

RAINY DAY FUND – CONSULTATION PAPER

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ECONOMIC
POLICY



An Roinn Airgeadais
Department of Finance

Consultation paper: establishment of a rainy day fund

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Section 1 – Introduction and background

- The 2016 *Summer Economic Statement* (SES) outlined that, once the Medium Term Objective (MTO) of a balanced budget is achieved,² a rainy day fund would be established.
- This policy is consistent with the *Programme for a Partnership Government*, which set out the establishment of a rainy day fund as part of a wider policy commitment to maintain sound public finances.
- The 2016 SES also set out the commitment of the Government to consult with the *Oireachtas* on this policy initiative. The purpose of this note is to fulfil this commitment. In doing so, the paper seeks to scope out some of the design and operational modalities for this budgetary management tool, including key issues such as resourcing, withdrawal triggers, governance, etc.
- The 2017 SES indicated that €500 million per annum (c. 0.2 per cent of projected 2019 GDP) of the 2019 – 2021 fiscal space³ will be deployed into a rainy day fund, i.e. the year after the MTO is achieved.
- The 2017 SES also outlined that the Government would consider whether an element of the Ireland Strategic Investment Fund (ISIF) should be reoriented towards complementing the role of the rainy day fund while, at the same time, ensuring that the majority of the ISIF continues with its statutory objective, namely of investing for a commercial return with an economic impact.
- The Irish economy is extremely vulnerable to fluctuations in the global business cycle given *inter alia* our deep trade links with the rest of the world.
- Our economic history – especially the most recent history – highlights the importance of creating a fiscal safety buffer to help absorb the shocks that are inevitable in the future while, at the same time, ensuring the long-term sustainability of the public finances.
- More generally, it is important to avoid repeating the pro-cyclical policies adopted in the past, and that budgetary policy ‘leans against the wind’ – on the basis of current projections, the amount of fiscal space in 2019 is significant and likely to be in excess of what the economy could absorb without further adding to over-heating pressures.
- It should also be clear that public debt remains elevated in Ireland (see figure 1). For instance, as outlined in the *Annual Report on Public Debt in Ireland 2017*⁴ public debt per capita in Ireland (at around €42,000) is the amongst the highest in the developed world.

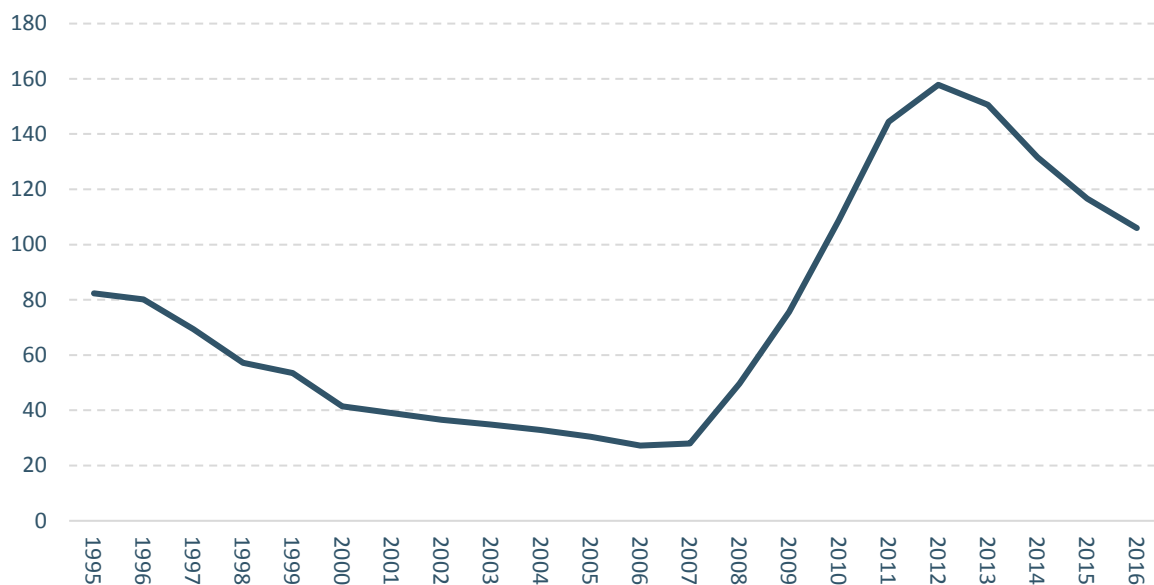
¹ The document has been prepared for consultation with the Oireachtas. It was produced by the Economic and the Banking and Financial Stability Divisions of the Department.

