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Towards a Global Carbon Dioxide Market: Shadow Pricing Carbon Dioxide Across Countries

Flavius Badau, Ph.D. Candidate

Oregon State University, Department of Applied Economics

badauf@onid.oregonstate.edu

Selected Poster prepared for presentation at the Agricultural & Applied Economics Association's 2014 AAEA Annual Meeting, Minneapolis, MN,
July 27-29, 2014

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Introduction

International talks at the United Nations about mitigating the effects of global climate change include the discussion of a global carbon dioxide (CO₂) market

Knowledge of carbon dioxide prices could support the development and implementation of this global market and could greatly facilitate exchanges in this market

Objectives

1. Estimate shadow prices of CO₂ across countries
2. Use shadow prices in a simulated CO₂ global trading market
3. Examine whether global emissions could be reduced and shadow prices of CO₂ equalized across countries without sacrificing economic growth

Methods

Derive shadow prices through the empirical tool known as the directional distance function:

- Natural functional representation of technology
- Accounts for inefficiencies
- Estimable functional form arises out of theory
- Knowledge of all prices not needed

Theoretical Model-Output Set

Main Features:

- Two outputs: one good-RGDP (y), one bad-CO₂ (b)
- Two prices: p (price of y), s (price of b)
- Two inputs: labor (l), capital (k)
- No good (y) production without pollution (b)
- There is a cost to reducing pollution (b)

