

Correct (and misleading) arguments for using market based pollution control policies*

Larry Karp[†]

September 25, 2008

Abstract

Disagreement over the form of regulation of greenhouse gasses motivates a comparison of market based and command and control policies. More efficient policies can *increase* aggregate marginal abatement cost, resulting in higher emissions. Multiple investment equilibria and “regulatory uncertainty” arise when firms anticipate command and control policies. Market based policies eliminate this uncertainty. Command and control policies cause firms to imitate other firms’ investment decisions, leading to similar costs and small potential efficiency gains from trade. Market based policies induce firms to make different investment decisions, leading to different costs and large gains from trade. We imbed the regulatory problem in a “global game” and show that the unique equilibrium to that game is constrained socially optimal.

Keywords: tradable permits, coordination games, multiple equilibria, global games, regulatory uncertainty, climate change policies, California AB32

JEL classification numbers C79, L51, Q58

*This paper benefited from comments by Meredith Fowlie, Gal Hochman, Richard McCann, Till Requate and Christian Traeger.

[†]Department of Agricultural and Resource Economics, 207 Giannini Hall, University of California, Berkeley CA 94720, karp@are.berkeley.edu

1 Introduction

Two aspects of the comparison between command and control and market based emissions policies appear to have gone unnoticed: (i) Although market based policies reduce the social cost of abatement, compared to inefficient command and control policies, the former do not globally reduce the *marginal* social abatement cost; they therefore do not necessarily lead to a higher socially optimal level of abatement. (ii) When the current policymaker cannot make binding commitments to future policy levels (and there is common knowledge about market fundamentals), and firms make lumpy investment decisions that affect their future abatement costs, command and control policies give rise to multiple competitive equilibria. From the standpoint of the individual firm, this multiplicity is indistinguishable from regulatory uncertainty. In the same circumstance, there is a unique (socially optimal) competitive equilibrium under market based policies, and therefore no regulatory uncertainty.

Market based policies encourage similar firms to make different investment decisions, increasing the differences in firms' abatement costs and thereby increasing the efficiency gains from trade in permits. A command and control policy, in contrast, encourages firms to all make the same investment decision, thereby preserving or increasing firm homogeneity. Thus, command and control policies may appear to cause little efficiency loss, because in equilibrium there would be little trade even if it were allowed. However, this firm homogeneity may be a consequence of the anticipated lack of opportunity for trade. An accurate measure of the efficiency gains from trade in permits must take into account the effect of the policy regime on the aggregate investment decisions.

Some contingencies that affect future policies are endogenous to the economy, but exogenous to individual firms. For example, the optimal future level of abatement depends on the future abatement costs, which depend on earlier investment decisions. An example demonstrates that market based policies reduce the regulatory uncertainty arising from current aggregate investment decisions. Consider an industry with many identical nonstrategic firms, each of which has the opportunity to make a discrete investment that reduces its average and marginal abatement costs. The firms know that in the next period the policymaker will set the *ex post* socially optimal level of abatement. All agents know the marginal pollution damage curve, and they know that the future social marginal abatement cost curve depends on the fraction of firms that make the investment, and on whether the regulator uses market based policies. In this setting, without exogenous uncertainty, taxes and cap-and-trade policies are equivalent (with one exception, noted below), so hereafter assume that the market based option is cap-and-trade. The non-market alternative gives each firm the same non-tradable emissions allowance.

The anticipation that the regulator will use non-tradable permits induces a coordination

game among non-atomic agents at the investment stage. Firms know that investment by a larger fraction of firms reduces the industry abatement cost curve. They therefore understand that the second-stage emissions allowance is a decreasing function of the fraction of firms that invest. Furthermore, the investment becomes more attractive, the lower is the anticipated emissions allowance. Thus, the use of a non-tradable emissions allowance in the second stage makes the first stage investment decisions strategic complements. In the simplest case with *ex ante* identical firms, there are in general two rational expectations competitive equilibria: all firms invest or none of them do. This multiplicity of equilibria creates “strategic uncertainty”: firms cannot rationally predict industry behavior. They therefore cannot rationally predict the regulator’s behavior. From the standpoint of the individual firm this strategic uncertainty looks like regulatory uncertainty.

In contrast, under the cap-and-trade policy there is a unique rational expectations competitive equilibrium. An increase in the fraction of firms that invest reduces the (second period) equilibrium price of tradable permits, thus reducing the value of the investment. The investment decisions are therefore strategic substitutes, leading to a unique, socially optimal equilibrium to the investment game. Rational firms can predict the level of permits and the permit price in the second stage. The commitment to use market based policies eliminates regulatory uncertainty even though the actual level of the policy is determined in the future.

This example assumes that firms have common knowledge. Suppose instead, in the scenario where the regulator chooses the level of non-tradable emissions after investment, that each firm receives a private signal about a market fundamental. Here there is a unique competitive equilibrium – a well-known result from the global games literature (Carlsson and Van Damme 1993), (Morris and Shin 2003). Surprisingly, the unique equilibrium in the global game is constrained socially efficient. That is, an arbitrarily small amount of uncertainty about market fundamentals not only eliminates the multiplicity of equilibria, but it also insures that the resulting equilibrium level of investment is the same as the social planner would choose, given the constraint of using non-tradable permits. This result occurs even though the social planner’s objective is to minimize the sum of abatement and investment costs and environmental damages, while firms care only about abatement and investment costs.

These results are of general interest to the theory of regulation and they are of particular interest in the climate change debate. There is considerable disagreement about the type of greenhouse gas regulations to use, and widespread recognition that current policymakers cannot lock in future policies. California law AB32, which mandates *future* reductions in greenhouse gas emissions, exemplifies these two points. Chapter 5 of AB32 recommends the use of market based mechanisms, without mentioning either taxes or tradable permits. The bill gives future regulators discretion over the manner of implementing the mandate. Governor Schwarzenegger

had wanted the bill to guarantee a market based mechanism; shortly after signing the bill, he issued an executive order forming a Market Advisory Committee to design a cap-and-trade market. Some sponsors of the bill considered this attempt to lock in the form of implementation inconsistent with the intent of the law (Robinson 2007). The bill also gives future policymakers discretion over the extent of implementation. Article 38599 gives the Governor the right to adjust the targets “in the event of extraordinary circumstances, catastrophic events, or threat of significant economic harm”.

This paper shows that economists should not promote market based policies on the grounds that these tend to lead to larger levels of abatement in equilibrium. That claim can easily be false. In addition to the usual efficiency argument in favor of market based policy, the paper identifies the more subtle fact that these policies reduce regulatory uncertainty. Furthermore, market based policies lead to *greater firm cost heterogeneity* – and therefore greater gains from subsequent market based policies. The paper also provides a new welfare result in the theory of global games.

Jaffe, Newell, and Stavins (2003) and Requate (2005) survey the literature on pollution control and endogenous investment. Many papers in this literature, including Biglaiser, Horowitz, and Quiggin (1995), Gersbach and Glazer (1999), Kennedy and Laplante (1999), Montero (2002), Fischer, Parry, and Pizer (2003), Moledina, Polasky, Coggins, and Costello (2003), Tarui and Polasky (2005) and Tarui and Polasky (2006) assume that firms behave strategically with respect to the regulator: firms believe that their investment decisions will affect future regulation. Several papers, including Malueg (1989), Milliman and Prince (1989), Requate (1998), Requate and Unold (2003), and Karp and Zhang (2002) treat firms as non-strategic. A related literature discusses the effect of regulation on technology development (Popp 2006), (Jaffe and Palmer 1997), (Newell, Jaffe, and Stavins 1999), (Taylor, Rubin, and Hounshell 2005). None of these papers discuss multiple competitive equilibria under command and control, so they do not consider the relation between the policy instrument and the existence of regulatory uncertainty; they do not examine the relation between the policy instrument and the equilibrium level of abatement; nor do they consider the global game application.

2 The model

The model consists of an investment period followed by an abatement period; firms have rational expectations. Suppose that firms are identical prior to investment and there is no exogenous uncertainty; Section 5 relaxes those assumptions. In the first period, each firm makes a binary decision: it does not invest in a new technology ($K = 0$) or it does invest ($K = 1$). The individual firm’s decision determines that firm’s abatement cost function in the second period.

The aggregate decisions determine the industry-wide abatement cost function. In the second period, the regulator chooses the required level of abatement, or equivalently, the allowable level of emissions, in order to minimize the sum of abatement costs and environmental damage. There are two possible policy regimes: trade in permits is either allowed or it is prohibited. The policy regime is known at the investment stage. (However, see closing comments in Section 5.)

For an arbitrary baseline level of emissions e^{base} and an actual level of emissions e , abatement in the second period is $a \equiv e^{base} - e$. The individual firm's abatement cost, $\tilde{c}(a, K)$, is increasing and convex in abatement. Investment decreases both abatement costs and marginal abatement costs.

Define the firm's benefit of emissions, $c(e, K)$, as the negative of abatement costs: $c(e, K) \equiv -\tilde{c}(a, K)$. The firm's marginal benefit of emissions is $c_e(e, K) \equiv \tilde{c}_a(a, K)$, equal to the marginal abatement cost. The assumptions above imply that $c(\cdot)$ is increasing and concave in e and decreasing in K , with $c_e(e, 1) - c_e(e, 0) < 0$. This inequality implies that the business-as-usual (BAU) level of emission, the level that satisfies $c_e(e, K) = 0$, is decreasing in K .

The firm's cost of investment is ϕ . The fraction of firms that invest is $0 \leq \kappa \leq 1$. If $0 < \kappa < 1$, firms are heterogenous in the second stage, when the regulator decides on the level of pollution permits.

