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CEPR PRESS

Edited by Assaf Razin

The Transition to Illiberal Democracy

Economic Drivers and Consequences

**CENTRE FOR
ECONOMIC
POLICY
RESEARCH**

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Economic Drivers and Consequences

CEPR

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Centre for Economic Policy Research
187 boulevard Saint-Germain
75007, Paris, France

33 Great Sutton Street
London, EC1V 0DX, UK

Tel: +44 (0)20 7183 8801

Email: cepr@cepr.org

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**CENTRE FOR
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RESEARCH**

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About the contributors

Itai Ater is an Associate Professor of Business Economics at the Coller School of Management at Tel Aviv University, a research fellow in the CEPR Industrial Organization Program, and a senior fellow at the Israeli Democracy Institute. Itai completed his undergraduate degrees in both law and economics with distinction from the Hebrew University of Jerusalem. Before heading to the economics PhD program at Stanford University, he worked at the Israeli Competition Authority. In 2023, he initiated a series of open letters, signed by hundreds of academic economists including economics Nobel laureates, that warned against the severe economic damage from weakening the democratic institutions in Israel.

Dan Ben-David (PhD in Economics, University of Chicago) heads the Shores Institute for Socioeconomic Research and is a senior faculty member in the Department of Public Policy at Tel-Aviv University. Ben-David is a former Research Fellow at the National Bureau of Economic Research (NBER) and the Centre for Economic Policy Research (CEPR) as well as the past executive director of the Taub Center for Social Policy Studies. Dan Ben-David was named ‘Person of the Year’ by *Calcalist* newspaper, included three times in the *Haaretz-TheMarker* newspaper’s annual list of Israel’s 100 most influential people and recently received the “Knight of Quality Government Award” granted by the Movement for Quality Government.

Barry Eichengreen is George C. Pardee and Helen N. Pardee Chair and Distinguished Professor of Economics and Professor of Political Science at the University of California, Berkeley. He is a Research Associate of the National Bureau of Economic Research and Research Fellow of the Centre for Economic Policy Research. In 1997-98 he was Senior Policy Advisor at the IMF. He is a fellow of the American Academy of Arts and Sciences (class of 1997), a distinguished fellow of the American Economic Association (class of 2022), a corresponding fellow of the British Academy (class of 2022), and a Life Fellow of the Cliometric Society (class of 2013). He has held Guggenheim and Fulbright Fellowships and been a fellow of the Center for Advanced Study in the Behavioral Sciences (Palo Alto) and the Institute for Advanced Study (Berlin). For 15 years from 2004 he served as convener of the Bellagio Group of academics and officials. He is a regular monthly columnist for Project Syndicate.

Ayal Kimhi is Sir Henry d’Avigdor Goldsmid Chair in Agricultural Economics at the Hebrew University. He also serves as Vice President and head of research at the Shores Institute for Socioeconomic Research. He previously served as Deputy Director of the Taub Center for Social Policy Studies in Israel and as Director of Research at the Center for Agricultural Economic Research. He has a PhD in Economics from the University of Chicago (1991), and has held visiting positions at the Universities of Maryland, Yale, Pennsylvania, Nagoya, Leuven, Sydney and at the Paris School of Economics. He published more than 50 articles in refereed academic journals, including *Food Policy*,

American Journal of Agricultural Economics, *Journal of Development Economics*, and *The Econometrics Journal*. His research spans the fields of labour economics, family economics, applied econometrics, agricultural economics, and development economics.

Assaf Razin is a Israeli economist renowned for his extensive contributions to the fields of international economics, and public economics. He is the author and co-author of of books such as *International Trade under Uncertainty*, *Fiscal Policy in the World Economy*, *International Taxation*, *Population Economics*, and more. His 2018 book *Israel and the World Economy: The Power of Globalization* delves into immigration, economic institution-building, technological advancement, and inflation control's impact on the global stage. Assaf is a Fellow of the Econometric Society, CEPR, and NBER, and the recipient of the EMET Prize.

Itzhak Tzachi Raz is an Assistant Professor in the Bogen Family Department of Economics and the integrative interdisciplinary programme in Philosophy, Political Science, and Economics at the Hebrew University of Jerusalem. Before joining the faculty at The Hebrew University of Jerusalem, Itzhak earned a PhD in Economics from Harvard University, and an MA in Economics and a BA in PPE from the Hebrew University. His research lies at the intersection of economic history, political economy, and cultural economics.

Efraim Sadka is Emeritus Professor of Economics, The Eitan Berglas School of Economics, Tel-Aviv University. He holds a BA *summa cum lauda* in Economics and Statistics from Tel-Aviv University and a PhD in Economics from MIT. He joined the faculty of the Economics Department of Tel-Aviv University in 1975 and retired as the incumbent of the Henry Kaufman Chair in International Capital Markets in 2014. He served as President of the Israeli Economic Association (2006-2008), as editor of its quarterly journal, and as co-editor of CESifo Economic Studies. He served as a Chairman of the board of directors of Housing and Construction, Inc. (1989-2015) and of KGM pension fund (1996-2000), and as an outside director in Bank Leumi (2006-2015) and in Paz Oil (2010-2009). He currently serves as chairman of the board of the Babylonian Jewry Heritage Center (since 2011) and as an outside director in Newmed Energy (since 2019). His research areas include public economics, social security, migration and international factor mobility.

Adam Szeidl is Professor of Economics at Central European University in Vienna, Austria, and a Research Fellow at CEPR. He has worked in the areas of political economics, development economics, and network economics. His current interests include the political economics of ideas and the role of firm networks in economic development. Adam is a Fellow of the Econometric Society, the International Economic Association, and the European Economic Association, a past editor of the *Review of Economic Studies*, and the recipient of European Research Council grants. Before joining Central European University in 2011, Adam was Associate and Assistant Professor of Economics at the University of California, Berkeley. He received his PhD from Harvard University in 2004.

Ferenc Szucs is Assistant Professor of Economics at Stockholm University, and a research fellow at the Hungarian Society of Economics. He received his PhD from UC Berkeley in 2018. Ferenc is a political economist. His previous research focused on the economic consequences of political favoritism and on the role of media in governmental accountability. He is currently working on the political economics of ideas and narratives.

Yannay Spitzer is an Assistant Professor in the Department of Economics and the PPE programme of the Hebrew University of Jerusalem and an affiliate in the CEPR. He earned a BA in Economics and History from the Hebrew University of Jerusalem and a PhD from Northwestern University. He was a postdoctoral fellow at the Population Studies and Training Center of Brown University and a visiting scholar at Harvard University and the NBER. His research deals with the economic history of the Jews and the economics of transatlantic mass migration from Europe.

Eran Yashiv is Professor of Economics at Tel Aviv University and a member of the Centre for Macroeconomics (CfM) at the London School of Economics (LSE). He is a CEPR Fellow in Monetary Economics and Fluctuations and in Labour Economics. Yashiv is a macroeconomist, mostly interested in the role of labour market frictions in business cycles, asset pricing implications of labour market frictions, economic and public health epidemic management policy, and minorities and migration issues. In 2023-2024 he has written extensively on the crises in Israel. Inter alia, his articles have been published in the *Financial Times*, *The Guardian*, and *Haaretz*.

Noam Yuchtman is the Drummond Professor of Political Economy in the Department of Economics at the University of Oxford and All Souls College. In addition to his role at Oxford, Noam is a Managing Editor at the Review of Economic Studies. Noam's research is on topics in the fields of political economy, economic history, and labour economics: the importance of educational content and the structure of educational institutions in the production of human capital; the political economy of legal institutions: particularly how they affect labour market outcomes and development, and how they are affected by political institutions in which they are embedded; the study of social interactions that shape economic and political behaviour; the drivers of political ideology and participation in political movements; and the role of the state in promoting economic growth and innovation.

Foreword

In the contemporary arena of political discourse, the transition from liberal democracy to its illiberal counterpart has become a focal point of academic discussion. Notable instances in Hungary, Poland, Turkey, and the attempted judicial overhaul in Israel, serve as poignant examples, shedding light on the gradual erosion of democratic principles.

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While scholarly attention has predominantly focused on the political dimensions of these shifts, the multifaceted economic aspects remain relatively unexplored within the literature. Through a collection of essays, this eBook endeavours to address this gap by offering an early and insightful examination of the economic transformations accompanying the transition from liberal democracy to illiberal democracy, and their drivers.

The transition to illiberal democracy is a concern in the countries examined in this book – Hungary, Poland, and Israel – but it is also a grave concern in the United States and India, as well as Mexico. Mexico is furthest along the illiberal track. There are many instances that highlight how populist-based economic policy can imperil liberal democracy. In Israel, as in Poland (especially after the recent election), there is at least a basis for believing the crisis is receding. To many, the upcoming November 2024 presidential election in the United States is the most concerning given the country’s democracy-leading global position. So far, the judicial weakening has come about mostly with the politicisation of the appointment of justices to the courts. It is spreading to more and more issues and more and more courts.

The essays contained in this book explore the various political drivers behind these transitions, including economic disparities, identity politics, the influence of social media and echo chambers, educational quality discrepancies, and disparities in access to societal and financial institutions. They also delve into the ramifications of anti-democratic forces on economic growth, examining their impact on areas such as social media dynamics, educational quality, foreign direct investment, the hi-tech industry, and entrepreneurship. Comprising essays authored by scholars with intimate knowledge and expertise in their respective fields, this collection offers a comprehensive exploration of the economic dimensions of democratic erosion.

Assaf Razin thanks his colleague, Haim Ben Shahr, whose insights were instrumental in shaping the intellectual inception of this eBook project, Anne Krueger for comments on an earlier draft, and Nir Lavee for his invaluable editorial assistance. CEPR would like to thank Assaf for his work as editor of this book and Anil Shamdasani for his work on its production. CEPR takes no institutional positions on economic policy matters, but is committed to provide a platform for an exchange of view on important topics.

Tessa Ogden
Chief Executive Officer, CEPR
May 2024

Introduction

Assaf Razin

Tel Aviv University and CEPR

1

In the wake of recent political shifts, democratic principles are being eroded, giving way to a consolidation of governmental power through autocratic means. The changes in government witnessed in Hungary, Poland, and Turkey serve as illustrations of how democratic values can be eroded due to electoral manipulative strategies and judicial overhauls. While the manifestations of these patterns differ, they invariably erode the rule of law and democratic institutions. An autocratic stance sharply contrasts with the democratic norms upheld by major Western nations: the separation of powers; judicial autonomy; and the intricate web of political, civic, and social organisations cultivated since the Enlightenment.¹ These century-old liberalising trends have been instrumental in fostering unprecedented prosperity.

Regime changes can vary, depending on the country's political, social, and historical context. There are, however, some common patterns to the ways these changes undermine the rule of law and 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 favour 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 favourable 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) utilising 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 organisations (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 laws and regulations that restrict citizens' rights in the name of maintaining order

1 The Enlightenment encompassed a range of ideas centred on the value of individual human happiness and the pursuit of knowledge obtained by means of reason and based on evidence.

and security; (xiii) solidifying control over the legislative process and suppressing any remaining challenges to the regime's authority; and (xiv) suppressing dissent through coercive measures, surveillance, and targeted repression.

Hungary's Fidesz government, led by Viktor Orbán, engineered sweeping judicial alterations, diminished judicial autonomy, and weakened checks and balances. Poland's Law and Justice (PiS) party likewise triggered concerns through reforms that seemingly compromised the separation of powers. Under the rule of PiS, Poland systematically overhauled its judicial system towards an illiberal democracy. However, the country's latest general elections point to an end to the eight-year rule of PiS. Israel's planned judicial overhaul pointed to a similar regime change.

Regime changes towards autocracy often lead to the following:

- **Protest and mobilisation:** Polarisation can fuel political activism and mobilisation. In highly polarised societies, people who feel strongly about their beliefs are more likely to engage in protests, rallies, and grassroots organising efforts. These movements can coalesce around a shared desire for change and ultimately lead to regime change through various means, including mass demonstrations and pressure on elected officials. Beyond the hallmark of elections, liberal democracies thrive on a complex interplay of formal and informal institutions, governmental bodies, non-governmental organisations, laws, and norms. Understanding the interdependence of these complementary elements is essential in deciphering the conflict surrounding Israel's institutions and comprehending the specific manifestation of this conflict.
- **Gridlock and dysfunction:** When political polarisation is extreme, it can result in legislative gridlock and government dysfunction. If the public perceives that the government is unable to address critical issues due to partisan bickering, it can create demand for change. In such cases, voters may opt for regime change to break the deadlock and achieve policy goals.
- **Judicial overhaul:** Without a strong separation of branches of power, changes often come with shifts in the entire direction of policy. When a new regime implements policies that significantly differ from those of the previous regime, this can deepen political polarisation. Supporters of the new regime may embrace these changes, while opponents may feel alienated.
- **Identity-based politics:** Different social, ethnic, or cultural groups support different regimes. This can lead to increased polarisation as groups become more entrenched in their positions and view the other side as a threat to their identity or way of life.

Israel has been experiencing a deepening divide, with frequent general elections, as the current coalition government teeters on a precarious electoral majority while devising a judicial overhaul. The coalition, composed of the nationalist Likud party, led by Benjamin Netanyahu, and smaller Orthodox and Jewish supremacist parties, deviates from Western democratic norms rooted in the Enlightenment ideas of separation of powers, judicial independence, and intricate political, and civic, and social frameworks. Their primary objective is to recalibrate Israel's judicial system, effectively blurring the lines of power separation and ushering in an era of potential autocracy. However, Israel's protest movement has thus far managed to stymie the major elements of this judicial overhaul.

This eBook offers a compilation of essays written by academic economists that explore critical economic turning points and features and examine the economic implications of judicial regime changes. Specifically, it delves into the 2023 judicial regime change in Israel, highlighting it as a significant episode within a broader trend of former democracies transitioning towards autocracy.

Part I explores the economic effects of a regime change that abuses democracy's 'separation of branches of power' on key economic drivers of growth and innovation, globalisation, crony capitalism, rent-seeking, departures from property rights, and manipulation of information.

Assaf Razin and **Efraim Sadka** compare the transitions from liberal democracy to illiberal democracy in Hungary and Poland to the 2023 judicial overhaul in Israel. They provide an overview of key economic structural changes that are reinforced by the judicial overhaul, such as crony capitalism, widespread rent-seeking, a dearth of foreign direct investment, preferential welfare state transfers to privileged sectors, and suffocated entrepreneurship. They also underscore the differential effects of public resistance to the overhaul. In Poland and Hungary, the regime change has been semi-successful in altering the political landscape, while in Israel public resistance and the unanticipated Israel-Hamas war have led to the suspension of the judicial overhaul in its infancy.

Barry Eichengreen, taking a broad perspective in reviewing the literature, suggests that while the relationship between democracy and economic growth remains unsettled, due to the endogeneity and poor measurement of the two variables, the connection between judicial independence and growth is more robust. Judicial independence is a well-defined concept, and the economic literature consistently presents theoretical arguments for its positive impact on economic outcomes, with few arguments suggesting negative effects. This contrasts with the mixed conclusions in the literature regarding the economic impact of democracy.

Itai Ater, **Itzhak Tzachi Raz**, and **Yannay Spitzer** examine the repercussions for Israel's financial market following the announcement of the judicial overhaul. The revised expectations instigated almost instantaneous capital outflows and considerable depreciation of the domestic currency, and led to an increase in stock market volatility.

The authors calculate a statistical correlation involving the S&P 500, the shekel/dollar exchange rate, and the interconnections between the Israeli and US stock markets which points to significant deviations from regression trends after the announcement of the judicial overhaul. However, the underpinning of the statistical correlations lacks a distinct theoretical mechanism explaining driving factors, which uncover the effects of the judicial overhaul. Particularly, the missing elements are interest rate differentials and the role of currency risk and equity premium. Interested readers may refer to the recent paper by Itshoki and Mukhin (2023).

Part II addresses *de facto* power and the fourth branch of power.