² Defined as a structural deficit of 0.5 per cent of GDP. The structural balance is the headline general government balance adjusted for one-off and temporary measures and corrected for the effects of the economic cycle.

³ The €500 million annual allocation is revised downwards from the €1 billion as originally proposed in the 2016 SES.

⁴ Department of Finance, June 2017.

Figure 1: public debt as a fraction of GNI*, per cent



Source: Department of Finance calculations.

Section 2 – the rainy day fund: conceptual issues

- At the outset, it is important to clarify what exactly a rainy day fund entails, with various models – with different objectives, designs and end-uses – in existence internationally.
- Broadly speaking, rainy day funds can be grouped into two categories – those whose purpose is to stabilise the economic cycle (involving discretionary measures to complement the operation of the automatic stabilisers) and those that are designed to address specific, unforeseen and ‘one-off’ events.
- In relation to the former, the economic rationale is to provide for an institutional counter-cyclical budgetary tool by way of a separate, stand-alone stabilisation fund. The general approach is to provide for the accumulation of reserves during ‘good times’ which can be deployed (e.g. to finance additional discretionary expenditure or to finance a tax reduction) in order to stabilise demand during ‘bad times’.
- One notable example is that of Finland – a small open economy similar to Ireland – which operates a counter-cyclical fund whereby additional social security payments from employers during upswings are set aside to enable the application of a lower contribution rate during downturns. This stabilisation mechanism is designed to help maintain employment over the business cycle.
- On the other hand, some countries operate a rainy day fund which is specifically reserved for defined purposes such as natural emergencies, educational and pension-related liabilities, etc. (i.e. pension reserve funds, savings funds) rather than for the purpose of broader economic stabilisation.
- In an Irish context, it is envisaged that the rainy day fund would primarily operate along the lines of a defined-purpose instrument (i.e. address only specific events or shocks rather than impact of the cycle) with the broad parameters set out in legislation, with withdrawal subject to Government decision and a *Dáil Éireann* motion of approval.

- The rationale for a defined-purpose instrument lies in the fiscal framework to which Ireland is subject to. In the preventive arm of the Stability and Growth Pact (the Pact), fiscal targets are set in structural terms, thereby allowing the automatic stabilisers – automatic changes in revenue and expenditure arising from the impact of the economic cycle – provide counter-cyclical fiscal support to the economy. In other words, the SGP already provides for in-built fiscal stabilisation mechanism.
- Having said that, the Pact is, for the most part, designed to smooth ‘normal’ cyclical conditions. The question arises, therefore, whether the rainy day fund should be deployed as an additional stabilisation mechanism in the event of particularly severe economic shocks.
- In the event that the resources in the fund are deployed as a result of a severe economic shock, ideally the expenditure would be directed to labour-intensive, ‘shovel-ready’ capital projects that deliver maximum returns (including by boosting the growth capacity / potential of the economy).
- One obvious use of the rainy day fund would be to finance additional public expenditure arising from the activation of the “unusual event” clause in the SGP. This could augment or even substitute the contingency reserve for specific expenditure linked to an “unusual event”, defined as outside the control of the authorities, with major general government expenditure implications, albeit not endangering medium term fiscal sustainability.
- A further possible consideration for a rainy day fund is its use in the structural reform or investment clause provisions within the SGP. Any use under these provisions should be to address a specific structural gap or capital shortfall that can be clearly demonstrated to increase national economic growth.

conceptual issues re. the rainy day fund – issues for consideration

The current proposal is to design a rainy day fund that will primarily meet budgetary demands arising from specific, one-off shocks.