Each (non-atomic) firm is given an emissions allowance of e , independently of whether it invested. The mass of firms is normalized to 1, so aggregate emissions are e . The damage function is $D(e)$, an increasing convex function. If firms that did not invest emit at the rate e^0 and firms that did invest emit at the rate e^1 , total emissions are $(1 - \kappa)e^0 + \kappa e^1 = e$ and social costs (abatement costs plus investment costs plus environmental damages) are

$$P(e^0, e^1, \kappa) \equiv -(1 - \kappa)c(e^0, 0) - \kappa c(e^1, 1) + \kappa\phi + D(e). \quad (1)$$

This model contains two notable assumptions. The first is that investment is lumpy at the firm level, but since firms are individually small, investment appears smooth at the societal level. The second assumption, that the regulator gives each firm the same level of permits, is consistent with the assumption of *ex ante* identical firms. In the absence of trade, a regulator's ability to condition the endowment of emissions permits on the investment decision would solve the efficiency problem at the abatement stage. However, that conditioning requires that the regulator is able to distinguish across firms, and it creates perverse incentives at the investment stage because firms that invest would receive lower allowances. (Of course, a sufficiently complex policy solves the investment – or almost any other – problem; but my objective is to compare the two most likely policy options, not to design an optimal policy.)

3 The abatement stage

This section establishes that trade in permits might either increase or decrease the socially optimal level of emissions for a given κ .¹ By equalizing heterogeneous firms' marginal abatement costs, trade in permits reduces total (industry) abatement costs for all levels of abatement. Therefore, trade must lower industry *marginal* abatement costs for *some* levels of abatement; consequently for a range of marginal damages, trade does increase the equilibrium level of abatement, i.e. it decreases the equilibrium level of emissions. However, the industry marginal abatement cost curves with and without trade might cross. When this occurs, trade can either increase or decrease the equilibrium level of abatement, depending on the marginal damage curve. Roughly speaking, trade reduces equilibrium abatement (increases emissions) when firms with low marginal abatement costs have steeper marginal costs for some interval of emissions (compared to firms with high marginal costs) and moreover the marginal damage curve crosses the industry marginal abatement cost curve in this interval.

In the absence of trade, and given the assumption that all firms receive the same level of permits, all firms emit at the same rate, so $e^0 = e^1 = e$. Subscripts denote partial derivatives and superscripts indicate the firm's investment decision. Given κ , the first order condition for the minimization of social costs is

$$D'(e) = (1 - \kappa) c_e(e, 0) + \kappa c_e(e, 1) \quad (2)$$

and the second order condition is

$$S \equiv -((1 - \kappa) c_{ee}^0 + \kappa c_{ee}^1) + D'' > 0.$$

Equation (2) implicitly defines the optimal e^* as a function of κ : $e^* = e(\kappa)$. More investment (higher κ) reduces the optimal level of emissions:

$$\frac{de^*}{d\kappa} = -\frac{c_e^0 - c_e^1}{S} < 0. \quad (3)$$

Now consider the optimal level of emissions in the presence of trade. Trade in permits equates investors' and non-investors' marginal costs, and the price of permits equals this marginal cost. Let e be each firm's endowment of permits, and e^t the equilibrium purchases of each non-investor – those with higher marginal abatement costs. Since the mass of purchases

¹The belief that the cost reductions resulting from the use of efficient policies lead to higher abatement seems to me widespread. For example, an expert group involved with designing California's environmental policy writes, "Properly structured market mechanisms can reduce the costs associated with emissions reductions and climate change mitigation while reducing emissions beyond what traditional regulation can do alone." (Economic and Technology Advancement and Advisory Committee 2008), page 2.

equals $(1 - \kappa) e^t$, each of the κ low cost firms (the investors) must be willing to sell $\frac{(1-\kappa)e^t}{\kappa}$. In an interior equilibrium, the conditions for quantity (e^t) and price (p) are

$$c_e(e + e^t, 0) = c_e\left(e - \frac{(1 - \kappa) e^t}{\kappa}, 1\right) \quad (4)$$

$$c_e(e + e^t, 0) = p(e, \kappa). \quad (5)$$

Equation (4) implicitly defines the function $e^t = e^t(e; \kappa)$. The assumption that the equilibrium is interior simplifies the discussion; it means that the price is positive, and the low cost firms do not sell all of their permits:

$$c_e(e + e^t(e; \kappa), 0) > 0 \text{ and } e - \frac{(1 - \kappa) e^t(e; \kappa)}{\kappa} > 0. \quad (6)$$

Given κ , the planner's problem is to choose e to minimize

$$W(e; \kappa) = -(1 - \kappa) c(e + e^t, 0) - \kappa c\left(e - \frac{(1 - \kappa) e^t}{\kappa}, 1\right) + D(e). \quad (7)$$

Using equations (4) and (5), the first order condition is

$$D'(e) = (1 - \kappa) c_e(e + e^t, 0) + \kappa c_e\left(e - \frac{(1 - \kappa) e^t}{\kappa}, 1\right) = p(e, \kappa). \quad (8)$$

Assuming that the planner's problem is convex, the second order condition holds:

$$S^t \equiv \frac{d^2W}{de^2} = -(1 - \kappa) c_{ee}^0 \left(1 + \frac{de^t}{de}\right) - \kappa c_{ee}^1 \left(1 - \frac{1-\kappa}{\kappa} \frac{de^t}{de}\right) + D'' > 0. \quad (9)$$

3.1 Comparison of pollution levels with and without trade, given κ

This section compares the equilibrium levels of pollution permits with and without trade in permits for a given κ , with $0 < \kappa < 1$. The two levels are equal at $\kappa = 0$ or $\kappa = 1$, where there is no incentive to trade, so those limiting cases are not interesting for this analysis. Recall that $e^t(e; \kappa)$ is the equilibrium level of purchases of permits per non-investing firm, when the fraction κ firms invest and the aggregate supply of permits is e . Define $e^n(e; \kappa) \equiv 0$, where the superscript "n" denotes "no trade".

The individual firm's marginal benefit of emissions equals its marginal abatement cost. The social marginal benefit of emissions, $G(e; \kappa, j)$, $j = \text{trade, no trade}$, equals the industry marginal abatement cost:

$$G(e; \kappa, j) \equiv (1 - \kappa) c_e(e + e^j, 0) + \kappa c_e\left(e - \frac{(1 - \kappa) e^j}{\kappa}, 1\right), \quad j = t, n \text{ (trade, no trade)}. \quad (10)$$

With trade, the two types of firms have the same marginal benefits, p , so $G(e; \kappa, \text{trade}) = p(e, \kappa)$. Without trade, the industry marginal benefit of emissions $G(e; \kappa, \text{no trade})$ is a convex

combination, with weights equal to $1 - \kappa$, κ , of the marginal benefit of emissions for the two types of firms (those who did not invest and those who did). For some levels of e and κ and for some technologies, $G(e; \kappa, \text{trade}) > G(e; \kappa, \text{no trade})$. If this inequality is satisfied at the socially optimal level of emissions without trade, then trade increases the socially optimal level of emissions.

To see that trade can increase industry marginal costs, suppose that initially all firms have e permits and there is no trade. Now remove de permits from each of the κ firms that invested and transfer these to the firms that did not invest, each of whom obtain $\frac{\kappa}{1-\kappa}de$ additional permits. The change in industry marginal costs is

$$(c_{ee}(e, 0) - c_{ee}(e, 1)) \kappa de.$$

Marginal costs increase if and only if $c_{ee}(e, 0) > c_{ee}(e, 1)$. Since both of these quantities are negative, this inequality means that the marginal cost of firms that invested is steeper than the marginal cost of firms that did not invest.

Relative to the optimal emissions levels with trade, the optimal levels without trade require over-emissions by the firms that invested, and under-emissions by the firms that did not invest. To a first order approximation, both of these departures from the first best outcome result in welfare losses proportional to the slope of the marginal cost curves, c_{ee} . When we transfer a unit of emissions from a low cost to a high cost firm, the marginal cost of the former increases by approximately $|c_{ee}(e, 1)|$ and the marginal cost of the latter decreases by approximately $|c_{ee}(e, 0)|$. The two-firm average of marginal abatement costs therefore increases if $c_{ee}(e, 0) - c_{ee}(e, 1) > 0$.

A simple geometric argument shows that the two industry marginal abatement costs, under cap and trade and under command and control, might cross. For $0 < \kappa < 1$, define $\Theta(e; \kappa)$ as the following *difference*: industry abatement costs under command and control minus industry abatement costs under cap and trade. For $e = e^{base}$ (the BAU level of emissions), $\Theta(e; \kappa) = 0$ and for $e < e^{base}$ the fact that cap and trade reduces abatement costs implies $\Theta(e; \kappa) > 0$. Thus, in the neighborhood of e^{base} it must be the case that $\Theta_e(e; \kappa) < 0$, i.e. industry marginal abatement costs are higher under command and control than under cap and trade. However, the fact that $\Theta(e; \kappa) > 0$ for $e < e^{base}$ obviously does not imply that $\Theta(e; \kappa)$ is monotonic in e . At any extreme point, the industry marginal costs under cap and trade and under market based policies cross. Where $\Theta_e(e; \kappa) > 0$, industry marginal costs are higher under cap and trade, relative to command and control.

Example 1 contains a situation where the industry marginal cost curves with and without trade do cross and Example 2 shows a situation where they never cross.

