

# **Economics and democracy**

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# Background

# The Government's goals

Press Releases

## PM Netanyahu's Remarks at the Start of the First Cabinet Meeting of the 37th Government

**Government:** The 37th Government

**Publish Date:** 29.12.2022

We have four main goals, which I defined today in my speech. I will repeat them because they are important:

First of all, to block Iran. This is an existential question. First of all, we will see to our existence and security.

Second, to restore the security and governance within the State of Israel.

Third, to deal with the cost of living and the housing problem.

Fourth, and I believe that this is within reach, to dramatically expand the circle of peace.

# What happened since?

- **Since December 29, 2022, the coalition has promoted a series of measures that will increase the government's involvement or give it effective control over a variety of institutions that were so far independent:**
  - Legislation to limit the independence of the judiciary
  - Legislation that would allow the Minister of National Security to control the conduct of the police
  - An attempt to intervene in the Bank of Israel's interest rate policy
  - An attempt to appoint a political ally of the PM to head the Central Bureau of Statistics
  - Attempt to intervene in the public broadcasting service (Kan)
  - An attempt to increase the government's intervention in the National Council for Planning and Construction
  - An attempted to takeover the National Library

# What happened since?

- **The coalition's actions since the new government was sworn amount to a judicial revolution**
- **Separation of powers is out, government's control is in**
- **Not a word about Iran, security, cost of living, and peace agreements**
- **Independence is essential to ensure that institutions (court, the police, the central bank, the central bureau of statistics, etc) will act professionally to the benefit the public at large**

# Lessons from Turkey

# Lesson from Turkey

- **Why does the government want to control the central bureau of statistics?**
- **Erdogan intervened with the interest rate policy in the Turkey and kept interest rates artificially low**
- **He replaced 4 governors of the central bank since 2016**

# Central Bank of the Republic of Türkiye - TCMB

- **April 2016 – Jul 2019: Murat Çetinkaya**
- **Jul 2019 – Nov 2020: Murat Uysal**
- **Nov 2020 – March 2021: Naci Ağbal**
- **March 2021 – present: Şahap Kavcıoğlu**
- **The outcome was a breakout of high inflation**



# Turkish inflation

## Turkish Inflation Soaring After Years of Relative Stability

Year-over-year change in the Consumer Price Index in Turkey



Source: TurkStat



statista

# Turkish inflation

- **To fight the high inflation Erdogan leaned in the heads of the statistical office to lower the inflation numbers**

# Turkey, January 2021

POLITICS | TURKEY

## Erdogan fires statistics chief amid inflation

01/29/2022

**The dismissal of Sait Erdal Dincer comes as inflation in Turkey reached a 19-year high. The Turkish president has also threatened the media over "moral values."**

# Turkey, March 2022

## Erdoğan fires more top officials of Turkey's statistics institute



Ahval

Mar 17 2022 11:36 Gmt+3

Last Updated On: Mar 17 2022 03:07 Gmt+3

Turkish President Recep Tayyip Erdoğan **dismissed** two deputy heads of the country's statistics institute in an overnight presidential decree.

Erdoğan's removal of Umut Serhat İdman and Nurettin Kaya late on Wednesday is the latest of several clear-outs of an institution tasked with calculating key economic data, including inflation, foreign trade, and gross domestic product.

# Turkey, November 2022

NEWS WIRE

Nov 12, 2022

## Erdogan Reshuffles Turkish Statistics Agency as Inflation Soars

Burhan Yuksekkas, Bloomberg News



(Bloomberg) -- Turkey's official statistics agency is undergoing a major reshuffle under President Recep Tayyip Erdogan, fueling a controversy about its independence and the accuracy of its inflation data as consumers face runaway costs.

In the latest twist, Deputy Chairman Fatih Sahin was removed from his post, according to a decree published late in the official gazette. He had served in the role for eight months.

A successor hasn't been named, an agency official said, adding that Sahin wasn't directly responsible for statistics and calculations.

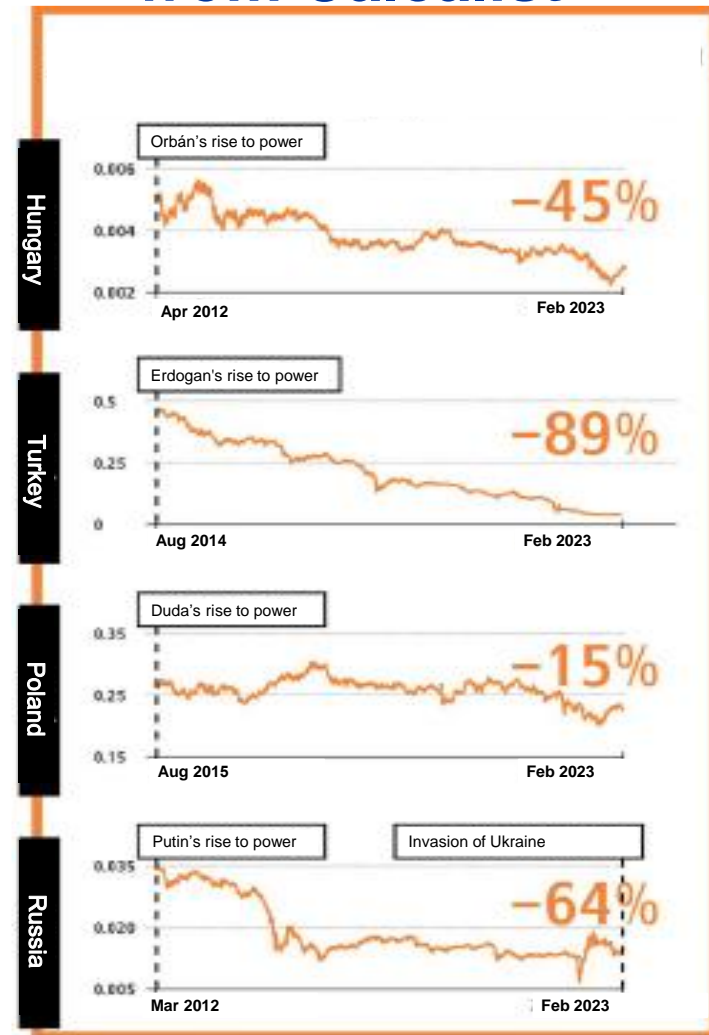
# Turkish Statistical Institute (TÜİK)

- **2016 – April 2019: Mehmet Aktaş**
- **April 2019 – May 2020: Yinal Yağan**
- **May 2020 – Feb 2021: Cahit Şirin (married to Erdogan's wife's private secretary)**
- **Feb 2021 – March 2021: Ahmet Kürşat Dosdoğru**
- **March 2021 – Jan 2022: Sait Erdal Dinçer**
- **Jan 2022 – March 2022: Erhan Çetinkaya**
- **April 2022 – Nov 2022: Fatih Şahin**

# Turkish inflation

- **Erdogan's interest rate policy not only led to high inflation, but also led to a depreciation of the Turkish Lira against the dollar**
- **The same thing has also happened in Hungary, Poland, and Russia**

# Currencies in Hungary, Turkey, Poland, and Russia from Calcalist



Hungary since April 2014

Turkey since August 2014

Poland since August 2015

Russia since March 2012



# The authoritarian-populist playbook

## Dani Rodrik's presentation

- **Capture the judiciary and the media**
- **Identify and target the “enemy of the people”**
- **Create alternative reality through control of public narratives**
- **Concentrate power and establish one-man rule**
- **Economic consequences**
  - descent into macroeconomic populism
    - expansionary fiscal, monetary, credit policies that distribute public and private goods to the political base beyond the capabilities of economy to supply them
  - enabled by weakening of “agencies of restraints,” domestic as well as external (e.g., independent central banks and regulatory agencies; EU, IMF, or global trade rules);
  - and one-man rule => hubris => aversion to expertise, denial of economic constraints

