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OVERVIEW

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Economic Consequences of a Regime Change: Overview
Assaf Razin and Efraim Sadka
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ABSTRACT

Regime changes toward autocracy typically reshape the judicial framework, effectively eroding the separation of powers and leading the nation toward an autocratic path. Recent instances of regime shift in Hungary, Poland, and Turkey offer templates of democratic erosion through manipulation and “democratic” means. Israel is now amid a conflicting judicial overhaul. Whereas 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. Their ideological 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 organizations cultivated since the Enlightenment. These century-old trends have been instrumental in fostering unprecedented prosperity. This paper overviews the economic consequences of regime changes from liberal democracy towards autocracy.

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Israel is experiencing a deepening divide, as a coalition government teeters on a precarious electoral majority. This coalition comprises the Likud party, along with Orthodox and the nationalist religious and the Jewish supremacist factions. Their ideological 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 organizations cultivated since the Enlightenment. These century-old trends have been instrumental in fostering unprecedented prosperity.

Hungary's Fidesz government (led by Viktor Orbán, engineered sweeping judicial alterations, raising alarms about political meddling, diminished judicial autonomy, and weakened checks and balances. Likewise, Poland's Law and Justice (PiS) party triggered concerns through 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. This coalition, composed of the Likud party, led by Benjamin Netanyahu (who stands trial on several charges), the Orthodox, and the nationalist religious and the Jewish supremacist smaller parties, deviates from Western democratic norms rooted in the Enlightenment ideas of separation of powers, judicial independence, and intricate political, civic, and social frameworks that fostered unparalleled prosperity. 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.

Hungary and Poland saw protests springing 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. Protests and rallies transformed into platforms for citizens to voice their apprehensions and demand

upholding the rule of law. Grassroots organizations, legal associations, and concerned individuals coalesced to counter perceived threats to the judiciary's integrity. These movements have not just attracted domestic attention; they resonated on an international scale. European Union institutions, human rights groups, and global legal entities expressed concern over these changes and their implications for democratic norms and the rule of law.

Public sentiment regarding protest movements varied. Dramatic examples of public protests are the protest held in Tiananmen Square, the Prague Spring protest, and Hong Kong's Umbrella protests, the Arab Spring uprisings – all suppressed; the Prague Velvet and the Polish Solidarity anti-authoritarian protests with notable success.¹ In Israel, the movement drew 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 constituents of the coalition government.

Judicial reforms by Poland's PIS and Hungary-Fides's governments sparked clashes with EU bodies and triggered Article 7 procedures, underscoring the potential fallout from undermining the rule of law within the European Union. Despite opposition, these reforms pressed on, raising questions about the EU's ability to enforce democratic norms among member states. Nevertheless, the EU had some restraining effect on the Judicial overhaul. Regretfully, no such safeguard applies to Israel.

Hungary and Poland encountered more forceful government responses to protests, often disregarding the protest and pushing forward with reforms despite both domestic and international opposition. In contrast to both Hungary and Poland, only the massive demonstrations in Israel, its strong civic institutions the massive public up-rise, had so far, a restraining effect. Israel's

¹ See Cantoni et al (2023)

proposition prompted robust resistance within the nation's democratic structures and the army (IDF) People, with the outcome still uncertain.

2. Democracy Causes Growth

The growth engines that led the Israeli economy to a remarkable level, almost unprecedented among the OECD economies - the high-tech sector, the core education, the science, the entrepreneurship, the welfare state, and the other social and economic features of the liberal economies – all rest on a traditional consensus about a free and independent judicial system and a liberal democracy. The “economic miracle” of the 75-year-old Israel manifests itself in its transformation from a poor agricultural to a high-tech/industrialized economy, well integrated into the world economy, with a GDP per capita at the top tier of the OECD economies. All this is in peril now due to the ongoing politico-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 citizen access to economic and political opportunities with a facilitated active involvement in decision-making, and safeguarded property rights. 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 upon 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 cultivate innovation and economic expansion by fostering competition, safeguarding property rights, and incentivizing investments in productive endeavors.

