

**When Populism Meets Religion:
Economic Lessons from Israel's Existential Crisis**

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Introduction

By year-end 2023 Israel will have gone through not one but two existential crises, which are still unfolding. The second crisis is the war, which has begun on October 7th, 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 the year, which is at the focus of this paper.

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, military personnel in key positions have stopped reporting to voluntary reserve duty. They include Air Force pilots, prominent Navy officers, military intelligence specialists, and elite units combat fighters.

Concurrently, the economy has suffered turbulence: there was 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 repeatedly issued warnings since March 2023, as have prominent economists, including Larry Summers and Ben Bernanke

Facing the vigorous opposition and the adverse circumstances, the government led by PM Netanyahu has alternated between a pause in the government's drive and the continued pursuit of it. The crisis has exposed deep fissures underlying Israeli society. Many believe it has turned into a conflict on Israel's essence and its future path. In a September 15 poll by Israel's leading TV station, channel 12, about 20% of respondents said they are seriously contemplating leaving the country. Out of center-left voters, around 30% thought of emigrating. Then the war broke out.

This paper addresses three questions. First, what are the fundamental forces, which 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 its economic ramifications, particularly 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 and slow 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, which is religious and non-democratic, alarms many Israelis. Hence, there was 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 polarization 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 Moslem. The secular Jewish group, now roughly a third of the adult population, is economically the strongest. It has relatively high levels of education, exhibits high participation rates in the labor 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 at the bottom on all the indicators. 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, which 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, are the majority of households, which 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 their educational

background. In particular, the Ultra-Orthodox study in a separate school system, which emphasizes religious education. Typically they do not study at all subjects that are crucial for the labor market – Math, English, and basic Science. The fourth group, traditional and religious Jews, constitutes a little over a third of the adult population. They are somewhat below the secular group on all of the afore-cited indicators and their education background is wider.

A key dynamic is the increase in the share of the population of the religious group and of the Ultra-Orthodox group, while becoming more radical in terms of religion and more right wing in terms of politics. Their weight in the population has risen, to around 24% combined², mostly due to high fertility rates (in the period 2019-2021, Ultra-Orthodox women TFR rate stood at 6.5, religious women stood at 3.9 and secular women stood at 2). The Ultra-Orthodox population, specifically, grows at 4% a year, twice the national average.

In 2003 there were 29 Knesset (Israeli parliament) members who were religious or Ultra Orthodox, by the latest, 2022 elections this number rose to 41 MKs. 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 aforementioned 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, a would-be autocrat, current PM Netanyahu has increasingly being promoting populist policies, all 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). Being prime minister for 16 of the past 27 years, he has an obsession with holding power. However, he has not achieved Orban's or Erdogan's scale of support and badly needs coalition partners. Moreover, under trial for over 3 years on three corruption charges, he seeks to escape legal predicaments, including a potential prison term.

² Statistical Report on the Ultra-Orthodox Society in Israel 2022, The Israel Democracy Institute

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 with 32 MKs; two Ultra-Orthodox parties with 18 MKs; and a union of two religious, Ultra Nationalist parties with 14 MKs. The common goal of these disparate parts of the coalition is the weakening of the judicial system, which is the major road block for the attainment of their 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 was enacted thus far, on July 24, 2023, and is currently under review at the Supreme Court. Were this review to annul the law, a constitutional crisis will break out. 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 affiliation. Inter alia, it includes the afore-mentioned members of the Israeli Defense 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 been marching 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, while the current coalition, essentially *Judea*, got only 52 MKs, pre October 7th.

However, there is a fear that the coalition will seek to distort the electoral map. For example, by effectively barring the Arab Israeli vote, they can insure future election victories. Thus, the current majority may 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 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, a full-fledged Netanyahu autocracy, and later on theocracy, led by the religious and the Ultra-Orthodox.

The War and the Political Crisis

What is the relation between this political crisis and the war, which broke out on October 7th? The strife and internal conflict in Israel were not lost on its neighbors, in particular on Iran, which is behind recent developments. Iran and its allies have followed the Israeli situation -- the deepening social rifts, political instability, and economic decline. The emerging divisions within Israel, the unprecedented fractions in the Israeli military and in its society, for example citizens refusing military service, were perceived as a significant weakening. This created the temptation to exploit using armed conflict. The timing was further informed by the advancement of the possibility that there would be a US-Saudi-Israeli accord. This quickened the decision to take an aggressive approach. Hence, the outbreak of armed conflict, with the current Hamas attack one building block in the Iranian plan.

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 Israel turns into an autocracy, or perhaps even a theocracy. Practically speaking this is likely to be manifested in the exit of the linchpin of the economy, the High Tech sector. Indeed, this movement has started earlier this year: flows of financial capital to the sector have 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 emigrating. Greece, Spain, and Portugal are actually offering incentives for such emigration. The realism of a big emigration scenario is further supported by noting that, in the crisis of the 2010s, a 5% share of Greece's population, mostly drawn from the upper part of the Greek income distribution, has left the country.

Taken together these shocks to financial capital and to human capital in the High Tech sector will have far-ranging consequences, as there are big, weak sectors that live off this sector. The High Tech sector pays a quarter of Israel's direct tax revenues, while the Ultra Orthodox are heavily subsidized and supported by big governmental transfers. If the High Tech sector were to be followed by sectors such as medical doctors, the shock will be even worse.

In economic terms this is likely to lead to lower GDP per capita, to a reduction in GDP growth, to a fall in investment and in exports, to a fall in labor productivity, and more. An August 2023 report by two think tanks, written by the academic economists Ater, Raz and Spitzer, estimates a range of 9% to 45% reduction in GDP per capita in the long run. 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 GDP due to the shutting down of sites of production near the border and the mobilization of workers into military service; the costs of caring for displaced population; increased fiscal costs with military expenditures and welfare payments of various kinds; the replenishing of the capital stock; and the drop in foreign investment and tourism. At the end of October 2023, Moody's estimated a drop of annual GDP growth from a positive rate of 2.8% in 2023 to a negative 1.4% rate in 2024 and an almost 3% decline in GDP per capita (in 2024).

Both the political crisis and the war have injected high uncertainty and increased the risk premium of Israel. With the High Tech sector reliant on 90% of its investment flows from foreign investors, this means that its future in Israel is at great risk.

Global Lessons

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

One is to recognize 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 redistribute resources from productive sectors and groups to their own sectors or groups, shamelessly. 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” in the linkages between democracy and economic growth and well-being. 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 it is enough to *expect* autocracy in the future, so as to take 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 may lead to domino effects and vicious cycles, which in turn will lead to further economic decline.

Thirdly, the political polarization apparent in Israel is by now a pervasive global phenomenon. There are currently many countries, which have separatist elements or exhibit deep divisions in their electorate. The tight connection between polarization 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 in question by these divisions. One possibility for government policy to preempt 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 prove to be a strong force even in the face of populists and religious fanatics. Moreover, the civil protest organizations carried their activity into the Gaza war, supplying services to the affected population. This refers to services, which the government proved too slow to provide. Hence they show the immense importance of an active involvement of citizens, outside 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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