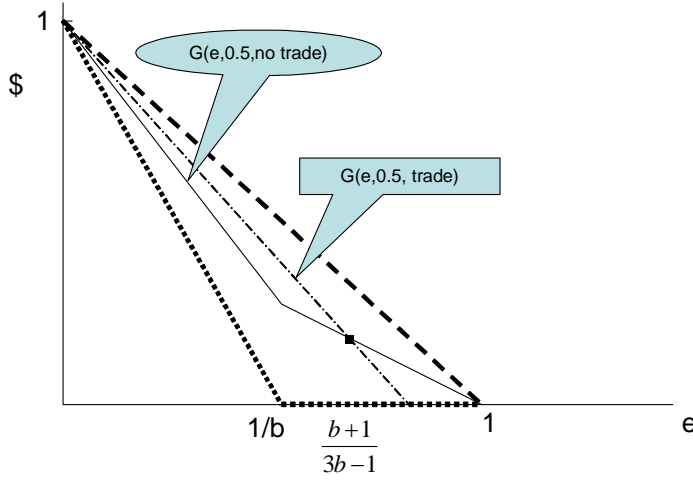


Figure 1: Dotted and dashed lines show marginal benefit of emissions with and without investment, respectively. The two solid lines show the social marginal benefit of emissions with and without trade for $\kappa = 0.5$

Example 1 Suppose that the marginal benefit of emissions without investment is $c_e(e, 0) = 1 - e$ for $e \leq 1$ and the marginal benefit with investment is $c_e(e, 1) = 1 - be$ for $e \leq \frac{1}{b}$, where $b > 1$. Marginal benefits of emissions are 0 for $e > 1$ without investment, and marginal benefits are 0 for $e > \frac{1}{b}$ with investment. The dotted and the dashed lines in Figure 1 graph these marginal benefits.² With $\kappa = 0.5$, in the absence of trade the marginal benefit of emissions is the kinked solid line labelled $G(e, 0.5, \text{no trade})$; for $e < \frac{1}{b}$ the slope of this line is $\frac{1+b}{2}$ and for $e > \frac{1}{b}$ the slope is $\frac{1}{2}$. With trade, the equilibrium level of trade is $e^t = \frac{b-1}{b+1}e$ and the marginal social benefit of emissions is the straight line labelled $G(e, 0.5, \text{trade})$, with slope $\frac{2b}{b+1} > 1$. Since $\frac{1+b}{2} > \frac{2b}{1+b}$ we have $G(e, 0.5, \text{trade}) > G(e, 0.5, \text{no trade})$ for small e . For all emissions levels $e < \frac{b+1}{3b-1}$ the social marginal benefit of emissions is higher when permits are tradable. A necessary and sufficient condition for the optimal level of emission with trade to exceed the optimal level without trade is for the latter to be less than $\frac{b+1}{3b-1}$.

Example 2 Let $c_e(e, 0) = 1 - e$ as in the previous example, but set $c_e(e, 0) = b(1 - e)$ with $b < 1$. Some tedious calculation shows that for all $0 < \kappa < 1$ trade reduces the social marginal

² For this specification, the firm that invests would, in the absence of trade, not use emissions permits in excess of $\frac{1}{b}$, so those permits would create no additional environmental damage. We can make one of two modifications in order to use this functional form to study either the investment or the abatement decision: (i) choose the marginal damages such that in equilibrium $e < \frac{1}{b}$ for all values of κ with or without trade (ii) perturb the marginal benefit for the investing firm so that this firm has positive marginal benefits for $\frac{1}{b} \leq e < 1$ (instead of 0 marginal benefits as the example assumes). The appendix discusses this example further. In Figure 2 and Example 3 below, I use the first modification, by making the marginal damage curve sufficiently high.

benefit of emissions and therefore reduces equilibrium emissions.

These two examples show that trade in permits might either encourage or discourage stricter regulation.

Equation (2) and the first part of equation (8) have the same form, but they have different arguments. They are identical if $e^t = 0$. The following proposition uses this fact to determine the effect of trade on the equilibrium level of emissions, holding investment fixed; all proofs are in the appendix.

Proposition 1 *Assume that $0 < \kappa < 1$, define $e^* = e^*(\kappa)$ as the optimal level of emissions in the absence of trade, and define $e^t(e; \kappa)$ as the equilibrium level of purchases (under trade) per non-investing firm for given e, κ . Assume that at $e^*(\kappa)$ the with-trade equilibrium is interior, i.e. the two inequalities in (6) hold. A sufficient condition for trade in permits to decrease the equilibrium level of emissions (i.e. to lead to stronger environmental regulation) is*

$$\Delta(\kappa, e^*(\kappa), s) \equiv c_{ee}(e^* + s, 0) - c_{ee}\left(e^* - \frac{(1-\kappa)s}{\kappa}, 1\right) < 0 \quad (11)$$

for all $0 \leq s \leq e^t(e^(\kappa); \kappa)$. A sufficient condition for trade to lead to weaker environmental regulation is for inequality (11) to be reversed for all $0 \leq s \leq e^t(e^*(\kappa); \kappa)$.*

The fact that trade in permits reduces abatement costs implies that the with-trade industry marginal abatement cost curve cannot lie above the no-trade industry marginal abatement curve for all levels of emissions. The insight in this section is that the two curves can cross, so that there can exist intervals over which the with-trade marginal abatement curve does lie above the no-trade curve. When such an interval exists, there is some marginal damage function $D'(e)$ for which trade increases the optimal level of emissions.

4 The investment stage

This section establishes that when permits are not tradable, firms play a coordination game at the investment stage, leading in general to multiple competitive investment equilibria (only one of which is constrained optimal) and resulting regulatory uncertainty. In contrast, the unique investment equilibrium when permits are tradable is socially optimal.

4.1 No trade in permits

When more firms invest (κ is larger), industry marginal abatement costs are lower, so the equilibrium number of permits is lower (equation (3)). The representative firm takes κ as given.

The firm forms (point) expectations about this parameter, and these expectations are correct in equilibrium. The firm's belief about κ (equal to its equilibrium value) affects its optimal investment decision. In the investment stage, a firm's net benefit of investing equals the difference between the costs when it does not invest, $-c(e(\kappa), 0)$, and the costs when it does invest, $-c(e(\kappa), 1) + \phi$. The benefit of investing is therefore

$$\Pi^{nt}(\kappa) = c(e(\kappa), 1) - c(e(\kappa), 0) - \phi. \quad (12)$$

(The superscript nt is denotes "no trade".) Differentiating this expression and using equation (3) implies

$$\frac{d\Pi^{nt}(\kappa)}{d\kappa} = \frac{(c_e^1 - c_e^0)^2}{S} > 0. \quad (13)$$

A larger anticipated value of κ increases the incentive to invest: the investment decisions are strategic complements.

The necessary and sufficient condition for multiple equilibria are

$$\Pi^{nt}(0) = c(e(0), 1) - c(e(0), 0) - \phi < 0 \quad (14)$$

$$\Pi^{nt}(1) = c(e(1), 1) - c(e(1), 0) - \phi > 0. \quad (15)$$

The net cost of adopting if no other firm adopts is $\Pi^{nt}(0)$. Inequality (14) implies that a firm does not want to invest if it knows that no other firm will invest ($\kappa = 0$); here the firm knows that the environmental standards will be lax. The net benefit of adopting if all other firms adopt is $\Pi^{nt}(1)$. Inequality (15) implies that it pays a firm to invest if all other firms do so; here the firm knows that abatement standards will be strict.

If equations (14) and (15) hold there is an interior unstable equilibrium that satisfies $\Pi(\kappa_u) = 0$, where $0 < \kappa_u < 1$. At κ_u a firm is indifferent between investing and not investing. This equilibrium is unstable; for example, if slightly fewer than the equilibrium number of firms invest ($\kappa < \kappa_u$), it becomes optimal for all other investors to change their decisions, and decide not to invest. In summary, we have

Proposition 2 *Inequalities (14) and (15) are necessary and sufficient for the existence of two stable boundary equilibria (all firms or no firms invest) and one unstable interior equilibrium. If either inequality fails, there exists a unique boundary equilibrium.*

If ϕ is very small, it is always optimal to invest; it is never optimal to invest if ϕ is very large. Multiplicity requires that ϕ is neither very large nor very small.

4.2 The equilibrium value of κ under tradable permits

As is the case without trade in permits, an increase in the number of adopters (larger κ) causes the regulator to use stricter environmental standards (smaller e). Totally differentiating equation (8), using the second order condition $S^t > 0$, implies

$$\frac{de}{d\kappa} = \frac{c_{ee}^0 c_{ee}^1}{\kappa S^t} \left(\frac{e^t}{\kappa c_{ee}^0 + (1-\kappa) c_{ee}^1} \right) < 0. \quad (*) \quad (16)$$

(A Referees' appendix, available upon request, shows the derivations of equations marked by (*).)

A larger value of κ has an ambiguous effect on the purchases per non-adopter, e^t . Totally differentiating equation (4), the equilibrium condition for quantity traded, implies

$$\frac{de^t}{d\kappa} = \frac{-\frac{\Delta}{S^t} \left(\frac{c_{ee}^0}{\kappa c_{ee}^0 + (1-\kappa) c_{ee}^1} \right) + \frac{1}{\kappa} c_{ee}^1 e^t}{\kappa c_{ee}^0 + (1-\kappa) c_{ee}^1} c_{ee}^1 e^t. \quad (*) \quad (17)$$

This equation shows that a sufficient condition for the purchases per non-adopter to increase with the number of adopters is $\Delta(\kappa, e, e^t) < 0$. From Proposition 1, this inequality also implies that trade in permits leads to tighter environmental regulations, given κ .

The effect of investment on the equilibrium permit price is not obvious. For a given level of permits, a higher level of investment obviously decreases the equilibrium price. However, a higher level of investment decreases the equilibrium level of permits. The first effect always dominates, so higher κ reduces the equilibrium price of permits:³

$$\frac{dp}{d\kappa} = \frac{c_{ee}^0 c_{ee}^1 e^t}{S^t (\kappa c_{ee}^0 + (1-\kappa) c_{ee}^1)} \frac{D''}{\kappa} < 0. \quad (*) \quad (18)$$

The cost incurred by the firm that invests, net of receipts from sales of permits, is

$$-c \left(e - \frac{1-\kappa}{\kappa} e^t, 1 \right) + \phi - p \frac{1-\kappa}{\kappa} e^t.$$

The cost incurred by the firm that does not invest, net of payments from purchases of permits, is

$$-c(e + e^t, 0) + p e^t.$$

The benefit of investing (equal to the cost savings) when trade in permits is allowed is the difference between these two costs:

$$\begin{aligned} \Pi^t(\kappa) \equiv & (-c(e + e^t, 0) + p e^t) - \left(-c \left(e - \frac{1-\kappa}{\kappa} e^t, 1 \right) + \phi - p \frac{1-\kappa}{\kappa} e^t \right) = \\ & c \left(e - \frac{1-\kappa}{\kappa} e^t, 1 \right) - c(e + e^t, 0) - \phi + p \frac{1}{\kappa} e^t. \end{aligned} \quad (19)$$

³An informal argument explains this result. The equilibrium level of emissions is the same under the cap-and-trade and the tax policy. The equilibrium permit price in the former equals the equilibrium tax in the latter. Since greater investment reduces the industry marginal cost of abatement, it must reduce the equilibrium tax – and the equilibrium permit price.