Noam Yuchtman delves into the profound implications of the Israeli government's challenge to judicial independence, probing two pivotal questions. Yuchtman reminds us that the crux of the matter lies in recognising the paramount role of *de facto* power in shaping the intricate components of a democratic system, thereby safeguarding the essence of a democratic society. First, he explores why such a challenge poses a significant threat to the fabric of a liberal, democratic society. Second, he investigates the motivations behind the robust street protests mounted by opponents of the judicial overhaul. The crux of the matter lies in recognising the paramount role of *de facto* power in shaping the intricate components of a democratic system and thereby safeguarding the essence of a democratic society. Beyond the hallmark of elections, liberal democracies thrive on a complex interplay of formal and informal institutions, governmental bodies, non-governmental organisations, laws, and norms. Understanding the interdependence of these complementary elements is essential in deciphering the conflict surrounding Israel's institutions and comprehending the specific manifestation of this conflict.

Societal mobilisation typically encompasses the broad involvement of the entire society, especially non-elites, in the political sphere. The capacity for coordination and mobilisation through protests within civil society is a direct result of invested *de facto* power. This insight holds promise for opposition movements within Israel, particularly as the conflict over the institutions unfolds. Mass movements not only reveal the prevailing norms but also signal the nature of future mobilisation, creating a formidable challenge for future governments to legislate against these norms or for judges to erode them.

Adam Szeidl and **Ferenc Szucs** explore the role of the media and the sphere of propaganda. They discuss the Hungarian experience, and emphasise the importance of false alternative realities and conspiracy theories that are disseminated as part of government propaganda. The authors demonstrate how the Hungarian government captured independent media and turned them into vehicles of propaganda; how the captured media disseminated false alternative realities in order to discredit criticism from independent experts and institutions; how these alternative realities succeeded in reducing trust in experts and institutions, helping the regime; and how this erosion in trust lead to lower-quality decision making in society (for example, related to COVID-19).

The authors argue that these forces may apply more generally in contexts experiencing populist backsliding, and suggest that early action to protect independent media is an important priority for civil society.

Part III delves into Israel's structural and societal issues – such as education, inequality emanating from the high cost of living, and policies stemming from identity politics based on religious differences – that heighten polarisation. Such polarisation is fertile ground for the judicial-political shift towards autocracy.

Dan Ben-David and **Ayal Kimhi** examine the education fault line. They highlight trends in the Israeli education system that widen the gaps between different sectors in society. They find that approximately half of Israel's children receive a similar level of education to children in low-income countries, which is a particularly strong gap-creating force given that these children belong to the country's fastest-growing population groups. The flaws of the education system include low average levels of knowledge in mathematics, science, and reading among Israeli children compared with high-income countries and high levels of knowledge gaps in these subjects across the country.

Eran Yashiv looks at the cultural and religious segregation that occurs when groups within society socialise primarily with members of their own type. This manifests in educational institutions and social interactions that trigger political polarisation. He focuses on the fault lines created by demographic trends and forces of cultural-religious segregation, taking Israel as a case study. These demographic trends lead to the populist politics that gave rise to the judicial overhaul. The author analyses the economic ramifications of such reforms and the important role that Israel's resistance movement has played. The judicial reform has stalled due to strong public resistance and the unexpected war, and Yashiv also delves into the interaction between these two elements.

PART I

**JUDICIAL REGIME CHANGES:
COMPARATIVE ECONOMIC
PERSPECTIVES**

CHAPTER 1

Economics of regime change: An overview

Assaf Razin^{ab} and Efraim Sadka^a

^aTel Aviv University; ^bCEPR

1 INTRODUCTION

Israel is experiencing a deepening divide, as a coalition government teeters on a precarious electoral majority. This coalition comprises the Likud party, along with the Orthodox and the nationalist religious and Jewish supremacist factions. Their ideological stance contrasts sharply with the democratic norms upheld by major Western nations: the separation of powers, judicial autonomy, and the intricate web of political, civic, and social organisations cultivated since the Enlightenment.

Regime changes towards autocracy typically reshape the judicial framework, effectively eroding the separation of powers and leading a nation down an autocratic path. Recent instances of regime shift in Hungary, Poland, and Turkey offer templates of democratic erosion through manipulation and ‘democratic’ means. Although the manifestations of these patterns differ based on the distinct political, social, and historical contexts of each country, they invariably erode the rule of law and the democratic institutions.

Hungary’s Fidesz government (led by Viktor Orbán) engineered sweeping judicial alterations, diminished judicial autonomy, and weakened checks and balances. Likewise, Poland’s Law and Justice (PiS) party triggered concerns over reforms that seemingly compromised the separation of powers.

Israel’s proposed judicial revamp, spearheaded by a coalition government resting on a fragile electoral majority, introduces a distinct narrative. The primary objective is to recalibrate Israel’s judicial system, effectively blurring the lines of power separation and ushering in an era of potential autocracy.

Hungary and Poland both saw protests spring forth due to perceived encroachments on judicial independence. Citizens and legal experts alike fear that the executive and legislative branches might exert undue influence over the judiciary, potentially compromising its role as a check on governmental and legislative power. Civil society played a pivotal role in each movement.

In Israel, a protest movement has drawn backing from diverse demographic sectors, army reserve volunteers, high-tech experts, the medical association, the media, the academia, and a wide cross-section of civil society. Among the protesters are also prominent members of ex-constituents of the coalition government.

While the governments in Hungary and Poland often disregarded the protests and pushed forward with reforms despite both domestic and international opposition, the massive demonstrations in Israel, the country's strong civic institutions and the massive public uprising have, so far, had a restraining effect.

Poland's latest general elections point to a break in the eight-year rule of PiS, which has seen a drastic overhaul of Poland's democratic institutions and grave warnings that the country was lurching towards populist authoritarianism. The new coalition government will attempt to restore democratic norms in Poland and cooperate with Western European allies. However, the judicial overhaul laws that have already been legislated will be hard to reverse.

Israel's judicial overhaul, which started on 4 January 2023, was abruptly interrupted on 7 October 2023 with the eruption of the Gaza-Israel war. Will it be possible to resume such a fundamental regime change towards autocracy after the war?

2 DEMOCRACY CAUSES GROWTH

The growth engines that led the Israeli economy to a remarkable level (almost unprecedented among OECD economies) – the high-tech sector, core education, science, entrepreneurship, the welfare state, and the other social and economic features of liberal economies – all rest on a traditional consensus on a free and independent judicial system and liberal democracy. The 'economic miracle' of the 75-year-old Israel manifests itself in its transformation from a poor agricultural economy to a high-tech/industrialised one, well integrated into the world economy, with a GDP per capita in the top tier of OECD economies. All this is in peril now due to the ongoing political-judicial regime change.

Acemoglu and Robinson (2017) posit that a nation's institutions, whether inclusive or extractive, serve as fundamental determinants of its economic and political trajectory. Inclusive institutions, they contend, afford a broad spectrum of citizens access to economic and political opportunities with facilitated active involvement in decision-making. In contrast, extractive institutions concentrate power and wealth within a select few, often leading to stagnation and restrained economic prosperity. Acemoglu and Robinson assert that autocracies frequently give rise to extractive institutions that bestow advantages on a small sector while disadvantaging the broader population. This controlling group employs its influence to exploit the country's resources and sustain its elevated status, inhibiting innovation and constraining overall growth. Inclusive institutions, instead, cultivate innovation and economic expansion by fostering competition, safeguarding property rights, and incentivising investments in productive endeavours.

In their groundbreaking research, Acemoglu et al. (2019) focus on the question of whether democracy causes growth. Their analysis covers 193 countries over a period of 50 years, between 1960 and 2010. They compare the rate of growth (or decline) of GDP of countries with stable liberal democratic regimes with others that have switched from democracy to an illiberal theocratic regime. Because the study is based on a period of 50 years, it also includes countries that have moved back to a democratic regime, such as Chile after Pinochet and Greece after the removal of the regime of the generals who seized power in a coup. Also included in the analysis are countries of the former Soviet Union and the satellite states that have moved to a Western-type democracy, as well as countries that have retreated to an autocratic regime, such as Poland and Hungary. They find that democratisation has historically equipped countries to achieve faster economic growth within 5-10 years, reflecting increased investments in education, health, and other public services, and reduced social unrest. The authors also show that the level of economic corruption in democratic countries is much lower than in autocracies.¹

Some of the immediate effects of Israel's planned judicial overhaul were capital flight, depreciation of the currency, inflationary pressures, and a downgrading of the credit rating of the sovereign debt that filters into the entire financial system. The effect of the latter is not only seen in rising mortgage interest rates but also an increase in business and government interest payments. Another channel of influence is the banks' ability to provide credit to households and businesses, as their capital adequacy ratio deteriorates (the ratio between their equity and risk assets). The banks' risky assets (such as loans and bonds) become riskier, forcing them to hold more equity and/or to decrease their lending.

3 CRONY CAPITALISM AND RENT SEEKING

Political-economic rent seeking refers to businesses using the government to advance their own interests in exchange for electoral support. Crony capitalism refers to politicians and regulators using businesses to advance the interests of politicians and interest groups in a symbiotic relationship: the government creates rents and then distributes them to itself and favoured interest groups. Weakening judicial oversight enhances both rent-seeking behaviour and systems of crony capitalism.

As Acemoglu and Robinson (2017) and Acemoglu et al. (2019) indicate, a judicial overhaul that undermines the entire legal system weakens the protection of investors' rights and triggers corruption. The latter encourages businesses to divert economic resources in order to 'integrate' into the corrupt system, instead of directing their efforts to productive activities. Such a judicial overhaul has short-term effects, including capital flight that shakes the stock and bond markets. Even more significant are the long-term

1 In his literature survey in this volume, Barry Eichengreen indicates that democratisation and economic growth are positively correlated. Evidently, correlation does not necessarily indicate the existence of causality or its direction. 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.

effects. Shleifer and Vishny (1998) study the legal systems and their implications for the functioning of the financial systems in democratic countries. They explain how the legal system protects investor rights in public and private companies under Anglo-Saxon common law compared to the legal infrastructure of France and Germany (civil law). They demonstrate that even within Western democracies, the significant differences in legal systems affect the way the financial system functions, and thus entrepreneurship and innovation. In the Anglo-Saxon world, the dominant institution for raising capital is the stock market; in Germany and France, it is the banking system. In the Anglo-Saxon system, for example, it is common for shareholders to receive dividends because they can dismiss the directors of a company. Creditors receive repayment on loans because they have the legal power to reclaim the collateral. These practices are less common under civil law. Shleifer and Vishny's research underscores the importance of an independent and reliable judiciary for the proper functioning of the financial system. The latter is essential to promote entrepreneurship, industrialisation, economic development, and prosperity. In illiberal democracies or autocracies, the judicial system is even further away from the civil law system.

For example, the Czech Republic is a democracy with a clear separation of power, while in autocratic Hungary, Viktor Orban is pushing out German investors and promoting his favourites (crony capitalism). Hungary's economy lags that of the Czech Republic, even though both have been subject to similar external shocks. Hungary's credit rating is also lower than that of the Czech Republic.

4 ISRAEL'S VERSION OF PREFERENTIAL CRONY CAPITALISM

Nowadays, the Haredi population constitutes about 12% of the Israeli population. The poverty rate among the Haredi population is significantly higher than in the general population. At the same time, the annual growth rate of this group is 3.6%, far above that of the general population, which is a mere 1.9%. The typical large Haredi family depresses the income per family member, and there are many other factors that also reinforce the poverty status. First, confined in closed communities, the Haredi population strictly follow their spiritual leaders (the Rabbis), who direct their male youngsters to study the Torah. As a result, they have little, if any, market-oriented education and skills. To avoid the draft, men tend to continue to attend a yeshiva full-time after the age of 18. Furthermore, given their political influence in the Israeli coalition-type government, they receive monetary benefits that discourage work efforts. Consequently, there is an exceptionally low participation rate of Haredi men in the labour market, and those that do work engage mostly in low-skill and low-paying jobs. Haredi women are better educated, but given their high fertility rate, their participation rate in the labour market is still below that of non-Haredi women.

This demographic situation inflicts a heavy burden on the welfare state, both on the expenditure side and on the revenue side, due to the low tax payments by the poor Haredi population and amplified by the political pressure exerted in the Knesset by the Haredi parties. Furthermore, some of the benefits of the welfare state are channelled – directly or indirectly – towards the Haredi population, meaning the benefits are unequally distributed in favour of the Haredi population.

Given the demographic trends, the share of the Haredi population in the general population will rise sharply. In view of this rise and the associated increase in their political power, the burden on the welfare state will intensify and the distribution of the benefits will become even more tilted in favour of the Haredi population. Recently, the Knesset enacted provisions in the fiscal budget of 2023-2024 that further increased the benefits to the Haredi population. These provisions also increase the disincentives to work and enable Haredi schools to deny their students core subjects such as mathematics, English and the sciences. According to the former chief economist of the finance ministry, these policies will cut the GDP per capita growth rate by one-half (i.e., 0.8 percentage points) over a five-year period and will reduce tax revenues by 0.22% of GDP in 15 years.

These policies that favour certain segments of the population based on religion are likely to intensify if the ongoing political-judicial overhaul is made into a law, as a weakened judicial system will not be able to check this autocratic (and unjust) trend.

There are prominent examples of preferential treatment for certain segments of the population in Israel, particularly the Haredi community. First, the government reallocates a significant portion of the state budget towards Orthodox Jewish communities, including the Haredi population. This reallocation is often done to secure political support from Haredi parties in the Knesset, even though it disproportionately benefits a specific religious group.

Second, legislative manoeuvres are used to reroute food subsidies primarily towards the Orthodox sector. This preferential treatment can disadvantage single-parent families, the working poor, and those facing health-related challenges, as they receive fewer benefits compared to the Orthodox community.

Third, the Haredi community is often granted tax benefits and monetary benefits due to their political influence in the Israeli coalition-type government. As discussed above, these benefits can discourage work efforts and contribute to an exceptionally low participation rate of Haredi males in the labour market.

Fourth, Haredi schools may receive special funding that allows them to deny their students core subjects like mathematics, English, and sciences. This preferential treatment in education funding can lead to disparities in educational opportunities and hinder the long-term economic prospects of Haredi students.

A pending law within the judicial overhaul package aimed at weakening the independent standing of legal advisors in various government entities and public organisations is a pathway to crony capitalism. This legislative shift would enable the government to tailor government tenders and contracts to its close associates, which could lead to cronyism and favouritism in the allocation of public resources.

These examples illustrate how crony capitalism and preferential treatment for specific religious or political groups can result in unequal distribution of resources and opportunities within a society, ultimately impacting economic growth and the welfare state.

5 FOREIGN DIRECT INVESTMENT, TECHNOLOGY, AND ENTREPRENEURSHIP

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 endeavours.

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 ecosystem.² 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 utilising 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

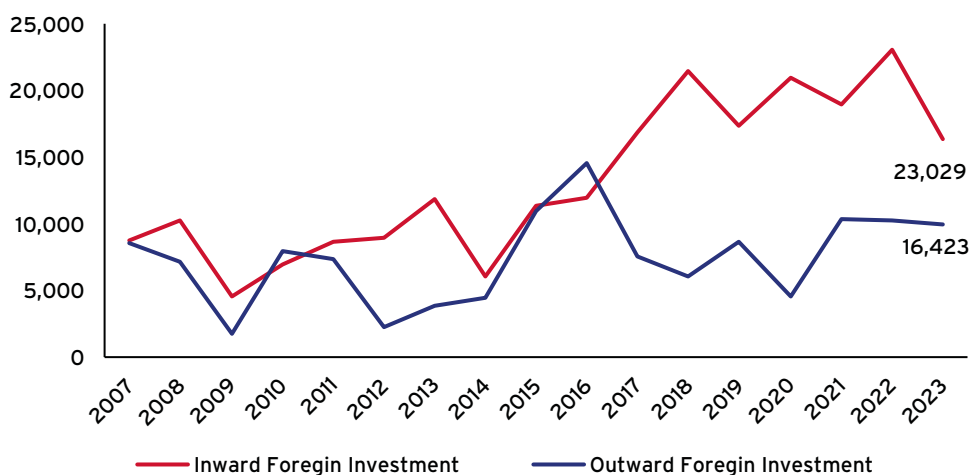
2 See Loungani and Razin (2001) and Razin (2018a) for the role of FDI and venture capital in promoting the hi-tech sector.

homegrown capital formation being inadequate to foster innovation. FDI, in the form of venture capital in the initial phase of a startup and foreign acquisition of the developed innovation, has been essential.

Israel's prowess in high-tech innovation since 2007 is reflected in the widening gap between outflows and inflows of FDI (Figure 1). 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.