# How can it happen?

- **A story in Ha'aretz on March 15 quotes a member of the Likud party who says: "I don't care that I won't have anything to eat, that the army will disband, that everything will be destroyed here. The main thing is that they don't humiliate us again, and appoint Ashkenazi judges."**
- **Such party member put a pressure on the Likud members of the Knesset to vote for the legislation**
- **The Likud members of the Knesset then care more about their party members who vote in the primaries than about the consequences of the legislation**

# How can it happen?

## פרשנות | בליכוד הסיתו שנים נגד מערכת המשפט, כעת זה מתהפך עליהם

ח"כים בסיעה חוששים כי הסתבכות הפרויקט להפיכה משטרית תפגע בעתידם הפוליטי. "אנחנו תקועים עם פרשה שעשויה לגמור אותנו", אמר מקור בליכוד. "נתניהו לא טיפש. הוא יודע שעם חוקים כאלו, הלך עלינו. הבעיה היא שעכשיו הוא כבר לא שולט בכלום"

רוית הכט 15,06:10 במרץ 2023 📌 עקוב

למרות הדברים הללו, והספקות שכן נפוצים בקרב חברי הכנסת, חשוב להבין שהבייס במקום אחר. בשנים האחרונות בכירי הליכוד, ובראשם נתניהו, הטריפו את הקהל הליכודי בהסתה נגד מערכת המשפט, ועכשיו הנמר יצא משליטה. הוא אווז במאלף בין שיניו, ומאיים לפצח אותו אם זה יגלה ויתור. "לא אכפת לי שלא יהיה לי מה לאכול, שהצבא יתפרק, שהכל ייחרב פה. העיקר שלא ישפילו אותנו שוב, וימנו עליו שופטים אשכנזים", אמר לי השבוע חבר מרכז דומיננטי. "אם נתניהו יתפשר עכשיו הוא נכנס לסיכון כפול: הוא גם יאבד את הבייס, וגם יאבד את השותפים הקואליציוניים".

# **What are the economic consequences of the judicial revolution in Israel**

# The harm to the Israeli economy

- **It's hard to predict economic developments because the economy is constantly hit by external shocks (Intifada, Corona, the financial crisis of 2008, the dot.com bubble)**
- **Regardless, economists are unanimous that the Israeli economy will suffer severely, including**
  - 15 Nobel laureates in economics (e.g., Tirole, Maskin, Milgrom, Hart, Roth, Spence, Romer, Barnanke, etc)
  - Well-known economists like Larry Summers or Nouriel Roubini
  - 12 past presidents of the Israeli Economic Association
  - Former chancellors of the Bank of Israel and many government officials
- **Organization which issued warnings:**
  - Moody's and Fitch
  - The OECD
  - The financial press: The Economist, The Financial Times, The New York Times

# The harm to the Israeli economy

- **Exactly how, when, and how much, no one can say for sure**
- **Some of harm, like an increase in the interest rate and the a depreciation of the shekel can materialize quickly**
- **Other harms may take longer to materialize**
- **The harm can be especially large given the challenges that the High-Tech sector currently faces**
- **90% of the financing of the Israeli High-Tech sector are from abroad and the fact that its heavily relies on exports**
- **A combination of an economic crisis and a security crisis could be fatal**

# The harm in the short and the long run

- **Harm in the short run:**
  - Interest rate increase
  - devaluation
- **Harm in the long run:**
  - Harm to the High-Tech industry
  - increased risk
  - An increase in corruption
  - Violation of property rights
  - Possible harm to pensions

# Position paper of Finance Ministry chief economist

- **The decline in Israel's democracy and governance indices is expected to lead to a structural decline at the GDP per capita growth rate of 0.8% per year**
- **Over the 5 budget years following the reform:**
  - The loss of GDP will amount to approximately 270 billion NIS
  - The loss of state revenues will amount to approximately 70 billion NIS



# **The High-Tech sector**

# The harm to the High-Tech sector can be large

- **Hi-tech is based on human capital which is highly mobile and can relatively easily move from one country to another**
- **Hi-tech requires huge investments that require protection of property rights**
- **Hi-tech produces intellectual property that requires legal protection**
- **High-Tech investors and customers are sensitive to ESG (environmental, social, and governance) issues which could be undermined without judiciary independence**
- **Hi-tech workers need freedom to and protection of human rights to foster creativity and independent thinking**
- **High-Tech is built on an ecosystem (investors, angels, entrepreneurs, employees); a harm to one actor could lead to a domino effect and harm others**

# The concern is real

**Intel VP warns: "We must stop the madness. We are a moment away from high-tech disappearing from here"**

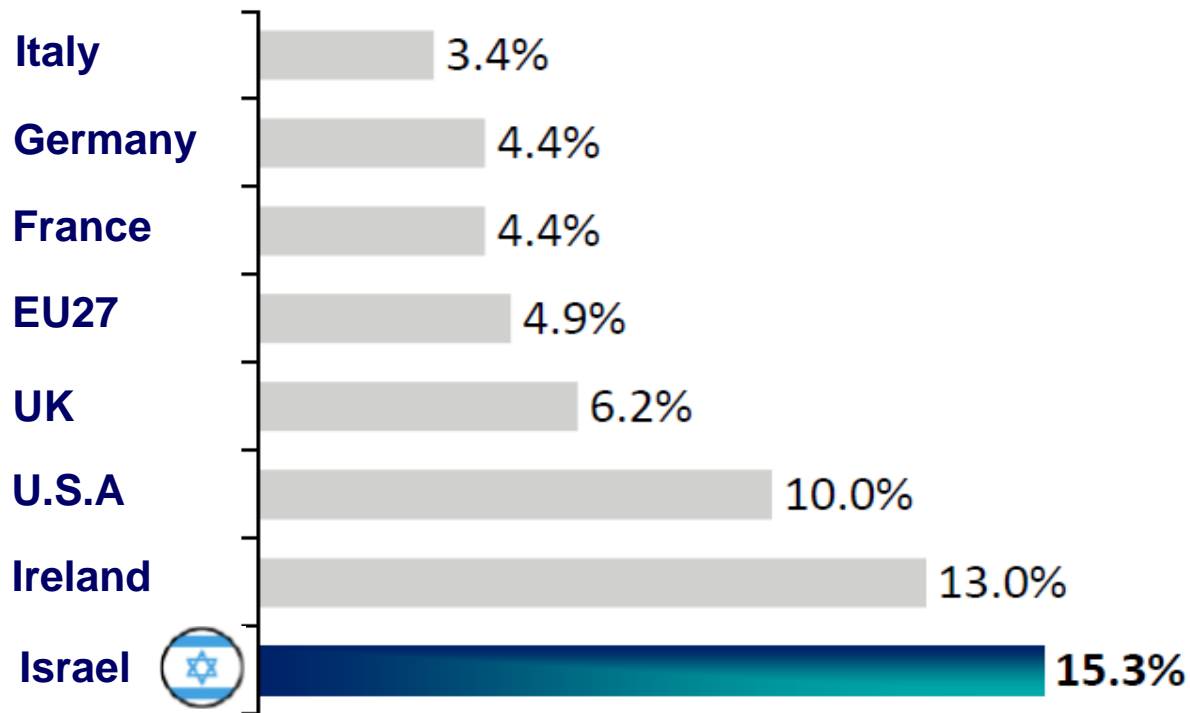
Tzahi Weisfeld, Intel Vice President and GM of the company's Ignite startup program, who emphasized that he is not speaking on behalf of Intel but only on his own behalf, candidly voices his opinions about the dangers of the impending judicial coup: "In the last few weeks, something in me broke, and I'm not alone. I know I'm jeopardizing my professional future, but the future of my children is more important"