(The superscript t denotes “trade”.) Using the equilibrium conditions (4) and (5) the derivative of the benefit of adoption is⁴

$$\frac{d\Pi^t}{d\kappa} = \frac{e^t}{\kappa} \frac{dp}{dk} < 0. \quad (20)$$

This inequality states that under tradable permits, investments are strategic substitutes: an increase in the number of other investors decreases the incentive for any firm to invest. The monotonicity of $\Pi^t(\kappa)$ implies that for $0 < \kappa < 1$ there is at most one root of $\Pi^t(\kappa) = 0$. In summary:⁵

Proposition 3 *When permits are tradable, investment decisions are strategic substitutes; there always exists a unique rational expectations competitive equilibrium. The equilibrium involves the fraction $0 < \kappa < 1$ of firms investing if and only if there is a solution to the equation $\Pi^t(\kappa) = 0$ for $0 < \kappa < 1$. Therefore, an interior equilibrium exists if and only if*

$$\Pi^t(0) > 0 > \Pi^t(1). \quad (21)$$

If $\Pi^t(1) > 0$ then the unique equilibrium is $\kappa = 1$, and if $\Pi^t(0) < 0$ then the unique equilibrium is $\kappa = 0$.

4.3 Trade’s effect on the incentive to invest

Homogenous firms all make the same investment decision under command and control emissions policies. Therefore, firms are homogenous ex post, so there is no apparent efficiency loss from the prohibition against trade. In contrast, with market based policies homogenous firms are induced to make different investment decisions, leading to ex post heterogeneity and resulting gains from trade. In this sense, the possibility of trade creates the rationale for trade. Of course, the assumption of ex ante homogenous firms is not realistic, but the point here is that the anticipation of market based policies is likely to increase firm heterogeneity, via the investment decision. Command and control policies are more likely to reinforce firm homogeneity.

In order to determine the relation between the levels of investment under command and control and under market based policies, it helps to see how allowing trade changes the incentive

⁴The equality in (20) is easiest to derive using the first rather than the second line of equation (19). Note that $\Pi^t(\kappa)$ depends on κ via the effect of κ on e , e^t , the ratio $\frac{1-\kappa}{\kappa}$, and finally on $p(\kappa)$. In view of the equilibrium conditions (4) and (5), the effect via each of the first three channels is 0, so we are left with the effect of κ on $\Pi^t(\kappa)$ via its effect on p .

⁵The first part of Proposition 7 of Requate and Unold (2003) describes the outcome under tradable permits or taxes, in line with my Proposition 3. I include Proposition 3 so that the analysis here is self-contained, and in order to make the point that investment decisions are either strategic complements or substitutes, depending on whether the regulator uses command and control or cap and trade.

to invest, in a boundary equilibrium. Recall that $e(0)$ and $e(1)$ are the socially optimal levels of emissions when $\kappa = 0$ and $\kappa = 1$, respectively; in these cases, trade plays no role since all firms have the same abatement costs in the second period. Let e^{t1} be the equilibrium level of purchases per non-adopting firm in the hypothetical situation where $\kappa = 1$ and a “single firm” (more formally: a set of firms of measure zero) deviates by not investing, and instead buys e^{t1} permits at the equilibrium price p^1 . The deviating firm obtains the consumer surplus

$$CS \equiv c(e(1) + e^{t1}, 0) - c(e(1), 0) - p^1 e^{t1} > 0. \quad (22)$$

The non-deviating firms (when $\kappa = 1$) each sell an infinitesimal amount to the deviating firms⁶, receiving infinitesimal producer surplus. This fact and equations (12), (19) and (22) imply

$$\Pi^t(1) = \Pi^{nt}(1) - CS < \Pi^{nt}(1). \quad (23)$$

The possibility of trade decreases the benefit of investment when $\kappa = 1$, because a firm knows that by deviating and not investing, it obtains consumer surplus.

Denote s as the equilibrium level of sales of an adopting firm in the hypothetical situation where $\kappa = 0$ and a “single firm” deviates by adopting, and then selling s permits at price p^0 . The deviating firm obtains the producer surplus

$$PS \equiv c(e(0) - s, 1) - c(e(0), 1) + p^0 s > 0. \quad (24)$$

Non-deviating firms (when $\kappa = 0$) each buy an infinitesimal amount⁷ and receive infinitesimal consumer surplus. Therefore

$$\Pi^t(0) = \Pi^{nt}(0) + PS > \Pi^{nt}(0). \quad (25)$$

Inequalities (23) and (25) and the monotonicity of $\Pi^t(\kappa)$ and $\Pi^{nt}(\kappa)$ imply that the curves must cross a single time. This fact means that there can be large differences between the investment equilibria with and without trade. For example, the configuration $\Pi^{nt}(0) < 0 < \Pi^t(1) < \Pi^{nt}(1)$ is possible. These inequalities imply that the unique equilibrium with trade requires $\kappa = 1$, but there are two stable equilibria ($\kappa = 0$ and $\kappa = 1$) without trade. In addition, it is easy to construct an example for which there is a unique interior equilibrium with trade, but two boundary equilibria without trade. The only possibility that can be ruled out is that there is a *different unique* boundary equilibrium with and without trade. For example, the case where $\kappa = 1$ with trade and the unique equilibrium without trade is $\kappa = 0$ violates inequality (23).

⁶This fact implies that the equilibrium price is $p^1 = c_e(e(1), 1)$ and e^{t1} satisfies $c_e(e(1) + e^{t1}, 0) = p^1$. Here again I assume that the equilibrium is interior, so that the deviating firm abates at a positive level.

⁷Therefore $p^0 = c_e(e(0), 0)$ and s satisfies $c_e(e(0) - s, 1) = p^0$.

4.4 Social optimality and the timing of actions

Several observations follow from the analysis above. First, (as is widely known) when permits are tradable, the outcome produces the social optimum regardless of whether the regulator announces the cap before or after firms decide on investment.⁸ To verify this claim, consider the social planner who is able to choose both κ and e , allowing trade. This planner wants to minimize environmental damages plus abatement and investment costs, $W(e; \kappa) + \kappa\phi$. (See equation (7).) The first order condition for this problem at an interior solution is

$$\frac{dW(e; \kappa)}{d\kappa} + \phi = -\Pi^t(\kappa) = 0. \quad (26)$$

This first order condition is identical to the condition for an interior competitive equilibrium. The second order condition for an interior equilibrium, $\frac{d\Pi^t(\kappa)}{d\kappa} < 0$, is identical to the condition that an interior competitive equilibrium is stable. The conditions for a boundary optimum are the same as the conditions for boundary competitive equilibria.

The second observation is that one of the competitive equilibria under command and control policies is constrained optimal.

Definition 1 *The “second best” (or “constrained optimal”) outcome is the socially optimal level of investment and emissions under the constraint that all firms receive the same number of permits and firms are not allowed to trade permits.*

Proposition 4 *(a) In the second best outcome, the planner chooses to have all or no firms invest ($\kappa = 1$ or $\kappa = 0$ is constrained optimal). (b) The planner who can credibly commit to the level of emissions before investment occurs, achieves the second best outcome.*

Corollary 1 *In the absence of trade, when the regulator announces the emissions ceiling after investment, one of the competitive equilibria coincides with the second best outcome.*

The third observation is that trade in permits eliminates regulatory uncertainty, regardless of when the regulator announces the level of emissions permits. Without trade in permits, regulatory uncertainty occurs only when the regulator cannot credibly announce the emissions level at the investment stage. These claims rely on the uniqueness of the rational expectations equilibrium with trade, the lack of uniqueness without trade, and Proposition 4.

Finally, trade in permits can increase or decrease the equilibrium level of emissions, regardless of whether investment is fixed or endogenous, and regardless of whether the regulator

⁸If the regulator announces an emissions tax before investment, there are in general multiple equilibria to the investment game; see Proposition 6 in Requate and Unold (2003). This is the situation, noted in the Introduction, where taxes and cap-and-trade are not equivalent.

announces the abatement level before or after investment. This claim relies on Proposition 1 and on the fact that equilibrium investment without trade can be larger or smaller than equilibrium investment with trade.

Figure 2 shows an example of the equilibrium level of emissions as a function of investment costs, ϕ , for three scenarios, using the abatement cost functions in Example 1 with $b = 1.5$ and marginal damage of pollution e . As the equilibrium value of κ ranges from 1 to 0 with increasing investment costs, the level of emissions ranges from 0.4 to 0.5. The piece-wise linear curve shows equilibrium emissions when these are tradable. The “interval of multiplicity” (0.104, 0.127), shown by the heavy line segment, is the range of investment costs for which there are two investment equilibria (at which $e = 0.4$ or $e = 0.5$) when emissions are not tradable and the regulator announces the cap after investment. The interval of multiplicity without trade includes all costs for which there is an interior equilibrium with trade.

When emissions are not tradable and the regulator announces emissions *before* firms invest, Proposition 4 implies that equilibrium emissions is a step function (not shown). The vertical line at $\phi = 0.117$ shows the critical investment cost at which the step occurs. For costs below (respectively, above) this level, the regulator announces $e = 0.4$ (respectively, $e = 0.5$) and all firms (respectively, no firms) invest. Under cap and trade the timing of the regulatory announcement is irrelevant. When the regulator announces a non-traded cap before investment, the equilibrium level of emissions is lower than under cap and trade for low-intermediate costs ($.10667 \leq \phi \leq .117$). For high-intermediate costs ($.117 < \phi \leq .125$) emissions are lower with trade. This qualitative comparison holds in general; with trade, emissions is a continuous non-decreasing function of ϕ , and without trade (but credible announcements of emissions levels), emissions is a non-decreasing step function of ϕ . Moreover, these two functions have the same domain and range.

