The Optimal Design of Climate Agreements

Inequality, Trade, and Incentives for carbon policy

WORK IN PROGRESS

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Introduction

- Fighting climate change requires implementing ambitious carbon reduction policies
  - However, one of the sources of international inaction is the "free-riding problem"
  - Implementing taxation of carbon and fossil fuels is costly for individual countries
  - Moreover, such climate policy redistributes across countries through
    (i) energy markets (ii) change in climate, and (iii) reallocation of activity through trade
- One proposal to solve climate inaction is the idea of "climate club" – Nordhaus (2015)
  - Climate coalitions taxing carbon are inherently "unstable"
  - Trade sanctions need to be imposed on non-participants to sustain a "club" and reduce emissions meaningfully

$\Rightarrow$ How can we design an optimal climate agreement that implements the optimal energy taxation in the presence of inequality and policy constraints ?

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- Trade-off between intensive margin and extensive margin :
  - Agreement with a small set of countries, high tax, large emissions reductions for members
  - Extensive agreements with a large number of countries but lower optimal tax to accommodate participation constraints
  - Trade tariffs/sanctions for non-members are crucial for the stability of the agreement

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- Build an Integrated Assessment Model (IAM) with heterogeneous countries & trade to :
  - Evaluate the welfare costs of global warming and solve optimal carbon policy
  - Analyze the strategic implications of joining climate agreements
  - Design the optimal size of the climate club

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- Preview of the results :
  - For unilateral deviation – i.e. Nast-equilibrium climate agreement – the world optimal policy is sustainable : high carbon tax, high tariffs, participation of the entire world
  - Optimal agreements robust to "subcoalition deviation" depend on the trade-off between (i) gains from trade, (ii) climate damage and (iii) distortionary effects of the carbon tax

Literature

- Climate change & optimal carbon taxation
  - RA model : Nordhaus DICE (1996-), Weitzman (2014), Golosov et al (2014)
  - HA model : Krusell Smith (2022), Kotlikoff, Kubler, Polbin, Scheidegger (2021)
  - Spatial models : Cruz, Rossi-Hansberg (2022, 2023) among others

  ⇒ *Optimal and constrained policy with heterogeneous countries & trade*
- Unilateral vs. climate club policies :
  - Climate clubs : Nordhaus (2015), Non-cooperative taxation : Chari, Kehoe (1990), Suboptimal policy : Hassler, Krusell, Olovsson (2019)
  - Trade policy : Kortum, Weisbach (2023), Farrokhi, Lashkaripour (2021), Hsiao (2022), Costinot, Donalson, Vogel, Werning (2015), Adao, Costinot (2022), Antras, Fort, Gutierrez, Tintelnot (2022)

  ⇒ *Climate cooperation and optimal design of climate club*
- Optimal policy in heterogeneous agents models
  - Policy with limited instruments : Diamond (1973), Davila, Walther (2022)
  - Bhandari et al (2021), Le Grand, Ragot (2022), Davila, Schaab (2022) . . .

  ⇒ *Application to climate and carbon taxation policy*

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Literature

- Nordhaus (2015)
  - Examine ”stable climate coalitions” (club imposing carbon tax) in a simple model
  - Abstract from General Equilibrium and distributional effects
  - Results : Penalty tariffs necessary to enforce a climate club
- Farrokhi, Lashkaripour (2021)
  - Study and characterize the optimal trade policy with climate externality
  - General static trade model. Results : unilateral tariffs not effective
  - Sequential search for one stable climate club if EU or US join.
- Main contribution :
  - Search for the *optimal* climate agreement
  - GE on good and energy market and redistribution effects are first-order
  - Cost of climate change is endogenous to policy (damages are non-linear)
  - Possibility of analyzing other distributional policies (transfers, *loss and damage funds*)
  - General framework for analyzing macrodynamics

Model – Household

- Deterministic Neoclassical economy, static (for today)
  - countries $i \in \mathbb{I}$, heterogeneous in productivity z_i, temperature τ_i, energy extraction cost $\mathcal{C}_i$
  - In each country, 3 agents :
    (i) Household, (ii) final good firm, (iii) (fossil) energy producer

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1. Representative household problem in each country i :

$$\mathcal{V}_i = \max_{c_{ij}} u(c_i) \qquad \mathbb{P}_i c_i = w_i + \pi_i^f + \mathrm{t}_i^{ls} \qquad c_i = \left(\sum_j a_{ij}^{\frac{1}{\theta}} c_{ij}^{\frac{\theta-1}{\theta}}\right)^{\frac{\theta}{\theta-1}}$$

$$c_{ij} \quad \text{at price} \quad \overbrace{(1+\mathrm{t}_{ij}^b)}^{\text{tariff}} \overbrace{d_{ij}}^{\text{iceberg cost}} \mathrm{p}_j$$

$$c_i \quad \text{at price} \quad \mathbb{P}_i = \left(\sum_j a_{ij}[(1+\mathrm{t}_{ij}^b)d_{ij}\mathrm{p}_j]^{1-\theta}\right)^{\frac{1}{1-\theta}}$$

- Labor income w_i from final good firm (labor normalized to 1), profit π_i^f from fossil firm

Model – Firms

2. Competitive homogeneous good producer in country i

$$\max_{e_i^f} \; \mathrm{p}_i \, \mathcal{D}(\tau_i) \, z_i f(e_i^f) - w_i - (q^f + \mathrm{t}_i^f) e_i^f$$

- Productivity / TFP residual z_i, $\Rightarrow$ creates inequalities across countries
- Fossil energy demand per unit of labor e_i^f – emitting carbon – subject to price q^f and tax/subsidy t^f.
- Climate externality on temperature τ_i
  - Damage affect productivity : $\mathcal{D}(\tau) \in (0, 1]$

Model – Energy markets & Emissions

- Competitive fossil fuels energy producer :
  - Supply fossil energy e_i^x by extraction at cost $\mathcal{C}_i^f(e_i^x)$

$$\pi_i^f = \max_{e_i^x} q^f e_i^x - \mathcal{C}_i^f(e_i^x) \mathbb{P}_i$$

  - Energy traded in international markets, at price q^f

$$E = \sum_{\mathbb{I}} e_i^f = \sum_{\mathbb{I}} e_i^x$$

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- Climate system
  - Fossil energy e^f releases GHGs in the atmosphere

$$\mathcal{E} = \sum_{\mathbb{I}} e_i^f$$

  - Country i's local temperature :

$$\tau_i = \bar{\tau}_{i0} + \Delta_i \mathcal{E}$$

    - Linear model + Climate sensitivity/pattern scaling factor Δ_i

Model – Equilibrium

- Given policies $\{\mathrm{t}_i^f, \mathrm{t}_{ij}^b, \mathrm{t}_i^{ls}\}_i$, a **competitive equilibrium** is a set of decisions $\{c_{ij}, e_i^f, e_i^x\}_{ij}$, states $\{\tau_i\}_i$ and prices $\{\mathrm{p}_i\}_i, q^f$ such that :
  - Households choose $\{c_{ij}\}_{ij}$ to max. utility s.t. budget constraint
  - Firm choose inputs $\{e_i^f\}_i$ to max. profit
  - Fossil firms extract/produce $\{e_i^x\}_i$ to max. profit.
  - Emissions $\mathcal{E}$ affects climate $\{\tau_i\}_i$.
  - Government budget clear $\sum_i \mathrm{t}_i^{ls} = \sum_i \mathrm{t}_i^f e_i^f + \sum_{i,j} \mathrm{t}_{ij}^b c_{ij} d_{ij} \mathrm{p}_j$
  - Prices $\{\mathrm{p}_i, q^f\}$ adjust to clear the markets for energy $\sum_{\mathbb{I}} e_{it}^x = \sum_{\mathbb{I}} e_{it}^f$ and for each good

$$y_i := z_i \mathcal{D}(\tau_i) f(e_i^f) = \sum_{k\in\mathbb{I}} c_{ki} d_{ki} + \sum_{k\in\mathbb{I}} g_{ki}$$

with g_{ki} net export of good i to pay for energy in k
In expenditure, with import shares $s_{ij} = \frac{c_{ij} d_{ij} \mathrm{p}_j}{c_i \mathbb{P}_i}$, it yields $\quad \mathrm{p}_i y_i = \sum_{k\in\mathbb{I}} s_{ki}\, \mathrm{p}_k y_k$

