Note on the Proposed Rainy Day Fund

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Irish Fiscal Advisory Council

Summary

- **While not a necessity, a Rainy Day Fund (RDF) could play a useful role in running countercyclical policy in Ireland.** The fiscal rules cannot entirely be relied upon to guide fiscal policy in an appropriately countercyclical direction. An additional tool, such as an RDF, may be useful to set savings aside in good times providing room for fiscal stimulus when needed. Another potential benefit of an RDF is that it could be used to save potentially transient revenue sources (e.g., unexpected surges in corporation tax receipts) rather than using these to fund permanent expenditure increases. An RDF could also improve liquidity, although the NTMA mitigates this risk through pre-funding.

- **The proposed size of the RDF is small and the design is not countercyclical.** Contributions to and withdrawals from an RDF should be linked to the economic cycle and should not be capped or time-limited. Given the open and volatile nature of the Irish economy, an RDF may need to be relatively large. With this in mind, the proposed fund looks quite small (€1.5bn is equivalent to 0.5 per cent of GDP or 2 per cent of total government revenue). Annual contributions in excess of €500m could be required to cool a rapidly growing economy.

- **How the fund interacts with the fiscal rules requires further consideration.** Existing exemptions under the rules are very unlikely to provide the required flexibility to ensure withdrawals from the fund in bad times without causing breaches of domestic and European rules. Rather than relying on exemptions or one-off clauses currently available under the fiscal rules, a change to the rules to accommodate the use of such a fund is warranted.

Introduction

This note sets out the Irish Fiscal Advisory Council's views on the proposed Rainy Day Fund (RDF). It follows the publication of a Consultation Paper on how such a fund might operate (Department of Finance, 2017) and a briefing paper of the Parliamentary Budget Office (2017). The Council has made a number of contributions in this regard over the last two years.[1]

While an RDF is not a necessity for prudent fiscal policy, the Council considers that an appropriately-designed RDF could be a useful countercyclical tool. Such a fund could provide a framework by which savings are set aside in good times. These savings could then be used in bad times when required. Such a tool could therefore help to ensure a countercyclical element to fiscal policy that has often been missing in Ireland and one which is not adequately provided for by the fiscal rules. This is especially important when improvements in the public finances might primarily reflect cyclical or transient revenues.

The design of an RDF requires careful consideration if it is to act as a potentially useful tool. In particular, it should be designed in an appropriately countercyclical manner (current proposals do not achieve this) and its functioning within the fiscal rules needs to be properly addressed. The rest of this note attempts to address these issues.

[1] Contributions have been made through various reports by the Council (IFAC 2017a; 2017b; 2017c; 2016a; 2016b) including Box A (pp.28–30) in the last *Fiscal Assessment Report* (IFAC, 2017c) and Box B (IFAC, 2016a) pp.19–21.

1. The Need for an Additional Countercyclical Tool

The fiscal rules may not provide enough scope for countercyclical policy as designed and this could warrant an additional tool such as an RDF. In terms of the Rainy Day Fund acting as a countercyclical tool, the consultation paper from the Department of Finance states that "the [Stability and Growth Pact] SGP already provides for in-built fiscal stabilisation mechanism". However, the Council do not view the SGP as always providing sufficient scope for such a stabilisation mechanism (i.e., countercyclical policy).

While the SGP attempts to guide fiscal policy in a countercyclical direction, there are clear shortcomings to this approach, particularly in the case of Ireland. These are mainly driven by problems associated with the Commonly Agreed Methodology for estimating potential output. Estimates using this methodology tend to be procyclical (i.e., estimates increase in cyclical upturns, and decrease in cyclical downturns). The standard methodology could therefore permit excessively loose fiscal policy in good times and require excessively tight fiscal policy in bad times.

An appropriately designed RDF could help to alleviate these problems by saving any of the unsustainable scope for spending increases or tax cuts allowed for under the rules. This could assist in fiscal policy being conducted so that the appropriate fiscal stance is taken, rather than simply always using all of the available fiscal space. An additional practical benefit relates to the ease of adjusting "expenditure". In a downturn, it is much easier to adjust "expenditure" by stopping contributions to the RDF rather than by cutting other elements of government spending. For more on how the RDF could operate alongside the fiscal rules, see Section 3 and the Appendix.

2. Designing an RDF that Helps to Avoid the Boom-Bust Cycle

If the fund were to operate as a countercyclical tool, then both contributions and withdrawals should somehow be linked to the economic cycle. The current RDF proposals include an upper limit of €500m on annual contributions and a three-year contribution limit. These are not in keeping with countercyclical policy.

The contributions to the fund ought to be dynamic so that the “unsustainable” element of fiscal space in any year is set aside into such a fund. If there were consecutive years where this is the case, then contributions would need to grow over the period to have a dampening effect on growth. As economic upturns often last more than three years, contributions may well need to be made over a longer horizon than currently planned. Setting up a countercyclical fund in this way could help guide policymakers towards the appropriate fiscal stance as opposed to using all of the available fiscal space.