The figure illustrates the fact that one of the equilibria in the absence of trade, when the level of permits is made after investment, is constrained optimal, as Corollary 1 states. It also shows that taking into account the endogeneity of investment greatly increases the set of parameter values under which trade has ambiguous effects on the level of equilibrium emissions.

5 Investment as a global game

There are number of ways in which uncertainty changes the equilibrium problem and might yield a unique equilibrium in the absence of trade, even when the regulator announces the emissions level after investment. This section examines the setting known as a “global game”, following Morris and Shin (2003) Previous applications of global games include models of currency attacks (Morris and Shin 1998), bank runs (Goldstein and Pauzner 2005) and resale

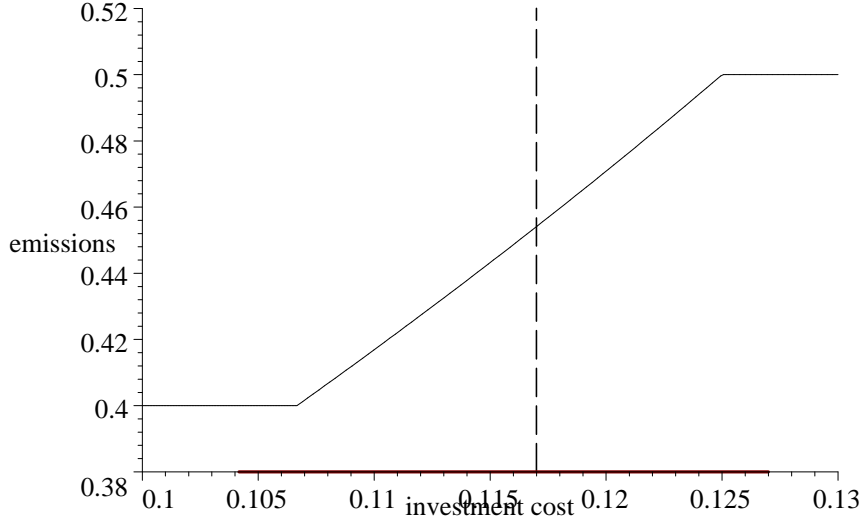


Figure 2: Piecewise linear curve: Equilibrium emissions with trade. Interval $0.104 < \phi < .127$: region of multiple equilibria without trade when regulator announces emissions after investment. Vertical dashed line: boundary of costs between regions where all or no firms invest when regulator announces non-tradable emissions before investment. Abatement costs given in Example 1 with $b = 1.5$ and marginal damages = e .

markets (Karp and Perloff 2005).

Suppose that firm i has investment cost $\phi_i = \bar{\phi} + \epsilon x_i$ where $\epsilon > 0$ and x_i is a random variable with pdf $p(x)$. The parameter $\bar{\phi}$ is unknown and all firms begin with a diffuse prior on $\bar{\phi}$ (a uniform prior over the real line). After observing its private cost, a firm forms a posterior belief on $\bar{\phi}$. As ϵ shrinks toward 0, each firm knows that with high probability all firms have approximately the same costs, and they all know that all firms know this, and so on with higher order beliefs.

The equilibrium to this game is a mapping from the signal ϕ_i to the action space: {invest, do not invest}. There is a unique equilibrium to this game, and that equilibrium does not depend on $p(x)$ or ϵ . The unique equilibrium survives iterated deletion of dominated strategies. This equilibrium can be calculated by determining the optimal action for an agent who receives signal ϕ_i and believes that κ , the measure of agents who invest, is uniformly distributed over the interval $[0, 1]$. Without loss of generality, suppose that a firm that is indifferent between investing and not investing decides to invest.

Using Prop 2.1 in Morris and Shin (2003), a firm wants to invest if and only if its signal ϕ_i satisfies

$$\phi_i \leq \phi^c \equiv \int_0^1 (c(e(\kappa), 1) - c(e(\kappa), 0)) d\kappa. \quad (27)$$

In equilibrium the fraction of firm that invest is

$$\kappa^c \equiv \int_{-\infty}^{\frac{\phi^c - \bar{\phi}}{\epsilon}} p(x) dx.$$

For $\phi^c - \bar{\phi} \neq 0$ (an almost-certain event) this fraction approaches 0 or 1 as $\epsilon \rightarrow 0$, depending on whether $\phi^c - \bar{\phi}$ is negative or positive.

Now consider the problem for the regulator who can choose κ in the first period and then choose the emissions allowance in the second – maintaining the assumption that there is no trade in emissions. This regulator obtains a signal $\phi_r = \bar{\phi} + \epsilon_r x_r$ where x_r is a random variable with density $p_r(x_r)$. With slight abuse of notation, denote as ϕ the regulator's expectation of industry-wide average investment costs, conditional on its signal. Since the regulator's payoff is linear in investment costs, it minimizes expected total costs by choosing κ and $e^0 = e^1 = e$ to minimize $P(e, e, \kappa)$ defined in equation (1). As shown in the proof of Proposition 4, this function is concave in κ ; therefore, the optimal investment decision, denoted κ^s , is always on the boundary. With the tie-breaking assumption that a planner who is indifferent chooses to invest, the decision is to set $\kappa = 1$ if and only if

$$\phi \leq \phi^s \equiv c(e(1), 1) - c(e(0), 0) + D(e(0)) - D(e(1)). \quad (28)$$

In both the competitive equilibrium and under the social planner who chooses κ directly, there is a threshold signal, below which investment occurs. Even if the thresholds ϕ^c and ϕ^s coincide, the equilibrium amount of investment under this social planner and in the competitive equilibrium might nevertheless differ. The planner and firms might have different distributions of signals; in addition, κ^s is always a boundary value, whereas it is possible that $0 < \kappa^c < 1$. However, as noted above, κ^c approaches a boundary 0 or 1 as ϵ approaches 0 (for $\phi^c - \bar{\phi} \neq 0$). In addition, if both ϵ and ϵ_r are small, both the firm and the regulator have approximately the same posterior expectation of $\bar{\phi}$. Thus, if $\phi^c = \phi^s$, for any $\epsilon^* > 0$, the probability that $|\kappa^c - \kappa^s| < \epsilon^*$ (i.e., that the outcomes are “essentially the same”) can be made arbitrarily close to 1 by choosing sufficiently small ϵ, ϵ_r .⁹ In contrast, if $\phi^c \neq \phi^s$, for sufficiently small ϵ, ϵ_r there exist values of $\bar{\phi}$ at which $|\kappa^c - \kappa^s| \approx 1$. These observations motivate the comparison of the thresholds ϕ^c and ϕ^s . If $\phi^c = \phi^s$ the equilibrium outcomes are “essentially the same” when the firms and the regulator have essentially the same information (ϵ and ϵ_r are small). If $\phi^c \neq$

⁹In this sentence, “the probability” is a conditional probability, conditioned on the event that nature chooses $\bar{\phi}$ from a finite connected subset of the real line that includes parts of the dominance regions. Without such conditioning, “the probability” is not well-defined because agents have diffuse priors over $\bar{\phi}$.

ϕ^s the outcomes are likely to be different even if the firms and the regulator have essentially the same information.

In this model the externality is associated with emissions, and only indirectly with investment. The competitive level of investment is socially optimal when the regulator uses market based methods, such as tradable permits, to correct the emissions externality; the regulator does not need a second policy instrument to target investment. The use of non-tradable permits results in a constrained optimum level of emissions, conditional on the level of investment. Why then does the competitive level of investment not always result in the constrained optimal investment level, in the case of command and control policies chosen after investment? In the common-knowledge scenario analyzed in the previous section, we saw that the answer was simply that there can be multiple competitive equilibria. Corollary 1 shows that one of these equilibria is constrained optimal (i.e., “second best”), so the other (when it exists) is not constrained optimal. However, we know that the strategic uncertainty in the global games setting induces a unique equilibrium. Since there is a unique equilibrium in the global games setting, the intuition from the tradable permits case seems applicable: If the planner corrects the emissions externality, the market yields the correct level of investment. The fact that the policy intervention, under command and control, is only a *constrained* optimum, does not appear relevant. This reasoning leads to the conjecture that $\phi^c = \phi^s$, an equality that states that the competitive equilibrium and the social planner’s outcome would differ significantly only if the firms and the planner have different information (i.e., if ϵ or ϵ_r are non-negligible).

The following proposition confirms this conjecture.

Proposition 5 *The two thresholds (in the global game and in the social planner’s problem) are equal: $\phi^c = \phi^s$. Therefore, when firms and the social planner have essentially the same information, the competitive equilibrium and the constrained social optimum are “essentially the same” (as defined above).*

Example 3 *Let the abatement costs be as in Example 1 and let emissions damages be $D(e) = \frac{\delta}{2}e^2$, with $\delta > b - 1$. This inequality insures that for all κ , at the equilibrium level of emissions a firm that invests has a positive marginal benefit of emissions. The threshold investment cost in the global game and for the social planner is*

$$\phi^c = \phi^s = \frac{1}{2}\delta(b-1) \frac{b+\delta+1}{b(b+\delta)(\delta+1)}.$$

This function is increasing in both b and δ . (The discontinuity in the step function in Figure 2 equals ϕ^s .) A larger value of b increases the reduction in abatement cost due to investment. A larger value of δ decreases the equilibrium level of emissions for all κ . Either of these changes makes investment more attractive, increasing the threshold level of investment costs.

It is worth emphasizing that, when firms and the planner have essentially the same information, the global games equilibrium is (constrained) *socially* optimal. It is not true that the global games equilibrium maximizes the expected payoff to the industry. The industry as a whole would like to have all firms rather than no firms invest, given expected costs ϕ , if and only if

$$\phi \leq \phi^{cartel} \equiv c(e(1), 1) - c(e(0), 0). \quad (29)$$

Equations (28) and (29) show that $\phi^{cartel} < \phi^s$. Thus, the global games equilibrium does not maximize the industry payoff; it maximizes society's constrained payoff.

