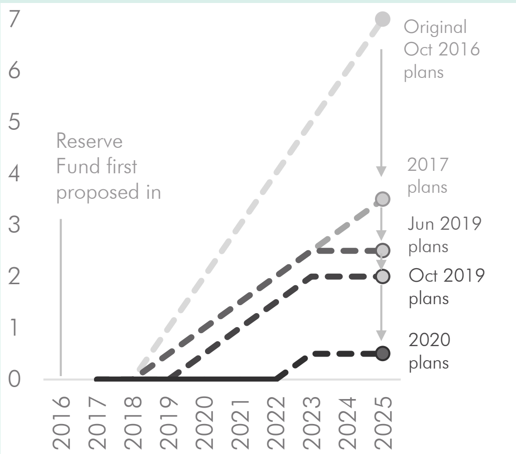
Box D: Ireland's Reserve Fund is restored but needs some rethinking

In *Budget 2023*, the Government set out plans to restore Ireland's "National Reserve Fund". The Reserve Fund was first proposed as part of the May 2016 Government programme as a way of securing "sound public finances and a stable and broad tax base".[57] But a series of policy announcements saw government ambitions for the Fund repeatedly scaled back. Until now, the State did not make any actual annual contributions to the Fund (Figure D1).[58]

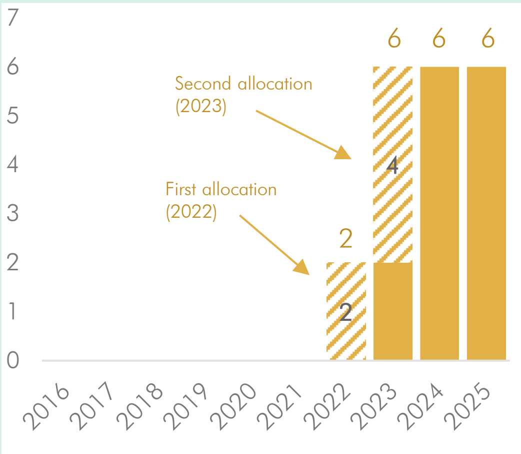
Plans for the Reserve Fund have now been scaled up significantly. The Fund is to be used to ensure that "windfall corporate tax receipts are not used to finance permanent increases in public expenditure". On Budget Day, the Government carried a motion to make a €2 billion allocation in 2022 and a €4 billion allocation in 2023. This entails €6 billion of cumulative allocations to the Reserve Fund by end-2023. It also represents a rapid catching-up on the original plans set out in October 2016, when annual allocations of €1 billion per annum were proposed from 2019 on (Figure D1).

Figure D1: Plans for the Reserve Fund were scaled back but now return

A. Old plans had been scaled back
€ billions, reserves accumulated in the fund



B. But new plans mean significant allocations
€ billions, reserves accumulated in the fund



Sources: Fiscal Council workings. Get the data.

The Council has long considered the Reserve Fund a potentially useful tool.[59] It offers a way to 1) sustain budget surpluses in good times, withstanding pressures to loosen policy as revenues grow strongly; 2) help governments avoid forced austerity in the event of losing the ability to borrow at low interest rates; and 3) access useful financial assets in the event of a crisis.

However, the Reserve Fund has several design problems:

1) **Operating with discretion rather than countercyclically** — the Reserve Fund is designed in a way whereby it does not function as a countercyclical tool. That is, it does not act in a manner that would lessen Ireland's tendency in the past to ramp up spending and cut taxes during a boom. Instead, the design assumes pre-determined allocations of €0.5 billion each year. These allocations have to be passed by Dáil Éireann. The allocations therefore depend on political discretion and do not necessarily evolve with the cycle. For example, this approach does not automatically entail larger contributions if there is a drastic upswing in the economy or if large tax windfalls suddenly arise. Similarly, withdrawals from the Fund are not linked to the cycle. These are instead intended to address only specific events or shocks — such as those arising due to very "exceptional circumstances" — rather than to smooth the impact of the cycle.

2) **Capped arbitrarily at €8 billion** — the Reserve Fund is limited to a maximum size of €8 billion. The reason for this is unclear. Simulations in Casey *et al.* (2018) and Fiscal Council (2018) suggested that, at the time, this level would be reasonable to smooth a typical cyclical downturn. However, it would not necessarily cover large downturns. Its size, which is set in nominal terms, is also shrinking

[57] At the time, the Fund was referred to as the "Rainy Day Fund".