- Is the more tightly defined scope of the rainy day fund more appropriate for the Irish context, rather than a wider budgetary stabilisation fund approach?
- If the scope were to be widened to include cyclical stabilisation in the event of a particularly severe economic shock, how would a ‘severe’ economic shock be defined?
- In the event that the fund is deployed for cyclical stabilisation purposes, should the rainy day fund be solely earmarked for labour-intensive capital projects which generate a significant rate of return?

Section 3 – possible role for the rainy day fund as a ‘contingency reserve’

- A natural question arises as to whether the rainy day fund should be used, in the first instance, as a contingency reserve.
- Contingency reserves are monies that are not provided for as part of the annual estimates process but are available in-year in order to meet unforeseen events. These instruments are common in other countries.
- These resources would be earmarked to meet expenditure demands arising from one-off unforeseen events which, by their nature, cannot be provided for through the annual estimates process (and which are in excess of expenditures from re-deployments or savings).

- In order to meet the underlying objective of this policy instrument, it would be imperative that resources allocated to any contingency reserve are not absorbed into funding ‘regular’ budgetary overruns or new programmes.
- In order to ring-fence the contingency reserve, the circumstances under which the funds in the contingency reserve can be deployed would need to be tightly defined. Clearly established quantitative and qualitative parameters governing the deployment of the contingency reserve are essential in order to avoid ‘contingency creep’, thus protecting its distinctive function and crisis-time impact.
- It would follow that any expenditure under the contingency reserve would be ‘sterilised’ from the base for the subsequent year.
- In terms of design, it is envisaged that the deployment of the contingency reserve would necessitate the occurrence of a *force majeure* event such as:
 - natural disaster;
 - public emergency;
 - other unforeseen one-off occurrence.⁵
- This would have an immediate budgetary impact with the level of additional expenditure capped by the upper bound of the available fiscal space. In terms of other fiscal considerations, this spending framework must avoid possible moral hazard, recurrent cost implications and be time-bound in nature.⁶
- Accordingly, these monies would be deployed, where necessary, following a Government decision to increase the Government Expenditure Ceiling (GEC) for the current year only.⁷ This would be subsequent to a proposal from the Minister for Finance, with the ensuing supplementary appropriations voted by *Dáil Éireann* on a case-by-case basis.
- The contingency reserve could be housed in the Exchequer account for deployment if required. If, at the end of the budgetary year, the contingency reserve remains unused, these monies would be transferred to the separate rainy day fund. This separate entity would need to be established by legislation as any such payment from the Central Fund requires legal underpinning (the fiscal treatment from a statistical perspective is set out later in this document).
- Alternatively, the contingency reserve could be housed within the rainy day fund in the form of highly liquid, easily accessible assets.

⁵ A recent example was in 2016 c. €100 million (net of Departmental contingency) was required to meet storm and flood damage to transport infrastructure.

⁶ This should be aligned with the one-off classification principles used in the EU fiscal surveillance.

⁷ Where the one-off expenditure runs over two years, the GECs for both years would have to be increased.

contingency reserve – issues for consideration

Contingency reserves are important policy instruments in other countries which, when suitably ring-fenced, play an important in-year role of absorbing unforeseen adverse (mainly natural rather than economic) shocks.

- Is there a role for the rainy day fund to be used, in the first instance, as a contingency reserve?
- If so, should the contingency reserve be held within the Exchequer account or within the rainy day fund?
- Should the criteria to be reached to trigger a withdrawal from the contingency reserve be codified, or be left to the discretion of Government
- What shocks or events should be considered as triggers?
- Should a minimum financial threshold be considered given smaller scale demands could reasonably be expected to be covered from savings / redeployments from elsewhere?

