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Optimal Aid in Environmental Policy A Real Options Approach

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Abstract: In this paper, we analyze an environmental policy that is designed to reduce the emission of pollutants when there is uncertainty over the social costs of environmental damage. We first establish a model that incorporates direct aid in which there are two noncooperative agents: a developing country and a developed country. Next, we derive closed-form solutions for the optimal levels of direct aid that the developed country provides the developing country. Finally, we compare the social welfare level implied by this model with those implied by two additional models. In one of the models, two agents cooperate, and in the other, the agents do not cooperate and there is no direct aid. As a result, the means of providing direct aid plays an important role in reducing the decline in social welfare caused by external effects.

Keywords: [external effect](#); [direct aid](#); [social welfare](#); [environmental policy](#); [real options](#)

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