

# Replication of Structural Estimations in Shapiro and Walker (2018, AER) \*

Wenjie Luo

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## Abstract

This note covers the model used in Shapiro and Walker (2018): Why is pollution from US manufacturing declining? The roles of environmental regulation, productivity, and trade. *American Economic Review*, 108(12), 3814-3854. I summarize the equilibrium equations that are crucial for quantification and analyze the counterfactual. Several replications and extensions are conducted to illustrate how the model explains changes in pollution emissions. I show detailed derivations and include MATLAB code to in the appendix.

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\*Wenjie Luo: Urban Governance and Design Thrust, The Hong Kong University of Science and Technology (Guangzhou) (email: [wluo928@connect.hkust-gz.edu.cn](mailto:wluo928@connect.hkust-gz.edu.cn) [wluo928@connect.hkust-gz.edu.cn](mailto:wluo928@connect.hkust-gz.edu.cn)). Code can be found at my GitHub [https://github.com/luowenjie1/Replication\\_SW2018](https://github.com/luowenjie1/Replication_SW2018).

## 1 — Introduction to Shapiro and Walker (2018)

Asking what factors have driven pollution emissions reduction in US, Shapiro and Walker (2018) develop a model to account for international trade, product composition, and environmental regulation. The model extends Melitz (2003) monopolistic competition by incorporating bilateral international trade and solves the counterfactual utilizing hat algebra. Shocks of international trade is characterized by iceberg trade costs and fixed costs of entering foreign market; Shocks of production composition are characterized by expenditure share of each sector; Shocks of environmental regulation are characterized by implicit pollution taxes.

The next Section provides a scratch of the model. Section 3 presents the data and algorithm used for quantification and analyzing counterfactual. Section 4 shows the replication results and some extensions. I also refer the readers to Li and Zhu (2025) who also utilizes the model under Chinese context. Appendix includes detailed derivations and MATLAB code.

## 2 — Scratch of the Model

In the following, I list the basic elements consisting of the model, and detailed derivations can be found in the Appendix.

### 2.1. Preference

A representative consumer in country  $d$  has a utility function of two layers. In the first layer, the consumer source products within a sector according to constant elasticity of substitution (CES) preference; In the second layer, the consumer allocate share of  $\beta_{d,s}$  of her total expenditure across sectors according to the Cobb-Douglas preference.

$$U_d = \prod_s \left[ \left( \sum_o \int_{\omega \in \Omega} q_{od,s}(\omega)^{\frac{\sigma_s-1}{\sigma_s}} \right)^{\frac{\sigma_s}{\sigma_s-1}} \right]^{\beta_{d,s}}$$

We omit  $\omega$  hereafter. The common conclusions of CES preference apply to the within sector

product consumption:

$$q_{od,s} = \frac{p_{od,s}^{-\sigma_s}}{P_{d,s}^{1-\sigma_s}} E_{d,s}$$

where  $P_{d,s}$  is the Dixit-Stiglitz price index, and  $E_{d,s}$  is the total expenditure in sector  $s$ :

$$P_{d,s} = \left[ \sum_o \int_{\Omega} p_{od,s}^{(1-\sigma_s)} \right]^{\frac{1}{1-\sigma_s}}$$

**Comment:**  $\beta_{d,s}$  is useful in the follow-up derivation. Common conclusion of C-D preference applies such that  $E_d = \sum_s \beta_{d,s} \cdot E_{d,s}$  and  $\sum_s \sigma_s = 1$ .

## 2.2. Production

In SW(2018), the production technology follows [Taylor and Copeland \(2003\)](#) where labor is the only input, pollution is a by-product, and a firms can allocate some of the labor to pollution abatement; the market structure follows [Melitz \(2003\)](#) in a monopolistic competition with firm entry and exit depending on productivity drawn from a Pareto distribution.

### 2.2.1. Technology

Firm produces using labor  $l_{od,s}$ , and a proportion of  $0 \geq a < 1$  of the employment is allocated to pollution abatement:

$$q_{od,s} = (1 - a)\phi l_{od,s}$$

where  $\phi$  is a productivity draw.

Pollution emissions  $z_{od,s}$  follows certain form similar to production:

$$z_{od,s} = \nu(a)\phi l_{od,s}$$

where  $\nu(a)$  means that the actually abatement is a function of abatement labor input. Following [Taylor and Copeland \(2003\)](#) to make  $\nu(a)$  has economic meaning, let  $\nu(a) = (1 - a)^{\frac{1}{\alpha_s}}$ , such that the production function can be written as

$$q_{od,s} = (z_{od,s})_s^{\alpha} (\phi l_{od,s})^{1-\alpha_s}$$

so that  $\alpha_s$  is the elasticity of substitution between labor and pollution “input”.

### 2.2.2. Market Structure

In the monopolistic competition, firms make entry decision before production. There is a mass of firm attempting entry  $M_{o,s}^e$ , they have to pay sunk cost  $f_{o,s}^e$  to draw a productivity  $\phi$  from Pareto distribution  $G(\phi, b_{o,s})$ ,

$$G(\phi, b_{o,s}) = 1 - \left( \frac{\phi}{b_{o,s}} \right)^{-\theta_s}$$

where  $b_{o,s}$  and  $\theta_s$  represent the location and shape parameter of Pareto distribution.

**Comment:**  $b_{o,s}$  is country-sector specific, and  $-\theta_s$  is sector specific.

### 2.2.3. Profit Function

If a firm decide to produce and export, it pays wages  $w_o$ , pollution tax  $t_{o,s}$ , fixed costs of entry foreign/domestic market  $f_{od,s}$ , and suffers from iceberg trade costs  $\tau_{od,s}$ . Its profit function writes as

$$\begin{aligned} \pi_{o,s} &= \sum_d \pi_{od,s} - w_o f_{o,s}^e \\ \pi_{od,s} &= p_{od,s} q_{od,s} - w_o l_{od,s} \tau_{od,s} - t_{o,s} z_{od,s} \tau_{od,s} - w_d f_{od,s} \end{aligned}$$

## 2.3. Equilibrium

The general equilibrium is characterized by consumer utility maximization, firm choosing optimal abatement share  $a$  to maximize its profits upon entry, and labor market clearing.

1. Firm's optimal share of  $a$  writes as

$$1 - a = \left( \frac{w_o}{\phi t_{o,s}} \frac{\alpha_s}{1 - \alpha_s} \right)^{\alpha_s}$$

2. Additionally, in monopolistic competition, the expected profits of an entrant have to cover the sunk fixed costs of entry

$$\frac{1 - \alpha_s}{\theta_s} \frac{\sigma_s - 1}{\sigma_s} R_{o,s} = w_o f_{o,s}^e m_{o,s}^e$$

3. Total labor supply  $L_d$  equals total labor demand used up in the following five purposes:

- paying fixed costs of entry  $L_{o,s}^e = f_{o,s}^e M_{o,s}^e$
- production and pollution abatement  $L_{o,s}^p = \sum_d M_{o,s}^e \Pr(\phi > \phi^*) \mathbf{E}[l_{od,s} \tau_{od,s} | \phi > \phi^*]$ , where  $\phi^*$  is the cutoff productivity satisfying zero-profit condition.
- paying pollution tax  $L_{o,s}^t = \frac{t_{o,s}}{w_o} Z_{o,s}$
- paying foreign/domestic market entry cost  $L_{o,s}^f = \sum_d M_{od,s} f_{od,s}$  where  $M_{od,s}$  is the mass of successful entrants exporting to country  $d$ .
- paying for net exports  $L_{o,s}^{NX}$ , which is a defined term according to the trade imbalance of  $NX_d = R_d - E_d$

such that

$$L_d = L_d^e + L_d^p + L_d^t + L_d^f + L_d^{NX} = \frac{R_d}{w_d}$$

**Comment:** For the ease of derivation and exposition, tax revenue is assumed be used for rent-seeking so that it requires labor resources.

### 3 — Data, Equilibrium, and Algorithm for Estimation

#### 3.1. Data

Main data used for structural estimation is country-sector-year trade data and pollution data in the US<sup>1</sup>. The data consists of two countries, US and the rest of the world (ROW), seventeen sectors, and nineteen years from 1990 to 2008. Bilateral trade data has been normalized to have a sum of one in each year to have a economic meaning.

Denoting bilateral trade as  $X_{od,s}$ , where  $o$  represents origin,  $d$  represents destination, and  $s$  represents sector, we calculate the following data used for estimation:

Sector  $s$ 's revenue  $R_{os}$  and a country total revenue  $R_o$ :

$$R_{o,s} = \sum_d X_{od,s}$$

$$R_o = \sum_s R_{os}$$

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1. Since the focal country is US, and counterfactual pollution emissions are determined by changes in wages, the mass of firms, and pollution tax, we do not need pollution data in the rest of the world

Sector  $s$ 's expenditure  $E_{ds}$  and a country total expenditure  $E_d$ :

$$E_{d,s} = \sum_d X_{od,s}$$

$$E_d = \sum_s E_{ds}$$

Sector  $s$ 's *net export*  $NX_{ds}$  and a country total expenditure  $NX_d$ :

$$NX_{d,s} = R_{d,s} - E_{d,s}$$

$$NX_d = R_d - E_d$$

The proportion of a sector's expenditure share in total expenditure  $\beta_{d,s}$ :

$$\beta_{d,s} = \frac{E_{ds}}{E_d}$$

The proportion of a sector's import share in total expenditure  $\lambda_{od,s}$ :

$$\lambda_{od,s} = \frac{X_{od,s}}{E_d}$$

The proportion of a sector's export share in total revenue  $\zeta_{od,s}$ :

$$\zeta_{od,s} = \frac{X_{od,s}}{R_o}$$

The model's structural parameters  $\{\alpha_s, \theta_s, \sigma_s\}$  are calibrated using US's firm-level manufacturing data and assumed to be constant through nineteen years.

Total labor endowment  $L_o$  is assumed to one and no changes in all years.

Using *hat algebra* to denote changes,

$$\hat{x} \equiv \frac{x'}{x}$$

where  $x'$  is the counterfactual value.

Since we have nineteen years data, we assume  $x$  the base-year (1990) value, and in other

years,  $x'$  are equilibrium values under all three shocks: foreign competition, US competition  $\hat{\Gamma}_{od,s}$ , environmental regulation  $\hat{t}_{o,s}$ , and production composition  $\hat{\beta}_{d,s}$ .

Using the hat algebra and the definition of wage  $w_o \equiv \frac{R_o}{L_o}$ , changes in wage  $\hat{w}_o$  equals changes in a country's total revenue  $\hat{R}_o$ .

Using Equation (11) and Equation (15) in the main text of SW(2018), we can also recover two other variables, changes in the mass of firm attempting to entry and changes in implicit pollution tax:

$$\begin{aligned}\hat{M}_{o,s}^e &= \frac{\hat{R}_{o,s}}{\hat{w}_o} \\ \hat{t}_{o,s} &= \frac{\hat{M}_{o,s} \hat{w}_o}{\hat{Z}_{o,s}}\end{aligned}\tag{1}$$

where  $\hat{Z}_{o,s}$  is changes in pollution emissions observed in the data.

**Comment:** Historical value of  $\{\hat{t}_{o,s}\}$  can be recovered using the second equality.

### 3.2. Equilibrium

Given exogenous parameters and model parameters, the equilibrium is characterized by consumer utility maximization, firm's profit maximization, and labor market clearing. Firm's profit maximization and labor market clearing in hat algebra form Equation (3) and Equation (2), respectively.

For simplicity purpose, define two sector-level constant:

$$\begin{aligned}\Xi_s &\equiv \frac{\theta_s - (\sigma_s - 1)(1 - \alpha_s)}{\sigma_s \theta_s} \\ \Theta_s &\equiv \frac{(\sigma_s - 1)(\theta_s - \alpha_s + 1)}{\sigma_s \theta_s}\end{aligned}$$

The equilibrium in counterfactual is that given the combination of changes or historical shocks  $\{\hat{\Gamma}_{od,s}, \hat{t}_{o,s}, \hat{\beta}_{d,s}\}$ , solve  $\{\hat{w}_o, \hat{M}_{o,s}^e\}$  from the following system of non-linear equations <sup>2</sup>:

$$1 - \frac{1 - \sum_s \beta_{o,s}}{1 - \sum_s \Theta_s \hat{\beta}_{o,s} \beta_{o,s}} \cdot \frac{\sum_s \hat{M}_{o,s}^e R_{o,s} \Xi_s + \eta_o'}{\sum_s R_{o,s} \Xi_s + \eta_o} = 0\tag{2}$$

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2. These two equations are Equation (12) and (13) in the main text of SW(2018).  $\hat{N}X_o$  and  $\hat{N}X_{o,s}$  are assumed to one, suggesting no changes of shocks in net exports.

$$\hat{w}_o - \sum_d \frac{\zeta_{od,s} \hat{w}_o^{-\theta_s} \hat{\Gamma}_{od,s}}{\sum_o \lambda_{od,s} \hat{w}_o^{-\theta_s} \hat{\Gamma}_{od,s}} \cdot \hat{\beta}_{d,s} \cdot \frac{\hat{w}_d R_d - \hat{N} X_d N X_d}{R_d - N X_d} = 0 \quad (3)$$

where

$$\begin{aligned} \hat{\Gamma}_{od,s} &\equiv \left( \frac{1}{\hat{\beta}_{o,s}} \right)^{-\theta_s} (\hat{\tau}_{od,s})^{-\frac{\theta_s}{1-\alpha_s}} \left( \hat{f}_{od,s} \right)^{1-\frac{\theta_s}{(\sigma_s-1)(1-\alpha_s)}} (\hat{t}_{o,s})^{-\frac{\alpha_s \theta_s}{1-\alpha_s}} \\ &= \frac{\hat{\lambda}_{od,s}}{\hat{M}_{o,s}^e \hat{w}_o^{-\theta_s}} \left( \frac{\hat{\beta}_{d,s} \hat{R}_d R_d - \hat{N} X_d N X_d}{\hat{w}_d R_d - N X_d} \right)^{1-\frac{\theta_s}{(\sigma_s-1)(1-\alpha_s)}} \\ \eta_o &\equiv \sum_s (1 - \Xi_s) \beta_{o,s} N X_o - \Theta_s N X_{o,s} \\ \eta'_o &\equiv \frac{1}{\hat{w}_o} \sum_s (1 - \Xi_s) \hat{\beta}_{o,s} \beta_{o,s} \hat{N} X_o N X_o - \Theta_s \hat{N} X_{o,s} N X_{o,s} \end{aligned}$$

**Comment:** Historical value of  $\{\hat{\Gamma}_{od,s}\}$  can be recovered using the second equality, as well as the following definition of foreign/US competition. Equation (2) forms a system of  $N$  (country) equations, and Equation (3) forms a system of  $N \times J$  (country-sector) equations.