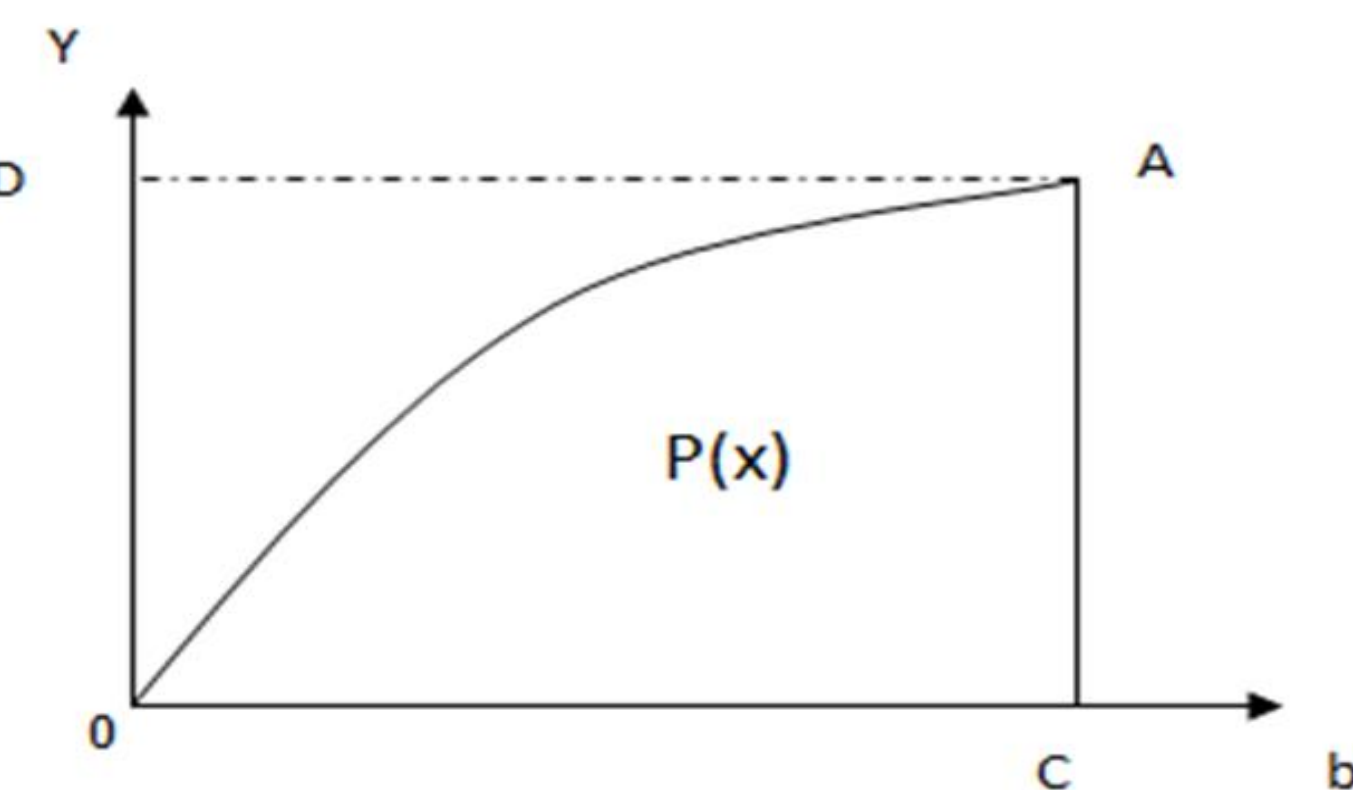
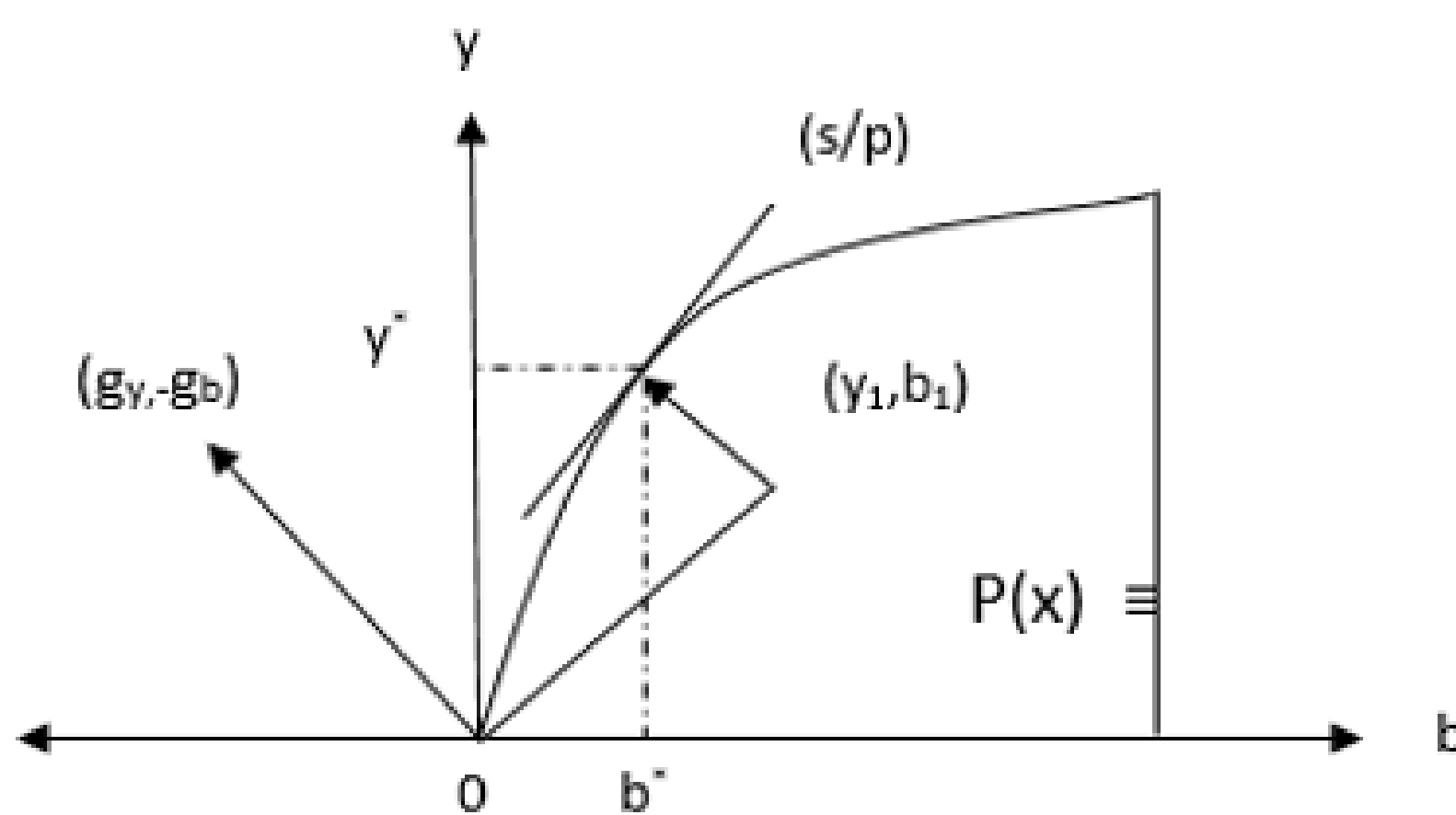


