What is the Impact of Environmental Regulations on Foreign Investment?

A Romanian researcher has analysed the effect of pollution regulations on foreign direct investments. The results suggest that the more stringent the environmental regulations in the investor’s country, the higher the likelihood of foreign investment and the higher its volume. Furthermore, firms in industries with higher abatement costs tend to invest more abroad.

Foreign Direct Investment (FDI) in developing countries has increased considerably over the last decades. In this context, the connection between FDI and environmental policies has been the subject of considerable debate. The "pollution haven" hypothesis assumes that polluting industries reallocate from developed to developing countries where the environmental standards are lower and the cost of complying with environmental regulations cheaper. Nevertheless, recent analyses have found little evidence for this hypothesis.

In order to further increase existing knowledge of the pollution haven hypothesis, a recent paper by a Romanian researcher analysed whether the stringency and sustainability of environmental regulations affects FDI. Unlike previous research, which only considered the characteristics of the host country, the present study focuses on the differences in the regulatory environments in home and host economies. Furthermore, it uses measures of the stringency and sustainability of environmental standards and controls for other FDI determinants such as the protection of property rights, level of taxation or labour standards. The analysis is based on a unique company database that covers new investments in 25 European countries.

The results suggest that more stringent environmental regulations in the investor’s country in comparison with those in the potential host country are positively correlated with both the probability of an investment abroad and also with the volume of investment. This is observed even after taking into consideration other determinants of foreign investment such as corporate tax rates and labour market regulations. For example, the author indicates that, as the stringency in the source country increases from the level of Romania (lax) to the level of Switzerland (very stringent), the volume of investment goes up by between 5% and 13%.

Furthermore, the author also argues that firms in industries with higher abatement costs invest more abroad. On the other hand, there is no evidence that firms operating in more polluting industries are more attracted to countries with weaker environmental standards than firms in less polluting industries.

Overall, this study provides new insights into the “pollution haven” hypothesis. It presents evidence that the level of stringency and sustainability of environmental regulations have an impact on foreign investments and on the location choices of manufacturing plants. This should be taken into consideration when considering the impacts on new legislation for pollution control.

Contact: marianas@andromeda.rutgers.edu
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