Additionally, SW(2018) defines shocks of foreign and US competition as follows. When the counterfactual is foreign competition,

$$\begin{aligned} \hat{\Gamma}_{od,s}^{\text{Foreign competition}} &= \hat{\Gamma}_{od,s}, o \neq \text{US} \\ \hat{\Gamma}_{o,s}^{\text{Foreign competition}} &= 1, o = \text{US} \end{aligned}$$

When the counterfactual is US competition,

$$\begin{aligned} \hat{\Gamma}_{od,s}^{\text{US competition}} &= 1, o \neq \text{US} \\ \hat{\Gamma}_{od,s}^{\text{US competition}} &= \hat{\Gamma}_{od,s} \cdot (\hat{t}_{o,s})^{\frac{\alpha_s \theta_s}{1-\alpha_s}}, o = \text{US} \end{aligned}$$

When the counterfactual is US environmental regulation,

$$\begin{aligned} \hat{\Gamma}_{od,s}^{\text{Regulation}} &= 1, o \neq \text{US} \\ \hat{\Gamma}_{od,s}^{\text{Regulation}} &= (\hat{t}_{o,s})^{-\frac{\alpha_s \theta_s}{1-\alpha_s}}, o = \text{US} \end{aligned}$$



Note that the real shocks  $\{\hat{\Gamma}_{od,s}, \hat{t}_{o,s}, \hat{\beta}_{d,s}\}$  relative to the base-year 1990 are observed in the data, and *counterfactual* means that *changing* only one shocks of  $\{\hat{\Gamma}_{od,s}, \hat{t}_{o,s}, \hat{\beta}_{d,s}\}$  to the real data and setting the rest of them to one (i.e., the same relative to the base-year) to see how that shock affects the trending of  $\{\hat{w}_o, \hat{M}_{o,s}^e\}$  and thus pollution emissions  $\hat{Z}_{o,s}$  in years after 1990.

### 3.3. Algorithm

For  $N$  countries, each with  $J$  sectors, Equation (2) and Equation (3) have  $N$  unknown changes in wage  $\hat{w}_o$  and  $N \times J$  unknown changes in masses of firms  $\hat{M}_{o,s}^e$ . When solving the model, change in foreign wage is excluded as the numeria, which is solved by the normalization that the sum of two countries' revenue equals one in every year:

$$\begin{aligned} \frac{R'_{US} + R'_{\text{Foreign}}}{R_{US} + R_{\text{Foreign}}} &= 1 \\ \Rightarrow \frac{\hat{R}_{US} R_{US}}{R_{US} + R_{\text{Foreign}}} + \frac{\hat{R}_{\text{Foreign}} R_{\text{Foreign}}}{R_{US} + R_{\text{Foreign}}} &= 1 \\ \Rightarrow \hat{w}_{US} \frac{R_{US}}{R_{US} + R_{\text{Foreign}}} + \hat{w}_{\text{Foreign}} \frac{R_{\text{Foreign}}}{R_{US} + R_{\text{Foreign}}} &= 1 \end{aligned}$$

The last equality utilizes  $\frac{L'_d}{L_d} = \frac{\hat{R}_d}{\hat{w}_d} = 1$ .

Algorithm 1 shows steps to calculate the counterfactual. SW(2018) exercises four counterfactual of  $\{\hat{\Gamma}_{o,s}, \hat{t}_{o,s}, \hat{\beta}_{d,s}\}$ :

1. Foreign competition: for  $o = \text{foreign countries}$ , set  $\hat{\Gamma}_{od,s}$  to  $\hat{\Gamma}_{od,s}^{\text{Foreign competition}}$ , set  $\hat{\Gamma}_{od,s}$  for US and  $\hat{\beta}_{d,s}$  to one.
2. US competition: for  $o = \text{US}$ , set  $\hat{\Gamma}_{od,s}$  to  $\hat{\Gamma}_{od,s}^{\text{US competition}}$ , set  $\hat{\Gamma}_{od,s}$  for foreign country and  $\hat{\beta}_{d,s}$  to one.
3. Environmental regulation: for  $o = \text{US}$ , set  $\hat{\Gamma}_{od,s}$  to  $\hat{t}_{o,s}$ , set  $\hat{\Gamma}_{od,s}$  for foreign country to one, set  $\hat{\beta}_{d,s}$  to one.
4. Product composition: set  $\hat{\beta}_{d,s}$  to the historical real value, and set  $\{\hat{\Gamma}_{od,s}\}$  to one.

**Comment:** In all counterfactual,  $\hat{N}X_{d,s}$  and  $\hat{N}X_d$  are set to one. Equation (2 shows that  $\hat{t}_{o,s}$  is actually a part of  $\{\hat{\Gamma}_{od,s}, \cdot\}$ ,

**Comment:** As you will see in the MATLAB code, for each year,  $\hat{\Gamma}_{od,s}$  is an  $N \times J$  (i.e.,  $2 \times 17$ ) matrix. If the second row represents US value, then, the first counterfactual means that set the value in the first row to  $\hat{\Gamma}_{od,s}^{\text{Foreign competition}}$ , while set the second row to one.

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**Algorithm 1:** Computing counterfactual pollution emissions

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**Data:** Base-year production composition  $\beta_{o,s}$ , sectoral and country-level revenue  $R_{o,s}$ ,  $R_o$ , sectoral and country-level net exports  $NX_{o,s}$ ,  $NX_o$ , bilateral import share  $\lambda_{od,s}$ , bilateral export share  $\zeta_{od,s}$ . Structural parameters  $\{\alpha_s, \theta_s, \sigma_s\}$ .

- 1 Initialize shocks  $\{\hat{\Gamma}_{od,s}, \hat{t}_{o,s}, \hat{\beta}_{d,s}\}$ .
- 2 Initialize guesses of  $\{\hat{w}_o, \hat{M}_{o,s}\}$ .
- 3 Iterate  $\{\hat{w}_o, \hat{M}_{o,s}\}$  until it satisfies both Equation (2) and Equation (3).
- 4 Calculate counterfactual pollution emissions  $\hat{Z}_{o,s} = \frac{\hat{M}_{o,s}^e \hat{w}_o}{\hat{t}_{o,s}}$ .

**Result:** Changes in wage, the mass of firms, and pollution emissions  $\{\hat{w}_o, \hat{M}_{o,s}^e, \hat{Z}_{o,s}\}$

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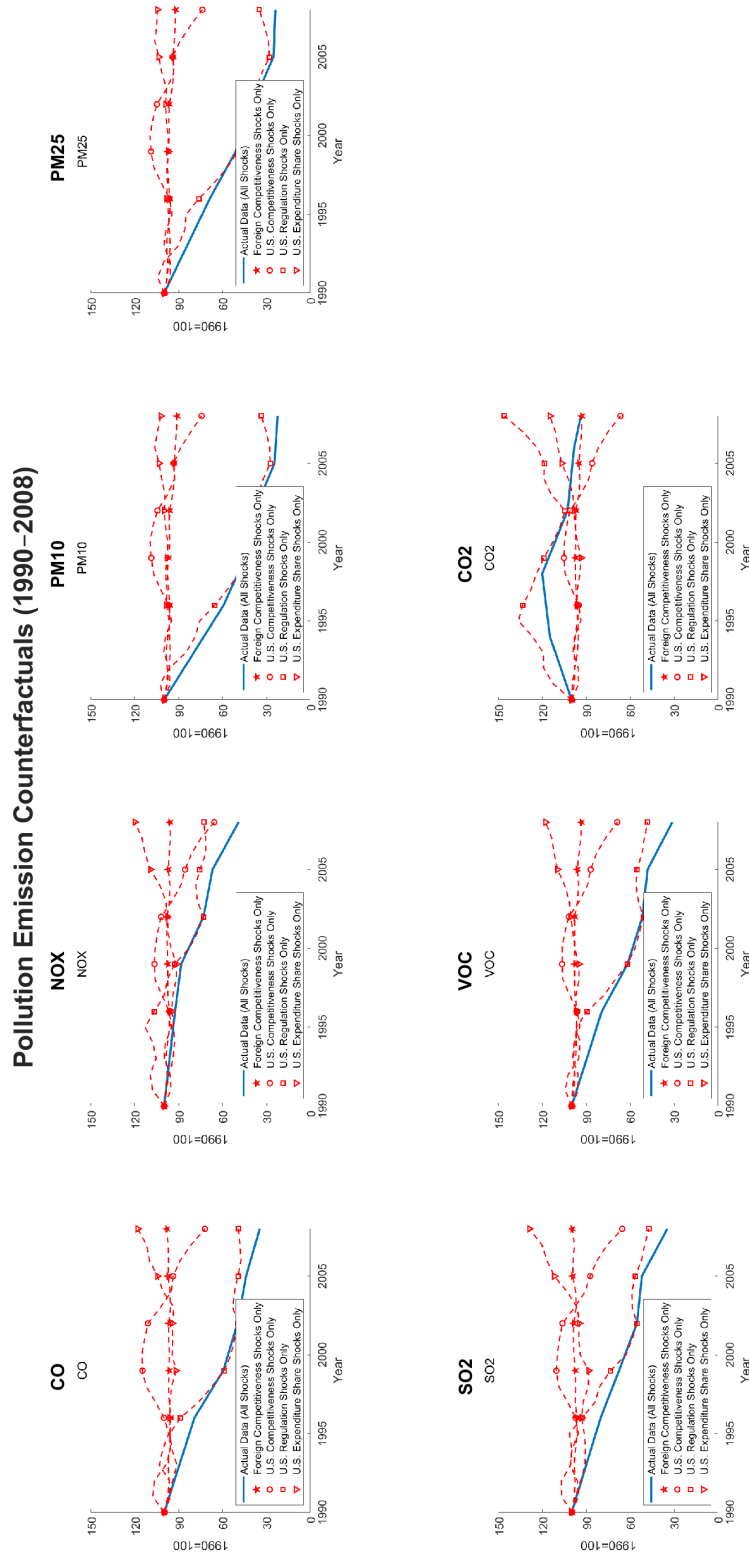
## 4 — Results and Extensions

The main replication results are shown in Figure 1 including seven pollutants, which corresponds to SW(2018) Figure 5 (the first six pollutants) and Panel B of Figure 7 (CO<sub>2</sub>) emissions. For the first six pollutants of CO, NX<sub>x</sub>, PM<sub>2.5</sub>, PM<sub>10</sub>, SO<sub>2</sub>, and VOC<sub>s</sub>, environmental regulation explains most of the decline in pollution emissions.

The second replication is the time trend of measurement of environmental regulation, “implicit pollution tax”,  $\hat{t}_{o,s}$ . Figure 2 shows how the historical  $\hat{t}_{o,s}$  for different pollutants, where  $\hat{t}_{o,s}$  is calculated utilizing Equation (1). Aligning with real trend of CO<sub>2</sub> emissions in Figure 1, implicit pollution tax for CO<sub>2</sub> emissions even has a decline in previous decades. However, pollution taxes for other pollutants have an increasing trend since 1990.

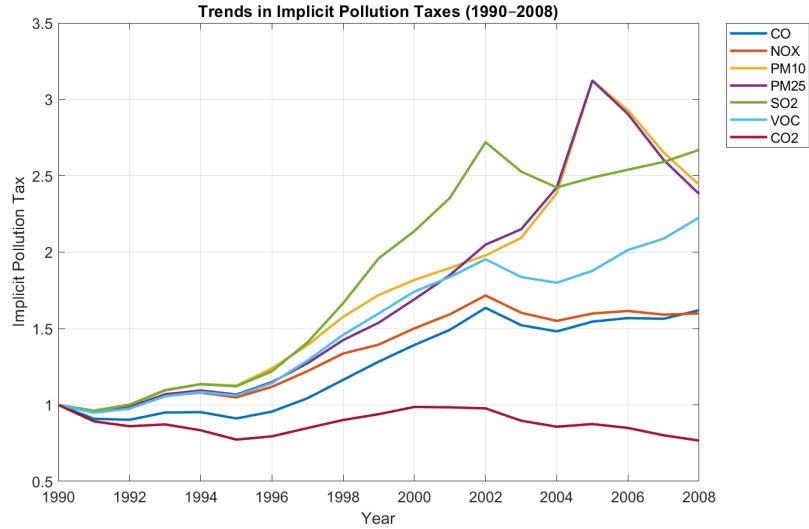
The third replication is the counterfactual of US international trade revenue (i.e, export) share in the world. Figure 3 shows that changes in environmental regulation (rectangle) and product composition (triangle) cannot explain the falling share of US export. Rather, the foreign and US competition explain.

The last replication extends the third replication by plotting changes in  $\Gamma_{o,s}$  to explain why foreign and US competition explain falling US exports. Figure 4 shows continuously increasing foreign competitiveness to both foreign countries and the US, while Figure 5 shows the competi-



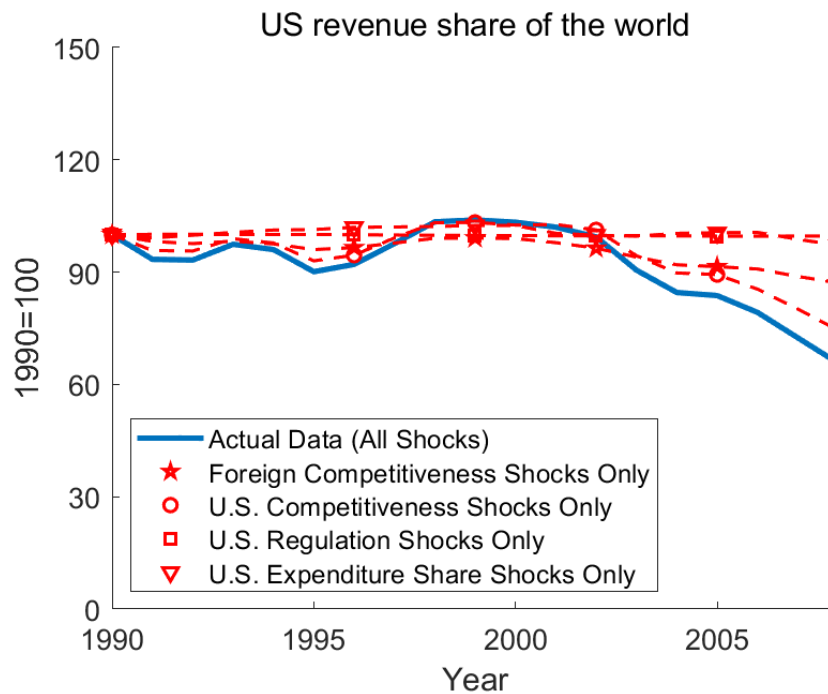
**Figure 1 — Pollution Emission Counterfactual (1990–2008)**

*Notes.* This figure replicates counterfactual Figure 5 in SW(2018) of seven pollutants. Value in 1990 has been normalized to 100, so that values in other years represent the relative change to 1990's.



