Notes on the investment of a possible surplus

Committee on Budgetary Oversight Remarks, May 24, 2023

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The government must choose how to allocate a large primary surplus. The primary surplus is estimated by the Department of Finance based on the likely growth of the economy over the medium term at or around €65 billion. As the Department's forecasts are typically quite conservative it is likely if current conditions prevail this amount could be larger.

The government has several broad choices in their allocation of this surplus:

1. Increase current spending by increasing public sector pay or transfers to businesses and households, that is, investing in improving conditions today;
2. Decreasing current taxes, that is, investing in consumption, investment to improve conditions today, and hoping private sector innovation creates growth tomorrow;
3. Increase capital spending to produce more housing, roads, and hospitals, that is, investing in physical assets to be used tomorrow;
4. Investing the surplus into longer term financial assets using a sovereign wealth fund[2], that is, investing in financial assets, returns of which are to be used tomorrow.
5. Paying down the stock of sovereign debt.

The government of the day will, of course, choose a combination of options 1, 2, 3 and 4. Option 5 is less likely. The current government has not given an indication of the likely proportions between the three options or an allocation framework. As I have argued to this Committee several times, a medium term fiscal framework is exactly what is required in this scenario to guide such an allocation.

Context and institutional landscape

The graphs below show, from top left counter-clockwise, the relative rarity of budget surpluses in Ireland. The policy problem of allocating so much public money efficiently and effectively is not one we are practised in. We are experiencing high levels of capital spending relative to trend, an economy at or near its full potential, with low unemployment, and forecasted surpluses for the coming three fiscal years at least. The source of these surpluses is windfall corporate taxes.

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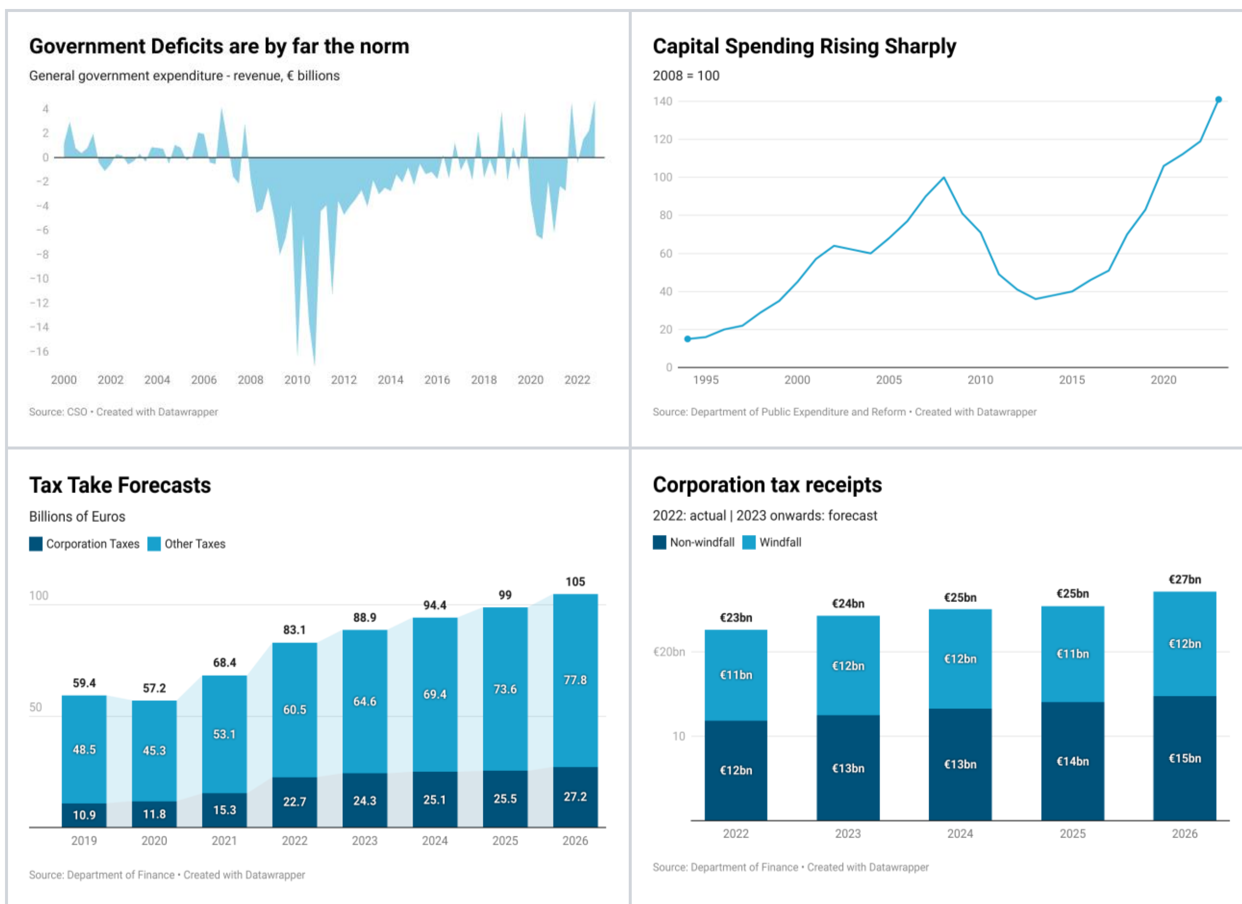
[2] See here for the key files.