Meir Orbach 11/07/21 02:32

# International comparison of High-Tech contribution to GDP, 2019

Israel Advanced Technology Industries, February 2023

## High-tech sector share of GDP



\*Year 2020

# High-Tech generates 23% of direct taxes

- The state's income from direct taxes in billions of NIS

	High-Tech 2021	Total 2020	Share
Income tax	22.1	92.6	24%
Social security	14.4	70.8	20%
Corporate and capital gains taxes	11	38.8	28%
<b>Total</b>	<b>47</b>	<b>202.2</b>	<b>23%</b>

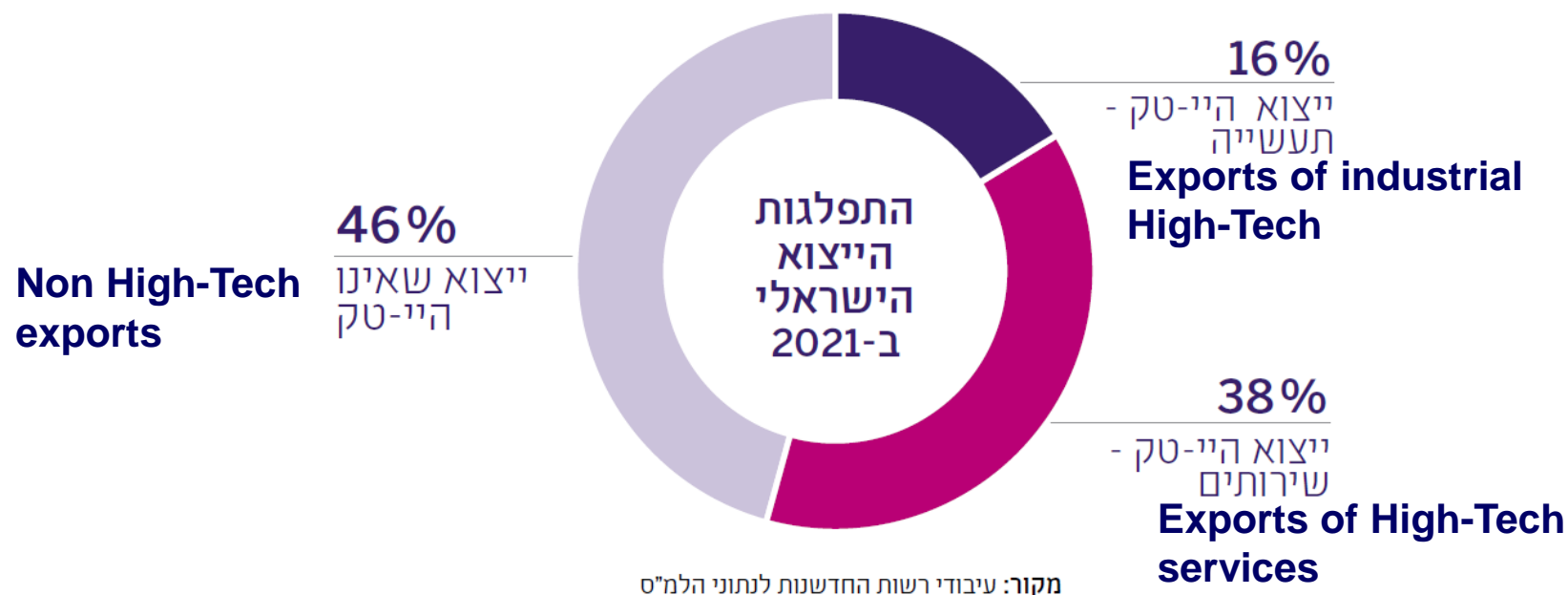
- **Sources**

- State revenues report, 2019-2020
- Israel Advanced Technology Industries, February 2023 (דו"ח תרומת תעשיית (ההייטק לכלכלה ולחברה הישראלית)

# The composition of Israeli Exports, 2021

## Israel Advanced Technology Industries, February 2023

התפלגות הייצוא מישראל לפי ענפים, 2021



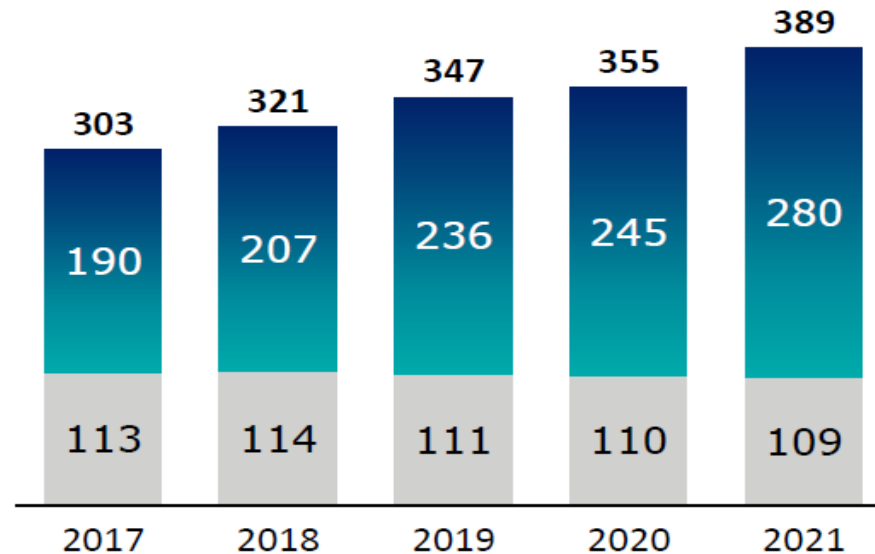
- High-Tech exports in 2021 amounted to 67 billion USD
- A 10% reduction in High-Tech exports are 6.7 billion USD, which is equal to half the budget of the Ministry of Health

# Employment in High-Tech

## Israel Advanced Technology Industries, February 2023

- In 2021, 390,000 Israelis were employed in the High-Tech sector
- This is 11.9% of the labor force among 25-64 years old

High-Tech services שירותי הייטק 10%  
Industrial High-Tech תעשיית הייטק -1%  
Total High-Tech סה"כ הייטק 6%