**Figure 2 — Implicit Pollution Taxes (1990–2008)**

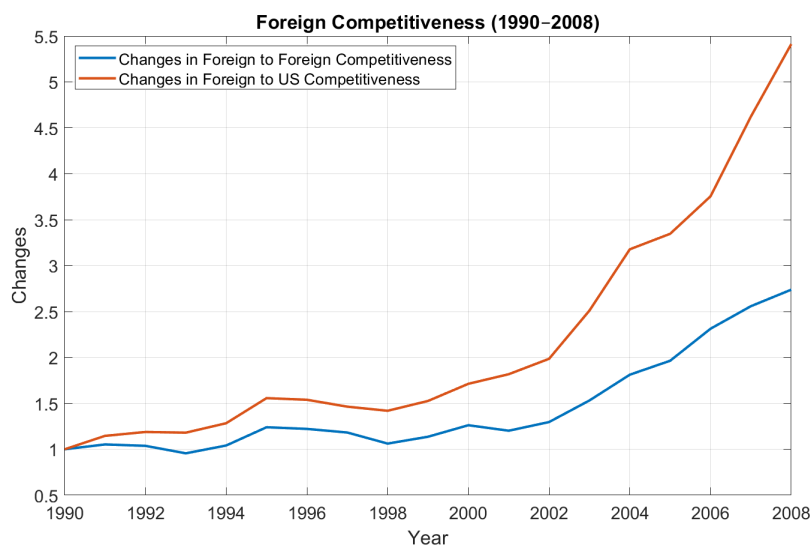
*Notes.* This figure replicates Figure 4 in SW(2018) of implicit pollution taxes of seven pollutants. Value in 1990 has been normalized to one, so that values in other years represent the relative change to 1990's.



**Figure 3 — US Export Share Counterfactual (1990–2008)**

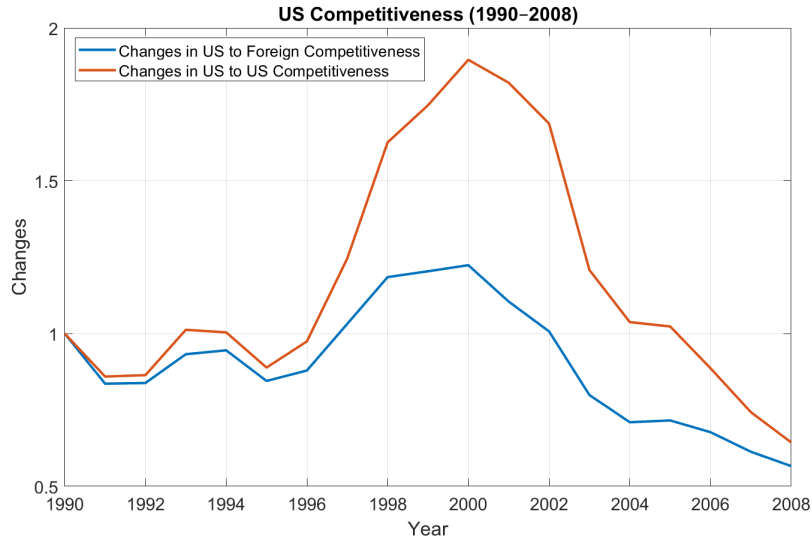
*Notes.* This figure shows how US export share changes under four different shocks. Value in 1990 has been normalized to 100, so that values in other years represent the relative change to 1990's.

tiveness of US has been increasing until 2000 when its competitiveness began to decrease. While several elements consist of such “competitiveness”: productivity, iceberg trade costs, fixed entry costs to foreign countries, as well as pollution tax, we are not able to observe specific changes of certain elements.



**Figure 4 — Changes in Foreign Competitiveness (1990–2008)**

*Notes.* This figure shows time trend of foreign competitiveness  $\Gamma_o^{\text{Foreign Competitiveness}}$ . Value in 1990 has been normalized to one, so that values in other years represent the relative change to 1990's.



**Figure 5 — Changes in US Competitiveness (1990–2008)**

*Notes.* This figure shows time trend of US competitiveness  $\Gamma_o^{\text{US Competitiveness}}$ . Value in 1990 has been normalized to one, so that values in other years represent the relative change to 1990's.

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## A — Appendix for Derivations

### Notations

In SW(2018), subscript  $o$  denotes origin country,  $d$  denotes destination country, and  $s$  denotes sector.

**Table A1 — Codebook for SW2018**

SW2018	Description
Structural parameters	
$\alpha_s$	pollution elasticity
$b_{o,s}$	location parameter of Pareto distribution
$\theta_s$	shape parameter of Pareto distribution
$\sigma_s$	elasticity of substitution
Exogenous characteristics	
$L_d$	labor endowment normalized to one
$f_{o,s}^e$	fixed costs of drawing a productivity
$f_{od,s}$	fixed costs of entering a market $d$
Endogenous characteristics and scalars	
$\phi$	Productivity draw
$l_{od,s}$	Labor demand
$z_{od,s}$	Pollution emissions
$a$	Share of labor allocated to pollution abatement
$q_{od,s}$	Output
$p_{od,s}$	Price
$c_{o,s}$	Variable cost
$w_{o,s}$	Wage
$t_{o,s}$	Pollution tax

Continued on next page

Table A1 (continued from previous page)

SW2018	Description
$\tau_{od,s}$	Iceberg trade cost
$\pi_{od,s}$	Profit
$X_{od,s}$	Bilateral trade share
$E_{d,s}$	Expenditure of sector $s$ in country $d$
$E_d$	Expenditure of country $d$
$R_{o,s}$	Revenue of sector $s$ in country $o$
$R_o$	Revenue of country $o$
$NX_{d,s}$	Net exports of sector $s$ in country $d$
$NX_d$	Net exports of country $o$
$\beta_{d,s}$	Cobb-Douglas expenditure share of sector $s$ in country $d$
$P_{d,s}$	Price index of sector $s$ in country $d$
$Z_{o,s}$	Pollution emissions of sector $s$ in country $d$
$M_{o,s}^e$	Mass of firms attempting to entry
$M_{o,s}$	Mass of firms successfully entry
$\phi_{od,s}^*$	Cutoff productivity making zero profits
$\lambda_{od,s}$	Bilateral trade share from county $d$ to country $o$
$\zeta_{od,s}$	Bilateral trade share from county $o$ to country $d$



**Comment:**  $\omega$  and  $\phi$  can both represent a firm. Since the equilibrium and the counterfactual actually utilize the sector-level aggregates, I have omitted these two notations.

## A.1. Derivation of preference

Consumer demand in country  $d$  is defined as

$$U_d = \prod_s \left[ \left( \sum_o \int_{\omega \in \Omega} q_{od,s}(\omega)^{\frac{\sigma_s-1}{\sigma_s}} \right)^{\frac{\sigma_s}{\sigma_s-1}} \right]^{\beta_{d,s}} \quad (\text{A.1})$$

Within each sector, the common conclusions of CES preference applies:

$$q_{od,s} = \frac{p_{od,s}^{-\sigma_s}}{P_{d,s}^{1-\sigma_s}} E_{d,s} \quad (\text{A.2})$$

where  $P_{d,s}$  is the Dixit-Stiglitz price index, and  $E_{d,s}$  is the total expenditure in sector  $s$ :

$$P_{d,s} = \left[ \sum_o \int_{\Omega} p_{od,s}^{(1-\sigma_s)} \right]^{\frac{1}{1-\sigma_s}} \quad (\text{A.3})$$

## A.2. Derivation of production

Firm produces using labor  $l_{od,s}$ , and a proportion of  $0 \geq a < 1$  of the employment is allocated to pollution abatement:

$$q_{od,s} = (1 - a)\phi l_{od,s} \quad (\text{A.4})$$

where  $\phi$  is a productivity draw.

Under the assumption of pollution emissions

$$z_{od,s} = (1 - a)^{\frac{1}{\alpha_s}} \phi l_{od,s} \quad (\text{A.5})$$

We can calculate

$$1 - a = \left( \frac{z_{od,s}}{\phi l_{od,s}} \right)^{\alpha_s} \quad (\text{A.6})$$

Substitute in Equation (A.4) gives

$$q_{od,s} = (z_{od,s})_s^\alpha (\phi l_{od,s})^{1-\alpha_s} \quad (\text{A.7})$$

### A.2.1. Optimal share of labor allocation $a$

To derive the optimal share of labor allocated to pollution abatement  $a$ , we turn to firm's profit maximization problem:

$$\max_{a, l_{od,s}} \pi_{od,s} = p_{od,s} q_{od,s} - w_o l_{od,s} \tau_{od,s} - t_{o,s} z_{od,s} \tau_{od,s} - w_d f_{od,s} \quad (\text{A.8})$$

$$= p_{od,s} (1-a) \phi l_{od,s} - w_o l_{od,s} \tau_{od,s} - t_{o,s} z_{od,s} = (1-a)^{\frac{1}{\alpha_s}} \phi l_{od,s} \tau_{od,s} - w_d f_{od,s} \quad (\text{A.9})$$

The second equality follows by substituting in Equation (A.4) and Equation (A.5).

Taking partial derivation of  $\pi_{od,s}$  with respect to  $a$  and  $l_{od,s}$ :

$$\frac{\partial \pi}{\partial a} = -p\phi + t\phi l \frac{1}{\alpha} (1-a)^{\frac{1}{\alpha}-1} \tau = 0 \Rightarrow p = \frac{t\tau}{\alpha} (1-a)^{\frac{1}{\alpha}-1} \quad (\text{A.10})$$

$$\frac{\partial \pi}{\partial l} = p(1-a)\phi - w\tau - t(1-a)^{\frac{1}{\alpha}} \phi \tau = 0 \Rightarrow p = \frac{w\tau + t(1-a)^{\frac{1}{\alpha}} \phi \tau}{(1-a)\phi} \quad (\text{A.11})$$

**Comment:** I omit the subscripts above for the ease of exposition when possible.

Equating the above two expressions for  $p$  gives the optimal share of labor inputs for production  $1-a$ :

$$1-a = \left( \frac{w_o}{\phi t_{o,s}} \frac{\alpha_s}{1-\alpha_s} \right)^{\alpha_s} \quad (\text{A.12})$$

### A.2.2. Pricing

Under monopolistic competition, firm's pricing is a constant markup to marginal costs

$$p_{od,s} = \frac{\sigma_s}{\sigma_s - 1} MC \quad (\text{A.13})$$

where  $MC$  refers to marginal costs.

To derive  $MC$ , we begin with total costs  $TC$ :

$$TC = wl\tau + tz\tau + wf \quad (\text{A.14})$$

$$= wl\tau + t \left[ \frac{q}{(\phi l)^{1-\alpha}} \right]^{\frac{1}{\alpha}} \tau + wf \quad (\text{A.15})$$

where the second equality follows by substituting in Equation (A.7).

**Comment:** Sunk entry costs  $f^e$  do not influence firms' pricing decision.

Taking partial derivation with respect to  $l$  to derive the optimal labor inputs:

$$\frac{\partial TC}{\partial l} = 0 \Rightarrow l = \left[ \frac{w}{tq^{\frac{1}{\alpha}} \frac{1-\alpha}{\alpha} \phi^{\frac{\alpha-1}{\alpha}}} \right]^{-\alpha} \quad (\text{A.16})$$

Substitute the above optimal  $l$  into  $TC$  to derive  $TC$  as a function of  $q$

$$TC = w^{1-\alpha} t^{\alpha} \left( \frac{1-\alpha}{\alpha} \right)^{\alpha} \phi^{\alpha-1} \tau q \quad (\text{A.17})$$

$$+ w^{1-\alpha} t^{\alpha} \left( \frac{1-\alpha}{\alpha} \right)^{\alpha-1} \phi^{\alpha-1} \tau q \quad (\text{A.18})$$

$$+ wf \quad (\text{A.19})$$

Taking partial derivation of  $TC$  w.r.t  $q$  derives  $MC$ :

$$MC = w_o^{1-\alpha_s} t_{o,s}^{\alpha_s} \left( \frac{1-\alpha_s}{\alpha_s} \right)^{\alpha_s-1} \frac{1}{\alpha_s} \phi^{\alpha_s-1} \tau_{od,s} \quad (\text{A.20})$$

Define

$$c_{o,s} \equiv \left( \frac{t_{o,s}}{\alpha_s} \right)^{\alpha_s} \left( \frac{w_o}{1-\alpha_s} \right)^{1-\alpha_s} \quad (\text{A.21})$$

we now writes firms pricing as

$$p_{od,s} = \frac{\sigma_s}{\sigma_s - 1} \frac{c_{o,s} \tau_{od,s}}{\phi^{1-\alpha_s}} \quad (\text{A.22})$$

### A.2.3. Cutoff productivity $\phi_{od,s}^*$ ; Zero-profit condition (ZPC)

There exists a cutoff productivity  $\phi_{od,s}^*$  making firms earn zero profits after entry, such that productivity draw lower than  $\phi_{od,s}^*$  will not enter the market.

Cutoff productivity  $\phi_{od,s}^*$  satisfies

$$\pi_{od,s}(\phi_{od,s}^*) = 0 \quad (\text{A.23})$$

$$\pi_{od,s} = pq - TC \quad (\text{A.24})$$

$$= pq - \left[ MC \cdot \frac{1-\alpha}{\alpha} \alpha q + MC \cdot \alpha q \right] - wf \quad (\text{A.25})$$

$$= pq - \left( pq \frac{\sigma-1}{\sigma} + wf \right) \quad (\text{A.26})$$

$$= \frac{pq}{\sigma} - wf \quad (\text{A.27})$$

$$= \frac{r_{od,s}}{\sigma_s} - w_d f_{od,s} \quad (\text{A.28})$$

$$(\text{A.29})$$

where the third equality utilizes the pricing rule  $p = \frac{\sigma}{\sigma-1} MC$ .

