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Opinions expressed in this paper are those of the author and do not necessarily reflect views of the institute.

IMPRESSUM

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Abstract

Energy is an important commodity in many economic activities. Its usage affects the environment via CO_2 emissions and the Greenhouse Effect. Modeling the energy-economy-environment-trade linkages is an important objective in applied economic policy analysis. Previously, however, the modeling of these linkages in GTAP has been incomplete. This is because energy substitution, a key factor in this chain of linkages, is absent from the standard model specification. This technical paper remedies this deficiency by incorporating energy substitution into the standard GTAP model. It begins by first reviewing some of the existing approaches to this problem in contemporary CGE models. It then suggests an approach for GTAP which incorporates some of these desirable features of energy substitution. The approach is implemented as an extended version of the GTAP model called GTAP-E. In addition, GTAP-E incorporates carbon emissions from the combustion of fossil fuels and this revised version of GTAP-E provides for a mechanism to trade these emissions internationally as well as domestically. The policy relevance of GTAP-E in the context of the existing debate about climate change is illustrated by some illustrative simulations of the implementation the European emissions trading scheme in 2005. It is hoped that the proposed model will be used by individuals in the GTAP network who may not be themselves energy modelers, but who require a better representation of the energy-economy-environmental linkages than is currently offered in the standard GTAP model.

1 Introduction

Energy is an important commodity in many economic activities. Its usage affects the environment via CO_2 emissions and the Greenhouse Effect. Modeling the energy-economy-environment-trade linkages is an important objective in applied economic policy analysis. Up to now, however, the modeling of these linkages in GTAP has been incomplete. This is because energy substitution, a key factor in this chain of linkages, is absent from the standard model specification. This paper remedies this deficiency by incorporating energy substitution into the standard GTAP model. It begins by first reviewing some of the existing approaches to this problem in contemporary CGE models. It then suggests an approach for GTAP which incorporates some of these desirable features of energy substitution.

The approach is implemented as an extended version of the GTAP model called GTAP-E. In addition, GTAP-E incorporates carbon emissions from the combustion of fossil fuels as well as a mechanism to trade these emissions internationally and domestically. The policy relevance of GTAP-E in the context of the existing debate about climate change is illustrated by some illustrative simulations of the implementation the European emissions trading scheme in 2005. This technical paper is a revised version of earlier papers written by Truong (1999) and Burniaux and Truong (2002). Compared with earlier versions, the model used here is derived from version 6.2 of the GTAP model (McDougall, 2003) and using version 6 of the GTAP data base (Dimaranan, 2006). In addition to inter-fuel substitution, this model incorporates some further improvements, such as the computation of a Social Account Matrix (SAM) which provides a full account of the carbon tax revenues and expenditures and a more specific treatment of carbon emission trading.

2 Review of existing approaches

In this section, we review some of the existing approaches to incorporating energy substitution into AGE models. The purpose of this section is not to undertake an exhaustive review of the literature, but rather, to select some typical approaches and examine their important features for possible incorporation into the GTAP model. There are three main models to be considered in this section, and these are: (1) the CETM model by Rutherford *et al*. (1997), (2) the MEGABARE model by ABARE (1996), and (3) the OECD's GREEN model by Burniaux *et al.* (1992). Some other models are also considered in sub-section 2.4.

2.1 The CETM model - Rutherford *et al.* (1997)

This model represents an attempt to bridge the gap between the (top down) economic models often used by economists, and the (bottom-up) process models used by engineers and environmentalists in studying the effect of energy policies on the environment. Recognizing that full integration of these two types of models is methodologically and computationally difficult, the authors of CETM attempted a 'partial' link. This means, firstly, the construction of a partial equilibrium 'process model' of the energy sector (ETA) (which is based on the MERGE model of Manne and Richels (1996)). The model is then linked to a general equilibrium model called MACRO. The process of linking the two sub-models is through the process of passing the energy price and quantity variables between the two sub-models and iteration until the 'input reference quantities' from ETA are close to the solutions of the MACRO model (Rutherford *et al.* (1997, p6)). In light of the fact that the energy sector makes up only a small fraction (less than 5%) of the gross output of most economies, 'convergence' of the two sets of results from ETA and MACRO is considered most likely. This is because if energy is only a small part of the industry cost structure then the changes in the prices and quantities of energy demand within ETA will affect only marginally the overall results of industry costs and prices within MACRO. This means convergence of the two sets of results from ETA and MACRO can be achieved through an iteration process as described above, rather than by having to solve the optimization problems of the two sub-models simultaneously.

2.1.1 The Structure of CETM

The structure of CETM is described in Figure 1. Within this structure, the MACRO submodel is a conventional computable general equilibrium (CGE) model, which has 5 internationally traded commodities and five industries: Y = Other manufactures and services, NFM = Non-ferrous metals, PPP = Pulp and paper, TRN = Transport industries, OTH = Other energy intensive sectors. The first industry is an aggregate of non-energy intensive industries, and the other four represent energy-intensive industries. Factors of production include: land, labor, capital, electricity, and non-electric energy. The latter two energy inputs are linked to ETA.

There are nine regions in MACRO: USA, JAPAN, CANZ (Canada, Australia, New Zealand), OECDE (Other OECD), CHINA, INDIA, EEFSU (Eastern Europe and Former Soviet Union), MOPEC (Mexico and OPEC countries), and ROW (The rest of the world). With eleven ten-year time periods, this model begins the period of simulation from 1990 (benchmark year) and ends in 2100.

The structure of industry production in MACRO is as described in Figure 2. First, capital and labor are combined via a Cobb-Douglas production function[1]. So are electric and non-electric energy inputs. The composite of non-energy material inputs, however, is combined using Leontief technology. The overall aggregation of composite primary factors, energy inputs, and non-energy materials is CES with an elasticity of substitution of 0.5.

[1] Figure 3 in Rutherford *et al.* (1997, p. 15) did not show land but the text (p. 9) mentioned land as one of the factors of production.

Consumption in MACRO is described as CES-nested aggregate of energy and non-energy composite goods. Composite energy is a Cobb-Douglas aggregate of electric and non-electric inputs, while composite non-energy is a Cobb-Douglas aggregate of the five industrial goods. Consumers substitute composite energy and non-energy inputs with an elasticity of substitution of σ_{end} = 0.5, which is chosen to approximate the own-price elasticity of demand for energy.

MACRO is linked to ETA, a partial equilibrium sub-model which describes in greater details the energy sub-sector. ETA specifies the supply functions of electric and non-electric energy. Electric energy is produced by a combination of hydro-electricity, natural gas, oil, coal, and two 'backstop' technologies: advanced high cost, and advanced low cost. Non-electric energy can be produced from either oil, gas, and coal, or by non-conventional technologies (such as carbon-free backstop, renewables, synthetic fuels). The list of electric and non-electric technologies in ETA are given in Table 1.

ETA includes the following internationally traded goods (*g*):

1	OIL	Crude oil
2	COAL	Coal
3	GAS	Natural gas
4	CRT	Carbon emission rights

ETA is formulated as a non-linear mathematical program. The decision variables in ETA include the following:

SURPLUS	the non-linear programming maximand defined as the sum of consumer and producer surplus
$EC_{r,t}$	Energy cost (in region *r* and time period *t*) - trillion dollars
$EN_{r,t}$	Composite energy demand
$E_{r,t}$	Electric energy (total)
$N_{r,t}$	Non-electric energy (total)
$PE_{e,t,r}$	Production of electric energy (by source *e*) - tkwh
$PN_{n,t,r}$	Production of nonelectric energy (by source *n*) - exaj
$GASNON_{t,r}$	Gas consumed to meet nonelectric demands
$OILNON_{t,r}$	Oil consumed to meet nonelectric demands
$RSC_{r,x,t}$	Undiscovered resources (by type *x*)
$RSV_{r,x,t}$	Proven reserves
$RA_{r,x,t}$	Reserve additions
$CLEV_{t,r}$	Carbon emissions level – billion tons

$CRLX_{t,r}$	Carbon limit relaxation – billion tons
$EXPRT_{g,t,r}$	Exports (of goods *g*)
$IMPRT_{g,t,r}$	Imports

To understand the internal workings of ETA, a list of some of the important equations in ETA is given in Table 2.

ETA solves for the aggregate shares of electric and non-electric energy. The solution is arrived at by MACRO first passing on to ETA the following variables and their time paths:

$\bar{e}_{r,t}$	Reference path of electric energy demand (TKW)
$\bar{n}_{r,t}$	Reference path of non-electric energy demand (EJ)
$pvcen_{r,t}$	Present value unit cost of energy sector inputs
$pvpe_{r,t}$	Present value price of electric energy
$pvpn_{r,t}$	Present value price of non-electric energy

ETA then uses the 'reference time path' of energy demand to calculate other variables and parameters such as the 'reference present value of energy demand' $\overline{en}_{r,t}$ (equation (1)), the distributive share parameter of electric energy $evls_{t,r}$ (equation (2)) which is then used to calculate the composite energy demand (in volume terms) $EN_{r,t}$ (equation (4)), and the total of consumers' and producers' surplus (equation (3)). Note that the total surplus is normally calculated as the area between the consumers' (regional) energy demand curve and the marginal cost curve. However, it can also be calculated as the total area under each region's energy demand curve and then subtracting from this the total cost of energy supply. The demand function is assumed to have a constant own-price elasticity of σ, and the function is 'calibrated to MACRO' (i.e. using the 'reference present value of energy demand' $\overline{en}_{r,t}$ as calculated from MACRO - see equation (3)). The total cost to produce energy is a linear combination of the direct costs to produce electric and non-electric energy, with an allowance for oil-gas price differential of OGPD = \$1.25/GJ for all regions, an allowance for interregional trade transportation costs of \$2/GJ for gas, \$1/GJ for coal, \$0.33/GJ for oil, and \$10/tonne for carbon emission rights (see equation (21)).

ETA then optimizes the mix of electric and non-electric technologies by maximizing the value of the total surplus subject to all the technological and institutional constraints (as described in equations (7-21)). These constraints include things like: (a) market clearing conditions (supply of fuels and energy sources must at least meet the demand, total imports must equal total exports, etc.) (equations (7-9,20)), (b) 'side constraints' which control the 'availability' of different technologies, through 'expansion limits' on new technologies, 'decline limits' on old (and new) technologies, and 'exhaustion limits' on non-renewable resources, etc. (equations (10-17)). In addition, equation (18) determines the carbon emission level and equation (19) specifies the limits on carbon emission rights which are given exogenously for each region and time period. Equation (22) defines the inverse demand function for composite energy in ETA, which is linked to the reference level in MACRO as explained in the next section below.

2.1.2 The Linkage of ETA to MACRO

In MACRO, the demand for composite (electric - non-electric) energy is structured as a CES function. This means the demand level for composite energy EN_j in sector j is related to the sector output Q_j, the sector unit cost C_j, and the composite energy price $PEN_{,j}$ by the relation:

$$EN_j = kQ_j \left(\frac{C_j}{PEN_j} \right)^{\sigma} \qquad \text{(a)}$$

where k is some constant and σ is the own-price elasticity of demand for composite energy.

Let $\overline{EN_j}$, $\overline{C_j}$, and $\overline{PEN_j}$ be the 'reference level' for these variables, i.e. the level as determined in the MACRO module. The linkage of ETA to MACRO is then defined by the following equation:

$$EN_j = \overline{EN}_j \left(\frac{PEN_j}{\overline{PEN}_j} \frac{\overline{C}_j}{C_j} \right)^{-\sigma} \qquad \text{(b)}$$

which follows from the previous relation, and

$$PEN_j = \left(\frac{P^E(1+t_j^E) + \mu_j^E}{\overline{P_j^E}} \right)^{-a_j} \left(\frac{P^N(1+t_j^N) + \mu_j^N}{\overline{P_j^N}} \right)^{1-a_j} \qquad \text{(c)}$$

where

t_j^E, t_j^N are ad-valorem tax rates on electric and non-electric energy demand in sector j.

μ_j^E, μ_j^N are distribution margins on electric and non-electric energy (cost indices).

$\overline{P_j^E}, \overline{P_j^N}$ are the reference prices (user costs) of electric and non-electric energy.

The last equation is based on the assumption that the structure of the electric and non-electric energy composition is Cobb-Douglas.

If energy cost is only a small proportion of the overall sector cost, i.e.:

$$\frac{PEN_j \cdot EN_j}{C_j} = \frac{PEN_j (\partial C_j / \partial PEN_j)}{C_j} << 1,$$

then equation (b) can be approximated by:

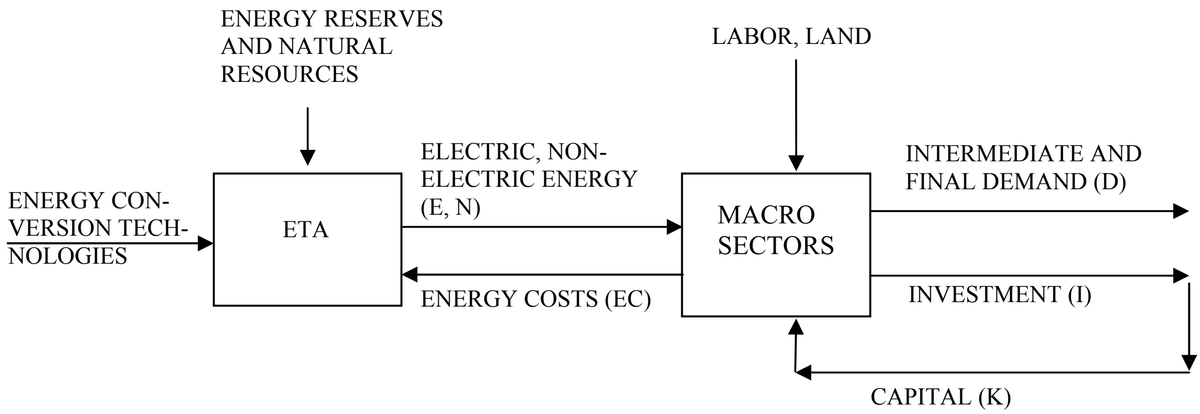
$$EN_j = \overline{EN}_j \left(\frac{PEN_j}{\overline{PEN}_t} \right)^{-\sigma}$$

or

$$PEN_j = \overline{PEN}_j \left(\frac{EN_j}{\overline{EN}_t} \right)^{-\frac{1}{\sigma}} \qquad \text{(d)}$$

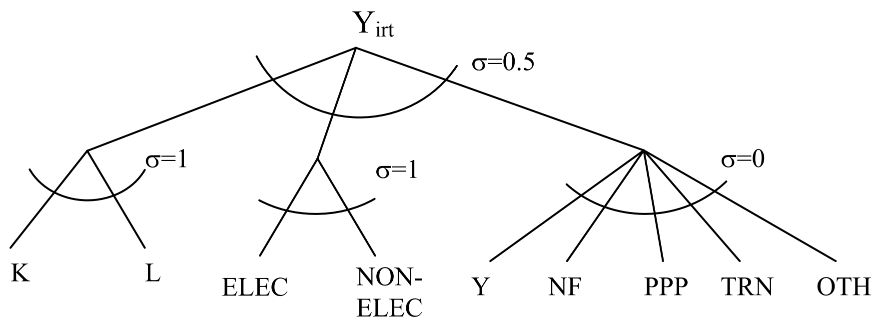
Equation (d) can be used to represent the inverse demand function for composite energy in ETA which will come out to be close to that modeled in MACRO. This is added to the list of equations for ETA (shown as equation (22) in Table 2).

Figure 1:
Structure of CETM



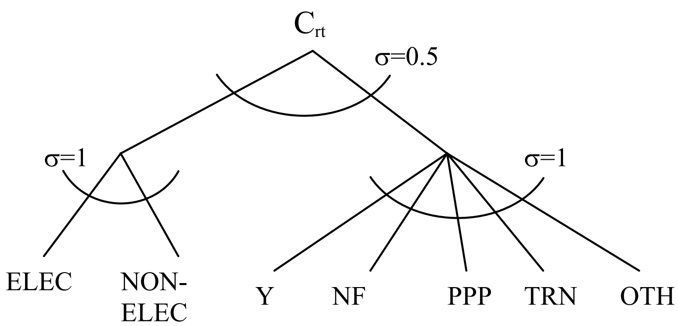
Source: Rutherford *et al.* (1997), Figure 1, p. 7.

Figure 2:
MACRO Production Nest



Source: Rutherford *et al.* (1997), Figure 3, p. 15.

Figure 3:
MACRO Consumption Nest



Source: Rutherford *et al.* (1997), Figure 2, p. 14.

Table 1:
List of Technologies in ETA

No.	*Short Name*	*Long Name*	*Restrictions*
Electricity supply technologies (*e*):			
1	HYDRO	Hydro electric	
2	GAS-R	Existing gas-fired	
3	OIL-R	Existing oil-fired	
4	COAL-R	Existing coal-fired	
5	NUC-R	Existing nuclear	
6	GAS-N	New vintage gas-fired	DLE(*e*)
7	COAL-N	New vintage coal-fired	DLE(*e*)
8	ADV-HC	Advanced high-cost	DLE(*e*), XLE(*e*)
9	ADV-LC	Advanced low-cost	XLE(*e*)
Non-electricity energy supply technologies (*n*):			
10	OIL-LC	Low cost oil reserves	X(*n*)
11	OIL-HC	High cost oil reserves	X(*n*)
12	GAS-LC	Low cost gas reserves	X(*n*)
13	GAS-HC	High cost gas reserves	X(*n*)
14	CLDU	Coal for direct use	DLN(*n*)
15	NE-BAK	Non-electric backstop	DLN(*n*), XLN(*n*)
16	RNEW	Renewables	XLN(*n*)
17	SYNF	Synthetic fuels (coal shales)	DLN(*n*), XLN(*n*)

Note:

X(*n*) Fossil fuels
DLE(*e*) Electricity technologies subject to decline limits,
DLN(*n*) Nonelectric technologies subject to decline limits,
XLE(*e*) Electricity technologies subject to expansion limits
XLN(*n*) Nonelectric technologies subject to expansion limits

Table 2:
List of Important Equations in ETA

$$\overline{en}_{r,t} = pvpe_{r,t} \cdot \bar{e}_{r,t} + .pvpn_{r,t} \cdot \bar{n}_{r,t} \quad (1)$$

$$elvs_{r,t} = pvpe_{r,t} \cdot \frac{\bar{e}_{r,t}}{\overline{en}_{r,t}} \quad (2)$$

$$SURPLUS = \sum_{r,t} \left(\overline{en}_{r,t} \cdot \frac{\sigma}{\sigma - 1} \right) \left(\frac{EN_{r,t}}{\overline{en}_{r,t}} \right)^{\frac{\sigma-1}{\sigma}} - pvcen_{r,t} \cdot EC_{r,t} \quad (3)$$

$$E_{r,t}^{elvs_{r,t}} \cdot N_{r,t}^{1-elvs_{r,t}} = EN_{r,t} \quad (4)$$

$$E_{r,t} = \sum_{e} PE_{e,r,t} \quad (5)$$

$$\begin{aligned} N_{r,t} &= OILNON_{t,r} + GASNON_{t,r} + PN_{cldu,t,r} \\ &\quad + PN_{synf,t,r} + PN_{rnew,t,r} + PN_{ne-bak,t,r} \end{aligned} \quad (6)$$

$$\begin{aligned} GASNON_{t,r} &= PN_{gas-lc,t,r} + PN_{gas-hc,t,r} + IMPRT_{gas,t,r} - EXPRT_{gas,t,r} \\ &\quad - ch_{gas-r,t,r} \cdot PE_{gas-r,t,r} - ch_{gas-n,t,r} \cdot PE_{gas-n,t,r} \end{aligned} \quad (7)$$

$$GASNON_{t,r} \leq 0.5 \cdot N_{r,t} \quad (7b)$$

$$\begin{aligned} OILNON_{t,r} &= PN_{oil-lc,t,r} + PN_{oil-hc,t,r} + IMPRT_{oil,t,r} - EXPRT_{oil,t,r} \\ &\quad - ch_{oil-r,htrt,r} \cdot PE_{oil-r,t,r} \end{aligned} \quad (8)$$

$$\begin{aligned} PN_{coal,t,r} &= EXPRT_{coal,t,r} - IMPRT_{coal,t,r} - ch_{coal-r,htrt,r} \cdot PE_{coal-r,t,r} \\ &\quad + ch_{coal-n,htrt,r} \cdot PE_{coal-n,t,r} + PN_{cldu,t,r} + (1 + syntpe) \cdot PE_{synf,t,r} \end{aligned} \quad (9)$$

$$PE_{dle,ty+1,r} \geq PE_{dle,ty,r} \cdot decf_r^{10} \quad (10)$$

$$PE_{dln,tp+1,r} \geq PE_{dln,tp,r} \cdot decf_r^{10} \quad (11)$$

$$PN_{xln,t,r} \cdot nxpf_r^{10} + nshf_n \cdot N_{r,t+1} \geq PN_{x\ln,t+1,r} \quad (12)$$

$$\sum_{xle} \left(PE_{xle,tp,r} \cdot \exp f_{rg}^{10} \right) + nshf_{RG} \cdot E_{r,t+1} \geq \sum_{xle} \left(PE_{xle,t+1,r} \right) \quad (13)$$

$$RSC_{r,x,t+1} = RSC_{r,x,t} - 5 \cdot RA_{r,x,t} - 5 \cdot RA_{r,x,t+1} \quad (14)$$

$$RSV_{r,x,t+1} = RSV_{r,x,t} + 5 \cdot (RA_{r,x,t} - PN_{x,t,r}) + 5 \cdot (RA_{r,x,t+1} - PN_{x,t+1,r}) \quad (15)$$

Table 2 (continued):
List of Important Equations in ETA

$$rdf_{x,r} \cdot RSC_{r,x,t} \geq RA_{r,x,t} \qquad (16)$$

$$prv_{x,r} \cdot RSV_{r,x,t} \geq PN_{x,t,r} \qquad (17)$$

$$\begin{aligned} CLEV_{t,r} = & \sum_{e} et, cece_{e,r} \cdot PE_{e,t,r} + \sum_{n} nt, cecn_{n,r} \cdot PN_{n,t,r} \\ & - \left(EXPRT_{gas,t,r} - IMPRT_{gas,t,r}\right) \cdot cecn_{gas,r} \\ & - \left(EXPRT_{oil,t,r} - IMPRT_{oil,t,r}\right) \cdot cecn_{oil,r} \end{aligned} \qquad (18)$$

$$CLEV_{t,r} = EXPRT_{crt,t,r} - IMPRT_{crt,t,r} \leq carlim_{t,r} \qquad (19)$$

$$\sum_{r} \left(EXPRT_{q,t,r} - IMPRT_{q,t,r}\right) = 0 \qquad (20)$$

$$\begin{aligned} EC_{t,r} = & \sum_{e} (PE_{e,t,r} \cdot ecst_{e,r}) + \sum_{n} (PN_{n,t,r} \cdot ncst_{n,r}) + ogpd_{r} \cdot GASNON_{t,r} \\ & + \sum_{n} (cstcexp_{q} \cdot EXPRT_{q,t,r}) \end{aligned} \qquad (21)$$

$$PEN_{j} = \overline{PEN}_{j} \left(\frac{EN_{j}}{\overline{\overline{EN}}_{t}} \right)^{-\frac{1}{\sigma}} \qquad (22)$$

2.1.3 Comments on the Structure of CETM

2.1.3.1 The Structure of Production and Inter-fuel and Fuel-factor Substitution.

The structure of production in the MACRO module of the CETM model groups labor and capital together, and these factors are separated from the energy branch (see Figure 2). This means that energy-capital and energy-labor will have the same substitution elasticity and this implies a severe restriction (see the discussion on the issue of capital - energy substitutability or complementarity in section 3.2 below).