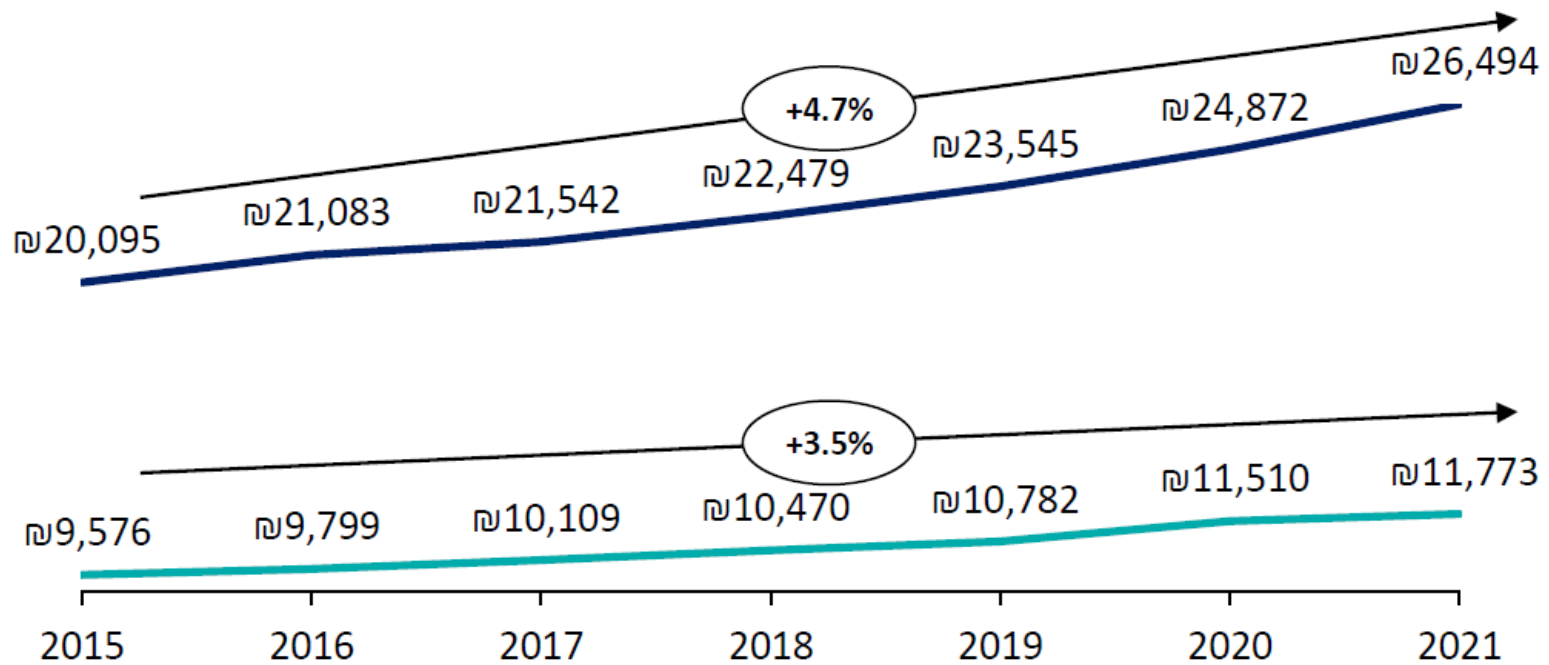


# Average salary in High-Tech

## Israel Advanced Technology Industries, February 2023

תרשים 28: השכר הממוצע בהייטק לעומת השכר הממוצע במשק, 2015-2021

— שכר ממוצע בהייטק **Average salary in High-Tech**  
— שכר ממוצע במשק **Average salary in Israel**





# Suppose High-Tech shrinks by 10%

- **The gap between the average wage in High-Tech and in the economy at large is 14,721 NIS per month, or 176,652 NIS per year**
- **If 10% of High-Tech employees lose their jobs, 39,000 employees will earn 176,652 NIS less per employee  $\Rightarrow$  6.9 billion NIS per year in total**
- **By comparison, the budget of higher education was 12.3 billion NIS in 2021**
- **The budget of the Holocaust Survivors rights authority in 2022 was NIS 5.1 billion**

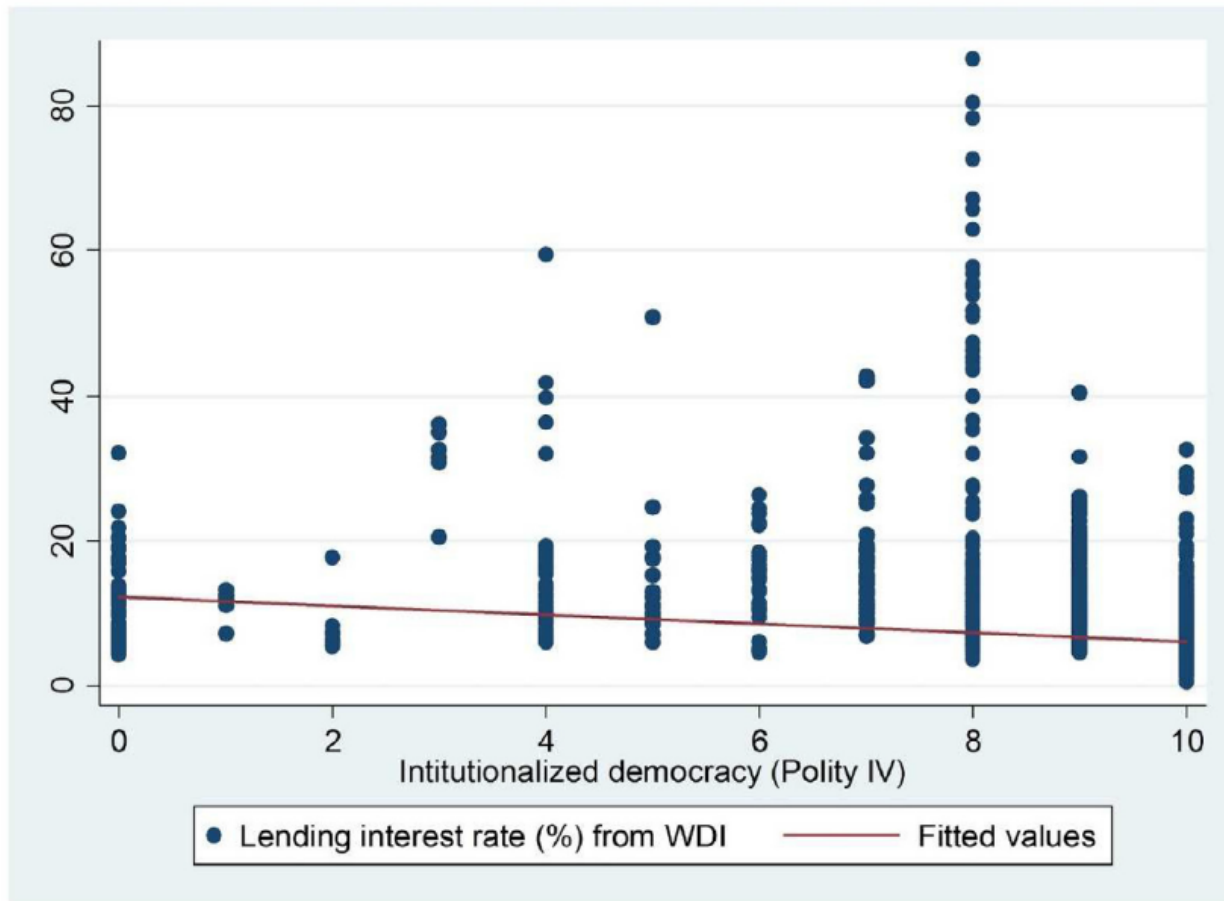
**An increase in the interest rate  
on Israeli foreign debt**

# Democracy and spreads

- **Delis, Hasan, Ongena (JFE, 2019) use global syndicated loan data from 1984 to 2014, and find that democratization has a sizable negative effect on loan spreads (premium over the LIBOR)**
- **A 1-point increase in the 0-10 Polity IV index of democracy shaves at least 19 basis points (a basis point is 0.01%) off spreads, but likely more**

# Delis, Hasan, Ongena (JFE, 2019)

- The figure shows the correlation between the measure of democracy and lending interest rates