Let  $\pi_{od,s} = 0$  and substitute in Equation (A.2)

$$\frac{p_{od,s}^{1-\sigma_s}}{P_{d,s}^{1-\sigma_s}} E_{d,s} \frac{1}{\sigma_s} = w_d f_{od,s} \quad (\text{A.30})$$

substitute in Equation A.22 solves  $\phi_{od,s}^*$

$$\phi_{od,s}^* = \left[ \frac{\sigma_s}{\sigma_s - 1} \frac{c_{o,s} \tau_{od,s}}{P_{d,s}} \left( \frac{\sigma_s w_d f_{od,s}}{E_{d,s}} \right)^{\frac{1}{\sigma_s - 1}} \right]^{\frac{1}{1-\alpha_s}} \quad (\text{A.31})$$

#### A.2.4. Free-entry condition

Free-entry condition says that the expected profits of firms attempting to entry have to at least cover the sunk fixed costs of entry. Applying total probability theorem:

$$\sum_d \Pr(\phi > \phi_{od,s}^*) \mathbf{E}[\phi_{od,s} | \phi > \phi_{od,s}^*] = w_o f_{o,s}^e \quad (\text{A.32})$$

We first list several characteristics of Pareto distribution, solve for the conditional density distribution, then calculate  $\mathbf{E}[\phi_{od,s}|\phi > \phi_{od,s}^*]$ .

The cumulative density function (CDF) and probability density function (PDF) of Pareto distribution are as follows:

$$G(\phi, b_{o,s}) = 1 - \left( \frac{\phi}{b_{o,s}} \right)^{-\theta_s} \quad (\text{A.33})$$

$$g(\phi, b_{o,s}) = \theta_s b_{o,s}^{\theta_s} \phi^{-\theta_s-1} \quad (\text{A.34})$$

To derive conditional PDF  $g(\phi|\phi > \phi_{od,s}^*)$ , we first derive conditional CDF:

$$G(\phi|\phi > \phi_{od,s}^*) = \Pr[\Phi \leq \phi | \Phi > \phi^*] = \frac{\Pr(\phi^* < \Phi \leq \phi)}{\Pr(\Phi > \phi^*)} \quad (\text{A.35})$$

$$= \frac{G(\phi) - G(\phi^*)}{1 - G(\phi^*)} \quad (\text{A.36})$$

The first equality utilizes conditional probability

$$\Pr(B|A) = \frac{\Pr(AB)}{\Pr(A)}$$

Taking differentiation solves conditional CDF:

$$g(\phi|\phi > \phi_{od,s}^*) = \frac{g(\phi)}{1 - G(\phi^*)} = \theta_s \frac{(\phi_{od,s}^*)^{\theta_s}}{\phi^{\theta_s+1}} \quad (\text{A.37})$$

A contrast of  $g(\phi)$  and  $g(\phi|\phi > \phi_{od,s}^*)$  is plotted in Figure A1.

We now turn to derive conditional expected profits  $\mathbf{E}[\phi_{od,s}|\phi > \phi_{od,s}^*]$ :

$$\mathbf{E}[\phi_{od,s}|\phi > \phi_{od,s}^*] = \int_{\phi_{od,s}^*}^{\infty} \pi_{od,s} g(\phi|\phi > \phi_{od,s}^*) d\phi \quad (\text{A.38})$$

$$= \int_{\phi_{od,s}^*}^{\infty} \left( \frac{r}{\sigma} - w_d f_{od,s} \right) g(\phi|\phi > \phi_{od,s}^*) d\phi \quad (\text{A.39})$$

$$= \int_{\phi_{od,s}^*}^{\infty} \frac{r}{\sigma} g(\phi|\phi > \phi_{od,s}^*) d\phi - \int_{\phi_{od,s}^*}^{\infty} w_d f_{od,s} g(\phi|\phi > \phi_{od,s}^*) d\phi \quad (\text{A.40})$$

$$= \int_{\phi_{od,s}^*}^{\infty} \frac{r}{\sigma} g(\phi|\phi > \phi_{od,s}^*) d\phi - w_d f_{od,s} \quad (\text{A.41})$$

$$= \int_{\phi_{od,s}^*}^{\infty} \frac{pq}{\sigma} g(\phi|\phi > \phi_{od,s}^*) d\phi - w_d f_{od,s} \quad (\text{A.42})$$

$$= \int_{\phi_{od,s}^*}^{\infty} p^{1-\sigma} P^{\sigma-1} E_{d,s} \cdot \frac{1}{\sigma} \cdot g(\phi|\phi > \phi_{od,s}^*) d\phi - w_d f_{od,s} \quad (\text{A.43})$$

$$= \int_{\phi_{od,s}^*}^{\infty} p^{1-\sigma} \frac{w_d f_{od,s} \sigma}{p(\phi^*)^{1-\sigma}} \cdot \frac{1}{\sigma} \cdot g(\phi|\phi > \phi_{od,s}^*) d\phi - w_d f_{od,s} \quad (\text{A.44})$$

$$= \int_{\phi_{od,s}^*}^{\infty} \left[ \frac{\phi^{\alpha-1}}{(\phi^*)^{\alpha-1}} \right]^{1-\sigma} w_d f_{od,s} g(\phi|\phi > \phi_{od,s}^*) d\phi - w_d f_{od,s} \quad (\text{A.45})$$

$$= \int_{\phi_{od,s}^*}^{\infty} \phi^{(\alpha-1)(1-\sigma)} (\phi^*)^{-(\alpha-1)(1-\sigma)} w_d f_{od,s} \cdot \theta_s (\phi_{od,s}^*)^{\theta_s} \phi^{-\theta_s-1} - w_d f_{od,s} \quad (\text{A.46})$$

$$= w_d f_{od,s} \theta (\phi^*)^{\theta-(\alpha-1)(1-\sigma)} \cdot \int_{\phi_{od,s}^*}^{\infty} \phi^{(\alpha-1)(1-\sigma)-\theta-1} d\phi - w_d f_{od,s} \quad (\text{A.47})$$

$$= w_d f_{od,s} \theta \frac{1}{\theta - (\alpha-1)(1-\sigma)} - w_d f_{od,s} \quad (\text{A.48})$$

$$= w_d f_{od,s} \frac{(\sigma-1)(1-\alpha)}{\theta - (\sigma-1)(\alpha-1)} \quad (\text{A.49})$$

The third equality follows by  $\int_{\phi_{od,s}^*}^{\infty} g(\phi|\phi > \phi_{od,s}^*) d\phi = 1$  (See Figure A1). The sixth equality follows by substituting in Equation (A.30), and the seventh equality follows by substituting in Equation (A.22) and note that  $\phi^*$  is a constant.

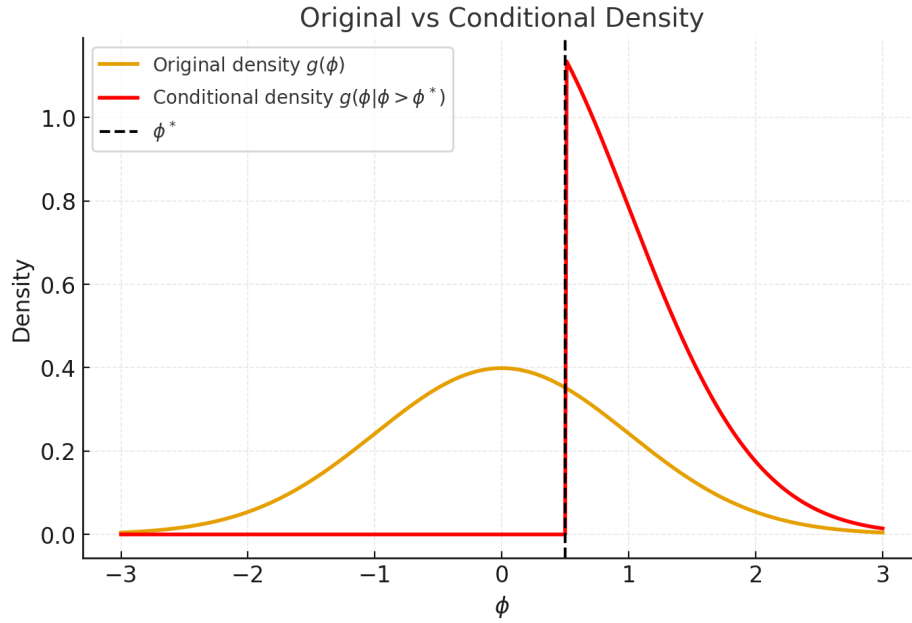
Finally, we can derive the free entry condition. Substitute  $\mathbf{E}[\phi_{od,s}|\phi > \phi_{od,s}^*]$  into Equa-

tion(A.32) and rewrite  $\Pr(\phi > \phi^*) = [1 - G(\phi^*)]$

$$\sum_d [1 - G(\phi^*)] \cdot w_d f_{od,s} \frac{(\sigma - 1)(1 - \alpha)}{\theta - (\sigma - 1)(\alpha - 1)} = w_o f_{o,s}^e \quad (\text{A.50})$$

$$\Rightarrow \sum_d \left( \frac{b_{o,s}}{\phi_{od,s}^*} \right)^{\theta_s} \cdot w_d f_{od,s} \frac{(\sigma - 1)(1 - \alpha)}{\theta - (\sigma - 1)(\alpha - 1)} = w_o f_{o,s}^e \quad (\text{A.51})$$

$$\Rightarrow f_{o,s}^e \frac{\theta - (\sigma - 1)(\alpha - 1)}{(\sigma - 1)(1 - \alpha)} = \sum_d \left( \frac{b_{o,s}}{\phi_{od,s}^*} \right)^{\theta_s} \frac{w_d}{w_o} f_{od,s} \quad (\text{A.52})$$



**Figure A1 – PDF and Conditional PDF of Pareto Distribution**

*Notes.* This figure shows PDF and Conditional PDF of Pareto Distribution using code in Code 1 which assumes  $\phi_{od,s}^* = 0.5$ .

### A.2.5. Simplifying Free-entry Condition

The free-entry condition can be further simplified after deriving  $P_{d,s}$  and bilateral trade flow  $X_{od,s}$ .

**Deriving  $P_{d,s}$ :**

Rewrite Equation (A.3) to  $P_{d,s}^{1-\sigma_s}$

$$\begin{aligned}
P_{d,s}^{1-\sigma_s} &= \sum_o \int_0^{M_{od,s}} (p_{od,s})^{1-\sigma_s} dv \\
&= \sum_o M_{od,s} \mathbf{E} [p_{od,s}^{1-\sigma_s} | \phi > \phi_{od,s}^*] \\
&= \sum_o \Pr(\phi > \phi_{od,s}^*) M_{o,s}^e \int_{\phi_{od,s}^*}^{\infty} p_{od,s}^{1-\sigma_s} g(\phi | \phi > \phi_{od,s}^*) d\phi \\
&= \sum_o M^e [1 - G(\phi^*)] \int_{\phi^*}^{\infty} p^{1-\sigma} \theta (\phi^*)^\theta \phi^{-\theta-1} d\phi \\
&= \sum_o M^e b^\theta (\phi^*)^{-\theta} \int_{\phi^*}^{\infty} \left( \frac{\sigma}{\sigma-1} \frac{c\tau}{\phi^{1-\alpha}} \right)^{1-\sigma} \theta (\phi^*)^\theta \phi^{-\theta-1} d\phi \\
&= \sum_o M^e \left( \frac{\sigma}{\sigma-1} c\tau \right)^{1-\sigma} \theta b^\theta \frac{1}{\theta - (1-\alpha)(\sigma-1)} (\phi^*)^{(1-\alpha)(\sigma-1)-\theta} \\
&= \sum_o M^e \left[ \frac{\sigma}{\sigma-1} \frac{t^\alpha w_o^{1-\alpha} \tau}{\alpha^\alpha (1-\alpha)^{1-\alpha}} \right]^{1-\sigma} \theta \beta^\theta \frac{1}{\theta - (1-\alpha)(\sigma-1)} \\
&\quad \cdot \left[ \left( \frac{\sigma}{\sigma-1} \cdot \frac{t^\alpha w_o^{1-\alpha} \tau}{\alpha^\alpha (1-\alpha)^{1-\alpha} P_{d,s}} \right) \left( \frac{\sigma w_d f_{od,s}}{E_{d,s}} \right)^{\frac{1}{\sigma-1}} \right]^{\frac{(1-\alpha)(\sigma-1)-\theta}{1-\alpha}} \\
&= \sigma^{1-\frac{\sigma\theta}{(1-\alpha)(\sigma-1)}} (\sigma-1)^{\frac{\theta}{1-\alpha}} \alpha^{\frac{\alpha\theta}{1-\alpha}} (1-\alpha)^\theta \\
&\quad \cdot \sum_o M_{o,s}^e (w_o)^{-\theta_s} (b_{o,s})^\theta (\tau_{od,s})^{-\frac{\theta}{1-\alpha}} (f_{od,s})^{1-\frac{\theta}{(1-\alpha)(\sigma-1)}} (E_{d,s})^{\frac{\theta}{(1-\alpha)(\sigma-1)}-1} (w_d)^{1-\frac{\theta}{(1-\alpha)(\sigma-1)}} (t_{o,s})^{\frac{\alpha\theta}{1-\alpha}} \\
&\quad \cdot P_{d,s}^{-\frac{(1-\alpha)(\sigma-1)-\theta}{1-\alpha}}
\end{aligned}$$

The second equality follows from firms' sourcing  $p_{od} \leq \min\{p_{o1}, p_{o2}, \dots, p_{od}\}$  (See international trade literature such as [Eaton and Kortum \(2002\)](#)). The fifth equality follows by substituting in Equation (A.21) of  $c_{o,s}$  and Equation (A.31) of cutoff productivity  $\phi_{o,s}^*$ .