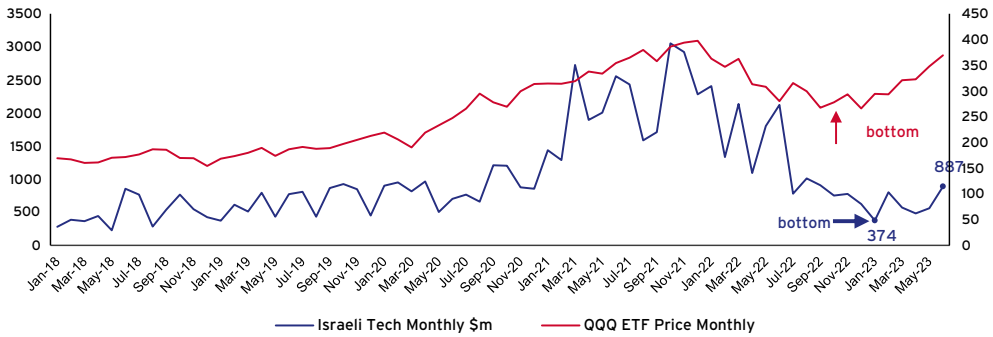
While part of the drop of FDI is attributable to the global recession in high-tech industries, Figure 2 demonstrates that the high-tech recession in Israel has been more severe than the global high-tech recession and that it started later (closer to the announcement of the judicial reform). Specifically, 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 programme. The exchange-traded fund shows a much quicker and larger surge than Israeli tech funding.

FIGURE 1 FDI IN ISRAEL BETWEEN 2007-2023: INFLOWS AND OUTFLOWS (US\$ BILLIONS)



Source: Bank of Israel and UNCTAD.

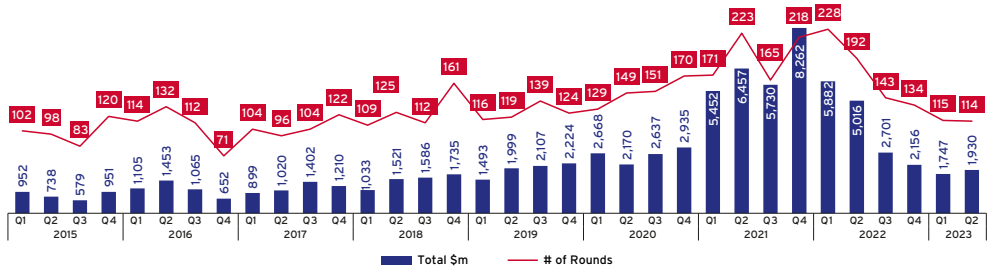
FIGURE 2 NASDAQ 100 VERSUS ISRAELI FUNDING AMOUNTS, 2018 TO H1/2023, MONTHLY SCALE (US\$ MILLION)



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 3 VENTURE CAPITAL INVESTMENT, QUARTERLY (US\$ BILLIONS)



Source: IVC.

In general, foreign direct investors are the most sensitive to a judicial overhaul that weakens property rights. As foreigners, they may be the first target of protectionist policies of the new regime. The case of the effect of Israel's judicial reform on foreign direct investors is therefore insightful.

6 PUBLIC RESISTANCE

Public sentiment towards protest movements varies. Prominent examples of public protests include Tiananmen Square in China, the Prague Spring protest, Hong Kong's Umbrella protests, and the Arab Spring uprisings – which were all suppressed. However, the Prague Velvet Revolution and the Polish Solidarity anti-authoritarian protests had notable success (Cantoni et al., 2023).

Hungary, Poland and Israel all saw protests spring forth due to perceived encroachments on judicial independence. Citizens and legal experts alike feared that the executive and legislative branches might exert undue influence over the judiciary, potentially compromising its role as a check on governmental power.

Yuchtman (2023) delves into the profound implications of the Israeli government's challenge to judicial independence, focusing on two pivotal questions. First, he explores why such a challenge posed a significant threat to the fabric of a liberal, democratic society. Second, he investigates the motivations behind the robust street protests mounted by opponents of the judicial overhaul. The crux of the matter lies in recognising the paramount role of *de facto* power in shaping the intricate components of a democratic system, and thereby safeguarding the essence of a democratic society. Beyond the hallmark of elections, liberal democracies thrive on a complex interplay of formal and informal institutions, governmental bodies, non-governmental organisations, laws, and norms. Understanding the interdependence of these complementary elements is essential in deciphering the conflict surrounding Israel's institutions and comprehending the specific manifestation of this conflict.

Societal mobilisation typically encompasses the broad involvement of the entire society, especially non-elites, in the political sphere. The capacity for coordination and mobilisation through protests within civil society is a direct result of invested *de facto* power. This insight holds promise for opposition movements within Israel, particularly as the conflict surrounding the institutions unfolds. Mass movements not only reveal the prevailing norms but also signal the nature of future mobilisation, creating a formidable challenge for future governments to legislate against these norms or for judges to erode them.

Civil society played a pivotal role in each movement. Protests and rallies transformed into platforms for citizens to voice their apprehensions and demand the rule of law be upheld. Grassroots organisations, legal associations, and concerned individuals coalesced to counter perceived threats to the integrity of the judiciary.

These movements did not just capture domestic attention, they resonated on an international scale. EU institutions, human rights groups, and global legal entities expressed concern over the changes and their implications for democratic norms and the rule of law.

Public sentiment regarding protest movements varied, however. In Israel, the movement drew backing from a diverse demographic, including army reserve volunteers and a wide cross-section of civil society. Hungary and Poland's movements garnered widespread support from those who saw these reforms as threats to democracy. These steps met with protest movements of various degrees.

Hungary's protest movement encountered hurdles in reversing the changes, hampered by the ruling party's entrenched position and limited avenues for legal recourse. This scenario accentuated concerns about democratic regression and the erosion of checks and balances.

Judicial reforms by Poland's PiS government sparked clashes with EU bodies and triggered Article 7 procedures, underscoring the potential fallout from undermining the rule of law within the EU.³ Despite opposition, the government pressed on with reforms, raising questions about the EU's ability to enforce democratic norms among member states. Nevertheless, the EU had a restraining effect on the judicial overhaul. Unfortunately, no such safeguard applies to Israel.

Hungary and Poland encountered more forceful government responses to protests, often disregarding concerns and pushing forward with reforms despite both domestic and international opposition. In contrast to both Hungary and Poland, the massive demonstrations in Israel, its strong civic institutions the massive public up-rise, had such a restraining effect. In contrast, Israel's proposition prompted robust resistance within the nation's democratic structures, with the outcome still uncertain.

7 EXTENSIONS

The fundamental drivers of political polarisation in Israel are still in force.

Economic disparities and inequality

Economic disparities, coupled with a sense of economic insecurity, can foster resentment and animosity between different socioeconomic groups. When people feel economically marginalised, they are more susceptible to radical ideologies and are often drawn towards political movements that promise economic reform. In 2011, Israel witnessed high cost of living and economic inequalities.⁴ Manuel Trajtenberg, who chaired the public reform committee which followed the protest, writes:

“Some measures were taken, such as free and universal education for young children and empowerment of the anti-trust authority, other critical issues like housing costs and ‘hidden taxes’ remained unaddressed. The current government’s approach of reducing the state’s role in supplying public goods and services, coupled with the impact of judicial reform on currency depreciation and rising consumer prices, is expected to exacerbate the high cost of living issue.”

3 Article 7 of the Treaty on European Union is a procedure allowing the suspension of certain rights for a member state if one or more of the EU's founding values are being breached (those include respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights). On 12 September 2018 the European Parliament voted for action against Hungary based on Article 7, and on 20 December 2017 the European Parliament triggered Article 7 in relation to the Polish judicial reforms.

4 The movement, which became known as the 'Israeli social justice protest', drew widespread public support and led to large-scale rallies across the country.

Disparities in quality of, and access to, education

Evidently, one of the primary factors contributing to the link between education and polarisation is the disparity in the quality of education and access to educational resources. Socioeconomic disparities often result in uneven access to quality education. When certain groups lack access to educational opportunities, it perpetuates a cycle of ignorance and limited exposure to diverse perspectives. This lack of exposure can lead to the entrenchment of existing beliefs and attitudes, deepening ideological divisions. A general low level of education and a high level of educational inequality are fertile grounds for populist policies and illiberal shifts. Ben-David and Kimhi (2023) show that Israeli students, and teachers, have consistently been ranked in the lowest tranche of developed countries in literacy, mathematics and science international exams. Within-country knowledge gaps in these subjects are highest in Israel.

Ethnic, cultural, and religious segregation

Deep segregation – between Orthodox and seculars, the periphery and centre, Sephardic and Ashkenazi Jews, and Arabs and Jews – drives political polarisation. Cultural and secular-religious segregation occurs when these groups within a society socialise primarily with members of their own type. It is reflected in residential patterns, educational institutions, and social interactions. Yashiv (2023) observes that the demographic growth of the religious population in Israel, together with populist politicians, is a driver of emerging illiberal democracy in the country.

Identity politics

The practice of organising political movements and shaping political agendas based on shared characteristics such as race, gender, sexual orientation, religion, or nationality has become a significant driver of political polarisation in contemporary societies. While identity politics can empower marginalised communities and raise awareness about social injustices, when used cynically it can result in enhanced polarisation.

Social media and echo chambers

The rapid advancement of technology, particularly the proliferation of the internet and social media, has transformed the way people access information, communicate, and engage in political discourse. While technology has the potential to connect diverse voices and foster understanding, it has also played a significant role in deepening political polarisation. Szeidl and Szucs (2023) explore the role of the media and the information-propaganda sphere. They discuss the Hungarian experience, and emphasise the importance of false alternative realities and conspiracy theories that are disseminated as government propaganda. They demonstrate how the Hungarian government captured independent media and turned them into vehicles of propaganda; how the captured media disseminated false alternative realities in order to discredit criticism from independent

experts and institutions; how these alternative realities succeeded in reducing trust in experts and institutions, helping the regime; and how this erosion in trust lead to lower quality decision-making in society (for example, related to COVID-19).

The intersection of illiberal democracy, political polarisation, and socioeconomic disparities presents a complex and interconnected set of economic research challenges.

CHAPTER 2

Judicial independence and economic prospects

Barry Eichengreen

University of California, Berkeley and CEPR

Unlike some other contributors to this volume, I regard the relationship of democracy to economic growth as unsettled. It is unsettled for four reasons.

First, there are *prima facie* grounds, based on what is referred to in political science as ‘modernisation theory’, for thinking that causality runs both ways. Democratisation can affect growth, but growth can also affect democratisation. Past growth leading to higher current incomes is positively associated with democratisation. Showing that democratisation and economic growth are positively correlated does not necessarily establish that democracy is good for growth.

The literature on modernisation has shown that economic growth can affect democratisation and vice versa. In a pioneering study that defined the concept, Lipset (1959) found a positive impact of economic and social development on democratisation.¹ Barro (1999), in an econometric study of over 100 countries, found that “improvements in the standard of living predict increases in democracy, as measured by a subjective indicator of electoral rights”. Wucherpfennig and Deutsch (2009) survey the vast subsequent literature, concluding that, while findings differ, “most studies do find a positive relationship” running from modernisation and economic development to democratisation.

Second, democracy is intrinsically difficult to measure. Democracies come in different flavours (presidential, parliamentary, etc.) and feature different electoral systems (proportional representation, first past the post, one round, two round, etc.). Whereas some studies focus on legislative selection and effectiveness (Is the legislative body elected? Is the legislature a rubber stamp?), others focus on electoral competitiveness (What kind of political parties are allowed? How competitive is the party system?). Geissel et al. (2016) enumerate and compare more than a dozen different measures that purport to capture the quality and extent of democracy. The absence of an estimated

¹ Boix (2003) remarks that, aside from Duverger’s law on the effect of single-member districts on party systems, Lipset’s point “may be the strongest empirical generalization we have in comparative politics to date”.

effect of one of these measures may indicate that democracy doesn't matter for the economic outcome of interest, or it may just mean that the investigator is focusing on the wrong measure or aspect of democracy.

Third, appropriate structural specification of the causal relationship is uncertain. Some investigators assume that the impact of democracy on economic performance is the same in all settings, while others entertain the possibility it has different effects in, inter alia, low- and high-income countries. Some assume that the impact of changes in the level of democracy are linear, while others posit that the effects on growth may be positive at low initial levels of democracy but turn negative at higher levels. Similarly, the timing of any impact of democracy on economic growth is uncertain. Should we think that the political system prevailing at a point in time affects economic performance at that same point in time? Or is it more plausible that effects show up with a lag? Is the extent of democratisation now or at a specific point in the past the key determinant of economic growth, or should we instead consider cumulative effects of democratic experience (how many years a democracy), similar to how economists think about the effects of education? Can we vest confidence in simple cross-section comparisons of growth experience in countries with different political systems, given how cross-country comparisons at a point in time are prone to omitted-variables bias and unobserved heterogeneity problems? Should we believe panel-based studies focusing on the change in growth following a transition to or from democracy, when such transitions may in fact be endogenous to the state of the economy? Many observers will have strong opinions on whether democracy is good, bad or indifferent for growth. But these methodological issues raise questions about whether those opinions are firmly grounded in evidence.

Select studies from the (very large) empirical literature on democracy and growth illustrate this third point. An article by Barro (1996) with over 5,000 Google cites considers about 100 countries from 1960 to 1990 and finds a weakly negative impact of democracy on growth. Although Barro distinguishes three periods (1965-75, 1975-85 and 1985-90), whether these regressions control adequately for other country characteristics can, to put it politely, be questioned. Acemoglu et al. (2019), in contrast, consider a full panel of annual observations for an analogous set of countries and argue forcefully that transitions to democracy are associated with accelerations of growth. Yet Ruiz Pozuelo et al. (2016) question the treatment of such transitions as exogenous or as a simple function of past economic growth. When they use prior knowledge to classify transitions to democracy as endogenous or exogenous and focus only on exogenous transitions, they find no evidence of an effect of democracy on economic growth.²

2 Gerring et al. (2005) assert that "[t]he predominant view is that democracy has either a negative effect on GDP growth or no overall effect". They note also some studies that find a positive relationship but submit that "this is not the standard finding". They then go on to present additional evidence in favour of this nonstandard finding.

Fourth, the theoretical literature is ambiguous about whether democracy is good, bad or indifferent for economic growth. Some models specify channels through which democracy has positive effects on growth. It is assumed that investor rights are better protected when investors have political agency; financial markets are deeper; investments in education are greater; democratic institutions provide checks on government power, limiting the ability of officials to amass personal wealth at public expense; political competition enabled by democracy acts as a solvent of corruption.

Other models posit that the main political activity in democracies is redistribution. Interest groups in democracies struggle over the distribution of income and wealth, often emphasising rich-to-poor redistribution, with negative implications for investment and growth. Where democratic elections are contested and parties alternate in power, unstable policies lead to unstable economies and poor economic performance. Lobbying by competing interest groups under democracy may produce policy gridlock or result in excessive government consumption that hinders growth. Wealthy individuals may be able to buy or bribe voters and reinforce the economic and political position, hindering economic development as a whole. As Barro (1996) concludes, “the net effect of democracy on growth is theoretically inconclusive”.

Different authors have built different models equally consistent with these different presumptions. Rivera-Batiz (2002) specifies and analyses a general equilibrium endogenous growth model in which stronger democratic institutions influence governance by constraining the actions of corrupt officials, which in turn stimulates technological change and spurs economic growth. Acemoglu and Robinson (2006, 2008) specify and analyse a theoretical model in which democracy leads to improvements in institutional quality but only in environments characterised by low inequality. Sirowy and Inkeles (1990) sum up the point as follows: “Competing theoretical models have been proposed that represent each of the possibilities: democracy as facilitating development, democracy as a hindrance to development, and democracy as bearing no independent relationship to development outcomes”.

Thus, I conclude that there are good reasons why the connections between democracy and economic performance are contested.

In contrast to the relationship of democracy to economic growth, I regard the relationship of judicial independence to growth as unambiguous. For one thing, judicial independence is a narrower concept than democracy. This makes it easier to conceptualise and measure precisely.³ For another, the literature is replete with theoretical arguments for why judicial independence should have a positive impact on economic outcomes but – in contrast to the literature on democracy more generally – few, if any, arguments for

3 Typically, measures focus on barriers to changing judicial procedure, processes for appointing justices, judicial tenure, renewability of terms, discretion in determining judges' salaries, adequacy of pay, accessibility of the course, discretion of the chief justice in allocating cases, and requirements for courts to publish their decisions and underlying reasoning. Klermen (2006) similarly concludes that judicial independence “is relatively easy to measure...”.

why the effects should be negative. Finally, whereas studies of the economic impact of democracy using different measures and methods reach conflicting conclusions, the literature on the effects of judicial independence, while more limited, is much more consistent in its conclusions.