## **A lesson from the UK about populist politicians ignoring the warnings of economists**

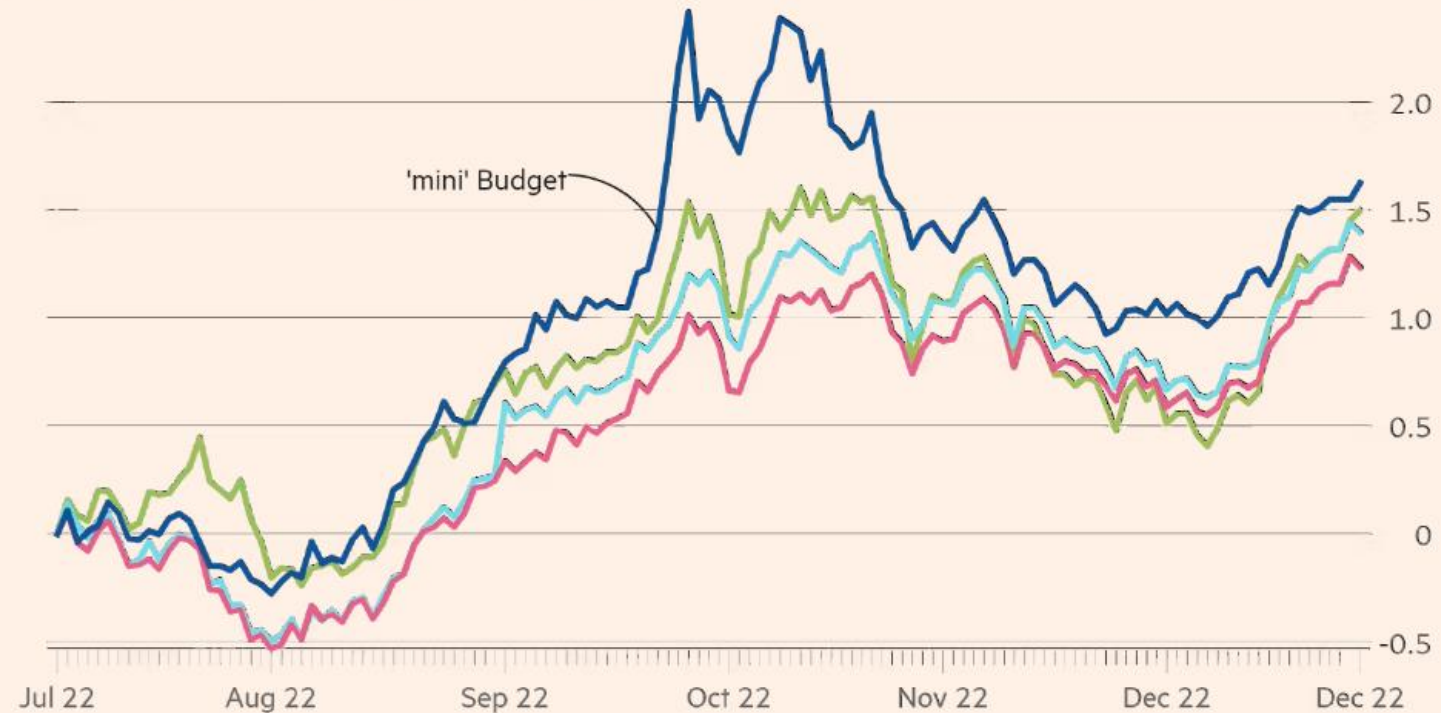
- **In early September 2022, Liz Truss was elected as the Prime Minister of the UK**
- **On September 23, Kwasi Kwartang, Chancellor of the Exchequer, announced various tax cuts as part of the "mini-budget" plan**
- **Economists warned that the mini-budget plan is dangerous for the economy**
- **Liz Truss chose to ignore the warnings**
- **The UK then paid a "moron premium" estimated at 30 billion pounds**

# UK's moron premium

The 'moron' premium has not disappeared completely

Change in yield on 10-year government bonds, from July 1 2022 (% points)

— UK — Germany — France — Italy



Source: Refinitiv  
© FT

# Israel's moron premium

Rueters, March 8, 2023

JERUSALEM, March 7 (Reuters) - Moody's Investor Service warned on Tuesday that the Israeli government's planned judicial reforms could weaken institutions and could negatively impact Israel's sovereign credit profile.

In its statement, Moody's did not downgrade Israel's A1 positive credit rating and did not walk back the positive outlook it assigned in April 2022 that was driven by solid government finances.

But Moody's warned, "there could arguably be downward pressure on those scores" if the government fully passed the **judicial overhaul**.

# What if the interest rate on Israeli debt increases?

- **Israel's public debt for 2021 is a little over one trillion NIS (1.072 trillion NIS)**
- **If the interest rate increases by one percentage point, the annual debt repayment will increase by 10 billion NIS**
- **For comparison: the annual budget of the Ministry of Welfare and Social Affairs in 2022 was 9.7 billion NIS**



# Depreciation of the shekel

# Nouriel Roubini

The Marker, March 6, 2023

- **"Continuing the legislation may bring Israel into economic turmoil"**
- **"You are playing with fire when you do extreme things, and the markets will punish you long before the rating agencies will do something. The pressure on the markets is only starting now, inflation has risen. In the last year, the Bank of Israel was already forced to raise the interest rate - and stability was maintained."**
- **"... if the legal reforms go ahead, they will lead to capital flight, this will exert negative pressure on the shekel, inflation will rise, the yield gap between Israeli and American bonds will increase - and the only way to deal with that would be to raise interest rates even more. So you will get not only a slowdown, but an economic contraction. If the reform continues, the possibility cannot be ruled out of an actual recession"**

# Ben Bernanke

The Times of Israel, March 12, 2023

## Ex-Federal Reserve head Bernanke: Israeli legal shakeup to cause 'tremendous damage'

“Israel is a small and open economy that depends on international trade and international investments for economic growth and prosperity,” Bernanke said according to Channel 13. “There will be tremendous damage to the security of foreign investors, trading partners, and Israeli entrepreneurs as a result of sudden institutional changes that will increase uncertainty, create new legal and political risks, and jeopardize the rights of minorities.

# The exchange rate

- **The shekel may depreciate:**
  - Withdrawal of funds from Israel
  - Decrease in foreign investments in Israeli High-Tech
  - High-Tech companies may transfer operations abroad
- **In general it is very hard to predict what will happen to the exchange rate**
  - If someone knew for sure, he could have made money by trading in forex
  - The trading will have affected the forex right away

# The exchange rate: example from Russia

- **An example from Russia which shows its hard to predict exchange rates:**
  - At the beginning of February 2022, the dollar was worth 76 Rubles
  - On March 11, the dollar jumped to 134 Rubles following the invasion of Ukraine
  - At the end of July 2022, the dollar fell to 54 Rubles - the ruble appreciated contrary to expectations
- **The Ruble depreciated due to a decrease in Russian exports which meant a lower supply of dollars**
- **But then due to a ban on exports to Russia, the demand for dollars decreased as well**
- **As of the end of March 2023, the dollar is app. 77 Rubles, similarly to the exchange rate before the war with Ukraine**
- **Although the Ruble did not depreciate, Russia was badly harmed because trade with Russia has declined dramatically (Russian can buy with dollars much fewer products and services)**

# The link between the legislation and the exchange rate

- **On Thursday, March 24, Yoav Galant, Israel's defense minister, announces that he'll hold a press conference in the evening; rumors are that he'll call Netanyahu to stop the legislation process**
- **He then cancels the press conference after meeting Netanyahu**
- **Netanyahu then holds a press conference of his own and announces that the legislation process will continue as planned**

# The link between the legislation and the exchange rate



# Citi's forecast

Globes, February 21, 2023

Citi sees NIS 3.95/\$ as judicial reforms weigh on shekel



Shekel depreciates credit: Tali Bogdanovsky



A-

A+



# What if Citi's forecast is right?

- **When the government was sworn in on December 29, 2022, the dollar was NIS 3.52**
- **If the dollar jumps to NIS 3.95, depreciation will be 12% (despite the above reservations)**
- **Historically, prices in Israel have risen around 0.3% for every 1% increase in the dollar**
- **Accordingly, prices will increase by 3.6%**
- **The Bank of Israel will have to continue with interest rate increases**
- **Mortgage will become more expensive:**
  - **Suppose the interest rate increases by 2% more than it would increase but for the legislation**
  - **Consider a mortgage of 600,000 NIS (the average mortgage in Israel), for 25 years, with a variable interest rate**
  - **Monthly repayment at 5% interest: NIS 3,084**
  - **Monthly repayment at 7% interest: NIS 3,788**
- **The situation will be much worse if the shekel depreciates like the Hungarian Forint or the Turkish Lira**