Define constant  $\chi_s$ :

$$\chi_s \equiv \sigma_s^{1-\frac{\sigma_s\theta_s}{(1-\alpha_s)(\sigma_s-1)}} (\sigma_s-1)^{\frac{\theta_s}{1-\alpha_s}} \alpha_s^{\frac{\alpha_s\theta_s}{1-\alpha_s}} (1-\alpha_s)^{\theta_s} \quad (\text{A.53})$$



Solving for the last equality derives  $P_{d,s}$ :

$$P_{d,s}^{-\frac{\theta_s}{1-\alpha_s}} = \chi_s \sum_o M_{o,s}^e \left( \frac{w_o}{b_{o,s}} \right)^{-\theta_s} (\tau_{od,s})^{-\frac{\theta_s}{1-\alpha_s}} (f_{od,s})^{1-\frac{\theta_s}{(1-\alpha_s)(\sigma_s-1)}} (t_{o,s})^{\frac{\alpha_s \theta_s}{1-\alpha_s}} \left( \frac{E_{d,s}}{w_d} \right)^{\frac{\theta_s}{(1-\alpha_s)(\sigma_s-1)}-1} \quad (\text{A.54})$$

Deriving  $X_{od,s}$ :

$$\begin{aligned} X_{od,s} &= \Pr(\phi > \phi_{od,s}^*) M_{o,s}^e \mathbf{E}[r_{od,s} | \phi > \phi_{od,s}^*] \\ &= [1 - G(\phi^*)] M^e \int_{\phi^*}^{\infty} pqg(\phi | \phi > \phi^*) d\phi \\ &= \left( \frac{\phi}{b_{o,s}} \right)^{-\theta} M^e \int_{\phi^*}^{\infty} \left[ \frac{\sigma}{\sigma-1} \frac{c\tau}{\phi^{1-\alpha}} \right]^{1-\sigma} P^{\sigma-1} E_{d,s} \theta (\phi^*)^{\theta} \phi^{-\theta-1} d\phi \\ &= \frac{\theta b_{o,s}^{\theta} M^e}{\theta - (1-\alpha)(\sigma-1)} \left( \frac{\sigma}{\sigma-1} c\tau \right)^{1-\sigma} P^{\sigma-1} E_{d,s} (\phi^*)^{(1-\alpha)(\sigma-1)-\theta} \\ &= b_{o,s}^{\theta} M_{o,s}^e w_o^{-\theta_s} (\tau_{od,s})^{-\frac{\theta_s}{1-\alpha_s}} (f_{od,s})^{1-\frac{\theta_s}{(1-\alpha_s)(\sigma_s-1)}} (t_{o,s})^{\frac{\alpha_s \theta_s}{1-\alpha_s}} \left( \frac{E_{d,s}}{w_d} \right)^{\frac{\theta_s}{(1-\alpha_s)(\sigma_s-1)}} w_d \chi_s P_{d,s}^{\frac{\theta_s}{1-\alpha_s}} \end{aligned} \quad (\text{A.55})$$

The fourth equality follows by substituting in Equation (A.21) of  $c_{o,s}$  and Equation (A.31) of cutoff productivity  $\phi_{o,s}^*$ .

**Comment:**  $X_{od,s}$  is a sector-level aggregates of firms' revenue.

### Simplifying Free-entry Condition

Rearrange free-entry condition Equation A.52 by multiplying  $w_0$ , then substitute in Equation

(A.31) of cutoff productivity  $\phi_{o,s}^*$ , finally simply using  $P_{d,s}$  and  $X_{od,s}$ :

$$\begin{aligned}
& w_o f_{o,s}^e \frac{\theta - (\sigma - 1)(\alpha - 1)}{(\sigma - 1)(1 - \alpha)} \\
&= \sum_d \left( \frac{b_{o,s}}{\phi_{od,s}^*} \right)^{\theta_s} w_d f_{od,s} \\
&= \sum_d b_{o,s}^\theta \left[ \frac{\sigma}{\sigma - 1} \frac{c\tau}{P} \left( \frac{\sigma w_d f_{od}}{E_{d,s}} \right)^{\frac{1}{\sigma-1}} \right]^{-\frac{\theta}{1-\alpha}} w_d f_{od} \\
&= \sum_d b_{o,s}^\theta \left( \frac{\sigma}{\sigma - 1} \right)^{-\frac{\theta}{1-\alpha}} (c\tau)^{-\frac{\theta}{1-\alpha}} (P_{d,s})^{\frac{\theta}{1-\alpha}} \sigma^{-\frac{\theta}{(1-\alpha)(\sigma-1)}} (w_d f_{od,s})^{1-\frac{\theta}{(1-\alpha)(\sigma-1)}} (E_{d,s})^{\frac{\theta}{(1-\alpha)(\sigma-1)}} \\
&= \sum_d b_{o,s}^\theta \chi_s w_o^{-\theta} \tau_{od,s}^{-\frac{\theta}{1-\alpha}} (w_d f_{od,s})^{1-\frac{\theta}{(1-\alpha)(\sigma-1)}} (E_{d,s})^{\frac{\theta}{(1-\alpha)(\sigma-1)}} \\
&\cdot \left[ \sum_o M_{o,s}^e \left( \frac{w_o}{b_{o,s}} \right)^{-\theta} (\tau_{od,s})^{-\frac{\theta}{1-\alpha}} (w_d f_{od,s})^{1-\frac{\theta}{(1-\alpha)(\sigma-1)}} \chi_s (E_{d,s})^{\frac{\theta}{(1-\alpha)(\sigma-1)}} \right]^{-1} \\
&= \sum_d \frac{X_{od,s} (M_{o,s}^e)^{-1} P_{d,s}^{-\frac{\theta}{1-\alpha}} w_d^{-1} \left( \frac{E_{d,s}}{w_d} \right)^{-\frac{\theta}{(1-\alpha)(\sigma-1)}} \chi_s^{-1} \cdot \frac{\theta - (\sigma - 1)(\alpha - 1)}{\theta \sigma} E_d}{P_{d,s}^{-\frac{\theta}{1-\alpha}} \chi_s^{-1} \left( \frac{E_{d,s}}{w_d} \right)^{1-\frac{\theta}{(1-\alpha)(\sigma-1)}}} \\
&= \sum_d \frac{X_{od,s}}{M_{o,s}^e} \cdot \frac{\theta - (\sigma - 1)(\alpha - 1)}{\theta \sigma} \\
&= \frac{R_{o,s}}{M_{o,s}^e} \cdot \frac{\theta - (\sigma - 1)(\alpha - 1)}{\theta \sigma}
\end{aligned}$$

The second equality follows by substituting in Equation (A.31) of cutoff productivity  $\phi_{o,s}^*$ ; The fourth equality follows by substituting in Equation (A.21) of  $c_{o,s}$  and Equation (A.54) of  $P_{d,s}$ , then rearrange; The fifth equality follows by substituting  $X_{od,s}$  and  $P_{d,s}$ ; The last equality follows by the definition of  $R_{o,s}$ :

$$R_{o,s} = \sum_d X_{od,s} \quad (\text{A.56})$$

Rearrangement derives Equation (11) in SW(2018):

$$\frac{1 - \alpha_s}{\theta_s} \frac{\sigma_s - 1}{\sigma_s} R_{o,s} = w_o f_{o,s}^e M_{o,s}^e \quad (\text{A.57})$$

### A.3. Derivation of Labor Market Clearing

Labor supply,  $L_d = \frac{R_d}{w_d}$ , is used for five purposes. We first derive sector-specific labor demand in origin/destination country, then sum them together across sectors.

#### A.3.1. Labor for fixed costs of drawing productivity

By definition, labor for fixed costs of drawing productivity equals the mass of firms attempting to entry times the sunk fixed costs of entry:

$$L_{o,s}^e = M_{o,s}^e f_{o,s}^e \tag{A.58}$$

### A.3.2. Labor for production and abatement

Labor for production and abatement equals the mass of successful entrants times the expected labor demand, and sum it across total markets:

$$\begin{aligned}
L_{o,s}^p &= \sum_d \Pr(\phi > \phi_{od,s}^*) M_{o,s}^e \mathbf{E} [l_{od,s} \tau_{od,s} | \phi > \phi_{od,s}^*] \\
&= \sum_d [1 - G(\phi^*)] M_{o,s}^e \int_{\phi^*}^{\infty} l \tau g(\phi | \phi > \phi^*) d\phi \\
&= \sum_d M_{o,s}^e b^\theta (\phi^*)^{-\theta} \int_{\phi^*}^{\infty} q \phi^{-1} (1-a)^{-1} \tau \theta (\phi^*)^\theta \phi^{-\theta-1} d\phi \\
&= \sum_d M_{o,s}^e b^\theta \int_{\phi^*}^{\infty} p^{-\sigma} P^{\sigma-1} E_{d,s} \phi^{-1} \left( \frac{w_o}{t_{o,s}} \frac{\alpha}{1-\alpha} \right)^{-\alpha} \phi^\alpha \tau_{od,s} \theta \phi^{-\theta-1} d\phi \\
&= \sum_d M_{o,s}^e \theta b^\theta \int_{\phi^*}^{\infty} \left( \frac{\sigma}{\sigma-1} \right)^{-\sigma} (c\tau)^{-\sigma} \phi^{1-\alpha} P^{\sigma-1} E_{d,s} \left( \frac{w_o}{t_{o,s}} \frac{\alpha}{1-\alpha} \right)^{-\alpha} \phi^\alpha \tau_{od,s} \theta \phi^{-\theta-1} d\phi \\
&= \sum_d M_{o,s}^e \theta b^\theta \left( \frac{\sigma}{\sigma-1} \right)^{-\sigma} c^{-\sigma} \tau^{1-\sigma} \left( \frac{w_o}{t_{o,s}} \frac{\alpha}{1-\alpha} \right)^{-\alpha} P^{\sigma-1} E_{d,s} \cdot \frac{(\phi^*)^{(1-\alpha)(\sigma-1)-\theta}}{\theta - (1-\alpha)(\sigma-1)} \\
&= \sum_d \frac{M_{o,s}^e \theta b^\theta}{[\theta - (1-\alpha)(\sigma-1)] (\phi^*)^\theta} \left( \frac{\sigma}{\sigma-1} \right)^{-\sigma} c^{-\sigma} \tau^{1-\sigma} \left( \frac{w_o}{t_{o,s}} \frac{\alpha}{1-\alpha} \right)^{-\alpha} P^{\sigma-1} E_{d,s} \\
&\quad \cdot \left[ \frac{\sigma}{\sigma-1} \frac{c\tau}{P} \right]^{\sigma-1} \frac{\sigma w_d f_{od,s}}{E} \\
&= M_{o,s}^e \theta \sum_d \frac{b^\theta (\sigma-1)(1-\alpha)}{(\phi^*)^\theta [\theta - (1-\alpha)(\sigma-1)]} \frac{w_d}{w_o} f_{od,s} \\
&= M_{o,s}^e \theta_s f_{o,s}^e
\end{aligned}$$

The seventh equality follows by substituting in cutoff productivity  $\phi^*$  (Equation A.31); The eighth equality follows by substituting in Equation (A.21), and the last equality follows by the free-entry condition (Equation A.52).

Rewrite the last equality here:

$$L_{o,s}^p = \theta_s M_{o,s}^e f_{o,s}^e \quad (\text{A.59})$$

### A.3.3. Labor for paying pollution tax

Labor for paying pollution tax equals the sum of pollution tax normalized by wage:

**Comment:** Below  $Z_{o,s}$  is the sum of  $z_{od,s}$  across d

$$L_{o,s}^t = \frac{t_{o,s} Z_{o,s}}{w_o} \quad (\text{A.60})$$

$$= \frac{t_{o,s}}{w_o} \sum_d \Pr(\phi > \phi_{od,s}^*) M_{o,s}^e \mathbf{E}[z_{od,s} \tau_{od,s} | \phi > \phi_{od,s}^*] \quad (\text{A.61})$$

$$= \frac{t_{o,s}}{w_o} \sum_d [1 - G(\phi_{od,s}^*)] M_{o,s}^e \int_{\phi_{od,s}^*}^{\infty} (1 - a)^{\frac{1}{\alpha_s}} \phi_{od,s} l_{od,s} \tau_{od,s} g(\phi | \phi > \phi_{od,s}^*) d\phi \quad (\text{A.62})$$

$$= \frac{t_{o,s}}{w_o} \sum_d [1 - G(\phi_{od,s}^*)] M_{o,s}^e \int_{\phi_{od,s}^*}^{\infty} \frac{w_o}{t_{o,s}} \frac{\alpha_s}{1 - \alpha_s} l_{od,s} \tau_{od,s} g(\phi | \phi > \phi_{od,s}^*) d\phi \quad (\text{A.63})$$

$$= \frac{t_{o,s}}{w_o} \cdot \frac{w_o}{t_{o,s}} \frac{\alpha_s}{1 - \alpha_s} \cdot L_{o,s}^p \quad (\text{A.64})$$

$$= \frac{\alpha_s}{1 - \alpha_s} \theta_s M_{o,s}^e f_{o,s}^e \quad (\text{A.65})$$

The fifth equality follows by the second equality in deriving  $L_{o,s}^p$ .

#### A.3.4. Labor for fixed costs of entering domestic/foreign markets

Labor for entering a domestic/foreign country market equals the mass of successful entrants times the fixed costs of entry:

$$L_{d,s}^m = \sum_o M_{od,s} f_{od,s}$$

We find  $M_{od,s} f_{od,s}$  from the definition of  $X_{od,s}$ :

$$X_{od,s} = M_{od,s} \cdot \mathbf{E}[r_{od,s} | \phi > \phi_{od,s}^*] \quad (\text{A.66})$$

$$= M_{od,s} \cdot w_d f_{od,s} \cdot \frac{\theta_s \sigma_s}{\theta_s - (1 - \alpha_s)(\sigma_s - 1)} \quad (\text{A.67})$$

$$\Rightarrow M_{od,s} \cdot w_d f_{od,s} = \frac{\theta_s - (1 - \alpha_s)(\sigma_s - 1)}{\theta_s \sigma_s} \cdot \frac{X_{od,s}}{w_d} \quad (\text{A.68})$$

The second equality follows by the former part of Equation (A.49) calculating  $\mathbf{E}\left[\frac{r_{od,s}}{\sigma_s} | \phi > \phi_{od,s}^*\right]$

Therefore,

$$L_{d,s}^m = \sum_o M_{od,s} f_{od,s} \quad (\text{A.69})$$

$$= \sum_o \frac{X_{od,s}}{w_d} \frac{\theta_s - (1 - \alpha_s)(\sigma_s - 1)}{\theta_s \sigma_s} \quad (\text{A.70})$$

$$= \frac{E_{d,s}}{w_d} \frac{\theta_s - (1 - \alpha_s)(\sigma_s - 1)}{\theta_s \sigma_s} \quad (\text{A.71})$$

### A.3.5. Labor for paying trade deficits

Labor for paying trade deficits is defined by assuming there exists trade imbalance  $R_{d,s} \neq E_{d,s}$  and  $NX_{d,s} = R_{d,s} - E_{d,s}$ , the difference between total labor supply  $\frac{R_d}{w_d}$  and the above four labor demand  $\sum_s L_{d,s}^e + L_{d,s}^p + L_{d,s}^t + L_{d,s}^m$ .

We first calculate the sum of the first four labor demand. Substitute in Equation (A.57)

$$\sum_s L_{d,s}^e + L_{d,s}^p + L_{d,s}^t + L_{d,s}^m = \sum_s \frac{R_{d,s}}{w_d} \left[ \frac{(1 - \alpha)(\sigma - 1)}{\sigma \theta} + \frac{(1 - \alpha)(\sigma - 1)}{\sigma} + \frac{(\sigma - 1)\alpha}{\sigma} \right] \quad (\text{A.72})$$

$$+ \sum_s \frac{E_{d,s}}{w_d} \left[ \frac{\theta - (1 - \alpha)(\sigma - 1)}{\sigma \theta} \right] \quad (\text{A.73})$$

Note that if we assume no trade deficits, i.e.,  $E_{d,s} = R_{d,s}$ , the above equation becomes  $\frac{R_d}{w_d} = L_d$ .