On the other hand, the internal structure of the inter-fuel substitution in the MACRO module makes a useful distinction between electric and non-electric energy inputs. Although econometric evidence is scarce with respect to the substitution between electric and non-electric energy inputs, this distinction is useful at least from a theoretical viewpoint. This is because the choice of the electricity generation technologies may have an important impact on the environment (such as the emission of CO_2), and hence the focus on electric energy consumption level may help focus attention on the choice of these technologies[2].

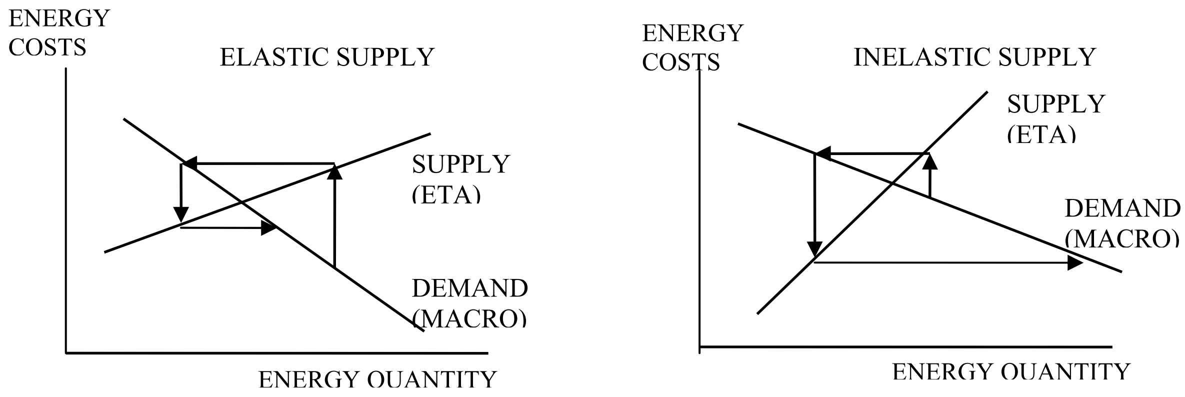
Different forms of non-electric energy such as oil, gas, coal (direct use), synthetic fuels, renewable fuels or the non-electric backstop technologies, are treated as perfect substitutes in the ETA module (see equation (6) in Table 2). This assumption is perhaps rather restrictive especially from the end-user's point of view. Natural gas, for example, is known to command some special 'premium' over coal because of its ease of handling. It may also come into conflict with other assumptions made in the model such as the fact that the market share for natural gas is limited (see equation (7)). Limited market share often implies some difficulty of substitution rather than limitation in supply. Finally, if these non-electric energy forms are perfectly substitutable, then their marginal costs (prices) must also be set equal to each other. These are strong assumptions.

2.1.3.2 The 'Small' Influence of the Energy Sector in Linking ETA to MACRO

Relying on the fact that the energy sector makes up less than 5% of the gross output of most economies, it is anticipated that any changes in the prices and quantities of energy demand within ETA will have only a small influence on the overall industry cost (and hence prices and demand within MACRO). This means that convergence of the results of ETA and MACRO can be achieved fairly rapidly. But this is likely to depend also on the assumptions regarding supply and demand elasticities. If supply elasticity is much greater (in magnitude) than demand elasticity then convergence can be assured. However, if the converse is true, then even if energy is only a small proportion of the overall industry costs, it can still act as a constraint on consumption activities, and can give rise to significant fluctuations in energy prices and demand, and therefore, will not help for convergence (see Figure 4). Since ETA is a process model rather than a conventional econometric model, therefore, the concept of 'supply elasticity' in ETA cannot be clearly defined and tested. However, the general concept of supply responsiveness to price and demand changes may still be an important factor to consider when looking at the issue of convergence.

[2] Furthermore, as Hogan (1989, p. 54) noted, the grouping of all energy forms together in an aggregate energy demand function may mask the historically important trend of 'electrification' in an energy economy (such as that observed in the US economy during the period from 1960 to 1982).

Figure 4:
ETA - MACRO Linkage



2.1.3.3 'Dynamic Adjustment Constraint' on Technologies could be Linked to Endogenous Factors within the MACRO Economy.

Equations (10-13) represent the 'dynamic adjustment constraints' on new and existing technologies. They define the limits to which existing technologies can be retired (because of sunk capital costs) or new technologies to be introduced (because of the difficulty of market penetration). These constraints reflect economic as well as institutional factors within the current and future markets, and therefore, they could also be determined 'endogenously' within the model rather than being set exogenously. For example, the rate of market penetration for new technologies may be dependent on the differences in production costs between existing and new technologies. The rate of retirement for existing technology can also be specified as a function of the expected increase in future demand and supply and the cost of capital. In other words, the dynamic adjustment constraints could be linked to the investment decisions within the model, rather than being specified as exogenous. Since the absence of such a linkage is largely due to practical considerations, this is probably an area for further research.

Table 3:
Summary Characteristics of CETM

Model Characteristics	CETM
Top-down versus bottom-up	Bottom-up in CETM, top-down in MACRO
Dynamic	Simultaneous
Inter-fuel substitution	Yes
Fuel-factor Substitution	Yes
Capital – Energy complementarity/substitutability	Energy and capital are substitutes in the MACRO production structure, but can be complements within the energy sub-module CETM

2.2 The MEGABARE Model and the "Technology Bundle' Approach[3]

In building the MEGABARE model on top of the GTAP framework, the authors of that model made 'a deliberate decision ...not to adopt the nested CES (constant elasticity of substitution) production function approach'. This was because:

> It was believed that it was possible to improve on the nested CES approach in terms of both accuracy and transparency by introducing what has been termed the 'technology bundle' approach. Using this approach, a level of detail about different technologies is introduced into MEGABARE that is normally found only in so-called 'bottom up' models. An attempt is made to introduce the realism in modelling substitution options that is a feature of 'bottom up' models while retaining extensive interactions between the energy and other sectors of the economy that is a feature of 'top down' models. (MEGABARE, 1996: 4).

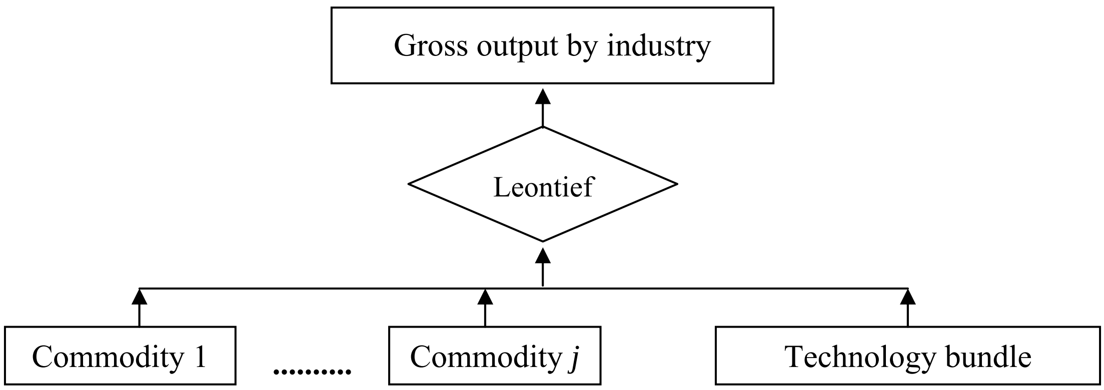
2.2.1 Description of the Technology Bundle Approach

The 'technology bundle' approach is described below in figures 5-7. First, the intermediate inputs into production are divided into technology bundle inputs – typically primary factors and primary energy inputs - and non technology bundle inputs (Figure 5). The technologies for an industry (for example, coal-fired electricity, gas-fired electricity etc.) are Leontief (fixed input-output coefficient) combinations of technology bundle inputs. The technology bundle for an industry is a conventional 'smooth production function' (such as CRESH) combination of the output of each technology. Industry output is a Leontief combination of the technology bundle and the non technology bundle inputs.

[3] ABARE (1996), The MEGABARE model: interim documentation, February.

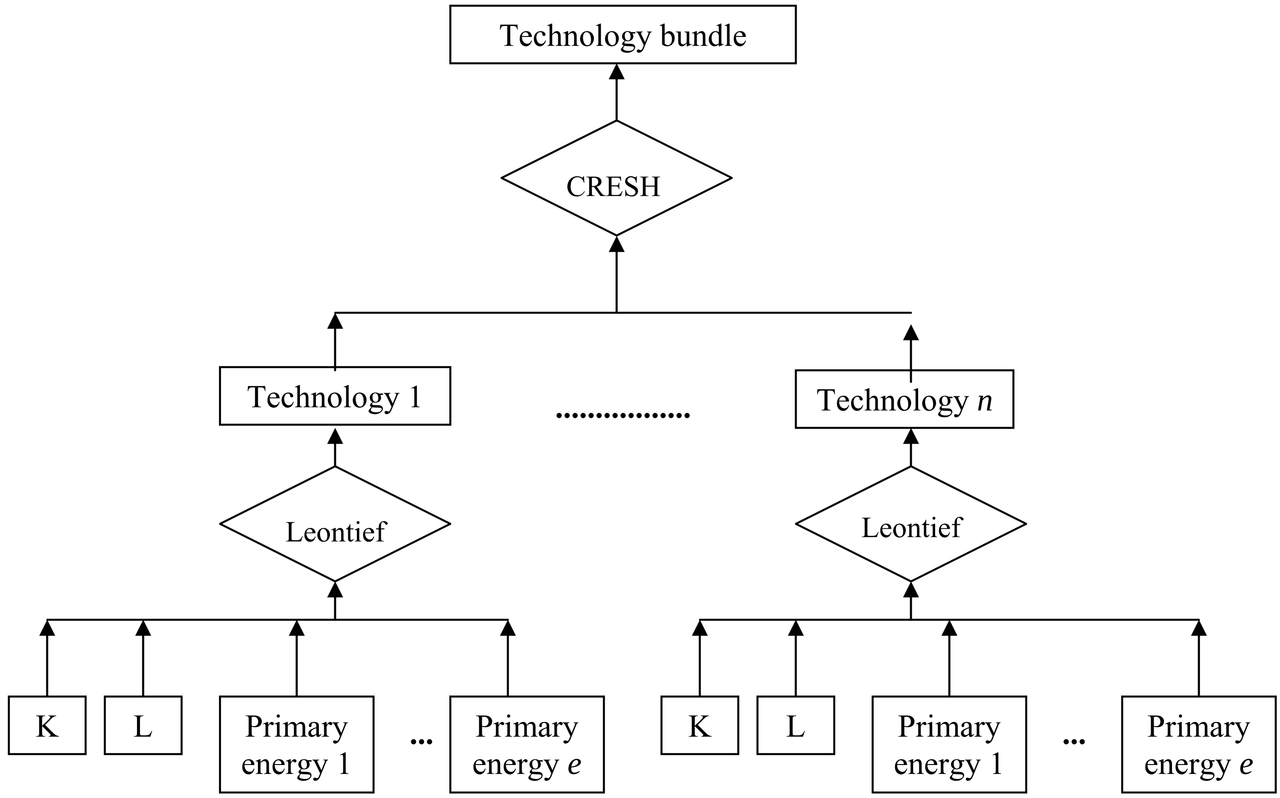
The technology bundle approach is used in the MEGABARE model to describe the input use of the *electricity* generation industry (Figure 6) and the *steel* industry, which represent typical examples of energy intensive industries. The approach, however, can also be used to describe other energy intensive industries. With the steel industry, the input structure differs slightly from the electricity industry: electricity and minerals are added to the input list, along with the primary factors and the primary energy inputs (Figure 7).

Figure 5:
Technology Bundle Approach



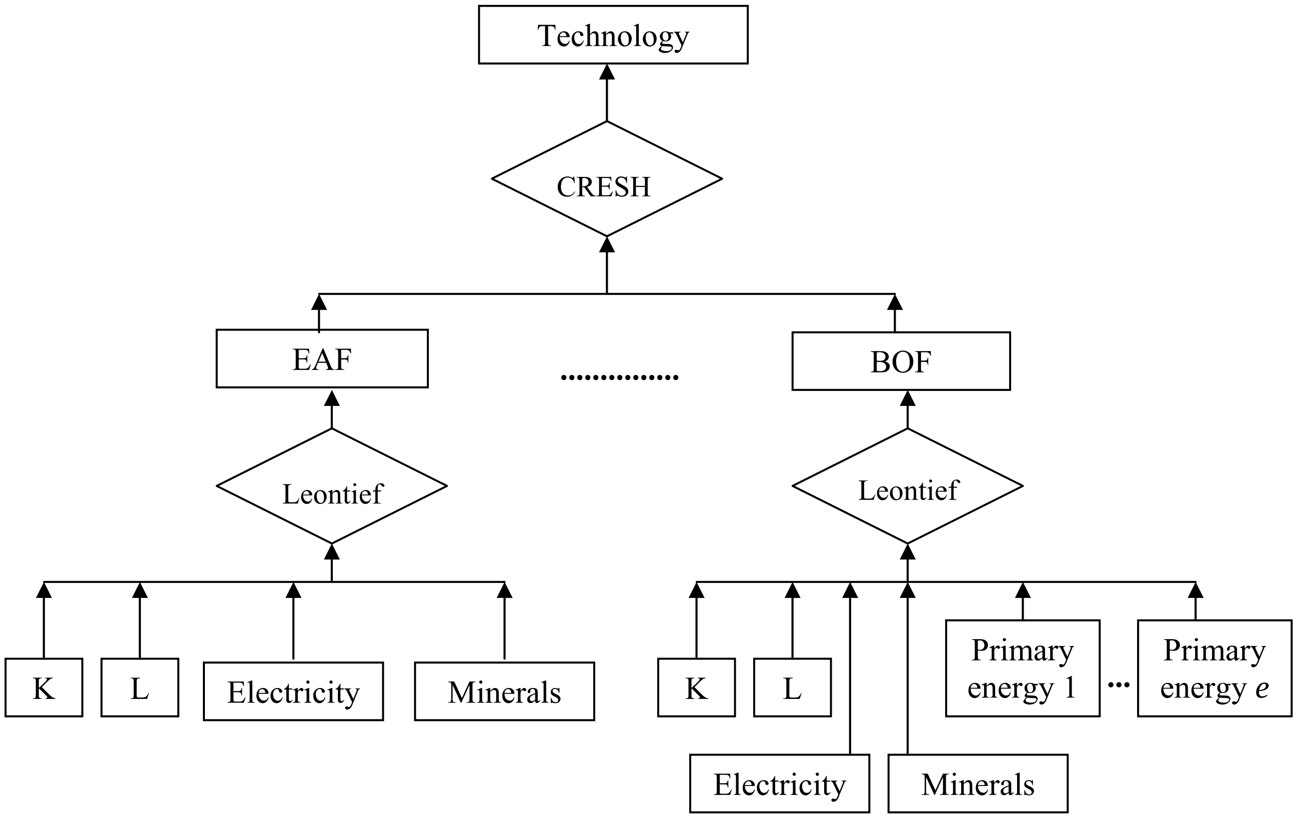
Source: ABARE (1996), Figure 6, p. 22.

Figure 6:
Composition of the Technology Bundle for the Electricity Industry



Source: ABARE (1996), Figure 9, p. 32.

Figure 7:
Composition of the Technology Bundle for the Steel Industry



Source: ABARE (1996), Figure 10, p. 32.
'EAF and 'BOF' stand for 'electric arc furnace' and 'basic oxygen furnace' respectively.

2.2.2 Comments on the Technology Bundle Approach

The technology bundle approach is interesting and innovative. It tries to introduce the concept of 'substitution' between alternative 'technologies' to give a more realistic description of the nature and range of substitution occurring within the energy producing and energy-using industries, in contrast to the more traditional concept of substitution between alternative energy and non-energy inputs. In doing so, the approach can claim the following advantages:

1. it 'ensures that the pattern of input use is consistent with known technologies' which usually exhibit what may be described as 'lumpy' or indivisibility constraints on certain inputs such as capital or labor,

2. it is highly transparent in the sense that it allows an assessment of how some policy change can lead to 'relative changes in the use of different technologies' rather than a mere observation of the derived changes in inputs use (ABARE, 1996: 35).

3. the elasticity of substitution parameters in the technology bundle approach can be estimated "by reference to the results from 'bottom up' models" and therefore, can cover 'a wider range of data values that might occur in a simulation' (ABARE, 1996: 36).

While in theory, it is true that the technology bundle approach can provide a more realistic description of the constraints facing the energy producing and energy-using industries than a conventional econometric approach, in practice, however, it is not clear how some of these potential advantages can always be implemented. In MEGABARE, for example, inputs into the technology bundles are still being specified as Leontief with no explicit 'indivisibility' or lumpy constraints imposed[4]. On point 3, it is not evident how the CRESH substitution parameter used in the MEGABARE model had been actually derived from some simulation experiment of a 'bottom-up' nature.

On a more important point, the technology bundle approach is not dissimilar to the conventional approach in econometrics where a nested production structure is used to describe complex substitution possibilities among the inputs[5]. As Powell and Rimmer (1998) noted: "Models in which output is produced according to a technology in which capital (K), labor (L) and energy (E) are substitutable run into the difficulty of how to allow parsimoniously for the higher likely substitutability between K and E than between L and E". In fact, the issue of 'substitutability' or 'complementarity' between K and E is a long-standing issue in the energy debate (see section 3.2 below). To handle this issue, most models allow for K and E to be separated from L. In the technology-bundle approach, although E and K are complements within a given technology structure, they are substitutes at the higher level, where technologies are substitutable for each other. Thus, given an energy price increase, although K cannot be used to replace E immediately in any given technology, a less energy-intensive but more capital-intensive technology can be put in place, to counter the energy price rise, thus fulfill-

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[4] The MEGABARE documentation (ABARE, 1996) does not refer to any of these indivisibility constraints but in a different documentation (Hanslow *et al.* (1994:28)), a reference is made to 'capacity constraint' in the context of the discussion of the pricing formula for a commodity which is used as input into a particular 'technology'. Here, it is stated that 'capacity constrained technology earns above normal returns to capital' which is to be represented by a 'slack' variable.

[5] See for example, Perroni and Rutherford (1995), Powell and Rimmer (1998).

ing the function of substitutability between K and E in the longer run. In this respect, the technology bundle approach is quite innovative and flexible.

Table 4:
Summary Characteristics of MEGABARE

Model Characteristics	MEGABARE
Top-down versus bottom-up	Bottom-up in technplogy bundle specification, top-down in the rest of the model structure
Dynamic	Recursive
Inter-fuel substitution	Indirectly though technology substitution
Fuel-factor Substitution	Indirectly though technology substitution
Capital – Energy complementarity/substitutability	Energy and capital are complements within a given technology, but can be substitutable through technology substitution

2.3 The OECD'S *GREEN* Model[6]

GREEN is a global, dynamic AGE model which highlights the relationships between depletion of fossil fuels, energy production and use, and CO_2 emissions. The main focus is on the energy sector and its linkage to the economy.