# Corruption

# The effect on corruption

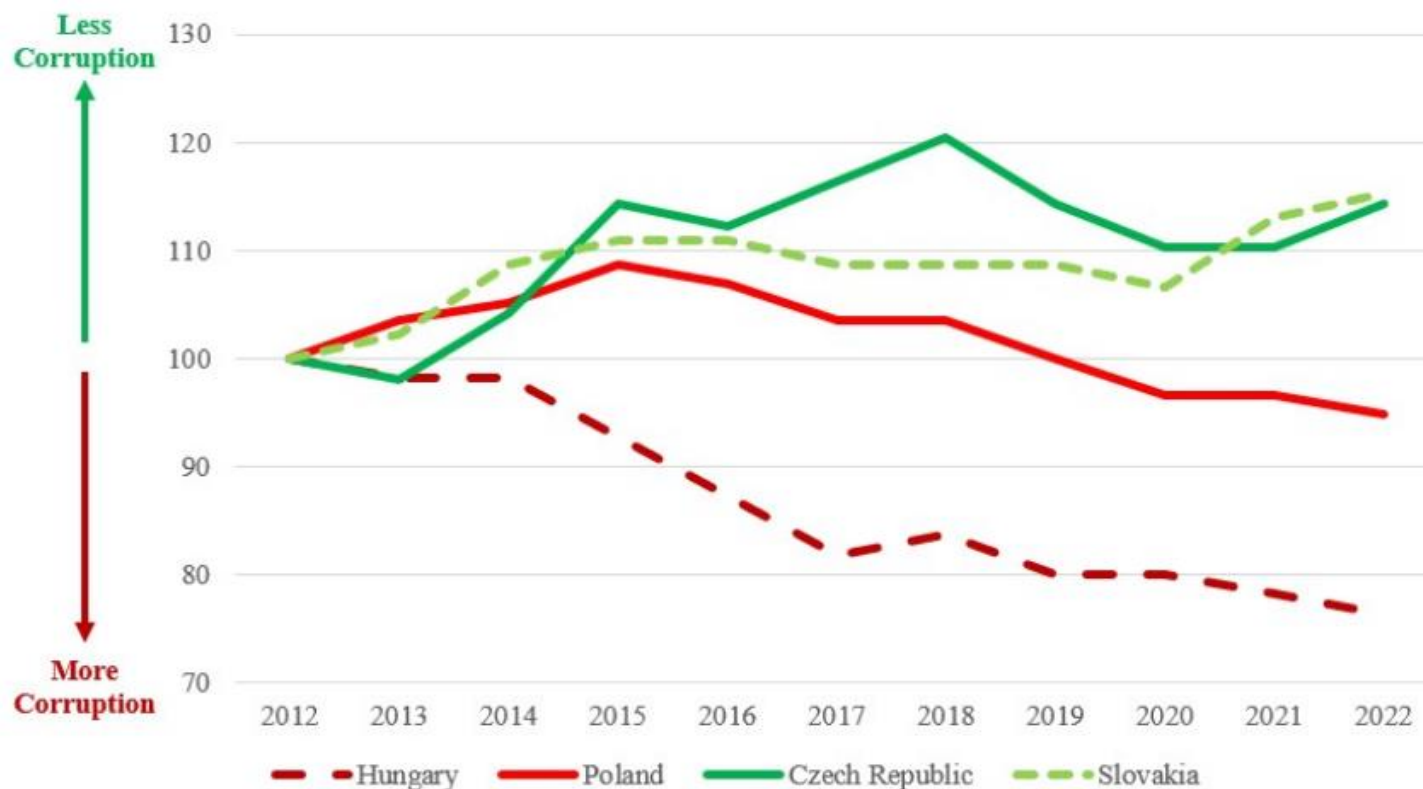
- **Without independent legal advisors and without judicial review, corruption may increase:**
  - Appointments of inappropriate people to official positions (e.g., the proposal to appoint Netanyahu's associate, Yossi Shelli, to head the Central Bureau of Statistics or the proposal to appoint Moshe Ben Zaken as the Director General of the Ministry of Transportation)
  - Favoritism in public procurement
  - Rent seeing
  - Transfers of budgets to associates

# Corruption in Poland and Hungary has increased relative to the Czech Republic and Slovakia after democracy was weakened

Itai Ater and Tzachi Raz

## Corruption Perception Index (CPI), 2012-2022

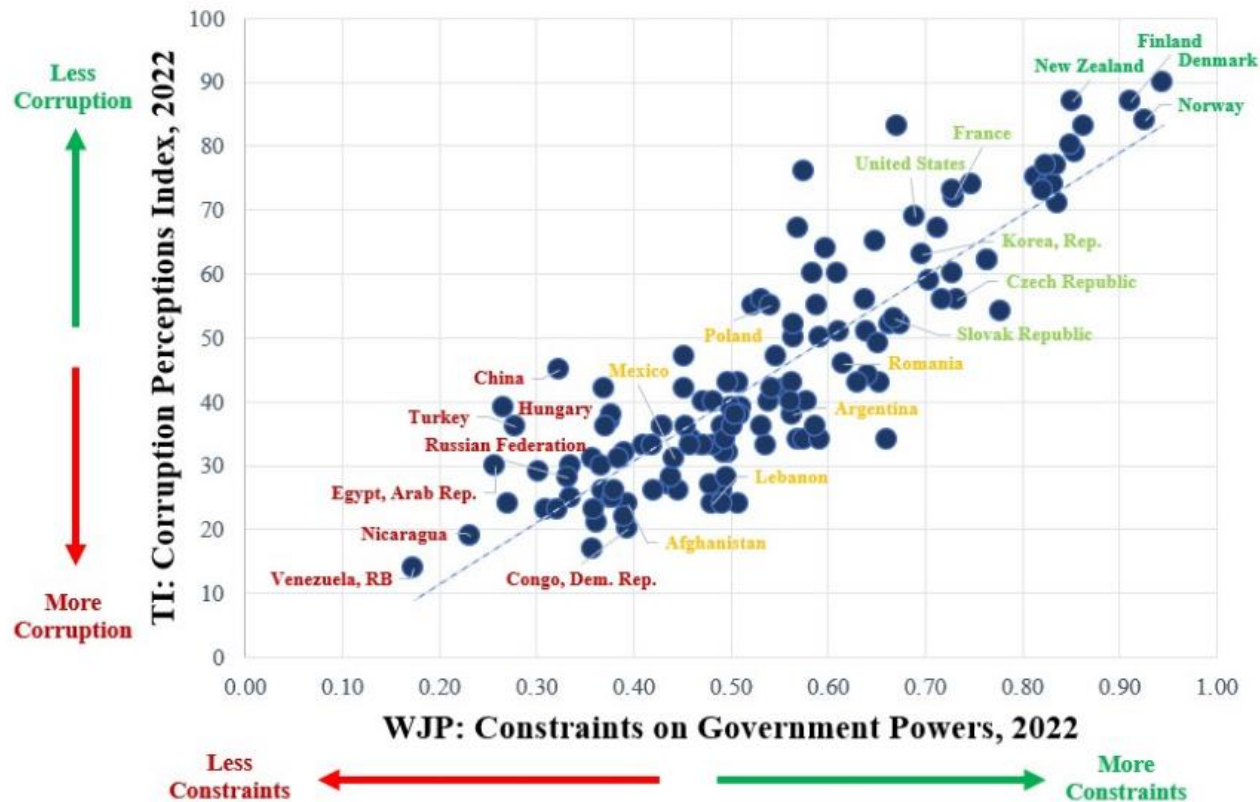
A lower score represents a higher level of corruption (2012=100)



