Foreign Direct Investment and Environmental Regulation in China

TianZi Yuan

As more pollution intensive industries are moved to the developing countries, policy makers become concerned with environmental issues. The Pollution Haven Hypothesis refers to the possibility that multinational firms, particularly those engaged in highly polluting activities, relocate their production to developing countries where environmental regulations are weaker. Because more pollution intensive industries may have a larger incentive to move, a haven of such industries could build up in developing countries. The purpose of my study is to investigate whether or not evidence from China supports the Pollution Haven Hypothesis. In order to identify it, I introduce an environmental stringency variable which relies on fees levied on wastes discharged by firms in each province during a given year (alternatively, investment in industrial pollution treatment project by industrial firms in each province during a given year). I adopt an eight-year panel dataset for China's 30 provinces over the period 1999 to 2006 and examine the effect of environmental stringency on foreign investors' location choice. A significant number of control variables such as agglomeration effect and some other regional characteristics are also included in the examination. I employ Feasible Generalized Least Square method to control for unobserved heterogeneity. The results suggest that there is a strong negative relationship between the stringency of environmental regulation and the location of FDI in China. The intensity of FDI will increase with relatively lenient environmental regulations. Both overall results and the regional results reflect that the provinces with lower levies per firm lead more FDI. It appears that foreign investors prefer to locate in regions with relatively lenient environmental regulations.