[58] A transfer of €1.5 billion of cash assets from one arm of the State to another did benefit the Fund in 2019. This involved the State moving assets from the Irish Strategic Investment Fund to the Reserve Fund. Yet this was far different in effect to the planned savings or contributions intended for the Fund as it had no impact on the State's net asset position.

[59] See Box B, *June 2016 Fiscal Assessment Report*.

relative to the size of the economy as prices rise. When established in 2019, €8 billion was equivalent to about 4% GNI*. By 2030, assuming trend growth of 3% and economy-wide inflation of between 1½ and 2%, the Fund's maximum value relative to the size of the economy could fall to almost half that. This will gradually weaken the tool's effectiveness as a way to counteract downturns in the economy. In addition, the fact that a cumulative €6 billion is planned to be allocated by next year could see the Fund rapidly hit this cap.

3) Potential conflicts with the fiscal rules — withdrawals from the Fund could breach EU fiscal rules if they entail higher-than-allowed spending. For example, the spending rule, referred to as the "Expenditure Benchmark", sets an annual limit on how much real spending can increase by after excluding interest and temporary costs. If the Government were to comply with the fiscal rule by a small margin, any additional spending funded by withdrawals from the Reserve Fund would most likely lead to a breach of the rule. This represents a major shortcoming of the fiscal rules. Policymakers using such funds could be unfairly punished for setting aside savings in good times when these funds are eventually used. To resolve this problem, Casey *et al.* (2018) suggest treating allocations as discretionary revenue-raising measures. This would mean the allocations using up fiscal space afforded by the rule. Withdrawals could then be treated as an offset to spending increases measured under the rule. However, this would require changes at EU level and it is not clear that such changes are likely to take place.

How the allocations to the Fund are treated in an accounting sense?

The allocations to the Reserve Fund are treated as increasing the Exchequer deficit (or reducing an Exchequer surplus). However, in terms of the broader general government definition, they do not have any impact on the budget balance. Allocations to the Reserve Fund represent a transfer within Government, and hence represent neither an increase in spending nor a reduction in revenue. The allocation therefore has no impact on the budget balance.

However, the focus on the budget balance measure adjusted for estimated corporation tax windfalls means that the excess corporation tax receipts do not impact on that measure. In effect, the Fund is providing a vehicle for saving part of the difference between the headline and the underlying measure, reinforcing the overall fiscal framework in this regard.

Will the new allocations limit the risks surrounding corporation tax receipts?

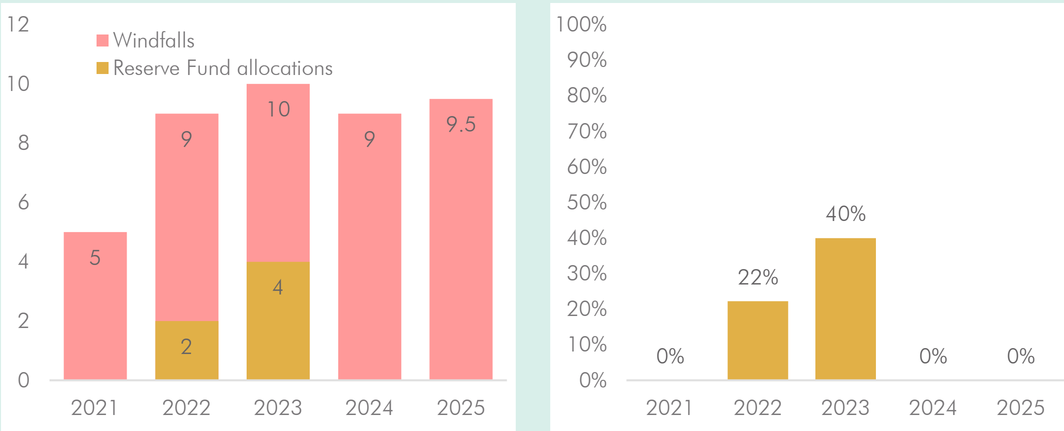
The objective of the new Reserve Fund allocations is to limit the risk that permanent increases in public expenditure are being funded by corporation tax receipts that could potentially prove to be windfall in nature. This approach is in line with recommendations made by the Council since 2017 (Fiscal Council, 2017). The Council's recommendations have been 1) to avoid using concentrated and unpredictable increases in corporation tax receipts as a basis for increasing permanent spending and 2) to redirect these to the Reserve Fund or towards debt reduction.

The allocations to the Reserve Fund, while welcome, on their own will not be sufficient to limit the risks surrounding corporation tax receipts.