The model in this section treats the investment cost ϕ as the random variable, but there are many other possibilities. The game described above involves private values of investment costs, ϕ_i . We can also consider the situation where the payoff depends on the common value of a parameter. For example, with the functions in Example 3, the value to the firm of investing, for all κ , is an increasing function of δ , because a larger value of δ reduces the equilibrium emissions allowance. Suppose that firms begin with diffuse priors over δ and then each receives a private signal δ_i of this common value. With minor changes in assumptions about the distribution of the signal, we can apply Proposition 2.2 of Morris and Shin (2003) to show that there is a threshold equilibrium in this setting, a value δ^c such that firms invest if and only if $\delta_i \geq \delta^c$. There is also a threshold signal in the social planner's problem, δ^s . The parameter δ , unlike ϕ , affects the equilibrium level of emissions conditional on κ ; δ consequently enters nonlinearly the firm's and the social planner's payoff obtained by substituting in the equilibrium level of e . However, as ϵ and ϵ_r approach 0, the uncertainty with respect to δ is of no consequence in either problem. There remains only the strategic uncertainty about other agents' actions, arising from the lack of common knowledge; of course this uncertainty is the reason for the unique equilibrium in the global game setting. Thus, provided that the firms and the regulator have essentially the same information, the competitive equilibrium leads to approximately the same outcome as the social planner's problem; that is, $\delta^c = \delta^s$.

If there is a public signal about ϕ (or about δ in the linear example), the competitive equilibrium might not be unique, and therefore might not duplicate the constrained socially optimal equilibrium. In the presence of a public signal, uniqueness requires that the private signal is "sufficiently more precise" than the public signal.

Comments on other types of uncertainty Two alternatives to the global games model studied above are worth considering briefly. First, suppose that firm i 's investment cost is a draw from the *known* distribution $p(\phi)$. Unlike in the global game, the firm's private information tells it nothing about the other firms' costs, since the distribution (and all its parameters) are known at the outset. Brock and Durlauf (2001) provide an example of such a game. As the

support of p (ϕ) shrinks, firms become more similar, and the game approaches the deterministic game in the previous section. However, if there is sufficient variability in the private cost, there is a unique equilibrium.

To illustrate this claim, suppose that ϕ takes two values, ϕ_l and ϕ_h with equal probability, with (known) mean $\bar{\phi}$; moreover, suppose that in the deterministic game there are multiple equilibria if $\phi = \bar{\phi}$. At one extreme, let ϕ_l and ϕ_h be very close to $\bar{\phi}$. In this case, it is obvious that there remain multiple equilibria in the game with uncertainty. At the other extreme, let ϕ_l and ϕ_h be sufficiently far from $\bar{\phi}$ so that they both lie in “dominance regions”. In this case it is obvious that there is a unique equilibrium to the investment game. This example illustrates a situation in which uniqueness requires a sufficient amount of uncertainty. In contrast, in the global games setting, an arbitrarily small amount of uncertainty yields uniqueness. Herrendorf, Valentinyi, and Waldman (2000) examine another setting where heterogeneity leads to uniqueness.

For the second alternative, suppose that firms think that with probability p they will face command and control and with probability $1 - p$ they will face cap and trade in the second period; this is the only source of uncertainty. For p close to 1 investment decisions are strategic complements as in section 4.1, and for p close to 0, actions are strategic substitutes as in section 4.2. At a critical level of p the nature of the game flips, and for lower values of p there is a unique equilibrium to the investment game, instead of multiple equilibria.

6 Conclusion

The fact that market based pollution policies are generally more efficient than command and control policies is widely understood. However, the argument in favor of market based policies is sometimes exaggerated, and a different argument in favor of these policies is usually ignored. Market based – compared to command and control – policies might result in either more or less abatement, regardless of whether investment is fixed or endogenous and regardless of whether the regulator announces the level of permits before or after firms invest.

However, market based policies do reduce regulatory uncertainty. Under command and control policies, the lumpiness of investment and the fact that future environmental policies (optimally) depend on previous levels of investment, imply that there can be multiple rational expectations equilibria. From the standpoint of individual firms, this multiplicity looks like regulatory uncertainty. Market based policies eliminate this multiplicity of equilibria.

Because command and control policies create incentives for firms to make the same investment decision, these policies tend to reinforce firm homogeneity. This *ex post* similarity may make it appear that the prohibition against trade in permits is unimportant. In contrast, market

based policies encourage firms to make different investment decisions, thus creating or increasing firm heterogeneity, and increasing the efficiency gains from trade. The possibility of trade creates or increases the rationale for trade.

The potential regulatory uncertainty arises only when the regulator conditions emissions level on the previous aggregate investment, i.e. on the current industry abatement cost curve. If the regulator is able to credibly commit to an a level of (command and control) emissions before investment, there is obviously no regulatory uncertainty, and there is consequently a unique investment equilibrium. This competitive equilibrium involves all firms or no firms investing and is constrained optimal.

The potential regulatory uncertainty, when command and control policies are conditioned on past investment, depends on firms having common knowledge about market fundamentals. Even a small amount of private information about a market fundamental, such as average investment costs or the slope of marginal damages, leads to a unique equilibrium in the investment game. Importantly, this equilibrium is constrained socially optimal: it reproduces the investment and abatement outcome selected by the regulator who (in the absence of trade in permits) can choose investment and emissions directly, or equivalently, the regulator who can choose the level of emissions permits before firms invest. Thus, in the “global games setting ” (i.e. without common knowledge about market fundamentals) command and control policies create no regulatory uncertainty, but they continue to result in inefficient investment and abatement (relative to the first best).

These observations are interesting to the field of environmental economics, and regulatory economics more generally. They are of particular interest given the discussion of climate change policies occurring at all governmental levels. California’s AB32 is a striking example. This law explicitly recognizes that future emissions levels will be conditioned on future contingencies. It leaves open the possibility of using market based policies, without embracing those policies. There is still opposition to market based policies, so economists should be clear about what they do – and do not – achieve.

References

- BIGLAISER, G., J. HOROWITZ, AND J. QUIGGIN (1995): "Dynamic pollution regulation," *Journal of Regulatory Economics*, 8, 33–44.
- BROCK, W., AND S. DURLAUF (2001): "Discrete Choice with Social Interactions," *Review of Economic Studies*, 68, 235–260.
- CARLSSON, H., AND E. VAN DAMME (1993): "Global Games and Equilibrium Selection," *Econometrica*, 61, 989–1018.
- ECONOMIC AND TECHNOLOGY ADVANCEMENT AND ADVISORY COMMITTEE (2008): "Draft Comments on the Draft Scoping Plan," <http://arb.ca.gov/cc/etaac/meetings/090408pubmeet>.
- FISCHER, C., I. PARRY, AND W. PIZER (2003): "Instrument choice for environmental protection when technological innovation is endogenous," *Journal of Environmental Economics and Management*, 45, 523–45.
- GERSBACH, H., AND A. GLAZER (1999): "Markets and Regulatory Hold-up Problems," *Journal of Environmental Economics and Management*, 37, 151–164.
- GOLDSTEIN, I., AND A. PAUZNER (2005): "Demand deposit contracts and the probability of bank runs," *Journal of Finance*, 39, 1293–1327.
- HERRENDORF, B., A. VALENTINYI, AND R. WALDMAN (2000): "Ruling out Multiplicity and Indeterminacy: the Role of Heterogeneity," *Review of Economic Studies*, 67(2), 295–307.
- JAFFE, A., R. NEWELL, AND R. STAVINS (2003): "Technological change and the environment," in *Handbook of Environmental Economics, volume 1*, ed. by K.-G. Maler, and J. Vincent, pp. 461–516. North-Holland, Amstredam.
- JAFFE, A., AND K. PALMER (1997): "Environmental regulation and innovation: a panel data study," *Review of Economics and Statistics*, 79, 610–619.
- KARP, L., AND J. PERLOFF (2005): "When promoters like scalpers," *Journal of Economic and Management Strategy*, 14, 447–508.
- KARP, L., AND J. ZHANG (2002): "Controlling a Stock Pollutant with Endogenous Abatement Capital and Asymmetric Information," Giannini Foundation of Agricultural Economics, Working Paper No. 928, University of California, Berkeley; <http://are.Berkeley.EDU/karp/>.

- KENNEDY, P., AND B. LAPLANTE (1999): “Environmental policy and time consistency: emission taxes and emission trading,” in *Environmental Regulation and Market Power*, ed. by E. Petrakis, E. Sartzetakis, and A. Xepapadeas, pp. 116–144. Edward Elgar, Cheltenham.
- MALUEG, D. (1989): “Emission Credit Trading and the Incentive to Adopt New Pollution Abatement Technology,” *Journal of Environmental Economics and Management*, 16, 52–57.
- MILLIMAN, S., AND R. PRINCE (1989): “Firm incentives to promote technological change in pollution control,” *Journal of Environmental Economics and Management*, 17, 247–65.
- MOLEDINA, A., S. POLASKY, J. COGGINS, AND C. COSTELLO (2003): “Dynamic Environmental Policy with Strategic Firms: prices vs. quantities,” *Journal of Environmental Economics and Management*, 45.
- MONTERO, J. (2002): “Permits, standards, and technology innovation,” *Journal of Environmental Economics and Management*, 44.
- MORRIS, S., AND H. SHIN (1998): “Unique Equilibrium in a Model of Self-Fulfilling Expectation,” *American Economic Review*, 88, 587–597.
- MORRIS, S., AND H. SHIN (2003): “Global Games: Theory and Applications,” in *Advances in Economics and Econometrics*, ed. by M. Dewatripont, L. Hansen, and S. Turnovsky. Cambridge University Press.
- NEWELL, R., A. JAFFE, AND R. STAVINS (1999): “The induced innovation hypothesis and energy-saving technological change,” *Quarterly Journal of Economics*, 114, 941–75.
- POPP, D. (2006): “International innovation and diffusion of air pollution control technologies,” *Journal of Environmental Economics and Management*, 51, 46–71.
- REQUATE, T. (1998): “Incentives to innovate under emissions taxes and tradeable permits,” *European Journal of Political Economy*, 14, 139–65.
- (2005): “Dynamic Incentives by Environmental Policy Instruments,” *Ecological Economics*, 54, 175–195.
- REQUATE, T., AND W. UNOLD (2003): “Environmental Policy Incentives to adopt advanced abatement technology: Will the True Ranking Please Stand Up?,” *European Economic Review*, 47, 125–146.