There are three types of fossil fuels in the model - oil, natural gas, and coal - and one source of non-fossil energy - the electricity sector. Each of these can be replaced at some future date by "backstop" technologies. These are assumed to become available at an identical time period in all regions. Their prices are determined exogenously and identically across all regions[7]. This implies an infinite elasticity of supply.

For each of the three fossil fuels, there are two alternative backstop technologies: one carbon-free (e.g biomass) and one carbon-based (synthetic fuel derived from shale or coal, with

[6] Burniaux, J. M., Nicoletti, G., and J. Oliveira-Martins (1992), "GREEN: A Global Model for Quantifying the Costs of Policies to Curb CO_2 Emissions", *OECD Economic Studies No. 19,* Winter, 49-92; Lee, Hiro, Joaquim Oliveira-Martins, and Dominique van der Mensbrugghe (1994), "The OECD GREEN Model: An Updated Overview", OECD Development Centre Technical Paper No. 97.

[7] Their marginal costs, however, are not identical, and therefore, there is a return attributed to the fixed factor. Backstops are not traded. Their role is primarily to limit the rise in prices, and therefore in carbon taxes.

higher carbon content than conventional technology). For electricity, the backstop technology is carbon-free (nuclear fusion, solar or wind power, but excluding hydro, or nuclear fission).

There are eight energy-producing sectors in GREEN: Coal mining, Crude oil, Natural gas, Refined oil, Electricity-gas-water distribution, Carbon-based back-stop, Carbon-free back-stop, Carbon-free electric back-stop. The three non-energy producing sectors are Agriculture, Energy-intensive industries, and Other industries and services.

There are four consumption goods: Food beverages and tobacco, Fuel and power, Transport and communication, and Other goods and services. These are chosen to be different from the outputs of the production sectors to highlight the principal components of final demand for energy. Consumers are assumed to be deciding on the optimal allocation of their given disposable income on saving and the four consumption goods. The demands for these consumption goods are then translated into the demands for producer goods (and energy) via a ‘transition’ or make matrix.

There are twelve regions in the GREEN model: United States, Japan, EC, Other OECD, Central and Eastern Europe, The former Soviet Union, Energy-exporting LDCs, China, India, Dynamic Asian Economies (Hong Kong, Philippines, Singapore, South Korea, Taiwan and Thailand), Brazil, Rest of the World (RoW).

Finally, there are five different types of primary factors: Labor, sector-specific "Old" Capital, "New" Capital, sector-specific Fixed Factors (for each fossil fuel type, and for the carbon-free backstop), and Land in agriculture.

2.3.1 Dynamics in GREEN

One special feature of the GREEN model is in its dynamic treatment of the energy-capital complementarity / substitutability issue and also in the handling of the resource depletion issue. The dynamics in GREEN in fact come mainly from these two issues: depletion of exhaustible resources, and capital accumulation.

In the resource depletion ‘sub-model’, the total (proven + unproven) reserves are assumed to be determined exogenously. However, the rate at which 'unproven' reserves are converted into 'proven' reserves (rate of discovery or rate of conversion) is made sensitive to the prices of oil and gas. This affects the 'potential supply', which is defined by the rate at which proven reserves are extracted[8]. Potential supply provides an upper bound on actual supply, and if actual demand falls short of potential supply, then the difference between potential and actual supply is added to the future reserves of the fossil fuels. The resource depletion sub-model is thus recursively dynamic (i.e. based on current and past prices only) rather than forward looking (i.e. based on some expected future prices).

Capital accumulation in the GREEN model is influenced by the putty/semi-putty assumption on the nature of capital. New capital (capital invested in current period) is putty which is highly substitutable for other factors (elasticity of substitution is 2). Sector-specific old capital (capital invested in previous periods), on the other hand, is semi-putty and much less substitutable for other factors (elasticity of substitution can be as low as 0.25). Sector-specific old capital is also much less mobile between sectors (implying small and sector-specific supply elasticities). This can result in equilibrium rental values of old and new capital being significantly different from each other, and the ratio of these rental values is used in GREEN to stimulate 'disinvestment' of old capital (see Burniaux *et al.* (1992: 57)). Once disinvested, old capital becomes available for use in new investment. At any point in time, the stock of capital will consist of old and new capital, and the rate of substitution between the stock of capital as a whole and other factors will therefore depend on the vintage structure of capital. Apart from this dynamic vintage structure, GREEN does not include any other explicit investment decision behaviour by firms. The total aggregate level of investment is defined as a residual from the aggregate level of savings minus government sector balance and plus net capital inflows. Once the aggregate level of investment is determined, this is then distributed optimally to the various sectors according to their levels of demand for new investment.

2.3.2 Inter-fuel Substitution

2.3.2.1 Inter-fuel Substitution in Production

In estimating the inter-fuel elasticities of substitution, the general assumption is that energy and capital are weakly separable in production. This means firms choose cost-minimising energy-mix *given* an energy-capital bundle. But this makes sense only if there are dual-fired or multi-energy technologies available, otherwise, inter-fuel substitution will involve the

[8] It is not clear from the document (Burniaux *et al.* (1992)) whether the rate of extraction is also sensitive to the prices of oil and gas.

installation of new capital and therefore, the assumption of separability between energy and capital breaks down (Burniaux *et al.* (1992, p. 75)). Thus, in choosing to represent the potential for inter-fuel substitution, the GREEN model assumes that short run to medium run elasticities of substitution between alternative forms of energy are small, between 0.5 and 1.0 in the medium term, and only 0.25 in the short term. Long-run[9] elasticities of inter-fuel substitution, however, are set as high as 2.0. This latter value is said to be based on empirical estimates of elasticities based on samples which have multiple power-generating facilities (Burniaux *et al.*, *loc. cit.*). These inter-fuel substitution elasticities apply only to the non-energy producing sectors and the electricity generation sector. For the rest of the energy producing sectors (coal mining, crude oil, natural gas, refined oil), there is no inter-fuel substitution (see Burniaux *et al.* (1992, Table 3, p. 76)).

The structure of inter-fuel substitution in production in the 1992 version of the GREEN model is as shown in Figure 9. In a subsequent version[10], the structure is altered significantly to allow for three levels of nested substitution: (i) substitution between electricity and a 'non-electric' composite fuel, (ii) substitution between coal and a 'non-coal' composite within the non-electric branch, and finally, (iii) substitution between oil, gas, and refined fuels within the non-coal branch. All substitution elasticities are set within the range $0.25 < \sigma < 2$, depending on whether it is short run, medium run, or long run.

2.3.2.2 Inter-fuel Substitution in Household Demand

Given the energy intensity of each consumer good, household demand for aggregate energy is derived from its demand for the four categories of consumer goods (see Figure 10). Once the demand for aggregate energy is known, this demand is then allocated optimally between the different fuels with the same structure of inter-fuel substitution as in the case of producers' demand for energy (Figure 9).

2.3.3 Fuel-factor Substitution

The GREEN model assumes that capital-labor and energy-labor have the same (positive) elasticities of substitution. This assumption accords with empirical econometric evidence which supports substantial short-run and long-run substitutability between labor and capital

[9] This long run is defined as the period over which new capital can be installed.
[10] see Lee *et al.* (1994, Figure 1b, p. 49).

on the one hand, and also between labor and energy on the other hand. On the issue of energy-capital substitutability or complementarity, however, empirical estimates seem to be more of a problem. A widely held opinion in this area is that perhaps energy and capital are complements in the short-run, but substitutes in the long-run. To incorporate this feature into the model, the approach in GREEN is to utilise a 'vintage capital' structure. Thus, short run substitution between 'old' capital and energy can be low, while long-run substitution between 'new' capital and energy can be high. The net effect will then depend on the capital vintage structure. Over time, the short-run elasticities will converge to the long-run elasticities (see Figure 5 in Burniaux *et al.* (1992, p. 66)). The gap between short- and long-run elasticities and the speed of the convergence depends on the dynamics of the capital stock adjustment process which in turn depends on assumptions made about depreciation rate and rate of new capital formation. The larger the net replacement rate, the smaller the gap between short- and long-run elasticities and the faster the convergence of the former to the latter.

In GREEN, capital is combined with a fixed factor through a Leontief structure before being combined with energy through a CES structure. The role of the fixed factor is to limit the substitution away from/towards capital formation in the energy-producing sectors so as to avoid an unrealistic situation where, for example, following an increase in the relative price of energy, 'too much' investment will occur in these sectors even in the short run. The role of the fixed factor in primary-energy producing sectors is thus to impose limits on the supply elasticities of these primary energies. These supply elasticities have a critical role to play especially in energy-environmental policy simulation studies.

Substitution between energy and the fixed factor-capital composite is set at zero for all energy-producing sectors, except electricity. For electricity and other non energy-producing sectors, it is set at zero for 'old' capital, and at a low value of 0.8 for new capital. Substitution between labor and capital-energy-fixed factor composite is also set at zero for all energy-producing sectors including electricity. For other sectors, it is set at a low value of 0.12 for old capital and a high value of 1.0 for new capital (Burniaux *at al.* (1992, Table 3, p. 76).

According to Borges and Goulder (1984, p. 340), to ensure that the capital-energy complementarity condition can be achieved, it is 'sufficient' that the elasticity of substitution between K and E within the KE nest be given a 'substantially smaller (even if positive)' value as compared to the elasticity of substitution between the KE composite and labor (or other factors) in the 'outer nest'. To be more precise, we can use the following formula established for the case of a nested CES structure by Keller (1980, p. 83):

$$\sigma_{KE-outer} = [\sigma_{KE-inner} - \sigma_{VA}] / S_{KE} + \sigma_{VA}$$

In this formula, S_{KE} is the share of the KE-composite in the outer (value-added) nest, and $\sigma_{KE\text{-}inner}$ and $\sigma_{KE\text{-}outer}$ stand for the inner and outer substitution elasticities between K and E respectively. If $\sigma_{KE\text{-}inner}$ is less than σ_{VA}, then the first term on the right hand side is negative. But whether $\sigma_{KE\text{-}outer}$ is negative (implying complementarity between K and E in the outer nest) depends on the size of S_{KE} as well. If S_{KE} is small, then this is likely even if σ_{VA} is large. For example, using the upper limit values of 0.8 and 1.0 for $\sigma_{KE\text{-}inner}$ and σ_{VA} respectively as used in the GREEN model for the case of new capital, this requires $S_{KE} < 0.2$ for $\sigma_{KE\text{-}outer} < 0$ (complementarity between K and E in the outer nest). Using the lower limit values of 0.0 and 0.12 respectively for $\sigma_{KE\text{-}inner}$ and σ_{VA} for the case of old capital, this requires $S_{KE} < 1.0$ for $\sigma_{KE\text{-}outer} < 0$. The condition is always satisfied since S_{KE} is always less than 1. Overall, thus, 'old' capital and energy will always come out as complements in the value added nest of the GREEN model production structure. For 'new' capital, this will also be the case if the share of capital-energy-fixed factor component in the value-added nest is less than 20 percent. Note that all these discussions apply to the non energy-producing sectors only. For the energy-producing sectors (except electricity) there is no fuel-factor substitution. The electricity sector is characterized by an 'inner' substitution elasticity of $\sigma_{KE\text{-}inner} = 0.8$ (for new capital only), and a zero 'outer' substitution elasticity of σ_{VA}.= 0 in the value-added nest. This implies 'new capital-fixed factor bundle' and 'energy' are always substitutes in the electricity sector.

2.3.4 Comments on the GREEN Model

One innovative feature of the GREEN model is in the handling of the energy-capital complementarity / substitutability issue through the use of a dynamic capital vintage structure. Through this structure, the issue of long-run substitutability versus short-run complementary between capital and energy is handled quite flexibly (see the illustrative numerical calculations carried out in the previous section). This is a significant improvement over many other models which do not handle this issue explicitly.

The specification of the capital vintage structure is an important first step. However, the next step can perhaps focus attention also on the issue of capital investment. Currently, the aggregate level of investment in the GREEN model is specified as a residual from the level of aggregate saving minus government sector balance plus net capital inflows. Once the aggregate level of investment is determined, the aggregate level of new investment is then distributed optimally among the sectors. Following from this, the ratio of the new- to old-capital rates of returns is also determined, and this will then influence the rate of old-capital disinvestment (i.e. the rate at which old capital is transformed back into the pool of 'new' investment in the next period). All of this will affect the capital vintage structure. Throughout this process, energy prices plays an important role, in influencing the rate of return on (old and new) capital, and hence on aggregate investment. However, this influence is still indirect via the aggregate return on capital. A more direct role for energy prices may be in influencing the capital vintage structure directly, for example, in bringing about a rate of investment which will 'equalise' the rates of return on 'old' and 'new' capital over the 'long run'. This, however, implies a more 'forward looking' investor than is currently assumed for the GREEN model.

Figure 8:
The Structure of Production in GREEN

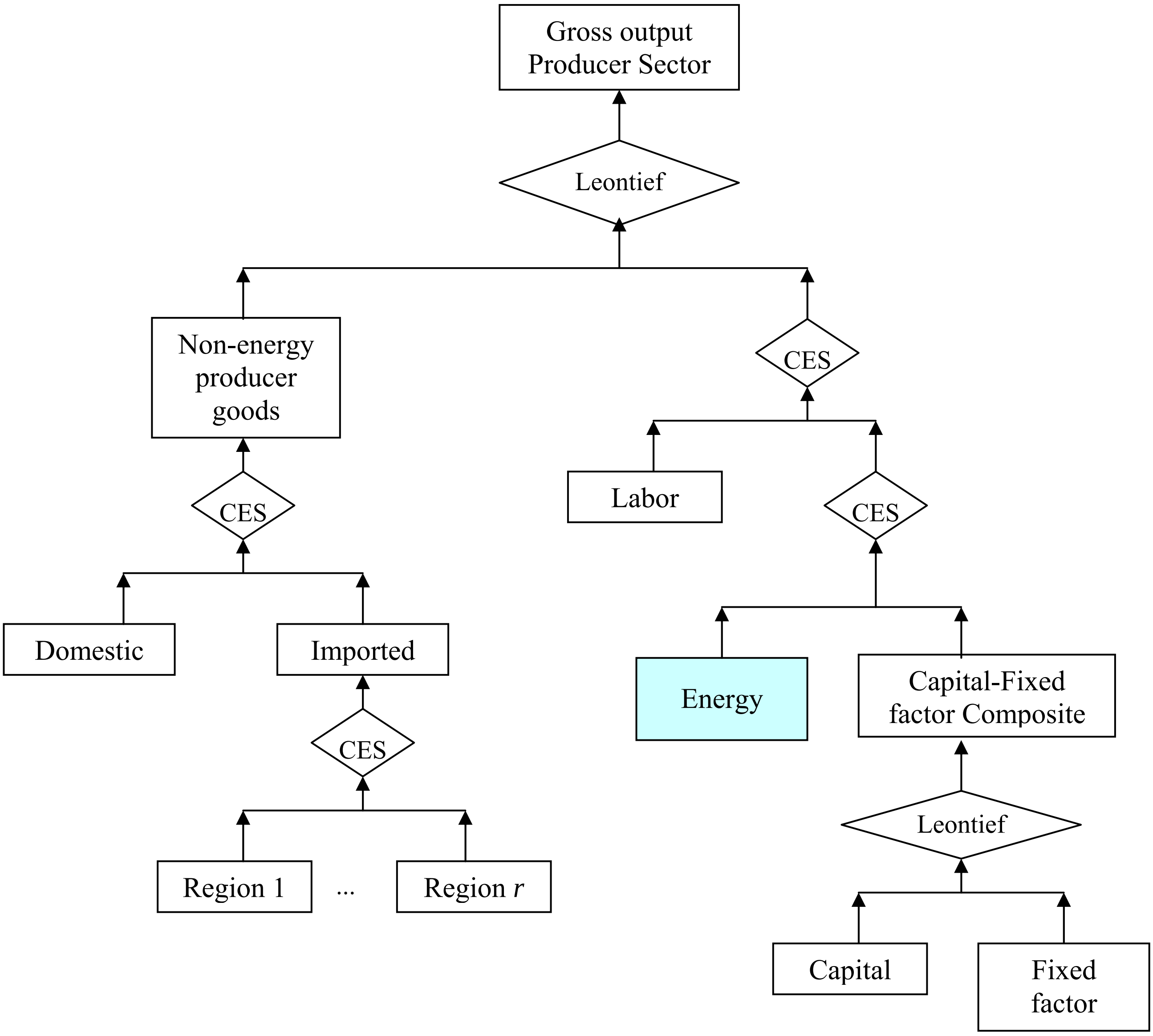
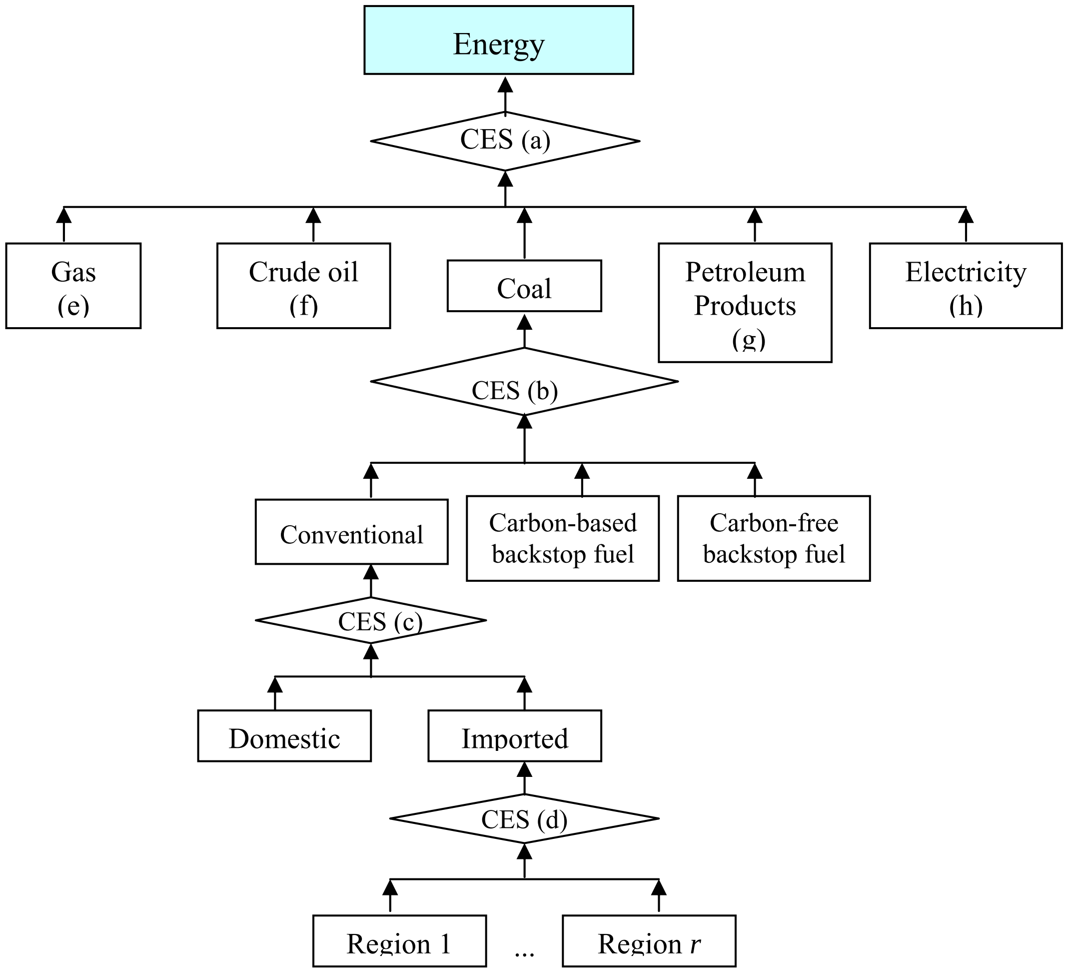


Figure 9:
Energy and Backstop Technologies in GREEN



(a) With elasticity of substitution (σ=0.25) for 'old' capital, and (σ=2) for 'new' capital, in all sectors except coal mining, crude oil, natural gas, and refined oil (see Burniaux *et. al.*, 1992, Figure 1b, p. 56, and Table 3, p. 76). In Lee *et al.* (1994), there is some further nesting (all with 0.25<σ<2): between electric and non-electric' composite, then between 'coal' and non-coal' composite within the non-electric branch, and finally between oil, gas, and refined fuel in the non-coal branch.

(b) Elasticity of substitution between conventional and backstop technologies is (σ=10) for agriculture, refined oil, electricity, energy-intensive industries, and other industries, as well as for consumer goods and government demand, and in the production of investment goods and inventories.

(c) Elasticity of substitution between domestic and imported fuels is (σ=4) for all fuels, except electricity (σ=0.3), and crude oil (σ=∞).

(d) Elasticity of substitution for fuels from different regions (world trade elasticities) is (σ=∞) for crude oil, (σ=5) for coal mining and natural gas, and (σ=3.0) for refined oil.

