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REGIME CHANGES AND FDI:
A TALE OF TWO COUNTRIES – POLAND AND ISRAEL

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ABSTRACT

This essay highlights the effects of radical transformations in the liberal characteristics of the regimes on foreign direct investors. To focus on the common patterns in the effects on foreign direct investment, of liberal vs. illiberal regime change, the essay spotlights the tale of two countries: Poland and Israel. The liberalization of the Polish economy and market reforms in the late 1980s and early 1990s boosted Poland's attractiveness to international companies. However, decades-long of illiberal policies under the PiS regime has reduced Poland's appeal to foreign investors. Similarly, Israel's GNP especially the high-tech sector saw significant growth from the 1990s to the 2010s, driven by the liberalization of capital and finance surges, and the global IT boom immigration. As a more-or-less a laboratory experiment for the real-economy impact of an abrupt transition to an illiberal regime, early steps of a comprehensive judicial overhaul have disrupted Israel's growth, causing a sharp decline in foreign direct investment.

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Abstract

This essay highlights the effects of radical transformations in the liberal characteristics of the regimes on foreign direct investors. To focus on the common patterns in the effects on foreign direct investment, of liberal vs. illiberal regime change, the essay spotlights the tale of two countries: Poland and Israel. The liberalization of the Polish economy and market reforms in the late 1980s and early 1990s boosted Poland's attractiveness to international companies. However, ra decade long of illiberal policies under the PiS regime has reduced Poland's appeal to foreign investors. Similarly, Israel's GNP and especially the high-tech sector saw

significant growth from the 1990s to the 2010s, driven by liberalization of capital and finance surges, and the global IT boom immigration. Fundamental forces, such as the workforce skill boost, advances in education and research ,. Were crucial for Israel's high-tech industry development. As a more- or- -less a laboratory experiment for the real-economy impact of an abrupt transition to an illiberal regime, early steps of a comprehensive judicial overhaul have disrupted Israel's growth, causing a sharp decline in foreign direct investment.

1. Introduction

In the wake of recent political shifts, democratic institutions are being eroded, giving way to a consolidation of governmental power through autocratic means, thereby weakening minority rights including foreign investor rights. Weakening minority rights might signal to investors that the rule of law is not robust and that discriminatory practices could extend to business operations. Investors may worry about the arbitrary application of laws, cronyism, corruption, and the potential for expropriation or unfair treatment, all of which increase the risks associated with investing in a country. Judicial overhauls, which have significantly weakened minority rights in Poland and Israel serve as case studies for understanding how foreign investors respond to changes in regulatory-legal environments. While the manifestations of these patterns differ, they invariably erode the rule of law and democratic institutions Although the manifestations of these patterns differ based on the distinct political, social, and historical contexts of each country, they invariably undermine the rule of law and democratic institutions. Such regime-change events compromised the separation of powers, underpinning what is the backbone of market economy.

There are some common features for the effects on the economy ecosystem of the changes which undermine the rule of law under democratic institutions. These are (i) gradually weakening the independence and authority of institutions like the judicial, electoral commissions, and oversight bodies; (ii) appointing loyalists to key positions within these institutions to ensure compliance with the controlling coalition agenda; (iii) introducing legal and administrative measures that hamper opposition parties, such as restrictive campaign laws or regulations; (iv) using state resources to favor the ruling party, preventing opposition parties from competing on a level playing field; (v) employing voter-suppression tactics or biased electoral boundaries to ensure a favorable outcome for the ruling party and using state-controlled media to promote the image of the ruling party and undermine the credibility of the opposition candidate; (vi) gradually tightening control over media outlets through legal measures or ownership changes and accumulating power in the hands of the executive branch, bypassing legislative and judicial checks; (vii) utilizing emergencies or crises to justify the concentration of authority in the executive office; (viii) weakening or eliminating term limits, allowing the leader to stay in power for an extended period; (ix) weakening civil society and non-governmental organizations (NGOs); (x) imposing restrictive laws on NGOs and civil society groups that advocate for human rights and democracy; (xi) using security concerns as a pretext to limit individual freedoms, such as freedom of assembly and association; (xii) gradually introducing .

