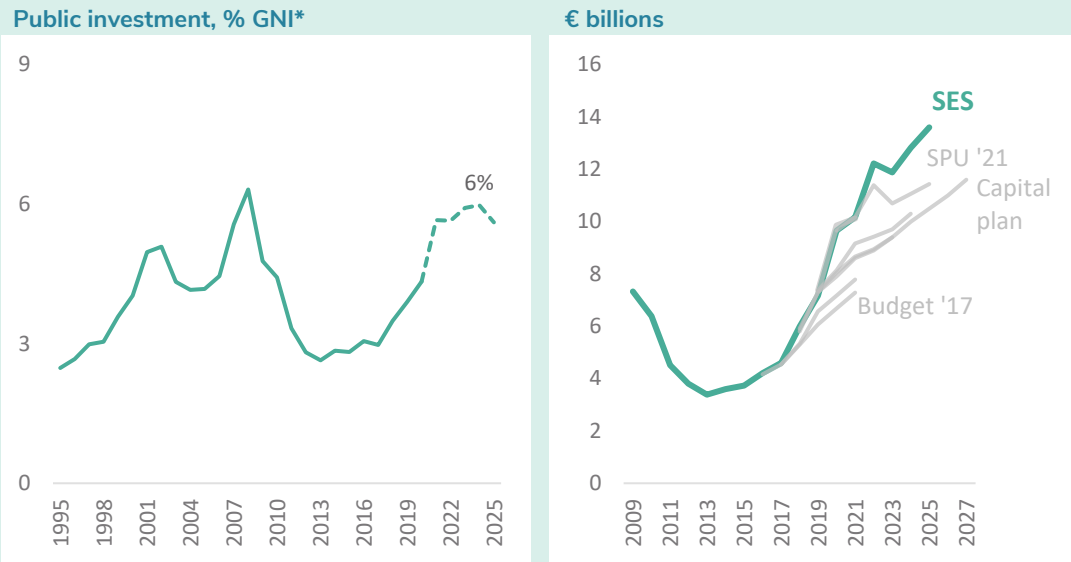


Box C: Higher investment helps address priorities but could be costly

The Irish Government plans to ramp public investment spending up to levels not seen in any other period outside of 2007–2008 in the past three decades (Figure C1). The increase will not only take Ireland's public investment spend to one of the highest rates in its history, but also to the fourth highest in the OECD by 2022 and above the median observed across OECD countries during the past decade (Figure C2). Successive Budgets and policy statements have rapidly ramped up planned investment spending; SES plans for spending this year are 40 per cent higher than was set out in Budget 2017.

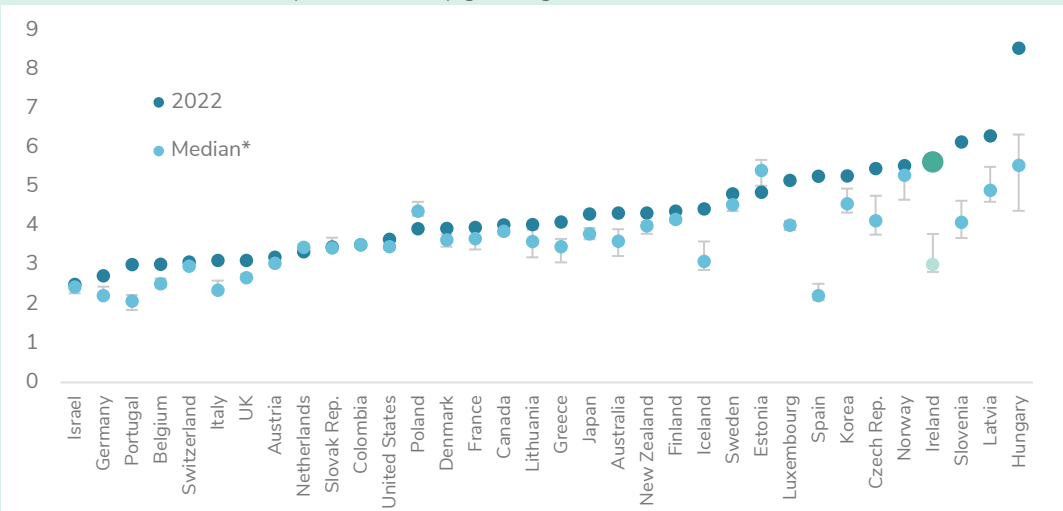
Figure C1: Investment is rising to high levels; well beyond earlier plans



Source: CSO; Department of Finance; and Fiscal Council workings.

Figure C2: Investment will be high by international and historical standards

Public investment as % GDP (GNI* for Ireland), general government basis



Source: OECD; and Fiscal Council workings.

