

Democratic Weakening and Exit: People Relocate, Foreign Capital Retreats

by

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Abstract

This paper investigates the consequences of regime change for both **migration** and **foreign direct investment (FDI)** by employing **quasi-natural experiments** that exploit **external and internal shocks** to democratic institutions. It compares evidence from **Europe**, which was afflicted by the “*Syrian Shock*”—an external institutional stress testing administrative and fiscal capacity—and **Israel**, which experienced the “*Corruption Shock*”—an internal credibility crisis that eroded judicial independence and policy predictability.

Motivation

- Democratic backsliding in OECD economies
- How migration and FDI respond

Key Question

How do regime shocks affect capital and people mobility?

Two Types of Shocks

- Internal (Israel – Corruption Shock)
- External (Europe – Syrian shock)

Why Migration?

Market-minded individuals relocate in response to economic weakening, while exit reflects rising political and legal risks to property rights.

Why FDI?

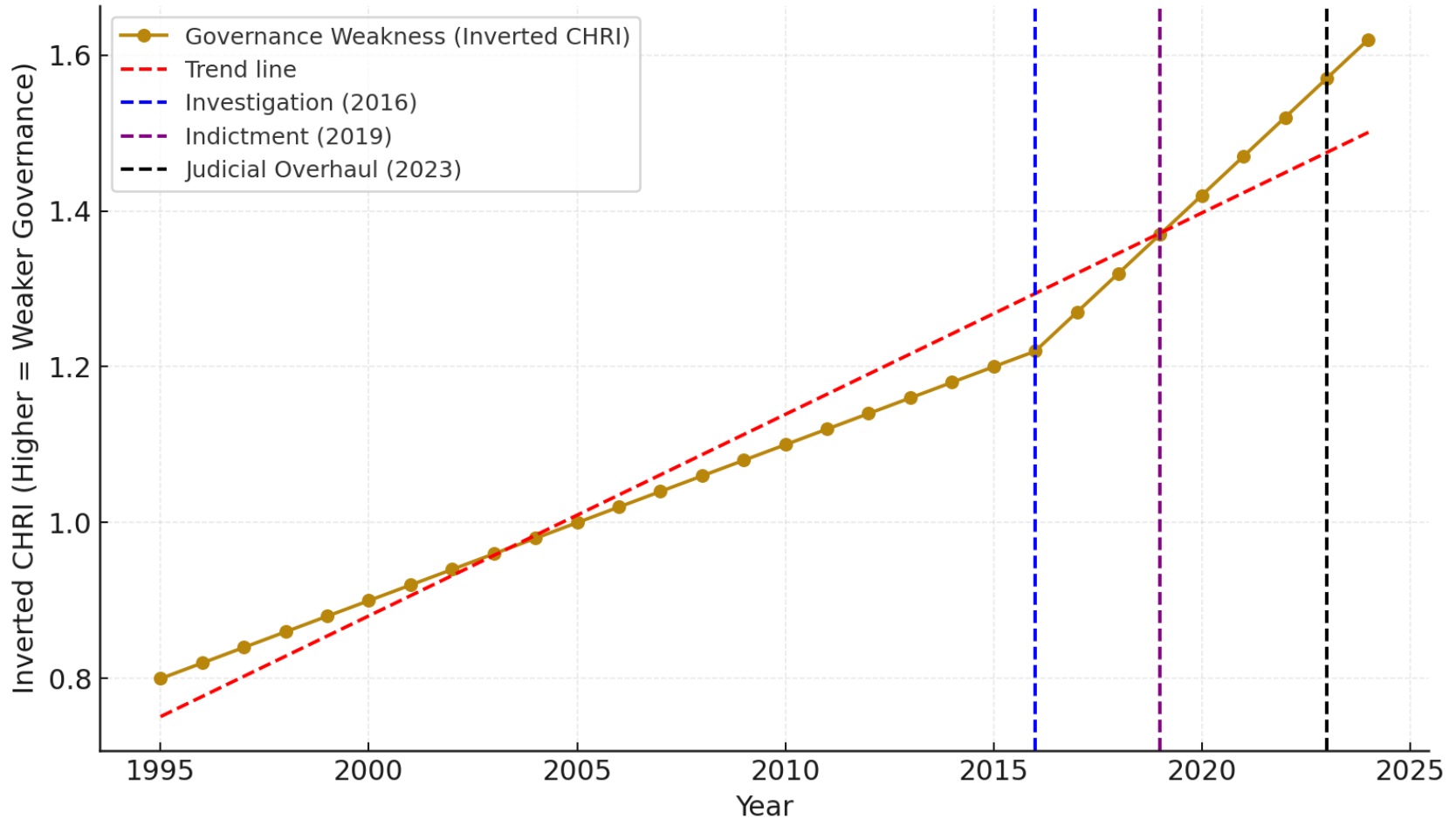
Sensitivity to rule of law and property right violations.

