{si}$. Then we get

$$\begin{aligned}\frac{1}{(\sigma-1)^2} \text{Var ln}\left(\frac{P_{si}Q_{si}}{P_sQ_s}\right) = \text{Var ln}\left(\frac{A_{si}}{\widetilde{P}_{si}}\right) \; + \\ [\ln(1+\tau^C)]^2 \text{Var}(1-\gamma_{si}-\eta_{si}) \; + \\ \text{Var ln}(1-\tau_{si}) \; + \\ 2\ln(1+\tau^C)\text{Cov}[\ln(1-\tau_{si}), (1-\gamma_{si}-\eta_{si})]\end{aligned}$$

The first time on the right hand side is the efficient source of variation in market shares. The next three terms are all inefficient sources of variation. The second row shows the differential impact of carbon taxes based on firm variation in fossil fuel intensity. The third row represents variation in market shares due to the idiosyncratic revenue taxes. And the final row captures the effect of any correlation between fossil fuel intensity and idiosyncratic taxes. If the correlation is positive (negative) then a carbon tax will amplify (dampen) the inefficient dispersion in market shares.

4. Model Counterfactual: Imposing a Unilateral Carbon Tax

We now calibrate the model so that we can calculate the hypothetical impact of carbon taxes.

Parameter values We set $\sigma = 4$, a standard value in the literature — for example Bils, Klenow and Ruane (2021). For each firm we set its production elasticities based on its cost-shares. Costs shares should reflect production elasticites if input markets are competitive, there are no adjustment costs for inputs, and returns to scale are constant. Total costs are defined as

$$TC_{si} = wL_{si} + RK_{si} + P^M M_{si} + (1+\tau^C)P^E E_{si}$$

Then we get

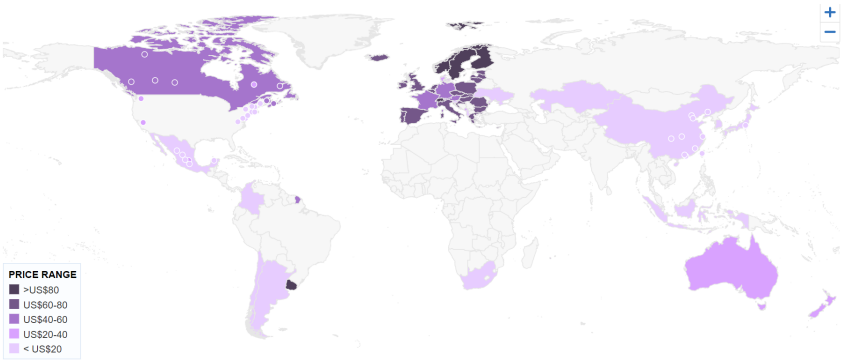
$$\alpha_{si} = \frac{RK_{si}}{RK_{si} + wL_{si}}$$

$$\gamma_{si} = \frac{RK_{si} + wL_{si}}{TC_{si}}$$

$$\eta_{si} = \frac{P^M M_{si}}{TC_{si}}$$

We infer the revenue tax based on dispersion in the gross profit margin, or rev-

Figure 6: Carbon taxes around the world in 2024



Source: World Bank (2024)

enue productivity (TFPR):

$$\tau_{si} = 1 - \frac{\sigma}{\sigma - 1} \frac{P_{si} Q_{si}}{TC_{si}}$$

And we back out A_{si} (or TFPQ) from:

$$A_{si} = \frac{(P_{si} Q_{si})^{\frac{\sigma}{\sigma-1}}}{TC_{si}} \left[(1-\alpha_{si})^{1-\alpha_{si}} (\alpha_{si})^{\alpha_{si}} \gamma_{si} \right]^{\gamma_{si}} [\eta_{si}]^{\eta_{si}} [1-\gamma_{si}-\eta_{si}]^{1-\gamma_{si}-\eta_{si}}$$

Carbon taxes When we compute the cost shares, we use $\tau_C = 0$ because this is approximately the case for Chile. Figure 6 shows levels of carbon taxes around the world in 2024, based on the World Bank (2024) dashboard. Levels of \$20 to \$40 a ton of CO_2 are most common. To translate carbon taxes per ton to an *ad valorem* rate, we leverage calculations in Conte et al. (2023) that of course depend on the price of energy. Table 4 shows that 40% carbon tax translates to roughly \$18.6 dollars per ton, and and 80% tax is tantamount to a \$37 tax per ton.

Counterfactuals We now impose various carbon tax rates $\tau_C > 0$ and assess the impact on $\Delta\ln(E)$, $\Delta\ln(Q)$, and $\Delta\ln(C)$. Given aggregate capital and labor are fixed, C is also proportional to aggregate TFP.

