Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Moderating the costs of implementing global climate policy in a post-Kyoto world

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Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Background and objective

- Climate negotiations raise the concerns about the issue of the short and long-term macroeconomic impacts and competitiveness loss.Since Copenhagen COP, many debates on the burden sharing and financial transfer of GHG mitigation between Annex I and developing countries.

- This study aims to evaluate the strategies and consequences of different negotiations schemes across Annex I and emerging countries in terms of emissions reduction and impacts on GDP growth.

- We investigate the extent to which global instruments (emissions trading) and domestic complementary policies (fiscal reform) may help mitigate economic costs when combined with appropriate tax recycling regimes.

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Existing Literature

- The international emission trading between parties is a cost-saving and flexible policy instrument in environmental regulations, and suited to restrict the emissions of a uniformly dispersed pollutant such as CO_2 (Tietenberg 1985, Klaassen 1996).

- Pizer (2002) demonstrates that the expected welfare gains from optimal price is significantly higher than optimal quantity policy to address global emissions mitigation even under suboptimal condition.

- However, the climate policy instruments often have to address a second-best world (Sassi et al.2010), and the uniform price policy seems to be very difficult to implement as most developing countries are reluctant to accept global emissions caps. Partial participation would be an alternative policy choice during the transition period.

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

- A number of application of CGE models to evaluate economic implications for climate policies under different policy circumstances, especially in the sectoral agreement based approach:

  - Carone et al.(2009) use a game theory based CGE model to show that emission trade would be effective even when countries behave non cooperatively.Smaller groups perform better than agreements with larger number of countries.

  - Hamdi-Cherif et al.(2011) show that a sectoral agreement based emission trading policy (electric power sector) with reduction in pre-existing taxes would achieve almost the same emissions reduction targets in the case of global cap and trade scenario. Redistribution of auction revenue is found to be more cost-effective than lump sum transfer to households, in line with Parry(1995).

  - Gavard et al.(2011) analyze trade carbon permits between the Chinese electricity sector and a U.S. economy-wide cap-and-trade program using the MIT EPPA model. And this sectoral policy induces significant financial transfers between the two countries. Nearly half of capped emissions in the U.S (valued at $42bn) will be purchased from China in 2030.

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Simulation strategies
Scenarios design

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Simulation strategies
Scenarios design

Simulation method

- Numerical simulations have been carried out with IMACLIM-R model(developed at CIRED) which accounts for imperfect foresight and infrastructure inertia as a result of short-sighted investments.

- In order to identify the main drivers of the structural changes of carbon emissions mitigation and to account for uncertainty of prospective energy supply and demand and underlying energy price, we simulate several combinations of parameters associating oil market(e.g. OPEC's strategies) with technological progress.

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Simulation strategies
Scenarios design

Simulation method

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Drivers of endogenous technical change may be twofold:

- knowledge progress along with capital accumulation (learning by doing);

- changes in relative price of production factors(Hicks induced innovation)partly due to public policy.

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Simulation strategies
Scenarios design

- IMACLIM-R is a hybrid CGE model which combine the TD and BU approaches by ensuring the consistence between energy and economy in the modelling framework.

  – 12 regions and 12 sectors,

  – hybrid model of money and physical flows.

  – both the characteristics of myopic agents and infrastructure's inertia result in high transition costs in the case of climate policy constraints.

- A comprehensive description of the model is available in Crassous et al. (2008); Guivarch et al.(2009); Sassi et al.(2010); Cassen et al.(2010);and Rozenberg et al.(2010).

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Simulation strategies
Scenarios design

IMACLIM is characterised by a recursive dynamic framework:

- Succession of **static equilibriums** under short-term constraints;

  - Consistent Macroeconomic snapshot
  - Technology and capacity constraints

- **Moving constraints** informed by reduced forms of BU models

- A comprehensive price & physical quantities account :

  - Hybrid matrices, physical production capacities, physical i/o coefficients
  - Secure the dialogue with sector-based expertise (sources of technical inertia, technical asymptotes in efficiency gains ...)
  - Assure consistency between economic projections and technical projections

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Simulation strategies
Scenarios design

Schematic representation of IMACLIM model

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Simulation strategies
Scenarios design
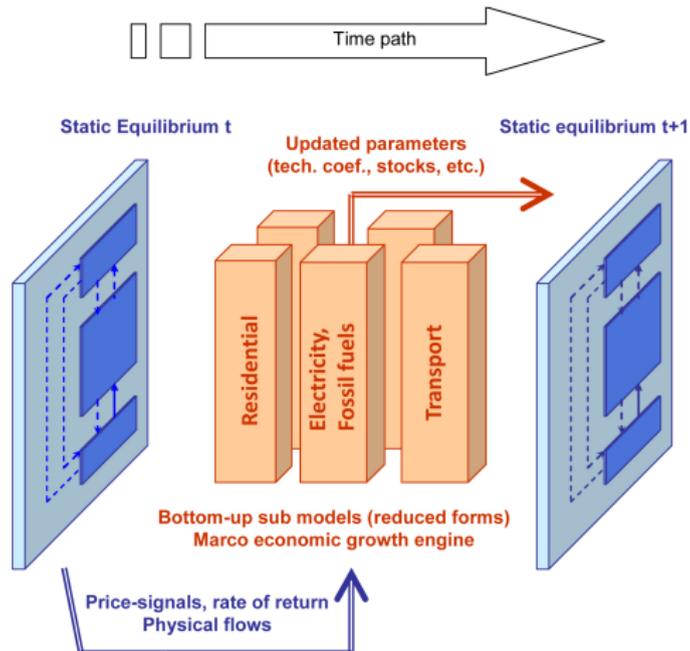
Storylines description

- BAU scenario refers to the situation in which no climate policy is implemented in any country over the period.

- In policy scenarios, world emissions trajectories are imposed exogenously to pursue certain climate targets (Copenhagen pledges or international agreement).

- Policy scenarios simulated in this study comprise an array of assumptions of engagement of Annex I countries and India and China in terms of carbon intensity reduction pledges announced at the Copenhagen COP.

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Simulation strategies
Scenarios design

Tax recycling regime

- Based on revenue-neutral, carbon tax is assumed to be recycled in two fashions:

  1. Only to households(HLDS);
  2. Recycled to all carbon tax payers including producers (LS).

- Only fossil fuels combustion related CO_2 emissions are accounted for, land use change and other GHG emissions are excluded.

- Note that the trading mechanism *per se* will not change the world emission profiles, it is actually playing a role of financial resource transfer to minimise the global costs to achieve the emissions targets.

- Under $450ppm$ scenarios, no international emissions trading is allowed and every country make mitigation efforts only domestically.

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Simulation strategies
Scenarios design

Scenario	EU target	Participants	Trading	Carbon tax recycling
BAU	No constraint	None		NA
$1A_h$	-30%	Annex I	No	households
$1A_{ls}$	-30%	Annex I	No	LS
$1B_h$	-30%	Annex I; IND; CHN	No	households
$1B_{ls}$	-30%	Annex I; IND; CHN	No	LS
$2A_h$	-30%	Annex I	Yes	households
$2A_{ls}$	-30%	Annex I	Yes	LS
$2B_h$	-30%	Annex I; IND; CHN	Yes	households
$2B_{ls}$	-30%	Annex I; IND; CHN	Yes	LS
450_h	$450ppm\ CO_2$	world	No	households
450_{ls}	$450ppm\ CO_2$	world	No	LS

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios

1 Introduction

2 Method

3 Results

4 Implications for extended Copenhagen framework

5 Conclusions

6 Appendix

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios
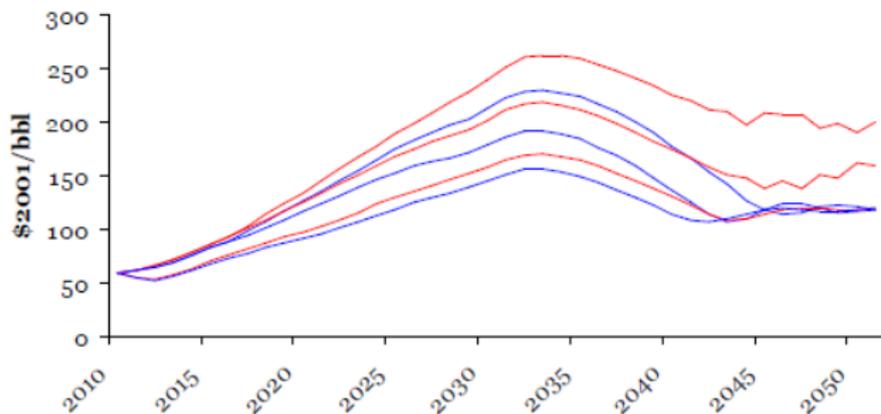
- There exist considerable difference amongst six core scenarios; ranging between $150 - 250US\$/bbl$ by 2035.

- Oil reserve assumptions influence heavily the oil price.

- Also,slower pace of technical change results in accelerated rise in oil price.