Model – Extensions & Dynamics

- Quantitative model (today)
  - Use an energy bundle of fossil and renewable energy
  - Renewable energy input price constant (for now)
  - Use capital as well to produce at interest $r = \rho$ (BGP)

- Dynamics, extensions :
  1. Energy market :
     – Fossil energy extraction/exploration reserves $\Rightarrow$ Hotelling problem
  2. Households
     – Consumption / saving in bonds and in capital $\Rightarrow$ Euler equation, Keynes-Ramsey rule
     – International markets to borrow/lend bonds
  3. Climate system with inertia : standard IAMs
  4. Population dynamics
  5. (Exogenous) growth : TFP change and Energy-augmenting Directed TC.

Benchmark : Optimal world policy – Summary of results

- Consider a social planner maximizing world's welfare :
  - Choose a single carbon tax t^f for the world

$$\mathcal{W} = \max_{\{\mathbf{t},\boldsymbol{c},\boldsymbol{e}\}_i} \sum_{i\in\mathbb{I}} \omega_i \, u(c_i) = \sum_{\mathbb{I}} \mathcal{W}_i$$

- Summary :
  - Optimal climate policy depends on the availability of redistribution instruments (i.e. lump-sum transfers t_i^{ls} across countries)
  - Without redistribution motives, optimal Pigouvian carbon tax : $\mathrm{t}^f = SCC$
  - Otherwise, optimal carbon tax should account for
    (i) inequality and local climate damage, (ii) energy supply elasticities, (iii) energy terms-of-trade redistribution effects, (iv) energy demand distortions

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- Details :
  - ***Competitive equilibrium*** Details eq 0
  - ***First-Best***, with unlimited instruments Details eq 1
  - ***Second-best***, Ramsey policy with limited instruments Details eq 2

Ramsey Problem with participation constraints

- Consider that countries can "exit" climate agreement.
- ***Definition*** A climate agreement is a set $\{\mathbb{J}, \mathrm{t}^f, \mathrm{t}^b\}$, with $\mathbb{J} \subseteq \mathbb{I}$ countries and a C.E. $\{\boldsymbol{c}, \boldsymbol{e}, \boldsymbol{q}\}$ such that :
  - Countries $i \in \mathbb{J}$ are subject to a carbon tax t^f on fossil energy
  - Countries can leave :
    If j exits the agreement, club members $i \in \mathbb{J}$ pay uniform tariffs $\mathrm{t}_{ij}^b = \mathrm{t}^b$ on goods from j.
    They still trade with club members in energy at price q^f. They obtain $\hat{c}_j$
  - Exit decision :
    Unilateral vs. subcoalition exit, s.t. only $\hat{\mathbb{J}}$ stay in the agreement : concept of "Core"

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  - Exit decision :
    Unilateral vs. subcoalition exit, s.t. only $\hat{\mathbb{J}}$ stay in the agreement : concept of "Core"
- Participation constraints :

$$u(c_i) \geq u(\hat{c}_i(\hat{\mathbb{J}})) \qquad [\nu_i] \qquad \forall\, \hat{\mathbb{J}} \subseteq \mathbb{J} \backslash \{i\}$$

Stable climate agreements

- Consider a climate agreement $\{\mathbb{J}, \mathrm{t}^f, \mathrm{t}^b\}$
  - It is a Nash equilibrium if it is stable to unilateral deviation, $\hat{\mathbb{J}} = \mathbb{J} \backslash \{i\}$
  - It belongs to "core" $\mathbb{C}(\mathrm{t}^f, \mathrm{t}^b)$ if it robust to deviation of sub-coalitions $\hat{\mathbb{J}} \subseteq \mathbb{J} \backslash \{i\}$
    - i.e. no subcoalition would be better off than in the current aggregement $\mathbb{J}$
    - note : the "core" $\mathbb{C}(\mathrm{t}^f, \mathrm{t}^b)$ can be empty
- Objective : search for the optimal climate agreement such that :

$$\max_{\mathbb{J}, \mathrm{t}^f, \mathrm{t}^b} \mathcal{W}(\mathbb{J}, \mathrm{t}^f, \mathrm{t}^b) \qquad s.t. \qquad \mathbb{J} \in \mathbb{C}(\mathrm{t}^f, \mathrm{t}^b)$$

- Welfare, for coalition $\mathbb{J}$, weighting all countries $i \in \mathbb{I}$

$$\mathcal{W}(\mathbb{J}, \mathrm{t}^f, \mathrm{t}^b) = \sum_{i \in \mathbb{I}} \omega_i \, u(c_i) \qquad s.t. \qquad \{\boldsymbol{c}, \boldsymbol{e}, \boldsymbol{q}\}_i \quad \text{is a C.E. for agreement} \quad \{\mathbb{J}, \mathrm{t}^f, \mathrm{t}^b\}$$

Approach : joint solution of policy and coalition

- Choosing policy $\{\mathrm{t}^f, \mathrm{t}^b\}$ at the same time as the set of countries $\mathbb{J}$
  - From one agreement $\{\mathbb{J}, \mathrm{t}^f, \mathrm{t}^b\}$, one can deduce the set $\widetilde{\mathbb{J}}$ of countries with binding participation constraints

$$\widetilde{\mathbb{J}} \quad s.t. \quad u(c_i) \geq u(\hat{c}_i) \quad \forall i \in \widetilde{\mathbb{J}} \quad \& \quad \forall \hat{\mathbb{J}} \subseteq \mathbb{J} \backslash \{i\}$$

  - Search for the couple $\{\mathrm{t}^f, \mathrm{t}^b\}$ such that $\mathbb{J} = \widetilde{\mathbb{J}}$
    - Difficult (but feasible)
    - Can be extended to dynamic settings :
      choose a path of $\{\mathrm{t}^f_t, \mathrm{t}^b_t\}$ instead of a path of combinations of clubs
  - Heuristics for an algorithm :
    - Start from the world agreement $\{\mathbb{I}, \mathrm{t}^{f\star}, \mathrm{t}^{b\star}\}$
    - For $\{\mathbb{J}, \mathrm{t}^f, \mathrm{t}^b\}$, deduce the country with binding participation constraints $\widetilde{\mathbb{J}} = f(\mathbb{J}, \mathrm{t}^f, \mathrm{t}^b)$
    - Search for a fixed point $\mathbb{J} = f(\mathbb{J}, \mathrm{t}^f, \mathrm{t}^b)$
  - Today : Brute force solution with a small number of countries