Governance-Israel

After two decades of steady improvement, Israel's government effectiveness departs from trend following the corruption investigations, indictment, and the judicial overhaul, indicating a structural institutional break rather than a cyclical fluctuation.

Israel Governance

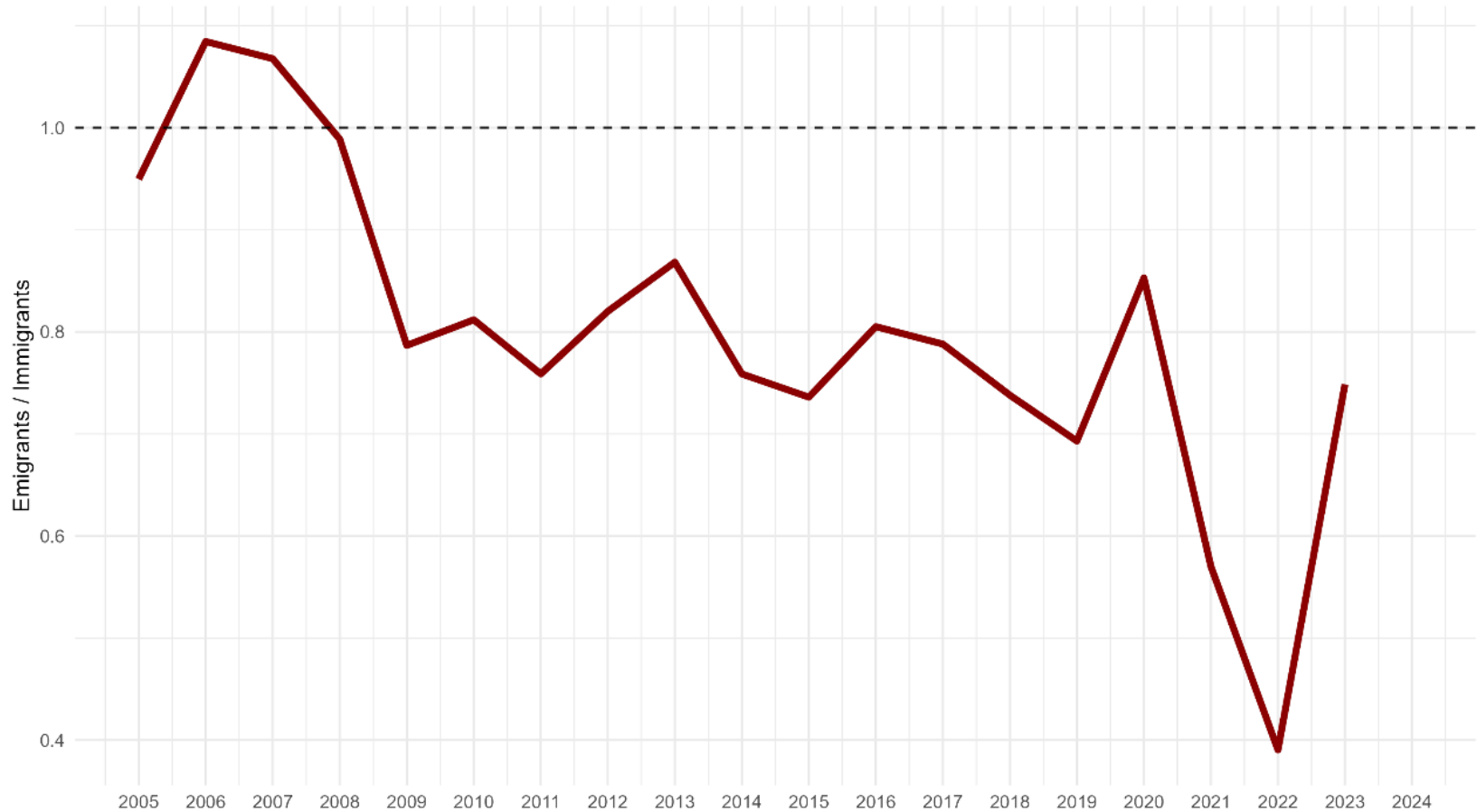
Governance Weakness (Inverted CHRI), 1995-2024