As Klerman (2006) summarises, “[g]ood, independent courts enforce contracts and protect property, and by doing so encourage the investment which is critical for economic development”. Courts intervene to prevent hold-up problems by counterparties with market power and to prevent arbitrary expropriation by governments with political power. Voigt et al. (2015) and many others argue that independent courts are critical for adjudicating conflicts between the government and citizens: courts check whether representatives of the state have followed procedures designed to safeguard the rule of law. They are further critical for arbitrating conflicts between branches of government, in whose absence policy is apt to be thrown off course. Along all these dimensions, courts turn promises into credible commitments that the letter of the law will be followed (that ‘rule of law’ will prevail). Note how, in contrast to arguments about the links running from democracy to economic growth, all of these arguments about links running from judicial independence to growth run in the same (positive) direction.

What is the evidence? Feld and Voigt (2003) and Voigt et al. (2016) are the fundamental studies here: they find 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.⁴ LaPorta et al. (2004) find a strong positive effect of judicial independence on economic freedom, strength of property rights, and a number of related variables. Islam (2003) finds that a stronger judiciary is associated with more rapid growth of small firms in particular. Bove and Elia (2017) analyse data for a sample of EU member states and find a positive and generally significant effect of judicial independence on value added, value added per worker, business dynamism and other measures of economic vitality. Faruque (2021) analyses an annual panel of South and Southeast Asian countries since 1990 and finds a strong positive effect on inward FDI, even after controlling for, inter alia, strength of property rights protection. Klerman and Mahoney (2005) analyse changes in judicial independence over time in 18th century England and find that strengthened independence is positively associated with equity market valuations (their measure of economic health).⁵ Notice again that all these estimated effects are in one direction: positive from an economic point of view.

Nor is China an exception. Whereas earlier literature had pointed to China as an economy that had developed successfully without an independent judiciary, Liu et al. (2022) show that the staggered rollout of judicial independence reform in China since 2014 had strong

4 The authors distinguish *de jure* independence, which can be constructed on the basis of legal provisions, from *de facto* judicial independence, which they construct from answers to questionnaires administered to experts.

5 Moreover, the thrust of the historical literature on judicial development in 18th century England is that legal changes are largely exogenous with respect to the equity market.

positive economic effects. This reform removed local governments' control of local courts' financial and personnel decisions. The authors find that smaller non-local firms were better able to win judicial redress from larger politically connected local defendants. The result was 8% more inward investment into reformed localities, and the potential of increasing China's GDP by 2.3% if the reform was implemented nationwide.

To be sure, certain other problems manifest in the literature on the economic effects of democracy crop up in this narrower context as well. Causality can be difficult to pin down – there are good reasons to think that as countries develop economically, they acquire the resources needed to build stronger and more independent judiciaries (Klerman, 2006). Judicial independence may be easier to measure than democratisation, but disagreements over measurement nonetheless remain (e.g., Rios-Figueroa and Staton, 2012). There is room for further research, as always. Still, I regard the presumption that judicial independence has positive effects on growth as strong.

I conclude on this basis that countries seeking to maintain economic stability and prosperity tamper with judicial independence at their peril.

CHAPTER 3

The short-run impact of the judicial overhaul on Israeli financial assets

27

Itai Ater,^{a,c,d} Itzhak Tzachi Raz^b and Yannay Spitzer^{b,d}

^aTel Aviv University; ^bThe Hebrew University of Jerusalem; ^cIsraeli Democracy Institute; ^dCEPR

The plan for a judicial overhaul in Israel, announced on 4 January 2023, sent shock waves through Israel's financial markets. In this chapter, we document two important, substantial, and relatively easy to identify effects that are plausibly attributed to the judicial overhaul: currency depreciation and under-performance of the stock exchange. The identification of the magnitude of the effects is enabled by particular features of Israeli financial markets, namely, their domination by a small number of major players (institutional investors) and the close dependence on US financial markets. In particular, we show that the S&P 500 index can be used to derive precise predictions of both the exchange rate between the Israeli shekel and the US dollar and of the leading indices of the Tel Aviv Stock Exchange, and thus form a counterfactual against which the effects of unusual local events can be assessed. This simple methodology yields estimates of a 20% excess depreciation in the value of the Israeli currency as well as a 25% loss in the value of Israeli stocks. While we interpret these effects as ominous symptoms for a future ailing economy rather than a reflection of current economic crisis, the loss of wealth they imply amounts to hundreds of billions of shekels – a devastating blow to the welfare of Israeli households that has already materialised.

EXCESS CURRENCY DEPRECIATION

To estimate the extent of excess depreciation of the shekel (NIS) against the US dollar (USD) since the judicial overhaul was announced in January 2023, we rely on the strong short-run correlation that exists between the S&P 500 index and the USD/NIS exchange rate. In the past ten years, the opening of Israeli forex-neutralised funds – those that invest in foreign indices and hedge this investment against volatility in the USD/NIS exchange rate – has become immensely important. To hedge their exposure to foreign capital markets – foremost the US market and above all the S&P 500 – the funds must make large-scale purchases of NIS whenever the foreign indices rise and, conversely, sell NIS when they fall. This phenomenon, coupled with the growing amounts of capital that these funds manage, has created a negative and very strong short-run correlation between the S&P 500 and the USD/NIS exchange rate (Ben Zeev and Nathan, 2022). Thus, the short-run correlation between the index and the USD/NIS exchange rate is so strong

that one can use it to identify, with a high degree of certainty, aberrant NIS depreciation or appreciation events. It follows that we can employ it to estimate the extent of excess depreciation of the NIS against the USD since the judicial overhaul became known.¹

To substantiate the strength of this statistical relationship, let us focus on the period from January 2022 to early October 2023 (Figure 1). Until the beginning of 2023, the USD/NIS exchange rate closely tracked a downward-sloping curve relative to the S&P 500 index. On the basis of 2022 data, the standard deviation of the daily residuals from the predicted exchange rate was only 1.3 log points (!), the equivalent of 4.5 agorot.² In other words, given the S&P 500, one could predict the USD/NIS rate with an error of no more than 8 agorot on around 90% of days, with hardly a day with a larger error than 10 agorot.³

As one may also see in Figure 1, the tight curve that prevailed in recent years was breached outward in late January 2023, coinciding with the stepwise increase in concern about the economic risks associated with the judicial overhaul. In particular, it was in the last week of January 2023 that the former governors of the Bank of Israel issued their warning and hundreds of economists in Israeli academia and dozens of former directors general of economy-related government ministries signed the 'Economists' Letter'. Such a deviation from the curve is highly uncommon and we are unaware of any evident reason for it to have happened just then other than the turmoil surrounding the judicial overhaul.⁴ In fact, in the past five years, such breaches took place only twice and for obvious reasons in both cases: first for only two days at the peak of uncertainty surrounding the eruption of the COVID-19 pandemic (17–18 March 2020) and again when the Bank of Israel revised its policy on purchasing foreign currency (January 2021). Thus, the depreciation in early 2023 was unusual and rapid relative to the longstanding pattern.

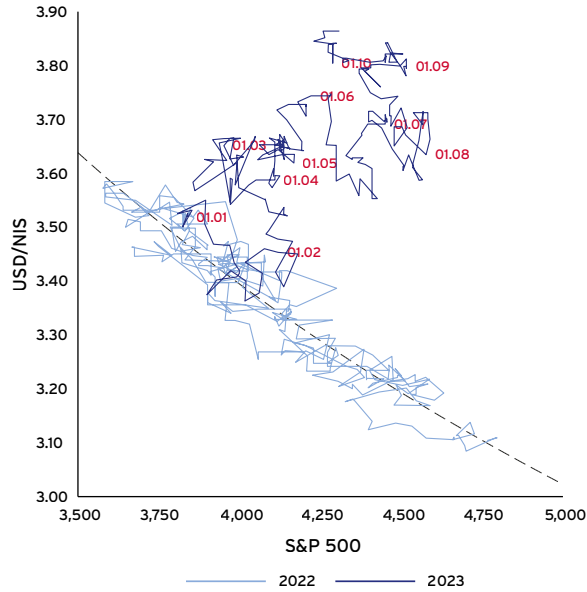
1 At the more fundamental level, excess currency depreciation is attributable to a shock to Israel's asterisk-adjusted country risk premium, which is captured by the risk-adjusted interest parity arbitrage condition (Krugman et al., 2021, Chapter 14). Our approach is descriptive and does not account for the full complexity of the determination of exchange rates, but since the patterns we document are striking, we choose to trade off analytic rigor for simplicity. In particular, the interest rate spread between US treasuries and Israeli NIS-denominated bonds was approximately fixed throughout the period, as both rates increased almost simultaneously and at a similar pace. Therefore, accounting for this spread does not affect the results.

2 An agora (pl. agorot) is 1/100 of a new Israeli shekel; during the period of interest, it was equivalent to 0.25–0.3 US cents.

3 To fix ideas, in January 2023 one dollar was equal to about 3.3 shekels (330 agorot).

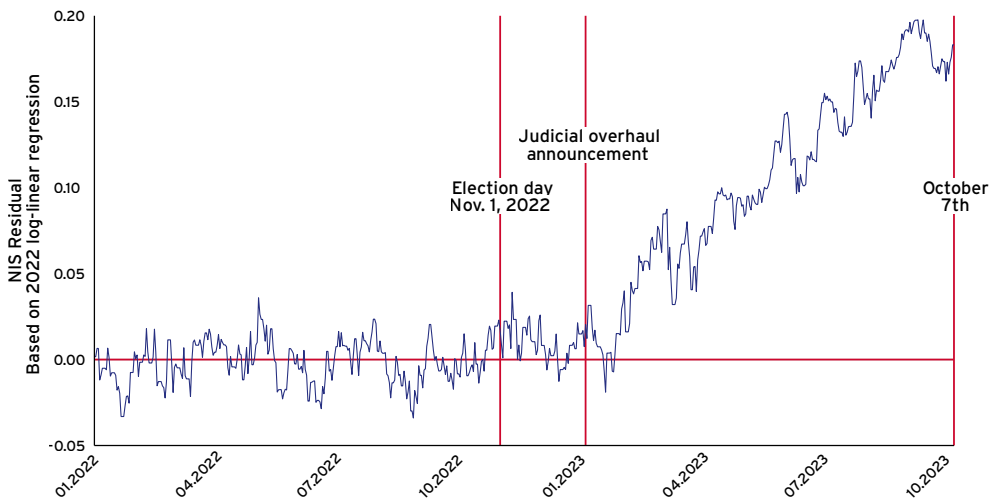
4 In the past year, for example, the Israeli and US central banks raised their rates, but the upturns were foreseen, gradual and, more importantly, almost concurrent in both markets. Similarly, there was no sudden intervention of the Bank of Israel in the foreign exchange market, as the Bank's reserve did not undergo an unusual change during that time. Therefore, these factors cannot explain the steep depreciation of the NIS relative to the forecast based on the S&P 500 index.

FIGURE 1 RELATION BETWEEN THE S&P 500 AND THE USD/NIS EXCHANGE RATE SINCE EARLY 2022



Note: This figure plots the USD/NIS exchange rate against the S&P 500 index on each day during 2022-23. The first day of each month in 2023 is labelled. The dashed line represents the predicted exchange rate based on a log-linear regression on 2022 data.

FIGURE 2 EXCESS NIS DEPRECIATION



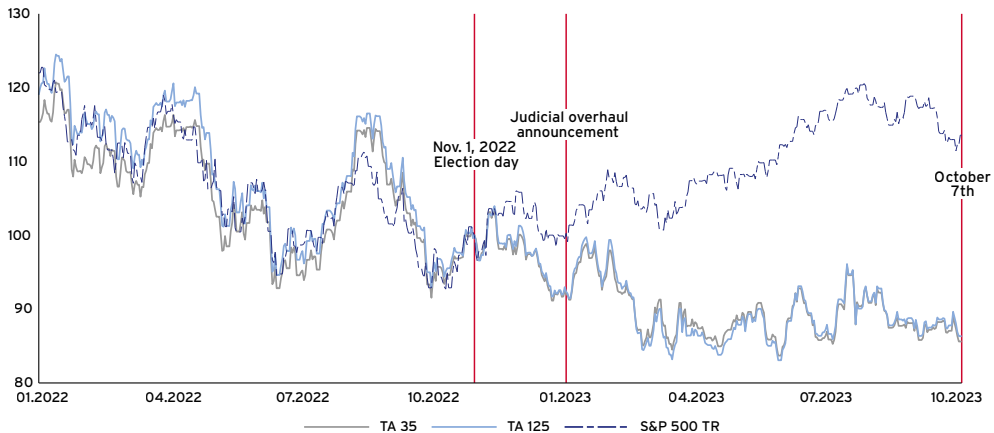
Note: Excess depreciation is the difference between the USD/NIS exchange rate and its predicted value based on log-linear regression on 2022 data, as a ratio of the predicted exchange rate. For example, on 8 September 2023 the actual exchange rate was 3.842, whereas the predicted exchange rate was 3.209, and therefore excess depreciation was $\frac{3.842-3.209}{3.209} = 0.197$.

The ‘errors’ relative to the forecasts, based on the regression coefficients for 2022, are plotted over time in Figure 2. Until the end of January 2023, the absolute value of excess depreciation was almost always smaller than 2%. Since then, however, excess depreciation has been rising persistently, reaching 20% by early September 2023; by that time, the predicted USD/NIS exchange hovered around 3.19–3.23, while the actual rate was more than 60 agorot higher (NIS 3.80–3.85).

YIELD SPREADS IN THE EQUITY MARKETS

The performance of the Israeli stock market gives another perspective on Israel’s capital outflow. As in the case of excess depreciation of the NIS, we use the strong short-run correlation between the US and the Israeli stock indices in order to detect excess negative returns of Israeli stocks. Figure 3 juxtaposes the time trend of the S&P 500 and that of the TA 35 and TA 125 – the latter two converted into US dollar terms and all indices normalised to 100 on the most recent election day (1 November 2022).

FIGURE 3 THE TEL AVIV AND S&P 500 INDICES



Notes: The values of the TA 125 and TA 35 indices and the American S&P 500 index are normalised to 100 on election day (1 November 2022). The three indices trended almost identically until election day; afterwards, the Israeli indices and the US index parted ways. The spread widened steadily until the end of the sample period in early September 2023.

Up to the end of 2022, the Tel Aviv indices tracked the US index with exactitude, with few deviations and no drift. In fact, what we have here is an almost perfect pre-trend that allows us to hypothesise that, absent shocks, the Israeli indices would have continued on the same path as their American counterparts. Shortly after election day, however, the trends decoupled, with the Tel Aviv indices branching away from the S&P 500 with remarkable vigour. By early September 2023, the TA indices were underperforming by 25–27% relative to the comparison index, which, in our judgement, approximates the counterfactual scenario absent the political shocks of recent months (12–14% loss of value in USD terms as against a 15–18% increase in value in the US index). The underperformance reflects not only the NIS-denominated slump of the Israeli indices

but also the currency depreciation that occurred. In other words, an investor who bought Israeli stocks on election day would be left at this writing with 27% less in USD terms than an investor who invested the same sum in US stocks on the same day.

CONCLUDING THOUGHTS

In this short chapter, we document two large changes in the value of Israeli financial assets. We attribute these changes to the judicial overhaul that was advanced by the new government starting in January 2023. Our interpretation is that these changes stem mainly from expected long-run damage to the Israeli economy. In other words, the judicial overhaul lowered investors' expectations regarding the performance of the Israeli economy in the long and medium run. That said, at the present writing, the coalition appears unable to fully realise its schemes in the near future. If so, could some of the short-run damage already sustained be repaired? And could the long-run damage be avoided? There is reason to fear that the answer to both questions is negative. The sweeping one-sided move to pass the judicial overhaul into law without trying to anchor it in broad consent broke the unwritten rules of the political system, those that define how comprehensive changes such as these should take place. Therefore, even if a short-run compromise is found, there is reason to fear that future political alignments will again try to apply a similar reform, this time successfully. Accordingly, when foreign investors consider whether to place their money at long-run risk and tether its fate to that of the Israeli economy, they will take into account the possibility of material and fundamental change in the business environment and the statutory framework in which they operate.

