The impact of environment on FDI

Is foreign direct investment (FDI) linked to easing environmental regulations? The pollution haven hypothesis, which theorises that global industries flock to places with low environmental regulation, was tested recently in the India by Vinish Kathuria, a Professor at the Indian Institute of Technology, Bombay. The findings were published in a study titled ‘Does environmental governance matter for foreign direct investment? Testing the pollution haven hypothesis for Indian States’ in the *Asian Development Review*. The results from 21 States show that environmental regulation has little impact on FDI, which is dependent on other variables of infrastructure and labour instead. In terms of policy, it would help India if it focussed more on these factors rather than on a blanket change in environmental regulation.

To tabulate the impact of environmental regulation on industry, Kathuria looked at the pollution abatement expenditures of the manufacturing sector between 2002 and 2010. In theory, higher costs in dealing with pollution from an industry show stricter environmental norms being in place.

Of the 28 States reviewed, 16 saw pollution abatement costs reduce (including Maharashtra, Gujarat, Tamil Nadu and Karnataka), while only in 11 States did the costs increase (undivided Andhra Pradesh, Odisha, Haryana, Madhya Pradesh and Kerala).

Kathuria also looked at industrial composition, which previous studies had not dealt with. A State with a high number of chemical industries, for instance, will have higher environmental costs despite the level of environmental regulations. To adjust for this, Kathuria created a industrial-composition-adjusted abatement index using unit level data from the Annual Survey of Industries. The index shows that Chandigarh, Odisha and Karnataka have the highest environmental stringency, while Bihar, Delhi and the northeastern States have the lowest.

FDI inflows were also compared to the control variables of per capita income of 21 States, manufacturing share of the State GDP, installed electricity generation capacity, transmission and distribution losses in the power sector (a reflection of industrial regulations), literacy, proximity to coast, and the readiness of a State to accept investments.

The study’s statistical models employed showed a positive correlation with industrial and economic regulations, while the study notes: “Environmental stringency does not influence a foreign firm’s location decision when other infrastructure and market access-related factors are considered.”

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