Leverage the combinatorial discrete choice literature

- Trade Literature on sourcing decisions :
  - Combinatorial discrete choice , c.f. Antras, Fort, Tintelnot (2017), Jia (2008), Arkolakis, Eckert, Shi (2023), Alfaro-Ureña, Castro-Vincenzi, Fanelli, Morales (2024)

- Search for complementarity, given **one** policy $\{t^f, t^b\}$
  - Key concept : Single crossing difference in choice - from below (SCD-C) :

$$\Delta\mathcal{W}(\mathbb{J}',j) := \mathcal{W}(\mathbb{J}' \cup j) - \mathcal{W}(\mathbb{J}') > \Delta\mathcal{W}(\mathbb{J},j) \qquad \text{when } \mathbb{J}' \supseteq \mathbb{J} \qquad \text{for all } j \in \mathbb{I}$$

  - Adding an extra member j is increasingly profitable with the size of the club $\mathbb{J}$
  - Can use a "squeezing procedure" to bypass the combinatorial problem

- Search optimal combination for **all** policies $\{t^f, t^b\}$?
  - Single crossing difference in type (SCD-T) :

$$\text{Define} \quad \Lambda_i(\mathbb{J}) = \{t^f, t^b \in \mathbb{R}^2_+ \mid \Delta\mathcal{W}(\mathbb{J},i) > 0\}$$

  - Welfare function has SCD-T if $\Lambda_i(\mathbb{J})$ is a connected set

Quantification

- Quadratic damage as in Nordhaus DICE $y = \mathcal{D}_i(\tau)\bar{y}$ with $\mathcal{D}_i(\tau) = e^{-\gamma_i(\tau-\tau_{i0})^2}$
- Energy parameters to match production/reserves,
  Isoelastic cost function $\mathcal{C}_i(e_i^x) = \bar{\nu}_i \left(e_i^x/\mathcal{R}_i\right)^{1+\nu}\mathcal{R}_i$
- Armington model, distance d_{ij} and preferences a_{ij} to match import shares $s_{ij} = \frac{c_{ij}d_{ij}p_j}{c_i\mathbb{P}_i}$
- Production $\bar{y} = zf(\ell_i, k_i, e_i^f, e_i^r)$
  - Nested CES energy vs. labor-capital Cobb-Douglas bundle $k_i^\alpha \ell_i^{1-\alpha}$ (elasticity $\sigma_y < 1$), and fossil/renewable $\sigma_e > 1$, $CES(e_i^f, e_i^r)$
  - TFP, and DTC, z_i, z_i^e, calibrated to match GDP / energy shares data.
- Details More details

Welfare and Pareto weights

- Recall welfare :

$$\mathcal{W}(\mathbb{J}) = \sum_{i \in \mathbb{I}} \omega_i \, u(c_i)$$

- Choose Pareto weights ω_i per country such that :

$$\omega_i = \frac{1}{u'(c_i)}$$

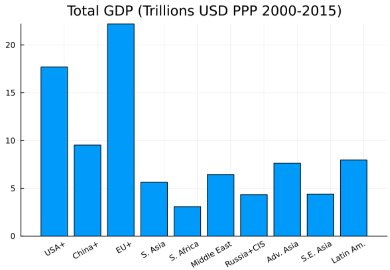
for c_i consumption in initial equilibrium “without climate change“, i.e. year $= 2000$

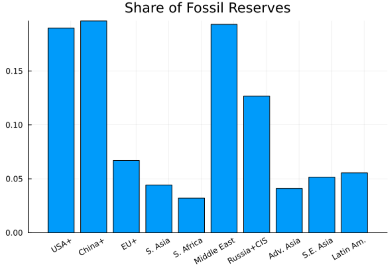
- Imply that there is no redistribution motive (in $t = 2000$)

$$\omega_i u'(c_i) = \omega_j u'(c_j) \qquad \forall i, j \in \mathbb{I}$$

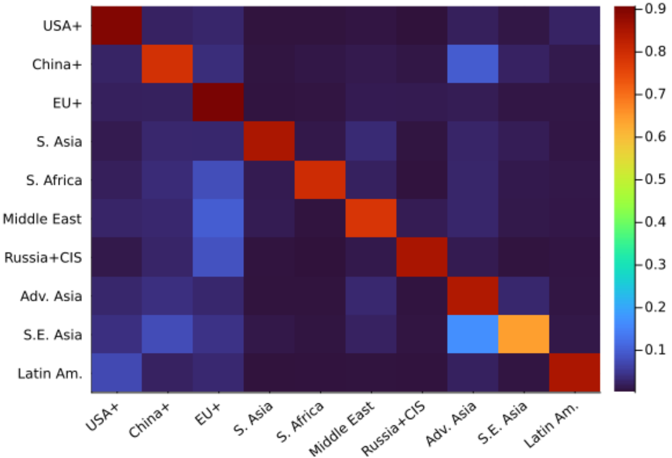
- Climate change, carbon taxation and climate agreement (tax and tariffs) have redistributive effects $\Rightarrow$ will change distribution of c_i.

Numerical Application - Sample of “10 regions”

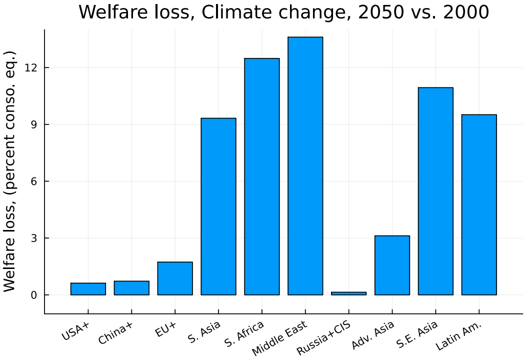




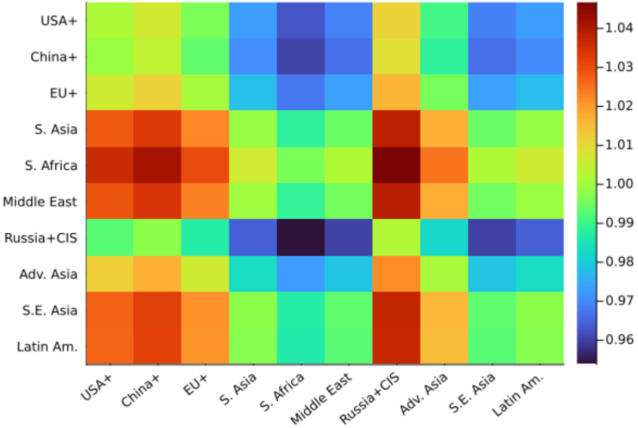
- Data on trade shares $s_{ij} = \frac{c_{ij} d_{ij} \mathrm{p}_j}{c_i \mathbb{P}_i}$, 10 regions, Average 2000-2015