Figure 1. Output set of a polluting technology

Theoretical Model-Shadow Prices

$$\vec{D}_o(x, y, b; g_y, -g_b) = \max\{\beta: (y + \beta g_y, b - \beta g_b) \in P(x)\}$$



Shadow Price of CO₂: $s = -p \frac{\partial \vec{D}_o(x, y, b; g_y, -g_b) / \partial b}{\partial \vec{D}_o(x, y, b; g_y, -g_b) / \partial y}$

Estimation

- Quadratic functional form has been shown to accommodate the properties of the directional distance function
- Estimate the quadratic function employing ordinary least square with time and country fixed effects

Estimation Results

Parameter Estimates

Parameter	Variable	Estimates
α_1	labor (l)	-0.0516
α_2	kapital (k)	0.5669
β_1	rgdp (y)	-0.7502
$\gamma_1 = \beta_1 + 1$	co2 (b)	0.2498
α_{11}	l^2	0.0180
α_{22}	k^2	-0.0764
$\alpha_{12} = \alpha_{21}$	l^*k, k^*l	-0.0249
$\beta_2 = \gamma_2 = \mu$	y^2, b^2, y^*b	-0.0176
$v_1 = \delta_1$	l^*y, l^*b	-0.0003
$v_2 = \delta_2$	k^*y, k^*b	0.0395

$$s = -p \frac{\gamma_1 + \gamma_2 b + \delta_1 l + \delta_2 k + \mu y}{\beta_1 + \beta_2 y + v_1 l + v_2 k + \mu b}$$

CO₂ Shadow Prices by Country Income Group

Income Group	Obs	Mean	Std. Dev.	Min	Max
High Income	810	772.72	266.32	601.00	3049.28
Middle Income	1242	692.95	84.33	61.18	1157.33
Low Income	486	697.78	4.80	679.19	729.48

CO₂ Market Simulation

Goals:

- Reduced global emissions of CO₂ through optimal reallocations
- Equalized shadow prices of CO₂ (s)
- Increased global RGDP (y)

CO₂ Market Simulation

Assumptions:

- Benevolent governing body
- Carbon dioxide allowances and quota set by governing body
- Allowances can be traded
- Free trade of allowances
- Two outputs: RGDP (y), carbon dioxide (b)
- Two inputs: labor (l), capital (k)

CO₂ Market Simulation Method

$$\max \left\{ \begin{array}{l} \sum_{i=1}^3 y_i : \\ \vec{D}_{oi}(\bar{x}_{1i}, \bar{x}_{2i} y_i, b_i; 1, -1) \geq 0, \\ \sum_{i=3}^3 b_i \leq \bar{b}, \text{ where } i = 1, 2, 3 \end{array} \right\}$$

Quadratic functional form given parameter estimates and data

Carbon Dioxide Quota

CO₂ Market Simulation Results

country	year	l	k	b	y	b*	y*	s	s*
China	2000	41.80	13.08	22.07	13.17	14.72	15.63	320	586
India	2000	22.83	3.97	7.69	6.26	4.18	6.10	381	586
Japan	2000	3.77	15.60	7.91	11.58	18.77	17.91	2283	586
Totals				37.67	31.01	37.67	39.64		

- Total emissions remain stable (b*) ; total RGDP increases (y*)
- Emissions reallocated from low CO₂ price countries to higher CO₂ price country
- Shadow Prices of CO₂ equalize (s*) eliminating further arbitrage opportunities

Concluding Remarks

Shadow prices of CO₂ could be used as a guide to policy makers towards the implementation of a CO₂ global market

Shadow prices of CO₂ could be used as an aide towards the implementation of carbon tariffs

Acknowledgements:

Many thanks to my advisers Dr. Rolf Färe and Dr. Munisamy Gopinath for their continued support and guidance in conducting this study, as well as Dr. William Weber for his assistance