Figure 7 plots the impact of higher carbon taxes on real energy imports E and

Table 4: Carbon taxes per ton and *ad valorem*

Carbon tax *rate*	Per ton equivalent
20%	9.3 \$/TCO2
40%	18.6 \$/TCO2
60%	27.8 \$/TCO2
80%	37.1 \$/TCO2
100%	46.3 \$/TCO2

spending on energy (excluding the tax). As the figure shows, carbon taxes naturally reduce fossil fuel consumption. This occurs both within and across firms. Each firm substitutes away from energy toward other inputs (with an elasticity of substitution equal to one in the baseline Cobb-Douglas case). And firms that are more intensive in fossil fuels see an increase in their relative margin cost and a drop in their resulting use of inputs and sales share. There is also substitution across industries, but this is blunted by the lower (unitary) elasticity of substitution across industries relative to that within industries ($\sigma > 1$).

Figure 8 indicates that both gross output and the wage decline monotonically with the level of a carbon tax. Gross output declines more than the wage. Figure 9 also shows that consumption is hump-shaped with respect to the carbon tax. This is due to the competing effects of carbon taxes on energy use (which is negative for consumption) and allocative efficiency (which is positive for consumption). That is, carbon taxes distort the use of energy but also usefully improve allocative efficiency. The second force is positive (increasing) even for carbon taxes as high as 100%. Consumption peaks at about 1.5% higher with a carbox tax of around 20%. The distortion to energy more than offsets any efficiency gains beyond that level. Consumption is fairly flat over the range of 20% to 50% for the carbon tax.

Figure 10 illustrates the effect of considering higher and lower elasticities of substitution between energy and a composite of physical capital, labor, and non-energy intermediate inputs. Compared to the baseline unitary elasticity of substitution,