Cost of Climate Change



- Trade reallocation, change in shares s_{ij} due to climate change



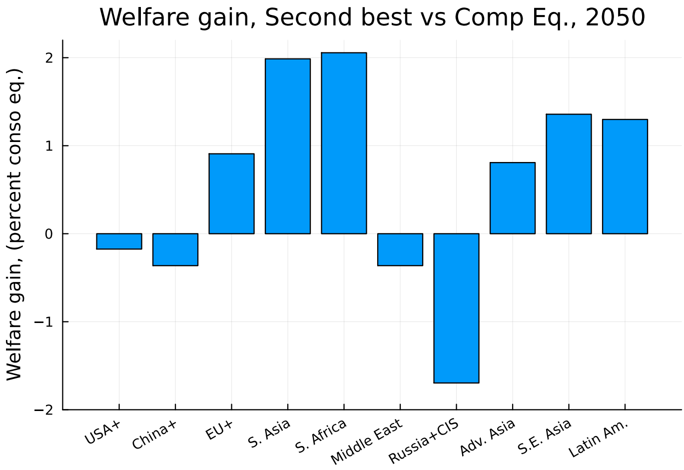
Gains from trade

- Static problem : Calibration subject to changes
- Losses from increasing trade tariffs :
- Losses from autarky

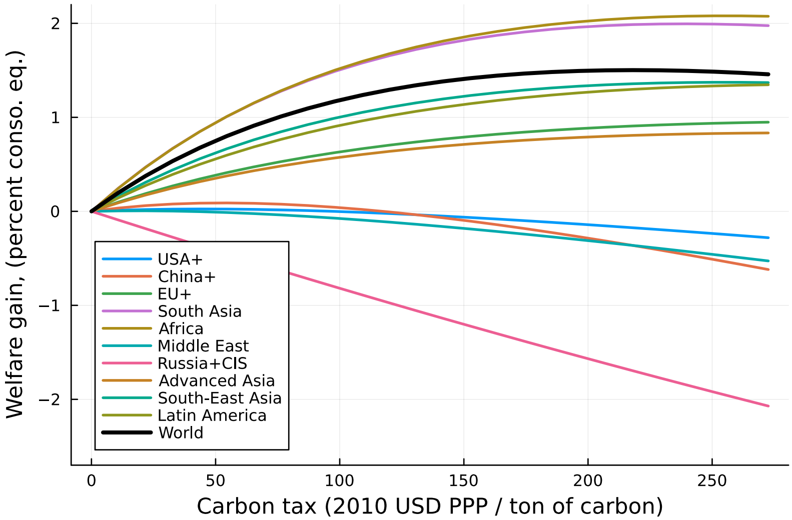
Picture of gains from trade per country here

Gains from cooperation – Second Best

- Static problem : Calibration subject to changes
- Optimal carbon tax, Second Best : $\sim \$215/tC$ $(\sim \$880/tCO_2)$
- Reduce fossil fuels / CO_2 emissions by 24% compared to Business as Usual (BAU)
- Welfare difference between World Second-Best Policy and BAU (Comp. Eq.)

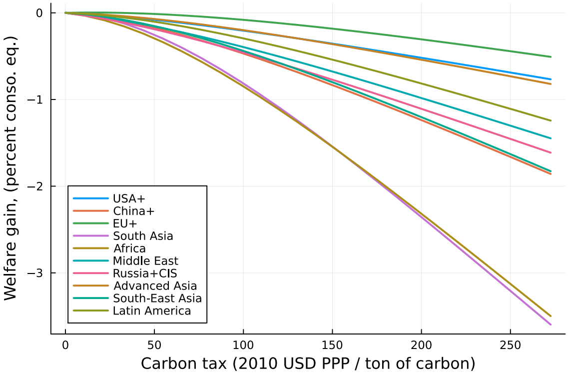


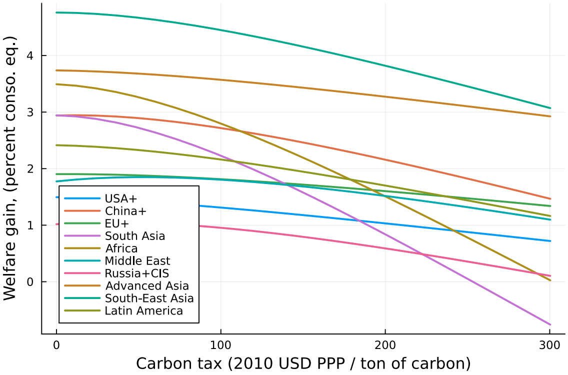
Gains from cooperation – Second Best – Tax variation



Free riding problem ... solved with trade tariffs

- Welfare difference between World Second-Best Policy and Unilateral deviation
  - Recover Nordhaus (2015) result

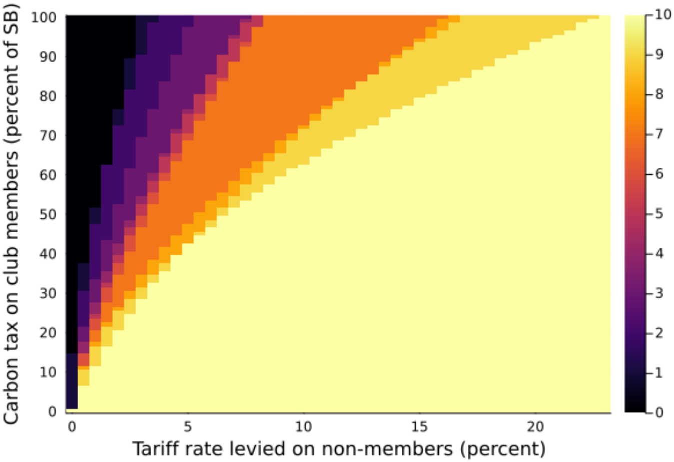




Taxes combination can recover any climate coalition

- Choice of any couples $(t^f, t^b) \in \mathbb{R}^2_+$ allow to enforce any coalitions (any number of countries)
- Trade penalties change the country's outside options, ruling out unilateral deviations

$\Rightarrow$ One can reproduce the second-best : full-cooperation, high-tax and maximum welfare



Nash equilibrium : conclusion – Optimal agreement is the Second-Best

- With flexible t^f, t^b, the "agreement designer" can reproduce the world's optimal policy
  - Carbon taxation corrects externality, accounting for terms-of-trade / redistribution effects
  - Trade tariffs serve as penalties to enforce the stability of the club

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- With flexible t^f, t^b, the ”agreement designer” can reproduce the world’s optimal policy
  - Carbon taxation corrects externality, accounting for terms-of-trade / redistribution effects
  - Trade tariffs serve as penalties to enforce the stability of the club
- Same mechanisms with conditional transfers (loss and damages funds – COP27)
  - Ensure stability (change one side of the participation constraint)
  - How to decide/rationalize who “deserves” the funds ? the poorest ? the most vulnerable ? or the countries with the highest outside options ?
  - Coase type of arguments : harder to bargain on I-instruments (c.f. Weitzman 2014)
- Obvious conclusion ?
  - With enough instruments, easy to reach full coordination
  - In practice, coordination failure to implement binding agreements

Conclusion

- In this project, I solve for the optimal climate policy
  - Accounting for inequality as it depends on the availability of transfer mechanisms
  - Redistributing through GE effects on energy and good markets $\Rightarrow$ terms-of-trade effects
- Climate agreement design jointly solves for :
  - The optimal choice of countries participating
  - The carbon tax level, both for correcting externality & respecting participation constraints
- Can reproduce any coalition with arbitrary trade tariffs or conditional transfers
  - Can achieve the second-best, world climate agreement and largest emission reductions
  - Objective to extend this to dynamic settings where the tradeoffs are less obvious/more realistic.