Section 4 – the rainy day fund: operationalisation issues

- The design of a rainy day fund is crucial and will ultimately underpin its effectiveness as a budgetary instrument. Research shows that rainy day funds governed by stringent requirements typically accumulate more and, in turn, are more effective in mitigating ‘rainy days’. An additional benefit for countries whose rainy day funds operate under strict, well-defined rules can be a better sovereign rating which, in turn, reduces the cost of sovereign financing.
- Four key design elements can be identified from both international experience and the literature that should be reflected in the design of a rainy day fund:

(i) *deposit mechanism*

- The deposit and withdrawal (see below) elements are the most critical determinants as an effective budgetary tool given their key ‘gatekeeper’ function, i.e. in determining the movement of resources both into and out of the fund. There should be clear rules and principles for these key elements that are consistent with the fund’s objective, and these should be underpinned by well-framed corporate governance arrangements, including the need for transparency and predictability.
- Contributions to the fund can, in principle, be:
 - discretionary;
 - arise if there is a budgetary surplus; or
 - a deposit based on objective budgetary or economic criteria.
- The literature shows that objective, formula-driven criteria are preferable in ensuring that resources are automatically provided to the fund based on objective budgetary or economic criteria. For instance, the annual contributions could be expressed as a share of a variable, such as GDP, or overall expenditure, or as a fixed nominal amount.⁸
- In an Irish context, the proposed initial contributions to the rainy day fund include:
 - an allocation of €1.5 billion from the Ireland Strategic Investment Fund (ISIF)⁹; and

⁸ While not established as a rainy day fund, the annual contribution to the National Pensions Reserve Fund was fixed at 1 per cent of GNP per annum.

⁹ The allocation of these funds is set out in the Minister for Finance’s Budget 2018 Financial Statement.

- a share of the estimated fiscal space up to a maximum of €500 million annually over the three year 2019-2021 period. Thereafter, the criteria for defining the annual contribution beyond 2021 would need to be spelt out.

(ii) *withdrawal mechanism*

- Drawdowns from the fund can be linked to a fixed, defined purpose such as an emergency, similar to the *force majeure* criteria envisaged under the contingency reserve.
- If the fund is to be deployed to stabilise demand in the event of a severe shock, clarity and transparency regarding what constitutes a severe shock would be needed. An additional consideration relates to how the pace / scale of drawdown is related to the severity of the economic shock.

(iii) *cap*

- There is also a question as to whether the size of the fund should be capped at a certain threshold, for instance as a share of GDP / total expenditure / in real terms.
- The level of any ceiling is significant as this impacts upon the future effectiveness of the fund. On the one hand, the larger the fund, the greater its stabilisation potential in the event of a shock or severe downturn.¹⁰ On the other hand, it is important to bear in mind that there is an opportunity cost associated with remitting these funds to a rainy day fund.
- It is also important to bear in mind that remitting funds to any rainy day fund will result in gross public indebtedness being higher than would otherwise be the case; net public indebtedness would, of course, be lower.

(iv) *replenishment*

- It would be appropriate for governance arrangements to provide for the orderly replenishment of the rainy day fund in accordance with the normalisation of the economic and budgetary position.

operationalisation of the rainy day fund – issues for consideration

International best practise highlights the importance of the design of the fund. In particular, the deposit and withdrawal mechanisms need to be robust and well defined.

- What are the best deposit criteria? Is the discretionary approach practical or would contributions made on the basis of objective criteria be optimal in an Irish context?
- It has been suggested that potentially volatile revenue upsides – such as from corporation tax – should be saved. Could a portion of these be earmarked in this manner?¹¹
- To safeguard the fund and help remove sub-optimal considerations from withdrawal decisions, as well as ensuring an appropriate balance between accessibility and flexibility, the basis on which withdrawals are made is important. It is envisaged that, in accordance with its mandate, the withdrawal rules for the rainy day fund would be stricter than for the contingency reserve. Should the decision to withdraw be a political decision or be linked to objective considerations?
- How large should the rainy day fund grow to? A trade-off exist between a fit-for-purpose, well capitalised fund, versus debt reduction and carry-cost of any borrowed funding.
- The recapitalisation methodology needs to be defined.

¹⁰ 5 per cent of expenditure is common in some US funds, although some have higher ceilings.

¹¹ It should be noted that reliably identifying volatile or cyclical revenues in real-time is difficult.