Notes: inverted CHRI for Israel, where an upward movement indicates a deterioration in governance quality. The blue line (2016) marks the beginning of the Netanyahu corruption investigation. The purple line (2019) indicates the formal indictment on corruption charges. The black line (2023) represents the launch of the judicial overhaul and the onset of the executive-judicial conflict. Source: The Fund for Peace (2024), Fragile States Index (FSI).

Net Migration-Israel

Figure 2: Ratio of emigrants to immigrants, Israel, 2005-2024



Notes: The figures plot migration patterns of Israel over the period 1996–2024. Source: Central Bureau of Statistics (CBS), author's calculations

Israel's Out-Migration

$$\text{out Migration} - LF_{jt} = \alpha + \beta_1 \text{Israel}_j + \beta_2 \text{POST}_t + \beta_3 (\text{Israel}_j \times \text{POST}_t) + \beta_4 \text{WGI}_{jt} + \beta_5 (\text{POST}_t \times \text{WGI}_{jt}) + \beta_6 (\text{Israel}_j \times \text{WGI}_{jt}) + \beta_7 (\text{Israel}_j \times \text{POST}_t \times \text{WGI}_{jt}) + \varepsilon_{jt}$$

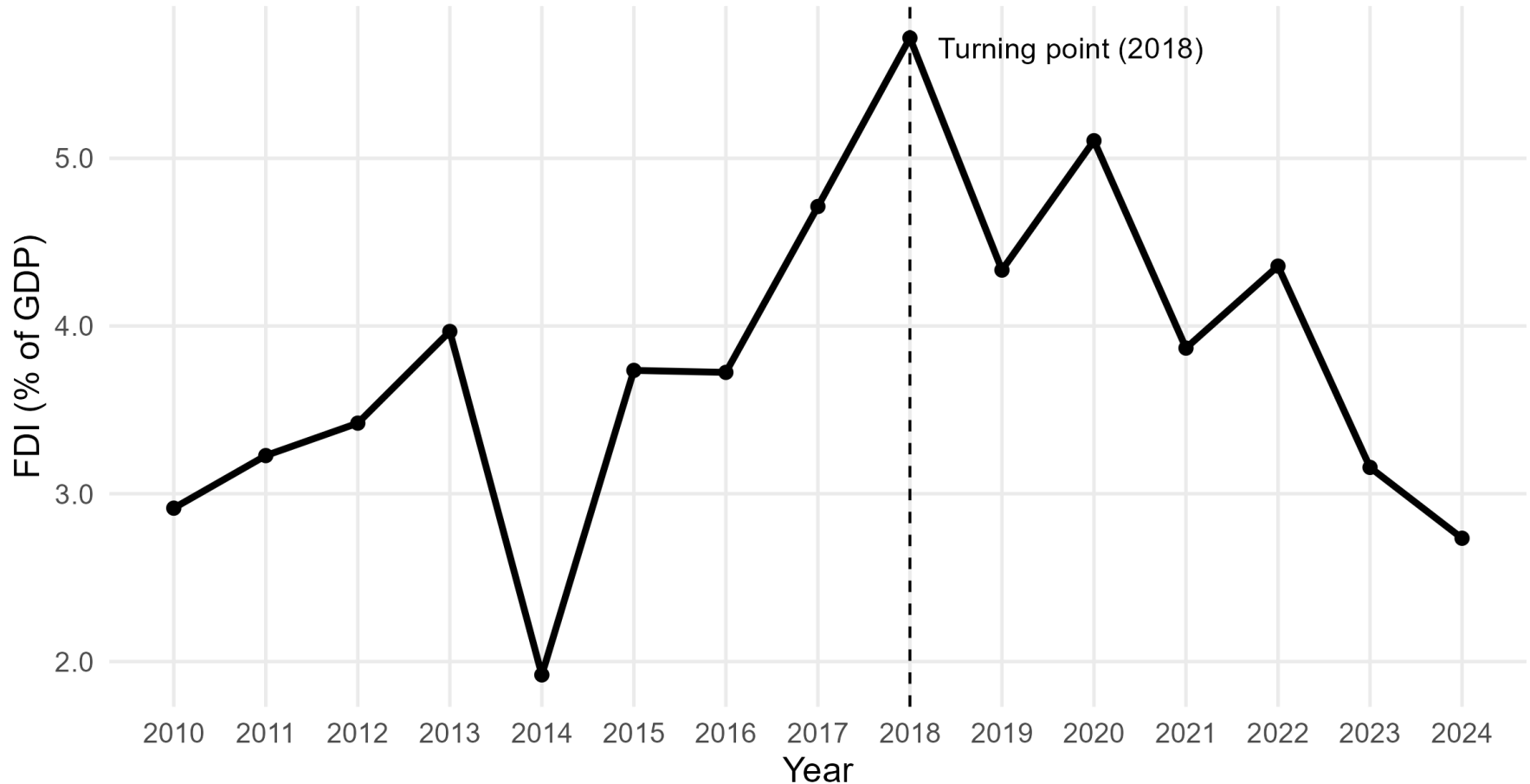
Variable	(1) Baseline DiD	(2) DiD + WGI
Intercept	1.276*** (0.063)	1.418*** (0.058)
Israel	-0.392*** (0.041)	-0.405*** (0.039)
POST (Post-2017/18)	0.011 (0.019)	0.008 (0.017)