Appendices

Step 0 : Competitive equilibrium & Trade

- Each household in country i maximize utility and firms maximize profit
- Standard trade model results :
  - Consumption and trade :

$$s_{ij} = \frac{c_{ij}p_{ij}}{c_i\mathbb{P}_i} = a_{ij}\frac{(d_{ij}(1+\mathrm{t}^b_{ij})\mathrm{p}_j)^{1-\theta}}{\sum_k a_{ik}(d_{ik}(1+\mathrm{t}^b_{ik})\mathrm{p}_k)^{1-\theta}} \qquad \& \qquad \mathbb{P}_i = \Big(\sum_j a_{ij}(d_{ij}\mathrm{p}_j)^{1-\theta}\Big)^{\frac{1}{1-\theta}}$$

  - Energy consumption doesn't internalize climate damage :

$$\mathrm{p}_i MPe_i = q^e$$

  - Inequality, as measured in local welfare units :

$$\lambda_i = u'(c_i)$$

  - "Local Social Cost of Carbon", for region i

$$LCC_i = \frac{\partial\mathcal{W}_i/\partial\mathcal{E}}{\partial\mathcal{W}_i/\partial w_i} = \frac{\psi_i^{\mathcal{E}}}{\lambda_i} = -\Delta_i\mathcal{D}'(\tau_i)z_i f(e_i^f)\frac{\mathrm{p}_i}{\mathbb{P}_i} \qquad (> 0 \text{ if heat causes losses})$$

back

Step 1 : World First-best policy

- Maximizing welfare of the world Social Planner :

$$\mathcal{W} = \max_{\{\mathbf{t}, \boldsymbol{e}, \boldsymbol{q}\}_i} \sum_{i \in \mathbb{I}} \omega_i \, u(c_i) = \sum_{\mathbb{I}} \mathcal{W}_i$$

  - Full array of instruments : cross-countries lump-sum transfers t_i^{ls}, individual carbon taxes t_i^f on energy e_i^f, bilateral tariffs t_{ij}^b
  - Budget constraint : $\sum_i \mathrm{t}_i^{ls} = \sum_i \mathrm{t}_i^f e_i^f + \sum_{i,j} \mathrm{t}_{ij}^b c_{ij} d_{ij} \mathrm{p}_j$

- Maximize welfare subject to
  - Market clearing for good $[\mu_i]$, market clearing for energy μ^e

back

Step 1 : World First-best policy

- Social planner results :
  - Consumption :

$$\omega_i u'(c_i) = \Big[\sum_j a_{ij}(d_{ij}\omega_j\mu_j)^{1-\theta}\Big]^{\frac{1}{1-\theta}}$$

  - Energy use :

$$\omega_i \mu_i MPe_i = \mu^e + SCC$$

  - Social cost of carbon :

$$SCC = -\frac{\sum_j \Delta_j \omega_j \mu_j \mathcal{D}_j'(\tau_j)\bar{y}_j}{\frac{1}{I}\sum_j \omega_j \mu_j}$$

back

Step 2 : World optimal Ramsey policy

- Maximizing welfare of the world Social Planner :

$$\mathcal{W} = \max_{\{\mathbf{t},\boldsymbol{e},\boldsymbol{q}\}_i} \sum_{i\in\mathbb{I}} \omega_i \, u(c_i) = \sum_{\mathbb{I}} \mathcal{W}_i$$

  - One single instrument : uniform carbon tax t^f on energy e_i^f
  - Rebate tax lump-sum to HHs $\mathrm{t}_i^{ls} = \mathrm{t}^f e_i^f$

- Ramsey policy : Primal approach, maximize welfare subject to
  - Budget constraint $[\lambda_i]$, Market clearing for good $[\mu_i]$, market clearing for energy
  - Optimality (FOC) conditions for good demands $[\eta_{ij}]$, energy demand & supply, etc.
  - Trade-off faced by the planner :
    - (i) Correcting externality, (ii) Redistributive effect, (iii) Distort energy demand and supply

back

Step 2 : World optimal Ramsey policy

- The planner takes into account
  (i) the marginal value of wealth λ_i
  (ii) the shadow value of good i, from market clearing, μ_i :

$$\text{w/o trade} \qquad \omega_i u'(c_i) = \omega_i \lambda_i$$

$$\text{vs. w/ trade in goods :} \qquad \omega_i u'(c_i) = \left(\sum_{j \in \mathbb{I}} a_{ij} (d_{ij} \mathrm{p}_j)^{1-\theta} \Big[\omega_i \lambda_i + \omega_j \mu_j + \eta_{ij} (1 - s_{ij}) \Big]^{1-\theta} \right)^{\frac{1}{1-\theta}}$$

- Relative welfare weights, representing inequality

$$\text{w/o trade :} \qquad \widehat{\lambda}_i = \frac{\omega_i \lambda_i}{\bar{\lambda}} = \frac{\omega_i u'(c_i)}{\frac{1}{I} \sum_{\mathbb{I}} \omega_j u'(c_j)} \lessgtr 1 \qquad \Rightarrow$$

ceteris paribus, poorer countries have higher $\widehat{\lambda}_i$

$$\text{vs. w/ trade :} \qquad \widehat{\lambda}_i = \frac{\omega_i (\lambda_i + \mu_i)}{\frac{1}{I} \sum_{\mathbb{I}} \omega_i (\lambda_i + \mu_i)} \lessgtr 1$$

Step 2 : Optimal policy – Social Cost of Carbon

- Key objects : Local vs. Global Social Cost of Carbon :
  - Marginal cost of carbon $\psi_i^{\mathcal{E}}$ for country i
  - "Local social cost of carbon" (LCC) for region i :

$$LCC_i := \frac{\partial \mathcal{W}_i / \partial \mathcal{E}}{\partial \mathcal{W}_i / \partial w_i} = \frac{\psi_i^{\mathcal{E}}}{\lambda_i} = -\Delta_i \mathcal{D}'(\tau_i) z_i f(e_i^f) \mathrm{p}_i \qquad (> 0 \text{ if heat causes losses})$$

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  - Social Cost of Carbon for the planner :

$$SCC := \frac{\partial \mathcal{W} / \partial \mathcal{E}}{\partial \mathcal{W} / \partial w} = \frac{\sum_{\mathbb{I}} \omega_i \psi_i^{\mathcal{E}}}{\frac{1}{I} \sum_{\mathbb{I}} \omega_i (\lambda_i + \mu_i)}$$

  - Social Cost of Carbon integrates these inequalities :

$$SCC = \sum_{\mathbb{I}} \widehat{\lambda}_i \, LCC_i = \sum_{\mathbb{I}} LCC_i + \mathbb{C}\mathrm{ov}_i \left(\widehat{\lambda}_i, LCC_i \right)$$

Step 2 : Optimal policy – Other motives

- Taxing fossil energy has additional redistributive effects :
  1. Through energy markets : distort supply, lowers eq. fossil price, benefit net importers
  2. Distort energy demand, of countries that need more or less energy
- New measure : Social Value of Fossil (SVF)

$$SVF := \frac{\partial \mathcal{W}/\partial E}{\partial \mathcal{W}/\partial w} = \mathcal{C}^f_{EE}\, \mathbb{C}\mathrm{ov}_i\left(\widehat{\lambda}_i, e^f_i - e^x_i\right) \; - \; \mathbb{C}\mathrm{ov}_i\left(\widehat{\lambda}_i, \frac{q^f(1-s^f_i)}{\sigma}\right)$$