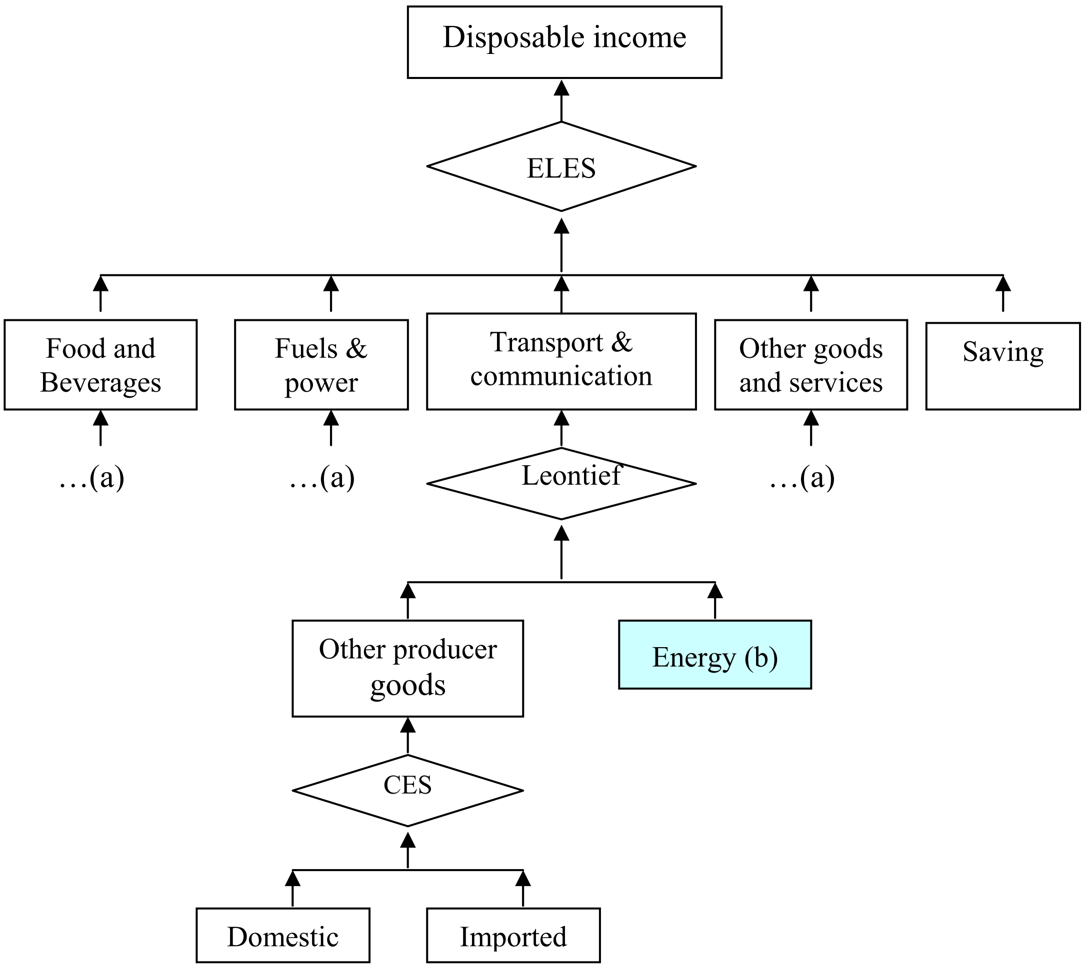
(e) same as for coal.

(f) same as for coal except with (σ=∞) for domestic-imported and inter-regional substitutions.

(g) same as for coal except there are no backstop fuels and world trade elasticities is (σ=3).

(h) same as for coal except there is only one carbon-free backstop option and world trade elasticities is (σ=0.5).

Figure 10:
The Structure of Household Demand in GREEN



(a) same as for transport & communication.
(b) see Figure 9.

Table 5:
Summary Characteristics of GREEN

Model Characteristics	GREEN
Top-down versus bottom-up	Top-down with some bottom-up details in backstop technologies specifications.
Dynamic <	Recursive
Inter-fuel substitution	Yes
Fuel-factor Substitution	Yes
Capital – Energy complementarity/substitutability	Given the vintage structure of production, capital and energy tend to be compliments in the short term and substitution over the longer term.

2.4 The Babiker-Maskus-Rutherford (BMR) Model

Babiker, Maskus, and Rutherford (1997) utilise a model for studying the economic impact of international trade and environmental policies on the world economy. The model includes a detailed structure of the inter-fuel and energy-factor substitution possibilities for the firm and for the household sector (see Figures 12 and 13).

The structure of production in the BMR model groups labor and capital together. This means that one cannot give to the energy-capital components a different elasticity of substitution as compared to the energy-labor or capital-labor components, and this is a severe restriction. On the other hand, the internal structure of the inter-fuel substitution in the BMR model does contain a rich structure, firstly with a distinction between electricity and non-electricity inputs, and then further disaggregation of the non-electric inputs into various types of fuels using a nested-CES structure (see Figure 12) with 5 levels: oil and natural gas at level 0 (bottom level); coal at level 1; electricity, land, labor, and capital are at level 2; aggregate energy and aggregate primary factor is at level 3; intermediate input and the combined energy-primary factor is at level 4; and finally output is at level 5.

To calculate the elasticity of substitution between any two inputs *n* and *m* at a particular level *L* in the nested-CES structure, we can refer to the formula derived by Keller (1980, p. 83):

$$\sigma_{nm} = \sigma_{n,K} S_{n,K}^{-1} - \sum_{l=K+1}^{L} \sigma_{n,l} [S_{n,l-1}^{-1} - S_{n,l}^{-1}]$$

where *K* represents the lowest level in the nested-CES structure at which a component exists, associated with both the *n* and the *m* inputs (the lowest common level) and *L* is the highest level in the nested structure at which the elasticity σ_{nm} is calculated, and the cost share $S_{n,l}$ is defined by:

$$S_{n,l} = \sum_{i \in n} S_i$$

i.e. the sum of all the cost shares associated with the aggregate input *n* at level *l*, or, in other words, the cost share of the input component *n*.

Using this formula, and considering the production structure of Figure 12, we can conclude that:

(1) energy-capital[11] substitution elasticity σ_{EK} (considered at the top level, i.e. holding output constant, L=5) is simply equal to $0.5/S_{EF}$ where S_{EF} is the cost share of aggregate energy-primary factors (land, labor, capital) in the production structure. Since this value is less than 1.0, σ_{EK} is greater than 0.5 - the CES substitution elasticity at level K=4.

(2) For inter-fuel substitution, electricity and non-electricity have an elasticity of substitution of:

$$1/S_E - 0.5*[1/S_E - 1/S_{EF}] = 0.5/S_{EF} + 0.5/S_E$$

where S_E is the cost share of aggregate energy in the production structure. Since S_E is rather small, the elasticity of substitution between electricity and non-electricity can therefore be very large. For example, with $S_E = 0.05$, $S_{EF} = 0.70$, the overall, output- constant, elasticity of substitution between electricity and non-electricity is 10.71.

(3) The elasticity of substitution between oil and gas is given by:

$$1/S_{OG} - 0.5*[1/S_{OG} - 1/S_{COG}] - 1*[1/S_{COG} - 1/S_E] - 0.5\ [1/S_E - 1/S_{EF}] =$$

$$0.5/S_{OG} - 0.5*/S_{COG} + [0.5/S_{EF} + 0.5/S_E]$$

where S_{OG} or S_{COG} is the cost share of inputs (*oil*, *gas*) or inputs (*coal*, *oil*, *gas*) in the total production structure. Again, assuming that $S_{OG} = 0.010$ and $S_{COG} = 0.015$, the overall elasticity of substitution between *oil* and *gas* is then 22 + 10.71 = 32.71. This is a very large figure.

The large magnitude of these output-constant (upper level) elasticities of substitution as compared to the composite input-constant (lower-level) elasticities of substitution can be explained as follows. When a composite input (such as aggregate energy E) is held constant, there is only a limited opportunity for the various components (fuels) of this composite energy to be substituted for one another. When the level of output is held constant, however, there are also substitutions between different types of aggregate inputs (e.g. aggregate energy E for capital K, or composite K-E for labor L, etc). This increases the range of substitution (or complementarity) between the lower-level inputs (fuels). Refer to Figure 11, for example, where it is assumed for simplicity that aggregate energy consists of only oil and gas. When the level of aggregate energy is held constant, an increase in the price of oil (relative to gas) will induce a

[11] Or energy-labor, or energy-land: since labor, land, and capital are grouped together, their substitution elasticity with respect to energy will be the same for all three primary factors.

substitution of gas for oil (movement from A to B). When the level of output is held constant, aggregate energy consumption may fall because aggregate energy price has increased relative to other factors: B may now move towards C. The total movement is now from A to C, which shows a larger reduction in oil consumption following an oil price increase, and therefore, it seems as though the degree of ‘substitutability’ between oil and gas is now much larger. Furthermore, as we go up the production structure, the share of the energy inputs will get smaller, and since the elasticity of substitution is price elasticity ‘normalized’ by the cost share, it will get even larger as the cost share gets smaller.

The purpose of these upper- or outer-level elasticity calculations is to show that the overall level of substitution between any two input components within a particular nest may be much larger than the magnitude of the substitution elasticities. This point is important to keep in mind when we compare different models which may have similar elasticities, but different nested structures.

Figure 11:
Substitution Elasticity when Total Output is Held Constant

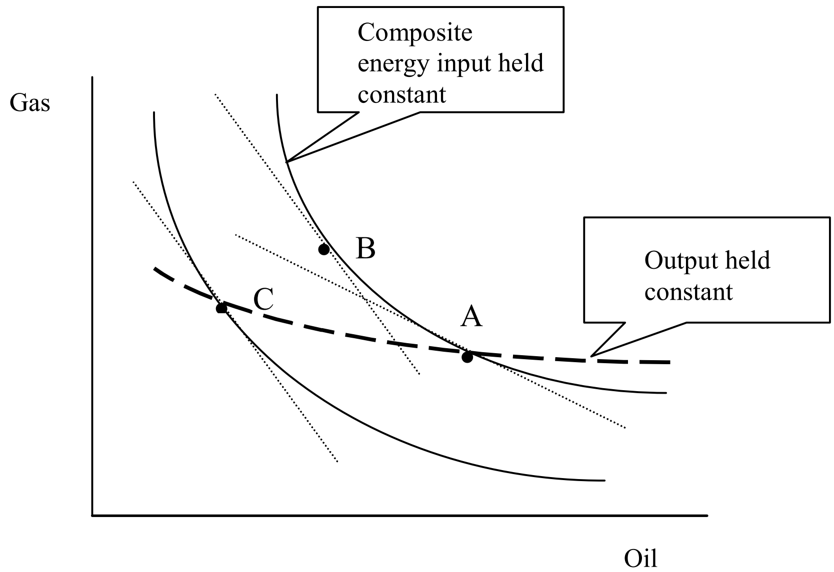


Figure 12:
Structure of Production in the Babiker-Maskus-Rutherford (1997) Model

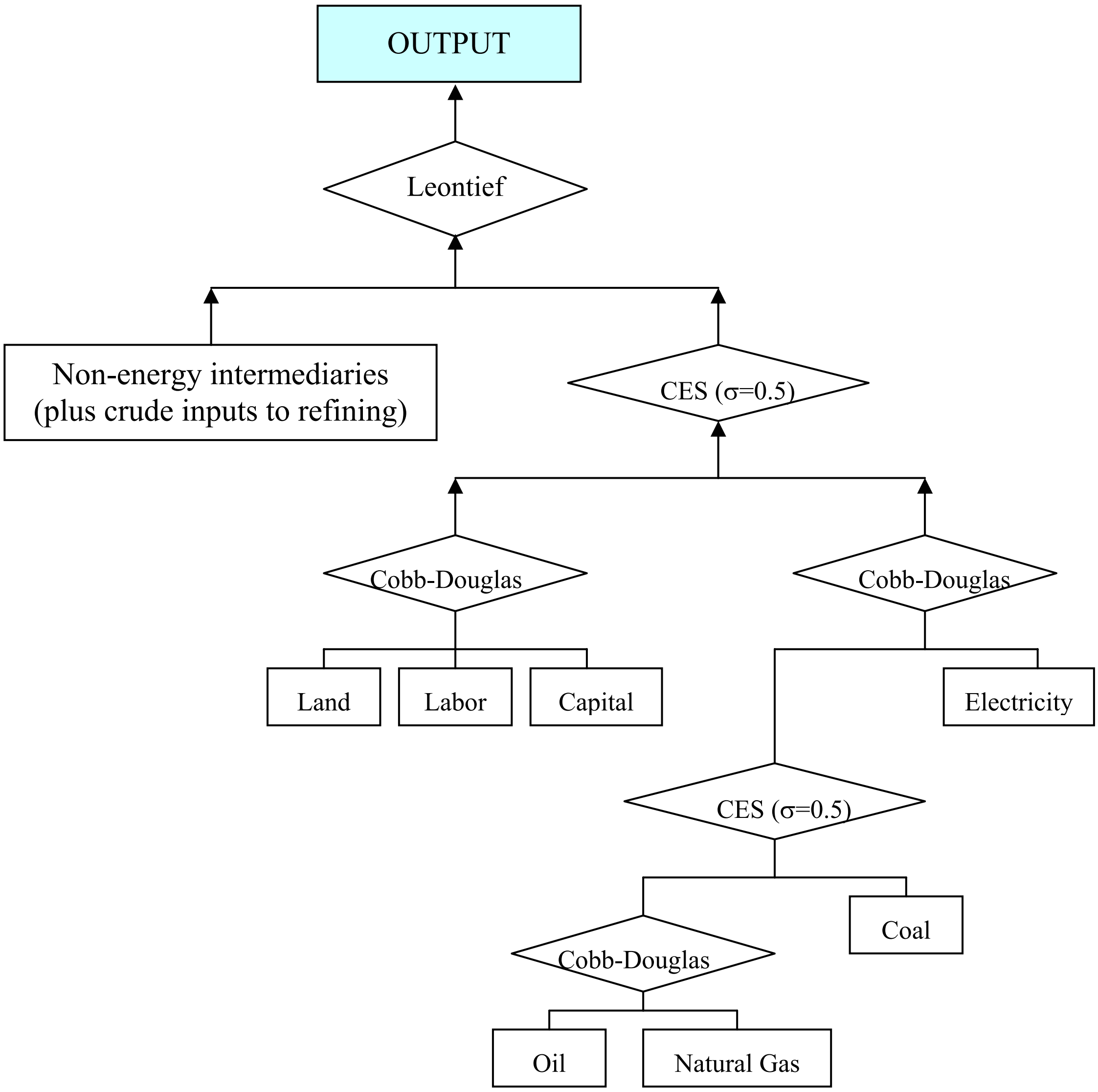


Figure 13:
Structure of Final Demand in the Babiker-Maskus-Rutherford (1997) Model

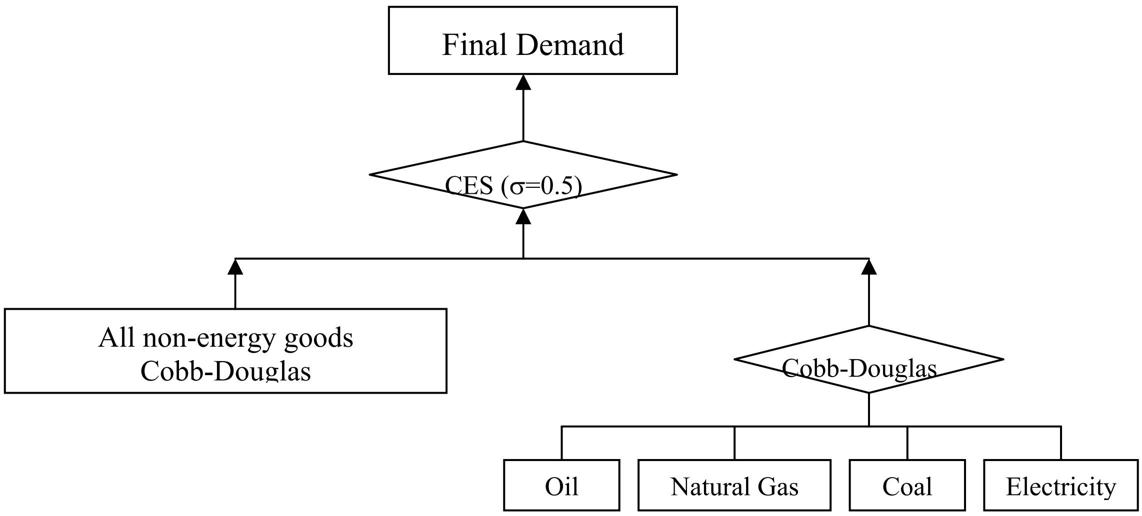


Table 6:
Summary Characteristics of the BMR Model

Model Characteristics	BMR Model
Top-down versus bottom-up	Top-Down
Dynamic	Recursive
Inter-fuel substitution	Yes
Fuel-factor Substitution	Yes
Capital – Energy complementarity/substitutability	Energy is a compliment to capital (as is land and labor)

2.5 Borges and Goulder (1984) Model

Borges and Goulder (1984, p. 340) assume a much simpler structure for the inter-fuel and fuel-factor substitution possibilities. However, the model allows for labor to be separated from capital, and energy and capital are to be grouped together in one nest. This is consistent with the approach taken in the GREEN model. To allow for the possibility of significant complementarity between K and E, Borges and Goulder assumed a fixed-coefficient structure for the KE composite. Using the Keller formula as described in the previous section, the substitution elasticity between energy and capital at the top level would then be given by $\sigma_{EK} = -1*[1/S_{EK} - 1]$, where S_{EK} is the cost share of capital and energy inputs. Since $S_{EK} < 1$, then

$\sigma_{EK} < 0$, i.e. capital and energy are significant complements at the top level of the production structure. On the issue of inter-fuel substitution, Borges and Goulder assume a Cobb-Douglas structure, but recognize that perhaps with the petroleum product and gas sectors, a fixed coefficient technology would be more appropriate (see Figure 14).

On the household consumption side, the utility structure allows for substitution between 'current consumption and future consumption', as well as between 'goods and services' and leisure. The goods and services sector is Cobb-Douglas with three different types of energy commodities: electricity, gas and 'gasoline and other fuels'.

Figure 14:
Structure of Production in Borges and Goulder (1984) Model

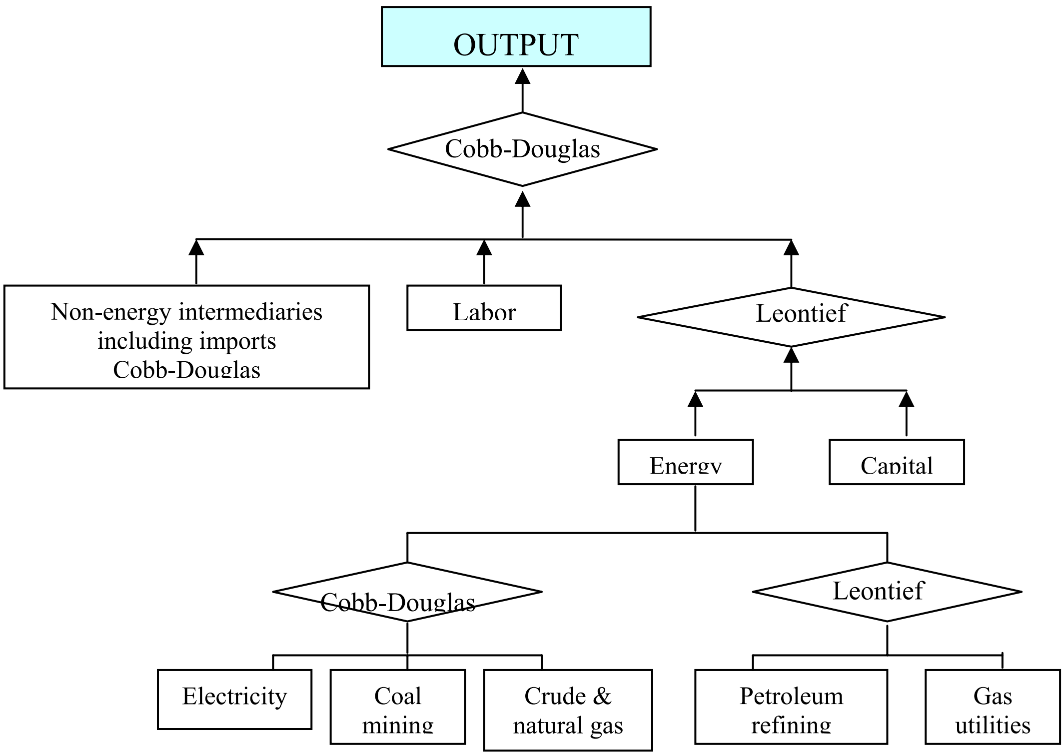


Table 7:
Summary Characteristics of the Borges and Goulder Model

Model Characteristics	CETM
Top-down versus bottom-up	Top-Down
Dynamic <	Simultaneous
Inter-fuel substitution	Yes
Fuel-factor Substitution	Yes
Capital – Energy complementarity/substitutability	Strict complementarity between capital and energy

3 Towards a GTAP Model with Energy Substitution

In this section we discuss the issue of how to incorporate the important features of energy substitution as reviewed in the previous section into the GTAP model. Currently, in the standard GTAP model[12], there is no inter-fuel nor fuel-factor (energy - primary factor) substitution, even though recent version of the model allows for a non-zero constant elasticity of substitution between *all* intermediate inputs. This latter feature is an improvement over previous versions. However, it still does not go far enough to allow for an adequate treatment of the issue of energy substitution, hence a more substantial approach needs to be taken here.

There are two important issues which must be addressed when considering extending the GTAP model to include energy substitution in its structure. The first relates to the question of a choice between a 'top-down' versus a 'bottom-up' approach. The second relates to the question about complementarity / substitutability between energy and capital inputs over time.