We now introduce trade deficits. Define  $NX$  as net exports:

$$E_{d,s} = R_{d,s} - NX_{d,s} \quad (\text{A.74})$$

$$E_d = R_d - NX_d \quad (\text{A.75})$$

recall that the Cobb-Douglas expenditure share  $\beta_{d,s}$  implies:

$$E_{d,s} = \beta_{d,s} E_d \quad (\text{A.76})$$

so that

$$\sum_s L_{d,s}^e + L_{d,s}^p + L_{d,s}^t + L_{d,s}^m = \sum_s \frac{R_{d,s}}{w_d} - \frac{NX_{d,s}}{w_d} \frac{\theta - (1 - \alpha)(\sigma - 1)}{\sigma\theta} \quad (\text{A.77})$$

$$= \sum_s \frac{E_{d,s}}{w_d} - \frac{NX_{d,s}}{w_d} \frac{(\sigma - 1)(\theta - \alpha + 1)}{\sigma\theta} \quad (\text{A.78})$$

$$= \sum_s \beta_{d,s} \frac{E_d}{w_d} + \sum_s \frac{NX_{d,s}}{w_d} \frac{(\sigma - 1)(\theta - \alpha + 1)}{\sigma\theta} \quad (\text{A.79})$$

$$= \sum_s \beta_{d,s} \frac{R_d}{w_d} - \sum_s \beta_{d,s} \frac{NX_d}{w_d} + \sum_s \frac{NX_{d,s}}{w_d} \frac{(\sigma - 1)(\theta - \alpha + 1)}{\sigma\theta} \quad (\text{A.80})$$

$$= L_d - \sum_s \beta_{d,s} \frac{NX_d}{w_d} + \sum_s \frac{NX_{d,s}}{w_d} \frac{(\sigma - 1)(\theta - \alpha + 1)}{\sigma\theta} \quad (\text{A.81})$$

The first equality follows by substituting in  $E_{d,s} = R_{d,s} - NX_{d,s}$ ; The second equality follows by substituting in  $R_{d,s} = E_{d,s} + NX_{d,s}$ ; The third equality follows by substituting in  $E_{d,s} = \beta_{d,s} E_d$ ; The fourth equality follows by substituting in  $E_d = R_d - NX_d$ . The last equality follows by utilizing  $\sum_d \beta_{d,s} = 1$  and  $L_d = \frac{R_d}{w_d}$ . The latter two terms of the last equality are the definition of  $-L_d^{NX}$ , so that

$$L_{d,s}^{NX} \equiv \beta_{d,s} \frac{NX_d}{w_d} - \frac{NX_{d,s}}{w_d} \frac{(\sigma_s - 1)(\theta_s - \alpha_s + 1)}{\sigma_s \theta_s} \quad (\text{A.82})$$

Finally, summing across the five sector-specific labor demand and simplifying:

$$\begin{aligned}
L_d &= \sum_s L_{d,s}^e + L_{d,s}^p + L_{d,s}^t + L_{d,s}^m + L_{d,s}^{NX} \\
&= \sum_s \left[ M_{d,s}^e f_{od,s}^e \left( \theta_s + 1 + \frac{\alpha_s \theta_s}{1 - \alpha_s} \right) \right] \\
&\quad + \sum_s \left[ \frac{\theta_s - (1 - \alpha_s)(\sigma_s - 1)}{\sigma_s \theta_s} \cdot \beta_{d,s} \frac{R_d - NX_d}{w_d} \right] \\
&\quad + \sum_s \left[ \beta_{d,s} \frac{NX_d}{w_d} - \frac{NX_{d,s}}{w_d} \frac{(\sigma_s - 1)(\theta_s - \alpha_s + 1)}{\sigma_s \theta_s} \right] \\
&= \sum_s \left[ M_{d,s}^e f_{od,s}^e \left( \theta_s + 1 + \frac{\alpha_s \theta_s}{1 - \alpha_s} \right) \right] \\
&\quad + \sum_s \left[ \frac{\theta_s - (1 - \alpha_s)(\sigma_s - 1)}{\sigma_s \theta_s} \cdot \beta_{d,s} L_d \right] \\
&\quad + \sum_s \left[ \left( \frac{\theta_s - (1 - \alpha_s)(\sigma_s - 1)}{\sigma_s \theta_s} - 1 \right) \beta_{d,s} \frac{NX_d}{w_d} - \frac{NX_{d,s}}{w_d} \frac{(\sigma_s - 1)(\theta_s - \alpha_s + 1)}{\sigma_s \theta_s} \right]
\end{aligned}$$

The first equality follows by substituting in Equation (A.57) and  $E_{d,s} = \beta_{d,s} E_d = \beta_{d,s} (R_d - NX_d)$ ;

The second equality follows by substituting  $\frac{R_d}{w_d}$  by  $L_d$ .

Then, the last equality solves  $L_d$ :

$$\begin{aligned}
L_d \cdot \left( 1 - \sum_s \frac{\theta_s - (1 - \alpha_s)(\sigma_s - 1)}{\sigma_s \theta_s} \beta_{d,s} \right) &= \sum_s M_{d,s}^e f_{od,s}^e \left( \theta_s + 1 + \frac{\alpha_s \theta_s}{1 - \alpha_s} \right) \\
&\quad - \left( \frac{\theta_s - (1 - \alpha_s)(\sigma_s - 1)}{\sigma_s \theta_s} - 1 \right) \beta_{d,s} \frac{NX_d}{w_d} \\
&\quad - \frac{(\sigma_s - 1)(\theta_s - \alpha_s + 1) NX_{d,s}}{\sigma_s \theta_s w_d}
\end{aligned} \tag{A.83}$$

**Comment:** One appealing thing of the expression for  $L_d$  is that it is a function of  $w_d$ ,  $M_{d,s}^e$  and  $\beta_{d,s}$ ,  $NX$ , where the former two are endogenous parameters in the model, and the latter two can be observed in the data.

#### A.4. Derivation of Hat Algebra

Using *hat algebra* to denote changes,

$$\hat{x} \equiv \frac{x'}{x}$$



where  $x'$  is the counterfactual value.

For the ease of exposition and calculation, sunk fixed costs of drawing a productivity  $f^{eod,s}$  are assumed to be unchanged.

#### A.4.1. Hat Algebra of Free-entry Condition (Equation A.57)

We first write Equation (A.57) in the hat form:

$$\frac{w'_o}{w_o} = \frac{R'_{o,s}}{R_{o,s}} \frac{M_{o,s}^e}{M_{o,s}^{e'}} \Rightarrow \hat{w}_o \cdot \hat{M}_{o,s}^e = \hat{R}_{o,s} = \sum_d \zeta_{od,s} \hat{X}_{od,s} \quad (\text{A.84})$$

where  $\zeta_{od,s}$  measures the bilateral trade flow share from  $o$  to  $d$  (i.e., export share over revenue):

$$\zeta_{od,s} = \frac{X_{od,s}}{\sum_d X_{od,s}} = \frac{X_{od,s}}{R_{o,s}} \quad (\text{A.85})$$

**Comment:** In practice,  $\hat{R}_{o,s}$  is hard to measure, so that we need to convert it to some function of “shocks”.

We then calculate  $\hat{X}_{od,s}$ :

Define  $\Upsilon_{od,s}$

$$\Upsilon_{od,s} \equiv \left( \frac{w_o}{b_{o,s}} \right)^{-\theta_s} (\tau_{od,s})^{-\frac{\theta_s}{1-\alpha_s}} (f_{od,s})^{1-\frac{\theta_s}{(1-\alpha_s)(\sigma_s-1)}} (t_{o,s})^{\frac{\alpha_s \theta_s}{1-\alpha_s}} \quad (\text{A.86})$$

such that

$$X_{od,s} = M_{o,s}^e \Upsilon_{od,s} P_d^{-\frac{\theta}{1-\alpha}} \left( \frac{E_d}{w_d} \right)^{\frac{\theta}{(1-\alpha)(\sigma-1)}} w_d \chi_s \quad (\text{A.87})$$

$$= \frac{M_{o,s}^e \Upsilon_{od,s}}{\sum_o M_{o,s}^e \Upsilon_{od,s}} \cdot E_{d,s} \quad (\text{A.88})$$

To simplify the fraction, define  $\lambda_{od,s}$  measuring the bilateral trade flow share from  $d$  to  $o$  (i.e., import share over expenditure):

$$\lambda_{od,s} = \frac{X_{od,s}}{\sum_o X_{od,s}} = \frac{X_{od,s}}{E_{d,s}} \quad (\text{A.89})$$

By definition,

$$\lambda_{od,s} = \frac{M_{o,s}^e \Upsilon_{od,s}}{\sum_o M_{o,s}^e \Upsilon_{od,s}} \equiv \frac{M_{o,s}^e \Upsilon_{od,s}}{\Omega_{d,s}} \quad (\text{A.90})$$

where

$$\Omega'_{d,s} = \sum_o M_{o,s}^{e'} \Upsilon'_{od,s} \quad (\text{A.91})$$

$$= \sum_o \hat{M}_{o,s}^e M_{o,s}^e \cdot \hat{\Upsilon}_{od,s} \Upsilon_{od,s} \quad (\text{A.92})$$

$$= \sum_o \hat{M}_{o,s}^e \hat{\Upsilon}_{od,s} \cdot M_{o,s}^e \Upsilon_{od,s} \quad (\text{A.93})$$

$$= \sum_o \hat{M}_{o,s}^e \hat{\Upsilon}_{od,s} \cdot \Omega_{d,s} \cdot \lambda_{od,s} \quad (\text{A.94})$$

$$\Rightarrow \hat{\Omega}_{d,s} = \frac{\Omega'_{d,s}}{\Omega_{d,s}} = \frac{1}{\sum_o \lambda_{od,s} \hat{M}_{o,s}^e \hat{\Upsilon}_{od,s}} \quad (\text{A.95})$$

Therefore,

$$\hat{X}_{od,s} = \frac{X'_{od,s}}{X_{od,s}} \quad (\text{A.96})$$

$$= \hat{M}_{o,s}^e \hat{\Upsilon}_{od,s} \hat{E}_{d,s} \cdot \frac{\Omega_{d,s}}{\Omega'_{d,s}} \quad (\text{A.97})$$

$$= \frac{\hat{M}_{o,s}^e \hat{\Upsilon}_{od,s}}{\sum_o \lambda_{od,s} \hat{M}_{o,s}^e \hat{\Upsilon}_{od,s}} \cdot \hat{E}_{d,s} \quad (\text{A.98})$$

$$= \frac{\hat{M}_{o,s}^e \hat{\Upsilon}_{od,s}}{\sum_o \lambda_{od,s} \hat{M}_{o,s}^e \hat{\Upsilon}_{od,s}} \cdot \hat{\beta}_{d,s} \cdot \frac{\hat{R}_d R_d - \hat{N} X_d N X_d}{R_d - N X_d} \quad (\text{A.99})$$

Substitute Equation (A.96) back to Equation (A.84) derives Equation (3):

$$\hat{w}_o - \sum_d \frac{\zeta_{od,s} \hat{w}_o^{-\theta_s} \hat{\Gamma}_{od,s}}{\sum_o \lambda_{od,s} \hat{w}_o^{-\theta_s} \hat{\Gamma}_{od,s}} \cdot \hat{\beta}_{d,s} \cdot \frac{\hat{w}_d R_d - \hat{N} X_d N X_d}{R_d - N X_d} = 0 \quad (\text{A.100})$$

where  $\hat{R}_d R_d = \hat{w}_d R_d$  utilizes  $\hat{L}_d = \frac{R'_d}{w'_d} \cdot \frac{w_d}{R_d} = \frac{\hat{R}_d}{\hat{w}_d} = 1$ .

#### A.4.2. Recover Historical Value of $\hat{\Gamma}_{od,s}$

To derive foreign/domestic competition  $\hat{\Gamma}_{od,s}$ , rewrite Equation (18) in SW(2018) by definition,

$$\hat{\Gamma}_{od,s} \equiv \left( \frac{1}{\hat{b}_{o,s}} \right)^{-\theta_s} (\hat{\tau}_{od,s})^{-\frac{\theta_s}{1-\alpha_s}} (\hat{f}_{od,s})^{1-\frac{\theta_s}{(1-\alpha_s)(\sigma_s-1)}} (\hat{t}_{o,s})^{\frac{\alpha_s \theta_s}{1-\alpha_s}} \quad (\text{A.101})$$

Rewrite Equation (A.55) of  $X_{od,s}$  in the hat form and contrast it with  $\hat{\Gamma}_{od,s}$ :

$$\hat{X}_{od,s} = \hat{\Gamma}_{od,s} \cdot \hat{M}_{o,s}^e \hat{w}_o^{-\theta_s} \hat{P}_{d,s}^{\frac{\theta_s}{1-\alpha_s}} \hat{E}_{d,s}^{\frac{\theta_s}{(1-\alpha_s)(\sigma_s-1)}} \hat{w}_d^{\frac{\theta_s}{(1-\alpha_s)(\sigma_s-1)}-1} \quad (\text{A.102})$$

so that we can derive  $\hat{\Gamma}_{od,s}$ , then simplify by substituting Equation (A.89) of  $\lambda_{od,s}$  in the hat form:

$$\hat{\Gamma}_{od,s} = \hat{X}_{od,s} \left( \hat{M}_{o,s}^e \right)^{-1} \hat{w}_o^{\theta_s} \hat{P}_{d,s}^{-\frac{\theta_s}{1-\alpha_s}} \hat{E}_{d,s}^{-\frac{\theta_s}{(1-\alpha_s)(\sigma_s-1)}} \hat{w}_d^{1-\frac{\theta_s}{(1-\alpha_s)(\sigma_s-1)}} \quad (\text{A.103})$$

$$= \frac{\hat{\lambda}_{od,s}}{\hat{M}_{o,s}^e \hat{w}_o^{-\theta_s}} \hat{P}_{d,s}^{-\frac{\theta_s}{1-\alpha_s}} \hat{E}_{d,s}^{-\frac{\theta_s}{(1-\alpha_s)(\sigma_s-1)}} \hat{w}_d^{1-\frac{\theta_s}{(1-\alpha_s)(\sigma_s-1)}} \quad (\text{A.104})$$

$$= \frac{\hat{\lambda}_{od,s}}{\hat{M}_{o,s}^e \hat{w}_o^{-\theta_s}} \hat{P}_{d,s}^{-\frac{\theta_s}{1-\alpha_s}} \left( \frac{\hat{\beta}_{d,s} \hat{R}_d \hat{R}_d - \hat{N} \hat{X}_d \hat{N} \hat{X}_d}{\hat{w}_d \hat{R}_d - \hat{N} \hat{X}_d} \right)^{1-\frac{\theta_s}{(1-\alpha_s)(\sigma_s-1)}} \quad (\text{A.105})$$

The second equality follows by substituting in  $\hat{\lambda}_{od,s} = \frac{\hat{X}_{od,s}}{\hat{E}_{d,s}}$ ; The third equality follows by substituting in  $\hat{E}_{d,s} = \hat{\beta}_{d,s} \hat{E}_d = \hat{\beta}_{d,s} \frac{R'_d - N X'_d}{R_d - N X_d}$ .