∘ Params : $\mathcal{C}^f_{EE}$ agg. fossil supply elasticity, s^f_i energy cost share and σ energy demand elasticity

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◦ Params : $\mathcal{C}^f_{EE}$ agg. fossil supply elasticity, s^f_i energy cost share and σ energy demand elasticity

- *Proposition 2 :* Optimal fossil energy tax :

$$\Rightarrow \qquad t^f = SCC + SVF$$

  – Social cost of carbon : $SCC = \sum_{\mathbb{I}} \widehat{\lambda}_i LCC_i$

back

Step 3 : Ramsey Problem with participation constraints

- Consider that countries can “exit” climate agreement.
- For a climate “club” of $\mathbb{J} \subset \mathbb{I}$ countries :
  - Countries $i \in \mathbb{J}$ are subject to a carbon tax t^f
  - Countries $i \in \mathbb{J}$ can unilaterally leave, subject to retaliation tariff $\mathrm{t}^{b,r}$ on goods and get consumption $\tilde{c}_i$
  - Countries $i \notin \mathbb{J}$ trade in goods subject to tariff t^b with club members and countries outside the club. They still trade with the club members in energy at price q^f

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  - Countries $i \notin \mathbb{J}$ trade in goods subject to tariff t^b with club members and countries outside the club. They still trade with the club members in energy at price q^f
- Participation constraints :

$$u(c_i) \geq u(\tilde{c}_i) \qquad [\nu_i]$$

- Welfare :

$$\mathcal{W} = \max_{\{\mathbf{t},\boldsymbol{e},\boldsymbol{q}\}_i} \sum_{\mathbb{J}} \omega_i \, u(c_i) + \sum_{\mathbb{J}^c} \alpha \omega_i \, u(c_i)$$

Step 3 : Ramsey Problem with participation constraints

- Participation constraints

$$u(c_i) \geq u(\tilde{c}_i) \quad [\nu_i]$$

- *Proposition 3.1 :* Second-Best social valuation with participation constraints
  - Participation incentives change our measure of inequality

$$\text{w/ trade :} \qquad \omega_i(1+\nu_i)u'(c_i) = \left(\sum_{j \in \mathbb{I}} a_{ij}(d_{ij}\mathrm{p}_j)^{1-\theta} \left[\omega_i \widetilde{\lambda}_i + \omega_j \widetilde{\mu}_j + \widetilde{\eta}_{ij}(1-s_{ij}) \right]^{1-\theta} \right)^{\frac{1}{1-\theta}}$$

$$\Rightarrow \qquad \widehat{\widehat{\lambda}}_i = \frac{\omega_i(\widetilde{\lambda}_i + \widetilde{\mu}_i)}{\frac{1}{J}\sum_{\mathbb{J}} \omega_i(\widetilde{\lambda}_i + \widetilde{\mu}_i)} \neq \widehat{\lambda}_i$$

$$\text{vs. w/o trade} \qquad \widehat{\widehat{\lambda}}_i = \frac{\omega_i(1+\nu_i)u'(c_i)}{\frac{1}{J}\sum_{\mathbb{J}} \omega_j(1+\nu_j)u'(c_j)} \neq \widehat{\lambda}_i$$

  - Similarly, the "effective Pareto weights" are $\alpha\omega_i$ for countries outside the club $i \notin \mathbb{J}$ and $\omega_i(\alpha - \nu_i)$ for retaliation policy on $i \in \mathbb{J}$

Step 3 : Participation constraints & Optimal policy

- *Proposition 3.2 :* Second-Best taxes :
  - Taxation with imperfect instruments :
    - Climate change & general equilibrium effects on fossil market affects all countries $i \in \mathbb{I}$
    - Need to adjust for the "outside" countries $i \notin \mathbb{J}$ not subject to the tax, which weight on the energy market as $\vartheta_{\mathbb{J}^c} \approx \frac{E_{\mathbb{J}^c}}{E_{\mathbb{I}}} \frac{\nu\sigma}{q^f(1-s^f)}$
      with ν fossil supply elasticity, σ energy demand elasticity and s^f energy cost share.
  - Optimal fossil energy tax $\mathrm{t}^f(\mathbb{J})$:

$$\Rightarrow \qquad \mathrm{t}^f(\mathbb{J}) = SCC + SVF$$

$$= \frac{1}{1-\vartheta_{\mathbb{J}^c}} \sum_{i\in\mathbb{I}} \widetilde{\lambda}_i LCC_i + \frac{1}{1-\vartheta_{\mathbb{J}^c}} \mathcal{C}^f_{EE} \sum_{i\in\mathbb{I}} \widetilde{\lambda}_i (e^f_i - e^x_i) - \sum_{i\in\mathbb{J}} \widetilde{\lambda}_i \frac{q^f(1-s^f_i)}{\sigma}$$

  - Optimal tariffs/export taxes $\mathrm{t}^{b,r}(\mathbb{J})$ and $\mathrm{t}^b(\mathbb{J})$: In search for a closed-form expression
    As of now, only opaque system of equations (fixed point w/ demand/multipliers)

back

Countries' incentives – Model w/o trade in goods

- Experiment : Model with trade in energy but not in "goods"
  - Start from the equilibrium where carbon tax $\mathfrak{t}^f(\mathbb{J}) = 0$,
    $\Rightarrow$ country i is indifferent to join the club $\mathbb{J}$ or not
  - Linear approximation around that point $\Rightarrow$ small changes in carbon tax $d\mathfrak{t}^f$

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$$\frac{d\mathcal{W}_{i|i\in\mathbb{J}}}{u'(c_i^{i\in\mathbb{J}})} - \frac{d\mathcal{W}_{i|i\notin\mathbb{J}}}{u'(c_i^{i\notin\mathbb{J}})} = -e_i d\mathfrak{t}^f - \gamma_i(\tau_i - \tau_{i0})^\delta y_i \Delta_i (dE_{i\in\mathbb{J}} - dE_{i\notin\mathbb{J}})$$
$$- e_i \frac{q^f \nu}{E_{\mathbb{I}}}(dE_{i\in\mathbb{J}} - dE_{i\notin\mathbb{J}}) + \pi_i \frac{(1+\nu)}{E}(dE_{i\in\mathbb{J}} - dE_{i\notin\mathbb{J}})$$

  - Difference in the GE effect on energy markets, for $\sigma \approx 1$

$$dE_{i\in\mathbb{J}} - dE_{i\notin\mathbb{J}} = -\left(E_{\mathbb{J}} - E_{\mathbb{J}\setminus\{i\}}\right) \frac{\sigma\, d\mathfrak{t}^f}{q^f(1-s^f)} \frac{1}{1 + \frac{\nu\sigma}{(1-s^f)}}$$

○ Params : σ energy demand elast^y, s^f energy cost share, ν energy supply elas^y, Climate damage γ_i and curv. δ

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Countries' incentives – Armington Model with trade in goods