Acemoglu et al. (2019) argue that a judicial overhaul that undermines the liberal legal system weakens the protection of investors' rights and triggers corruption. The latter encourages businesses to divert economic resources to 'integrate' into the corrupt system, instead of directing their efforts to productive activities. Eichengreen (2024) indicates that democratization and economic growth are positively correlated. Evidently, correlation does

not necessarily indicate the existence of causality or its direction. [1] Eichengreen (2024) observes that the relationship between the various measures of democracy and economic growth are ambiguous. In contrast, the relationship between measures of judicial independence and economic growth is clearer. His survey of the literature finds a strong, positive, and highly significant effect of de facto judicial independence on economic growth, both when *levels* of growth and judicial independence are considered, and when the effects of *changes in the level* of judicial independence are the focus.

There is robust evidence that foreign direct investment (FDI) is a significant driver of growth in an open economy. As foreigners, Investors like any minority, are first targets of national protective policies of the illiberal regime. Foreign direct investors are excessively sensitive to changes in the judicial-regulatory-tax regime and the liberal characteristics of the regime. [2]

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[1] Acemoglu et al. (2019) are aware of this 'endogeneity problem' and employ a dynamic panel strategy control for country fixed effects and the time variety of patterns of GDP, which would otherwise confound the effect of democracy on growth.

[2] Goldstein and Razin (2003), and Razin and Sadka (2007), introduce a finance-based mechanism concerning discrete adjustments of foreign direct Investment (FDI). The need to liquidate investments due to judicial -'tax-, and regulatory- restrictions result in investors liquidation of direct investment Resales of assets under such conditions are inherently disadvantageous assets if because of the need to resell their foreign asse at low prices. As a result, shallow-pocket investors expecting the possibility of dire circumstances prefer ex-ante foreign portfolio investments, while deep-pocket investors opt for direct investments.

This environment leads to multiple equilibria, which imply abrupt shifts from an equilibrium with large volume of foreign direct investments to one with significantly small levels of foreign direct investments. Such mechanism may explain why a country under a liberal regime attracts more direct investments than a country under an illiberal regime with similar characteristics. It also elucidates why certain periods are characterized by higher levels of

Multinational enterprises are the main vehicle of foreign direct investment (FDI). They had been assuming an increasingly pivotal role. Historically, the bulk of FDI has been concentrated in highly developed countries, predominantly targeting human capital-intensive industries within the services sector.

For economies, such as the former communist countries of Europe, the FDI surge is attributable to the liberalization and internationalization of these economies, coupled with substantial reductions in transportation costs, communicating costs, and the costs associated with cross-border business operations.

This essay explores regime changes in Poland and Israel and their impacts on developments in Poland and Israel, and their impacts on the attraction of these countries for foreign direct investment.

The organization of the essay is as follows. Section 2 describes Poland's emergences as a globalized economy since the early 1990s and the turning point towards illiberal democracy in the last decade and a half. Section 3 surveys the role of multinational enterprises. Section 4 surveys Israel ascendence to a high-tech and its attraction to foreign investors. Section 5 focus on foreign venture capital in Israel. Section 6 draw an inference on common patterns. Section 7 concludes. .

2. Poland's Liberalization and FDI

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direct investment than others. Multiple equilibria in the composition of low- and high-pocket investors can lead to discrete shifts from a high-investment equilibrium to a low-investment equilibrium.

Poland's economic liberalization in the 1990s was marked by a series of radical reforms designed to transition from a centrally planned economy to a market-oriented one. This transformation.[3]

Key elements of these reforms included:

Price Liberalization: Prices were freed from state control, which allowed the market to determine the value of goods and services.

Privatization: State-owned enterprises were privatized, attracting both domestic and foreign investors.

Trade Liberalization: Tariffs were reduced, and Poland opened its economy to international trade.

Currency Stabilization: The Polish złoty was made convertible, which helped stabilize the currency and control hyperinflation.

These measures resulted in significant economic growth, reduced inflation, and increased productivity. By the mid-1990s, Poland had one of the fastest-growing economies in Europe.

Poland's liberalization efforts made it an attractive destination for foreign direct investment (FDI). Key factors contributing to the surge in FDI included:

Macro-Economic Stability: The successful implementation of market reforms created a stable economic environment.

EU Accession: Poland's accession to the European Union in 2004 further boosted investor confidence, providing access to the single European market.

Strategic Location: Poland's geographic position made it a gateway to both Western and Eastern European markets.

[3] See Blanchard et al (1994.

Skilled Workforce: Poland offers a well-educated and cost-effective labor force.

As a result, FDI inflows increased significantly, particularly in sectors such as manufacturing, automotive, financial services, and retail. Major multinational corporations established a presence in Poland, contributing to job creation and technology transfer.

