

The background of the cover is an abstract composition. It features several dark, silhouetted human figures standing in a row, facing forward. The background is a dense collage of overlapping, rectangular shapes in various shades of yellow, orange, and red, resembling torn pieces of paper or documents. The overall effect is one of complexity and layered information.

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Economic Drivers and Consequences

**CENTRE FOR
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CHAPTER 7

When populism meets religion: Economic lessons from Israel's existential crisis¹

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INTRODUCTION

By the end of 2023, Israel had gone through not one but two existential crises, which are still unfolding. The second crisis is the war, which began on 7 October 2023 when Hamas brutally attacked Israeli border towns and military bases. Israelis suffered a shock comparable to Jewish pogroms of the past, the worst such experience since the Holocaust. At this moment in time, the conflict looks set to continue for months, if not years, to come. Less clear is its connection with the political crisis in which Israel has been engulfed since the beginning of 2023, which is the focus of this chapter.

Since January 2023, a right-wing coalition government has been pursuing two goals: a fundamental judicial overhaul likely to turn Israel into a non-democratic state; and a plethora of laws and budgetary measures, which extract national resources for partisan usage. As a result, large masses have taken to the streets in tenacious and energetic opposition. Since late July 2023, military personnel in key positions have stopped reporting to voluntary reserve duty. These include Air Force pilots, prominent Navy officers, military intelligence specialists, and elite unit combat fighters.

At the same time, the economy has suffered turbulence: there has been a big drop in foreign investment, especially in the high-tech sector, early signs of capital flight and a significant weakening of the currency. The Bank of Israel and the Chief Economist of the Treasury have estimated possible significant losses in GDP per capita growth over the next decade. Foreign banks and credit rating agencies have issued repeated warnings since March 2023, as have prominent economists including Larry Summers and Ben Bernanke. In early 2024, Moody's and S&P actually downgraded Israeli debt.

Faced with vigorous opposition and adverse circumstances, the government led by PM Netanyahu has alternated between pausing the government's drive and continued pursuit of it. The crisis has exposed deep fissures underlying Israeli society. Many believe it has

¹ I thank Tel Aviv University seminar participants for comments and Oded Neeman for research assistance. Any errors are my own.

turned into a conflict over Israel's essence and its future path. In a poll on 15 September 2023 by Israel's leading TV station, Channel 12, about 20% of respondents said they were seriously contemplating leaving the country; among centre-left voters, around 30% were thinking of emigrating. Then the war broke out.

This chapter addresses three questions. First, what are the fundamental forces that underlie the outbreak of the crisis? In discussing this question, I tie the political crisis to the outbreak of the war in October 2023. Second, what are the economic ramifications of the crisis, particularly the long-run effects? Third, what can other liberal democracies learn from this crisis? It turns out that the three questions are tightly inter-connected.

POPULISM AND RELIGION - THE FORCES UNDERLYING THE CRISIS

This crisis is not a temporary flare-up. It comes on top of a more subtle, slow and long-run process of religious forces gaining political power in conjunction with the rise of a populist politician. Both oppose democracy and seek to dismantle its key institutions. The prospect of a state that is religious and non-democratic alarms many Israelis. Hence, there has been a very lively discussion of the possibility of a break-up of the country into a secular, democratic *Israel* and a clerical, non-democratic *Judea*, governed and adjudicated by religious institutions. It is not clear how feasible this idea is, but the polarisation it expresses reflects the operation of the afore-cited forces over time.

To understand the changing role of religion, it is useful to frame the discussion in terms used by Israeli sociologists to break down the composition of the population. They speak of four groups: three are Jewish, classified by levels of religiosity – secular, traditional and religious, and ultra-Orthodox; the fourth group are Arab-Israelis, who are predominantly Muslim. The secular Jewish group, now roughly a third of the adult population, is the strongest economically. It has relatively high levels of education, exhibits high participation rates in the labour market and in military service, and has relatively high income. At the other end of the spectrum are the ultra-Orthodox Jews and the Arabs, a little over a quarter of the adult population, who are ranked bottom on all indicators². This sociological division also corresponds to a division of the Israeli economy into a dual structure. The former segment has fostered a very dynamic and successful high-tech sector that has become the linchpin of the economy. It produces 17% of GDP and around half of Israel's exports. The Arabs and the ultra-Orthodox, on the other hand, account for the majority of households that are classified below the poverty line and who receive significant social security benefits from the state. An important fact in this context is that the poor economic performance of both groups is linked to