- Trade in energy and goods *à la* Armington, Linear approx. around $\mathrm{t}^f \approx 0$ and $\mathrm{t}^b \approx 0$
  - Change in welfare if $i \in \mathbb{J}$, vs. $i \notin \mathbb{J}$

$$\frac{d\mathcal{W}_{i|i\in\mathbb{J}}}{u'(c_i^{i\in\mathbb{J}})c_i} - \frac{d\mathcal{W}_{i|i\notin\mathbb{J}}}{u'(c_i^{i\notin\mathbb{J}})c_i} = -e_i d\mathrm{t}^f - \gamma_i(\tau_i - \tau_{i0})^\delta \eta_i^y \Delta_i (dE_{i\in\mathbb{J}} - dE_{i\notin\mathbb{J}})$$
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$$+ \eta_i^y \Big(\frac{d\mathrm{p}_i}{\mathrm{p}_i}\Big|_{i\in\mathbb{J}} - \frac{d\mathrm{p}_i}{\mathrm{p}_i}\Big|_{i\notin\mathbb{J}} \Big) - s_{i\mathbb{J}^c} d\mathrm{t}^b - \sum_{j\in\mathbb{I}} s_{ij} \Big(\frac{d\mathrm{p}_j}{\mathrm{p}_j}\Big|_{i\in\mathbb{J}} - \frac{d\mathrm{p}_j}{\mathrm{p}_j}\Big|_{i\notin\mathbb{J}} \Big)$$

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  - GE effect on energy markets, same as before
  - GE effect on goods markets, equilibrium on expenditure $v_i = \mathbb{P}_i c_i$, for $\theta \approx 1$

$$\frac{dv_i}{v_i} = \sum_{k\in\mathbb{I}} \mathcal{P}_k \alpha_{ki} \left(\frac{dv_k}{v_k} - \theta \frac{d\mathrm{t}_{ki}^b}{1+\mathrm{t}_{ki}^b} \right) \qquad \alpha_{ki} = \frac{c_{ki} d_{ki} \mathrm{p}_i}{\sum_\ell c_{k\ell} d_{k\ell} \mathrm{p}_\ell} \frac{v_k}{v_i} = s_{ki} \frac{v_k}{(1+\mathrm{t}_{ki}^b) v_i}$$

    – Params : σ energy demand elasticity, s^f energy cost share, ν energy supply elasticity, share of output y in income $\eta_i^y = \frac{y_i \mathrm{p}_i}{v_i}$, fossil rent share $\eta_i^f = \frac{\pi_i}{v_i}$

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Complementarity in coalition formation – Model w/o trade in goods

- Is marginal gain $\Delta\mathcal{W}(\mathbb{J},j) := \mathcal{W}(\mathbb{J}\cup j) - \mathcal{W}(\mathbb{J})$ "growing" in $\mathbb{J}$?
  - Linear approximation for small $\{t^f, t^b\}$

$$\Delta\mathcal{W}(\mathbb{J},j) = -\omega_j u'(c_j) e_j dt^f + \Big[\sum_{i\in\mathbb{I}} \omega_i u'(c_i)\Delta_i \gamma_i (\tau_i - \tau_{i0})^{\delta} y_i\Big] \frac{\sigma\, e_j dt^f}{q^f(1-s^f+\nu\sigma)}$$
$$+ \Big[\sum_{i\in\mathbb{I}} \omega_i u'(c_i) e_i\Big] \frac{1}{1+\frac{1-s^f}{\nu\sigma}} \frac{e_j dt^f}{E_{\mathbb{I}}} - \Big[\sum_{i\in\mathbb{I}} \omega_i u'(c_i)\pi_i\Big] \frac{(1+\nu)}{E_{\mathbb{I}}} \frac{\sigma\, e_j dt^f}{q^f(1-s^f+\nu\sigma)}$$

  - Free-riding problem : $\Delta\mathcal{W}(\mathbb{J},j)$ could be negative
  - If $\Delta\mathcal{W}(\mathbb{J},j) > 0$, what effects does $\mathbb{J}$ have on marginal gain ?
    - Marginal climate benefit decreases in $\mathbb{J}$, since temperature τ_i declines !
    - G.E. effect on energy price : $E_{\mathbb{I}}$, q and π^f decreases with $\mathbb{J}$, effect on demand ambiguous
    - Similar formula for the case with trade tariffs : Work in progress.

Quantification – Firms

- Production function $y_i = \mathcal{D}_i^y(\tau_i) z_i f(k, \varepsilon(e^f, e^r))$

$$f_i(k,\ell,\varepsilon(e^f,e^r)) = \left[(1-\epsilon_i)^{\frac{1}{\sigma_y}} \left(k^\alpha \ell^{1-\alpha}\right)^{\frac{\sigma_y-1}{\sigma_y}} + \epsilon_i^{\frac{1}{\sigma_y}} \left(z_i^e\ \varepsilon_i(e^f,e^r)\right)^{\frac{\sigma_y-1}{\sigma_y}}\right]^{\frac{\sigma_y}{\sigma_y-1}}$$
$$\varepsilon(e^f,e^r) = \left[\omega_i^{\frac{1}{\sigma_e}} \left(e^f\right)^{\frac{\sigma_e-1}{\sigma_e}} + (1-\omega_i)^{\frac{1}{\sigma_e}} \left(e^r\right)^{\frac{\sigma_e-1}{\sigma_e}}\right]^{\frac{\sigma_e}{\sigma_e-1}}$$

  - Calibrate TFP z_i to match $y_i = GDP_i$ per capita in 2011 (PPP).
  - Today : $\omega_i = \bar{\omega} = 85\%$ and $\epsilon_i = \bar{\epsilon} = 12\%$ for all i
  - Future : $(z_i^e, \omega_i, \epsilon_i)$ to match Energy/GDP $(e_i^f + e_i^r)/y_i$ and energy mix (e_i^f, e_i^r)

- Damage functions in production function y :

$$\mathcal{D}_i^y(\tau) = e^{-\gamma_i^{\pm,y}(\tau-\tau_i^\star)^2}$$

  - Asymmetry in damage to match empirics with $\gamma^y = \gamma^{+,y}\mathbb{1}_{\{\tau>\tau_i^\star\}} + \gamma^{-,y}\mathbb{1}_{\{\tau<\tau_i^\star\}}$
  - Today $\gamma_i^{\pm,y} = \bar{\gamma}^{\pm,y}$ & $\tau_i^\star = \bar{\alpha}\tau_{it_0} + (1-\bar{\alpha})\tau^\star$

Quantification – Energy markets

- Fossil production e^x_{it} and reserve $\mathcal{R}_{it}$
  - Cost $\mathcal{C}_i(e^x, \mathcal{R}) = \frac{\bar{\nu}_i}{1+\nu_i}\left(\frac{e^x}{\mathcal{R}}\right)^{1+\nu_i}\mathcal{R}$
  - Now : $\bar{\nu}_i$ to match extraction data e^x_i, $\mathcal{R}_{it}$ calibrated to *proven reserves* data from BP. $\nu_i = \nu = 1$ quadratic extraction cost.
  - Future : Choose $(\bar{\nu}_i, \nu_i, \mathcal{R}_i)$ to match marginal cost $\mathcal{C}_e$ & extraction data e^x_i (BP, IEA)