3.1 Top-Down versus Bottom-Up Approach

In selecting an approach for incorporating energy-substitution into the GTAP model, there are generally two different approaches[13]. The 'bottom-up' (engineering) approach often starts with a detailed treatment of the energy-producing processes or technologies, and then asks the questions: *given* a particular level of demand for energy *services* (which may be defined in terms of the level of outputs of certain activities, such as travel, heating, air conditioning, lighting, or even steel making, etc.), what is the most efficient way of going about to meet

[12] As documented in Hertel, T.W. and M.E. Tsigas "Structure of GTAP", Chapter 2 in Hertel (1997).
[13] See, for example, Wilson and Swisher (1993).

these demand in terms of the energy technologies employed and the level of inputs. The top-down (economic) approach, on the other hand, starts with a detailed description of the macro (and international) economy and then derive from there the demand for energy inputs in terms of the demand for various sectors' outputs through highly aggregate production or cost functions.

The advantage of a bottom-up approach is in the detailed specification of the energy technologies, through which newly developed or future technologies can be incorporated into the analysis. This provides it with much more realism than is the econometrically-specified 'production function' of the top-down approach. On the other hand, the latter can claim advantage in the fact that there is historical evidence in support of the assumed *behavioral* response implied in the production function specification, whereas the technology specifications may lack this behavioral content[14]. To utilise the advantages of both approaches, a top-down (macro-econometric or computable general equilibrium) model can be 'linked' to a bottom-up process model and the two models are solved simultaneously. However, there are many theoretical and computational difficulties associated with such a linkage. As a result, in some cases, a 'partial link' is pursued (such as the ETA-MACRO link in the CETM model discussed in section 2) or a 'simulated' approach to a process model is used (such as the specification of the energy-sector production possibilities in terms of 'technology bundles' in the MEGABARE model, see also section 2). While there are certain advantages associated with these 'partial' approaches, the price to pay for such an approach is in the added complexity in model specification, and also the additional data or parameter requirements. For example, in the MAGABARE model, there is the question of what parameters are to be used for the substitution between the 'technology bundles' to ensure some consistency with past behaviors which are implied in the historical data base being used in the model. As a result of these difficulties, and the desire to offer a widely-accessible energy model, these approaches are not pursued here. Instead, it is suggested that a simple 'top-down' approach be used, which can incorporate most of the important features of the existing top-down models in this area, such as GREEN or BMR (Babiker, Maskus, and Rutherford (1997)) models.

[14] As a result, there would be some difficulties in guessing what would be the future rates of penetration of new technologies into the market.

3.2 The Issue of Energy-Capital Substitutability or Complementarity

Having settled on a top-down approach to represent energy-substitution, the next question to consider is: which particular structure should be used to represent the substitution possibilities between alternative fuels (inter-fuel substitution) and between the energy aggregate as a whole and other primary factors, such as labor and capital (fuel-factor substitution). In particular, the question of energy-capital complementarity or substitutability is a major issue in this literature. In this section, we look at this issue from a theoretical viewpoint and then go on to review some of the empirical estimates of the parameters for energy and capital substitution /complementarity in the literature.

3.2.1 Importance of the Issue

According to Vinal (1984), the issue of energy-capital complementarity or substitutability may turn out to be a crucial one in determining the direction of the adjustment of aggregate output following energy price changes:

> '...the key parameter that determines whether output produced goes up or down after an energy price increase is the degree of complementarity/substitutability between energy and capital, measured by σ_{EK} [the substitution elasticity between energy and capital]' (Vinal, 1984: 237-238).

In Vinal's simple one-sector model with no distortions, when the capital stock is given, and the wage level is flexible, energy-capital substitutability 'is a sufficient condition for output produced to decline following an energy price increase. Alternatively, energy-capital complementarity is a necessary condition for output produced to rise following an energy price increase'. These results point out '*how crucial it is for macroeconomic analysis to determine whether energy and capital are complements or substitutes*' (Vinal, 1984, p 238, italics original)

3.2.2 Empirical Estimates of σ_{EK}

Despite the theoretical importance of the σ_{EK} parameter, *empirical* estimates of this parameter must overcome many difficulties. Table 4 gives some indicative values of σ_{EK} as estimated from various empirical studies. It can be seen from this Table that both the sign and magnitude of this parameter varies significantly between different studies.

The problem arises partly because energy-capital substitutability is a long-term adjustment process, and therefore, empirical estimates of σ_{EK} must take into account the issue of how short-term energy usage can be dynamically adjusted to a 'theoretically optimal' level in the long run, based on the level of investment. Conversely, capital must also adjust to the expected level of energy prices in the long term. Hogan (1989) has shown that where a 'correct' specification of a dynamic capital-energy usage structure is specified, more meaningful and accurate estimates of the inter-fuel and energy-primary factor substitution elasticities can be achieved. The key to the problem of specification is that a model must be able to represent the flexibility (in energy usage) in the long run but also allow for rigidity or inflexibility in the short to medium term due to capital constraint:

> ....responses to price changes take time. Although there is overwhelming evidence of great flexibility in the use of energy and other inputs, the most important changes in energy utilization depend upon changes in energy-using equipment. If this equipment changes slowly, then the full response to energy price changes will take many years to unfold... Initially, the price shocks have little effect on demand per unit of output; often the effects are so small as to suggest little response at all. But the new prices unleash forces that eventually produce dramatic changes in total energy demand...this demand response can be both a substantial break from trend and a confusing mixture of fuel substitutions. Analysis of this short-run record, in the search for insights into long-run possibilities, places great emphasis on the need for a description of the dynamics of energy demand adjustment.[15]

Inflexibility in capital adjustment comes from technological factors (such as discrete or lumpy investments), as well as adjustment costs. To describe this 'inflexibility', one approach is to use a technology or *process* model. Alternatively, the long-term adjustment process of capital can also be specified directly in an economic model (such as in GREEN). However, it is not always easy to find empirical estimates for the parameters of these models, hence the uncertainty surrounding the extent of energy-capital substitutability or complementarity.

[15] Hogan (1989, p. 54).

Table 8:
Estimates of the Partial Hicks-Allen Elasticities of Substitution (σ) and Factor Shares (α)

	US Berndt-Wood (1975)	US Kulatilaka (1980)	US Pindyck (1979)	Europe Pyndyck (1979)	Australia Truong (1985)
σ_{KK}.	-8.8	-2.75	-1.66	-0.98	-16.46
σ_{LL}.	-1.5	-0.22	-1.19	-0.82	-1.388
σ_{EE}.	-10.7	-2.70	-24.21	-13.16	-19.60
σ_{MM}.	-0.39				-0.222
σ_{KL}.	1.01	0.69	1.41	0.69	1.02
σ_{KE}.	-3.5	-1.09	1.77	0.60	-2.95
σ_{LE}.	0.68	0.61	0.05	1.13	1.77
σ_{KM}.	0.49				0.78
σ_{LM}.	0.61				0.42
σ_{EM}	0.75				0.17
α_L	0.289	0.76	0.478	0.526	0.263
α_E	0.044	0.10	0.032	0.055	0.023
α_K	0.046	0.14	0.488	0.409	0.044
α_M	0.619				0.67

K = capital, L= labor, E = Energy, M= Material.
Source: Vinal (1984), Table 3, p. 242, and Truong (1985).

3.3 The Structure of Inter-Fuel and Fuel-factor Substitution in GTAP-E

3.3.1 Production Structure with Energy Substitution

Based on the various structures of inter-fuel and fuel-factor substitutions adopted in other models as described in section 2, the following is suggested as a good option for GTAP-E.

On the production side, energy must be taken out of the intermediate input 'nest' to be incorporated into the 'value-added' nest (see Figures 15 and 16). The incorporation of energy into the value-added nest is in two steps. First, following the structure in the CETM model as well as the Babiker-Maskus-Rutherford (1997) model, energy commodities are first separated into 'electricity' and 'non-electricity' groups. Some degree of substitution is allowed within the non-electricity group (σ_{NELY}) as well as between the electricity and the non-electricity groups (σ_{ENER}). The values of these substitution elasticities are shown in Table 5. These are chosen to be in the middle range of the values adopted in other models.

Next, the energy composite is then combined with capital to produce an energy-capital composite[16], which is in turn combined with other primary factors in a value-added-energy (*VAE*)[17] nest through a CES structure (See Figure 17). The substitution elasticity between capital and the energy composite (σ_{KE}) is still assumed to be positive (indicating energy and capital are substitutes in the 'inner nest'). However, provided the value of σ_{KE} is set at a level lower than σ_{VAE}, the overall substitution elasticity (as viewed from the 'outer nest') between capital and energy may still be negative (Borge and Goulder (1984, p. 340)). To be more precise, we can use the formula derived by Keller (1980, p. 83) which specifies the relationship between the 'inner' and 'outer' elasticity of substitution between *K* and *E* as follows:

$$\sigma_{KE-outer} = [\sigma_{KE-inner} - \sigma_{VAE}] / S_{KE} + \sigma_{VAE} / S_{VAE}$$

where S_{KE} is the cost share of the *KE*-composite in the outer (value-added) nest, and $\sigma_{KE\text{-}inner}$ and $\sigma_{KE\text{-}outer}$ indicate the inner and outer substitution elasticities between *K* and *E* respectively.

In GTAP-E, the (inner) value of σ_{KE} is assumed to be 0.5 for most industries[18] (including electricity), and is set equal to 0.0 for coal, oil, gas, petroleum and coal products, and agriculture/forestry/fishery. This is based on the (low-to-middle) range of the values adopted by other models, such as the GREEN model, and the models used by Babiker *et al.* (1997), Rutherford *et al.* (1997), Bohringer and Pahlke (1997) (see Table 5). The value of σ_{VAE} ranges from 0.2 to 1.45 and this seems to be slightly larger than the values adopted by other models (see Table 6), but these are the values currently used in the standard GTAP model.

Based on the values of S_{KE} for some typical regions in the GTAP- 4E data base[19], the 'outer' values of σ_{KE} are derived using the above formula and are shown in Table 7. From this Table, it can be seen that most industries (with the exception of 'electricity' in the USA, and 'electricity', 'ferrous metals', and 'chemical, rubber, plastic products' in Japan) are characterized as having an overall complementarity relationship between energy and capital despite the fact that σ_{KE} is still specified as non-negative within the energy-capital nest.

Finally, Tables 8 and 9 show the Armington elasticities for the substitution between domestic and imported good (σ_D), and between imported goods from different regions (σ_M). The values

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[16] The reason for a focus on the energy-capital composite was given in section 3.2. See also the discussion in section 2.3.3 regarding the differences between energy-capital and energy-labor substitution.

[17] The term 'value-added-energy' is used to emphasize the fact that energy is now present in this nest.

[18] For details on the industry sector aggregation, see Table A1 of the Appendix.

[19] See Malcolm and Truong (1999).

of σ_D and σ_M for GTAP-E are taken from the 'standard' GTAP model, and are seen to be lower than some of the values used in other models, such as those in Babiker *et al.* (1997). In studies which seek to simulate the trade effect of a 'homogeneous energy commodity market' (such as that for coal) in response to an energy-environmental shock (such as the imposition of a carbon tax), these Armington elasticities may play a crucial role. However, this issue is not considered in this paper.

Figure 15:
Standard GTAP production structure

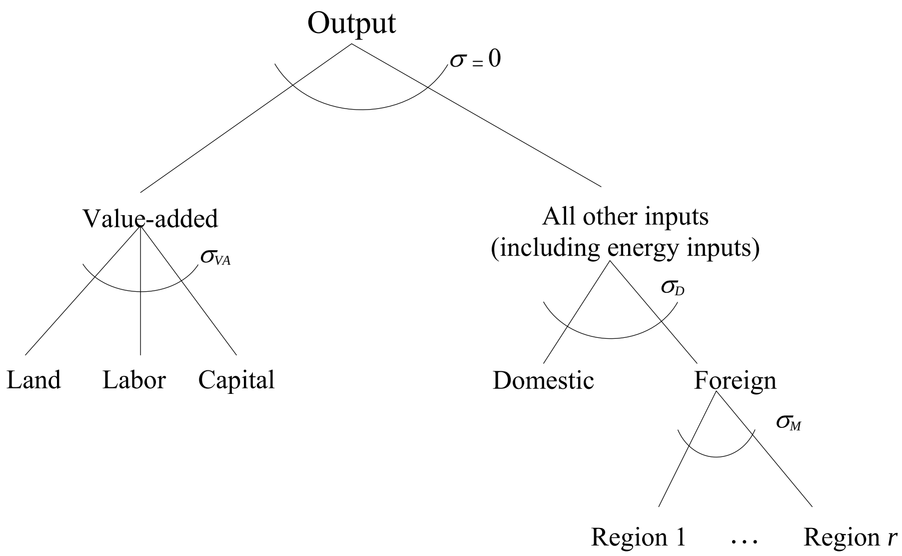


Figure 16:
GTAP-E production structure

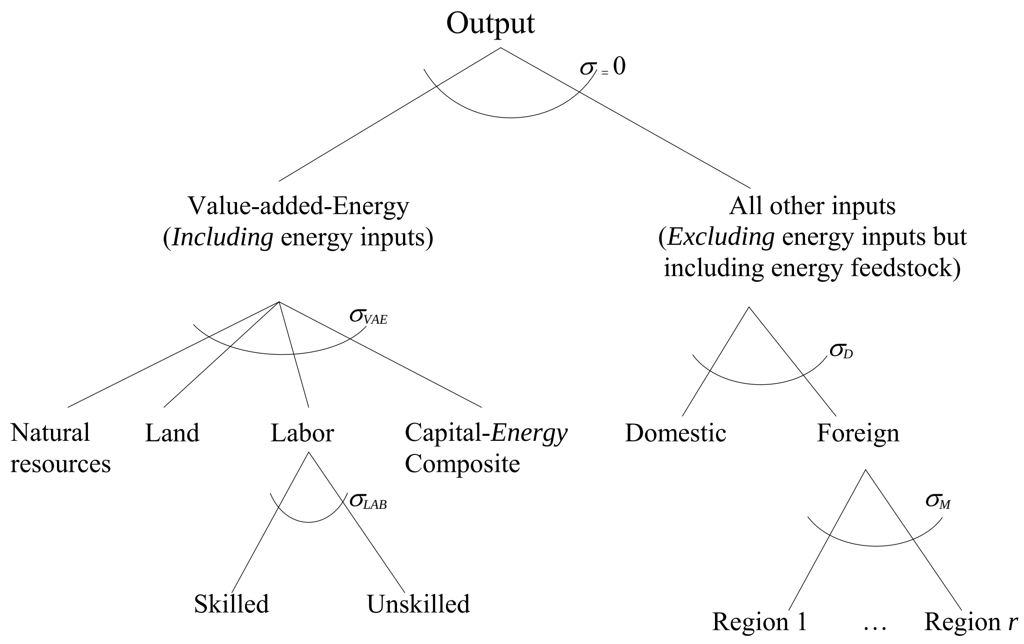


Figure 17:
GTAP-E capital-energy composite structure

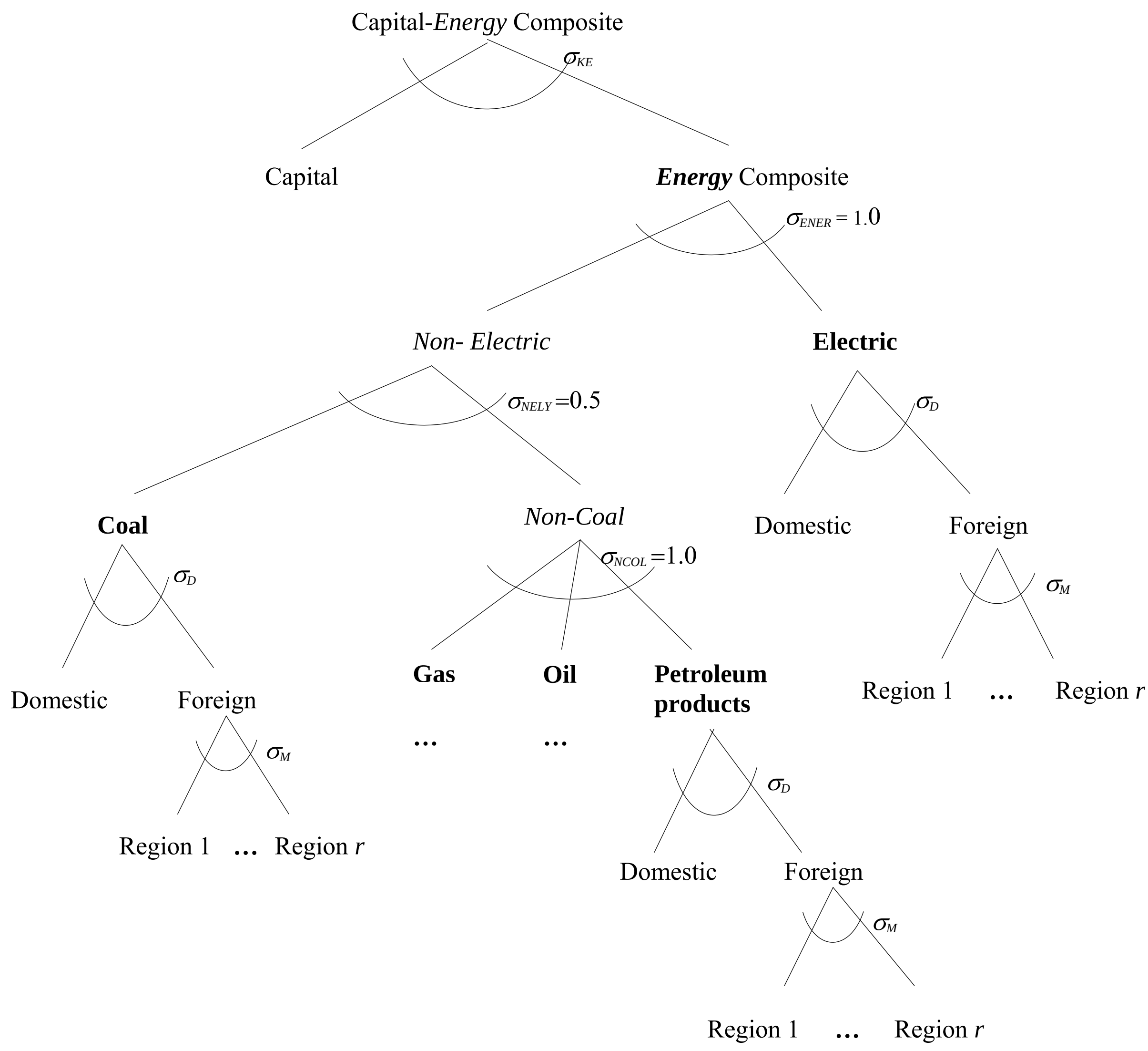


Table 9:
Energy Substitution Elasticities in GTAP-E and Other Models

Sector*	Capital-Energy (*K-E*)			Inter-fuel			
	GTAP-E (a)	GREEN (b)	Rutherford (c)	GTAP-E (e)			GREEN
				Electric vs Non-electric	Coal vs other non-electric	between non-coal, non-electric	
Coal	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Crude Oil	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gas	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Petroleum, coal products	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Electricity	0.5	0.0 - 0.8	-(d)-	1.0	0.5	1.0	0.25 - 2.0
Ferrous metals	0.5	0.0 - 0.8	0.5	1.0	0.5	1.0	0.25 - 2.0
Chemical, rubber, plastic products	0.5	0.0 - 0.8	0.5	1.0	0.5	1.0	0.25 - 2.0
Other manufacturing; trade, transport	0.5	0.0 - 0.8	0.5	1.0	0.5	1.0	0.25 - 2.0
Agriculture, forestry, and fishery	0.0	0.0 - 0.8	0.5	1.0	0.5	1.0	0.25 - 2.0
Commercial/public services, dwellings	0.5	0.0 - 0.8	0.5	1.0	0.5	1.0	0.25 - 2.0

[*] For details on the sector aggregation, see Table A1 of the Appendix.

[a] To ensure capital and energy are complements in the short run, while substitutes in the long run, the elasticity of substitution between *K* and *E* aggregate must be set lower than the elasticity between *K* and other primary factors (σ_{VAE}).

[b] In the GREEN model, if the long-term elasticity between *K* and *E* is equal to 2.0 and the short run value set equal to 0.25, then the 'intermediate' term (approximately 5 years) elasticity - which depends on the vintage structure of the capital - will be about 0.8 (see Figure 5, Burniaux *et al.* (1992), p. 66).

[c] In Rutherford models, a value of 0.5 is set for substitution between energy composite and land-labor-capital composite in the non energy-producing industries (Babiker *et al.* (1997)), or between energy composite and labor-capital composite (Rutherford *et al* (1997), and Bohringer and Pahlke (1997)).

[d] *K-E* substitution for the electricity industry is determined, not by an econometric parameter, but by the specification of alternative electricity-generation technologies in the 'process model'.

[e] This is based on the values of 1.0 chosen for the substitution between electric and non-electric, and between non-coal fossil fuels in (Babiker *et al.* (1997)), Rutherford *et al.* (1997). Bohringer and Pahlke (1997) however, chose a value of 2.0 for the substitution between non-coal fossil fuels. For substitution between coal and non-coal fossil fuels, Babiker *et al.* (1997) chose a value of 0.5, whereas Bohringer and Pahlke (1997) chose a value of 0.25 if the non-coal aggregate includes electricity.