Figure D2: Reserve Fund captures some but not all corporation tax windfalls

A. Windfalls estimated to be large
€ billions

B. Reserve fund allocations capture only a portion
Reserve Fund allocations as % of annual windfalls



Sources: Department of Finance; and Fiscal Council workings. Get the data.

First, the allocations are small relative to the size of windfall corporation tax receipts. The Department estimates that windfalls were of the order of €5 billion in 2021, rising to €9 billion in 2022. Further windfalls are projected for 2023, 2024 and 2025, at around €9 to 10 billion each year. However, compared to these substantial figures, the allocations to the Reserve Fund are relatively small at €2 billion in 2022 and €4 billion in 2023 (Figure D2A). For these two years, the allocations are just 22% and 40% of the estimated windfalls, respectively (Figure D2B). Beyond 2023, it is unclear whether any further allocations are planned. It is clear that the windfalls are not being fully captured by the Reserve Fund. Moreover, these excess corporation tax receipts have been building up since about 2015. The Council's own estimates of excess corporation tax receipts would suggest that excess corporation tax receipts taken in since 2015 could have amounted to a cumulative €32 billion by 2022. This is in effect the size of a Fund that might have resulted had these excess receipts been allocated in full to the Reserve Fund. Note that the uncertainty range around estimates of the cumulative excess receipts is very wide at €21 to 43 billion.

Second, the 5% Spending Rule and planned surpluses are doing more to limit risks, with the Reserve Fund playing a relatively passive role. The key change in policy in recent years helping to generate budget surpluses and to contain risks associated with corporation tax receipts is the 5% Spending Rule. By broadly following this, the Government is helping to ensure permanent spending growth is tied to more sustainable growth in revenues. In particular, by applying this in 2022 and 2023, the Government helped to limit its exposure to excess corporation tax receipts closer to 2021 levels of around €5 billion. The additional annual windfalls over-and-above this level are ending up in larger surpluses, with a portion of these, in turn, being allocated to the Reserve Fund. However, the Reserve Fund itself is not directly contributing to the additional saving, although it may play a supportive role.

The Government should continue to stick to its 5% Spending Rule

The key way to mitigate risks around how much of the excess corporation tax receipts are used for permanent spending is through the Government's 5% Spending Rule rather than through the Reserve Fund. Sticking to the 5% Spending Rule would ensure that the Government increases spending at a pace that is broadly sustainable. It would entail "looking through" the additional excess corporation tax receipts collected in a given year and limit the increase in public spending to a rate more consistent with trend growth in the economy and in government revenues.

While the 5% Spending Rule is an effective way of limiting risks associated with further increases in excess corporation tax receipts, it does not help to reduce the existing level of risk. It basically caps the Government's exposure to excess corporation tax receipts at recent levels It does not address the past build-up of excess receipts. For instance, the Government looks set to broadly stick to the spending rule in 2022 and 2023. However, doing so would only limit the exposure to 2021 levels of excess corporation tax receipts. These are estimated by the Government to be of the order of €5 billion. If the Government were to unwind its exposure, this would require it to grow core spending by less than the 5% set out in the Spending Rule or to introduce net revenue-raising measures elsewhere.

Conclusions

Using the Reserve Fund is a welcome development. It helps set aside any additional excess receipts, but it does not cover the full extent of their impact. In any case, the Government, by broadly sticking to its 5% Spending Rule, will most likely generate relatively larger surpluses. These savings would far exceed the expected Reserve Fund allocations.

The Government needs to develop its thinking on the goals and design of the Reserve Fund. The purpose of the Fund has evolved over time from a countercyclical tool in the Programme for Government to a Fund that only helps in exceptional circumstances, and now to a Fund that is limiting the risk of permanent increases in public spending being funded by excess corporation tax receipts. However, its importance as a tool is diminished by the more important roles being played by the 5% Spending Rule and the adjusted general government balance. A fund with liquid assets could prove helpful in future downturns, but the State has already amassed large cash buffers elsewhere, with further surpluses adding to these. In addition, the current design shortcomings of the Fund will limit its effectiveness.

One option for the Reserve Fund might be to redefine it as a new Pension Reserve Fund. This would set a new goal for the large assets that are being accrued; it would give it a mandate to invest in assets with potentially greater returns, and help deal with a longstanding problem — the expected shortfall in pension funding over the coming decades. In particular, it could take some of the pressure off the tax system having to raise additional revenues to meet these shortfalls.