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- Fossil production e^x_{it} and reserve $\mathcal{R}_{it}$
  - Cost $\mathcal{C}_i(e^x, \mathcal{R}) = \frac{\bar{\nu}_i}{1+\nu_i}\left(\frac{e^x}{\mathcal{R}}\right)^{1+\nu_i}\mathcal{R}$
  - Now : $\bar{\nu}_i$ to match extraction data e^x_i, $\mathcal{R}_{it}$ calibrated to *proven reserves* data from BP. $\nu_i = \nu = 1$ quadratic extraction cost.
  - Future : Choose $(\bar{\nu}_i, \nu_i, \mathcal{R}_i)$ to match marginal cost $\mathcal{C}_e$ & extraction data e^x_i (BP, IEA)

- Renewable : Production $\bar{e}^r_{it}$ and price q^r_{it}
  - Now : $q^r_{it} = z^r e^{-g_r t}$, with g_r growth rate in renewable energy price decreases.
  - Future : Choose z^r_i to match the energy mix (e^f_i, e^r_i)

back

Quantification – Future Extensions :

- Damage parameters :
  - $\gamma_i^{\pm,y}$ depends on daily temperature distribution $\tau \sim \mathcal{T}_i(\bar{T}, \sigma^T)$ following Rudik et al. (2022)
  - Use Climate Lab's (Greenstone et al) estimates for damage γ_i ?
- Fossil Energy markets :
  - Divide fossils e_{it}^f / e_{it}^x into oil/gas/coal
  - Match the production/cost/reserves data across countries
  - Use a dynamic model : extraction/exploration a la Hotelling
- Renewables Energy markets :
  - Make the problem dynamic with investment in capacity C_{it}^r
- Population dynamics
  - Match UN forecast for growth rate / fertility

Calibration

TABLE – Baseline calibration ($\star$ = subject to future changes)

Technology & Energy markets			
α	0.35	Capital share in $f(\cdot)$	Capital/Output ratio
ϵ	0.12	Energy share in $f(\cdot)$	Energy cost share (8.5%)
σ	0.3	Elasticity capital-labor vs. energy	Complementarity in production (c.f. Bourany 2020)
ω	0.8	Fossil energy share in $e(\cdot)$	Fossil/Energy ratio
σ_e	2.0	Elasticity fossil-renewable	Slight substitutability & Study by Stern
δ	0.06	Depreciation rate	Investment/Output ratio
$\bar{g}$	$0.01^\star$	Long run TFP growth	Conservative estimate for growth
g_e	$0.01^\star$	Long run energy directed technical change	Conservative / Acemoglu et al (2012)
g_r	$-0.01^\star$	Long run renewable price decrease	Conservative / Match price fall in R.E.
ν	$2^\star$	Extraction elasticity of fossil energy	Cubic extraction cost
Preferences & Time horizon			
ρ	0.03	HH Discount factor	Long term interest rate & usual calib. in IAMs
η	2.5	Risk aversion	
n	$0.01^\star$	Long run population growth	Conservative estimate for growth
ω_i	1	Pareto weights	Uniforms / Utilitarian Social Planner
T	90	Time horizon	Horizon 2100 years since 2010

Calibration

TABLE – Baseline calibration ($\star$ = subject to future changes)

Climate parameters			
ξ	0.81	Emission factor	Conversion 1 $MTOE \;\Rightarrow\; 1\; MT\; CO_2$
ζ	0.3	Inverse climate persistence / inertia	Sluggishness of temperature $\sim 11-15$ years
χ	$2.1/1e6$	Climate sensitivity	Pulse experiment : 100 $GtC \equiv 0.21^{\circ}C$ medium-term warming
δ_s	0.0014	Carbon exit from atmosphere	Pulse experiment : 100 $GtC \equiv 0.16^{\circ}C$ long-term warming
$\gamma^{\oplus}$	$0.00234^{\star}$	Damage sensitivity	Nordhaus' DICE
$\gamma^{\ominus}$	$0.2\times\gamma^{\oplus\,\star}$	Damage sensitivity	Nordhaus' DICE & Rudik et al (2022)
$\alpha^{\mathcal{T}}$	$0.2^{\star}$	Weight historical climate for optimal temp.	Marginal damage decorrelated with initial temp.
$\tau^{\star}$	15.5	Optimal yearly temperature	Average spring temperature / Developed economies
Parameters calibrated to match data			
p_i		Population	Data – World Bank 2011
z_i		TFP	To match GDP Data – World Bank 2011
τ_i		Local Temperature	To match temperature of largest city
$\mathcal{R}_i$		Local Fossil reserves	To match data from BP Energy review

Sequential solution method

- Summary of the model :
  - ODEs for states $\{\boldsymbol{x}\} = \{w_{it}, \tau_{it}, \mathcal{R}_{it}, \mathcal{S}_t\}_{it}$
  - Backward ODE for the costates $\{\boldsymbol{\lambda}\} = \{\lambda^w_{it}, \lambda^\tau_{it}, \lambda^{\mathcal{S}}_t, \lambda^{\mathcal{R}}_{it}\}_{it}$
  - Non-linear equations (FOCs) for household controls $\{\boldsymbol{c_1}\} = \{c_{it}, b_{it}, k_{it}\}_{it}$ and static demands for energy/capital $\{\boldsymbol{c_2}\} = \{e^f_{it}, e^r_{it}, k_{it}\}_{it}$ and static supplies $\{\boldsymbol{c_3}\} = \{e^x_{it}, \bar{e}^r_{it}\}_{it}$.
  - Market clearing as equation for prices $\{\boldsymbol{q}\} = \{q^f_t, r^\star_t\}_t$
  - Existence and Uniqueness, c.f. Mean Field Game theory (Carmona-Delarue)

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- Global Numerical solution :
  - Discretize agents (countries) space $i \in \mathbb{I}$ with M and time-space $t \in [t_0, t_T]$ with T periods
  - Express as a large vector $\boldsymbol{y} = \{\boldsymbol{x}, \boldsymbol{\lambda}, \boldsymbol{c}, \boldsymbol{q}\}$ in a large non-linear function

$$F(\boldsymbol{y}) = \boldsymbol{0}$$

  - Solve for the large system with $N = (N_{ind,vars} \times M + N_{agg,vars}) \times T$ unknowns and N equations with gradient-descent – Newton-Raphson methods.

Sequential method : Pros and Cons

- Why use a sequential approach ?
  - *Global approach* : *Only* need to follow the trajectories for i agents :
  - Arbitrary (!) number of dimension of *ex-ante* heterogeneity :
    Productivity z_i Population p_i, Temperature scaling Δ_i, Fossil energy cost $\bar{\nu}_i$, Energy mix $\epsilon_i, \omega_i, z_i^r$,
    Local damage $\gamma_i^y, \gamma_i^u, \tau_i^\star$, Directed Technical Change z_i^e
  - Potentially large dimensions of *ex-post* heterogeneity and aggregate state variables :
    For now : Wealth w_{it}, temperature τ_{it}, reserves $\mathcal{R}_{it}$, Carbon $\mathcal{S}_t$
    Extension with a large climate system as a proof of concept (e.g. Cai, Lontzek, Judd, 2013)
  - Newton method & Non-linear solvers very efficient
- Why not :
  - Numerical constraint to solve a large system of ODEs and non-linear equations :

  $\Rightarrow$ Constraint on $N = (N_{ind,vars} \times M + N_{agg,vars}) \times T$, so either M or T can't be too large
  - Relying on numerical solvers/structure of the problem can be opaque

back