ROBINSON, E. (2007): “Schwarzenegger Foe-Wasting Image Gives Way to Green Governor,”
www.bloomberg.com.

TARUI, N., AND S. POLASKY (2005): “Environmental regulation with technology adoption, learning and strategic behavior,” *Journal of Environmental Economics and Management*, 50, 447–67.

——— (2006): “Environmental regulation in a dynamic model with uncertainty and investment,” Presented at NBER conference.

TAYLOR, M., E. RUBIN, AND D. HOUNSHELL (2005): “Regulation as the mother of innovation: the case of SO₂ Control,” *Law and Policy*, 27, 348–78.

Appendix: Proofs

Proof. (Proposition 1) Figure 3 shows the graph of $G(e, \kappa, \text{no trade})$ (the negatively sloped solid curve) and the level of e^* . Trade decreases the equilibrium level of emissions if and only if $G(e^*, \kappa, \text{trade}) < G(e^*, \kappa, \text{no trade})$, as shown by the curve labelled “A”. If $G(e^*, \kappa, \text{trade}) > G(e^*, \kappa, \text{no trade})$, as shown by curve labelled “B”, trade increases the equilibrium level of emissions.

Define

$$\tilde{G}(e, \kappa, s) \equiv (1 - \kappa) c_e(e + s, 0) + \kappa c_e \left(e - \frac{(1 - \kappa)s}{\kappa}, 1 \right),$$

the social marginal benefit of emissions given e, κ and permit purchases of level s (per non-investing firm). Using this definition, $\tilde{G}(e, \kappa, s) = G(e, \kappa, \text{trade})$ for $s = e^t(e, \kappa)$, and $\tilde{G}(e, \kappa, s) = G(e, \kappa, \text{no trade})$ for $s = 0$.

Thus,

$$\begin{aligned} G(e; \kappa, \text{no trade}) - G(e; \kappa, \text{trade}) &= \tilde{G}(e, \kappa, 0) - \tilde{G}(e, \kappa, e^t) = \\ &= - \int_0^{e^t} \frac{\partial \tilde{G}(e, \kappa, s)}{\partial s} ds = - (1 - \kappa) \int_0^{e^t} \left(c_{ee}(e + s, 0) - c_{ee} \left(e - \frac{(1 - \kappa)s}{\kappa}, 1 \right) \right) ds. \end{aligned} \quad (30)$$

Evaluating this expression at $e = e^*(\kappa)$ implies the sufficient conditions in the Proposition. ■

Discussion of Proposition 1 In Figure 3, in the absence of trade the equilibrium level of emissions is e^* and the industry marginal cost equals x . In order to determine the effect of introducing trade, consider the following question: If the per firm endowment of permits were set to e^* , and firms were allowed to trade, would the price of permits be higher or lower than x ? If the market price is higher under trade, e.g. if the price equals $y > x$ in Figure 3, then the industry marginal cost curve with trade must lie above the industry marginal cost without trade in the neighborhood of point e^* . In that case, the industry marginal cost with trade “resembles” the curve labelled B in Figure 3, and the optimal level of permits under trade is greater than e^* . If the market price is lower under trade, e.g. if the price equals $z < x$ when $e = e^*$, then the industry marginal cost curve under trade must lie below the industry marginal cost without trade (at least in the neighborhood of point e^*). In that case, the industry marginal cost with trade “resembles” the curve labelled A in Figure 3, and the optimal level of permits under trade is less than e^* . In short, trade in permits shifts down the industry marginal cost curve (to a location such as A in Figure 3) if and only if the equilibrium price, under trade, is lower than the industry marginal cost without trade. That marginal cost equals a convex combination of the two types’ marginal abatement costs.

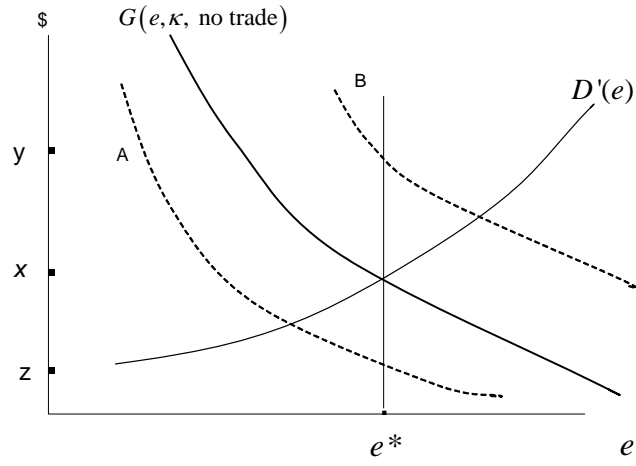


Figure 3: Comparison of emissions level for given $0 < \kappa < 1$, without trade (solid curve) and with trade (curves labelled A and B).

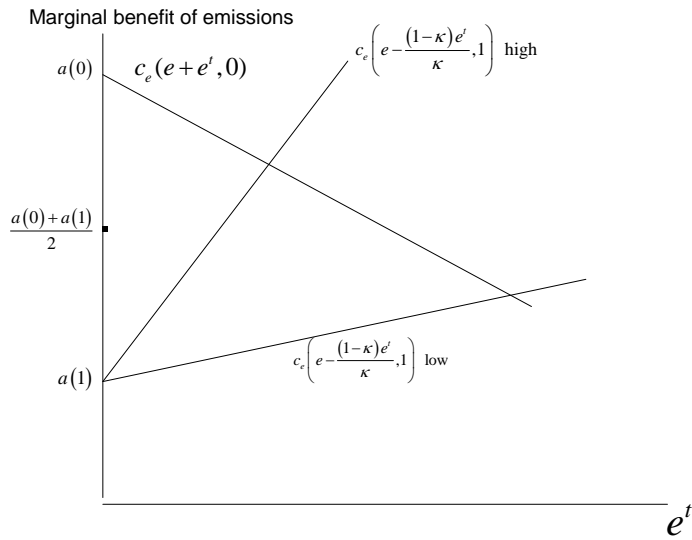


Figure 4: Market for permits under “high” and “low” scenarios, with fixed e and $\kappa = 0.5$.

Figure 4 helps in describing the circumstances under which the equilibrium (with-trade) permit price is greater or less than the industry marginal cost without trade, holding the aggregate level of permits fixed at e^* . The figure graphs the demand function for permits and two possible supply functions, labelled “high” and “low”, representing different assumptions about the abatement technology. The firms that did not make the investment buy permits, so their marginal cost falls with e^t . Firms that made the investment sell permits. Under the “low” scenario, investment causes a large fall in marginal abatement costs. Under the “high” scenario, investment causes a smaller fall in marginal abatement costs. Firms that do not invest have the same marginal cost in both scenarios, so Figure 4 shows a single demand curve. In the absence of trade ($e^t = 0$), the two types of firms have marginal abatement costs $a(0)$ and $a(1)$.

For simplicity, Figure 4 embodies two assumptions. First, $\kappa = 0.5$; second, the intercept of the adopter’s marginal cost, $a(1)$, is the same in the high and the low scenario; the linearity of the curves is not significant. The social marginal benefit of emissions without trade is $\frac{a(0)+a(1)}{2}$ for this particular value of e and for $\kappa = 0.5$. If the investor’s marginal benefit curve is “low”, the equilibrium price is lower than $\frac{a(0)+a(1)}{2}$. This possibility corresponds to curve A in Figure 3. Here the volume of trade is high, and the price is low when permits are tradable. In this case, trade reduces the equilibrium level of e , for given κ . Trade has the opposite effect in the “high” scenario. There the volume of trade is low and the price is high; trade increases the equilibrium level of e for given κ .

For this linear example, trade increases the social marginal benefit of emissions, thereby reducing the equilibrium level of emissions, if and only if the investors’ marginal cost curve is steeper than the non-investors’ curve. Figure 1 and Example 1 insure that this relation holds for sufficiently small e . In that example, the slope of the noninvestors’ marginal cost curve is 1, and the slope of the investors’ curve is $b > 1$ for $e < \frac{1}{b}$.

This graphical analysis helps to understand why trade might either increase or decrease the equilibrium aggregate level of emissions, for a given κ . The optimal level of emissions depends on a comparison of marginal damages and the aggregate marginal abatement cost. In the absence of trade, the aggregate marginal abatement cost is simply a convex combination of the marginal abatement costs of investor’s and non-investors, and therefore (given κ) it depends only on the *level* of the marginal abatement costs of the two types of firms. With trade, firms’ emissions do not equal their endowment. Trade equalizes marginal costs for the two types of firms, and the equilibrium level of marginal costs depends on the slopes (not just the levels) of the two marginal costs, as Figure 4 illustrates.

Propositions 2 and 3 are merely summaries of results shown in the text, so formal proofs are not shown.

Proof. (Proposition 4) Part (a) follows from the concavity of the planner's objective function: social costs $P(e^0, e^1, \kappa)$, given in equation (1), subject to the constraint that $e^0 = e^1$. Using the fact that e is chosen optimally, equation (3), and the fact that investment decreases marginal abatement costs ($c_e(e, 0) - c_e(e, 1) > 0$) the second derivative of $P(e^0, e^1, \kappa)$ with respect to κ is

$$(c_e(e, 0) - c_e(e, 1)) \frac{de}{d\kappa} < 0.$$

Therefore, the planner's objective is concave in κ ; the optimal κ is either 0 or 1.