Notes: The median shows the median public investment ratio for the past ten years (2012–2021) and lines the middle 50% (interquartile) range observed over the same period.

The rise in investment spending should help the Government to directly address pressures in areas such as health, climate change, and housing. The case for higher spending in these areas is reasonably strong, given that there are clear needs to address various shortfalls. Interest rates are

also low, such that a sustained period of exceptionally high investment has merits prior to returning to more normal steady state levels of investment.

Efficient capital spending should provide benefits to the State in future years, either in the form of a flow of public services or through benefits to the private economy that may flow back to the government in the future through higher revenues. Conceptually, there is therefore an important difference between spending on current services and payments and capital spending in the timing of spending: current services are paid for when they are used, while capital investment requires a payment that is made up front and may require on-going payments to service the interest on the debt accumulated as a result. In a low interest rate environment, it is more attractive to borrow as these interest costs are lower and the marginal return required for investment projects is lower.

However, the speed of the ramp up in investment and the fact that it is planned to be financed by running larger deficits implies risks. One question is whether the planned increase in capital spending is realistic and can be delivered. In the past, investment spending has not always been fully delivered.

More importantly, capacity constraints in construction could see the costs of delivering investments rise. This would threaten the value-for-money assessments of investment projects. There are also wider sustainability risks, given that Ireland's government debt ratio will remain at more vulnerable levels as a result of the higher borrowings.

Two important considerations will be (1) the costs and benefits of the investments and (2) how sustained of an impact they will have on the public finances and the economy.

The impact of budgetary supports on growth is one of the most contentious questions in macroeconomics. Returns are notoriously difficult to estimate for various forms of public spending let alone specific investment programmes. Estimates of the fiscal multiplier—the economic impact of public spending—tend to be higher for public investment than other forms of budgetary stimulus. Previous work by the Fiscal Council (Ivory, Casey and Conroy, 2019) using a range of approaches suggests that short-term benefits to growth are indeed higher from investment spending. However, their effects become statistically insignificant after a few years. This chimes with findings elsewhere for Ireland and other countries (Bénétrix and Lane, 2009; Hall, 2010; Giordano et al., 2007). As such, it is hard to say with confidence that public investment spending will result in higher growth beyond the short term. Timing also matters. Fiscal multipliers tend to be higher in recessions. For example, Auerbach and Gorodnichenko (2012) estimate spending multipliers to be close to zero in US expansions and as high as 2 or 3 in recessions. This suggests that the benefits to investment may be higher in the early recovery phase but substantially smaller once the economy has recovered. In addition, the nature of the investment is important. More labour-intensive investment, such as in housing, would be expected to be more domestically oriented, with stronger positive growth impacts. However, it could also mean that capacity constraints may be greater. By contrast, more capital-intensive investment, such as infrastructure and equipment, would be less likely to hit these constraints, though many countries are likely to increase investment in these areas at the same time and domestic growth benefits would be less.

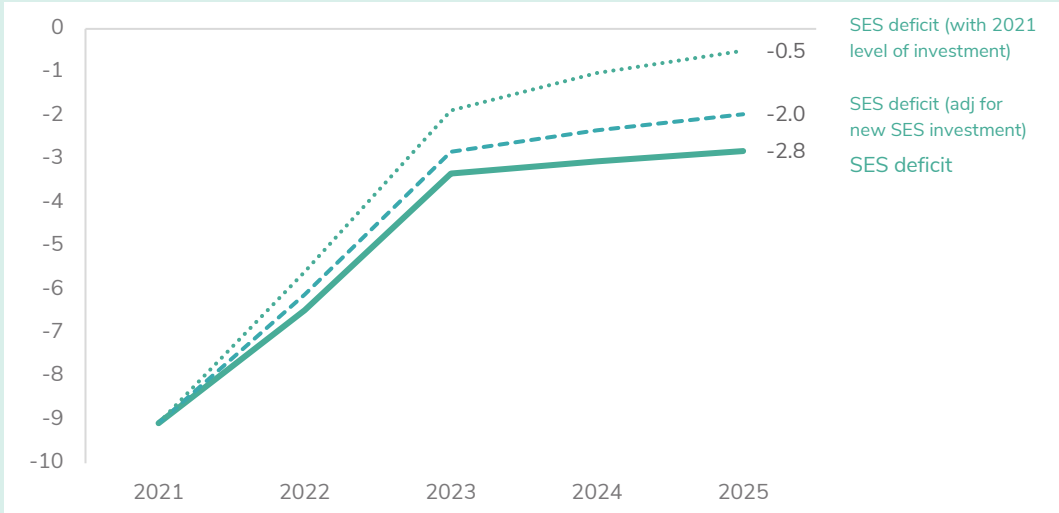
Value for money is an important consideration. In its 2017 technical assistance report on public investment, the IMF (2017) assessed that Ireland had shortcomings in the effectiveness of past investment spending. Comparing the quality and quantity of infrastructure to the size of past investment spending (the size of the capital stock per capita), it estimated an efficiency gap of 58 percent compared to the best performing advanced countries. The relatively poor “bang for buck” from public investment in Ireland was assessed to be due to a variety of factors. A proliferation of sector strategies, weak results frameworks, limited information on cost estimates, inadequate links between plans and funding decisions, and a need to prioritise maintenance spending contributed to the assessment. It noted substantial scope for the Irish authorities to adopt policies that will help improve the efficiency of public investment management.