Acemoglu et al (2019) focus in their groundbreaking research 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 that have stable liberal democratic regimes with others that have switched from democracies 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 removing the regime of the generals who seized power by a coup. Also included in the analysis are countries of the former Soviet Union and the satellite states, which 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 democratization, historically, has equipped countries to achieve faster economic growth within 5-10 years, reflecting increased investments in education, health, and other public services, and reducing social unrest. The researchers also showed that the level of economic corruption in democratic countries is much smaller than in autocracies.²

One of the immediate effects of the judicial overhaul is capital flights, depreciation of the currency, inflationary pressures, and credit-rating downgrading of the sovereign debt filters into the entire financial system. The effect of the latter is not only on 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

² Eichengreen (2023) in his literature survey (this volume) indicates that democratization and economic growth are positively correlated. Evidently, correlation does not necessarily indicate the existence of causality or its direction. Acemoglu et al (2019) are obviously aware of this “endogeneity problem”, thus employing a dynamic panel strategy control for country fixed effects and the time variety of patterns of GDP, which otherwise confound the effect of democracy on growth.

(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-economy rent-seeking is a system in which businesses use the government to advance their own interests in exchange for electoral support. Crony Capitalism is where politicians and regulators use 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 favored interest groups. Weakening the judicial oversight enhances both rent-seeking behavior and crony capitalism systems.

As Acemoglu (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 the business sector to divert economic resources in order to "integrate" into the corrupt system, instead of directing its efforts to productive activities. The judicial overhaul has short-term effects – a capital flight that shakes the stock and bond markets. Even more significant, are the long-term effects. Shleifer and Vishny (1998) focus on the long-run effects. They studied 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 in the Anglo-Saxon – the common law – compared to the legal infrastructure of France and Germany (the Civil Law). They demonstrate that even within Western democracies the significant differences in the legal systems affect the financial system functions, and thereby 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. Creditors receive repayment on the loan because they have the legal power to repay the collateral. These practices are less common under the Civil Law. Their research underscores the importance of an independent and reliable judiciary for the proper functioning of the financial system. The latter is essential to promoting entrepreneurship, industrialization, economic development, and prosperity. In illiberal democracies or autocracies, the judicial system is so far away even from the Civil Law system.

The Czech Republic is a democracy with a clear separation of power. In autocratic Hungary, Viktor Orban is pushing out German investors, promoting instead his favorite - Crony Capitalism. Hungary's economy lags the Czech Republic, even as both have been subject to similar external shocks.

Hungary's credit rating is below 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. The annual growth rate of this population is 3.6%, far above that of the general population, which is merely 1.9%. The large Haredi family depresses the income per standard adult. There are also many other factors that reinforce the poverty status. First, confined in closed communities the Haredi population follows strictly 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.

Furthermore, to avoid the draft, men tend to continue attending full-time the Yeshiva after the age of thirteen. Furthermore, given their political influence in the Israeli coalition-type of government, they manage to receive monetary benefits that discourage work efforts. Consequently, there is an

exceptionally low participation rate of Haredi males in the labor market; they are also engaged mostly in low-skill and low-paying jobs. Women are better educated, but given their high fertility rate, their participation rate in the labor market is still below the rate of that of the Jewish females.

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, amplified by the political pressure exerted in the Knesset by the Haredi parties. Either furthermore, some of the benefits of the welfare state are directly, or indirectly, channeled recently toward the Haredi population, thereby making the benefits unequally distributed in favor of the Haredi population.

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

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

Here 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 toward 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 maneuvers are used to reroute food subsidies primarily toward the Orthodox sector. This preferential treatment in food subsidies 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 of government. These benefits can discourage work efforts and contribute to an exceptionally low participation rate of Haredi males in the labor market, as mentioned in the text.

Fourth, the 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 organizations 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 favoritism 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. FDI, Technology, and Entrepreneurship

Israel's economy is the most tech dependent in the world, with 13 percent of the country's GDP and 31 percent of all exports originating in the high-tech sector; thus, the global high-tech slowdown has hit Israel harder than other advanced economies. Pointedly, the domestic legal system is a key to both entrepreneurship, innovation, and the securing of steady flows of venture capital, to finance such endeavors.

Large capital inflows are typically viewed as hazardous in financial markets living with memories of recent financial and currency crises. In the last decades, however, in Israel foreign capital in the form of FDI, including venture capital (VC), provided crucial funding for investment in its 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 flock to learn how to develop an innovation ecosystem.³ Israel pulled in the fourth highest level of FDI in relation to the size of its economy. Israel brought in about 4 percent of GDP in FDI. The OECD average was just 1.4 percent. Israel's inward FDI flows accelerated in the 1990s and the 2000s. Israel's VC development exhibits a remarkable increase as a proportion of total inward FDI, demonstrating the sharp increase in funding to high-tech startups.