The election of the Law and Justice Party (PiS) in 2015 marked a gradual shift towards illiberal policies. PiS implemented a series of measures that challenged the liberal democratic norms established in the post-communist era. Key aspects of this illiberal turn include:

Judicial Reforms: The government enacted laws that increased political control over the judiciary, undermining judicial independence.

Media Control: State influence over public media increased, leading to concerns about press freedom and biased reporting.

Constitutional Changes: Attempts to alter the Constitution and other legislative measures weakened checks and balances.

Centralization of Power: The government centralized power, reducing the autonomy of local governments and other institutions.

The illiberal policies under the PiS regime had mixed effects on FDI. While Poland remained an attractive destination for investors due to its economic fundamentals. The political instability and legal uncertainties posed challenges. Specific impacts included:

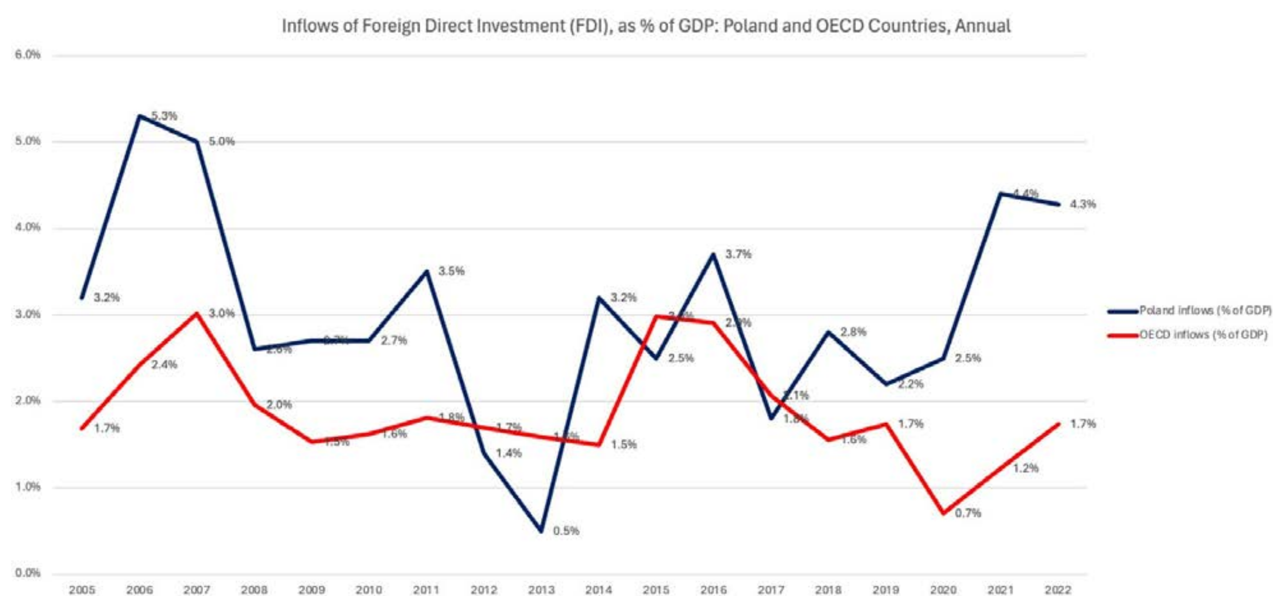
Investor Confidence: Concerns about the rule of law and property rights affected investor confidence. Unpredictable regulatory changes made the investment climate less certain.

EU Relations: Strained relations with the European Union, due to issues like rule-of-law disputes, led to potential funding cuts and increased scrutiny of Poland's compliance with EU standards.

Economic Resilience: Despite these challenges, Poland's strong economic performance and strategic advantages continued to attract FDI, though the growth rate was potentially tempered by the political environment.

Figure 1 illustrates the development of Poland's FDI inflows as a percentage of GDP from 2005 to 2012, compared to OECD inflows. The figure shows that Poland was catching up with OECD countries until 2015, before experiencing a decline in FDI inflows relative to OECD countries following a regime change.

Figure1: Foreign Direct Investment (FDI) in percent of GD: Poland and OECD countries



Source: UNCTAD

3. Multinational Enterprises in Poland

The liberalization of the Poland economy and the success of market reforms carried out in Poland in the early 1990s made the Polish economy an attractive place for international companies to locate their activities. In 1991, the legislation regulating the establishment and operation of companies with foreign capital was significantly liberalized. After further amendments, it has been the basis of their activity in Poland up to this day. This new legislation abolished most of the previously required permits for the establishment of

companies with foreign capital and introduced significant amendments regarding the possibility of transferring profits and withdrawing invested capital abroad. More liberal regulations for foreign investors and macroeconomic stabilization achieved through economic reforms led to a rapid increase in the number of companies with foreign capital establishing operations in Poland in the 1990s.