Israel × POST	0.072*** (0.025)	0.081*** (0.026)
WGI (t)	—	0.187*** (0.037)
Israel × WGI	—	-0.029 (0.024)
POST × WGI	—	-0.044** (0.020)
Israel × POST × WGI	—	-0.086*** (0.029)
Country FE	Yes	Yes
Year FE	Yes	Yes
Observations	432	432
R²	0.76	0.81

Notes: Countries sample: Israel, Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia, Canada, Chile, Japan, Korea, New Zealand, United States. Turkey and Mexico — excluded due to inconsistent reporting of WGI sub-indices and migration data. Iceland and Luxembourg — excluded because of missing series for out-migration by destination and small population base. Source: set of OECD control countries representing advanced democracies with comparable data coverage in the World Governance Indicators (WGI) and migration statistics (OECD IIN CBS)

Israel FDI

Israel — FDI Net Inflows (% of GDP)

2010–2024 (vertical line marks 2018 turning point)



Source: World Bank (WDI: BX.KLT.DINV.WD.GD.ZS)

Out-migration rises sharply following institutional deterioration in Israel.

Israel's Legal Shock on Incoming FDI

$$y_{it} = \alpha_i + \gamma_t + \beta \cdot (Israel_i \times Post2018_t) + u_{it}$$

Predictors	Estimates
Israel × Post-2018	- 4.71 (1.55)**
Observations	1261
R2 / R2 adjusted	0.022 / 0.077