Section 5 – statistical issues, fiscal rules, administration, and interaction with other state cash

- At the outset, it is crucial to stress that the operation of this contingency reserve / rainy day fund must be consistent with compliance with Ireland’s legal obligations as set out in the SGP and the *Fiscal Compact*.
- A properly designed rainy day fund should fund government expenditure (or a tax reduction as a stabilisation tool) only where a temporary need emerges. Using a rainy day fund to compensate for a structural deficit through the use of once-off monies does not represent a sound or sustainable approach to fiscal policy management.
- Any utilisation of the contingency reserve or annual payment to the rainy day fund is treated as expenditure undertaken by the Exchequer. However, as the monies provided to the rainy day fund are considered a financial transaction within general government, they are not recorded as part of the general government deficit, although they will impact negatively in gross debt terms.
- Withdrawals from the fund will, for the most part, result in expenditure that worsens the general government balance (in a similar vein, tax reductions to provide cyclical support in the event of a severe downturn also reduce the fiscal balance). Fiscal measures under either the contingency reserve or rainy day fund, whilst dis-improving the deficit, if compliant with the ‘one-off’ principles of the Pact, could be taken into account when assessing compliance with the expenditure benchmark and structural balance.
- Similar to the contingency reserve, when a decision is taken to deploy the rainy day fund, the GEC for the given budgetary year would have to be increased to facilitate the supplementary estimates as approved by *Dáil Éireann*.
- Subsequently, to facilitate access to the fund, it should be maintained on a liquid / semi liquid basis. Consideration needs to be given to an appropriate investment policy, balancing access to the monies while at the same time ensuring at a minimum the real value of the fund is maintained.
- In terms of a possible location for housing the rainy day fund, the National Treasury Management Agency (NTMA), through the ISIF, has indicated that it is available, if required and as appropriate, to assist in the management of a Fund.
- The interaction between the rainy day fund and NTMA cash balances must also be considered.
- The NTMA holds cash balances in accordance with the Ministerial Guidelines on Debt, primarily to ensure that the Exchequer is adequately funded for in excess of 12 months as a contingency against unforeseen unfavourable market conditions. As the rainy day fund may act as a cyclical buffer in case of the State facing acute financial distress, a related reduction in the NTMA’s cash balances with associated carry cost savings could be considered.
- If, after a period of time, monies accumulate in the rainy day fund without being utilised, the carry cost associated with debt may imply that an optimal use of a portion of these monies would see them better deployed for debt reduction purposes. Debt reduction is an alternative way of reducing the State’s vulnerability and boosting its capacity to absorb shocks.

administration and interaction with other state cash – issues for consideration

In terms of the operation of the rainy day fund a number of practical issues need to be considered:

- how is it invested;
 - its liquidity;
 - governance structure; and,
 - what bodies are best placed to manage such a fund.
- What existing institutions are best equipped to manage the rainy day fund balances or should new structures be established?
 - Should the rainy day fund be maintained on a separate basis, allowing greater visibility, or should it be integrated with other investments and / or cash balances?
 - Should the level of NTMA cash balances be reduced to take into account liquid assets in the rainy day fund?
 - Relating to earlier design stage questions around ceiling limits for the fund, what is considered an appropriate maximum level to hold, bearing in mind the diversion of resources from debt reduction and the potential carry-cost?

Section 6 – conclusion

- The Irish economy has been subject to two severe fiscal crises over just two decades (1987- and 2007-). Preventing a third crisis is of paramount importance.
- While considerable progress has been made in repairing the public finances, significant fiscal challenges remain:
 - The need to avoid pro-cyclical budgetary policies;
 - Reducing public debt further;
 - Longer-term sustainability of the public finances, in view of demographic changes.
- Establishing a rainy day fund is in line with best international practice and important enhancement to the domestic fiscal policy toolkit. Accumulating fiscal buffers can boost the shock absorption capacity of an economy which is deeply integrated into global value chains and, accordingly, very exposed to the global business cycle.
- The design of the rainy day fund should be governed by a number of principles in order to optimise the fund. These principles include the need for a clear and transparent rules-based framework that governs the deposit and withdrawal arrangements for the contingency reserve and the rainy day fund.
- The creation of a contingency reserve / rainy-day fund should be market-positive for Ireland. Prudently building up financial safety buffers will help provide additional insurance against adverse economic and fiscal developments and complement the Government's commitment to prudent fiscal management.