#### A.4.3. Hat Algebra of Labor Market Clearing (Equation A.83)

Define two terms as in SW(2018):

$$\eta_{o,s} \equiv \left( \frac{\theta_s - (1-\alpha_s)(\sigma_s-1)}{\sigma_s \theta_s} - 1 \right) \beta_{d,s} N X_d - \frac{(\sigma_s-1)(\theta_s-\alpha_s+1)}{\sigma_s \theta_s} N X_{d,s} \quad (\text{A.106})$$

$$\Psi_o \equiv \left[ 1 - \sum_s \frac{\theta_s - (1-\alpha_s)(\sigma_s-1)}{\sigma_s \theta_s} \beta_{d,s} \right] \cdot \left[ 1 - \sum_s \frac{\theta_s - (1-\alpha_s)(\sigma_s-1)}{\sigma_s \theta_s} \beta'_{d,s} \right]^{-1} \quad (\text{A.107})$$

Write Equation (A.83) into the hat form:

$$\frac{L'_o}{L_o} = \frac{R'_o}{R_o} \cdot \frac{w_o}{w'_o} = \Psi_o \left[ \frac{\sum_s \frac{R'_{o,s}}{w'_o} \cdot \frac{(1-\alpha)(\sigma-1)}{\sigma\theta} \cdot \left(\theta + 1 + \frac{\alpha\theta}{1-\alpha}\right) + \frac{\eta'_o}{w'_o}}{\sum_s \frac{R_{o,s}}{w_o} \cdot \frac{(1-\alpha)(\sigma-1)}{\sigma\theta} \cdot \left(\theta + 1 + \frac{\alpha\theta}{1-\alpha}\right) + \frac{\eta_o}{w_o}} \right] \quad (\text{A.108})$$

$$\Rightarrow \hat{R}_o = \Psi_o \left[ \frac{\sum_s R'_{o,s} \cdot \frac{(\sigma-1)(\theta-\alpha+1)}{\sigma\theta} + \eta'_o}{\sum_s R_{o,s} \cdot \frac{(\sigma-1)(\theta-\alpha+1)}{\sigma\theta} + \eta_o} \right] \quad (\text{A.109})$$

$$\Rightarrow \hat{R}_o = \Psi_o \left[ \frac{\sum_s \hat{R}_{o,s} R_{o,s} \cdot \frac{(\sigma-1)(\theta-\alpha+1)}{\sigma\theta} + \eta'_o}{\sum_s R_{o,s} \cdot \frac{(\sigma-1)(\theta-\alpha+1)}{\sigma\theta} + \eta_o} \right] \quad (\text{A.110})$$

$$\Rightarrow \frac{\hat{R}_o}{\hat{w}_o} = \Psi_o \left[ \frac{\sum_s \frac{\hat{R}_{o,s}}{\hat{w}_o} R_{o,s} \cdot \frac{(\sigma-1)(\theta-\alpha+1)}{\sigma\theta} + \eta'_o}{\sum_s R_{o,s} \cdot \frac{(\sigma-1)(\theta-\alpha+1)}{\sigma\theta} + \eta_o} \right] \quad (\text{A.111})$$

$$\Rightarrow \hat{L}_o = \Psi_o \left[ \frac{\sum_s \frac{\hat{R}_{o,s}}{\hat{w}_o} R_{o,s} \cdot \frac{(\sigma-1)(\theta-\alpha+1)}{\sigma\theta} + \frac{\eta'_o}{\hat{w}_o}}{\sum_s R_{o,s} \cdot \frac{(\sigma-1)(\theta-\alpha+1)}{\sigma\theta} + \eta_o} \right] \quad (\text{A.112})$$

$$\Rightarrow 1 = \Psi_o \left[ \frac{\sum_s \hat{M}_{o,s}^e R_{o,s} \cdot \frac{(\sigma-1)(\theta-\alpha+1)}{\sigma\theta} + \frac{\eta'_o}{\hat{w}_o}}{\sum_s R_{o,s} \cdot \frac{(\sigma-1)(\theta-\alpha+1)}{\sigma\theta} + \eta_o} \right] \quad (\text{A.113})$$

The first equality follows by substituting in Equation (A.57); The fourth equality follows by multiplying LHS and RHS with  $\frac{1}{w_o}$ ; The fifth equality follows by substituting in the hat algebra form of Equation (A.57) and utilizes the normalized labor supply/demand  $\frac{L'_d}{L_d} = 1$ .

#### A.4.4. Hat Algebra of Pollution Emissions (Equation 1)

$Z_{o,s}$  appears in Equation (A.65) where we derive labor demand for paying pollution tax

$$Z_{o,s} = \frac{w_o}{t_{o,s}} \cdot \frac{\alpha_s}{1-\alpha_s} \theta_s M_{o,s}^e f_{o,s}^e \quad (\text{A.114})$$

$$\Rightarrow \hat{Z}_{o,s} = \frac{\hat{w}_o \hat{M}_{o,s}^e}{\hat{t}_{o,s}} \quad (\text{A.115})$$

## B — Code Appendix

### B.1. Code for conditional CDF

```
1  import numpy as np
2  import matplotlib.pyplot as plt
3  from scipy.stats import norm
4
5  # Define the original distribution: standard normal
6  phi = np.linspace(-3, 3, 500)
7  g_phi = norm.pdf(phi)
8  G_phi = norm.cdf(phi)
9
10 # Threshold
11 phi_star = 0.5
12 mask = phi > phi_star
13
14 # Conditional density
15 g_cond = np.zeros_like(phi)
16 g_cond[mask] = g_phi[mask] / (1 - norm.cdf(phi_star))
17
18 # Plot
19 plt.figure(figsize=(8,5))
20 plt.plot(phi, g_phi, label="Original density  $g(\phi)$ ", lw=2)
21 plt.plot(phi, g_cond, label="Conditional density  $g(\phi \mid \phi > \phi^*)$ ", lw
    =2, color="red")
22 plt.axvline(phi_star, color="black", ls="--", label=" $\phi^*$ ")
23
24 plt.title("Original vs Conditional Density", fontsize=14)
25 plt.xlabel(" $\phi$ ", fontsize=12)
26 plt.ylabel("Density", fontsize=12)
27 plt.legend()
28 plt.grid(alpha=0.3)
29 plt.show()
```

Code 1: Code for PDF and Conditional PDF of Pareto Distribution

## B.2. Code for Algorithm to solve $\hat{w}_o$ and $\hat{M}_{o,s}^e$

```

1  function diff = solveWhatMhat(guess, baseline, shocks, loop_shock, n, N, J,
2      parameter)
3
4      %=====
5      % Purpose: Solve the nonlinear system of Eq.(12) + Eq.(13)
6      % Inputs:
7      %   guess      = Initial guesses (hats of wages and firm numbers)
8      %   baseline   = Baseline data (year 1990)
9      %   shocks     = Various shocks (Gamma_hat_foreign, Gamma_hat_US, etc.)
10     %   loop_shock = Type of shock (1=Foreign, 2=US, 3=Regulation, 4=Expenditure)
11     %   n          = Year index
12     %   N          = Number of countries
13     %   J          = Number of industries
14     %   parameter  = Model parameters (alpha, sigma, theta)
15     % Output:
16     %   diff = Residuals of Eq.(12) + Eq.(13) (passed to fsolve to approach zero)
17     %=====
18
19     %% ----- 1. Initialize shock variables (Appendix Step 1) -----
20     Gamma_hat = ones(N,N,J); % bilateral productivity shifter
21     beta_hat  = ones(N,J);   % expenditure share shock
22     NX_hat    = ones(N,1);   % net exports shock (agg.)
23     NXs_hat   = ones(N,J);   % net exports shock (sectoral)
24
25     if loop_shock == 1
26         Gamma_hat = shocks.Gamma_hat_foreign(:,:,n); % Foreign competitiveness shock
27     elseif loop_shock == 2
28         Gamma_hat = shocks.Gamma_hat_US(:,:,n);      % U.S. competitiveness shock
29     elseif loop_shock == 3
30         Gamma_hat = shocks.t_hat(:,:,n);             % Environmental regulation shock
31     elseif loop_shock == 4
32         beta_hat  = squeeze(shocks.beta_hat(:,:,n)); % Expenditure share shock
33     end

```

```

34
35 %% ----- 2. Recover wages & firm numbers from guess -----
36 % guess = [ w_US ; M_hat(N*J) ]
37 w_US = guess(1);
38
39 % Foreign wage determined by numeraire constraint:
40 % w_US * (R_US / total R) + w_F * (R_F / total R) = 1
41 w_foreign = (1 - w_US .* baseline.R(2, :)) ./ baseline.R(1, :);
42
43 w_hat = [w_foreign; w_US]; % N×1
44
45 % Firm number change (N×J)
46 M_hat = reshape(guess(2:end), [N J]);
47
48 %% ----- 3. Eq.(13): Wage condition -----
49
50 w_hat_nnj = reshape(w_hat, [N 1 1]);
51 w_d_hat_nnj = reshape(w_hat, [1 N 1]);
52 M_hat_nnj = reshape(M_hat, [N 1 J]);
53 beta_hat_nnj = reshape(beta_hat, [1 N J]);
54 NX_d_hat_nnj = reshape(NX_hat, [N 1 1]);
55
56 baseline.R_d_nnj = reshape(baseline.R, [1 N 1]);
57 baseline.NX_nj = reshape(baseline.NX, [N 1]);
58 baseline.NX_d_nnj = reshape(baseline.NX, [1 N 1]);
59
60 parameter.theta_nnj = reshape(parameter.theta, [1 1 J]);
61
62 diff1 = w_hat_nnj - sum( (baseline.zeta .* w_hat_nnj.^(-parameter.theta_nnj) .*
63     Gamma_hat) ...
64     ./ (sum(baseline.lambda .* M_hat_nnj .* w_hat_nnj.^(-parameter.theta_nnj) .*
65         Gamma_hat, 1)) ...
66     .* beta_hat_nnj ...
67     .* ( (w_d_hat_nnj .* baseline.R_d_nnj - NX_d_hat_nnj .* baseline.NX_d_nnj) ...
68         ./ (baseline.R_d_nnj - baseline.NX_d_nnj) ...
69     ) ...

```

```

68     ,2);
69
70     diff1 = squeeze(diff1);
71     diff1 = reshape(diff1, [N*J 1]);
72
73     %% ----- 4. Eq.(12): Market equilibrium condition (resource condition) -----
74     % Parameter constants
75     cons1 = (parameter.theta - (parameter.sigma-1).*(1-parameter.alpha)) ...
76     ./ (parameter.sigma .* parameter.theta);
77     cons2 = ((parameter.sigma-1).*(parameter.theta-parameter.alpha+1)) ...
78     ./ (parameter.sigma .* parameter.theta);
79
80     cons1 = reshape(cons1, [1 J]);
81     cons2 = reshape(cons2, [1 J]);
82
83     %  $\psi$ : (Footnote 16)
84     psi = (1 - sum(cons1 .* baseline.beta, 2)) ...
85     ./ (1 - sum(cons1 .* beta_hat .* baseline.beta, 2));
86     psi = reshape(psi, [N 1]);
87
88     %  $\eta$ : (Footnote 16)
89     eta_0 = sum( (-cons1+1) .* baseline.beta .* baseline.NX_nj ...
90     - baseline.NXs .* cons2 , 2);
91
92     %  $\eta_{post}$ :
93     eta_0_post = sum( (-cons1+1).*beta_hat.*baseline.beta.*NX_hat.*baseline.NX_nj ...
94     - NXs_hat.*baseline.NXs.*cons2, 2);
95     eta_0_post = eta_0_post ./ w_hat;
96
97
98     eta_0      = reshape(eta_0, [N 1]);
99     eta_0_post = reshape(eta_0_post, [N 1]);
100
101     % Eq.(12): resource condition
102     diff2 = 1 - psi .* ( sum(M_hat .* baseline.Rs .* cons2, 2) + eta_0_post ) ...
103     ./ ( sum(baseline.Rs .* cons2, 2) + eta_0 );

```



```

104 diff2 = diff2(2:end); % drop one equation (numeraire country)
105
106 %% ----- 5. Combine residuals of Eq.(12)+(13) -----
107 diff = [diff2; diff1];
108
109 end

```

Code 2: Matlab code for Algorithm to solve  $\hat{w}_o$  and  $\hat{M}_{o,s}^e$

### B.3. Code for Data Processing $X_{od,s}$

```

1 %=====
2 % Date:      2025-10-10
3 % Author:    Wenjie Luo
4 %
5 % Purpose:
6 %   This script solves the nonlinear system consisting of Eq. (12) and
7 %   Eq. (13) in the model. The system determines the equilibrium wage
8 %   and the number of firms (in hat values) under various counterfactual
9 %   scenarios. Numerical methods (fsolve) are used to find the solution
10 %   based on the baseline calibration and specified shocks.
11 %
12 % Reference:
13 %   - Shapiro, J.S. and Walker, R. (2018). "Why Is Pollution from U.S.
14 %     Manufacturing Declining? The Roles of Environmental Regulation,
15 %     Productivity, and Trade". American Economic Review, 108(12),
16 %     3814-3854.
17 %
18 % Notes:
19 %   - Input data "rawFile.mat" comes from replication file in SW2018
20 %   - CHANGE "pollution_index" \in [1, 7] in Line 41 for different pollutants
21 %=====
22
23 clear all;
24 clc;
25