In the period preceding the economic and political transition, the number of companies with foreign capital operating in Poland in the second half of the 1980s was on average about 300 per year. Until 1988, this number was growing at a relatively small rate, averaging only about 9% per year. In 1989, the rate increased sharply to over 80%, and in 1990 it exceeded 130%.

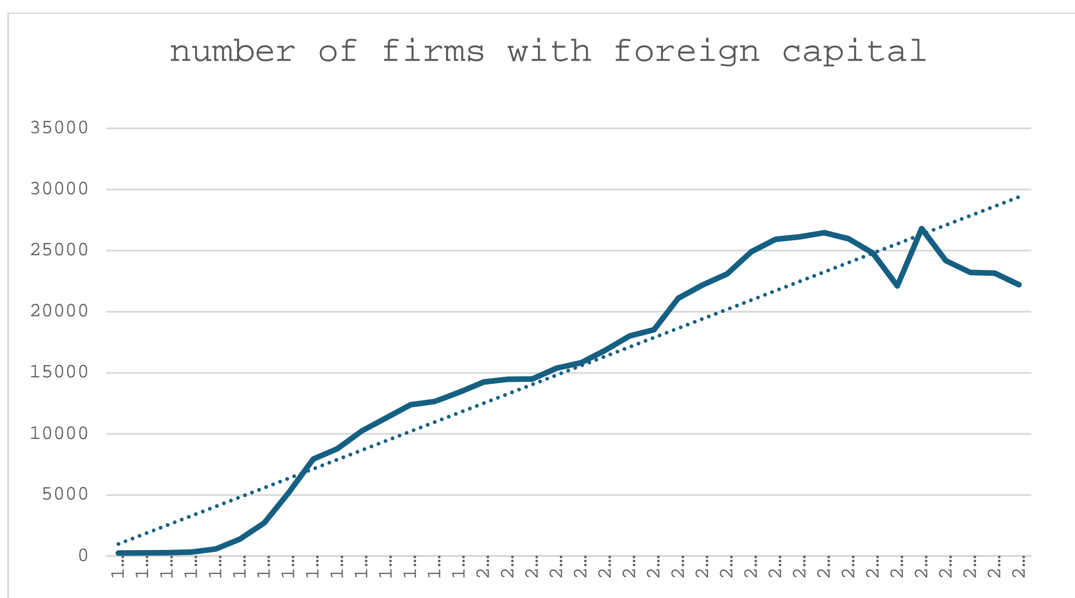
In the first half of the 1990s, the growth rate was still relatively high and exceeded 70% per year on average. On the other hand, in the second half of the 1990s, despite Polish's accession to the OECD and the NATO, this rate dropped to single-digit values after 1997 and amounted to an average of 9% per year.

The early 2000s' slowdown at the turn of the 20th and 21st centuries were attributed to several factors, including the destabilization of the global economy due to terrorist attacks, the deterioration of the macroeconomic situation both in Poland and globally, and the broader destabilization of the Central and Eastern European region following the 1998 Russian financial crisis. However, Poland's accession to the European Union in 2004 triggered a rapid increase in the number of foreign capital companies. In the first year after EU accession, the growth rate of foreign-capital companies reached 6.4%, and it approached 7% the following year. The number of foreign capital companies in Poland continued to grow steadily until 2014, which saw a record-high number of such enterprises.

However, in the subsequent years, the number of foreign-capital companies began to systematically decline. This decline is attributed to the worsening global macroeconomic

conditions and the instability of Poland's legal environment, which was a consequence of the illiberal institutional changes initiated by the populist government that assumed power in 2015.. The change in time in the number of companies operating in Poland with foreign capital participation since the mid-1980s is illustrated in Figure 1 below. broadly describes the ascent of FDI following the liberalizing regime of the 1990s and the declining trend following the illiberal regulation in 2011 and on.