- The decline in oil price is explained by deployment of electric vehicles (partly decarbonized car fleet) from 2030 as well as endogenous technical change.

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios

Global CO_2 emissions BAU compared with SRES
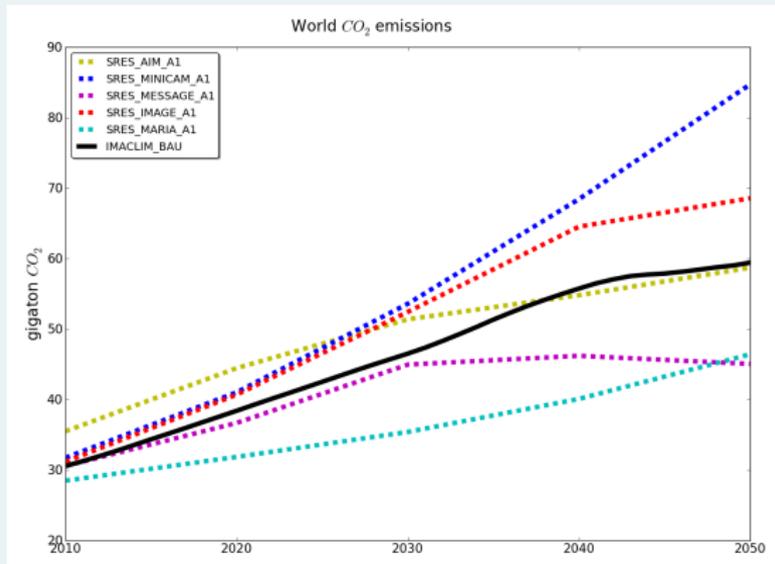
- IMACLIM's central BAU falls in the SRES A1 family

- sustained GDP growth in the world through 2050 → 2.8% per year

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios

Global CO_2 emissions under BAU
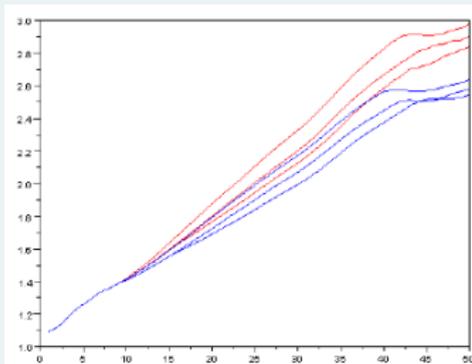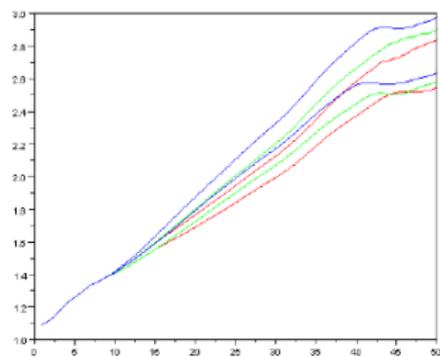
(a) Technical change   (b) oil reserve

- CO_2 emissions grow steadily in all scenarios until 2040; due to oil reserve depletion mechanism; and faster penetration of energy technologies reflect gradual transformation in production system , in which case the emissions trajectories bend downward sharply by 2050.

- Emissions are likely to stabilize around 2050 regardless of oil reserve assumptions (price effect will drive up the uptake of low carbon technologies).

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios

CO_2 emissions across regions without trading
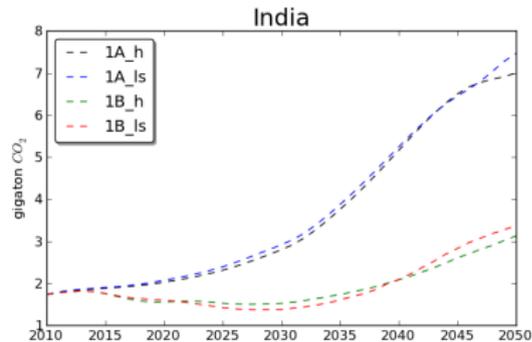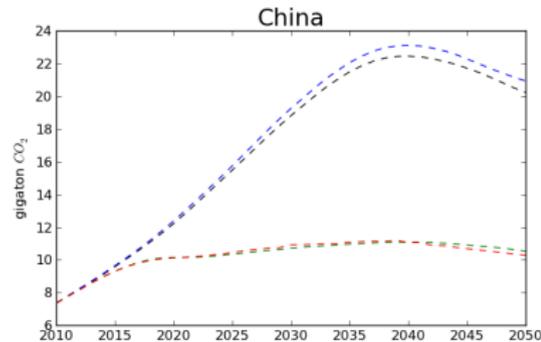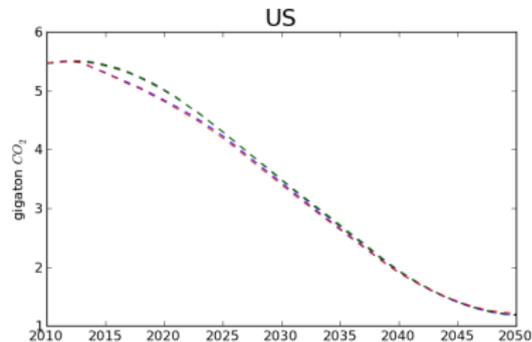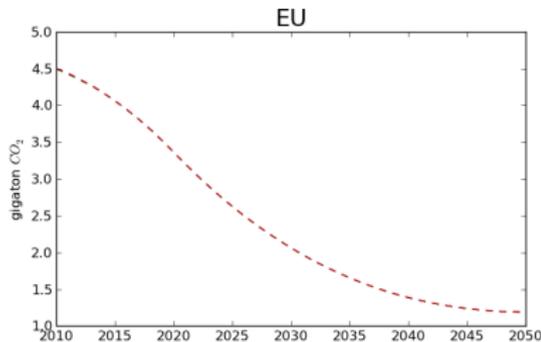
CO_2 emissions without emission trading

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios

CO_2 emissions across regions with trading
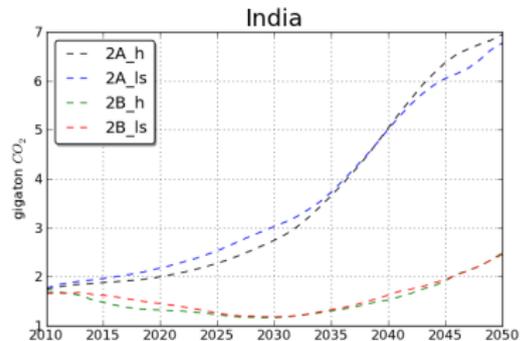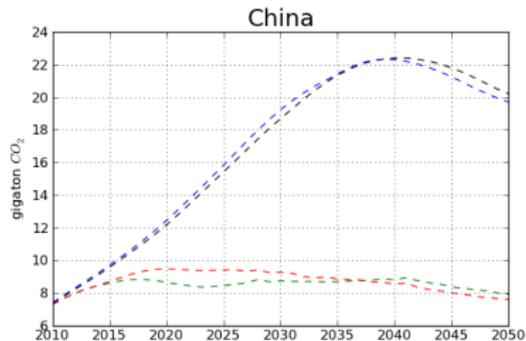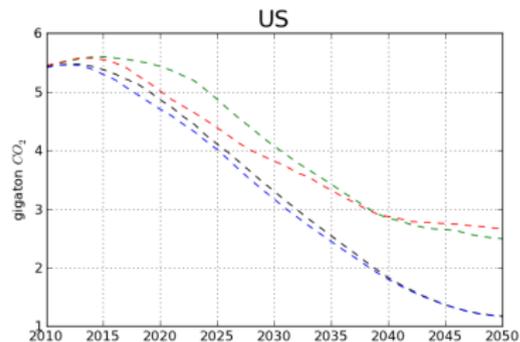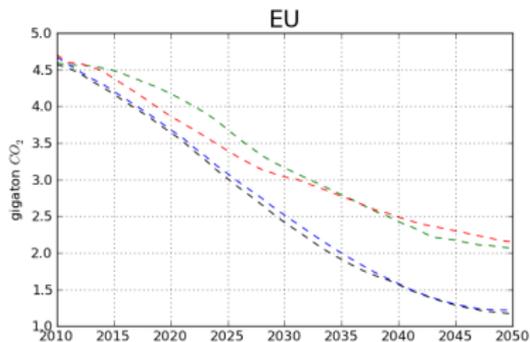
CO2 emissions with emission trading