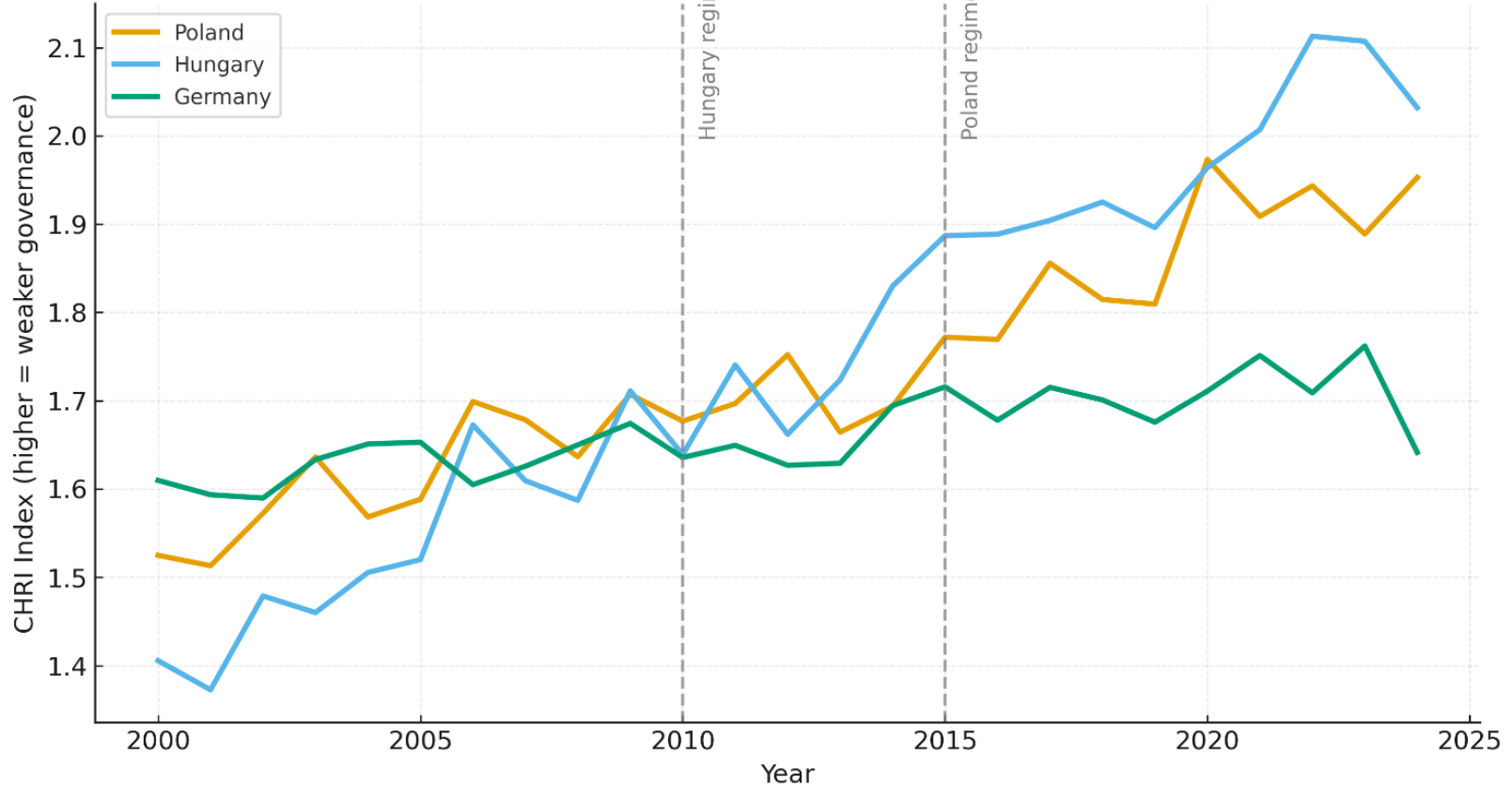
* p<0.05 ** p<0.01 *** p<0.001

Governance-Europe

After regime changes in Hungary (2010) and Poland (2015), governance quality deteriorates steadily, while Germany's institutional performance remains stable, highlighting divergence within the EU driven by illiberal transitions.

Governance-Europe

CHRI (Constraints on Government Power, inverted)
Poland, Hungary, and Germany (2000-2024)



Notes: The figure plots the inverted CHRI for Poland, Hungary, and Germany from 1996 to 2023, where an upward shift denotes deterioration in governance quality. Poland and Hungary show marked increases following regime shifts, while Germany remains stable throughout the period, serving as a benchmark of institutional resilience. Source: European Commission, World Governance Indicators, and author's calculations.