2 Many factors contribute to the disparity in educational outcomes among the cited demographic groups. To give but three examples: Haredi schools primarily prioritise religious education, which does not align with marketable skills sought after in the market economy; evidence suggests that budgetary discrepancies, with Arab schools often receiving lower allocations, play a role in the underperformance of Arab students; and children from disadvantaged socioeconomic backgrounds, including Arabs, tend to have lower participation rates in the different educational systems.

their educational background. In particular, the ultra-Orthodox study in a separate school system that emphasises religious education. Typically, they do not study at all subjects that are crucial for the labour market –maths, English, and basic science. The fourth group, traditional and religious Jews, constitute a little over a third of the adult population. They rank somewhat below the secular group on all of the afore-cited indicators and their educational background is wider.

A key dynamic is the religious group and the ultra-Orthodox group accounting for an increasing share of the population, while becoming more radical in terms of religion and more right-wing in terms of politics. Their combined share in the adult population has risen to around 27% (Israel Democracy Institute, 2023), mostly due to high fertility rates (in the period 2019-2021, total fertility rates were 6.4 for ultra-Orthodox women, 3.8 for religious women and 2 for secular women). The ultra-Orthodox population in particular is growing at 4% a year – twice the national average.

In 2003, 29 members of the Knesset (MKs), the Israeli parliament, were either religious or ultra-Orthodox; by the latest elections in 2022, this number had risen to 41. The religious wish to turn Israel into a clerical state, with rabbinical courts dominating secular civil ones, and to expand settlements in the West Bank. The ultra-Orthodox wish to enshrine in law their exemption from military service, to expand the generous social welfare system supporting their communities, and to maintain religious education without giving in to the demand that it include the afore-mentioned secular subjects. While the economic fortunes of these two groups are diverse, their political goals converge. These are the building blocks of *Judea*.

At the same time, current Prime Minister Netanyahu, a would-be autocrat, has increasingly promoted populist policies, while purging the Likud party of any significant rival. He has closely followed the playbook of Orban, Erdogan, and Trump, which has been aptly described in Guriev and Treisman (2022) and in Wolf (2023). Prime minister for 16 of the past 27 years, he has an obsession with holding on to power, but he has not achieved Orban's or Erdogan's scale of support and badly needs coalition partners. Moreover, under trial for four years on three corruption charges, Netanyahu is seeking to escape legal predicaments, including a potential prison term.

The immediate antecedent of the political crisis was a confluence of interests of the religious forces and the populist Netanyahu. The three constituent parts of the 64 strong parliamentary majority (out of 120 MKs) that came to power following the November 2022 elections are the Likud party, headed by Netanyahu (32 MKs); two ultra-Orthodox parties (18 MKs); and a union of two religious, ultra-nationalist parties (14 MKs). A common goal of these disparate members of the coalition is the weakening of the judicial system, which is the major roadblock for the attainment of their other cited goals. In January 2023, they set out to pass eleven key pieces of legislation designed to greatly weaken, if not eliminate, the power of the courts. One of these has been enacted thus far, on 24 July 2023, and was ultimately struck down by the Supreme Court. Dozens of

additional laws are in the process of proposition or enactment. It was made clear that the next steps will target free speech, the media, and subsequently academia and even the army.

The coalition, however, has met with fierce resistance. There has been a very impressive mass protest movement, encompassing people from all walks of life and political affiliations. This includes, among others, the afore-mentioned members of the Israeli defence forces; high-tech workers, who are essential to Israel's economic success; key business leaders; other important sectors such as the medical profession; and many former high-ranking officials of the Treasury, the Bank of Israel, and important government ministries. Hundreds of thousands of people have marched every week for almost 40 weeks in street protests. Polls have been indicating for months that this grouping – essentially, *Israel* – commands the majority in public opinion. The coalition, essentially *Judea*, with 64 MKs in the current Knesset, was polling at 44 MKs following the 7 October 2023 attacks; by May 2024, this number had risen to around 50 MKs.

There is a fear, however, that the coalition will seek to distort the electoral map. For example, by effectively barring the Arab-Israeli vote, they can ensure victory in future elections. The current majority may thus turn into a permanent one. If the current plans by the government were to be implemented, they will spell the end of democracy in Israel. They will break up the power of the Supreme Court to counter governmental decisions and parliamentary laws, in a country with one chamber of parliament and no constitution. Such irreversibility will spell out the end of democracy, to be replaced with a full-fledged Netanyahu autocracy, and later on a theocracy led by the religious and the ultra-Orthodox.