While there is no established metric for what size such a fund should be, it would seem logical that a small, open and volatile economy like Ireland would require a larger fund (as a percentage of government revenue or national income) relative to other countries. With this in mind, the proposed RDF looks quite small. The proposed maximum contributions of €500 million for three years would amount to a fund of €1.5bn, equivalent to 0.5 per cent of GDP or 2 per cent of total government revenue. In addition, contributions of a maximum of €500 million would seem unlikely to significantly cool an economy growing above its sustainable rate. The size of contributions at any time should be linked to economic conditions. As many macroeconomic indicators in Ireland are distorted, a range of indicators should be examined, possibly by an external agency, when considering the scale and timing of contributions to be made.[2]

While an RDF would primarily act as a tool for countercyclical fiscal policy, there are two other potential motivations for establishing an RDF. First, it could help

[2] Linking contributions or withdrawals to a measure of domestic activity, such as the labour market, underlying domestic demand or wage inflation could be useful. See Box C in IFAC (2016a) for a discussion of headline and underlying contributions to growth.

overcome liquidity difficulties in a downturn (albeit the NTMA already manages much of the funding risk). Second, an RDF could be a destination for potentially transient revenue sources (such as unexpected surges in corporation tax). Rainy day funds or, more generally, sovereign wealth funds have been used in other countries to save temporary or transient revenues, such as those from a finite natural resource. More generally, it is advisable to save increases in revenue from temporary or transient sources, rather than using them to fund permanent expenditure increases. In a number of its recent Fiscal Assessment Reports, the Council has cautioned against using increased corporation tax revenue for permanent expenditure increases, given the high level of volatility associated with this tax heading.

3. Interaction with the Fiscal Rules

Another key issue in establishing a Rainy Day Fund is how it interacts with the fiscal rules. The Consultation Paper rightly notes that any additional expenditure or tax cuts funded by withdrawals from the fund could result in breaches of the domestic and EU fiscal rules unless changes are made as to how these are accounted for or other exemptions are provided.

For instance, the spending rule (Expenditure Benchmark) sets a limit on spending growth.[3] Using the fund to increase spending over and above what is already allowed under the rules could lead to breaches of the fiscal rules as things stand.[4]

One option considered in the consultation paper to ensure that withdrawals do not lead to unnecessary breaches of the rules would be to use existing clauses in the fiscal rules.[5] The Consultation Paper notes that the unusual event clause – the one-off classification – or structural reform/investment clauses are avenues that could be used to enable withdrawals, while still complying with the rules. However, these flexibilities are not designed explicitly to allow a fund to support the economy. They are unlikely to allow meaningful withdrawals and the procedures governing them could well prove too restrictive depending on circumstances and measurement issues. For example, the structural reform/investment clauses cited by the proposal:

- tend to be limited to 0.5 per cent of GDP in practice (equivalent to €1.3bn for Ireland using 2016 data);
- are only allowed as temporary deviations from requirements and so have to be corrected for shortly afterwards;

[3] Specifically, it limits the growth in spending excluding interest costs and current spending on EU programmes fully matched by EU funds revenue, while also correcting for investment spending that is unusually high or low and unemployment spending that is related to the economic cycle. Tax increases enable a higher growth in spending while tax cuts reduce the allowable increase in spending under the Expenditure Benchmark.

[4] At present, the Expenditure Benchmark only applies if the Medium Term Objective is not being achieved. In addition, as currently designed, the Expenditure Benchmark does not allow unused fiscal space in one year to be carried forward for use in a following year.

[5] It is worth noting however, that if structural surpluses are run then no exemptions/clauses are required, as unused fiscal space is being used in the downturn with the spending rule not applying if a country has (over)achieved its Medium Term Objective. However, measurement of the structural balance is highly uncertain.

- can have strict conditions in terms of the macroeconomic context – often depending on potential output measurements that are typically based on the EU methodology, which does not work well for Ireland;

- can have various other requirements, including co-financing by the EU; being formally assessed as having direct long-term positive and verifiable budgetary effects; and not leading to deficits greater than 3 per cent of GDP.

The limited size, short timeframe and strict conditionality on using the structural investment/reform clauses mean it is unlikely that an RDF could operate as an effective countercyclical tool by relying on these clauses to access the funds in bad times. In addition, the uncertainties attached to these requirements could potentially limit the flexibility and responsiveness of any Rainy Day Fund and could make it less desirable to make contributions in the first place.

A better approach to address the interaction of the RDF with the fiscal rules would be to explore ways in which the fiscal rules could be changed to allow the reasonable use of resources that have been set aside in good times (this is explored more in the Appendix). This would require engagement 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.

In this context, it is notable that many Member States are already considering the introduction of Rainy Day Funds, and meaningful discussions are underway at EU level to explore a way in which such funds could work in tandem with the fiscal rules.[6]

[6] See Section 4.2 of the Five Presidents Report (Juncker *et al.*, 2015). A separate set of proposals are offered by Balassone *et al.,* (2007) who note that a change in the definition of the "Maastricht deficit" may be needed need to accommodate the use of an RDF within the fiscal rules, with contributions to the RDF recorded as expenditure and withdrawals treated as revenue. However, this approach would have undesirable consequences. In particular, it would make the recording of deficits less transparent (introducing large timing differences between actual expenditure and recorded expenditure).

