



## **ABSTRACT WORKING PAPER 2.17**

### **The Effect of FDI on Regional Inequality in the ENPs; Evidence from Israel**

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FDI is an important source of capital for the ENPs. This paper investigates whether FDI polarizes regional inequality in host counties. In the absence of regional FDI data we propose a method for estimating the effects of FDI on regional inequality. An empirical application of this method is presented for Israel. We use time series data to show that regional capital stocks vary directly with the stock of national FDI and other variables, and that the sensitivity of regional capital stocks to FDI varies by region. We use regional panel data to show that regional wages vary directly with regional capital-labor ratios. In this way a link is established between FDI and regional wages via regional capital. Finally we decompose the factors driving regional wage inequality, as measured by the variance of regional wages. One of these factors is the polarizing effect of FDI on regional wages. Our results show capital stocks in the central (wealthier) regions of the country are more sensitive to FDI shocks. Also, the polarizing effect of FDI has increased absolutely during 1987-2010. However, it has decreased relatively; the contribution of FDI to regional wage inequality decreased from 50 percent in 1987 to 30 percent in 2010. Policy implications of these findings are discussed.