ECONOMIC RAMIFICATIONS

The economic consequences are potentially dramatic precisely because of the political-demographic structure and dynamics described above. Essentially, the richer, more productive elements of Israel may refuse to maintain the economy and the military. In other words, *Israel* will refuse to continue to carry *Judea* on its back when the country turns into an autocracy, or perhaps even a theocracy. Practically speaking, this is likely to manifest in the exit of the linchpin of the economy, the high-tech sector. Indeed, this movement started in early 2023: flows of financial capital to the sector dropped 68% in the first half of the year relative to 2022, and most start-ups have stopped registering in Israel, with their tax payments going elsewhere. High-tech workers have started to emigrate; Greece, Spain, and Portugal are actually offering incentives for such emigration. The realism of a big emigration scenario is further supported by the observation that, in the crisis of the 2010s, 5% of Greece's population – mostly drawn from the upper part of the Greek income distribution – left the country.

These shocks to financial capital and to human capital in the high-tech sector will have far-ranging consequences, as other large but weak sectors live off this sector. The high-tech sector accounts for a quarter of Israel's direct tax revenues, while the ultra-Orthodox are heavily subsidised and supported by large governmental transfers. If developments in the high-tech sector were to be replicated in sectors such as healthcare, the shock will be even worse.

In economic terms, this is likely to lead to lower GDP per capita, a reduction in GDP growth, a fall in investment and in exports, a fall in labour productivity, and more. An August 2023 report by two Israeli think tanks estimates a range of 9% to 45% reduction in GDP per capita in the long run (Ater et al., 2023). The speed of these changes is unknown, but the time scale is to be measured in years.

The costs of war will come on top of these potential long-term risks that have emerged during the political crisis. These costs include loss of GDP³ due to the shutting down of sites of production near the border and the mobilisation of workers into military service; the costs of caring for displaced populations; increased fiscal costs, with military expenditures and welfare payments of various kinds; the cost of replenishing the capital stock; and a drop in foreign investment and tourism.

Both the political crisis and the war have injected high uncertainty and increased Israel's risk premium. With the high-tech sector reliant on foreign investors for 90% of its investment flows, its future in Israel is at great risk.

GLOBAL LESSONS

What can the rest of the world, and in particular liberal democracies, learn from this experience? There are three key lessons.

One is to recognise the grave dangers posed by the association of populism and religion. While it is unclear how global such a phenomenon may become, it is already manifest in countries such as Turkey and India. It may further rise in the face of large-scale migrations, engendering both a large-scale attempt to dismantle democratic institutions and the extraction of resources for partisan and personal benefits. Populists and religious conservatives, not to speak of fanatics, share goals that are anti-democratic, and are ready to shamelessly redistribute resources from productive sectors and groups to their own sectors or groups. Indeed, they are ready to 'kick out' whoever stands in their way.

A second lesson is to see the Israeli crisis as a 'case study' on the linkages between democracy and economic growth and wellbeing. In particular, it highlights the role of investors' *expectations* as well as the crucial importance of the mobility of financial and human capital. For investors and high-skilled workers, the expectation of autocracy

3 In early 2024, forecasts for annual GDP growth for the year range from +2% to -2%, relative to an estimated 2% in 2023. The forecasts depend on the scale and intensity of the war.

in the future is enough to prompt action in the present, such as moving investment elsewhere or emigrating. Thus, the Israeli experience calls for attention to be placed on the high mobility of both kinds of capital. These can lead to domino effects and vicious cycles, which would lead in turn to further economic decline.

Third, the political polarisation apparent in Israel is by now a pervasive global phenomenon. There are currently many countries that have separatist elements or that exhibit deep divisions in their electorate. The tight connection between polarisation and the economic fortunes of the various constituents of the population is key. The events in Israel over a period of less than a year have demonstrated how economic progress can quickly unravel and be put into question by such divisions. One potential government policy to pre-empt such developments is to use taxes and transfers judiciously to defuse tensions and economic disparities.

However, there is one significant ray of light in the Israeli story of 2023, which offers another kind of lesson. The mass protests have created important dynamics. They have proven to be a strong force even in the face of populists and religious fanatics. Moreover, the civil protest organisations carried their activity into the Gaza war, supplying services to the affected population – services that the government proved too slow to provide. The protests show the immense importance of the active involvement of citizens, outside of elections. They demonstrate that ‘direct democracy’ has a role to play and that it has power against forces of autocracy and theocracy. If people have the vision and the commitment, they can make a real difference.

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