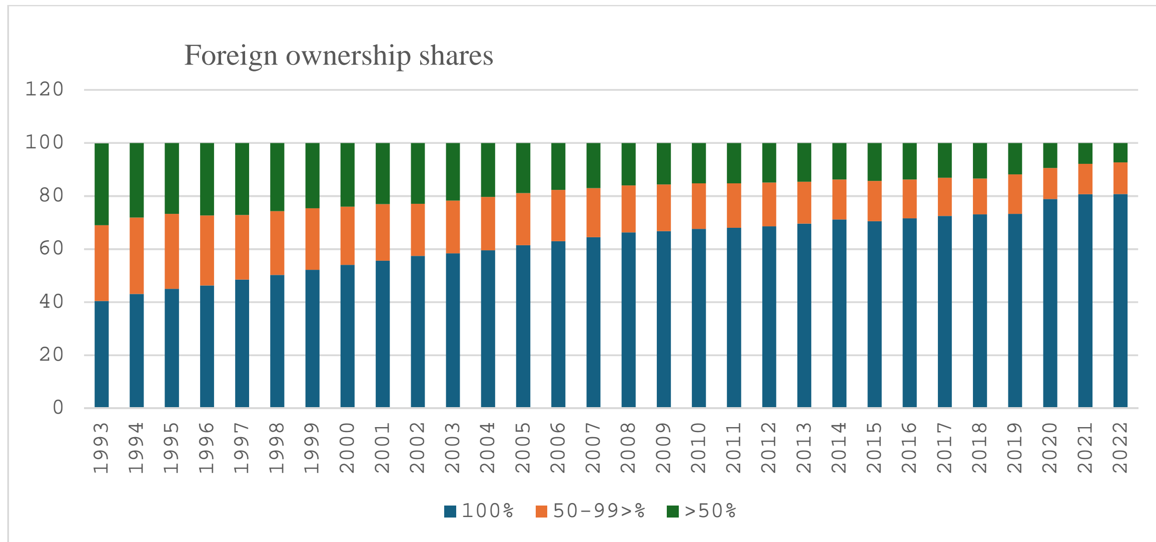
Figure 2:. The number of firms firm with foreign capital in Poland during 1985-2022.



Source: Statistics Poland.

Changes in the distribution of companies with foreign capital by percentage share of foreign capital in the period 1993-2022 are presented in Figure3.

Figure3. Forms of ownership of companies with foreign capital participation in Poland in the period 1993-2022.



Source: Statistics Poland

Currently, the most important role among companies with foreign capital operating in Poland is played by companies that are wholly owned by foreign capital.[4] Since the late 1990s, this form of ownership has been the most preferred form of foreign involvement in Poland. On the other hand, the shares of joint ventures with a majority or minority stakes have been steadily decreasing. The share of wholly owned companies increased from about 40% in 1993 to over 80% in 2022 at the expense of a decline in the share of majority and minority joint ventures.

4. Israel's Hi-Tech

Israel is the most tech-dependent economy in the world, with 13% of the country's GDP and 31% of all exports originating in the high-tech sector. The global high-tech slowdown has therefore hit Israel harder than other advanced economies. Pointedly, the domestic legal

system is key to entrepreneurship, innovation, and the securing of steady flows of venture capital to finance such endeavors.[5]

Large capital inflows are typically viewed as hazardous in financial markets living with memories of recent financial and currency crises. In recent decades, however, foreign capital in the form of foreign direct investment (FDI), including venture capital, has provided crucial funding for investment in Israel's showcase technology sector. Until the proposed judicial overhaul in January 2023, Israel had been solidly established as a high-tech powerhouse – a place where budding venture capitalists from developed countries flocked to learn how to develop an innovation ecosystem6. Israel pulled in the fourth highest level of FDI in relation to the size of its economy: Israel's FDI comprises about 4% of GDP, well above the OECD average of 1.4%. Israel's inward FDI flows accelerated in the 1990s and the 2000s and the country's venture capital development exhibited a remarkable increase as a proportion of total inward FDI, demonstrating the sharp increase in funding to high-tech startups.

Naturally, an isolated and small economy cannot be a centre of innovation. The incentives for entrepreneurs to invest efforts and resources in generating valuable services are related to the ability to use the resulting knowledge repeatedly, on a large scale, over time. Foreign direct investment provides critical incentives to be able to use scale economies, to leap from the precarious innovation stage in the confines of a small economy to the worldwide execution stage, by using global markets. The globalisation of an economy is crucial for a global high-tech industry to develop, and flourish. Foreign venture capital has been crucial to the emergence of Israel's high-tech sector to an elite position in the world economy; Israel's domestic market alone is far too small, with its homegrown capital formation being inadequate to foster innovation.

