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Three New Empirical Tests of the Pollution Haven Hypothesis When Environmental Regulation is Endogenous
by Daniel L. Millimet, Jayjit Roy
(August 2011)

Abstract:
The validity of existing empirical tests of the Pollution Haven Hypothesis (PHH) is constantly under scrutiny due to two shortcomings. First, the issues of unobserved heterogeneity and measurement error in environmental regulation are typically ignored due to the lack of a credible, traditional instrumental variable. Second, while the recent literature has emphasized the importance of geographic spillovers in determining the location choice of foreign investment, such spatial effects have yet to be adequately incorporated into empirical tests of the PHH. As a result, the impact of environmental regulations on trade patterns and the location decisions of multinational enterprises remains unclear. In this paper, we circumvent the lack of a traditional instrument within a model incorporating geographic spillovers utilizing three novel identification strategies. Using state-level panel data on inbound U.S. FDI, relative abatement costs, and other determinants of FDI, we consistently find (i) evidence of environmental regulation being endogenous, (ii) a negative impact of own environmental regulation on inbound FDI in pollution-intensive sectors, particularly when measured by employment, and (iii) larger effects of environmental regulation once endogeneity is addressed. Neighboring environmental regulation is not found to be an important determinant of FDI.

Text: See Discussion Paper No. 5911

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