On the other hand, the events of the past few months have demonstrated the strength of Israel's civil society and its willingness to defend democratic values and, through them, to bolster its long-term economic outlook.⁵ Insofar as Israel's civil society power persists and even grows, it will be possible to assume, cautiously, that some of the damage already inflicted on the Israeli economy may be reversed.

5 For instance, according to Moody's in-depth report on the Israeli economy from 20 November 2023: "The strength of civil society and the judiciary is scored at "a", with civil society having emerged as a highly effective check on the exercise of government power in the context of the government's judicial overhaul plans" (www.moody.com/credit-ratings/Israel-Government-of-credit-rating-423305/).

PART II

***DE FACTO* POWER AND THE FOURTH BRANCH OF POWER**

CHAPTER 4

Fight fire with fire: The erosion of Israel's democracy and the popular response

Noam Yuchtman

University of Oxford and CEPR

1 INTRODUCTION

In January 2023, Israeli Prime Minister Benjamin Netanyahu's government announced proposals for a wide-ranging reform of the nation's judiciary, viewed by commentators as plans to "effectively eliminate the independence of Israel's high court".¹ This reform was immediately seen as representing a threat to Israel's democracy; Aharon Barak, former Chief Justice of Israel's Supreme Court, predicted that "[t]he result will be a nation without true separation of powers, without checks and balances, a country that effectively has only one authority — the government — which controls the Knesset and indirectly that judicial system".²

Soon thereafter, Israel saw the start of a series of protests. The first organised protest on January 7 drew 20,000 participants;³ weekly protests attracting upwards of 100,000 people were sustained over several subsequent months.⁴ Popular opposition to the reform was reflected in the business community. A *Haaretz* headline summarises: "Foreign Investors Flee Israel: 'Decide if You're a Democracy or a Dictatorship'".⁵

Nonetheless, the Netanyahu government moved forward with planned reforms. One of the bills making up the reforms, eliminating the possibility of judicial review on the basis of an "unreasonableness" standard, was passed by the Knesset in July. However, the judicial reform process was paused (perhaps halted) by the horrific terrorist attacks carried out in Israel on 7 October and the subsequent, also horrific, campaign in Gaza by the Israeli Army.

While the armed conflict occupies public attention at this moment, Israel's institutional crisis may, in time, return to the fore. Its outcome will determine the political and economic future of the nation. If Israel slides into autocracy, the consequences will be

1 "Netanyahu Is Shattering Israeli Society", *New York Times*, 28 February 2023.

2 "Ex-chief justice Barak: Government's judicial reform plan 'will strangle democracy'", *Times of Israel*, 6 January 2023.

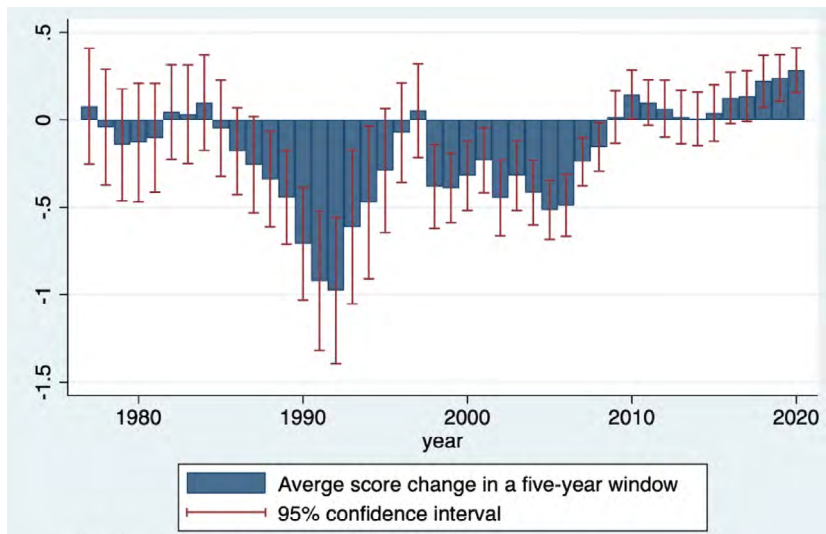
3 "Thousands March in Tel Aviv in Protest of Netanyahu's Far-right Gov't, Judicial Overhaul", *Haaretz*, 7 January 2023.

4 See, for example, "Over 200,000 protest judicial reform across Israel for 21st weekend", *Jerusalem Post*, 27 May 2023.

5 "Foreign Investors Flee Israel: 'Decide if You're a Democracy or a Dictatorship'", *Haaretz*, February 12, 2023.

felt globally, by further polarising a volatile region and undermining Israel's economic position as a global information technology hub. It is thus extremely important to analyse the government's proposed judicial reforms and the opposition's response in order to understand Israel's political and economic trajectory. But such an analysis also sheds light far beyond the Israeli case, helping us understand the backsliding of democracy observed more generally over the last ten years (see Figure 1) and the continued importance of popular protests in preserving political rights (e.g., Tufekci, 2017).

FIGURE 1 CHANGES IN GLOBAL AVERAGE FREEDOM HOUSE SCORES: NEGATIVE VALUES ARE MOVEMENTS TOWARD FREEDOM AND POSITIVE VALUES MOVEMENTS AWAY FROM FREEDOM



Notes: Figure shows five-year rolling global average changes in Freedom House scores. Negative values mean changes towards freedom. Positive values mean changes against freedom.

Source: Callen et al. (2023).

This chapter will ask, first, why was the Netanyahu government's challenge to the independence of the judiciary such a threat to liberal, democratic society? Second, why did Netanyahu's opponents respond with street protests? The answer to both questions is rooted in the importance of *de facto* power in shaping the complementary pieces of the democratic system, and thus the preservation of a democratic society.

Liberal democracies survive because of institutions that range beyond the elections that are their hallmark. Formal institutions and informal institutions; government entities and nongovernmental organisations; laws and norms – all play a role in sustaining a liberal, democratic society. Appreciating the role of the complementary pieces that hold democracies together helps us understand the conflict over Israel's institutions and why that conflict has taken the precise form it has.

2 DEMOCRATIC INSTITUTIONS AND THE IMPORTANCE OF *DE FACTO* POWER

Acemoglu and Robinson (2019) describe a liberal, democratic polity as existing within a “narrow corridor” in which states are governed by a “shackled Leviathan”. Where does such a government come from? It requires far more than devising a special set of written, formal institutions. Acemoglu and Robinson describe the shackled Leviathan as standing on two pillars. The first pillar is a strong state:

First there must be a set of individuals or groups in society, our state builders, to push for a powerful state, which will work to put a stop to the Warre “of every man, against every man,” help resolve conflicts in society, protect people from dominance, and provide public services. (Acemoglu and Robinson, 2019, p. 49).

The second pillar is a strong civil society that prevents the strong state from developing into despotism:

The second pillar of the Shackled Leviathan, societal mobilization, is even more critical because it is the essence of the Red Queen effect. By societal mobilisation we mean the involvement of society at large (in particular non-elites) in politics, which can take both noninstitutionalised forms, such as revolts, protests, petitions, and general pressure on elites via associations or the media, and institutionalised forms through elections or assemblies. Noninstitutionalised and institutionalised powers are synergistic and support each other. (ibid., pp 49-50).

Thus, even in states with formal elections, the *de facto* power of civil society is key to constraining a would-be autocrat (see also Acemoglu and Robinson, 2008). This *de facto* power is a measure of the capacity of civil society to oppose despotism by a strong state, both through formal political opposition and (especially) informal mobilisation. It depends on a wide range of institutions that complement elections in a liberal democracy: a free media and freedom of speech, as politically engaged citizens require information; freedom of association, as they need to be able to mobilise; and politically independent judiciary and military, as they need to trust that the state (e.g., the military and the courts) will serve the state, rather than a party or individual. The absence of any of these complementary pieces of liberal democracy will provide space for autocracy to erode civil society's *de facto* power, placing it on the path from democracy to autocracy.

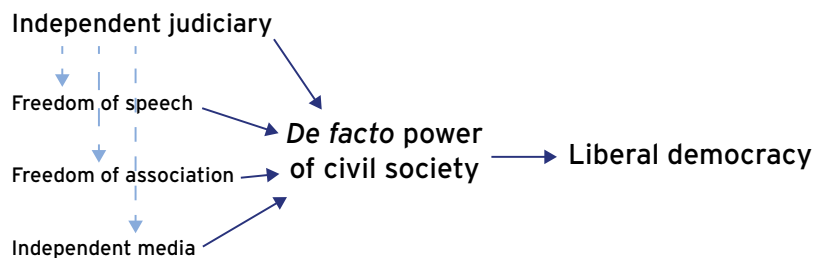
3 THE ROLE OF THE JUDICIARY IN SHAPING *DE FACTO* POWER

Judicial independence is thus a complementary institution directly supporting a successful democracy (e.g., interpreting the laws that govern elections).⁶ But in fact it is much more than that, in that it plays a central role in shaping a wide range of other

6 For example, judicial decisions that ruled against claims of electoral fraud contributing to President Joe Biden's defeat of Donald Trump in 2020.

institutional determinants of the *de facto* power of civil society. The judiciary plays this role by ruling on contested issues relating to all of the complementary institutions discussed above. A simple framework illustrating the direct and indirect role of an independent judiciary is shown in Figure 2.

FIGURE 2 FRAMEWORK LINKING INDEPENDENT JUDICIARY AND OTHER COMPLEMENTARY INSTITUTIONS TO *DE FACTO* POWER AND LIBERAL DEMOCRACY



Just in the last several months, this pivotal role of the judiciary in shaping democracy's complementary institutions has been observed in weakly democratic or autocratic regimes. Judges have been asked to rule on the allegedly subversive activities of formal opposition figures (Alexei Navalny in Russia), media tycoons (Jimmy Lai in Hong Kong), and human rights activists (Xu Zhiyong and Ding Jiaxi in China).⁷ Of course, this is nothing new. Stalin famously relied on show trials to repress opponents in the 1930s. In more recent years, Hugo Chavez dismantled Venezuela's independent judiciary, using judges under political control to persecute opponents and uphold government actions – and punishing judges who refused to comply with the regime (e.g., Wilks, 2015). Ultimately, decisions determining the boundaries of acceptable political speech, association, and action are in the hands of judges; their decisions thus shape the future distribution of *de facto* power in a society.

An independent judiciary is, of course, far more likely to empower civil society to challenge incumbents. The opposition in Israel is thus taking to the streets not only because of the threat to judicial independence; it is everything that is expected to follow that could destroy Israeli democracy: the future inability to mobilise, the future inability to criticise the government, the future threats to free speech and free media, and the disappearance of meaningful political opposition.

⁷ A discussion of the Navalny case can be found in "'Stalinist': Putin nemesis Alexei Navalny gets 19 more years in prison", *Politico*, 4 August 2023. The Lai case is discussed in "Arrested in 2020, Hong Kong Pro-Democracy Tycoon Gets His Day in Court," *New York Times*, 17 December 2023. The cases of Xu and Ding are discussed in "China jails two leading human rights lawyers after closed-door trial", *Guardian*, 10 April 2023.

4 PROTESTS AS AN EXPRESSION OF, AND INVESTMENT IN, *DE FACTO* POWER

But why did the opposition choose to express itself through protest? One could imagine organising politically to form a new formal opposition. One could imagine media campaigns to persuade politicians and voters to oppose the judicial reform and any anticipated adverse consequences. Surely some of the latter strategies will be pursued, but protests are central to the reaction. In part, this is because the formation of a coordinated political opposition requires a difficult alignment on a broad range of issues beyond the focal issue of preserving judicial independence. In part, it is because protests are able to express an intensity of political preferences far beyond traditional political participation. But primarily, protests are a natural response to the government's instigation of a battle over *de facto* power – this is not an electoral battle within the confines of formal democratic institutions, but outside them.

The protesters are fighting fire with fire, and the most powerful signal of opposition *de facto* power is a display of that power by mobilising people in protest. This goes far beyond electoral mobilisation: voting is low cost, and the ability to express oneself is limited to casting one vote. Mobilisation for street protests is costly – in time, effort, and coordination.⁸ Mobilisation for sustained engagement in an opposition movement is repeatedly costly, and yet protesters in Israel turned out week after week for months. Protests also provide an opportunity for the emotional expression of political views (Passarelli and Tabellini, 2017), which can be far more persuasive (or threatening) to opposition voters and politicians considering any future erosion of democratic institutions.

The political action of protest will have immediate consequences: it challenges the government and might even change some minds in the Knesset. Indeed, Yuli Edelstein, a long-standing member of Netanyahu's Likud Party, called for a pause in the reform process and negotiation. Protests (and other forms of civil disobedience) also impose indirect costs on the government by disrupting economic life. The economic consequences of Israel's protests began to appear already in the spring of 2023, with the Moody's rating agency downgrading Israel's economic outlook to stable from positive, stating that "[t]he executive and legislative institutions have become less predictable and more willing to create significant risks to economic and social stability".⁹

Participation in a mass movement also builds a foundation for future political engagement. Studying Hong Kong's antiauthoritarian protests, my co-authors and I found that individuals who were randomly 'nudged' to participate in a single protest were substantially more likely to sustain participation in the protest movement one year later (Bursztyrn et al., 2021). Thus, the experience of Israel's protesters has already planted

8 The 'free-rider' problem in protests - the temptation to stay home while others pay the cost of participation - has long been an object of social scientific inquiry (e.g., Olson, 1965; Tullock, 1971; Palfrey and Rosenthal, 1984; Cantoni et al., 2019).

9 "Moody's sees negative economic consequences of Israel's judicial upheaval", Reuters, 25 July 2023.

a seed of future political action when needed. Protests also build political and social capital among participants, which will further support future mobilisation (e.g., Tufekci, 2017). This will make future mobilisation – both within and outside formal politics – more effective. Indeed, anecdotal evidence suggests that in the days after the terrorist attack in Israel on 7 October, the same actors coordinating protests very quickly pivoted to coordinate aid for victims. This sort of coordination and mobilisation capacity is the result of investment in civil society's *de facto* power. It suggests hope for opposition movements within Israel when the war in Gaza comes to an end.

The dynamic consequences of protest are thus especially important. A mass movement signals what political norms exist and how strongly held those norms are. But it also signals what future mobilisation will look like. This makes it more difficult for future governments to legislate against those norms, or for judges to erode those norms. A mass movement sends the message that any such actions will come at a cost – economic and political – to would-be autocrats.

5 PROTESTS AS *DE FACTO* POWER: THE CASE OF HONG KONG

Hong Kong is an example of a once (relatively) liberal society very quickly falling into autocracy, and it illustrates the importance of *de facto* power, its expression in mass protests, and the role of the judiciary in shaping it. From Hong Kong's handover to China in 1997 until 2020, Hong Kong's citizens were able to mobilise an immense amount of *de facto* power in the form of protests against perceived over-reach by the ruling Chinese Communist Party (CCP). Yearly 1st July protest marches signalled to the CCP Hong Kong citizens' capacity to mobilise, regularly drawing hundreds of thousands of participants, and in 2019 drawing nearly 2 million protesters.¹⁰ Hong Kong citizens had some democratic rights, but what truly protected citizens' liberties was continual mass protest, which achieved:

- the withdrawal of a proposed national security law that would have severely limited free speech and free association (2003);
- the withdrawal of a proposed national education law that would have taught Communist Party ideology to Hong Kong students (2012); and
- the withdrawal of an extradition bill that would have subjected Hong Kong citizens to the risk of police extradition to mainland China (2019).

However, in 2020, the Chinese Communist Party imposed a National Security Law on Hong Kong that dramatically increased the risk of any organised political action. The Hong Kong judiciary – under the authority of the CCP in Beijing – enforced this law, as

¹⁰ For a discussion of Hong Kong's political institutions and the importance of protest to maintaining Hong Kong's equilibrium preservation of civil liberties, see Cantoni et al. (2017, 2022). For a discussion of the 1 July 2019 protest march, see "Hong Kong Protests, One Year Later", *New York Times*, 9 June 2020.

did the Hong Kong police. Political activists were arrested, sentenced to jail, or fled into exile.¹¹ Independent media were raided by police and have shut down.¹² Public political protests have since essentially disappeared since the repression.¹³

Without the *de facto* power that comes from the ability to protest – eliminated by a judiciary subservient to political masters in Beijing – Hong Kong citizens' remaining democratic rights have become a hollow shell. In 2021, Hong Kong passed what the BBC described as “a controversial electoral reform law, aimed at keeping people China deems ‘unpatriotic’ from positions of political power. The reform will allow a pro-China panel to vet and elect candidates, reducing democratic representation. Critics warn it is designed to remove all opposition from the city’s parliament, allowing Beijing to tighten its control over Hong Kong.”¹⁴

Without the complementary institutions necessary for a democratic society, and in particular without the *de facto* power that came with the ability to protest, Hong Kong’s institutions have slid ineluctably towards autocracy.