```

```

26 % Try to set the working directory automatically
27 if isempty(mfilename('fullpath'))
28 % Fall back to current folder if script is run interactively
29 currentPath = pwd;
30 else
31 currentPath = fileparts(mfilename('fullpath'));
32 cd(currentPath);
33 end
34
35
36
37 %% ===== Basic Settings =====
38 load rawFile.mat
39
40 % Select the index of the pollutant (1=CO, 2=NOx, 3=PM10, ...)
41 pollution_index = 1;
42
43 % Data structure: xbilat(o,d,j,t)
44 % o: origin countries (2: foreign, US)
45 % d: destination countries (2: foreign, US)
46 % j: industries (17 industries)
47 % t: years (19 years, -1990:2008)
48 %
49 % Original data:
50 % co2_poll(j,t) - CO2 emissions (6 observed years)
51 % poll(j,t,p) - emissions of 7 pollutants (6 observed years)
52 % vship(o,j,t) - production by country and industry (equivalent to Rs)
53 % xbilat(o,d,j,t) - bilateral trade flows
54
55 %% ===== Parameter Settings =====
56 N = 2; % Number of countries (1=foreign, 2=US)
57 us = 2; % US index
58 J = 17; % Number of industries
59 Y = 19; % Number of years
60 yvec = 1990:2008;
61 pollutants = {'co', 'nox', 'pm10', 'pm25', 'so2', 'voc', 'co2'};

```

```

62
63 % run plot_pollution_trend.m
64
65 % parameter: model parameters
66 % alpha: pollution elasticity: Table 2, Column (2)
67 parameter.alpha = [.0040; .0022; .0103; .0223; .0212; .0205; .0048; .0303; .0557;
68                   .0019; .0015; .0023; .0005; .0014; .0016; .0019; .0047];
69
70 % inputshare: wL/R: Table 2, Column (3)
71 inputshare = [.74;.79;.83;.79;.88;.70;.78;.73;.85;.79;.76;.81;.79;.65; .82;.74;.73];
72
73 % sigma: elasticity of substitution <- Footnote 8, App p19
74 parameter.sigma = (1-parameter.alpha)./((1-parameter.alpha)-inputshare);
75
76 % theta: Pareto shape parameter: Table 2, Column (5)
77 parameter.theta = [4.81; 5.38; 8.30; 4.29; 17.52; 4.13; 5.02; 3.39; 9.72; 5.60;
78                   4.30; 5.07; 4.13; 2.09; 5.29; 3.27; 4.77];
79
80 % pm.dirty: dirty industries; pm.dirty: clean industries
81 % parameter.dirty = [4 5 6 8 9];
82 % parameter.clean = [1 2 3 7 10 11 12 13 14 15 16 17];
83
84 %% ===== Data Processing =====
85 % Total import expenditure and total revenue
86 Es = squeeze(sum(xbilat,1)); % destination-sector-year  $\sum(\text{origin})$ 
87 Rs = squeeze(sum(xbilat,2)); % origin-sector-year  $\sum(\text{destination})$ 
88 NXs = Rs - Es; % Net exports by industry
89
90 E = squeeze(sum(Es,2)); % destination-year
91 R = squeeze(sum(Rs,2)); % origin-year
92 NX = R - E; % Net exports by country
93
94 %  $\beta$ : CES expenditure share
95 beta = Es ./ reshape(E, [N 1 Y]); % d×j×t
96 lambda = xbilat ./ reshape(Es, [1 N J Y]); % o×d×j×t, expenditure share
97 zeta = xbilat ./ reshape(Rs, [N 1 J Y]); % o×d×j×t, revenue share

```

```

96
97 % extrapolate CO2 emissions
98 % [1991,1994,1998,2002,2006,2010] -> (1990:2008)
99 for j = 1:J
100 Z_co2(j,:) = interp1([1991,1994,1998,2002,2006,2010]',co2_poll(j,:)',(1990:2008) ','
    linear','extrap')';
101 for n = 1:length(pollutants)
102 Z(j,:,n) = interp1q([1990,1996,1999,2002,2005,2008]',poll(j,:,n)',(1990:2008)')';
103 end
104 end
105 Z(:,:,7) = Z_co2;
106
107 %% ===== Baseline Data (t=1, 1990) =====
108 baseline.xbilat = xbilat(:,:,:,1);
109 baseline.lambda = lambda(:,:,:,1);
110 baseline.zeta = zeta(:,:,:,1);
111 baseline.Rs = Rs(:,:,:,1); % origin×sector
112 baseline.R = R(:,1); % origin
113 baseline.NXs = NXs(:,:,:,1); % origin×sector
114 baseline.NX = NX(:,1); % origin
115 baseline.Z = Z(:,1,:); % sector×pollutant
116 baseline.wage = baseline.R; % Baseline wage □ income
117 baseline.beta = beta(:,:,1); % destination×sector
118
119 %% ===== Hat Variables =====
120 lambda_hat = lambda ./ baseline.lambda;
121 Z_hat = Z ./ baseline.Z;
122 Rs_hat = Rs ./ baseline.Rs;
123 R_hat = R ./ baseline.R;
124 NXs_hat = NXs ./ baseline.NXs;
125 NX_hat = NX ./ baseline.NX;
126 w_hat = R ./ baseline.wage; % Equation (13), wage hats
127 M_hat = Rs_hat ./ reshape(w_hat, [N 1 Y]); % Equation (11), mass of firms
    hats
128
129 %% ===== Shocks =====

```

```

130  beta_hat = beta ./ baseline.beta;
131
132  % Pollution tax (Eq. 15)
133  t_hat = reshape(M_hat, [N 1 J Y]) ...
134  .* reshape(w_hat, [N 1 1 Y]) ...
135  ./ reshape(Z_hat(:, :, pollution_index), [1 1 J Y]);
136  t_hat = squeeze(t_hat);
137
138  % Construct 4D arrays (o×d×j×t) to be substituted into Eq.19 / Eq.21
139  M_hat_4D = reshape(M_hat, [N 1 J Y]);
140  w_hat_4D = reshape(w_hat, [N 1 1 Y]);
141  w_d_hat_4D = reshape(w_hat, [1 N 1 Y]);
142  beta_hat_4D = reshape(beta_hat, [1 N J Y]);
143  R_hat_4D = reshape(R_hat, [N 1 1 Y]);
144  R_d_hat_4D = reshape(R_hat, [1 N 1 Y]);
145  NX_hat_4D = reshape(NX_hat, [N 1 1 Y]);
146  NX_d_hat_4D = reshape(NX_hat, [1 N 1 Y]);
147  t_hat_4D = reshape(t_hat, [N 1 J Y]);
148
149  baseline.R_d_4D = reshape(baseline.R, [1 N 1 1]);
150  baseline.NX_d_4D = reshape(baseline.NX, [1 N 1 1]);
151
152  parameter.theta_4D = reshape(parameter.theta, [1 1 J 1]);
153  parameter.sigma_4D = reshape(parameter.sigma, [1 1 J 1]);
154  parameter.alpha_4D = reshape(parameter.alpha, [1 1 J 1]);
155
156
157  %% ===== Gamma (Eq.19, Eq.21) =====
158  Gamma_hat_star = lambda_hat ...
159  ./ (M_hat_4D .* w_hat_4D.^(-parameter.theta_4D)) ...
160  .* ( (beta_hat_4D ./ w_d_hat_4D) ...
161  .* ((R_d_hat_4D.*baseline.R_d_4D - NX_d_hat_4D.*baseline.NX_d_4D) ...
162  ./ (baseline.R_d_4D - baseline.NX_d_4D)) ...
163  ).^( 1 - parameter.theta_4D ./ ((parameter.sigma_4D - 1).*(1 - parameter.alpha_4D))
164  );
165  % Foreign only

```

```

165 Gamma_hat_foreign = [Gamma_hat_star(1,:,:,:); ones(1,2,J,Y)];
166 % US only, with environmental tax shock (Eq.21)
167 Gamma_hat_US = Gamma_hat_star ./ t_hat_4D.^( -(parameter.alpha_4D.*parameter.
    theta_4D)./(1-parameter.alpha_4D) );
168 Gamma_hat_US = [ones(1,2,J,Y); Gamma_hat_US(2,:,:,:)];
169
170 % Save
171 shocks.Gamma_hat_foreign = Gamma_hat_foreign;
172 shocks.Gamma_hat_US = Gamma_hat_US;
173 shocks.beta_hat = reshape(beta_hat,[1 N J Y]);
174
175 t_hat_shcok = t_hat_4D.^( - (parameter.alpha_4D .* parameter.theta_4D) ...
176 ./ (1 - parameter.alpha_4D) ...
177 );
178 t_hat_shcok = squeeze(t_hat_shcok);
179 shocks.t_hat = reshape([ones(1, 17, 19); t_hat_shcok(2, :, :)], [N 1 17 19]);
180
181 save('my_results.mat');
182
183 %% ===== Step 1: Construct Initial Guess =====
184 % Corresponds to Appendix p.22 Step 1
185 % Initial guess: current wage change (w_hat) and firm number change (M_hat)
186 % Dimension: [ (-N1 wages) + (N*J firms) ] × 1 vector
187 for n = 1:Y
188     guess(:, n) = [ w_hat(2, n); ... % US wage change (foreign
        wage as numeraire)
189     reshape(M_hat(:, :, n), [N*J, 1]) ]; % Firm number change for each
        country×industry
190 end
191
192 %% ===== Step 2: Solve the Nonlinear System Using fsolve
        =====
193 % Corresponds to Appendix p.22 Step 2
194 % Solve the system of equations (Eq.12, Eq.13), unknowns = w (-N1) + M (N*J)
195 % Number of equations = number of unknowns → system solvable
196 options = optimset('Display','off', ...

```

```

197 'MaxFunEvals',60000, ...
198 'MaxIter',4500, ...
199 'TolFun',1e-14, ...
200 'TolX',1e-14, ...
201 'Algorithm','trust-region-dogleg');
202
203 for n = 1:Y
204     for loop_shock = 1:4    % Four types of shocks (Appendix p.22 Step 3)
205         initial_guess = squeeze(guess(:, n));
206
207         % Call fsolve to solve Eq.(12)+(13)
208         [solver, fval, flag] = fsolve(@(g) solveWhatMhat(g, baseline, shocks, loop_shock, n,
209             N, J, parameter), ...
210             initial_guess, options);
211
212         % ===== Step 3: Update Variables (Eq.12, Eq.13) =====
213         % Results from fsolve include:
214         % solver(1) = w_US (wage change)
215         % solver(2:end) = M_hat (firm number change, reshaped to N×J)
216
217         % Recover wage changes (foreign wage determined by numeraire)
218         w_US = solver(1);
219         w_foreign = (1 - w_US .* (baseline.R(2) ./ sum(baseline.R))) ...
220             ./ (baseline.R(1) ./ sum(baseline.R));
221         % w_us * US's GDP(or wage) share + w_foreign * Foreign's GDP(or wage) share = 1
222         w_hat = [w_foreign; w_US];    % N×1 vector
223
224         % Firm number change (N×J matrix)
225         M_hat = reshape(solver(N:end), [N J]);
226
227         % Expand wages to N×J for emission calculation
228         w_hat_nj = reshape(w_hat,[N 1]);
229
230         % ===== Counterfactual Emissions (Eq.15, Eq.19, Eq.21)
231         =====
232         if loop_shock == 3

```

```

231 % Regulation shock
232 Z_hat_counterfactual(:,:,n,loop_shock) = (w_hat_nj .* M_hat) ./ squeeze(t_hat(:,:,n)
    );
233 else
234 % Other shocks, pollution tax fixed at baseline
235 Z_hat_counterfactual(:,:,n,loop_shock) = (w_hat_nj .* M_hat) ./ squeeze(t_hat(:,:,1)
    );
236 end
237 end
238 end
239
240 %% ===== Calculate Aggregate Emissions (Weighted Average, Eq.22)
    =====
241 % Weight = baseline pollution level (Z0)
242 Z0_sum = sum(baseline.Z(:,:,pollution_index),1); % Sectoral baseline pollution
    Σorigin
243 Z0_sum = reshape(Z0_sum, [1 1 1]);
244
245 % Counterfactual US emission path (weighted sum, converted to %)
246 Z_hat_counterfactual_us = squeeze(Z_hat_counterfactual(us,:,:,));
247 Z_hat_counterfactual_us = sum(Z_hat_counterfactual_us .* baseline.Z(:,:,,
    pollution_index),1) ./ Z0_sum;
248 Z_hat_counterfactual_us = squeeze(Z_hat_counterfactual_us) .* 100;
249
250 % Actual data (observed emission trajectory)
251 Z_hat_real = squeeze(sum(Z(:,:,,pollution_index),1))';
252 Z_hat_real = Z_hat_real ./ Z_hat_real(1) .* 100;
253
254 % Combine actual and counterfactual results
255 Z_hat_counterfactual_us = [Z_hat_real'; Z_hat_counterfactual_us'];
256
257 %% ===== Plotting =====
258 % Create a folder called "figure" (if it doesn't exist)
259 figDir = fullfile(currentPath, 'figure');
260 if ~exist(figDir, 'dir')
261 mkdir(figDir);

```



```

262 end
263
264 nei_yrs = [1990 1996 1999 2002 2005 2008];
265 nei_yrsIndex = [1 7 10 13 16 19];
266
267 f = figure('Visible','on');
268 figHandles(pollution_index) = f; % store handle for later combination
269 clf;
270
271 plot(1990:2008,Z_hat_counterfactual_us(:,1),'-','LineWidth',2.5); hold on;
272
273 plot(nei_yrs,Z_hat_counterfactual_us(nei_yrsIndex,2),'rp','LineWidth',1.5);
274 plot(nei_yrs,Z_hat_counterfactual_us(nei_yrsIndex,3),'ro','LineWidth',1.5);
275 plot(nei_yrs,Z_hat_counterfactual_us(nei_yrsIndex,4),'rs','LineWidth',1.5);
276 plot(nei_yrs,Z_hat_counterfactual_us(nei_yrsIndex,5),'rv','LineWidth',1.5);
277
278 plot(1990:2008,Z_hat_counterfactual_us(:,2),'--r','LineWidth',1.5);
279 plot(1990:2008,Z_hat_counterfactual_us(:,3),'--r','LineWidth',1.5);
280 plot(1990:2008,Z_hat_counterfactual_us(:,4),'--r','LineWidth',1.5);
281 plot(1990:2008,Z_hat_counterfactual_us(:,5),'--r','LineWidth',1.5);
282
283 set(gca,'FontSize',13,'YTick',[0 30 60 90 120 150],'XTick',[1990 1995 2000 2005
    2010]);
284 axis([1990 2008 0 150]);
285 xlabel('Year'); ylabel('1990=100'); box off;
286 legend('Actual Data (All Shocks)', ...
287 'Foreign Competitiveness Shocks Only', ...
288 'U.S. Competitiveness Shocks Only', ...
289 'U.S. Regulation Shocks Only', ...
290 'U.S. Expenditure Share Shocks Only', ...
291 'Location','Southwest');
292 title(upper(pollutants{pollution_index}));
293 saveas(f, fullfile(figDir, [pollutants{pollution_index}, '.png']));

```

Code 3: Matlab code for Data Processing  $X_{od,s}$