Figure 7: Energy and Energy Share of GDP

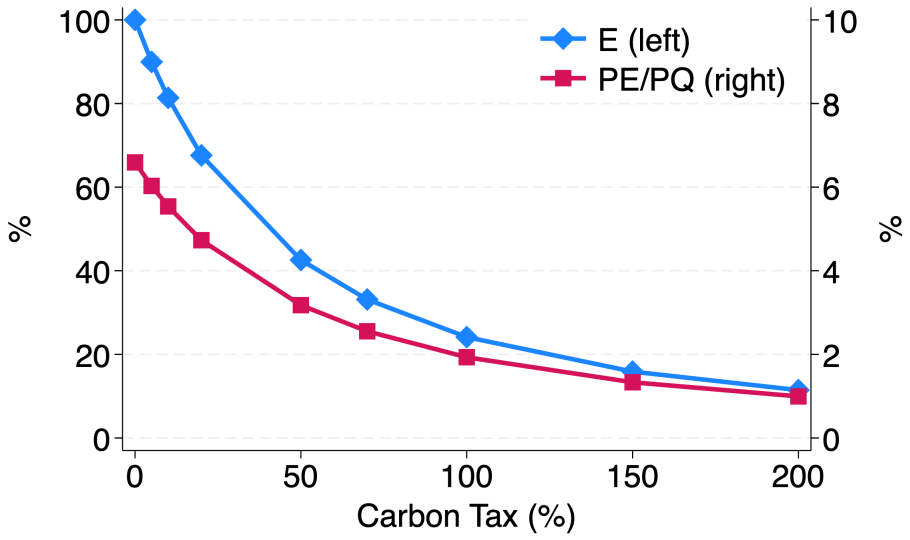


Figure 8: Output and real wage

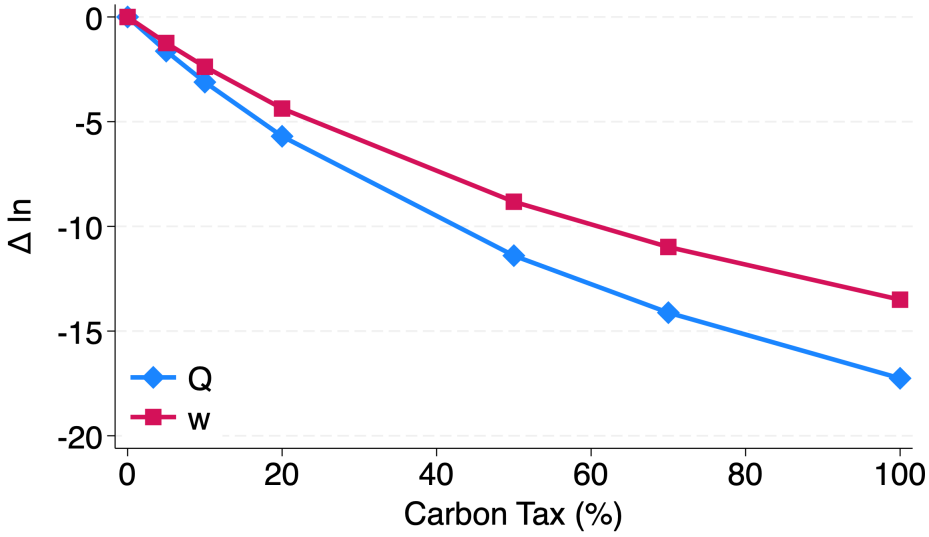
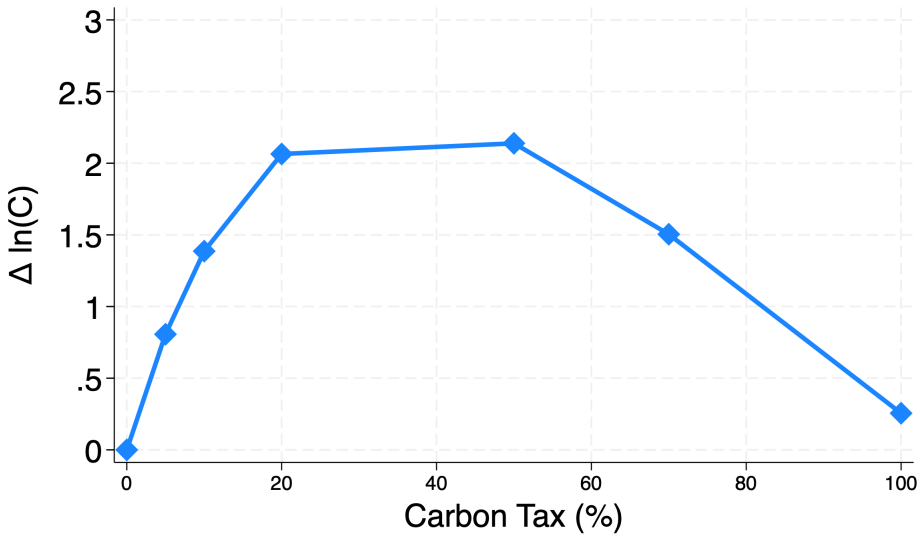


Figure 9: Consumption (proportional to TFP)



energy use predictably declines more slowly (quickly) with the carbon tax for elasticities below (above) one.

Figure 11 presents the response of consumption to the carbon tax under different elasticities of substitution between energy and other inpus. The bigger the elasticity, the smaller the increase in consumption. Energy use is distorted more the higher is this elasticity, which serves as a drag on consumption.

Our analysis begs the question of why Chile does not pursue policies to offset the idiosyncratic revenue distortions. The impact of getting rid of such idiosyncratic revenue distortions is portrayed in Figure 12. Gross output rises, energy use falls, and consumption rises. The rise in TFP owes to better allocative efficiency. The fall in energy use reflects that the average revenue tax is negative, and that firms with higher fossil fuel intensity lower prices less in response. Thus a policy to offset revenue distortions (e.g. due to markup dispersion) may coincidentally help curtail carbon consumption.

Figure 10: Energy and the elasticity between E and (K, L, M)

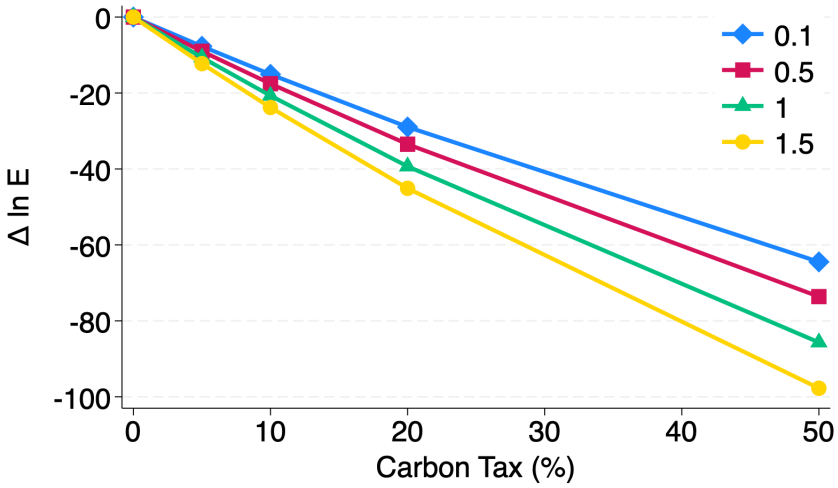


Figure 11: Consumption and the elasticity between E and (K, L, M)