6 CONCLUSION

Daron Acemoglu has said that “[t]rue democracy and liberty don’t originate from checks and balances or from clever institutional design. They originate [and are sustained] in the much more messy process of society mobilising, people defending their own liberties, and actively setting constraints on how rules and behaviours are imposed on them.”¹⁵

Israelis, like Hong Kong’s citizens and many others before them, are taking action to preserve their liberal institutions. Israelis benefit from advantages that Hong Kong’s citizens lack, not least a government (at least theoretically) accountable to them. Yet, history teaches us that liberal institutions are extremely fragile: Hong Kong had a free press, substantial civil liberties, and constitutionally enshrined rights to free association and free speech just a few years ago. History teaches us that when one of democracy’s complementary institutions falls, others can come down quickly like dominoes. Vigilance and action – the continued development and expression of *de facto* power – are citizens’ most effective bulwark against Israel’s slide towards autocracy.

11 “The young faces who were part of Hong Kong’s democracy movement – Agnes Chow, Joshua Wong, Nathan Law – and where they are now”, *South China Morning Post*, 5 December 2023.

12 “Hong Kong’s Apple Daily, symbol of pro-democracy movement, to close”, *Guardian*, 23 June 2021.

13 “Hong Kong’s first protest in 3 years shows how the city has changed”, CNN, 28 March 2023.

14 “Hong Kong electoral reform: LegCo passes ‘patriots’ law”, BBC News, 27 May 2021.

15 “The permanent struggle for liberty”, MIT News, 24 September 2019.

CHAPTER 5

Media capture and belief in alternative realities

43

Adam Szeidl^{a,c} and Ferenc Szucs^b

^aCentral European University; ^bStockholm University; ^cCEPR

A core institution of a well-functioning democracy is trusted and independent media. In this chapter, we describe the erosion of media freedom in Hungary and its implications for voters' beliefs, political accountability, and trust in experts. Our narrative may hold lessons for Israel and other countries that are at risk of similar democratic backsliding.

A near majority of the supporters of Hungary's prime minister, Viktor Orbán, incorrectly believe that the Hungarian government did not support sanctions against Russia.¹ An actual majority believe in the existence of a 'Soros plan' to bring Muslims to Europe.² These misbeliefs are not isolated; they seem to combine into a coherent but false alternative reality in which a coalition of the liberal media, NGOs, and EU bureaucrats criticize Orbán for being anti-democratic because they disagree with his strict immigration policy. Orbán talks about this alleged conspiracy explicitly: "And we understand what is happening. George Soros has bought people, he has bought organisations, he is feeding them out of the palm of his hand, Brussels is under his influence, and it is his plan that the Brussels machine is implementing in the case of immigration. They want to remove the fence, they want to let in millions of immigrants".³

Conspiratorial alternative realities seem to be a common feature of populism more broadly. Israel is a case in point, with a key narrative appearing to be that Netanyahu is the target of an attempted coup by a leftist alliance of politicians, media, and state prosecutors because of his right-wing ideology and pro-annexation policies.⁴

How do these alternative realities emerge, and what are their implications? Based on our prior research (Szeidl and Szucs, 2021, 2023), in this chapter we argue that in Hungary such alternative realities were disseminated by government propaganda through captured media; that they discredited criticism from experts and institutions and thus enabled the government to stay in power; and that they eroded trust in experts and thus generally lowered the quality of decision-making in society.

1 "A Fidesz-szavazók fele szerint a kormány nem szavazta meg a szankciókat - kutatás az orosz-ukrán háborúval kapcsolatos attitűdökrol", *Political Capital*, 16 November 2022 (in Hungarian).

2 "A magyarok csaknem fele nem is hisz a Soros-tervben", *hvg.hu*, 20 October 2017 (in Hungarian).

3 "Orbán Viktor a Kossuth Radio '180 perc' című műsorában", website of the Hungarian Government, 6 October 2017 (in Hungarian).

4 "Victim of a left-wing coup? Why Netanyahu's conspiracy theory is foul and absurd", *The Times of Israel*, 25 May 2020.

THE GOVERNMENT CAPTURES PRIVATE MEDIA

The Hungarian administration has long considered establishing control over media a priority. As Orban's political director put it: "...who rules a country's media rules the country's thinking, and through that the country".⁵ In Szeidl and Szucs (2021), we document that the government established control over the media through media capture, by providing advertising favours in exchange for preferential coverage.

For an illustration, consider Figure 1, which focuses on the two leading online outlets in Hungary, Index and Origo. Index was independent throughout the sample period of 2013-2017. Over the same period, Origo experienced two key events: in August 2014, its editor was replaced, allegedly because of government pressure; and in January 2016, it was sold to the family of the governor of the central bank, an ally of Orban.

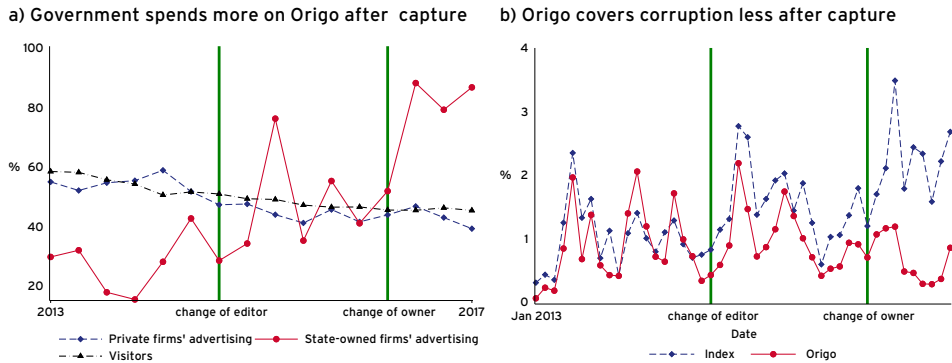
Figure 1a plots advertising on Origo relative to the combined advertising on Origo and Index for private and state-owned advertisers, respectively. For comparison, we also plot the share of visitors to Origo out of the total visitors to Origo and Index. The key point of the figure is that advertising by state-owned companies, but not by private companies, was meaningfully reallocated to favour Origo after its change of editor, and even more so after its change of owner. Figure 1b investigates return favours for the government, plotting the share of articles covering government corruption scandals on Origo and Index over the same period. Initially, Origo was slightly more critical of the government, but its corruption coverage dropped below that of Index after the change in editor, and the gap grew further after the change in owner. We find similar patterns in several other media outlets.

Over time, media capture broadened and solidified. In 2018, most captured outlets were merged to form a conglomerate, the Central European Press and Media Foundation, which has close ties to the inner circles of Viktor Orban.⁶ In 2020, Index, the largest independent news outlet, was purchased by a pro-government oligarch and absorbed into the government-controlled media empire.⁷ We estimate that today the Hungarian government controls half of the television and two-thirds of the print, online and radio markets.

5 "Orbán Balázs: Aki uralja egy ország médiáját, az uralja annak az országnak a gondolkodását", Telex.hu, 25 January 2023 (in Hungarian).

6 "Huge pro-government media conglomerate formed in Hungary", AP News, 28 November 2018.

7 "The Art of Media War - This is how Viktor Orban captured the free press in Hungary", 444.hu, 28 February 2022.

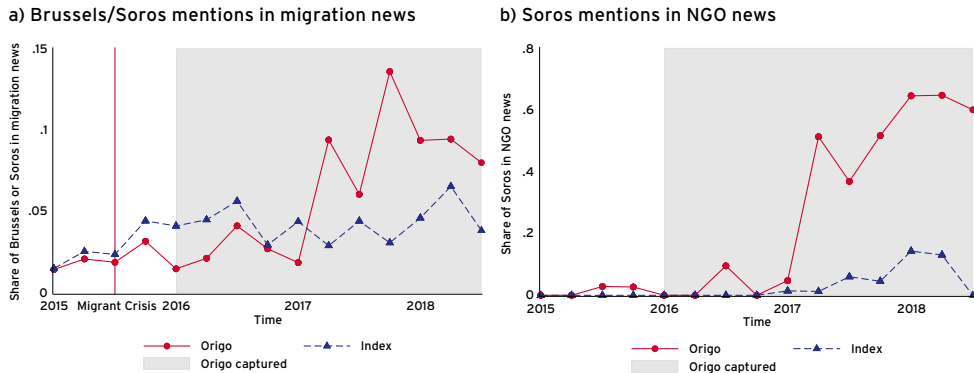
FIGURE 1 TWO-WAY FAVOURS BETWEEN THE GOVERNMENT AND MEDIA

CAPTURED MEDIA DISSEMINATES PROPAGANDA

How does the government use the captured media? We argue that beyond suppressing corruption news, the government has turned captured media into a propaganda tool to disseminate their conspiratorial narrative. As we highlighted above, the core thesis of this narrative is that a conspiracy of Soros-backed NGOs and EU bureaucrats criticise Hungary for a fake issue – that of eroding democratic institutions – because they disagree with Hungary’s tough stance on immigration.

In Figure 2, we document how the regime uses captured media to spread this alternative reality. In Figure 2a, we plot the share of articles covering immigration that mention the alleged conspirators (Soros or ‘Brussels’) in their title. Until 2017, these terms were mentioned in 2–5% of the articles on migration on both Origo and Index. In early 2017, however, when the government launched its ‘Stop Soros’ campaign, which accused the Hungarian-born billionaire of organising mass-migration, the government-controlled Origo – but not the independent Index – sharply increased its mentions of Soros and Brussels in migration news. In Figure 2b, we explore co-mentions of Soros and NGOs. In the government’s narrative, the conspiracy also involves NGOs that monitor corruption and human rights. The figure plots the share of articles covering one of four major NGOs that mention Soros in their title.⁸ Although some of these NGOs do receive (non-transformative) financial support from the Soros-founded Open Society Foundation, the share of articles covering them that mention Soros was essentially zero before 2017, and remained low on Index even after 2017. However, starting from the launch of the Stop Soros campaign, Origo sharply increased mentions of Soros in news articles about these NGOs. These figures provide evidence that captured media contributed to spreading the government’s alternative reality.

8 The NGOs are Transparency International, Amnesty International, Hungarian Helsinki Committee, and Társaság a Szabadságjogokért (TASZ).

FIGURE 2 CAPTURED MEDIA SPREADS THE GOVERNMENT'S NARRATIVE

PROPAGANDA ERODES TRUST IN EXPERTS AND INSTITUTIONS

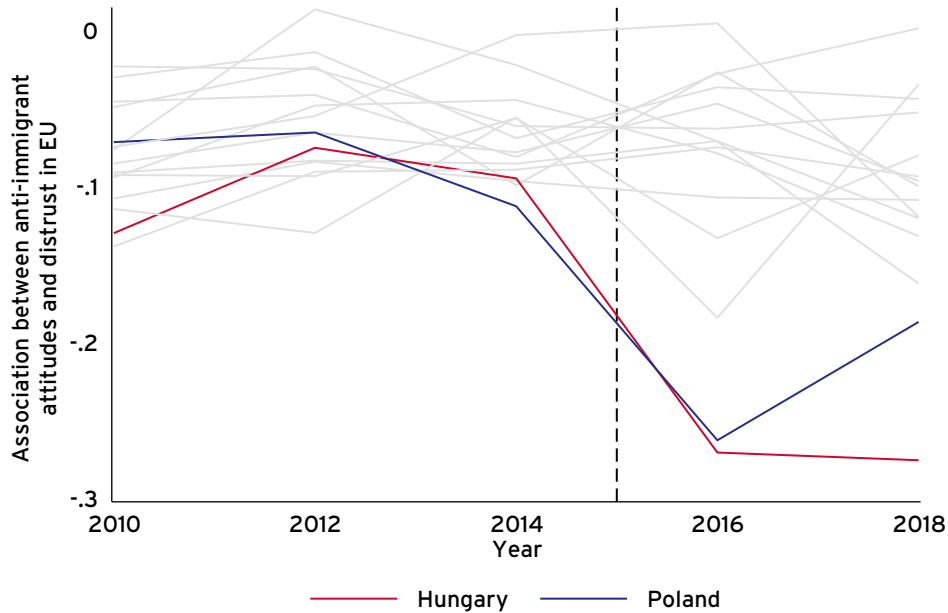
Our argument is that the government creates and spreads its alternative reality to discredit critical experts and institutions. Intuitively, criticism from Brussels will not reduce, and may in fact increase, the support of voters who believe that such criticism is driven purely by ideological disagreement. In the case of Israel, criticism from the judiciary is discredited if the voter believes that it is driven by ideological disagreements related to Palestine.

But how successful is populist propaganda in shaping beliefs about experts and institutions? We turn to present suggestive evidence that conspiratorial narratives do undermine trust in critical institutions. We explore this idea using data from the European Social Survey (ESS) for the period of 2010-2018.

Figure 3 plots the association between anti-immigrant attitudes and trust in the European Parliament for 16 EU countries separately (with Hungary and Poland highlighted). These are associations that remain after controlling for respondents' gender, age, education, trust in politicians, and trust in the own parliament. In most countries, there is a small negative association between anti-immigrant sentiment and trust in the European Parliament. Two countries stand out: Hungary and Poland. In both countries, there was a sharp increase in the magnitude of the association after the 2015 refugee crisis. That is, after 2015, people with anti-immigrant attitudes in these countries substantially lowered their trust in European institutions. Hungary and Poland did not accept many refugees, but their populist governments did use conspiratorial narratives blaming the EU for the influx of immigrants. Meanwhile, both countries were heavily criticised by the European

institutions for dismantling checks and balances.⁹ These results are consistent with our argument that the Hungarian government successfully used an alternative reality to discredit the critical voice of the European Parliament.

FIGURE 3 ASSOCIATION BETWEEN ANTI-IMMIGRANT ATTITUDES AND DISTRUST IN THE EUROPEAN PARLIAMENT

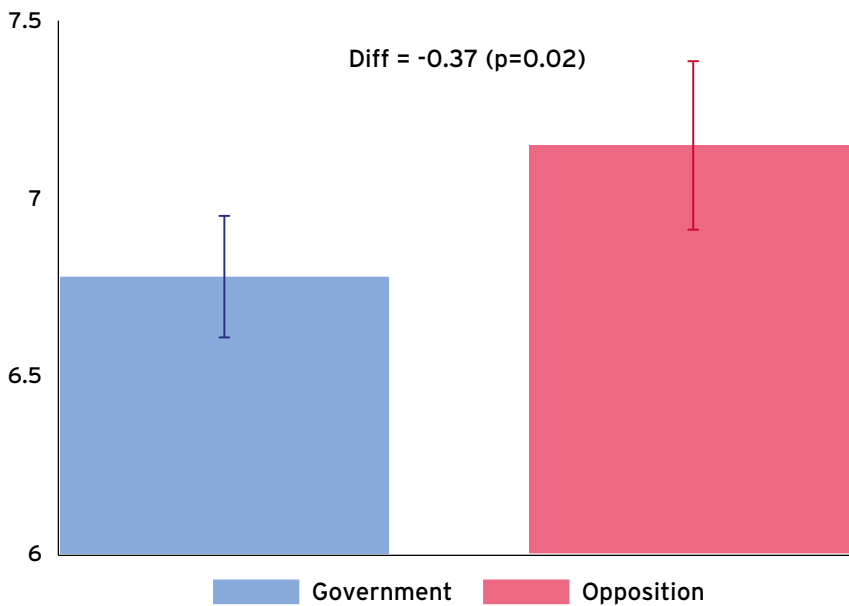


Distrust in critical voices may spill over to other domains as well. Figure 4 plots trust in science – from the European Social Survey – among government and opposition supporters in Hungary (after we control for the respondents’ gender, age, education, trust in politicians, and trust in the Hungarian parliament). Consistent with our argument, government supporters exhibit lower trust in science. These differences in beliefs may also translate into differences in key decisions. In 2021, 59% of opposition supporters, but only 51% of government supporters, intended to get vaccinated against COVID-19.¹⁰ Thus, through its effect on trust in experts and the quality of decisions, the political supply of a conspiratorial alternative reality can generate large social costs.