Appendix: Additional Detail

The RDF as a Complement to the Fiscal Rules

As highlighted in the note, estimates of potential output growth have a significant impact on the domestic and European fiscal rules. As an example, for the spending rule (the Expenditure Benchmark), the maximum permitted growth rate of real expenditure is set using a ten-year backward and forward looking average of potential output growth (called the Reference Rate). Using differing estimates of potential output growth leads to very different reference rates and hence allowable expenditure growth.

Table 1 below shows the sensitivity of permitted expenditure growth out to 2021 to different reference rates. Four different scenarios are examined. First, the Reference Rate as calculated by the Department in *Budget 2018* (3.8 per cent) would allow almost €12bn increases in nominal expenditure over 2019-2021 under the spending rule.[7] The other three scenarios show the implications of alternative estimates using different methods to that used for the estimates in *Budget 2018*. The IFAC scenario takes a reference rate of 3.25 per cent based on the average of IFAC mid-range estimates for potential output (IFAC, 2017c). Two scenarios based on ESRI estimates of potential output are also presented. Both draw on McQuinn *et al.,* (2017), which gives long-run potential output growth estimates for the whole economy (3.3 per cent) and the non-traded sector (2.4 per cent).

Table1: Illustrative expenditure increases allowed under various Reference Rates

	DoF	IFAC	ESRI(a)	ESRI(b)
Reference Rate (%)	3.8	3.25	3.3	2.4
Cumulative allowable expenditure increases (2019 – 2021, nominal, €bn)	11.6	10.3	10.4	8.3

Note: ESRI(a) refers to the estimates for the whole economy; ESRI(b) covers the non-traded sector. DoF = Department of Finance.

It is clear from Table 1 that more conservative estimates of the growth rate of potential output would lead to significantly less permitted expenditure growth.

[7] In fact, this level of spending would result in over-compliance of the Medium Term Objective, so the allowable expenditure growth under the fiscal rules would be even higher.

Over a three year period, the range of estimates here is €3.3bn (or 1.2 per cent of GDP). There is a danger that the approach currently used by the Department of Finance and the European Commission may interpret recent (and expected) strong growth as being reflective of a much higher pace of potential growth in the economy, as opposed to a cyclical upturn.[8] This misinterpretation was an issue contributing to perceptions of a stronger budgetary position when correcting for the cycle in the 2000s prior to the crisis.

Potential Changes to Fiscal Rules/Government Statistics

As noted above, for an RDF to function with the desired purpose, it should importantly take into account the way it interacts with the fiscal rules. If the RDF is to aid countercyclical policy, then withdrawals from the fund will be made in bad times. This could be to allow automatic stabilisers to take hold or to fund discretionary extra spending or reduced taxation which would act as a fiscal stimulus. One of the mechanisms put forward in the consultation paper for using the RDF within the current fiscal rules is to avail of the one-off aspect of the SGP. If the RDF was to be used to fund an additional once-off investment project, for example, then this may be considered to be a one-off item under the rules. By contrast, if the fund was being used to allow automatic stabilisers take hold, then this is unlikely to be classified as a one-off item. Relying on the one-off clause also seems undesirable given the uncertainty and time lags associated with decisions on classifying spending or tax measures as one-off or not.

An alternative approach may be to seek changes to the existing fiscal framework to better facilitate deposits into and withdrawals from an RDF.

One possibility is to adjust the structural balance and corrected expenditure aggregate used when assessing compliance with the fiscal rules. For example, when (in good times) contributions to the fund are made, these could be counted as a discretionary revenue-reducing measure. For withdrawals (in bad times), withdrawals would be treated as a discretionary revenue-raising

[8] However, it is worth noting the latest estimates in *Budget 2018* producing using the Commonly Agreed Methodology suggest that overheating is already present in the Irish economy, with growth exceeding potential growth in 2014 and 2015.

measure (with a corresponding offset in the structural balance).[9] Alterations such as these could be in place purely for the assessment of fiscal rules and not change Maastricht definition of government deficits or debt.

One existing mechanism for countercyclical fiscal policy in Ireland is the Social Insurance Fund (SIF). Prior to the last crisis the SIF ran surpluses (i.e. social insurance contributions into the fund exceeded payments out to recipients), while during the crisis, deficits were run. The fund is currently in surplus and a recent review of the fund showed plans for surpluses out to 2019 (Department of Employment Affairs and Social Protection, 2017).

[9] How this offset comes about would have to be considered more. One mechanism would be to introduce the corresponding offset as a temporary revenue item that is removed from the structural balance when the withdrawal is made (i.e., when expenditure is boosted temporarily using RDF funds). This should be conditional on the temporary expenditure fulfilling the relevant governance criteria for withdrawal from the RDF. Such an approach would mean that previous lodgements could then be clearly relatable to the withdrawal. This would provide greater certainty in terms of describing the RDF-related expenditure as exceptional when assessing the structural balance.

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