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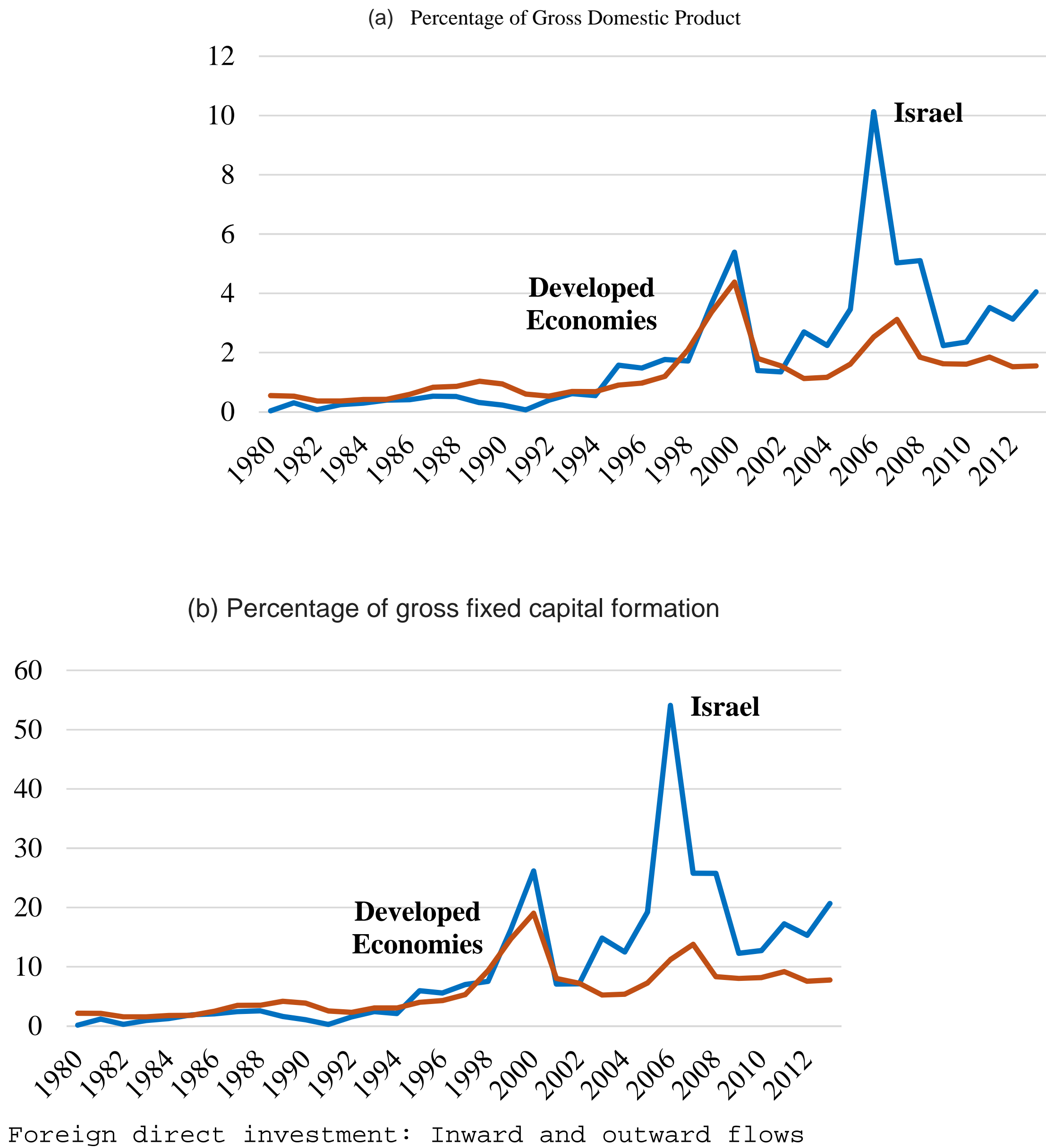
[5] See Razin (2018).

[6] See Loungani and Razin (2001) and Razin (2018) for the role of FDI and venture capital in promoting the hi-tech sector.

Figure 4 (a,b) demonstrates the attraction of Israel to foreign direct investors, compared with other developed economies.

Figure 4(a, b). Foreign direct investment: Inward FDI flows, annual, 1980-2014



FDI, in the form of venture capital in the initial phase of a startup and foreign acquisition of the developed innovation, has been essential.