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios

CO_2 emissions across regions in 450 ppm scenario
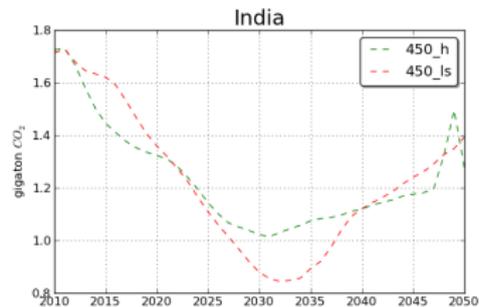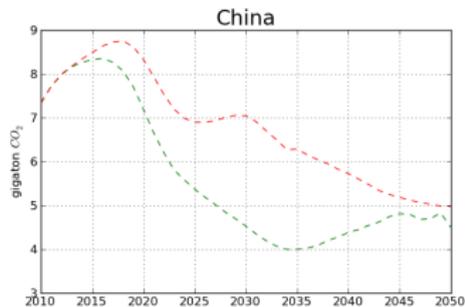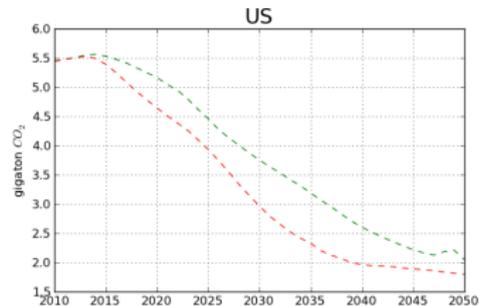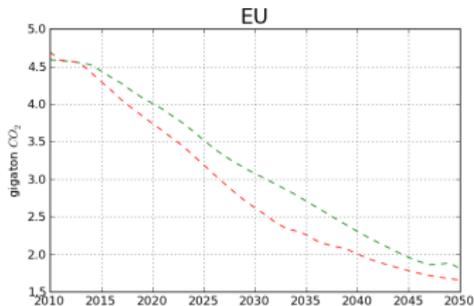
CO_2 emissions under 450 ppm

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios

GDP growth variation in EU (relative to BAU)
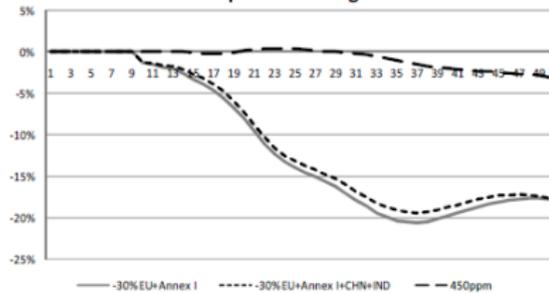
Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios
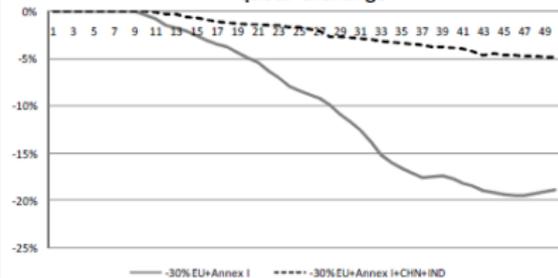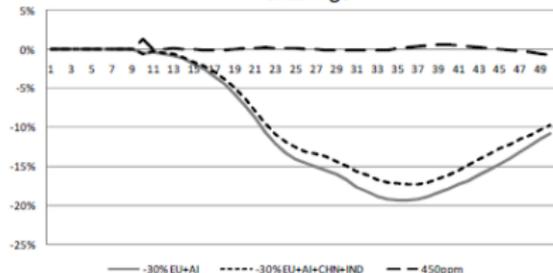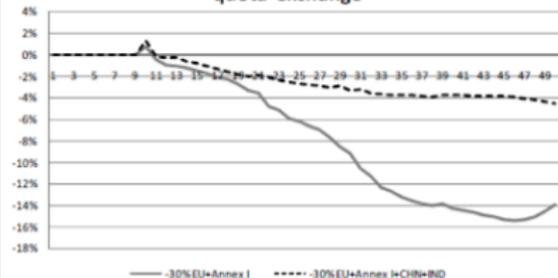
Comments on impacts on GDP growth in EU

- GDP growth rate loss in EU would be reduced significantly when India and China commit to their Copenhagen pledges. This is not surprising as the negative impact on economic competitiveness of EU would be largely mitigated when other regions participate in climate mitigation actions instead of acting alone.

- Most importantly, the variation in GDP growth rate in EU would be nearly neutral in the case of global caps aiming at 450*ppm*.
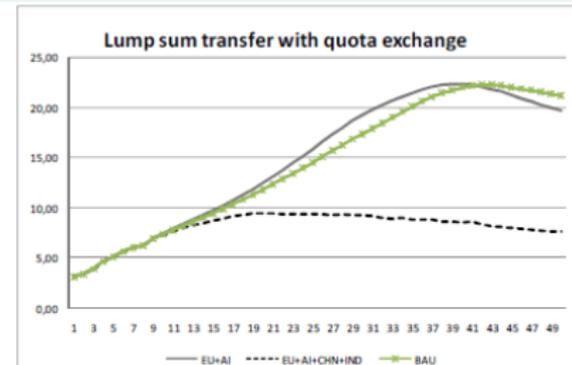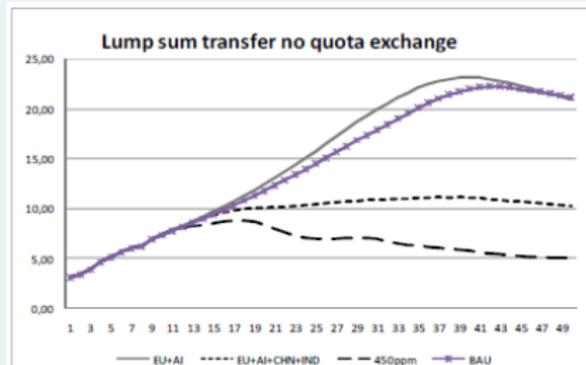
Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
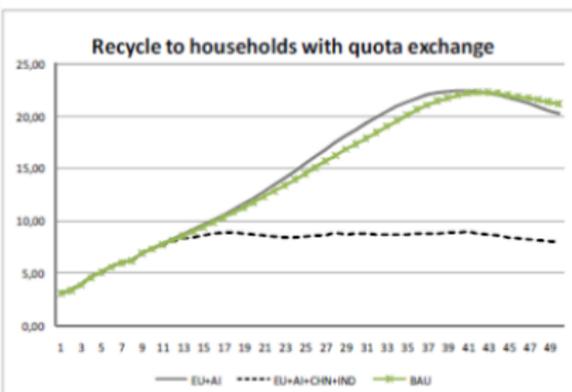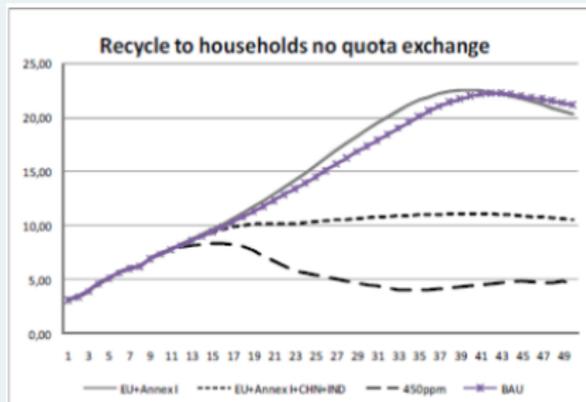**EU scenarios**
U.S scenarios
China scenarios
world scenarios

Isses of carbon tax recycling

- The carbon tax recycling regime has extremely impact on carbon tax to achieve the emissions targets in Europe. Lump-sum redistribution results in a factor of 3 of carbon tax compared to recycling to households.

- This result is somewhat counterintuitive since reduction in pre-tax is thought to be more cost-efficient than recycling to households for enhancing the economic competitiveness in most cases.

- Also, the global caps for $450ppm$ would reduce significantly the carbon tax burden in Europe, this is consistent with the findings in existing literature.

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
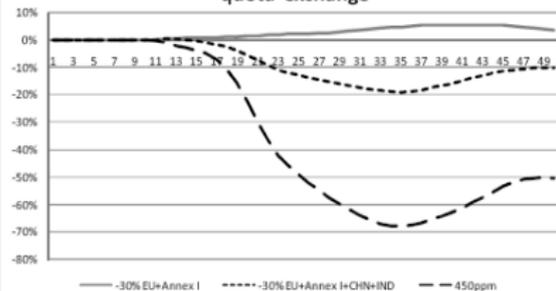China scenarios
world scenarios

The case of US.

- Similar to the situation in Europe, US would need less efforts in emissions reduction when China and India participate in the climate deal and fulfil their pledges.

- US GDP would suffer most in the case of non-participation of China and India with LS of carbon tax recycling, GDP growth rate be 25% lower relative to the BAU case, compared to only less than 3% when India and China commit to their Copenhagen pledges.