Table 10:
Elasticities of Substitution Between Different Factors of Production

Sector	GTAP-E[a] (σ_{VAE})	GREEN L - KEF[b]	GREEN E - KF[c]	Rutherford[d]
Coal	0.2	0.0	0.0	1.0
Crude Oil	0.2	0.0	0.0	1.0
Gas	0.84	0.0	0.0	1.0
Petroleum, coal products	1.26	0.0	0.0	1.0
Electricity	1.26	0.0	0.0 - 0.8	1.0
Ferrous metals	1.26	0.12 - 1.0	0.0 - 0.8	1.0
Chemical, rubber, plastic products	1.26	0.12 - 1.0	0.0 - 0.8	1.0
Other manufacturing; trade, transport	1.45	0.12 - 1.0	0.0 - 0.8	1.0
Agriculture, forestry, and fishery	0.23	0.12 - 1.0	0.0 - 0.8	1.0
Commercial/public services, dwellings	1.28	0.12 - 1.0	0.0 - 0.8	1.0

[a] In GTAP-E: between land, natural resources, aggregate labor, and capital-energy composite.
[b] between labor (L), and energy-capital-fixed factor composite (EKF).
[c] between energy (E) and capital-fixed factor composite (KF).
[d] between land, labor, and capital (see Babiker *et al.* (1997)), or between labor and capital (Rutherford *et al.* (1997) and Bohringer and Pahlke (1997)).

Table 11:
The Relationship Between Inner ($\sigma_{KE\text{-}inner}$) and Outer ($\sigma_{KE\text{-}outer}$) Elasticities of Substitution for the Cases of Japan and the US

Sector	$\sigma_{KE\text{-}inner}$	σ_{VAE}	Japan S_{VAE}	Japan S_{KE}	Japan $\sigma_{KE\text{-}outer}$	USA S_{VAE}	USA S_{KE}	USA $\sigma_{KE\text{-}outer}$
Coal	0.0	0.2	0.49	0.11	-1.50	0.67	0.16	-0.97
Crude Oil	0.0	0.2	0.64	0.24	-0.52	0.69	0.34	-0.30
Gas	0.0	0.84	0.97	0.95	-0.02	0.81	0.55	-0.49
Petroleum, coal products	0.0	1.26	0.68	0.59	-0.28	0.91	0.88	-0.04
Electricity	0.5	1.26	0.83	0.71	0.45	0.84	0.71	0.43
Ferrous metals	0.5	1.26	0.51	0.34	0.27	0.43	0.18	-1.35
Chemical, rubber, plastic products	0.5	1.26	0.42	0.26	0.05	0.50	0.30	-0.05
Other manufacturing; trade, transport	0.5	1.45	0.46	0.16	-2.65	0.51	0.18	-2.45
Agriculture, forestry, and fishery	0.0	0.23	0.58	0.20	-0.77	0.46	0.26	-0.38
Commercial/public services, dwellings	0.5	1.28	0.62	0.30	-0.58	0.63	0.23	-1.41

Note: $\sigma_{KE-outer} = [\sigma_{KE-inner} - \sigma_{VAE}]/S_{KE} + \sigma_{VAE}/S_{VAE}$, where S_{KE}, $\sigma_{KE\text{-}inner}$ are the cost share and substitution elasticity respectively for the capital-energy composite and S_{VAE}, σ_{VAE} are the cost share and substitution elasticity respectively for the value-added-energy composite.

Table 12:
Elasticities of Substitution Between Domestic and Foreign Sources (σ_D)

Sector	GTAP-E	GREEN[b]	Rutherford[c] Low-High
Coal	2.80	4.0	2.0
Crude Oil	10.0[a]	∞	∞
Gas	2.80	4.0	2.0
Petroleum, coal products	1.90	4.0	2.0
Electricity	2.80	0.3	2.0
Ferrous metals	2.80	2.0	4.0 – 8.0
Chemical, rubber, plastic products	1.90	2.0	4.0 – 8.0
Other manufacturing; trade, transport	2.59	2.0	4.0 – 8.0
Agriculture, forestry, and fishery	2.47	3.0	4.0 – 8.0
Commercial/public services, dwellings	1.91	2.0	4.0 – 8.0

[a] This is higher than the standard value of 2.8 used in most GTAP applications.
[b] Burniaux *et al.* (1992), p. 76.
[c] Babiker *et al.* (1997).

Table 13:
Elasticities of Substitution Between Different Regions (σ_M)

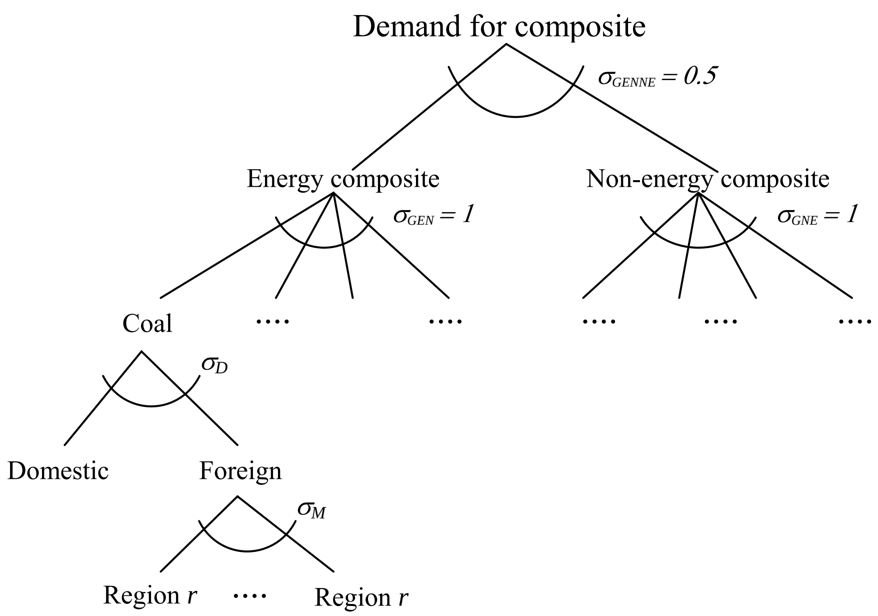
Sector	GTAP-E	GREEN[b]	Rutherford[c] Low-High
Coal	5.60	5.0	4.0
Crude Oil	20.0[a]	∞	∞
Gas	5.60	5.0	4.0
Petroleum, coal products	3.80	3.0	4.0
Electricity	5.60	0.5	4.0
Ferrous metals	5.60	3.0	8.0 - 16.0
Chemical, rubber, plastic products	3.80	3.0	8.0 - 16.0
Other manufacturing; trade, transport	6.04	3.0	8.0 - 16.0
Agriculture, forestry, and fishery	4.62	4.0	8.0 - 16.0
Commercial/public services, dwellings	3.80	3.0	8.0 - 16.0

[a] This is higher than the standard value of 5.6 used in most GTAP applications.
[b] Burniaux *et al.* (1992), p. 76.
[c] Babiker *et al.* (1997).

3.3.2 Consumption Structure

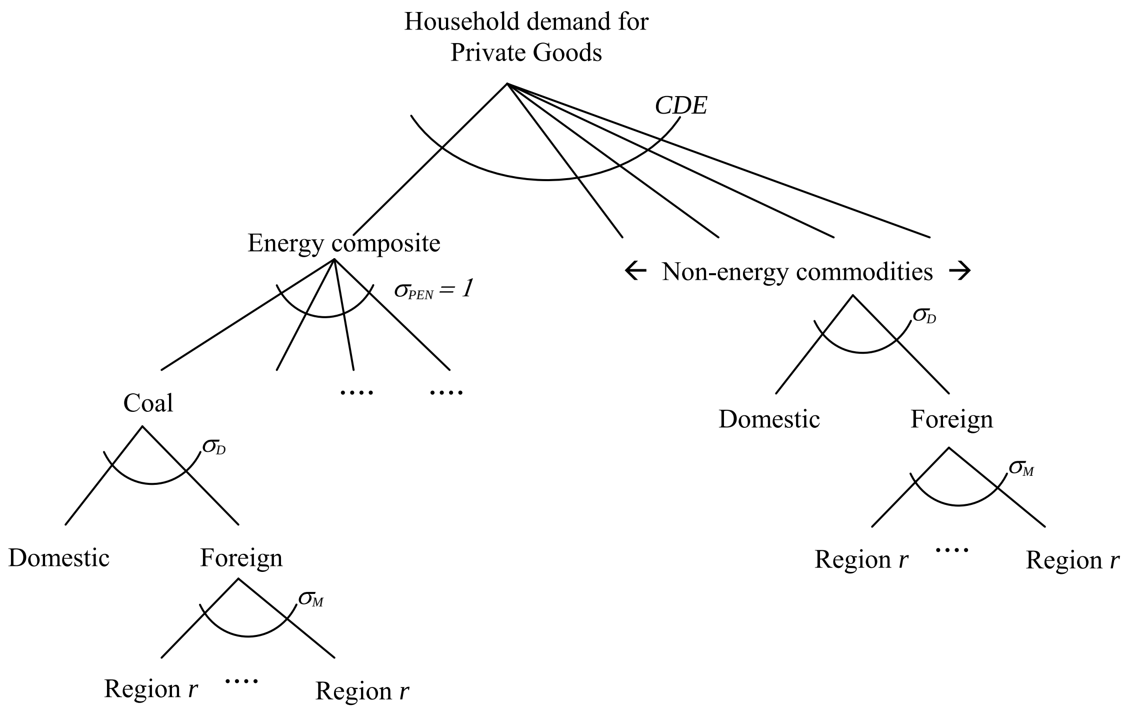
On the consumption side, the existing structure of GTAP assumes a separation of 'private' consumption from 'government' consumption (consumption by households of publicly provided goods) and private savings. Government consumption expenditure is then assumed to be Cobb-Douglas with respect to all commodities (σ_G = 1). In the GTAP-E model, energy commodities are separated from the non-energy commodities with a nested-CES structure as shown in Figure 18. If, however, the substitution elasticity σ_{GEN} given to the inner energy nest and σ_{GENNE} given to the outer nest are both equal to 1 (substitution elasticity σ_{GNE} in the non-energy nest is assumed to be equal to σ_G and is therefore also equal to 1), then the GTAP-E structure is equivalent to the original GTAP structure. In general, however, if $\sigma_{GEN} \neq \sigma_{GENNE} \neq 1$, then the GTAP-E structure allows for different substitution elasticities within the energy and non-energy sub-groups, as well as between the two groups. For the current version of GTAP-E, the following values are adopted: σ_{GEN} = 1, and σ_{GENNE} = 0.5. This structure is very similar to the structure of household demand given in Rutherford *et al.* (1997) (see Figure 3), and Bohringer and Pahlke (1997), except that in the model of Bohringer and Pahlke, a smaller value of 0.3 is used for substitution between energy and non-energy aggregates, and a higher value of 2 is used for substitution between fossil fuels (excluding coal).

Figure 18:
GTAP-E Government Purchases



Household 'private' consumption (i.e. consumption of private goods) is assumed to be structured according to the constant-difference of elasticities (CDE) functional form in the existing GTAP model. If the energy commodities within the CDE structure have the same income and substitution parameters, then according to the theory of the CDE structure, these commodities can be aggregated into a single composite with the same parameters as that of the individual components. Currently, in fact, within the GTAP model, four of the five energy commodities (coal, oil, gas, and electricity) have similar parameters, which differ only from that of the 'petroleum and coal products'. This implies we can aggregate the energy commodities into a composite which remains in the CDE structure and has the same (or the average of the) CDE parameter values characterizing the individual energy commodities. To allow for flexible substitution between the individual energy commodities, the energy composite is now specified as a CES sub-structure, with a substitution elasticity of $\sigma_{PEN} = 1$ (see Figure 19) which is similar to the value given to σ_{GEN} (see Figure 18). This is the same as the value adopted in Rutherford *et al.* (1997) (see Figure 3) and consistent with the medium term value adopted in the GREEN model (see section 2.3.2).

Figure 19:
GTAP-E Household Private Purchases



To better characterize the behavior of GTAP-E in comparison with GTAP, it is worth calculating the overall general equilibrium (GE) elasticities in both models (see Annex 1). GE elasticities depend on the structure of the model, the value of the substitution parameters and the particular closure assumed. They also depend on the benchmark database. The elasticities in Annex 1 have been calculated by using the version 4 of the GTAP data base. Thus the elasticities reported in Annex 1 are primarily to illustrate the behavioral implications of introducing interfuel substitution. Since these elasticities are also dependent on the base data, they are different in the current version of the model that is based on the version 6 of the GTAP data base.

4 Illustrative experiments

GTAP-E has been specifically designed to simulate policies in the context of Greenhouse Gas (GHG) mitigation. This is best illustrated by using GTAP-E (based on GTAP Version 6 Data Base) to simulate the implementation of the European emissions trading scheme in 2005.

By signing the Kyoto Protocol in 1997, a number of industrialized countries – referred to hereafter as Annex 1 countries – committed themselves to reduce their GHGs emissions relative to their 1990 levels. Initially, the Protocol aimed at ambitious reductions: the total emissions of Annex 1 countries were planned to be brought down in 2012 by 5 per cent below their 1990 levels. The Protocol made provision for country specific targets. A number of so-called “flexibility mechanisms” were also provided in order to allow emission reductions to be reallocated among Annex 1 countries. The “Emission Trading” (ET) mechanism and the “Joint Implementation” (JI) mechanism aimed at reallocating the burden of the emission reductions among Annex 1 countries. In contrast, the “Clean Development mechanism” (CDM) would allow Annex 1 countries to fund emission reductions in non-Annex 1 countries.

In 2005, the European Union (EU) introduced an emissions trading system (ETS) in order to pursue its Kyoto obligations. This instrument gives emitters the flexibility to undertake reduction measures in the most cost-efficient way. The EU ETS is a cap-and-trade system, i.e. the absolute quantity of emission rights is fixed at the beginning, and only involves CO_2 emissions. In this section, we use the GTAP-E model and version 6 GTAP database to analyse the economic and environmental effects of the implementation of the EU ETS. We look at the value of the flexibility gained by the trading of emissions compared to the case of fixed emissions quotas[20]. We conduct four simulation experiments to analyse the effects of the EU ETS. In Experiment 1, the fixed EU ETS quotas are imposed on all the participating sectors and no emission trading is allowed. In Experiment 2 emission trading is allowed across the participating sectors within a national economy but not across the national borders. In Experiment 3, we allow emission trading to occur across the national borders of the participating EU member states, and finally in Experiment 4, emission trading is allowed also across *all* sectors and *al*l regions of the world. Table 14 describes the regions and the countries represented in the EU ETS Experiment. Table 15 describes the sectors.

Table 14:
Categorisation of Regions/Countries

No.	Code	Description (comprising GTAP V6 Countries/Regions)
1	fra (*)	France
2	deu (*)	Germany
3	gbr (*)	United Kingdom
4	ita (*)	Italy
5	REU	Rest of European Union: Austria, Belgium, Denmark, Finland, Greece, Ireland, Luxembourg, the Netherlands, Portugal, Spain, Sweden, Cyprus, Czech Republic, Hungary, Malta, Poland, Slovakia, Slovenia, Estonia, Latvia, Lithuania.
6	CHIND	China and India
7	JPN	Japan
8	USA	United States
9	LAM	Latin America: Mexico, Colombia, Peru, Venezuela, Rest of Andean Pact, Argentina, Brazil, Chile, Uruguay, Rest of South America, Central America, Rest of FTAA, Rest of Caribbean.
10	RoW	Rest of the World: Australia, New Zealand, Rest of Oceania, Hong Kong; Korea, Republic of Taiwan; Rest of East Asia, Indonesia, Malaysia, Philippine; Singapore; Thailand; Vietnam, Rest of SE Asia, Bangladesh; Sri Lanka; Rest of South Asia; Canada, Switzerland, Rest of EFTA, Rest of Europe, Albania, Bulgaria, Croatia, Romania, Russian Federation, Rest of Former Soviet Union, Turkey, Rest of Middle East, Morocco, Tunisia, Rest of North Africa, Botswana, South Africa, Rest of SACU, Malawi, Mozambique, Tanzania, Zambia, Zimbabwe, Rest of ASDC, Madagasca, Uganda, Rest of sub-Saharan Africa.

(*) Countries participating in the EU ETS which are represented in our illustrative experiments. The full list of countries participating in the EU ETS consist of: Austria, Belgium, Denmark, Finland, France, Germany, Greece, United Kingdom, Italy, the Netherlands, Portugal, Spain, Sweden, Czech Republic, Hungary, and Poland. In Kemfert *et al.* (2007) we included all of these countries in the setoff regions for the experiments. Here, however, for the illustrative purpose of the use of the GTAP-E model and to simplify the experiment, we include only four countries.

[20] Full details of this analysis is given in Kemfert *et al.* (2007). Here, we summarise only the essential points to illustrate the use of the GTAP-E model.

Table 15:
Categorisation of Sectors

No.	Code	Description (GTAP V6 sectors)
1	Coal	coal mining
2	Oil	crude oil
3	Gas	natural gas extraction, gas manufacture and distribution
4	Ely (*)	electricity
5	P_C (*)	petroleum and coal products
6	Metals (*)	ferrous metals, metals nec, metal products
7	Min_Prod (*)	chemical, rubber, plastic products, mineral products nec
8	Paper (*)	paper products, publishing
9	Oth_Ind (*)	other industries: textiles, wearing apparel, motor vehicles and parts, transport equipment nec, electronic equipment, machinery and equipment nec, manufactures nec, water, construction.
10	ROE	Rest of the economy: paddy rice, wheat, cereal grains nec, vegetables, fruit, nuts, oil seeds, sugar cane, sugar beet, plant-based fibers, crops nec, bovine cattle, sheep and goats, horses, animal products nec, raw milk, wool, silkworm cocoons, forestry, fishing, bovine cattle, sheep and goat meat , meat , vegetable oils and fats, dairy products, processed rice, sugar, food products nec, beverages and tobacco products, leather products, wood products, trade, transport nec, water transport, air transport, communication, financial services nec, insurance, business services nec, recreational and other services, public admin. and defence, education, health, ownership of dwellings

(*) Sectors represented in the EU ETS Experiment. For the full set of sectors participating in the EU ETS, see Kemfert *et al.* (2007).

4.1 Experiment 1 – No Emissions Trading

To calculate the emissions quotas to be imposed on the emitting sectors participating in the EU ETS scheme, we first estimate the 'Business-as-Usual" or reference emissions for the period up to 2007 for each of the sectors. These are then compared with the emissions caps as defined by the EU ETS. From this, we calculate the percentage change in emissions due to the EU ETS caps. If these percentage changes are negative (the shaded areas), this implies that the emissions caps are binding and the ('binding') sectors have to reduce their emissions relative to the BaU case. This will mean the sectors incur *positive* marginal abatement costs (MACs) which are going to be determined endogenously by the model. In contrast, if the emissions percentage changes are positive, this implies the EU ETS emissions caps are not binding and therefore, instead of 'shocking' (i.e. forcing) the emissions levels to the same level as the quotas – which are not meaningful, we just let the MAC be zero. The emissions levels will then be determined endogenously by the model and will often be less than the quotas[21] but can exceed the BaU levels due to the fact that other ('binding') sectors being forced to reduce their emissions levels, some leakage may occur towards the non-binding sectors. Table 16 shows the percentage changes in emissions as defined by the EU ETS. Table 17 (first part) shows the actual changes (as estimated by the GTAP-E model) in Experiment 1. The non-shaded areas show the *endogenous* changes as determined by the model (for the non-binding sectors). The shaded areas show the percentage changes as fixed by the EU ETS (for 'the binding sectors'). Table 18 (Part 1) shows the resulting MACs for the binding sectors as determined from the GTAP-E model.

Table 16:
Percentage difference from the Projected BaU Emissions to the EU ETS 'Allocated Emissions' (*)

Sector\ Region	Ely	P_C	Metals	Min_Prod	Paper	Oth_Ind	ROE
fra	-0.4	-2.8	-10.3	-8.1	7.3	NC	NC
deu	-3.1	-2.6	-0.5	-0.4	-1	-2.2	NC
gbr	-8.7	-0.9	-18.4	-5.7	-3.3	-3.3	NC
ita	-5.5	0.5	-4.2	-1.7	-3.4	NC	NC

(*) (Allocated emissions – Projected BaU Emissions)/(Projected BaU Emissions) * 100. Shaded areas show the sectors where the EU ETS emissions caps are binding, and the non-shaded areas show the sectors where the EU ETS emissions caps are projected to be non binding. 'NC' indicates no emission cap is imposed (non-participating sectors).

4.2 Experiment 2 – Domestic Emissions Trading

In Experiment 2, we allow all the sectors of each region with an EU ETS cap to trade in emissions with each other (but not to trade with other sectors in a different region). This will result in a uniform MAC across all trading sectors for each region but the MAC will be different for different regions. To allow the results to be compared between Experiments 1 and 2, the total level of emissions of all *trading*[22] sectors is kept constant across the two Experiments. Within each region (for example, "fra"), we find that the trading sectors with a high MAC (such as "Metals" and "Min_Prod" which have MACs at 35.5 \$/tC and 44.3 \$/tC respectively)[23] can now lower their emissions reduction targets (from -10.3% and -8.1% in Experiment 1 to -

[21] In the unlikely event that the endogenous emissions for these sectors turn out to be greater than the quotas, we will then have to re-run the experiment and reclassify the 'binding' sectors. However, this approach has not been found necessary as all endogenous emissions of these sectors are found to be less than the quotas.

[22] The total level of emissions of *all* sectors *including the non-trading sectors*, however, will not remain the same across the Experiments because of the 'leakage' effect.