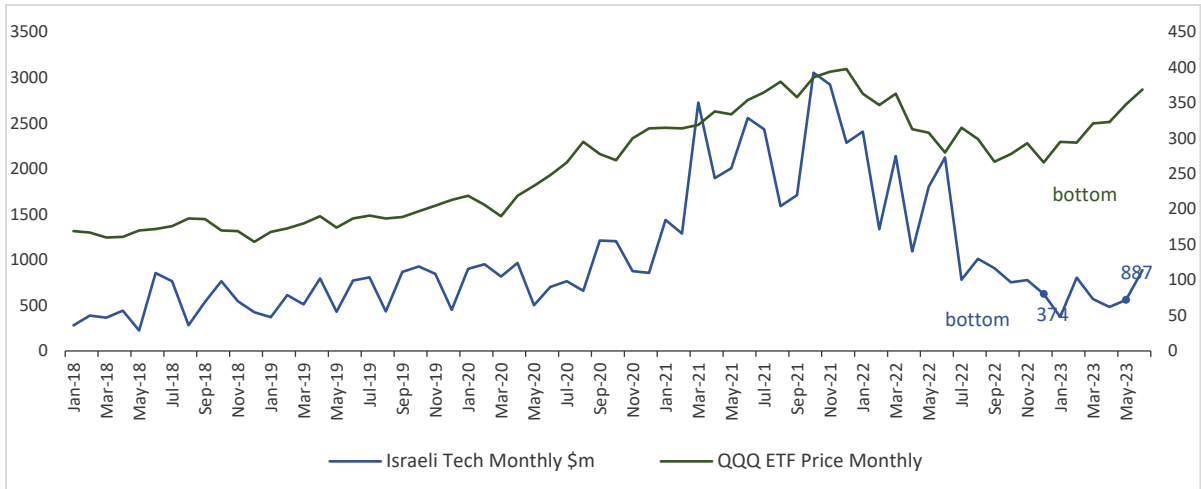
Evidently, an isolated and small economy cannot be a center of innovation. The incentives of entrepreneurs to invest efforts and resources in generating valuable services are related to the

³ See Longani and Razin (2001) and Razin (2018) for the role of FDI and venture capital in promoting the hi-tech sector.

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 at the confines of a small economy to the worldwide execution stage, by utilizing the world markets. The globalization of an economy is crucial for its world-power high-tech industry to develop, and flourish. Foreign VC has been crucial for the emergence of Israel's high-tech sector into an elite position in the world economy. Evidently, Israel's domestic market alone is far too small with its homegrown capital formation being inadequate to foster innovation. FDI in the form of VC, in the initial phase of the startup, and foreign acquisition by of the developed innovation has been essential.

Things have changed since the announcement of the judicial reform in the beginning of 2023. The second quarter of 2023 shows a decline of 62% year on year (compared to 2022) and a drop of 71% compared to the second quarter of 2021. Hi-tech funding in Israel started its slowdown that is already stretching past 6 quarters. A comparison of 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 is shown in Figure 1. Both bottomed out at the end of 2022 and then started moving up towards the beginning of 2023 when the Israeli government announced its judicial regime-change program. The exchange-traded fund has shown a much speedier and higher surge than the Israeli tech funding.

Figure 1. Nasdaq 100 vs Israeli funding amounts (\$m), monthly scale, 2018 – H1/2023



Source: Israel's Venture Capital (IVC)

Figure 2 describes high-tech investments in the first half of 2023. It shows a sharp downtrend for investments in the hi-tech sector from 2022 - at the height of the worldwide pandemic recession - reaching below the 2019 second-quarter level.

Figure 2. Investment in Israel's Hi-Tech (half years, \$ Billions)



Source: IVC

Figure 3. Venture Capital Investment (Half year, \$ Billions)

6. Public Resistance

All three countries, Hungary, Poland and Israel, 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.

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

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

Public sentiment regarding protest movements varied. Among 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 these 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 European Union. Despite opposition, these reforms pressed on, raising questions about the EU's ability to enforce democratic norms among member states. Mostly the EU had a restraining effect on the Judicial overhaul.

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, only 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.

Israel's regime change has very significant economic consequences, which this essay explores. The State of Israel, whose economic success (the "economic miracle") is closely linked with the global economy, is at particular risk from the proposed Judicial overhaul. Even though this judicial overhaul has not yet been implemented due to the overwhelming public resistance, one can still observe some signs of an economic backlash. This has been manifested in a massive capital flight and a sharp

decline in foreign direct investment (FDI), resulting in currency depreciation, a relatively sluggish stock market, a slowdown in tax revenues, and rising public debt. The Israeli economy is particularly vulnerable to severe damage when investor confidence in the international capital markets and in the independent functioning of its judicial system is undermined. The capital market softness is an immediate consequence of the investors' fear of the ongoing regime change.

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