5. Israel's Foreign Venture Capital

Israel, often referred to as the "Startup Nation," has become a global hub for innovation and technology. This reputation has been significantly bolstered by the influx of foreign venture capital (VC), which has played a crucial role in nurturing and expanding Israel's startup ecosystem. The relationship between Israel's startups and foreign investors is symbiotic, driving technological advancements, economic growth, and international collaboration.

Foreign venture capital firms bring more than just capital; they offer valuable mentorship, strategic guidance, and global networks. These resources help Israeli startups navigate the complexities of scaling their businesses and accessing new markets. Furthermore, the presence of high-profile international investors often serves as a validation of a startup's potential, attracting additional investment and talent.

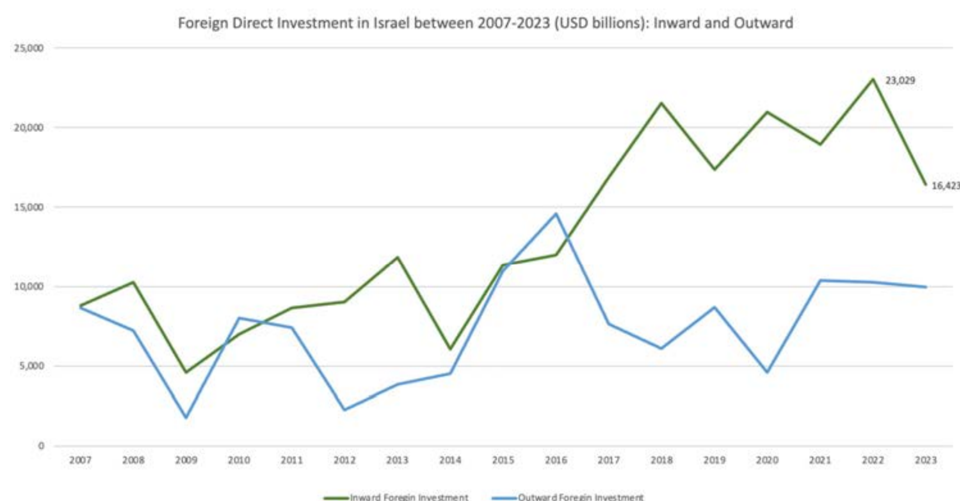
Several factors make Israel an attractive destination for foreign venture capital. First, Israel boasts a high concentration of tech talent, particularly in fields like cybersecurity, biotechnology, and artificial intelligence. This talent pool is supported by world-class universities and a culture of innovation fostered by mandatory military service, which often involves technical training and problem-solving skills. Second, Israel's robust legal framework, which protects intellectual property and encourages entrepreneurship, further enhances its appeal to foreign investors.

Figures 4, and 6, illustrate the surge in FDI, and venture capital investment in the 1990s up to in the 1990s up to 2002. The effect of the 2023 judicial reform is illustrated by the sharp

drop in FDI inflows in Figure 4. Following the announcement of the judicial overhaul in January 2023, inward FDI dropped sharply from $23,029 to $16,423, a drop of 29% for the full year.

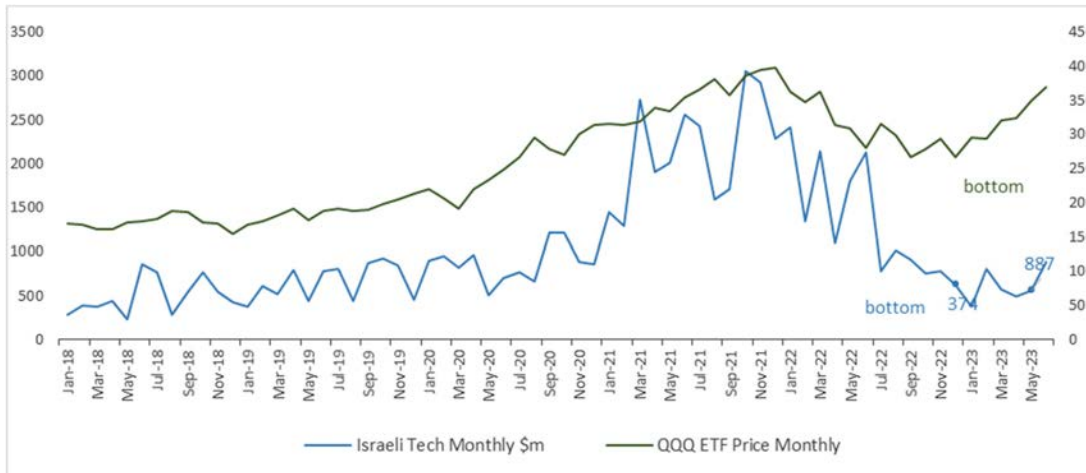
While part of the drop in FDI is attributable to the global recession in high-tech industries, Figure 2 demonstrates that the high-tech recession in Israel has been more severe than the global high-tech recession and that it started later (closer to the announcement of the judicial reform). Specifically, Figure 2 compares the exchange-traded fund that tracks the Nasdaq 100 index (abundant with high-tech companies) to the funding amounts for Israeli tech on a monthly scale. Both bottomed out at the end of 2022 and then started moving up towards the beginning of 2023 when the Israeli government announced its judicial regime-change program. The exchange-traded fund shows a much quicker and larger surge than Israeli tech funding.