# Constraints on government power and corruption

Itai Ater and Tzachi Raz

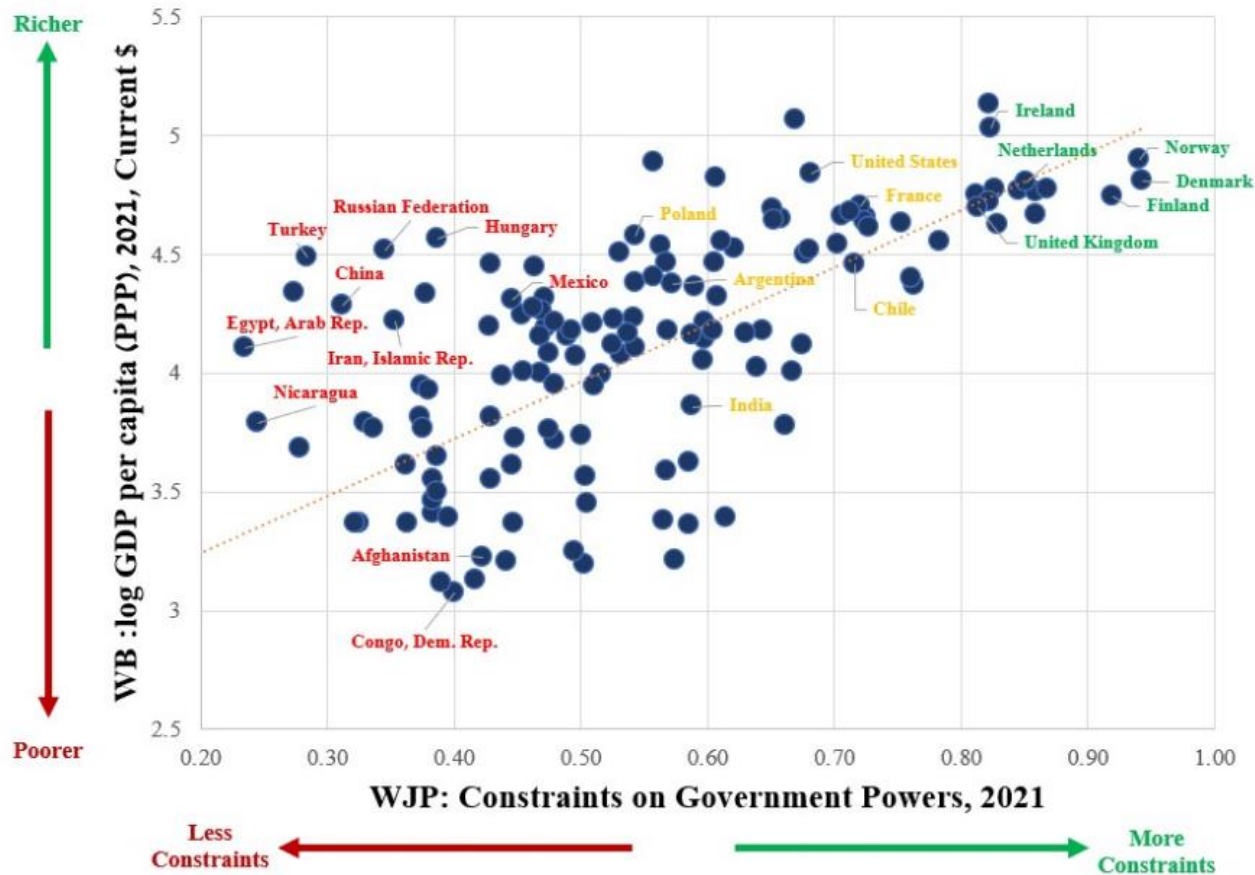
## Constraints on Government Powers and Public Sector Corruption, 2022



# Constraints on government power and GDP

Itai Ater and Tzachi Raz

Constraints on Government Powers and GDP per capita, 2021



# Property Rights

# How can property rights can be harmed?

- **Absent independent judiciary property rights can be compromised**
  - Legal disputes with the government will be decided in favor of the state
  - New, unexpected and disproportionate regulation
- **Absent protection of property rights, investors will be reluctant to invest in Israel, and Israeli firms will be reluctant to keep funds in Israeli banks**
  - Roubini (The Marker, March 5, 2023): "I think that everyone who has invested in technology in Israel is concerned about the future of investment, and wonders if they should make new investments in Israel now. There is already evidence of a decrease in the amount of new funds flowing to Israel. Investors are adopting a 'wait and see' approach - There is already significant concern, they want to understand what is going to happen here."



# The concern of investors from hold up

- **Sir Ronald Cohen (March 3, 2023): I will hesitate to invest in Israel and I am not alone"**
- **"The entrepreneurs and businessmen are concerned about the government's absolute power. When all the power is concentrated in the government's hands, when the checks and balances of a democratic regime are dismantled, the productive sector which is based on the norms of fair play, feels extremely threatened. They tell themselves: if I get into a dispute with this government, who will guarantee that it will not use its power against me? Who will I turn to protect me, when judges appointed by the government will also sit in the court? There is no one to stop the government. Investors will be especially careful to put money in the companies that are exposed to extensive government regulation, regardless of its declared ideology. The government's initiatives to erode democracy will be deter many. Already deter."**

# Intervention in the private sector

- **Absent judiciary independence the government can put pressure on the private sector to get favors, say by threatening to stop cooperating with them**
- **In January 2023, Chaim Katz, the minister of tourism, blatantly demanded that Avi Nissencorn, the president of the Israel Hotel Association will finish his term, otherwise the ministry will not cooperate with the association**
- **The reason for the demand was that when Nissecorn served as chairman of the Knesset committee, he refused to grant immunity to Katz**

# Harm to pensions

- **Absent judiciary independence the government may harm pension rights with seemingly innocuous legislation**
- **Turkey, February 14, 2023:**
  - Erdogan orders private pension funds to invest at least 30% of the government matching funds (the government matches 30% of private pension savings up to the minimum wage) in Turkish stocks following the earthquake to strengthen the Turkish stock market
- **Hungary 2010:**
  - Orban nationalizes the private pension funds
  - The right to early retirement has been canceled (except for women who have accumulated 40 years of pension)
  - Simonovich (2022) shows that the amount of the pension relative to the salary decreased from 65% in 2010 to 50% in 2021
- **It is hard to know what will happen in Israel, but pensions may not be safe anymore**

**Increased risk**

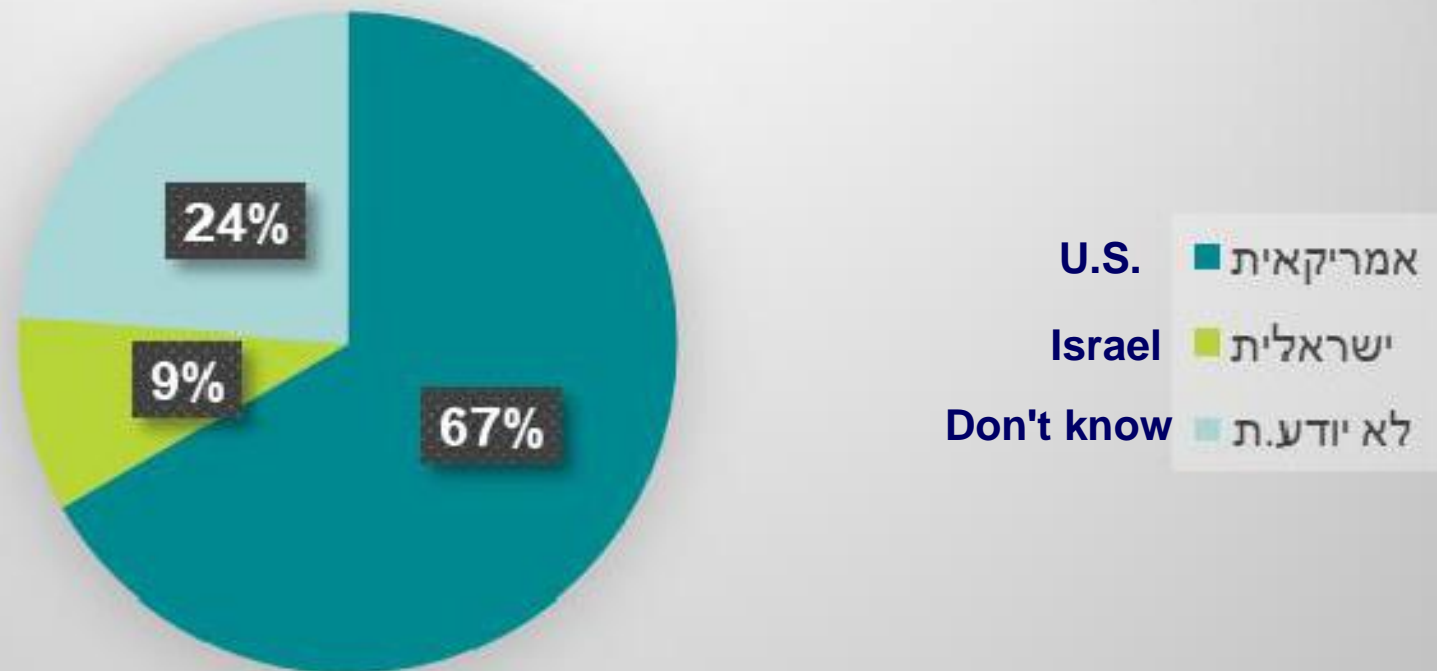
# Increased business risk

- **Absent checks and balances, there is less stability, making it harder for firms to predict future government's actions**
- **Instability discourages investors who worry that the government will hold them up by**
  - Taxation of profits
  - Revoking various benefits given to firms
  - Violating of workers' rights
- **Deterioration of security and foreign relations will damage the "start up nation" brand and will alienate investors who care about ESG (social and environmental responsibility)**