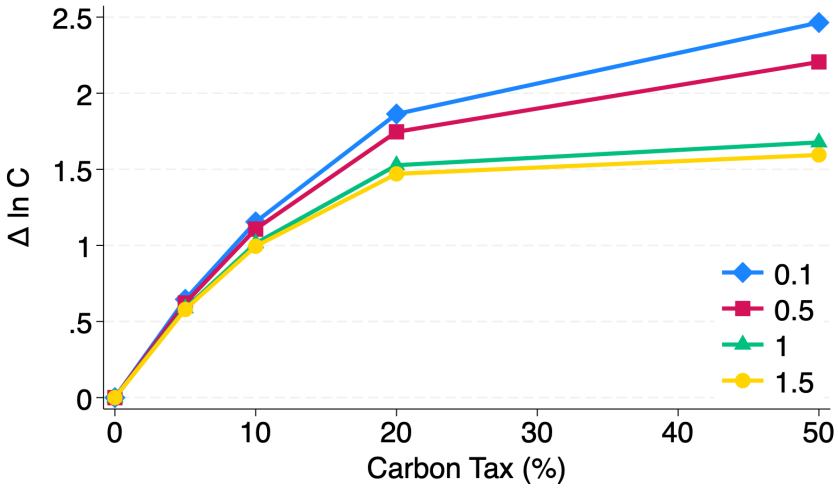
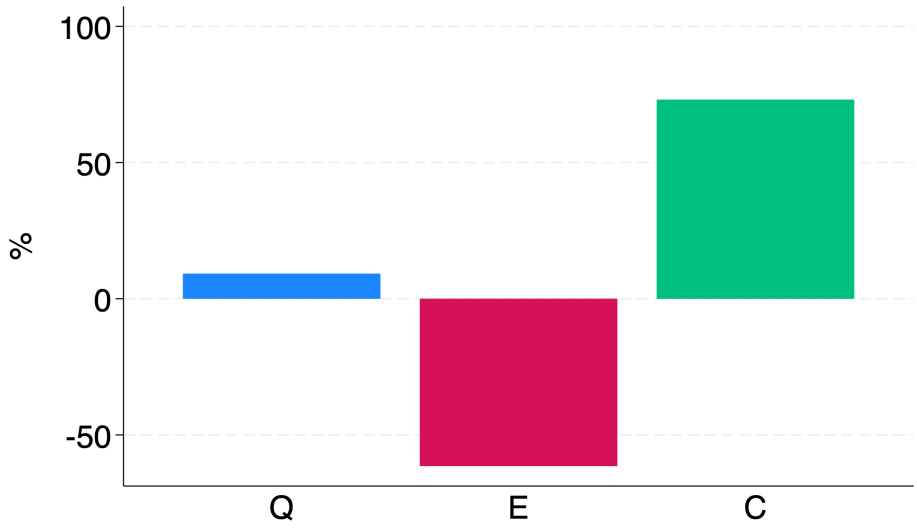


Figure 12: Impact of $\tau_{si} = 1$



5. Conclusion

We documented lower revenue productivity at fossil fuel intensive firms in Chile over 2015–2019. Fossil fuel use was correlated negatively with residual demand, a common proxy for product quality. So perhaps attaining high product quality requires skilled labor and advanced equipment, but not more fossil fuels. Thus the correlation could be due to quality variation that also affects markups. This raises the possibility that the patterns we find in Chile may hold elsewhere, such as found among firms in the U.S. (Kim, 2023).

We then analyzed the impact of a a hypothetical carbon tax in Chile. We found that a carbon tax of 20% to 40% would increase allocative efficiency in Chile. Carbon taxes may helpfully reallocate inputs away from low-quality, low-markup firms that are intensive in fossil fuels, towards high quality high-markup firms with low fossil fuel intensity. Over this same range a carbon tax would appear to increase consumption in Chile by one to two percentage points. Thus a unilateral carbon tax may raise Chilean welfare.

A natural follow-up question is why countries need to pursue a carbon tax to reduce misallocation from (say) markup dispersion. As revenue productivity tends to be higher at larger firms, such a policy might be seen as regressive in terms of its distribution implications. Size-dependent policies typically favor smaller firms, the opposite of what would be needed to help equalize markups. Thus political economy considerations could make a carbon tax more palatable than policies to directly mitigate misallocation. Moreover, firms may manipulate their financial statements to procure subsidies tied to their reported revenue productivity. A tax related to carbon use may be easier to enforce and monitor and less subject to financial reporting manipulation.

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