- 450 ppm would make US GDP increase much faster than other scenarios as its comparative economic competitiveness would be enhanced at the expense of China and India and other emerging countries.
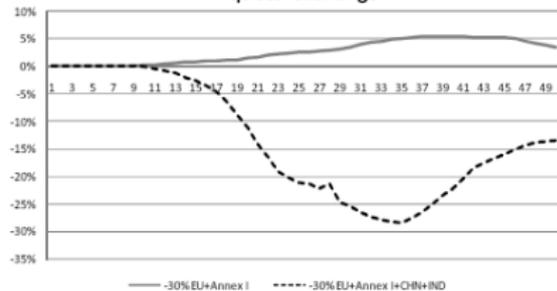
Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios

China's CO_2 emissions trajectories

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios

GDP growth variation in China (relative to BAU)

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios
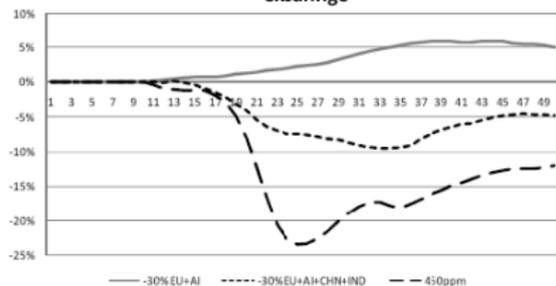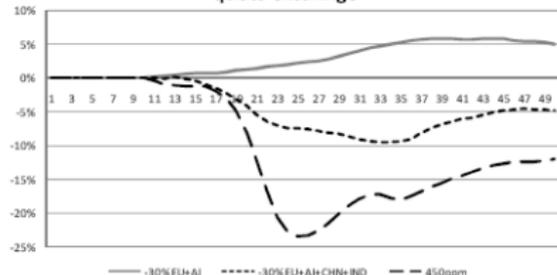
Impacts on China's CO_2 emissions

- China's emissions would be lower than BAU when participating in the global climate deal together with Annex I and India. China does have incentives to to reduce further if the allowances can be traded internationally.

- Global emissions would be higher than BAU in the case of participation of Annex I only; consistent with the theoretical prediction of carbon leakage.

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios

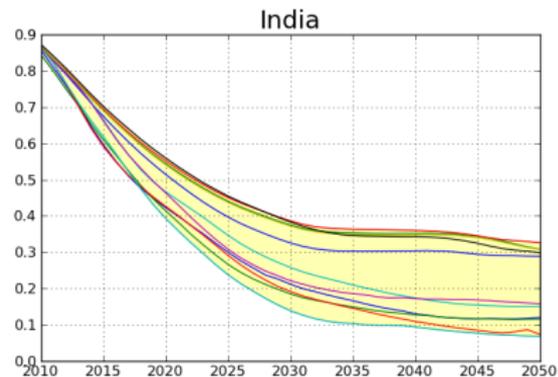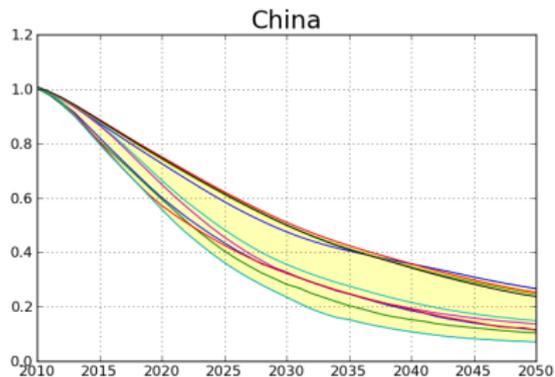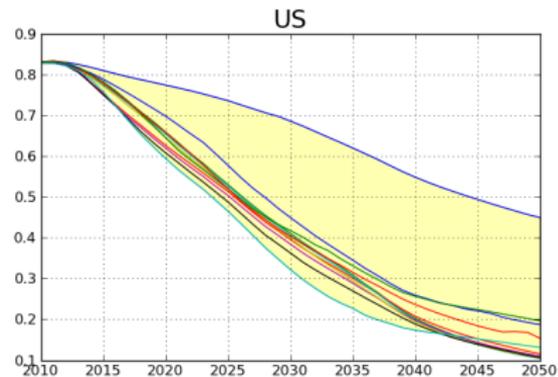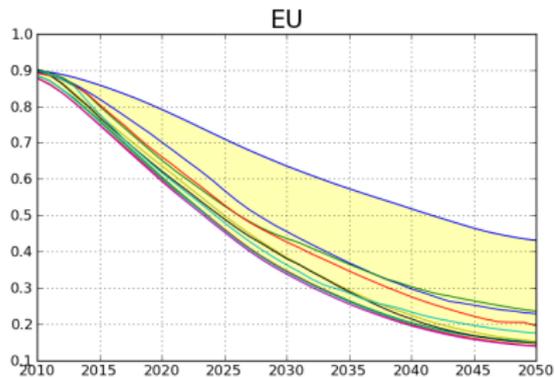## Impacts on China's GDP growth

- Unlike EU, non-participation of China (non commitment of Copenhagen pledge) will make Chinese GDP increase faster at the expense of Europe and other Annex I countries, as its comparative advantages are enhanced by gaining larger market share as the relative production price is lower.

- By contrast, the commitment to $450ppm$ trajectory would be extremely costly for China's economy as its annual real GDP growth rate may be sacrificed significantly.

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios

Two main factors may explain the large reduction in GDP growth rate for strong climate policy
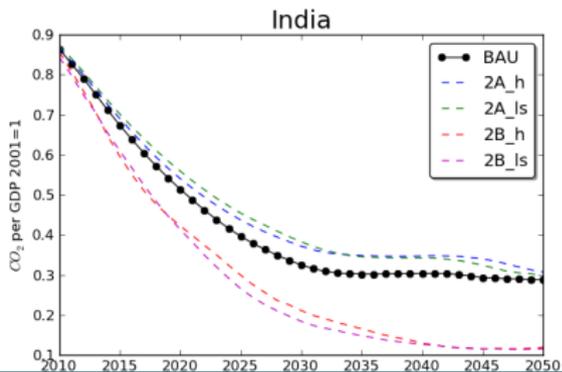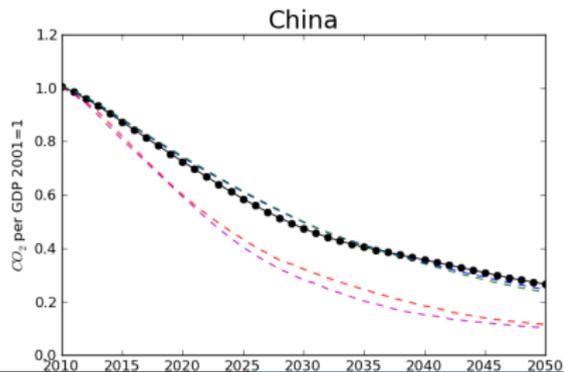
- The sharp decrease in exterior demand for energy and carbon intensive goods and services, the exports shrink consequently on the one hand;

- Ageing demography as well as decreasing working population result in declining saving rates and sluggish domestic consumption and investment.

Tax recycling is crucial in determining the negative impact of implementing strong climate policy, instruments must be selected with care to minimize the negative impacts on GDP.

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios

Carbon intensity reduction across 4 regions in all scenarios

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios

Carbon intensity reduction across 4 regions with trading

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios
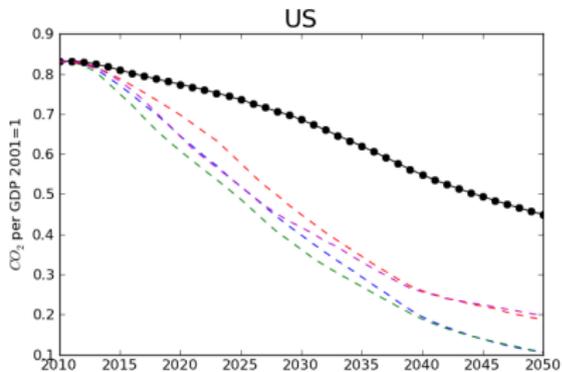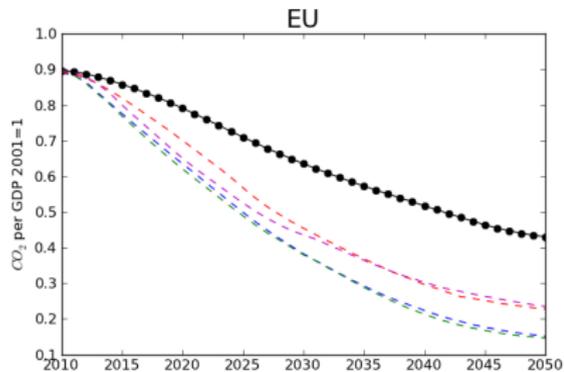
Carbon tax across regions when no trade is allowed