Figure 5: FDI in Israel between 2007-2023: Inflows and outflows (US$ billions)



Source: Bank of Israel and UNCTAD.

Figure 5 Nasdaq 100 versus Israeli funding amounts, 2018 to H1/2023, monthly scale (US$ million)



Source: Israel's Venture Capital (IVC).

Importantly, there has been a big drop in venture capital investment in Israel's high-tech industry. Figure 3 plots quarterly venture capital investment in the country and shows a sharp downtrend for investments in the hi-tech sector from 2022 – at the height of the worldwide pandemic recession – reaching below the level in the second quarter of 2019.

Figure 6 Venture capital investment, quarterly (US$ billions)

Source: IVC

Recent instability in the country negatively affects Israeli startups worldwide, including among investors. It has already led to the relocation of operations and intellectual property from Israel. Nearly a quarter of the venture capital funds operating in the country estimate that over 30% of their portfolio companies transferred significant activities abroad in 2023 or will do so soon. About 40% of them reported at least one company doing so. The funds predict that these trends will worsen in the coming year. Fundraising for the funds themselves fell by 70% in 2023 compared to the average fundraising in 2018-2022.

6. Common Patterns

The liberalization of the Polish economy and the successful implementation of market reforms in the late 1980s and early 1990s significantly enhanced Poland's attractiveness as a destination for international companies. In 1991, legislation regulating the establishment and operation of companies with foreign capital was liberalized, forming a foundation for foreign business activities that remains relevant today despite subsequent amendments. However, recent illiberal policies under the PiS regime, which altered minority rights and favored domestic companies, have diminished Poland's appeal to foreign investors.

Innovation requires scale, and scale necessitates trade. A small, isolated economy cannot serve as a hub of innovation. Entrepreneurs' incentives to invest in creating valuable services are linked to their ability to leverage the resulting knowledge repeatedly, on a large scale, and over an extended period. Foreign direct investment (FDI) is crucial in facilitating economies of scale, enabling the transition from precarious innovation stages within a small economy to effective execution by accessing global markets. Additionally, the innovation sector in small, open economies often relies on suitable financial support, such as venture capital, which frequently originates from abroad.

Israel, starting at the 1990s all through the 2010s witnessed an increase in immigration, which elevated the workforce's skill level, education, and human capital stock, as well as a

global information technology surge. This period saw unprecedented growth in Israel's high-tech sector. Over the past three decades, the increasing globalization of the Israeli economy has been vital for the development and prosperity of its nascent high-tech industry.

However, Israel's growth trajectory has been significantly disrupted by recent illiberal regime changes. As a result, foreign venture capital inflows have dramatically declined. In the period 1989-2022, by far the largest number of companies with foreign capital operating in Poland came from the European Union member states, from the old EU countries.

7. Conclusion

This essay underscores the significant common patterns in the effects of foreign direct investment (FDI) under liberal versus illiberal regime changes by examining the experiences of Poland and Israel, two dissimilar open economies. The liberalization of the Polish economy and market reforms in the late 1980s and early 1990s significantly enhanced Poland's attractiveness to international companies. However, recent illiberal policies under the PiS regime have diminished Poland's appeal to foreign investors. Similarly, Israel's high-tech sector experienced substantial growth from the 1990s to the 2010s, driven by factors such as immigration, workforce skill enhancement, education, liberalization of capital and finance flows, and the global IT boom. Globalization played a crucial role in the development of Israel's high-tech industry. However, recent shifts towards illiberal policies have disrupted Israel's growth, leading to a sharp decline in foreign venture capital inflows. This analysis highlights the profound impact that changes in the liberal characteristics of regimes have on foreign direct investors.

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