4.2% and -3.0% respectively in Experiment 2). This will also lower their MACs to a uniform level of 13.5 $/tC. To meet the emissions caps, they can buy the extra emissions rights from the “Ely” sector, also at the same price f 13.5 $/tC. The “Ely” sector, on the other hand, now finds it more profitable to *increase* its emissions reduction target, from -0.4% to -8.6%. This is because it can then sell the surplus emissions rights to the “Metals” and “Min_Prod” sectors, at a price of 13.5 $/tC which is considerably higher than its MAC (which starts from 1.5 $/tC at -0.4% emissions reduction and reaching reach 13.5 $/tC only at the -8.6% emissions reduction level).

4.3 Experiment 3 – Regional Emissions Trading

In Experiment 3, we allow emissions trading to occur not only between sectors of a particular region, but also across regions. This will result in a MAC which is uniform not only across the trading sectors of a particular region, but also across regions. To allow meaningful comparison between Experiments 2 and 3, we impose the restriction that the total level of emissions of all *trading* sectors and regions in Experiment 3 will be kept the same as in Experiment 2. Regions with a high MAC (such as “fra” and “gbr” which have a MAC of 13.5 $/tC and 14.4 $/tC respectively) will now find it much cheaper to meet their regional emissions caps by lowering their own emissions reduction targets (from -1.4% and -3.63% to -0.91% and -2.27% respectively), and then buy the emissions rights from the other region (“deu”). Germany (“deu”), on the latter hand, will find it more profitable to *increase* its own emissions reduction target, from -1.62% to -2.64% (see the last column of Table 17), and then sell the surplus emissions rights to “fra” and “gbr”. The price of emissions rights is 8.8 $/tC which is higher than Germany’s MAC (5.5 $/tC at -1.62% emissions reduction and reaching 8.8 $/tC only when emissions reduction is at -2.64% level).

4.4 Experiment 4 – World Emissions Trading

In all previous Experiments, we restrict emissions trading to only specific sectors within each region which have been imposed with an emission cap as specified in the EU ETS (see Table 16). Suppose now that emission trading can occur across *all* sectors and *al*l regions of the

[23] The currency unit is 2000 $US. Emission unit is ton of carbon (tC).

world[24] We can see from Table 18 that the MAC for the world as a whole is now much less than the MAC which would have prevailed under Experiment 3 (i.e. 0.26 \$/tC as compared to 8.8 \$/tC). The regions which originally participated in the EU ETS can now relax in their own emissions reduction efforts (compare the last column of Part 4 of Table 17 with Part 3 of the same Table). This is because the ‘burden’ of emissions reduction is now shifted onto or shared with other regions. The benefit to these regions is the income gained from selling the surplus emissions rights to the ‘deficit’ regions (i.e. the regions which originally participated in the EU ETS). Table 19 shows the value of the economic gains, when we move from Experiment 1 to Experiment 2, from Experiment 2 to Experiment 3, and finally, from Experiment 3 to Experiment 4. These gains are measured approximately as : $W = -½*(\Delta P. \Delta Q)$, where ΔQ is the absolute change in the levels of emissions (tC) from one Experiment to the next, and ΔP is the absolute change in the price of these emissions (as indicated by the change in the MAC). Since ΔQ and ΔP are almost always in the opposite directions, the value of welfare gains will always be positive (except in the rare cases where the income effect dominates the substitution effect, and therefore, ΔQ and ΔP may be of the same sign – see the footnote in Table 19). From Table 19, it is seen that the largest welfare gains, however, are still confined mostly to the sectors/regions which originally participated in the EU ETS.

[24] Even though this is quite clearly an unrealistic assumption, it is used to illustrate the most ideal situation where climate change can be achieved with the least possible economic cost if all sectors and regions in the world participated. To ensure consistency between Experiment 3 and 4, we impose the restriction that each region will now be given a quota which is exactly equal to the emissions which would have prevailed under Experiment 3, and the total level of emissions of the world as a whole will not change between Experiments 3 and 4.

Table 16:
Percentage change in emissions for period 2005-2007 in various Experiments

Sector\ Region	Coal	Oil	Gas	Ely	P_C	Metals	Min_ Prod	Paper	Oth_ Ind	ROE	Total
Experiment 1 (No Emissions Trade)											
fra	-1.4	-0.2	0.0	-0.4	-2.8	-10.3	-8.1	0.0	-0.3	-0.6	-1.52
deu	-2.4	-0.1	0.0	-3.1	-2.6	-0.5	-0.4	-1.0	-2.2	-0.5	-1.75
gbr	-5.1	-0.1	-0.8	-8.7	-0.9	-18.4	-5.8	-3.3	-3.3	0.0	-3.36
ita	-0.8	0.0	-0.3	-5.5	-0.2	-4.2	-1.7	-3.4	0.8	0.3	-1.75
REU	-0.3	-0.1	-0.3	0.3	0.5	0.2	0.2	0.1	0.0	0.0	0.22
CHIND	-0.1	-0.1	-0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.06
JPN	-0.3	-0.1	-0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.07
USA	-0.2	-0.1	-0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.08
LAM	-0.6	-0.1	0.0	0.1	0.1	0.2	0.1	0.1	0.1	0.0	0.07
RoW	-0.3	-0.1	-0.2	0.2	0.2	0.2	0.2	0.1	0.1	0.0	0.11
Experiment 2 (Domestic Emissions Trade)											
fra	-1.2	-0.2	0.0	-8.6	-2.2	-4.2	-3.0	0.1	-0.1	-0.5	-1.40
deu	-2.7	-0.1	-0.1	-3.4	-1.5	-2.0	-1.3	-1.7	-1.1	-0.2	-1.62
gbr	-4.7	-0.1	-0.5	-8.7	-2.2	-10.0	-1.4	-4.2	-1.1	-0.6	-3.63
ita	-0.9	0.0	-0.2	-5.3	-0.1	-4.3	-2.5	-2.3	0.7	0.3	-1.75
REU	-0.3	-0.1	-0.3	0.4	0.5	0.1	0.1	0.1	0.0	0.0	0.22
CHIND	-0.1	-0.1	-0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.06
JPN	-0.3	-0.1	-0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.06
USA	-0.2	-0.1	-0.1	0.2	0.1	0.1	0.1	0.1	0.0	0.0	0.09
LAM	-0.7	-0.1	0.0	0.2	0.1	0.2	0.1	0.1	0.1	0.0	0.07
RoW	-0.3	-0.1	-0.1	0.2	0.2	0.2	0.2	0.1	0.1	0.0	0.11
Experiment 3 (Regional Emissions Trade)											
fra	-0.9	-0.1	-0.1	-5.7	-1.4	-2.7	-1.9	0.1	-0.1	-0.3	-0.91
deu	-4.3	0.0	0.1	-5.5	-2.5	-3.2	-2.2	-2.8	-1.8	-0.4	-2.64
gbr	-2.9	-0.1	-0.3	-5.5	-1.3	-6.4	-0.8	-2.6	-0.7	-0.4	-2.27
ita	-0.9	0.0	-0.2	-4.7	-0.1	-3.8	-2.2	-2.0	0.7	0.3	-1.56
REU	-0.3	-0.1	-0.3	0.4	0.5	0.1	0.1	0.1	0.0	0.0	0.23
CHIND	-0.1	0.0	-0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.0	0.06
JPN	-0.3	-0.1	-0.1	0.1	0.0	0.1	0.1	0.1	0.0	0.0	0.06
USA	-0.2	-0.1	-0.1	0.1	0.1	0.1	0.1	0.1	0.0	0.0	0.08
LAM	-0.7	-0.1	0.0	0.2	0.1	0.1	0.1	0.1	0.1	0.0	0.07
RoW	-0.3	-0.1	-0.2	0.2	0.1	0.2	0.2	0.1	0.1	0.0	0.11
Experiment 4 (World Emissions Trade)											
fra	-0.1	-0.1	-0.2	0.0	0.0	0.0	0.0	-0.1	-0.1	0.0	-0.02
deu	-0.2	-0.1	-0.1	-0.1	0.0	-0.1	0.0	-0.1	0.0	0.0	-0.05
gbr	-0.2	0.0	0.0	-0.1	0.0	-0.2	0.0	-0.1	0.0	0.0	-0.04
ita	-0.3	0.0	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	0.0	0.0	-0.04
REU	-0.2	-0.1	-0.1	-0.1	-0.1	-0.1	0.0	-0.1	0.0	0.0	-0.05
CHIND	-0.5	0.0	-0.3	-0.6	-0.1	-0.3	-0.2	-0.5	-0.1	-0.1	-0.36
JPN	-0.2	0.0	-0.1	-0.1	0.0	0.0	-0.1	-0.1	0.0	0.0	-0.03
USA	-0.2	0.0	0.0	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.08
LAM	-0.2	0.0	-0.1	-0.1	0.0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.05
RoW	-0.2	-0.1	0.0	-0.1	0.0	-0.1	-0.1	-0.1	0.0	-0.1	-0.05

Table 17:
Marginal Abatement Cost (\$/t CO_2) in various Experiments

Sector\ Region	Coal	Oil	Gas	Ely	P_C	Metals	Min_ Prod	Paper	Oth_ Ind	ROE
Experiment 1 (No Emissions Trade)										
fra	0.0	0.0	0.0	1.5	16.1	35.5	44.3	0.0	0.0	0.0
deu	0.0	0.0	0.0	5.1	9.3	2.2	2.1	3.3	9.9	0.0
gbr	0.0	0.0	0.0	14.6	5.4	29.7	73.6	13.0	57.0	0.0
ita	0.0	0.0	0.0	10.2	0.0	9.9	7.1	14.0	0.0	0.0
REU	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
CHIND	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
JPN	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
USA	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
LAM	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
RoW	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Experiment 2 (Domestic Emissions Trade)										
fra	0.0	0.0	0.0	13.5	13.5	13.5	13.5	0.0	0.0	0.0
deu	0.0	0.0	0.0	5.5	5.5	5.5	5.5	5.5	5.5	0.0
gbr	0.0	0.0	0.0	14.4	14.4	14.4	14.4	14.4	14.4	0.0
ita	0.0	0.0	0.0	10.0	0.0	10.0	10.0	10.0	0.0	0.0
REU	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
CHIND	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
JPN	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
USA	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
LAM	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
RoW	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Experiment 3 (Regional Emissions Trade)										
fra	0.0	0.0	0.0	8.8	8.8	8.8	8.8	0.0	0.0	0.0
deu	0.0	0.0	0.0	8.8	8.8	8.8	8.8	8.8	8.8	0.0
gbr	0.0	0.0	0.0	8.8	8.8	8.8	8.8	8.8	8.8	0.0
ita	0.0	0.0	0.0	8.8	0.0	8.8	8.8	8.8	0.0	0.0
REU	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
CHIND	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
JPN	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
USA	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
LAM	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Experiment 4 (World Emissions Trade)										
fra	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26
deu	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26
gbr	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26
ita	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26
REU	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26
CHIND	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26
JPN	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26
USA	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26
LAM	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26
RoW	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26	0.26

Table 18:
Welfare gains from emissions trading ($ millions)

Sector\ Region	Coal	Oil	Gas	Ely	P_C	Metals	Min_ Prod	Paper	Oth_ Ind	ROE
From Experiment 1 (No Emissions Trade) to Experiment 2 (Domestic Emissions Trade)										
fra	0.00	0.00	0.00	3.62	0.11	1.59	5.88	0.00	0.00	0.00
deu	0.00	0.00	0.00	0.05	0.68	0.15	0.13	0.01	0.09	0.00
gbr	0.00	0.00	0.00	0.00	1.32	1.24	2.61	0.00	0.99	0.00
ita	0.00	0.00	0.00	0.01	0.00	0.00	0.09	0.02	0.00	0.00
REU	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
CHIND	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
JPN	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
USA	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
LAM	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
RoW	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
From Experiment 2 (Domestic Emissions Trade) to Experiment 3 (Regional Emissions Trade)										
fra	0.00	0.00	0.00	0.50	0.23	0.08	0.18	0.00	0.00	0.00
deu	0.00	0.00	0.00	2.88	0.53	0.13	0.13	0.03	0.04	0.00
gbr	0.00	0.00	0.00	3.55	0.55	0.19	0.03	0.01	0.03	0.00
ita	0.00	0.00	0.00	0.11	0.00	0.01	0.01	0.00	0.00	0.00
REU	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
CHIND	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
JPN	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
USA	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
LAM	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
RoW	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
From Experiment 3 (Regional Emissions Trade) to Experiment 4 (World Emissions Trade)										
fra	0.00	0.00	0.00	1.78	0.76	0.27	0.60	0.00	0.00	-0.02*
deu	0.00	0.00	0.00	19.01	3.24	0.84	0.82	0.18	0.27	-0.02*
gbr	0.00	0.00	0.00	9.19	1.21	0.51	0.07	0.03	0.06	-0.02*
ita	0.00	0.00	0.00	6.73	0.00	0.73	0.72	0.08	0.00	0.01
REU	0.00	0.00	0.00	0.10	0.07	0.00	0.01	0.00	0.00	0.00
CHIND	0.01	0.00	0.00	0.50	0.01	0.03	0.05	0.01	0.00	0.03
JPN	0.00	0.00	0.00	0.02	0.00	0.00	0.00	0.00	0.00	0.01
USA	0.00	0.00	0.00	0.20	0.01	0.00	0.01	0.00	0.00	0.05
From Experiment 1 (No Emissions Trade) to Experiment 4 (World Emissions Trade)										
fra	0.00	0.00	0.00	0.02	2.83	4.26	13.15	0.00	0.00	-0.04*
deu	0.00	0.00	0.00	6.01	3.59	0.03	0.03	0.02	0.38	-0.03*
gbr	0.00	0.00	0.00	24.44	0.48	5.16	4.27	0.06	1.97	0.00
ita	0.00	0.00	0.00	9.12	0.00	0.92	0.44	0.23	0.00	0.01
REU	0.00	0.00	0.00	0.08	0.07	0.00	0.01	0.00	0.00	0.00
CHIND	0.01	0.00	0.00	0.49	0.01	0.03	0.05	0.01	0.00	0.03
JPN	0.00	0.00	0.00	0.02	0.00	0.00	0.00	0.00	0.00	0.01
USA	0.00	0.00	0.00	0.20	0.02	0.00	0.01	0.00	0.00	0.05
LAM	0.00	0.00	0.00	0.02	0.01	0.00	0.00	0.00	0.00	0.01

[*] negative value indicates that general equilibrium ‘income effect’ dominates ‘substitution’ effect.

5 Conclusion

This paper has surveyed some existing CGE models which deal with the issue of energy substitution. Important features of these models are highlighted, and where possible, some of these important features have been adapted into the existing standard GTAP model. The result, a model nick-named GTAP-E, is then used to conduct some illustrative experiments to show the potential economic and environmental effects of the implementation of the European Union Emissions Trading System (EU ETS) which started in 2005. The main purpose of the experiments is to show the potential usefulness of the GTAP-E model in analyzing real-world climate change policy scenarios. The introduction of the energy-environmental dimension in this version of the GTAP model is only one step towards the building up of a more elaborate suite of models for analyzing GHG emissions issues. It is expected that a future extension of the current model will look into the issue of non-CO_2 GHGs, especially those related to land uses and to technological innovations.

Annex 1: General Equilibrium Elasticities in GTAP-E and GTAP

To compare GTAP-E with GTAP, the simplest and most effective way is to compare the overall general-equilibrium (GE) elasticities of the GTAP-E model with those of the GTAP model. The GE elasticities are a function of the structure of the model, the values of the substitution parameters assumed, the benchmark database and the particular closure assumed[25]. For a standard GE closure where all the prices and quantities of non-endowment commodities are allowed to be endogenously determined, the GE elasticities calculated for this closure will truly reflect the general equilibrium character of the demand elasticities[26].

First we look at the GE *own-price* elasticities. These elasticities measure the percentage change in the output of commodity *i* in region *r* (i.e. *qo*(*i*,*r*)) following a 1% change in its own-price (*pm*(*i*,*r*)) induced by an appropriate perturbation in the output tax *to*(*i*,*r*). The change in the output level can come from two different causes: (i) changes in the general level of activity (we can refer to this as the "output (expansion or contraction) effect"), and (ii) changes due to the substitution of one activity or output for another (the "substitution effect"[27]).

For the energy commodities, because of the additional (energy) input-substitution structure introduced into the GTAP-E model, we expect the negative "substitution effect" in this model to add to the negative "output effect" when the price of an energy commodity increases. This means the magnitude of the GE own-price elasticities for energy commodities in the GTAP-E model will be greater than those in the GTAP model. This is in fact confirmed in Table 10: the changes in the GE elasticities for the energy commodities are all negative when we go from GTAP to GTAP-E, indicating that the magnitudes of the (negative) elasticities are all increasing.

For the non-energy commodities, on the other hand, since both the GTAP and GTAP-E models have similar structures for these commodities, we will expect that there are insignificant changes in the GE own-price elasticities as we move from GTAP to GTAP-E. From Table 10, this is again confirmed: the small variations in the magnitudes of these elasticities for the non-

[25] As the GE elasticities are a function of the particular closure assumed, in this section, we present the GE elasticities which are associated with the experiment considered in the next section. Changing this experiment and its closure will affect the GE elasticities.

[26] See Chapter 5 of Hertel (ed.) (1997).

[27] Here substitution can occur between different *outputs* (i.e. in final demand) as well as between different *inputs* (intermediate demand).

energy commodities arise only from the output (expansion/contraction) effects and which are seen to be small. Also, the variation can be in either direction.

Tables 11 and 12 give the GE *cross-price* elasticities for the US and China for illustrative purposes. For both of these countries, we notice that all energy commodities are substitutes (cross-price elasticities being positive), with the exception of the pairs: COL and ELY, and OIL and P_C. These pairs of energy commodity are complements because COL is a significant input into ELY, and similarly OIL is a significant input into P_C.

As we move from GTAP to GTAP-E, the magnitudes of the cross-price GE elasticities for the energy commodities become greater, as expected. This is in contrast to the case of the GE cross-price elasticities for the non-energy commodities. In the latter case, since both GTAP and GTAP-E assume similar structures for these non-energy commodities, their corresponding GE cross-price elasticities as thus also similar[28].

Finally, between the energy and non-energy commodities, we notice a significant degree of complementarity (negative cross-price elasticities) between P_C and ELY on the one hand, and the non-energy commodities on the other hand. This reflects the importance of P_C and ELY as major energy inputs into the production of these non-energy commodities.

[28] The non-energy commodities are also observed to be all ‘substitutable’ for each other despite the fact that in the intermediate input sub-structure, zero substitution was assumed between these non-energy intermediate inputs. The ‘substitution’ as reflected in the GE cross-price elasticities, however, reflects mainly the output (contraction/expansion) effects, which come from a re-allocation of resources resulting from a change of the relative prices among these commodities.