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios

Carbon tax across regions with trading

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios
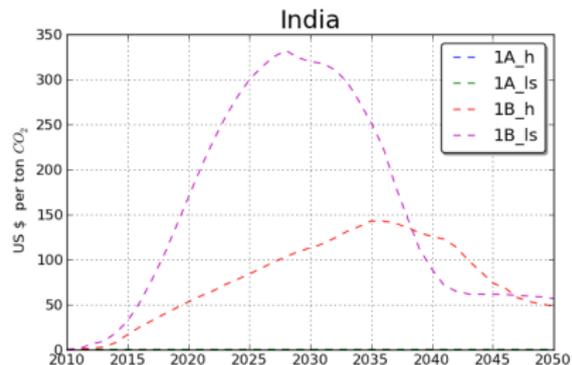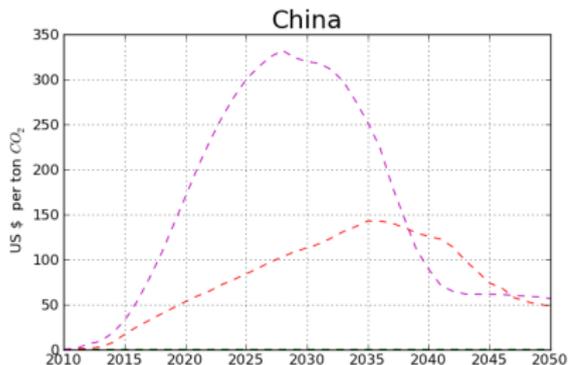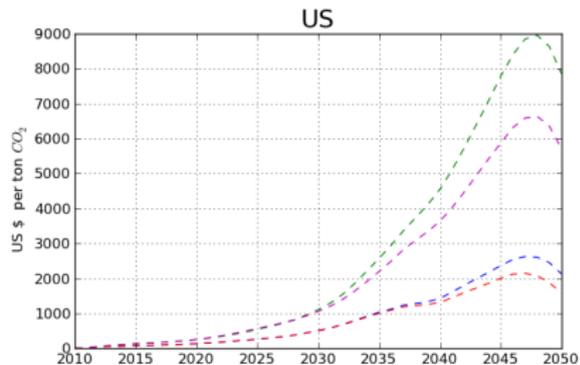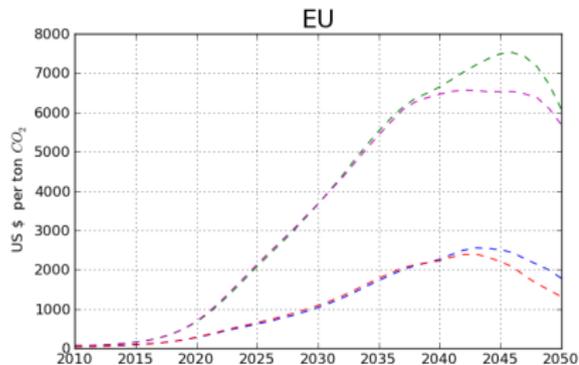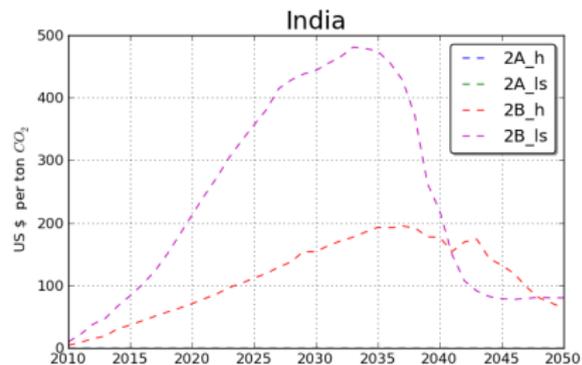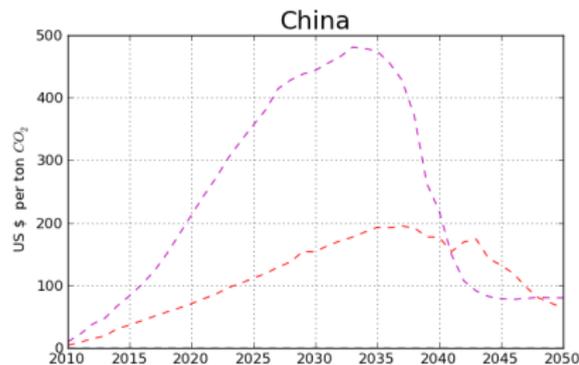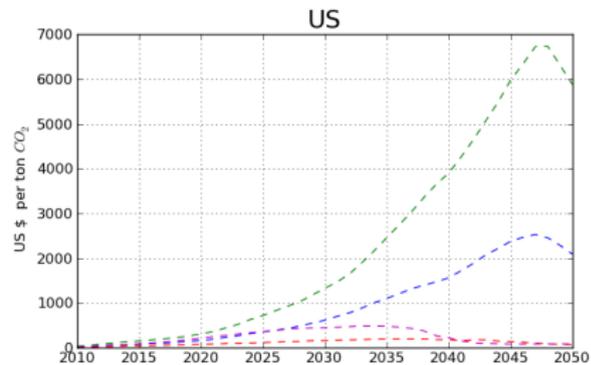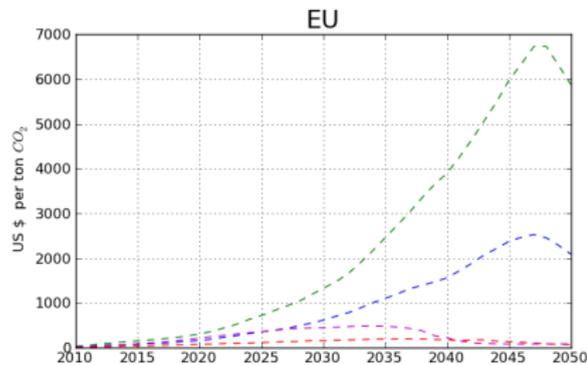
Unique carbon tax in 450 ppm scenario

World unique carbon tax in 450 ppm

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios
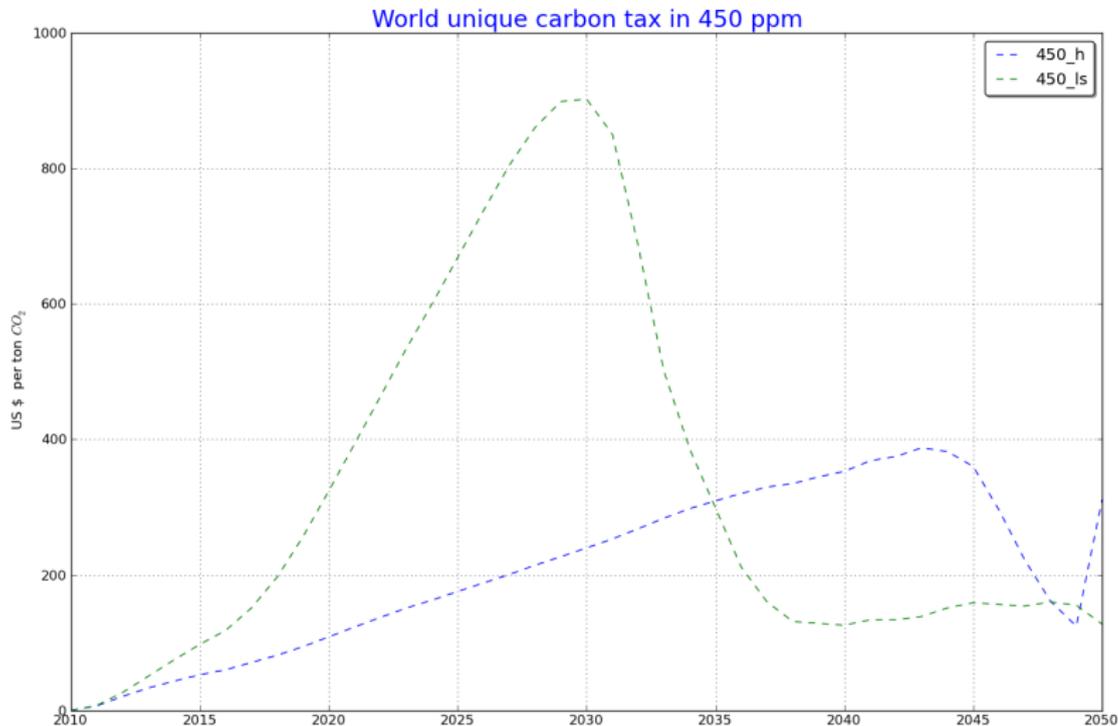
World energy prices without emission trading