9 The European Commission and Parliament launched Article 7 procedures against Poland (in 2017) and Hungary (in 2018) for breaching core European values.

10 “Propaganda ellen beoltva - Az ellenzéki szavazóknál nagyobb az oltási hajlandóság”, *Népszava*, 9 April 2021 (in Hungarian).

FIGURE 4 TRUST IN SCIENCE BY GOVERNMENT AND OPPOSITION SUPPORTERS IN HUNGARY



CONCLUSION

We have argued that the Hungarian government captured independent media and used the captured media to disseminate an alternative reality about conspiring elites. This alternative reality succeeded in deflecting criticism of the regime by experts and institutions. It also reduced trust in experts and institutions, and the lower trust resulted in worse decisions.

Israel, and other democracies, may be at risk of similar propaganda-driven alternative realities. Our analysis suggests that in Hungary, the early capture of many independent media outlets may have been important, because it gave the alternative realities broad reach. Thus, one priority for civil society in other democracies may be to protect the independent media.

PART III

POLARISING FAULT LINES: TRIGGERING AND REINFORCING REGIME CHANGES

CHAPTER 6

Education in Israel from an international and demographic perspective

Dan Ben-David^{ac} and Ayal Kimhi^{bc}

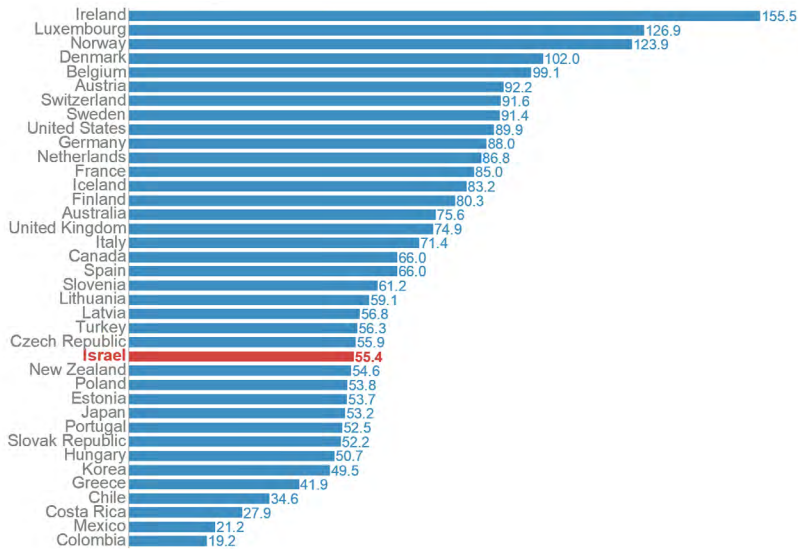
^aTel Aviv University; ^bHebrew University of Jerusalem; ^cShoresh Institution for Socioeconomic Research

1 INTRODUCTION

Despite being home to one of the world’s most innovative hi-tech sectors, Israel’s labour productivity falls far below the OECD average. While value added per worker in Israel’s hi-tech sector in 2018 was 25% higher than average OECD business sector productivity, the vast remainder of Israel’s business sector exhibited 40% lower productivity – resulting in 32% lower productivity for Israel’s business sector as a whole (OECD, 2023). Overall, labour productivity (as measured by GDP per hour worked) in Israel falls below nearly two-thirds of the OECD countries (Figure 1).

FIGURE 1 LABOUR PRODUCTIVITY IN 2022

GDP per hour worked in 38 OECD countries



Note: Current PPP-adjusted dollars.

Source: Dan Ben-David, Shoresh Institution and Tel Aviv University. Data source: OECD.

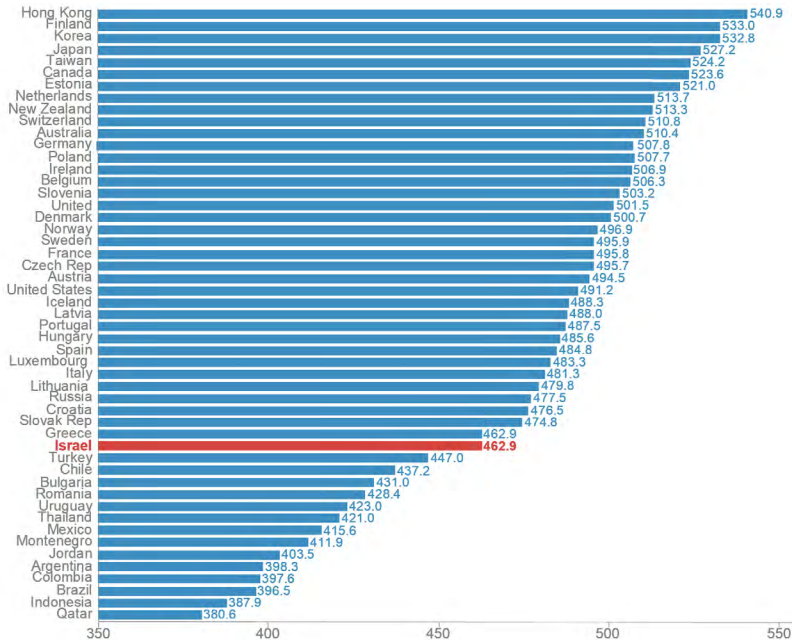
Education plays a key role in determining labour productivity. Ostensibly, Israel has one of the OECD's most educated populations: the share of Israelis with an academic education is among the highest in the developed world, as is the average number of years of schooling per Israeli (Ben-David, 2017). The problem, as Hanushek and Kimko (2000), Hanushek and Woessmann (2015), Ben-David and Kimhi (2021) and many others have shown, is that what matters most when it comes to growth and wages is not the quantity of education but the quality.

2 THE LEVEL OF EDUCATION IN ISRAEL

PISA exams administered every three years in core subjects – maths, science, and reading – illustrate just how low the quality of education provided in Israel actually is. Savin et al. (2023) conducted a comparison of all 51 countries who participated in at least 14 of the 15 PISA exams (administered to 15-year-olds) held in the years 2006-2018. The average Israeli score on these exams is below 36 of the 50 remaining countries – essentially below the average level of every developed country participating in these exams (Figure 2).

FIGURE 2 MULTIYEAR NATIONAL AVERAGE PISA SCORE IN ALL EXAMS

All 51 countries participating in at least 14 of the 15 exams, 2006-2018



Note: Average scores in maths, science and reading.

Source: Savin et al. (2023).

What amplifies the severity of this outcome is the very rudimentary level of education received by Israel's ultra-Orthodox Jews (Haredim), most of whom do not study the material and do not take the exams. While the girls study a partial core curriculum through high school, the situation among the boys is considerably worse. Even the very partial core curriculum that they do receive is terminated in eighth grade. Given the large number of Haredi pupils and the very poor core education that they receive (more on this below), it is conceivable that had they participated in the exams, the Israeli national average would have been even lower than what is shown in Figure 2.

In addition to the Haredi education stream, Israel's education system is divided into three additional broad streams: the non-religious Jewish stream, the religious (not Haredi) Jewish stream, and the Arab-Israeli stream. Ben-David and Kimhi (2021) have shown that in the most recent PISA exam, administered in 2018, the average score on the three core subjects by the non-religious Jewish stream placed them slightly above half of the developed countries. The average score of the religious stream was considerably lower – below 80% of the developed countries. The Arab-Israeli pupils scored below many developing countries. In fact, they placed below nine of the ten predominantly Muslim countries that participated in the 2018 exam.

The impact of families on their children's scholastic achievements has been well documented for many years (e.g. Coleman et al., 1966; Levy et al., 2021; Central Bureau of Statistics, 2019). While the relationship between parental education and their children's achievements cannot be entirely eliminated, some countries' education systems have been better able to weaken this relationship.

Continuing with the examination of the 51 countries mentioned above, Savin et al. (2023) created a benchmark group of the five countries that perennially attained the highest scores in the 15 exams.¹ The pupils in these countries and in Israel were divided into four groups on the basis of their parents' education:²

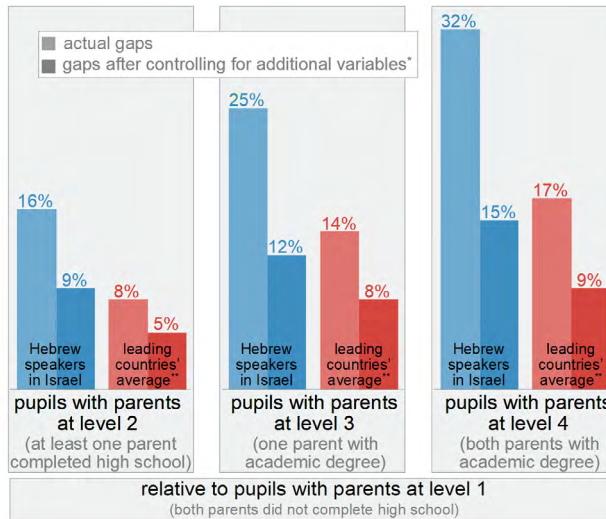
- Level 1: pupils whose parents do not have an academic degree and did not finish high school.
- Level 2: pupils whose parents do not have an academic degree and at least one of them graduated from high school.
- Level 3: pupils who have one parent with an academic degree.
- Level 4: pupils whose parents each have an academic degree.

1 The leading countries are Finland, Japan, Taiwan, Canada and Estonia.

2 Parental education was determined on the basis of the pupils' self-reporting. While this was found to be relatively accurate in general, there were considerable discrepancies between what Arabic-speaking pupils in Israel reported and actual education levels as reported by the Central Bureau of Statistics. Therefore, the analysis of Israel is based on the Hebrew-speaking Israeli pupils.

Figure 3 shows the achievement gaps between pupils in levels 2, 3 and 4 versus those in level 1. In general, the higher the level of parental education, the larger the gap in scores vis-à-vis the level 1 base group. While this is true in the leading countries as well, the gaps there are half, or just over half, of the gaps among Israeli pupils.

FIGURE 3 GAPS IN SCORES BETWEEN CHILDREN WITH AT LEAST ONE PARENT WITH HIGH SCHOOL EDUCATION AND UP, AND CHILDREN WITH TWO PARENTS WHO DID NOT COMPLETE HIGH SCHOOL



Note: "Leading countries" = Finland, Japan, Taiwan, Canada and Estonia. Control variables include gender, presence of various items in the home, native born, and fixed effects. Results significant at the 1% level.

Source: Savin et al. (2023).

Characteristics of the pupils' family and home environment are strongly correlated with parental education. As shown in Figure 3, statistically controlling for these attributes accounts for a substantial share of the gap in scores resulting from parental education. While this is true in both the benchmark group of leading countries and in Israel, the remaining link between parental education and their children's scores is considerably higher in Israel – highlighting the relative failure of Israel's education system. This failure in reducing the relationship between parental education and children's academic achievements has far reaching economic implications.

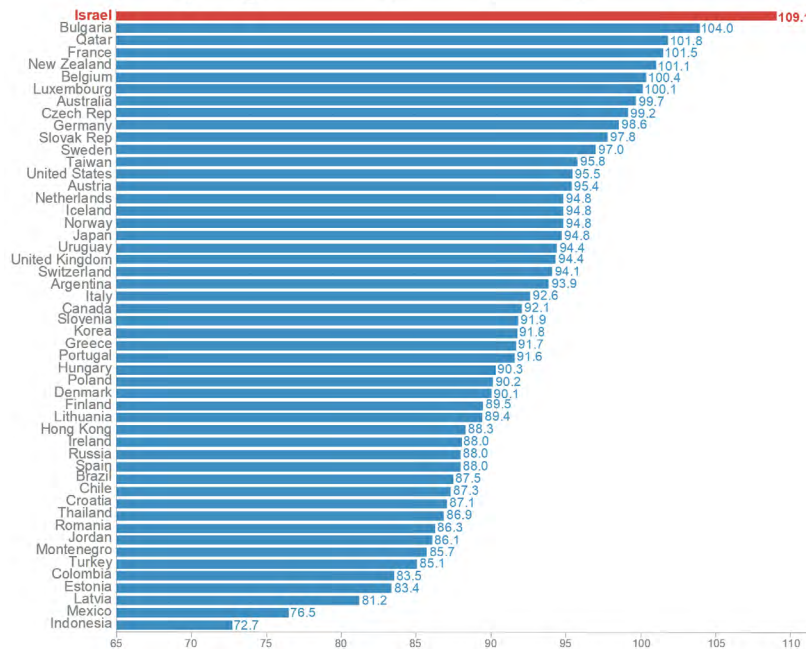
Chetty et al. (2011) note that their findings suggest that qualitative differences in education among schools perpetuate income inequality. Chetty and Friedman (2011) find that the intergenerational relationship in incomes would decline by a third if all American children were to study in schools of identical quality.

Thus, while average national scores provide an indication of how each country is preparing its children to compete with one another in the global economic marketplace, educational gaps within countries are suggestive of future domestic income inequality.

As shown in Figure 4, the standard deviation in scores between Israeli pupils is the highest – by far – of all the 51 countries participating in at least 14 of the 15 exams from 2006 through 2018. Here, too, it is important to point out that this outcome was attained without the general participation of Haredi pupils. In light of the fact that most Haredim do not study these core subjects, the actual educational gap between Israeli children is presumably even higher than what is reported in Figure 4.

FIGURE 4 DOMESTIC GAPS IN PISA SCORES

Multiyear average in each of the 51 countries participating in at least 14 of the 15 exams, 2006-2018



Note: Average standard deviations within countries in maths, science and reading.

Source: Savin et al. (2023).

3 ON THE MECHANICS OF ISRAELI EDUCATION

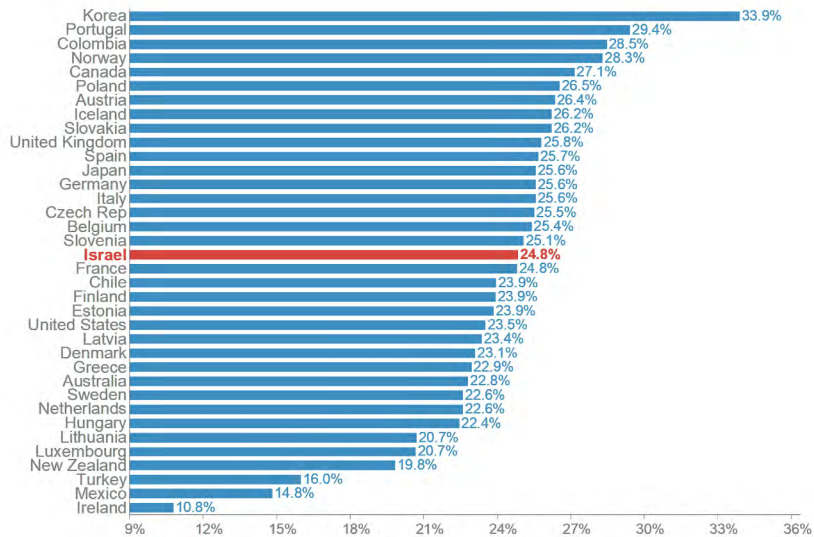
Israel's education budget is its government's highest budgetary expenditure, surpassing even defence expenditures. National primary and secondary education expenditures, as a share of GDP, are the second highest in the OECD. In and of itself, this is neither an indication of a high prioritisation of education in the national agenda nor of relatively high levels of inefficiency. Rather, it is primarily a reflection of Israel's high fertility rates and the fact that the share of primary and secondary school pupils in the population is the third highest in the OECD.

Discounting primary and secondary education expenditures as a share of GDP by the share of primary and secondary school pupils in the population is equivalent to discounting expenditures per pupil by GDP per capita (the common measure for

national living standards). The resultant calculation indicates that Israeli expenditures on primary and secondary education are neither high nor low in comparison with the other OECD countries (Figure 5). In other words, Israel's education system does not lack resources when compared to the other OECD countries.

