Box A: Rainy Day Fund

This box discusses the Government's planned Rainy Day Fund. The Council assess that the Rainy Day Fund could be a potentially very useful countercyclical tool to ensure more sustainable growth and prudent management of the public finances. It welcomes the publication of a Consultation Paper on how the Fund might operate (Department of Finance, 2017d). Yet key issues have still not been addressed adequately, and the Fund envisaged in the Consultation Paper appears to be have been scaled back from initial plans. The Council identifies three key issues still to be addressed: (i) countercyclicality; (ii) interaction with the fiscal rules; and (iii) governance procedures.[24]

(i) Countercyclicality

The fund envisaged by the Department of Finance does not appear to function as a countercyclical tool for fiscal policy (i.e., it does not act in a manner that would lessen past tendencies to ramp up spending and cut taxes during a cyclical upturn). The paper appears to indicate that part of the reason for this is that the *SGP* is "for the most part, designed to smooth 'normal' cyclical conditions". However, as Boxes B and E emphasise, there are good reasons to suggest that the *SGP* will fail to identify the cycle accurately and an additional tool is needed to manage the public finances in a manner that would help to avoid any procyclical bias evident in the fiscal rules.

Rather than responding to cyclical developments, it would appear that the fund, as proposed, would be set with pre-determined allocation limits that are applicable for a pre-determined period of time. Allocations are set at a maximum of €500 million annually over the three-year period 2019–2021 and there is no clear basis for how allocations are expected to vary within this limit. The Consultation Paper notes that the fund will be used to address "only specific events or shocks rather than the impact of the cycle". This runs contrary to the original purpose of the fund and it would contribute little to improving fiscal policy when the State already holds large reserves of liquid assets.

The prospect of a cap on total cumulative allocations to the fund is also outlined. This, again, would appear to be inconsistent with the idea of a countercyclical tool. If, for example, an upturn is strong and persists over a prolonged period of time, then allocations to the fund should be allowed to expand accordingly without constraints on its capacity to dampen the boom–bust cycle. Correspondingly, if a cyclical downturn were to ensue, then having pre-committed to making allocations to the fund would not be wise, nor would it be consistent with the principle of counteracting the cycle.

Plans for the fund have already exhibited a procyclical pattern whereby proposed allocations have been reduced as economic prospects have improved. Allocations to the Rainy Day Fund have been twice scaled back from original plans. As part of *Summer Economic Statement 2016* and *Budget 2017*, it was announced that €1 billion annual allocations would be made in 2019, 2020 and 2021. Yet the *Summer Economic Statement 2017* noted that these allocations would be halved to €500 million. Following this, *Budget 2018* noted that the €500 million allocations would instead be a maximum limit rather than a target for annual allocations. Over this time, real GDP growth forecasts produced by the Department of Finance for 2017 and 2018 have been revised upwards by 0.8 and 0.1 percentage points, respectively, such that – all else equal – the cyclical position of the economy would be more positive than assessed when the Rainy Day Fund was first proposed. Moreover, risks to the macroeconomic outlook are now assessed by the Department as broadly balanced, whereas at the time of *Budget 2017* they were viewed as firmly tilted to the downside. Against the backdrop of these reduced allocations, a decision was taken in *Budget 2018* to move €1.5 billion of existing liquid assets held by the Ireland Strategic Investment Fund to the Rainy Day Fund.

The Council is of the view that annual allocations to be made to the fund should give some consideration to cyclical conditions and that upper limits on allocations should not be imposed if it

[24] Many of these issues were highlighted by the Council prior to budget day in its *Pre-Budget 2018 Statement* (IFAC, 2017c).

is to function meaningfully. An example would be to link contributions to measures that track the underlying performance of the economy such as labour market data (Box B of IFAC, 2016b); underlying domestic demand; and/or wage inflation. Distortions are common in Irish economic data, and any single measure is unlikely to prove consistent and sensible basis for calibrating annual allocations to a countercyclical fund. A role for external monitoring could be considered in terms of the timing of allocations. One option would be to include a provision that suggests that allocations should be made to the fund whenever unemployment is below the Department's estimate of what is consistent with full employment (e.g., a non-CAM-based NAWRU estimate) with an explanation being required when this is not pursued.

Restricting the countercyclical nature of the fund runs the risk that transient revenues could – as in previous crises – be used to fund long-lasting expenditure increases. This is a possibility that is exacerbated by the procyclicality of the estimates of Irish potential output underpinning the fiscal rules (Box B) – an issue which a well-designed Rainy Day Fund can serve to mitigate.

(ii) Interaction with the Fiscal Rules

A key aspect of the Rainy Day Fund that still needs to be addressed is how it might interact with the fiscal rules. The Consultation Paper notes that withdrawals from the fund could be complicated by the fact that increasing spending funded by drawing on resources built up in the fund could ultimately breach the domestic and EU fiscal rules. For instance, the spending rule (the Expenditure Benchmark) sets a limit on real spending growth net of interest costs and new tax measures, while the domestic government expenditure ceilings are designed to set ceilings for aggregate departmental spending. Using the fund to increase spending over and above what is already permitted under the rules or ceilings could lead to breaches of the fiscal rules – especially if budgetary plans are set on the basis of assumed minimum compliance.

More options should be considered for how withdrawals from the Rainy Day Fund can operate without running the risk of breaching the fiscal rules. The Consultation Paper notes that the unusual event clause, the one-off classification, and the structural reform/investment clauses are avenues that could be used to enable withdrawals while still complying with the rules. These flexibilities are not designed for such mechanisms; they may not permit the envisaged scope for temporary departures from the rules; and the procedures governing when the clauses may be triggered may not be sufficiently well-defined to suit the purposes intended. A better approach would be to engage with the European Commission on means through which the rules could be adapted to ensure that Member States employing tools such as the Rainy Day Fund are not treated in a punitive manner.

(iii) Governance Procedures

Specific procedures governing how the Rainy Day Fund is to operate should be examined in more detail. As noted in the Consultation Paper, there is a risk that if resources are not properly safeguarded, these could be used to fund ongoing expenditure overruns. The safeguards which will be put in place to prevent such actions need to be robust and key to this process will be defining the reasons for which resources may be drawn from the fund.

In addition, greater consideration should be given to whether other structural issues (such as addressing the accrued liability of public service occupational pensions) will also be addressed by this fund or by other funds.