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios
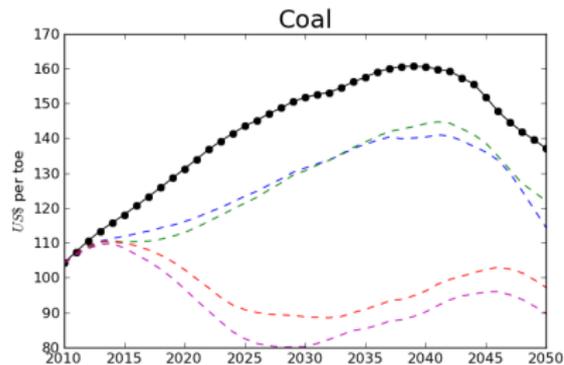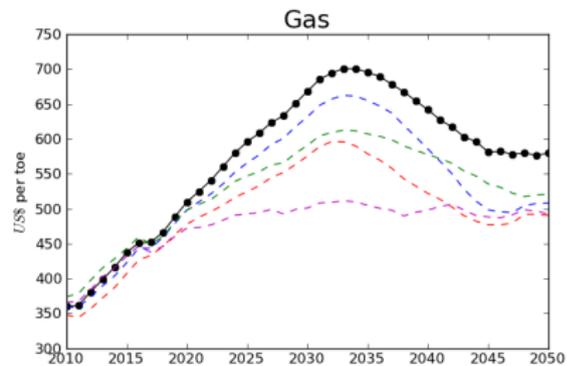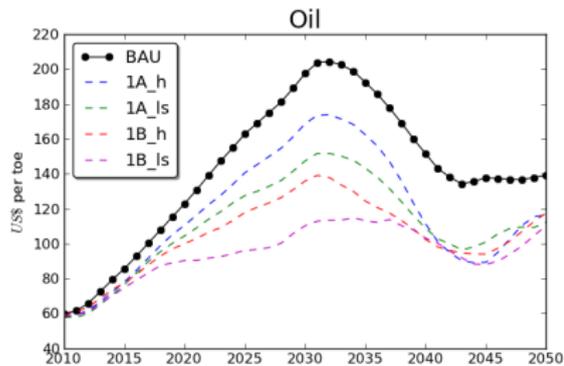
World energy prices with emission trading

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

BAU cases
EU scenarios
U.S scenarios
China scenarios
world scenarios
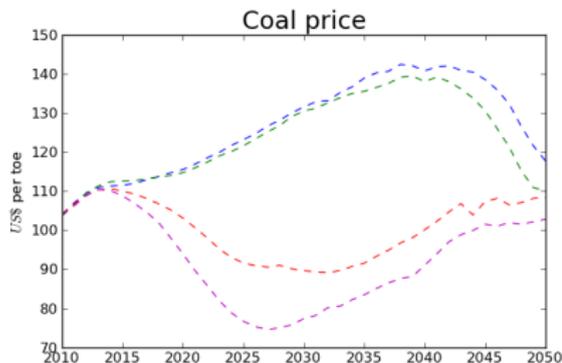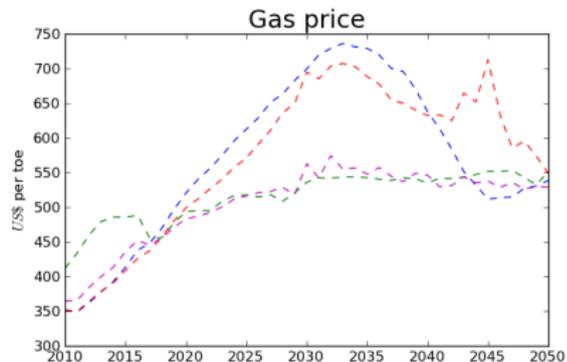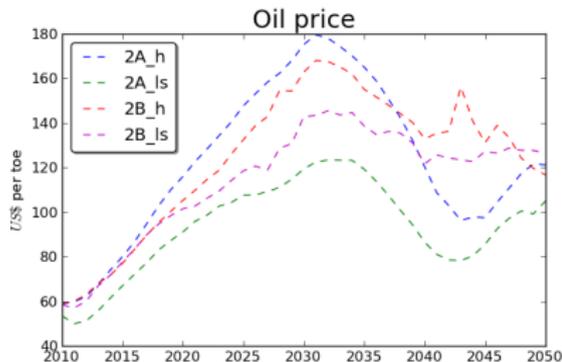
World energy prices in 450 ppm scenario
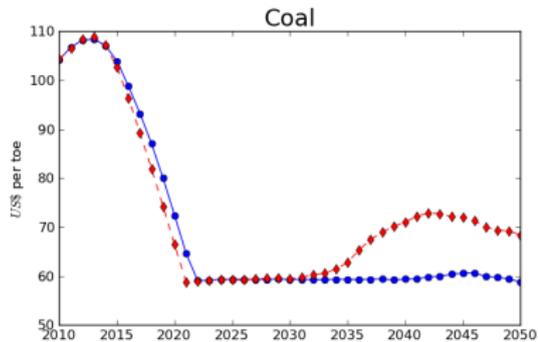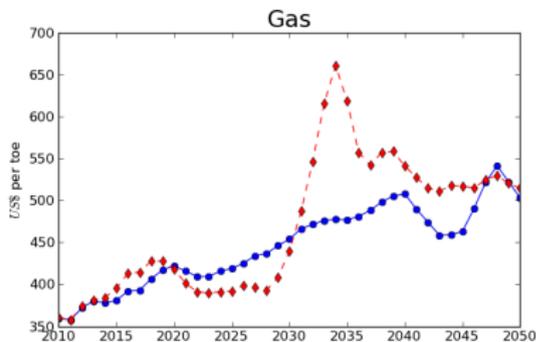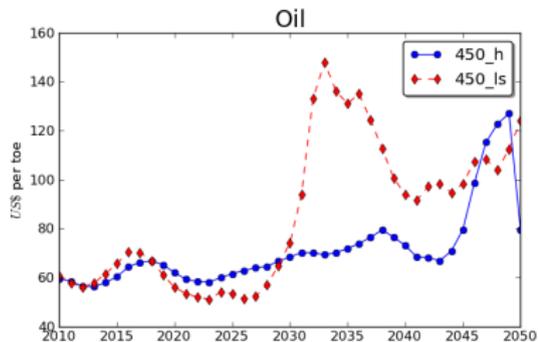
World energy prices under 450

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Uncertainty
Short-term
Mid to long term

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Uncertainty
Short-term
Mid to long term

Large uncertainty of emissions scenarios

carbon emission in all scenarios
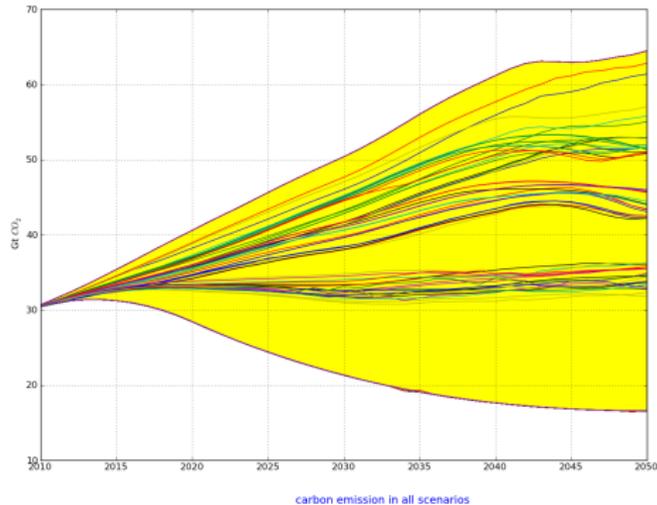
- emissions in 2050 may vary by a factor of 3 depending on climate policies

- 550 ppm scenario is a stringent target to achieve

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Uncertainty
Short-term
Mid to long term

Stringent Climate policy's Short-term impacts on global growth

World

550ppm CO2e
294.7GtC

Annual growth rate

world GDP growth grate

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Uncertainty
Short-term
Mid to long term
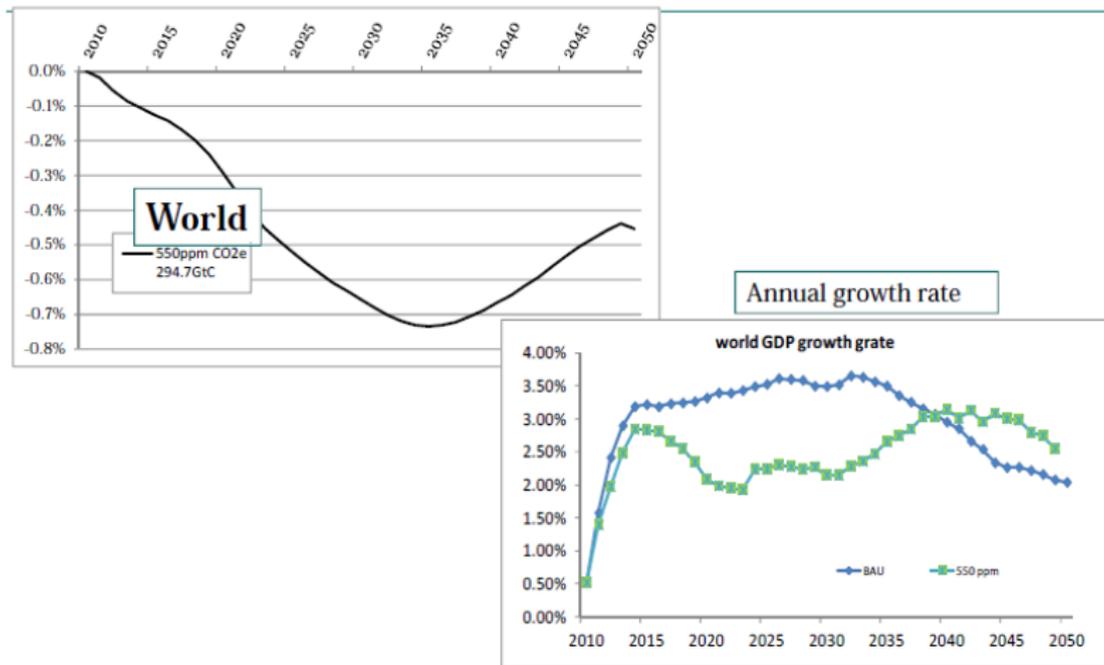
Copenhagen-extended with emissions trading

