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

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OBJECTIVE

While increased capital outflow from the EU to the ENPs may be a tangible expression of economic integration and a reflection of the internationalization of the economies in the EU neighborhood, it can also lead to increased regional inequality and distorted spatial distribution of economic activity in the recipient countries. This report examines whether EU FDI polarizes inequality in the ENPs. The topic has not received much attention primarily due to the paucity of available empirical data especially relating to FDI. To address this lacuna, we present an empirical method for estimating the effects of FDI on regional inequality, in the absence of regional FDI data. We suggest using data on national FDI which is universally available and estimating its effect on regional capital stock. This in turn is related to regional wages and thus a link between FDI and regional earnings inequality is established. The policy implications of this are clear. FDI is not simply a vehicle for the transfer of capital flows but also a mechanism for transferring technology, skills and capabilities to the ENPs. Thus, if FDI does cause spatial polarization this is likely to have secondary effects in a whole slew of other areas no less important for the economic development and economic integration of the ENPs.

MAIN RESULTS

First and foremost FDI exacerbates regional economic disparities. Policy makers should be aware that this is an unfortunate side-effect of FDI, which otherwise has desirable effects on the host economies. Second, since polarization varies inversely with the elasticity of labor supply, these adverse effects of FDI may be mitigated by policies which encourage internal migration. For example, in the context of Israel the economic center has benefited from FDI relative to the periphery. The government has changed its regional development policy by concentrating investment grants in the periphery at the expense of the center.