Europe: The Syrian Effect on Legal Governance

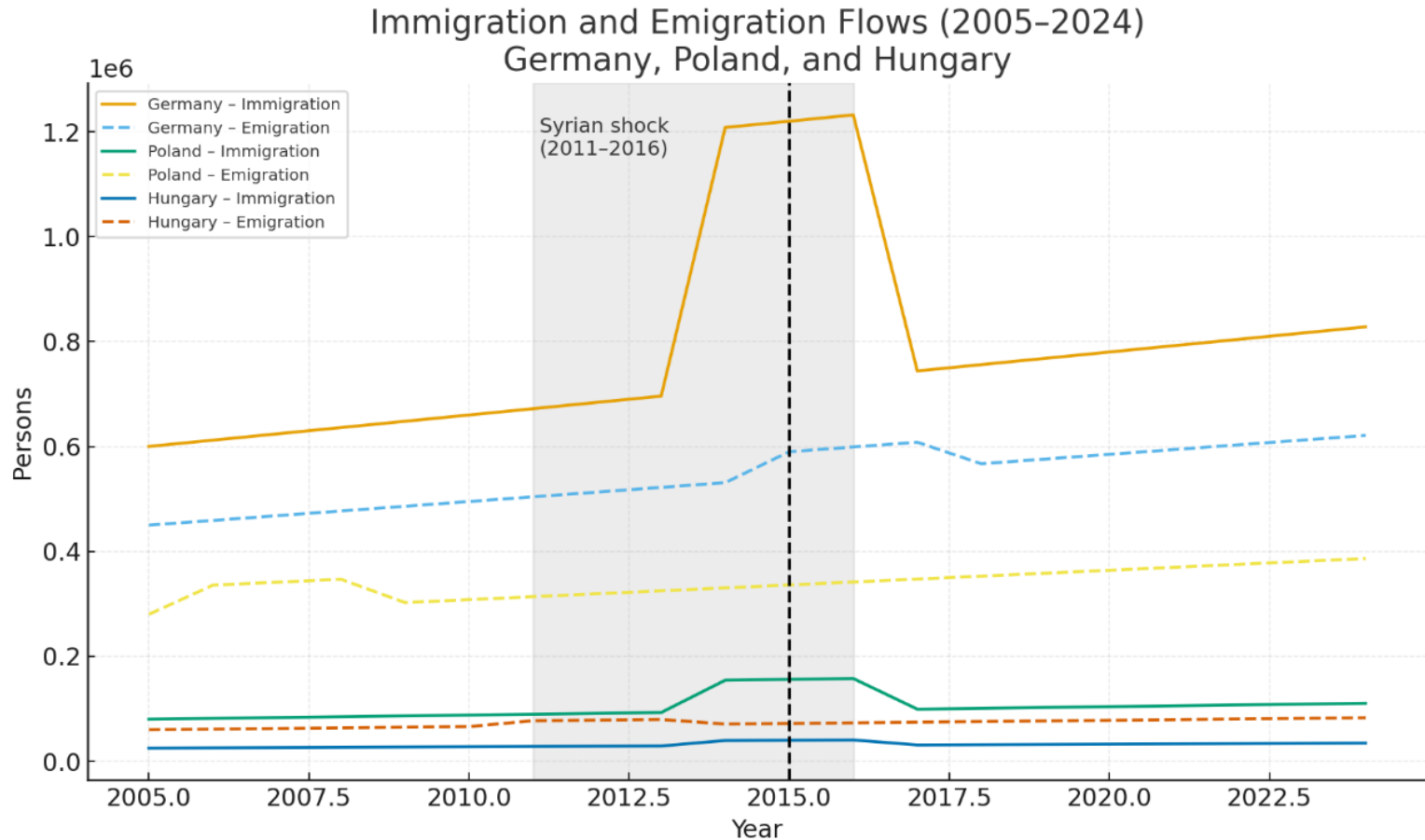
Weak legal Governance (CHRI) and the Syrian Shock

$$CHRI_{jt} = \alpha_0 + \alpha_1 SYR_t + \alpha_2 Year_t + \alpha_3 Country_j + u_{jt}$$