Emissions scenarios

Cop-ext
-43%

550ppm
-72%
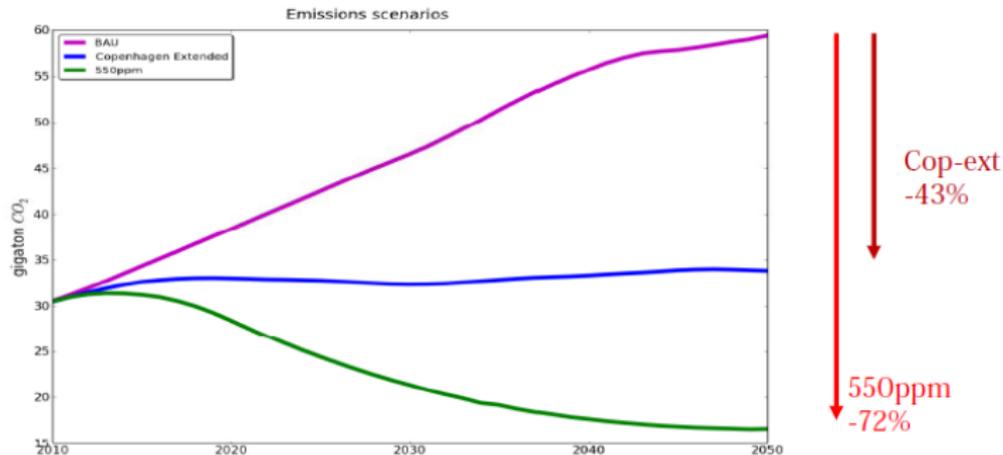
2020 Copenhagen extended pledges:
  ➢ Europe -30% (1990)
  ➢ Rest Annex I
  ➢ China + India } *Official pledges*

Domestic reductions

11

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Uncertainty
Short-term
Mid to long term

Copenhagen-extended macro costs

Average growth rate variation
(stabilization wrt BAU)

High costs remain!

- - - Cophg-Dom
—— 550 ppm
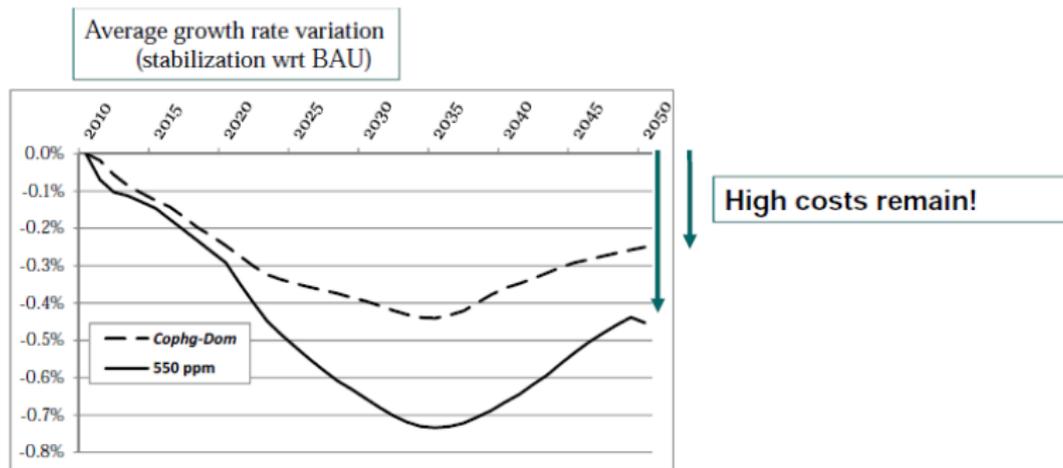
Necessity to introduce accompanying complementary measures to reduce
the *Copenhagen* mitigation costs ...!

Possibility of action:
➤ Global level
➤ Local level

12

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Uncertainty
Short-term
Mid to long term

Copenhagen-extended & complementary measures:Global emissions trading

Average growth rate variation
(stabilization/ BAU)

Annex I & Developing countries:
➢ **Combine their reduction efforts**
  (uniform global CO2 price)
➢ **Tradable permits scheme**
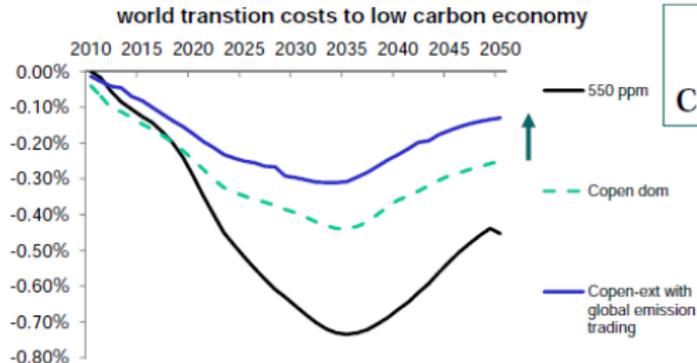
Regional quota allocations
=
Copenhagen-extended emissions

world transtion costs to low carbon economy

550 ppm

Copen dom

Copen-ext with
global emission
trading

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Uncertainty
Short-term
Mid to long term

macro costs comparison in US and China
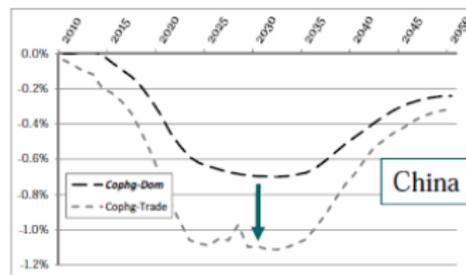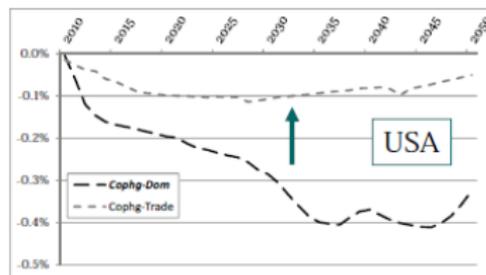
✓ Combining Copenhagen mitigation efforts make it worse for developing countries…. even if they trade emissions permits !

✓ Solutions to improve their situation:

➢ Adjust the global emissions quota allocation scheme →
e.g. Contraction & Convergence (GCI proposal)

➢ **Implement local measures to reduce GDP losses**

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Uncertainty
Short-term
Mid to long term

Copenhagen-extended, emissions trading and fiscal reform

Real lump-sum recycling of carbon tax revenues:

Transfer to households + Reduction of production taxes
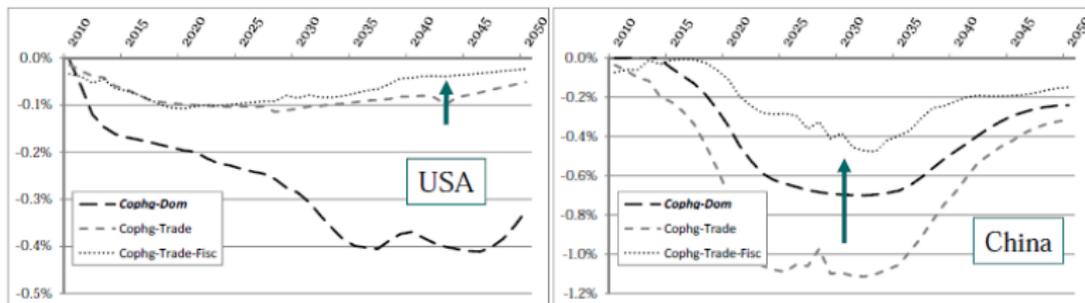
➤ Emerging countries are energy/carbon intensive economies

➤ A carbon tax increases their production costs

➤ Reduction of production taxes partially offsets the impact of the carbon tax

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Uncertainty
Short-term
Mid to long term