Table A1-1:
General-Equilibrium Own-Price Elasticities

sectors/ commodities	GE elasticities WITH energy substitution from GTAP-E model (A):							
	JPN	CHN	IND	USA	E_U	FSU	NEX	NEM
COL	-3.75	-0.43	-0.07	-0.85	-1.19	-1.59	-1.22	-1.38
OIL	-9.88	-3.02	-9.39	-3.33	-7.09	-5.27	-0.88	-7.39
GAS	-1.69	-1.03	-0.72	-0.94	-1.46	-1.68	-1.27	-1.18
P_C	-0.91	-0.83	-1.13	-0.97	-0.91	-1.28	-1.28	-1.05
ELY	-0.84	-1.00	-0.79	-0.82	-1.15	-1.07	-1.21	-1.15
I_S	-0.47	-0.86	-1.09	-0.78	-1.00	-2.83	-1.66	-1.78
CRP	-0.50	-1.02	-1.15	-0.95	-0.96	-1.27	-1.40	-1.26
OMN	-0.75	-1.66	-1.43	-0.89	-0.87	-1.34	-1.40	-1.46
AGR	-0.40	-0.32	-0.24	-0.67	-0.59	-0.99	-0.55	-0.56
SER	-0.25	-0.27	-0.30	-0.32	-0.31	-0.30	-0.37	-0.35
sectors/ commodities	**GE elasticities WITHOUT energy substitution from GTAP model (B):**							
	JPN	CHN	IND	USA	E_U	FSU	NEX	NEM
COL	-3.71	-0.40	-0.02	-0.26	-0.69	-1.14	-0.81	-1.03
OIL	-9.82	-2.16	-9.13	-1.92	-4.70	-3.58	-0.24	-6.05
GAS	-1.20	-0.03	0.00	-0.27	-0.92	-1.13	-0.65	-0.47
P_C	-0.41	-0.32	-0.79	-0.40	-0.50	-0.85	-0.90	-0.54
ELY	-0.22	-0.08	-0.03	-0.16	-0.34	-0.33	-0.48	-0.27
I_S	-0.47	-0.85	-1.09	-0.78	-1.00	-2.82	-1.66	-1.78
CRP	-0.50	-1.03	-1.16	-0.95	-0.96	-1.27	-1.40	-1.26
OMN	-0.80	-1.59	-1.62	-0.93	-0.84	-1.41	-1.38	-1.48
AGR	-0.40	-0.31	-0.24	-0.67	-0.59	-0.99	-0.54	-0.56
SER	-0.25	-0.25	-0.29	-0.32	-0.29	-0.31	-0.37	-0.34
sectors/ commodities	**Change in own-price elasticity from (B) to (A)**							
	JPN	CHN	IND	USA	E_U	FSU	NEX	NEM
COL	-0.04	-0.03	-0.05	-0.59	-0.50	-0.45	-0.41	-0.35
OIL	-0.06	-0.86	-0.26	-1.41	-2.39	-1.69	-0.64	-1.34
GAS	-0.49	-1.00	-0.72	-0.67	-0.54	-0.55	-0.62	-0.71
P_C	-0.50	-0.51	-0.34	-0.57	-0.41	-0.43	-0.38	-0.51
ELY	-0.62	-0.92	-0.76	-0.66	-0.81	-0.74	-0.73	-0.88
I_S	0.00	-0.01	0.00	0.00	0.00	-0.01	0.00	0.00
CRP	0.00	0.01	0.01	0.00	0.00	0.00	0.00	0.00
OMN	0.05	-0.07	0.19	0.04	-0.03	0.07	-0.02	0.02
AGR	0.00	-0.01	0.00	0.00	0.00	0.00	-0.01	0.00
SER	0.00	-0.02	-0.01	0.00	-0.02	0.01	0.00	-0.01

Table A1-2:
General-Equilibrium Cross-Price Elasticities for the USA

sectors/ commodities	GE cross-price elasticities WITH energy substitution from GTAP-E model (A):									
	COL	OIL	GAS	P_C	ELY	I_S	CRP	OMN	AGR	SER
COL		0.06	0.00	0.03	-0.15	-0.01	-0.01	0.14	-0.03	0.03
OIL	0.01		0.01	-0.21	0.05	0.01	0.01	0.52	0.02	0.06
GAS	0.00	0.14		0.16	0.09	-0.01	0.04	0.47	-0.13	0.11
P_C	0.02	-0.51	0.03		0.13	-0.02	-0.13	-0.94	-0.03	0.14
ELY	-0.07	0.10	0.01	0.10		-0.01	-0.02	0.20	-0.12	0.09
I_S	-0.01	0.04	0.00	-0.04	-0.03		0.06	0.21	0.04	0.32
CRP	0.00	0.02	0.00	-0.06	-0.01	0.01		0.90	0.03	0.36
OMN	0.00	0.02	0.00	-0.02	0.00	0.00	0.04		0.01	0.35
AGR	-0.01	0.03	-0.01	-0.02	-0.08	0.01	0.04	0.28		0.18
SER	0.00	0.00	0.00	0.01	0.00	0.01	0.03	0.56	0.01	

sectors/ commodities	GE cross-price elasticities WITHOUT energy substitution from GTAP model (B):									
	COL	OIL	GAS	P_C	ELY	I_S	CRP	OMN	AGR	SER
COL		0.02	0.00	0.00	-0.09	-0.01	-0.01	0.40	-0.05	0.13
OIL	0.00		0.00	-0.11	-0.01	0.01	0.01	0.81	0.02	0.15
GAS	0.00	0.02		0.00	-0.06	-0.01	0.02	0.50	-0.11	0.19
P_C	0.00	0.02	0.00		0.00	-0.01	-0.12	-0.29	-0.01	0.36
ELY	0.00	0.01	0.00	0.00		-0.01	-0.03	0.19	-0.10	0.14
I_S	0.00	0.03	0.00	-0.02	-0.03		0.06	0.21	0.04	0.33
CRP	0.00	0.02	0.00	-0.01	-0.01	0.02		1.00	0.03	0.36
OMN	0.00	0.02	0.00	-0.01	-0.01	0.00	0.04		0.01	0.37
AGR	0.00	0.02	0.00	-0.01	-0.02	0.01	0.03	0.26		0.19
SER	0.00	0.00	0.00	0.01	0.01	0.01	0.03	0.62	0.01	

sectors/ commodities	Absolute difference: (A) - (B)									
	COL	OIL	GAS	P_C	ELY	I_S	CRP	OMN	AGR	SER
COL		0.04	0.00	0.03	-0.06	0.00	0.00	-0.26	0.02	-0.10
OIL	0.01		0.01	-0.10	0.06	0.00	0.00	-0.29	0.00	-0.09
GAS	0.00	0.12		0.16	0.15	0.00	0.02	-0.03	-0.02	-0.08
P_C	0.02	-0.53	0.03		0.13	-0.01	-0.01	-0.65	-0.02	-0.22
ELY	-0.07	0.09	0.01	0.10		0.00	0.01	0.01	-0.02	-0.05
I_S	-0.01	0.01	0.00	-0.02	0.00		0.00	0.00	0.00	-0.01
CRP	0.00	0.00	0.00	-0.05	0.00	-0.01		-0.10	0.00	0.00
OMN	0.00	0.00	0.00	-0.01	0.01	0.00	0.00		0.00	-0.02
AGR	-0.01	0.01	-0.01	-0.01	-0.06	0.00	0.01	0.02		-0.01
SER	0.00	0.00	0.00	0.00	-0.01	0.00	0.00	-0.06	0.00	

Table A1-3:
General-Equilibrium Cross-Price Elasticities for China

sectors/ commodities	GE cross-price elasticities WITH energy substitution from GTAP-E model (A):									
	COL	OIL	GAS	P_C	ELY	I_S	CRP	OMN	AGR	SER
COL		0.05	0.01	0.04	-0.01	0.02	0.04	1.19	0.06	0.01
OIL	0.01		0.00	-0.11	0.04	0.03	0.03	1.97	0.06	0.05
GAS	0.16	0.19		0.22	0.07	0.03	-0.30	0.60	0.01	0.02
P_C	0.03	-0.50	0.01		0.14	-0.04	-0.20	-2.01	-0.11	0.00
ELY	-0.01	0.16	0.00	0.14		-0.06	-0.13	-0.30	-0.03	0.01
I_S	0.01	0.06	0.00	-0.02	-0.03		0.14	2.12	0.21	-0.03
CRP	0.01	0.03	0.00	-0.06	-0.04	0.09		2.61	0.05	0.06
OMN	0.01	0.07	0.00	-0.02	-0.01	0.03	0.07		0.09	0.05
AGR	0.00	0.01	0.00	-0.01	-0.01	0.03	0.01	0.76		0.12
SER	0.00	0.01	0.00	0.00	0.00	0.00	0.02	0.73	0.08	
sectors/ commodities	GE cross-price elasticities WITHOUT energy substitution from GTAP model (B):									
	COL	OIL	GAS	P_C	ELY	I_S	CRP	OMN	AGR	SER
COL		0.01	0.00	0.00	0.00	0.03	0.05	1.10	0.04	0.00
OIL	0.00		0.00	-0.05	0.00	0.04	0.04	2.68	0.09	0.06
GAS	0.01	0.04		0.00	-0.01	0.02	-0.40	0.85	0.03	0.08
P_C	0.00	0.04	0.00		-0.01	-0.01	-0.18	0.40	0.03	0.08
ELY	0.00	0.04	0.00	0.00		-0.07	-0.13	0.39	0.05	0.06
I_S	0.00	0.05	0.00	-0.01	-0.01		0.15	2.26	0.21	-0.04
CRP	0.01	0.05	0.00	0.00	0.00	0.08		2.71	0.05	0.05
OMN	0.01	0.05	0.00	-0.01	-0.01	0.05	0.09		0.10	0.05
AGR	0.00	0.03	0.00	0.01	0.01	0.02	0.00	0.98		0.13
SER	0.00	0.01	0.00	0.01	0.01	-0.02	0.00	0.89	0.09	
sectors/ commodities	Absolute difference: (A) - (B)									
	COL	OIL	GAS	P_C	ELY	I_S	CRP	OMN	AGR	SER
COL		0.04	0.01	0.04	-0.01	-0.01	-0.01	0.09	0.02	0.01
OIL	0.01		0.00	-0.06	0.04	-0.01	-0.01	-0.71	-0.03	-0.01
GAS	0.15	0.15		0.22	0.08	0.01	0.10	-0.25	-0.02	-0.06
P_C	0.03	-0.54	0.01		0.15	-0.03	-0.02	-2.41	-0.14	-0.08
ELY	-0.01	0.12	0.00	0.14		0.01	0.00	-0.69	-0.08	-0.05
I_S	0.01	0.01	0.00	-0.01	-0.02		-0.01	-0.14	0.00	0.01
CRP	0.00	-0.02	0.00	-0.06	-0.04	0.01		-0.10	0.00	0.01
OMN	0.00	0.02	0.00	-0.01	0.00	-0.02	-0.02		-0.01	0.00
AGR	0.00	-0.02	0.00	-0.02	-0.02	0.01	0.01	-0.22		-0.01
SER	0.00	0.00	0.00	-0.01	-0.01	0.02	0.02	-0.16	-0.01	

Annex 2: Technical Details for the Illustrative Experiments

The following boxes shows the closure and shocks used in the four Illustrative Experiments. In Experiment 1 ("No Emissions Trade" case), the scenario assumes no change of the trade account: thus the variable DTBAL (a linear variable expressed in changes) is exogenous and equal to zero in all countries/regions except one. Accordingly, the slack variable cgdslack is made endogenous (while it is exogenous in the standard closure). Thus investment is calculated as a residual in order to guarantee no change of the trade account. The quantitative restrictions applied to carbon emissions are introduced by making the nominal carbon tax for the trading sectors of the trading countries endogenous and the emission growth rates made exogenous and set equal to the EU ETS caps (expressed as percentage reductions relative to the BaU projections for these sectors/regions). Total values of the carbon taxes are shown in Table A2.1 for the four Experiments, and the value of the carbon trade in 2000 $US are also shown in Table A.2.1. Proceeds from the carbon tax adds to the indirect tax revenue and returned to the regional household via the INCOME variable y. Note, however, that the EU ETS is a cap and trade system and the caps are distributed at the beginning of the period free of charge (grandfathered) rather than being auctioned, therefore, the carbon tax variable in this case stands for the amount of economic resources that the sector has to expend in order to reduce its emissions level to the cap level. The 'proceeds' from this 'tax', therefore, does not accrue to the government, but still end up as income to the regional household because some resources have been employed to reduce the emissions levels. When regions trade in emissions permits, resources are spend in the regions which sell the surplus emissions rights (to reduce emissions beyond their BaU levels) and these regions will receive income compensation for these resources in the form of the value of the emissions trade. This emission trade value (DVCO2TRAD) is then added to the normal trade balance variable DTBAL to form a new variable called DTBALCTRA. In Experiments 3 and 4 where emissions trade occur across national or regional boundaries rather than just across domestic sectors, the new trade balance variable DTBALCTRA is used instead of the normal one (see Boxes 3 and 4).

Table A2-1:
Total value of carbon tax and the value of emissions trading ($ millions)

Sector\ Region	Experiment 1 (No Emissions Trade)	Experiment 2 (Domestic Emissions Trade)	Experiment 3 (Regional Emissions Trade)	Experiment 4 (World Emissions Trade)
Total value of carbon tax (or value of resources spent on reducing emissions)				
fra	584	384	255	21
deu	753	711	1126	49
gbr	951	914	573	27
ita	440	450	401	25
REU	0	0	0	106
CHIND	0	0	0	254
JPN	0	0	0	70
USA	0	0	0	294
LAM	0	0	0	70
RoW	0	0	0	402
Value of emissions trading				
fra	0	0	-98.6	-0.82
deu	0	0	-1.4	-5.01
gbr	0	0	-132.1	-2.24
ita	0	0	-101.5	-1.49
REU	0	0	0	1.12
CHIND	0	0	0	3.73
JPN	0	0	0	0.24
USA	0	0	0	1.76
LAM	0	0	0	0.32
RoW	0	0	0	2.35

Box 1:
Closure for “No Emissions Trade” (Experiment 1)

```
exogenous
          pop
          psaveslack pfactwld
          profitslack incomeslack endwslack
!          cgdslack
          tradslack
          ams atm atf ats atd
          aosec aoreg avasec avareg
          afcom afsec afreg afecom afesec afereg
          aoall afall afeall
          au dppriv dpgov dpsave
          to tp tm tms tx txs
          qo(ENDW_COMM,REG)
!         tfd tfm tpd tpm tgm tgd : blocked for CO2TAX-module
! ------------E-module------------------------
     afLab afKE afNELY afNCOL afener
! ------------CO2TAX-module-------------------
! -- non carbon Tax on ENERGY commodities need to remain exogenous:
     tpd_nc tpm_nc tgd_nc tgm_nc tfd_nc tfm_nc
! -- Tax on NON-ENERGY commodities need to remain exogenous:
     tpd(NEGY_COMM,REG) tpm(NEGY_COMM,REG)
     tgd(NEGY_COMM,REG) tgm(NEGY_COMM,REG)
     tfd(NEGY_COMM,PROD_COMM,REG)
     tfm(NEGY_COMM,PROD_COMM,REG)
! ------------ CO2 EMISSION TRADING scheme ------------
     c_INT_MARKCTAX
     c_DOM_MARKCTAX
     c_SEC_CTAX
!    DTBAL exogenous for all regions except one,
!    and cgdslack exogenous for that one region (which can be any one).
     dtbal(not_ROW)
     cgdslack(RoW)
Rest Endogenous ;

swap  c_SEC_CTAX(DTRs_fra,"fra") = gCO2SR(DTRs_fra,"fra");
swap  c_SEC_CTAX(DTRs_deu,"deu") = gCO2SR(DTRs_deu,"deu");
swap  c_SEC_CTAX(DTRs_gbr,"gbr") = gCO2SR(DTRs_gbr,"gbr");
swap  c_SEC_CTAX(DTRs_ita,"ita") = gCO2SR(DTRs_ita,"ita");
Shock gCO2SR(DTRs_fra,"fra")= file DTR_shk.prm Header "SFRA";
Shock gCO2SR(DTRs_deu,"deu")= file DTR_shk.prm Header "SDEU";
Shock gCO2SR(DTRs_gbr,"gbr")= file DTR_shk.prm Header "SGBR";
Shock gCO2SR(DTRs_ita,"ita")= file DTR_shk.prm Header "SITA";

! also shock quota:
exogenous gCO2DTRQ(DTRs_fra,"fra");
exogenous gCO2DTRQ(DTRs_deu,"deu");
exogenous gCO2DTRQ(DTRs_gbr,"gbr");
exogenous gCO2DTRQ(DTRs_ita,"ita");
Shock gCO2DTRQ(DTRs_fra,"fra")= file DTR_shk.prm Header "SFRA";
Shock gCO2DTRQ(DTRs_deu,"deu")= file DTR_shk.prm Header "SDEU";
Shock gCO2DTRQ(DTRs_gbr,"gbr")= file DTR_shk.prm Header "SGBR";
Shock gCO2DTRQ(DTRs_ita,"ita")= file DTR_shk.prm Header "SITA";
```

Box 2:
Closure for “Domestic Emissions Trade” (Experiment 2)

```
exogenous
          pop
          psaveslack pfactwld
          profitslack incomeslack endwslack
!          cgdslack
          tradslack
          ams atm atf ats atd
          aosec aoreg avasec avareg
          afcom afsec afreg afecom afesec afereg
          aoall afall afeall
          au dppriv dpgov dpsave
          to tp tm tms tx txs
          qo(ENDW_COMM,REG)
!         tfd tfm tpd tpm tgm tgd : blocked for CO2TAX-module
! ------------E-module-----------------------
     afLab afKE afNELY afNCOL afener
! ------------CO2TAX-module-------------------
! -- non carbon Tax on ENERGY commodities need to remain exogenous:
     tpd_nc tpm_nc tgd_nc tgm_nc tfd_nc tfm_nc
! -- Tax on NON-ENERGY commodities need to remain exogenous:
     tpd(NEGY_COMM,REG) tpm(NEGY_COMM,REG)
     tgd(NEGY_COMM,REG) tgm(NEGY_COMM,REG)
     tfd(NEGY_COMM,PROD_COMM,REG)
     tfm(NEGY_COMM,PROD_COMM,REG)
! ------------ CO2 EMISSION TRADING scheme ------------
     c_INT_MARKCTAX
     c_DOM_MARKCTAX
     c_SEC_CTAX
!    DTBAL exogenous for all regions except one,
!    and cgdslack exogenous for that one region (which can be any one).
     dtbal(not_ROW)
     cgdslack(RoW)
Rest Endogenous ;

swap  c_DOM_MARKCTAX("fra") = gCO2TS_T("fra");
swap  c_DOM_MARKCTAX("deu") = gCO2TS_T("deu");
swap  c_DOM_MARKCTAX("gbr") = gCO2TS_T("gbr");
swap  c_DOM_MARKCTAX("ita") = gCO2TS_T("ita");
! the following are results from Experiment 1- see header "gCO2DTR”:
Shock gCO2TS_T("fra")= -4.1300930;
Shock gCO2TS_T("deu")= -2.6712210;
Shock gCO2TS_T("gbr")= -6.1993780;
Shock gCO2TS_T("ita")= -4.6830660;
! keep same quota as in the case of Experiment 1:
exogenous gCO2DTRQ(DTRs_fra,"fra");
exogenous gCO2DTRQ(DTRs_deu,"deu");
exogenous gCO2DTRQ(DTRs_gbr,"gbr");
exogenous gCO2DTRQ(DTRs_ita,"ita");
Shock gCO2DTRQ(DTRs_fra,"fra")= file DTR_shk.prm Header "SFRA";
Shock gCO2DTRQ(DTRs_deu,"deu")= file DTR_shk.prm Header "SDEU";
Shock gCO2DTRQ(DTRs_gbr,"gbr")= file DTR_shk.prm Header "SGBR";
Shock gCO2DTRQ(DTRs_ita,"ita")= file DTR_shk.prm Header "SITA";
```

Box 3:
Closure for "Regional Emissions Trade" (Experiment 3)

```
exogenous
          pop
          psaveslack pfactwld
          profitslack incomeslack endwslack
!          cgdslack
          tradslack
          ams atm atf ats atd
          aosec aoreg avasec avareg
          afcom afsec afreg afecom afesec afereg
          aoall afall afeall
          au dppriv dpgov dpsave
          to tp tm tms tx txs
          qo(ENDW_COMM,REG)
!         tfd tfm tpd tpm tgm tgd : blocked for CO2TAX-module
! ------------E-module------------------------
     afLab afKE afNELY afNCOL afener
! ------------CO2TAX-module-------------------
! -- non carbon Tax on ENERGY commodities need to remain exogenous:
     tpd_nc tpm_nc tgd_nc tgm_nc tfd_nc tfm_nc
! -- Tax on NON-ENERGY commodities need to remain exogenous:
     tpd(NEGY_COMM,REG) tpm(NEGY_COMM,REG)
     tgd(NEGY_COMM,REG) tgm(NEGY_COMM,REG)
     tfd(NEGY_COMM,PROD_COMM,REG)
     tfm(NEGY_COMM,PROD_COMM,REG)
! ------------ CO2 EMISSION TRADING scheme ------------
     c_INT_MARKCTAX
     c_DOM_MARKCTAX
     c_SEC_CTAX
!    DTBALCTRA exogenous for all regions except one,
!    and cgdslack exogenous for that one region (which can be any one).
     dtbalCTRA (not_ROW)
     cgdslack(RoW)
Rest Endogenous ;

swap  c_INT_MARKCTAX = gCO2TS_Tot;
! the following is the result from Experiment 2 – see header "gCO2DTR_T":
Shock gCO2TS_Tot = -4.027621;
! keep same quota as in the case of Experiment 1:
exogenous gCO2Q(reg_DTR);
Shock gCO2Q("fra")= -4.130093;
Shock gCO2Q("deu")= -2.671221;
Shock gCO2Q("gbr")= -6.199378;
Shock gCO2Q("ita")= -4.683066;
```

Box 4:
Closure for "World Emissions Trade" (Experiment 4)

```
exogenous
          pop
          psaveslack pfactwld
          profitslack incomeslack endwslack
!          cgdslack
          tradslack
          ams atm atf ats atd
          aosec aoreg avasec avareg
          afcom afsec afreg afecom afesec afereg
          aoall afall afeall
          au dppriv dpgov dpsave
          to tp tm tms tx txs
          qo(ENDW_COMM,REG)
!         tfd tfm tpd tpm tgm tgd : blocked for CO2TAX-module
! ------------E-module------------------------
     afLab afKE afNELY afNCOL afener
! ------------CO2TAX-module-------------------
! -- non carbon Tax on ENERGY commodities need to remain exogenous:
     tpd_nc tpm_nc tgd_nc tgm_nc tfd_nc tfm_nc
! -- Tax on NON-ENERGY commodities need to remain exogenous:
     tpd(NEGY_COMM,REG) tpm(NEGY_COMM,REG)
     tgd(NEGY_COMM,REG) tgm(NEGY_COMM,REG)
     tfd(NEGY_COMM,PROD_COMM,REG)
     tfm(NEGY_COMM,PROD_COMM,REG)
! ------------ CO2 EMISSION TRADING scheme ------------
     c_INT_MARKCTAX
     c_DOM_MARKCTAX
     c_SEC_CTAX
!    DTBALCTRA exogenous for all regions except one,
!    and cgdslack exogenous for that one region (which can be any one).
     dtbalCTRA (not_ROW)
     cgdslack(RoW)
Rest Endogenous ;

swap  c_INT_MARKCTAX = p_CO2W;
! the following is the result from Experiment 2 – see header "gCO2DTR_T":
Shock p_CO2W = -0.1137300;
! keep same quota as in the case of Experiment 3:
exogenous gCO2Q;
Shock gCO2Q = file gCO2R.prm Header "gCO2";
```

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