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Heterogeneous firms and the environment: A cap-and-trade program

Lisa Anouliès



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# Heterogeneous firms and the environment: a cap-and-trade program

**Abstract** Currently, cap-and-trade programs are a cornerstone of many countries' climate change policies and proposals. This paper investigates the economic and environmental effects of different climate change policy designs in a general equilibrium setting with heterogeneous firms and monopolistic competition. The analysis predicts that the cap on emissions perfectly defines the environmental quality but has no effect on firms' profits, or decisions to enter or exit the market. In contrast, increasing the share of free allocations of emissions allowances, as opposed to auctions, has no effect on environmental quality but reallocates resources among firms toward the most productive ones which has an impact on firms' entry and exit decisions, the mass of firms, and the composition of the market. Firm heterogeneity magnifies these economic effects of changes in the initial allocation of allowances. The paper provides a decomposition of the change in aggregate emissions which takes account of the changes at sector level, across the firms within a sector, and at the firm level.

**Keywords** Emissions trading, heterogeneous firms, monopolistic competition

**JEL classification** Q58 - D43 - H23

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