The constraint mentioned in part (b) is that trade in permits is not allowed. To establish part (b), suppose that the constrained optimal level of investment is $\kappa = 1$. (The proof is similar when it is optimal to have $\kappa = 0$.) This hypothesis implies

$$-c(e(0), 0) + D(e(0)) - D(e(1)) > -c(e(1), 1) + \phi \quad (31)$$

. This inequality states that the difference, under no investment and under full investment, in the sum of the abatement cost and environmental damages, exceeds the cost of having all firms invest, ϕ . If the planner credibly announces $e^*(1)$ at the investment stage, the individual firm does not care what other firms do, and *does not* invest if and only if

$$-c(e(1), 1) + \phi > -c(e(1), 0). \quad (32)$$

Both inequalities (31) and (32) hold if and only if

$$D(e(0)) - c(e(0), 0) > D(e(1)) - c(e(1), 0). \quad (33)$$

Inequality (33) is false because by definition $e(0)$ minimizes social costs conditional on $\kappa = 0$.

■

Proof. (Corollary) The corollary is trivial when there are two multiple competitive equilibria, because these are both on the boundary, as is the second best outcome. The proof of Proposition 4b establishes the corollary when there is a unique competitive equilibrium. ■

Proof. (Proposition 5) The statement requires that the right sides of inequalities (27) and (28) are equal. Use integration by parts to write

$$\phi^c = \int_0^1 (c(e(\kappa), 1) - c(e(\kappa), 0)) d\kappa = \quad (34)$$

$$((c(e(\kappa), 1) - c(e(\kappa), 0)) \kappa) \Big|_0^1 - \int_0^1 \kappa (c_e(e(\kappa), 1) - c_e(e(\kappa), 0)) \frac{de^*}{d\kappa} d\kappa.$$

Define

$$g(\kappa) \equiv (1 - \kappa) c_e(e(\kappa), 0) + \kappa c_e(e(\kappa), 1).$$

Equation (2) states that $g(\kappa) = D'(e(\kappa))$. Use this relation and make a change of variables in the equation defining ϕ^s to write

$$\begin{aligned}
\phi^s &= c(e(1), 1) - c(e(0), 0) + D(e(0)) - D(e(1)) = \\
& c(e(1), 1) - c(e(0), 0) - \int_{e(0)}^{e(1)} D'(e) de = \\
& c(e(1), 1) - c(e(0), 0) - \int_0^1 D'(e) \frac{de^*}{d\kappa} d\kappa = \\
& c(e(1), 1) - c(e(0), 0) - \int_0^1 g(\kappa) \frac{de^*}{d\kappa} d\kappa.
\end{aligned} \tag{35}$$

Subtracting these two equations give

$$\begin{aligned}
\phi^c - \phi^s &= \\
& ((c(e(\kappa), 1) - c(e(\kappa), 0)) \kappa) \Big|_0^1 - \int_0^1 \kappa (c_e(e(\kappa), 1) - c_e(e(\kappa), 0)) \frac{de^*}{d\kappa} d\kappa - \\
& \left(c(e(1), 1) - c(e(0), 0) - \int_0^1 g(\kappa) \frac{de^*}{d\kappa} d\kappa \right) = \\
& c(e(0), 0) - c(e(1), 0) + \int_0^1 c_e(e(\kappa), 0) \frac{de^*}{d\kappa} d\kappa = \\
& c(e(0), 0) - c(e(1), 0) + \int_{e(0)}^{e(1)} c_e(e(\kappa), 0) de = 0.
\end{aligned}$$

■

Referees' appendix: derivation of "starred" equations

Derivation of equation (16) (the effect of k on the equilibrium level of emissions with trade): I begin by showing how κ affects the volume of trade for given e . Differentiating equation (4) with respect to e^t and κ , holding e fixed, implies¹⁰

$$\frac{\partial e^t}{\partial \kappa} = \frac{c_{ee}^1}{\kappa c_{ee}^0 + (1 - \kappa) c_{ee}^1} \left(\frac{e^t}{\kappa} \right) > 0. \quad (36)$$

If there are more adopters (larger κ) then each non-adopter buys more permits, holding fixed the aggregate supply of permits, e . Hereafter I use the definition of $\Delta = \Delta(k, e, e^t)$ from equation (11), i.e. we set $s = e^t$. Differentiating the planner's first order condition, equation (8) implies

$$\begin{aligned} \frac{de}{d\kappa} &= \frac{(1 - \kappa) \Delta \frac{\partial e^t}{\partial \kappa} - (c_e^0 - c_e^1) + \frac{e^t}{\kappa} c_{ee}^1}{S^t} \\ &= \frac{(1 - \kappa) \Delta \frac{\partial e^t}{\partial \kappa} + \frac{e^t}{\kappa} c_{ee}^1}{S^t} \end{aligned}$$

The second equality uses equation (4). Using equation (36) to eliminate $\frac{\partial e^t}{\partial \kappa}$ and simplifying produces equation (16).

Derivation of equation (17) (the effect of k on equilibrium purchases per non-adopter) I begin by totally differentiating equation (4), again setting $s = e^t$ and using the definition of $\Delta(k, e, e^t)$ from equation (11).

$$\begin{aligned} \frac{de^t}{d\kappa} &= \frac{-\left(\Delta \frac{de}{d\kappa} - c_{ee}^1 \frac{e^t}{\kappa^2} \right)}{c_{ee}^0 + c_{ee}^1 \frac{1-\kappa}{\kappa}} \\ &= \frac{\left(-\Delta \frac{c_{ee}^0 c_{ee}^1}{\kappa S^t} \left(\frac{e^t}{\kappa c_{ee}^0 + (1-\kappa) c_{ee}^1} \right) + c_{ee}^1 \frac{e^t}{\kappa^2} \right)}{c_{ee}^0 + c_{ee}^1 \frac{1-\kappa}{\kappa}} \end{aligned}$$

The second equality uses equation (16). I obtain equation (17) from simplification.

The effect of investment on the equilibrium price of permits I begin with an intermediate result. Differentiating equation (4) (holding κ fixed) implies

$$\frac{de^t}{de} = -\frac{\kappa \Delta}{\kappa c_{ee}^0 + (1 - \kappa) c_{ee}^1}.$$

¹⁰Recall the meaning of superscripts. These indicate that the function is evaluated at arguments corresponding to the type of firm (non-investor or investor). For example $c_{ee}^1 = c_{ee} \left(e - \frac{(1-\kappa)e^t}{\kappa}, 1 \right)$.

Substituting this result into the expression for $c_{ee}^0 + S^t$ yields

$$\begin{aligned}
c_{ee}^0 + S^t &= \\
c_{ee}^0 + \left(-(1-\kappa) c_{ee}^0 \left(1 + \frac{de^t}{de} \right) - \kappa c_{ee}^1 \left(1 - \frac{1-\kappa}{\kappa} \frac{de^t}{de} \right) + D'' \right) &= \\
\kappa c_{ee}^0 \left(1 - \frac{1-\kappa}{\kappa} \frac{de^t}{de} \right) - \kappa c_{ee}^1 \left(1 - \frac{1-\kappa}{\kappa} \frac{de^t}{de} \right) + D'' &= \\
\Delta \kappa \left(1 - \frac{1-\kappa}{\kappa} \frac{de^t}{de} \right) + D'' &= \\
\Delta \kappa \left(1 + \frac{(1-\kappa)\Delta}{\kappa c_{ee}^0 + (1-\kappa)c_{ee}^1} \right) + D'' &= \\
\frac{\Delta \kappa c_{ee}^0}{\kappa c_{ee}^0 + (1-\kappa)c_{ee}^1} + D'' &=
\end{aligned} \tag{37}$$

With slight abuse of notation, write $p = p(\kappa) = p(e(\kappa), \kappa)$. Totally differentiating equation (5) and using equations (16), (17), and (37) implies

$$\begin{aligned}
\frac{dp}{dk} &= c_{ee}^0 \left(\frac{de}{d\kappa} + \frac{de^t}{d\kappa} \right) = \\
c_{ee}^0 \left(\frac{c_{ee}^0 c_{ee}^1}{\kappa S^t} \left(\frac{e^t}{\kappa c_{ee}^0 + (1-\kappa)c_{ee}^1} \right) + \frac{\left(\left(\frac{\Delta}{S^t} \left(\frac{c_{ee}^0}{\kappa c_{ee}^0 + (1-\kappa)c_{ee}^1} \right) + \frac{1}{\kappa} \right) \right)}{(\kappa c_{ee}^0 + (1-\kappa)c_{ee}^1)} c_{ee}^1 e^t \right) &= \\
\frac{c_{ee}^0 c_{ee}^1 e^t}{S^t (\kappa c_{ee}^0 + (1-\kappa)c_{ee}^1)} \left(\frac{c_{ee}^0}{\kappa} + \left(-\Delta \left(\frac{c_{ee}^0}{\kappa c_{ee}^0 + (1-\kappa)c_{ee}^1} \right) + \frac{S^t}{\kappa} \right) \right) &= \\
\frac{c_{ee}^0 c_{ee}^1 e^t}{S^t (\kappa c_{ee}^0 + (1-\kappa)c_{ee}^1)} \left(\frac{c_{ee}^0 + S^t}{\kappa} - \frac{\Delta c_{ee}^0}{\kappa c_{ee}^0 + (1-\kappa)c_{ee}^1} \right) &= \\
\frac{c_{ee}^0 c_{ee}^1 e^t}{S^t (\kappa c_{ee}^0 + (1-\kappa)c_{ee}^1)} \left(\frac{\Delta c_{ee}^0}{\kappa c_{ee}^0 + (1-\kappa)c_{ee}^1} + \frac{D''}{\kappa} - \frac{\Delta c_{ee}^0}{\kappa c_{ee}^0 + (1-\kappa)c_{ee}^1} \right) &= \\
\frac{c_{ee}^0 c_{ee}^1 e^t}{S^t (\kappa c_{ee}^0 + (1-\kappa)c_{ee}^1) \kappa} D'' < 0 &
\end{aligned} \tag{38}$$