Predictors	Estimates
SYR	0.08 * (0.03)
Observations	261
R^2 / R^2 adjusted	0.301 / 0.202

Notes: SYR measures the Syrian Shock. The Syrian migration effect is captured starting in 2015 for a subset of countries: Germany, Greece, Hungary, Poland, and Turkey. Standard deviations are shown in parentheses. Time period: 1995–2023. Sample of countries: Australia, Austria, Belgium, Canada, Chile, Colombia, Costa Rica, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States. Source: World Governance Indicators (WGI), European Commission, and author's calculations.

Immigration and emigration flows for Germany, Poland, and Hungary



Notes: Solid lines represent immigration flows (entries of foreign-born persons). Dashed lines represent emigration flows (departures of residents abroad). Each color corresponds to a country: Germany – orange; Poland – yellow; Hungary – green; The gray shaded area (2011–2016) marks the Syrian refugee shock, a major migration inflow period. The vertical dashed line (2015) indicates the peak of the Syrian shock and onset of its political effects. Source: Eurostat migration data (tables migr_imm1ctz and migr_emi1ctz, 2024 update).

Europe: Out Migration

$$\text{Log} \left(\frac{\text{Migration Outflow}}{\text{Labor Force}} \right) = \alpha_0 + \alpha_1 \text{Post}_1 + \alpha_2 \text{Country} + \alpha_3 \text{Year} + u$$

Predictors	Estimates
Post1	0.44** (0.16)
Observations	691
R2 / R2 adjusted	0.831 / 0.815