As well as the costs and benefits of individual investments, one should also consider the sustainability of the public finances and the economy. Taking the other SES budgetary plans as given, the rise in investment spending after 2021 originally planned for in the SPU would have

implied a deficit of roughly 2 per cent of GNI* as compared to a broadly balance position of about 0.5 per cent if investment had remained at 2021 levels. However, the additional investment set out in the SES means that the deficit is now projected to be about 2.8 per cent of GNI* (Figure C3). The larger deficit also reflects the fact that the SES projections for current spending rise at a more realistic pace sufficient to cover the cost of maintaining Existing Levels of Services, recognising demographic and price pressures. As a result of the additional borrowing, official projections would suggest that the net debt ratio will remain at high levels close to 100 per cent of GNI* out to 2025 and falling at a slow pace.

Figure C3: Planned deficits are accounted for heavily by investment increases

% GNI*, general government balance



Sources: Department of Finance; and Fiscal Council workings.

Notes: The SES deficit path is first adjusted for the newly announced public investment relative to SPU 2021 (dashed line), then for all of the increases in investment relative to 2021 currently planned in the SES, plus the estimated interest costs associated with the additional spending. Note that the 2021 level of public investment at €11.1 billion in general government terms would be broadly consistent with a public investment ratio of just over 4 per cent of GNI* by 2025.

One strategy for the coming years might be to frontload the build-up of the capital stock with a temporary period of unusually high public investment spending. Investment rates could then be returned to more normal historical levels and in line with norms for advanced economies after a period of time, closer to 4 per cent of GNI*, for example, then the deficit would unwind over time.¹ Gross investment would nevertheless need to remain higher than in the past to maintain the new higher level of the capital stock.

This strategy has some merit, especially when interest rates are currently low and the pressures to address longstanding priorities like housing and climate change targets exist. Frontloading some of the spending could also entail efficiency gains if it means less spending being required over the long run, particularly if interest rates are at temporarily low levels. An example of this is in housing where the costs of current spending supports might outweigh the costs of frontloaded capital outlays.

Figure C4 considers an illustrative extension of the Recovery Scenario where public investment rates are gradually returned to a 4 per cent of GNI* rate after 2025. This would be in line with previous targets, including those set out in the National Development Plan, and close to the OECD median. Provided that the Recovery Scenario broadly pans out, with no shocks in the interim, and

¹ A 4 per cent of GNI* investment rate would also be consistent with the original National Development Plan. The Plan projected that public capital investment would reach 4 per cent of GNI* by 2024, with “sustained investment” averaging 4 per cent on an annual basis over the period 2022 to 2027 (Department of Public Expenditure and Reform, 2018).

that other parts of the budget are maintained, the deficit could gradually be closed by the end of the decade. This would mean that the Government's net debt ratio would fall towards 65 per cent of GNI* by 2030, with a steady pace of debt reduction of over 3½ percentage points per annum reached by then.

However, there are risks to this approach. First, with the public debt ratio already high and public investment management historically weak in Ireland, there is a greater need to ensure that future investments generate value for money. Second, many sectors in the economy are expected to recover rapidly in the coming years such that output may rebound to pre-crisis levels quickly and capacity constraints may begin to bite in the construction sector. This could mean higher costs to investment. Third, there are of course risks that shocks to growth in the coming years could arrest the improvement in the deficit, and potentially lead to debt rising again.

Figure C4: A path to gradually reduce exceptional rates of public investment

Debt ratio, % GNI*



Change in net debt ratio (p.p. GNI*)



Sources: Fiscal Council workings.

Notes: The scenario shown is an illustrative extension of the Recovery Scenario wherein public investment rates return to 4 per cent of GNI* by 2030 linearly after 2025. It is assumed that both taxes and current spending are kept constant as a share of GNI* (except for interest costs, which are projected by assuming the average effective interest rate remains constant).