Copenhagen-extended, emissions trading and fiscal reform
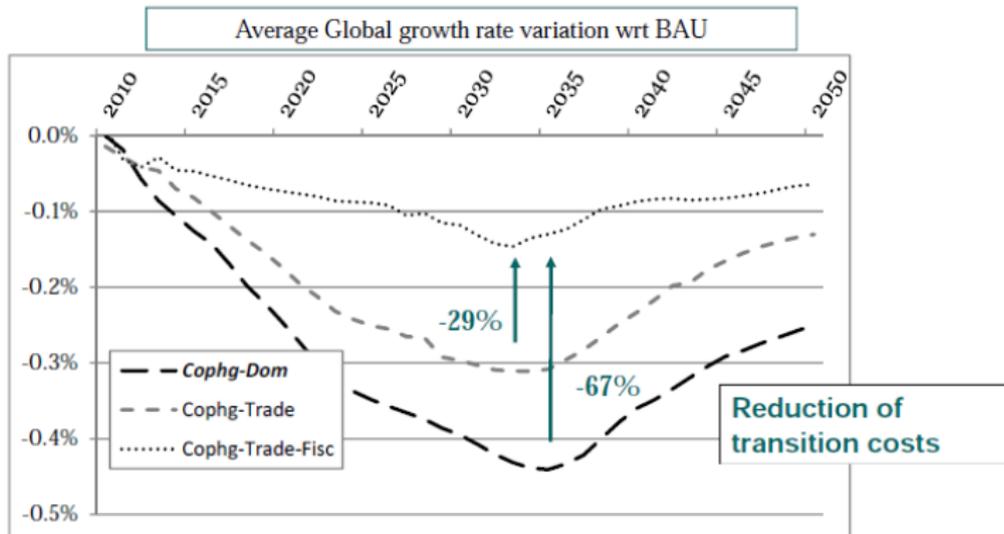
Combining emissions trading and a well-adjusted fiscal reform significantly reduce global mitigation costs

16

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Uncertainty
Short-term
Mid to long term

Asymmetric impacts should be taken into account in global climate policy

GDP loss in 4 regions under climate policy

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Uncertainty
Short-term
Mid to long term
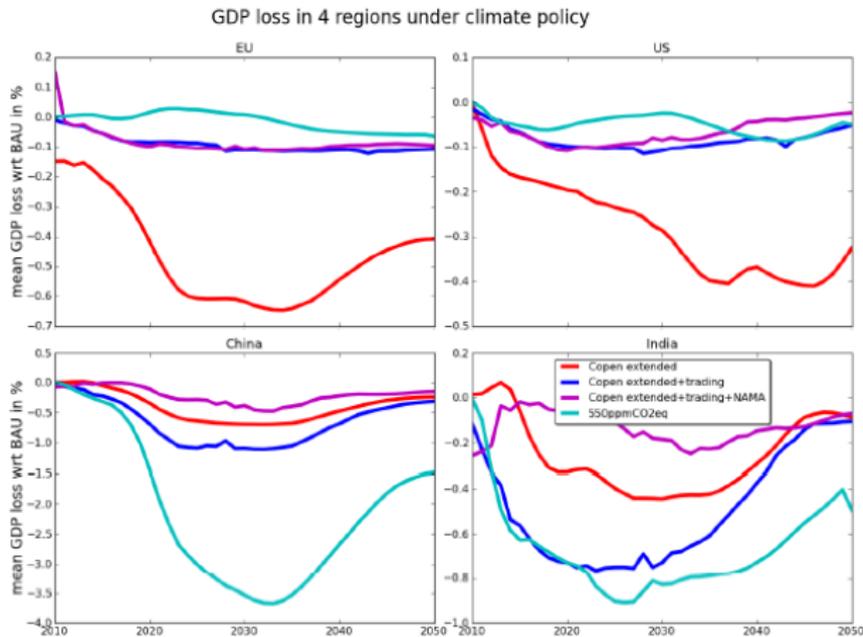
Some remarks on the GDP loss in different regions

- Unlike EU, non-participation of China (non commitment of Copenhagen pledge) will make Chinese GDP increase faster at the expense of Europe and other Annex I countries, as its comparative advantages are enhanced by gaining larger market share as the relative production price is lower.

- By contrast, the commitment to $450ppm$ trajectory would be extremely costly for China's economy as its annual real GDP growth rate may be sacrificed significantly.

1 Introduction

2 Method

3 Results

4 Implications for extended Copenhagen framework

5 Conclusions

6 Appendix

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Main lessons for the world

- Trans-boundary emissions trading with the participation of India and China would reduce considerably the costs to world economy.

- Carbon tax recycling is crucial to narrowing the gap between different climate regimes.

    – LS is arguably preferred to transfer to households as the costs to GDP growth reduction could be nearly halved.

    – Specifically, the costs in 450 ppm scenario could be reduced by more than twice by the mid-century.

    ▸ World GDP growth loss is less when emerging countries like China and India are *NOT* involved in emissions reduction commitments whiles Annex I countries are obliged to abate.

    ▸ GDP loss would be less in the case of global participation than unilateral commitment of Annex I countries if trading is allowed, otherwise the global participation would cause larger loss to world GDP even than 450 ppm case which is counterproductive for climate policy.

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Conclusions and perspective

- Global climate agreement (e.g. Copenhagen, global C&T):

  - ► Significantly affects developing countries in the short term
  - ► Combining efforts + Emissions trading partially limit the transition costs at the global level but have asymmetric implications at the regional level
  - ► The articulation of international and domestic policies such as adjusted fiscal and labour market reform is a way to smooth the transition
  - ► Appropriate climate finance compensation scheme needs to be designed to address the fairness and equity concerns of global climate policies

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Perspectives

- The combinatory framework (quotas + national policies, as NAMAs) could be an acceptable option for developing countries

    - Is aligned with country specific development priorities

    - Offers flexibility for domestic policies to support the transition

    - A first step towards a more ambitious global climate agreement

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Summary

Our simulations show that

- Commitments or stronger participation of emerging countries will generally make Annex I countries better off as the costs to GDP may be reduced to large extent

- Implementing ETS alone without appropriate complementary mechanisms might lead to immiserizing growth trajectory for developing countries like China in the short run

- Global costs of implementing climate policy with ambitious emissions reduction targets could be reduced significantly when economic instruments are implemented with appropriate complementary domestic measures

- However, participation of non-Annex I countries would entail significant costs to their economic growth (in particular in the 450 ppm case) and appropriate burden sharing mechanism have to be put in place in the international climate negotiations for reducing the negative socioeconomic impacts

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Producer's problem

The sectoral budget function determines the prices of final goods produced in each sector in the economy, i.e.

$$\boldsymbol{p_{k,i}} = \sum_j \boldsymbol{pIC_{i,j,k}} \cdot \boldsymbol{IC_{i,j,k}} + (\boldsymbol{\Omega_{k,i}} \cdot \boldsymbol{w_{k,i}}) \cdot l_{k,i} \cdot (1 + tax_{k,i}^{\boldsymbol{w_{k,i}}}) + \pi_{k,i} \cdot \boldsymbol{p_{k,i}} \qquad (1)$$

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Consumer's problem

As IMACLIM comprises different regions and countries, international trade (imports and exports) are taken into account in consumer prices formulation, the final consumption price for households for good i in region k is determined by a CES function in the following way

$$
\begin{aligned}
pC_{k,i} &= [(b_{k,j}^{dom})^{\sigma_{k,i}} \cdot (p_{k,i} \cdot (1 + tax_{k,i}^{domC}))^{1-\sigma_{k,i}} \\
&+ (1 - b_{k,j}^{dom})^{\sigma_{k,i}} \cdot (p_{k,i}^{imp} \cdot (1 + tax_{k,i}^{impC}))^{1-\sigma_{k,i}}]^{\frac{1}{1-\sigma_{k,i}}}
\end{aligned}
\tag{2}
$$

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Consumer's problem

The objective in IMACLIM is maximization of the household utility function (denoted U) that adopts the following form:

$$U = \prod_{goods_i} (C_i - bn_i)^{\xi_i} \cdot (S_{house} - bn_{house})^{\xi_{house}} \cdot (S_{mobility} - bn_{mobility})^{\xi_{mobility}} \quad (3)$$

$$i \in \{agriculture, industry, services\}$$

Introduction
Method
Results and discussion
Implications for extended Copenhagen framework
Concluding remarks
Appendix

Government's problem and markets equilibria

government exhibits revenue neutral behaviour:

$$State\_budget_k = \sum tax = \sum_{sectors\ i} \boldsymbol{G_{k,i}} \cdot \boldsymbol{pG_{k,i}} + \boldsymbol{transfer_k} + \boldsymbol{Infra\_inv_k} \quad (4)$$

Market clearing implies:

$$\boldsymbol{Q}_{i,j} = \boldsymbol{Q}_{dom_{i,j}} + \boldsymbol{Q}_{exp_{i,j}} + \boldsymbol{Q}_{ExpIT_{i,j}} \quad (5)$$

At each static equilibrium, the model solve a system of equations

$$Economy(\mathbf{X,Q,P}) = \{\mathbf{Q}, \mathbf{IC}, \mathbf{DF}, \mathbf{Imp}, \mathbf{Exp}, \mathbf{P}\} = 0 \quad (6)$$