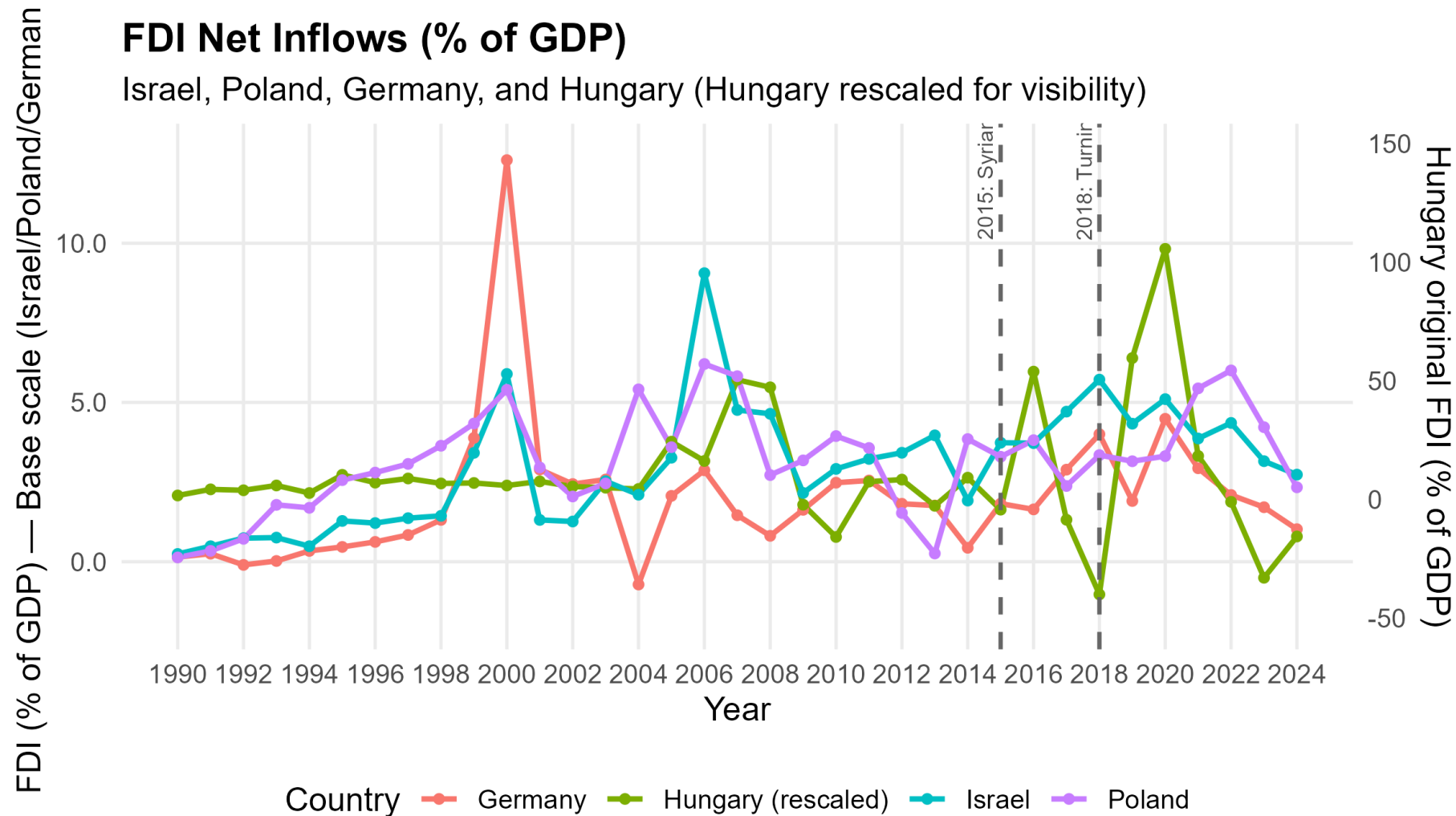
* p<0.05 ** p<0.01 *** p<0.001

Notes: 1995-2023 (when possible), sample of countries: Australia, Austria, Belgium, Canada, Chile, Colombia, Costa Rica, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Latvia, Lithuania, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom and United States. POST1 is a dummy variable that equals 1 for all years following (and including) the year in which a country experiences a regime change from a liberal to an illiberal political system. It takes the value of 1 for countries that undergo such a transition, starting from the year of the change and continuing in all subsequent years. For countries that do not experience a liberal-to-illiberal transition during the sample period, POST1 remains 0 throughout. In the Difference-in-Differences (DiD) regression, the "treatment" variable is a dummy indicating the year of the regime change. Source: OECD.

Europe: FDI Net Inflows

FDI Net Inflows (% of GDP)

Israel, Poland, Germany, and Hungary (Hungary rescaled for visibility)



Rescaling for Hungary: $y' = a \cdot y + b$ with $a = 0.0744$, $b = 1.96$. Anchored to base countries' mean & SD.
 Source: World Bank (WDI: BX.KLT.DINV.WD.GD.ZS)

FDI Responses to Internal and External Institutional Shocks (OECD Panel, 1995–2023)

Model	Shock(s)	Coefficient (β)	Std. Error	Significance
(1) One-Shock Europe	Exposed Europe \times Post-2015 (Syrian Shock)	-2.84	(1.37)	p < 0.05
	<hr/>			
(2) One-Shock Israel	Israel \times Post-2018 (PM Investigation)	-4.71	(1.55)	p < 0.01
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(3) Double-Shock Model	Israel \times Post-2018	-5.31	(1.73)	p < 0.01
	Exposed Europe \times Post-2015	-2.97	(1.39)	p < 0.05

FDI Responses to Internal and External Institutional Shocks

In the **one-shock Israeli model**, the *2018 corruption and judicial crisis* produced a sharper, more durable decline of roughly **4.7 percentage points** ($p < 0.01$), indicating a deeper erosion of investor confidence linked to governance uncertainty.

The **double-shock model**, which includes both events, confirms that these effects persist jointly, Israel's internal shock remains larger and more robust (-5.3 p.p.) than Europe's external shock (-3.0 p.p.).

Conclusion: Protect rule of law to retain capital & talent

DiD estimates comparing Israel's judicial-overhaul shock with the external Syrian-refugee shock show that democratic weakening, whether internal or external, induces emigration and sustained FDI withdrawal.

Overall, the comparison underscores an **asymmetry of response**: external shocks impose short-term people relocation capital withdrawal, while internal institutional weakening triggers more sustained adjustment cost.