FIGURE 5 NATIONAL EDUCATION EXPENDITURE PER PUPIL

In primary and secondary schools, relative to GDP per capita, 2020



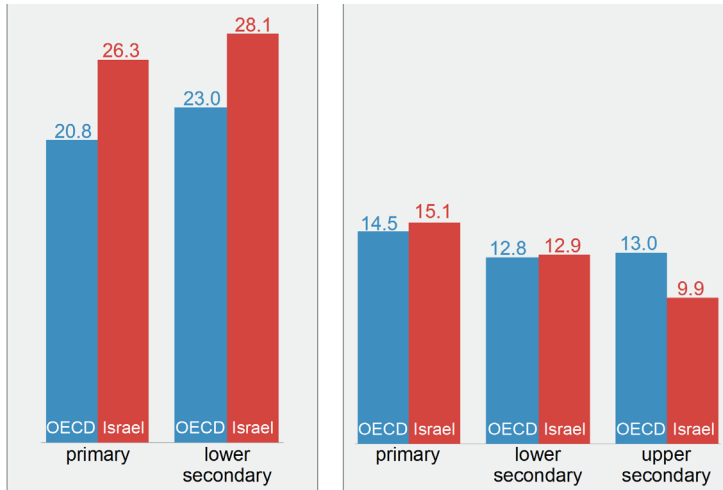
Source: Ben-David (2021) (updated).

Crowded classrooms in Israel are often cited as a key reason for the poor scholastic performances. While average class sizes are indeed high (Figure 6), the number of pupils per full-time equivalent teacher in Israel is roughly the same as the OECD average in primary and lower secondary schools – and is considerably lower in upper secondary schools. In other words, a lack of resources in this realm does not appear to be the source of the problem. Israel is funding enough teachers, and yet its classrooms are severely congested in comparison with the OECD average.

The annual number of school days in Israel is substantially greater than in all other OECD countries. This is because Israeli schools operate six days a week. A more accurate comparison is of annual instruction hours. Figure 7 displays the number of instruction hours in developed countries relative to Israel. A large majority of countries teach less than Israel does. In each of these countries, average scores in maths, science and reading in the PISA 2018 exam were higher than in Israel. Here, too, a lack of resources does not appear to be the primary cause of the poor educational achievements in Israel.

FIGURE 6 AVERAGE CLASS SIZE (LEFT)* AND NUMBER OF PUPILS PER TEACHER (RIGHT)**

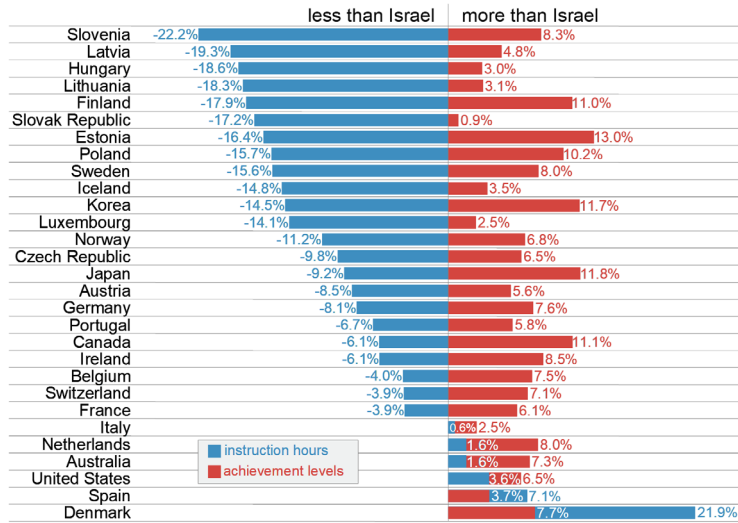
2019 or most recent year



Note: *Number of pupils per class. **According to full-time equivalents.
 Source: Dan Ben-David, Shores Institution and Tel Aviv University. Data source: OECD.

FIGURE 7 INSTRUCTION HOURS AND ACHIEVEMENT

29 OECD countries relative to Israel



Note: Cumulative number of compulsory instruction hours in lower secondary schools in 2019 (US data for 2018) and average achievement levels in maths, science and reading in PISA 2018.
 Source: Ben-David (2021).

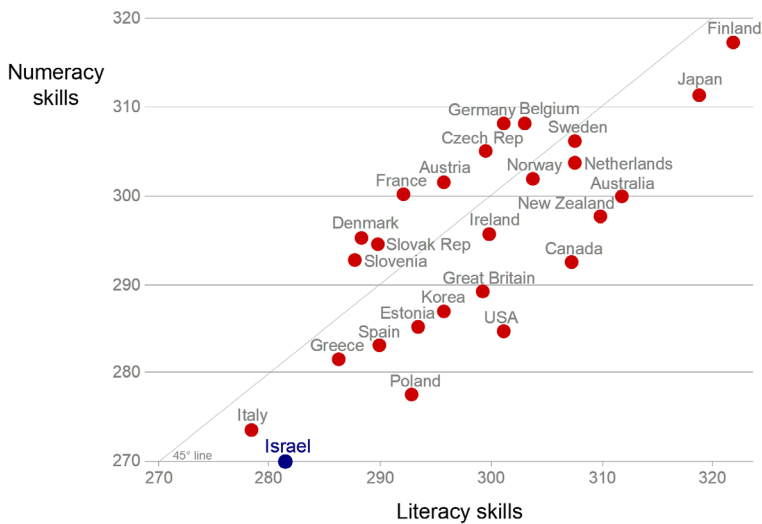
Furthermore, there does not appear to be any relationship across countries between the number of instruction hours and achievement levels. There are countries with very few instruction hours and relatively high scores, while there are countries with many instruction hours that do not exhibit exceptional performance in the exams.

Seventy-nine percent of all undergraduates studying education in Israel study in teaching colleges. Another 17% study in general non-research colleges, while the remaining 4% study education in the country's research universities. Israel's psychometric exams (which serve the same function as the American SATs to enable qualitative comparisons among applicants to higher education) provide an illuminating comparison between these teacher candidates and average first-year students in the research universities. Education students in the universities score 9% below their fellow university students. Teaching college students score 23% below, while general college students studying education score 32% below the average university students.

When this is the relative level of incoming teachers, it should not come as a surprise that the general skill level of Israeli teachers is quite low. Hanushek et al. (2019) find that among developed countries, the literacy and numeracy skills of Israeli teachers are near or at the bottom (Figure 8).

FIGURE 8 SKILL LEVELS OF TEACHERS IN DEVELOPED COUNTRIES

Median achievement scores of teachers in PIAAC 2011/12 and 2014/15



Note: Excluding Chile and Turkey.

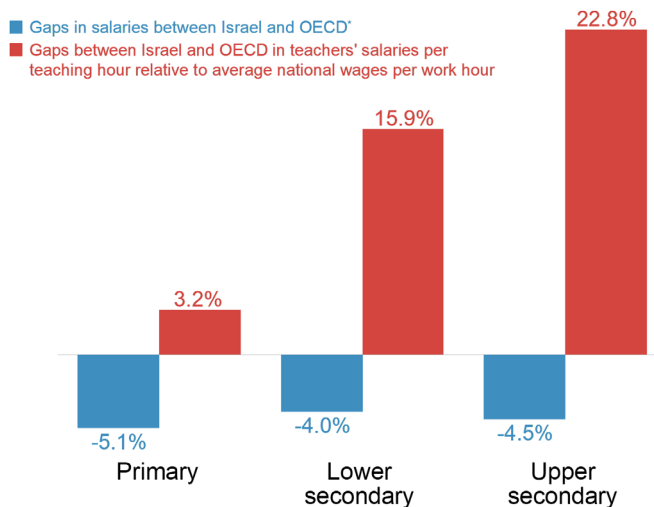
Source: Hanushek et al. (2018).

It is often argued that the quality of Israeli teachers is due to the low salaries that they receive. Depending on the level of the school – primary, lower secondary or upper secondary – Israeli teachers' monthly salaries are 4%-5% lower than the OECD average (Figure 9). However, this only reflects what is given to teachers and does not take into

account what is received from them. A comparison of teachers' salaries per teaching hour relative to average national wages per work hour in Israel to the OECD does not support the contention that Israeli teachers' wages are low. They are higher at each level of school, reaching a gap of 23% above the OECD average in upper secondary schools.

FIGURE 9 TEACHERS' SALARIES IN ISRAEL RELATIVE TO OECD

Percent gap in teachers' average actual salaries, 2019



Note: Comparisons using purchasing power parities.

Source: Ben-David (2021).

4 HAREDIM

The Haredim's considerable political power enables them to avoid taking any of the national or international exams, making it much more difficult to gauge the severity of the problem. Lipiner and Zussman (2021) provide an interesting glimpse into the deterioration in educational and economic outcomes of pupils studying in Haredi schools founded by the Shas political party. As this party grew and evolved towards the end of the 20th century, it developed a Haredi school network that began to attract many children in Israel's geographic-socio-economic periphery belonging to families along the religious spectrum who were not necessarily Haredim at the time.

Lipiner and Zussman's study focused on boys reaching first grade in the years 1992-2003. It compared boys studying in the Shas network to boys with similar characteristics who studied in other streams of Hebrew education, after controlling for additional variables (this included comparisons between siblings where the older ones studied in non-Haredi schools and the younger ones studied in the Haredi Shas schools). Among their findings are that the boys studying in the Haredi network exhibited a 10% higher high school

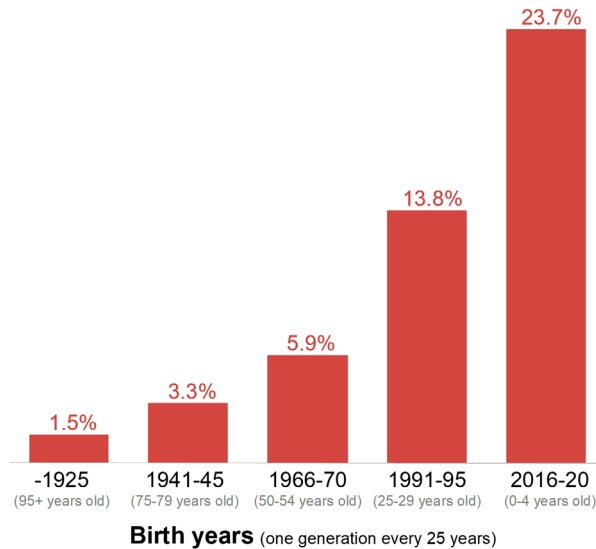
dropout rate, with 15% fewer pupils attaining a matriculation (bagrut) certificate. Subsequent employment of the Shas pupils was 14% below the comparison group, while their gross annual wages were 19% lower.

In general, the Haredim are one of Israel's poorest population groups. A huge majority of their children study in schools run by the political parties that intentionally deprive them of an education that could offer them opportunities as adults. Consequently, Haredi schools ensure that their former students remain financially dependent in perpetuity on government benefits secured by the politically powerful Haredi parties.

The Haredim are not an inconsequential group in Israeli society. Their share in the population is doubling every 25 years (i.e. every generation) (Figure 10). While they only comprise 6% of the 50-year olds in the country, they make up nearly one-quarter (24%) of the infants. At this exponentially increasing pace, almost half of Israel's infants will be Haredim in just 25 years.

FIGURE 10 SHARE OF HAREDIM IN EACH GENERATION

Israel, 2020



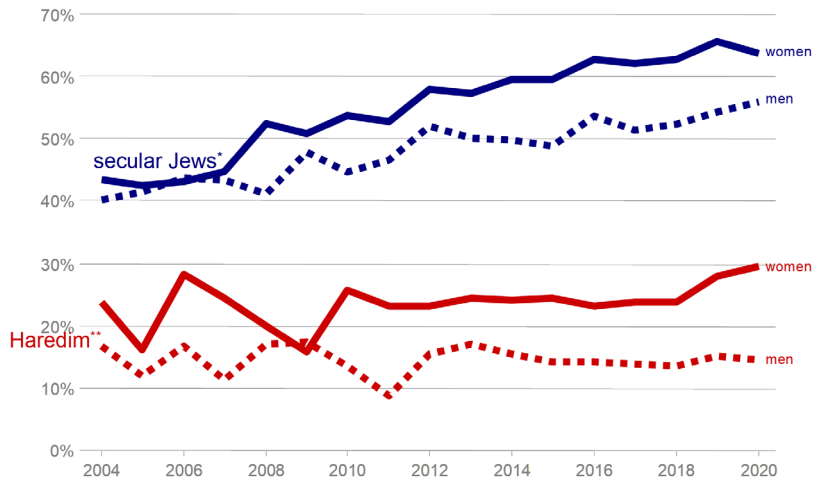
Source: Ben-David (2021).

While a small, but growing, number of Haredim try to overcome their lack of a core education by attempting to enter the academic track – from the pre-academic (mechina) courses through academia – as young adults, the majority have experienced what turn out to be insurmountable hurdles. According to Israel's State Comptroller (2019), over half (53%) of the women and over three-quarters (76%) of the men dropped out of the higher education tracks, despite the very low academic levels of the colleges that most attended. Consequently, as shown in Figure 11, the share of Haredim aged 35-54 with an academic degree has remained very low and relatively unchanged for nearly two decades

(with a slight increase among women in the last two years of the sample). It is simply not possible for most individuals to skip necessary core material in school and then hope to attain an academic degree at a later age.

FIGURE 11 SHARE OF PRIME WORKING AGE ISRAELIS WITH ACADEMIC DEGREES

Ages 35-54, 2004-2020



Note: *Non-religious Jews; **ultra-Orthodox Jews.

Source: Ben-David and Kimhi (2021) (updated).

5 CONCLUSION

Israeli children’s average level of knowledge in mathematics, science and reading is one of the lowest among all countries consistently taking the PISA exam since 2006. At the same time, education gaps among Israeli children are by far the highest in comparison with all of these other countries. Both of these dismal results are not due to the country’s Haredi children, most of whom do not even study the material and do not participate in exams. Had these children been tested, Israel’s outcomes would probably be even worse than those reported here.

The reason for the poor showing by Israeli pupils does not appear to be due to a lack of resources. After discounting differences in living standards, as measured by GDP per capita, national education budgets per pupil are average in comparison with the OECD. The number of pupils per FTE teacher is roughly the same, or lower (depending on the school level), than the OECD average. Teacher quality is relatively low, despite hourly wages above the OECD average (after discounting domestic hourly wages). The primary problem appears to be an overly bureaucratic and severely inefficient education system.

In 2022, 23% of Israel’s first-graders were Arab-Israelis, whose performance at a later age in the PISA exams was below that in many developing countries – including nine of the ten predominantly Muslim countries participating in the most recent 2018 PISA exams.

Another 21% of first-graders studied in Haredi schools, where the majority do not even study the complete core curriculum. In addition to these two groups are many pupils in the non-religious and religious Jewish streams from Israel's social and geographic peripheries who also receive a very low level of education in the core subjects. This means that roughly half of Israel's children currently receive an education at developing country levels, and they belong to the country's fastest growing population groups. As adults, they will only be able to maintain an economy at developing country levels, which will be unable to support developed-country healthcare and welfare systems, not to mention developed-country defensive capabilities in the world's most dangerous region.

The Haredi and religious parties – representing the two fastest-growing population groups in Israel, with over six children per Haredi family and over four children per religious Jewish family – have excessive influence on their respective sectors' education streams. This is reflected not only in the low level of knowledge in subjects vital for subsequent work as adults in a competitive global economy, but also in extremely low understanding of the fundamental tenets underlying liberal democracies.

Manifestations of this demographic-educational mix have already begun to surface – most recently in the outcomes of the 1 November 2022 elections that resulted in the most extreme Israeli government in history. Because the prime minister is on trial on corruption charges, the only political parties willing to form a government with him were the two Haredi parties and the three religious Jewish supremacist parties. The current demographics, if left unchanged, will enable future representatives of these groups to create a government without needing a prime minister on trial – with all of the long-term existential implications that this portends for Israel's future.

The key to changing Israel's current demographic course lies in a complete overhaul of the country's education system alongside an overhaul in the country's benefits system that enables non-work lifestyle choices. While these are not sufficient conditions for ensuring a change in the demographic trends, they are certainly necessary conditions.

CHAPTER 7

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

Eran Yashiv

Tel Aviv University, Centre for Macroeconomics (LSE) and CEPR

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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187 boulevard Saint-Germain | 75007 Paris | France
33 Great Sutton Street | LONDON EC1V ODX | UK
TEL: +44 (0)20 7183 8801 | EMAIL: CEPR@CEPR.ORG
WWW.CEPR.ORG