Abstract

The behavior of fiscal policy over the business cycle has received increasing attention from researchers in recent years. The terms pro-cyclical and counter-cyclical are used to describe how an economic policy is related to economic fluctuations, indicating a government's approach to spending and taxation. A pro-cyclical fiscal policy can be summarized as governments choosing to increase public spending and reduce taxes during an economic boom, but cut spending and raise taxes during a recession. A counter-cyclical fiscal policy refers to the opposite approach: reducing spending and raising taxes during a boom period, whereas increasing spending and cutting taxes during a recession. Most economists would agree with the normative prescription that tax rates and discretionary government spending should follow a counter-cyclical pattern. Pro-cyclical fiscal policy leads to macroeconomic instability and aggravates crises. Literature shows that, although considered sub-optimal, developing countries historically adopted pro-cyclical fiscal policies. In recent times, however, we are observing a shift in this trend, since several developing economies have been able to escape the pro-cyclicality trap and become counter-cyclical (Vegh and Vuletin, 2014).

This work analyzes cyclicality of government expenditures in Israel. Previous literature found that, although Israel has traditionally adopted a highly pro-cyclical fiscal policy, it has attenuated since the Economic Stabilization Program in 1985. This work adds to previous literature in Israel through two new angles: first, it continues the analysis using updated data in order to check whether Israel also "graduated" by turning into counter-cyclical fiscal policy; second, it analyzes for the first time the transmission channels that allowed Israel to change fiscal policy reaction to cycles.

The main finding of this work is that since 2008, right before the worldwide economic crisis, Israel's fiscal policy "graduated" and turned into counter-cyclical. We show that this result is valid for total general government expenditure in real terms (deflated by GDP prices). According to our findings, total government expenditure’s coefficient was -0.1 since 2008 (i.e., countercyclical) after showing a positive value for all previous sub-periods of Israel's economic history. It also happens among cyclically adjusted deficits, which show significant counter-cyclical levels in particular from 2005. Expenditures’ components - in particular transfer payments - are following the same

direction: despite traditional pro-cyclicality levels, transfer payments coefficient became -0.5 for the period after 2008. We also found that pro-cyclicality of fiscal policy in the past was mainly related to recessions, a pattern that is similar to developing economies since those are periods of rising government deficit. Consequently, governments cut expenditure or raise taxes as a way of coping with the increasing deficit.

Another finding of the present work is that high public debt seems to be the main restraint toward adopting counter-cyclical fiscal policy over time. Our regressions show that historical procyclicality was associated with a high external and total debt. This finding is consistent with the reduction of pro-cyclicality that occurred when Israel's government debt as a percent of GDP was reduced substantially, and became lower than most developed economies after the last world economic crisis. In addition, historical pro-cyclicality proved stronger in recession compared expansion years, and the difference stems indeed from high debt periods.