# Concern about establishing a new firm in Israel

The Israeli High-Tech Survey, February 2023

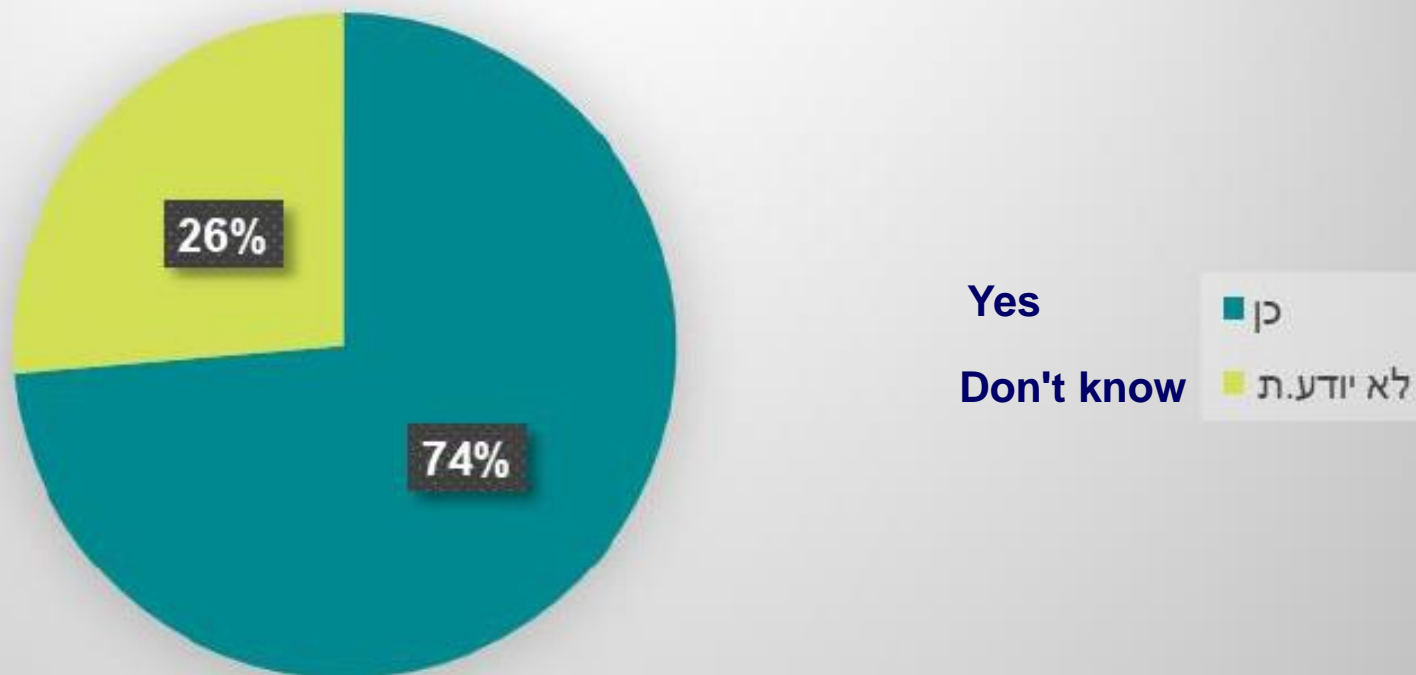
- If you had to establish a new firm, would you do it in Israel or in the U.S.?



# Rising funds after following the reforms

The Israeli High-Tech Survey, February 2023

- Do you have difficulties to raise funds for a new VC after the reforms were announced?

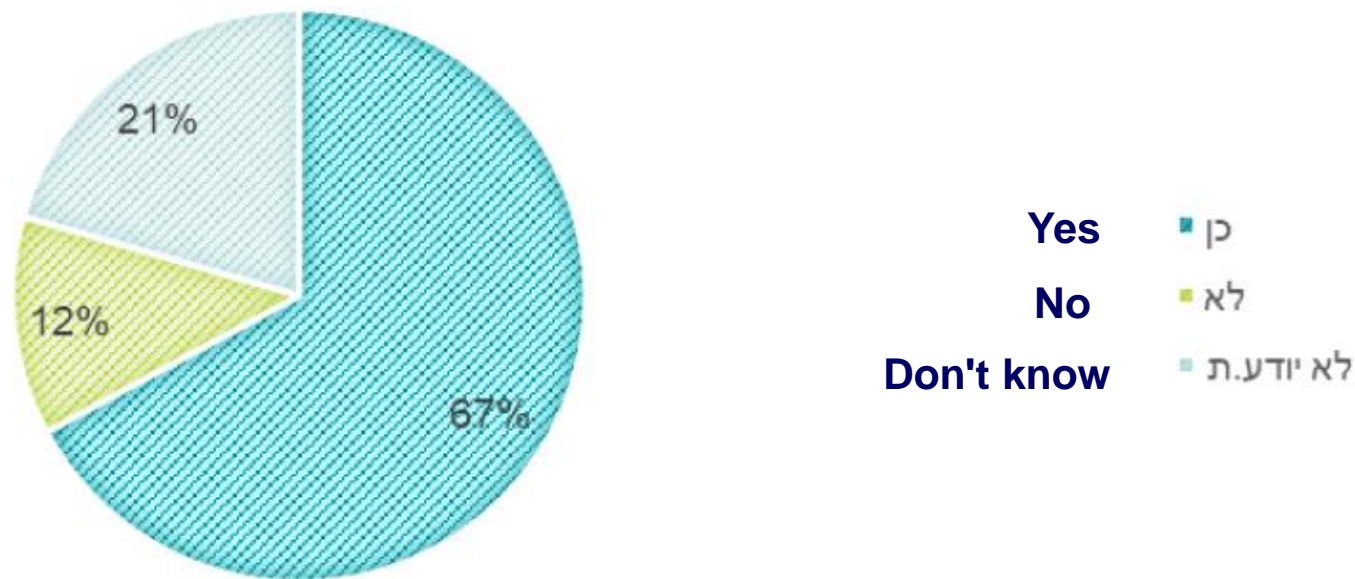




# Concern about a harm to ESG strategies

The Israeli High-Tech Survey, February 2023

- Are you concerned that the situation in Israel will harm your ESG strategies



# Nouriel Roubini

The Marker, March 6, 2023

- **"It is not only the legal reform. They want to intervene in academia, the media, the Central Bureau of statistics. This is what happens when there is an authoritarian government that takes over the executive branch, the legislation and the judiciary — and then tries to control the media and the institutions that define democracy."**
- **"In Israel there is no constitution, so the Supreme Court serves as a substitute for the constitution. There are always different political views, but this coalition undermines everything that defines, the meaning, of democracy - and not only at the level of the judiciary"**