The State already has two 'savings' funds. The first is the Irish Strategic Investment Fund, charged with investing in the productive capacity of the Irish economy for a commercial return. In the NTMA's latest report it had €14.5 billion under management at the end of 2021. The second fund is the National Reserve Fund, which is also called the 'rainy day' fund, and this has €6 billion in it. The maximum amount allowable into this second fund is €8 billion.

Proposal

The proposal is to create a third savings fund dedicated to investing windfall corporation taxes to cope with a single objective, demographic change, estimated to cost €7-8 billion by 2030. The timespan of the fund is between 7 and 15 years, at a maximum 20 years. In a very real sense, this is the National Pension Reserve Fund, 2.0, as most of the costs associated with ageing are pensions. There is a key difference in that this fund has no liability side in the way a classic pension fund has, which is a big advantage.

There is a buildup phase from now until 2030 or 2035, and a drawdown phase thereafter. The goal of the drawdown phase is to either partially or fully cover the estimated costs of ageing. The fund has many of the features of a sovereign wealth fund.

What is a sovereign wealth fund?

Sovereign wealth funds[3] are state-owned investment funds managing pools of financial assets. Sovereign wealth funds are usually funded by surpluses generated from a nation's reserves. Typically the sources of these funds are commodity exports, foreign exchange reserves, or fiscal surpluses. These funds are distinct from central bank reserves. Their primary objective is to maximise long-term returns rather than supporting shorter term monetary or other policy objectives.

Main characteristics of sovereign wealth funds and some remarks on the current proposal

State ownership: Sovereign wealth funds are owned and controlled by sovereign nations, typically representing the government's interests. In this the proposed fund is typical.

The best funds follow strict and well defined sets of objectives: Sovereign wealth funds have varying objectives depending on when, why, and by whom they are set up. These objectives include wealth preservation, macroeconomic stabilisation, intergenerational savings, and promoting economic development. The current proposal is extremely narrowly defined, perhaps too much so, in focusing on mitigating only one type of fiscal cost, ageing, with one type of funding, corporation taxes.

Financial assets: Sovereign wealth funds invest in a diverse range of financial assets including bonds, public equities, private equity, real estate, infrastructure, and alternative investments. The investment approach of these funds can, and do, vary. Given the relatively short term focus of the fund it seems unlikely to invest in real estate. ISIF already exists, and so investing in Irish equities seems like a non-runner as well as two large funds would likely crowd out any private investment.

Most sovereign wealth funds have limits regarding the percentage allocations that can be put towards single name equities. There are limits regarding any potential exposure to a single government bond issue, for example. These issuer limits make a lot of sense in my view, because not only do they avoid concentration risks, but they also avoid having portfolios that are heavily correlated in one direction or the other.

Long-term horizon: Sovereign wealth funds have a long-term investment horizon, enabling them to tolerate short-term market fluctuations and capture potential higher returns. The horizon of this fund is, at maximum, 20 years. This would place it at the lower end of the longer term. I would argue a true sovereign wealth fund should have a longer time horizon of at least fifty years. Many

[3] See James, A., Retting, T., Shogren, J. F., Watson, B., & Wills, S. (2022). Sovereign Wealth Funds in Theory and Practice. *Annual Review of Resource Economics*, *14*, 621-646. Link, and Bahoo, S., Alon, I., & Paltrinieri, A. (2020). Sovereign wealth funds: Past, present and future. *International Review of Financial Analysis*, *67*, 101418. Link, and Alhashel, B. (2015). Sovereign wealth funds: A literature review. *Journal of Economics and Business*, *78*, 1-13. Link

funds started simply investing in bonds. Then they learned about investing in equities, and then simply public ones. Then private equity, seed investing, and so on. The overarching concept should be a perpetual balance sheet.

Size and scale: Sovereign wealth funds vary in terms of size. Some of the largest funds manage trillions of dollars in assets. The proposed fund will manage, under its most optimistic scenario, be between €100 and 120 billion. The injection options are shown below. Keeping fees low and transaction costs controlled will be very important.

	Option 1 (€bn)	**Option 2 (€bn)**	**Option 3 (€bn)**
2024	4	10	18
2025	4	6	12
2026	4	8	12
2027	4	10	12
2028	4	12	12
2029	4	12	12
2030	4	12	12
Total	**28**	**70**	**90**

Similarly, withdrawal roles as restrictive as possible are preferable.

Transparency and Governance: Greater transparency enhances accountability and public confidence in SWFs. Many SWFs have adopted measures to improve transparency, such as publishing annual reports, disclosing their investment policies and strategies, and reporting on their performance and asset allocation. Some funds have also joined global initiatives like the International Forum of Sovereign Wealth Funds (IFSWF) and adopted the Santiago Principles, which promote transparency, accountability, and good governance practices.

The level of transparency and governance practices adopted by sovereign wealth funds varies across countries, ranging from highly transparent to far more opaque structures. Managed by the NTMA, we can expect similar levels of transparency in respect of the operation of this fund. Many funds use a variety of external asset managers for the sovereign wealth fund's liquid investments and this makes ample sense as well. The choice of appropriate benchmarks will be extremely

important, by which to measure the performance of both internal and external managers. The funds invested will of course have a strong ESG component, and this will have to be explicitly outlined regarding what is and is not an acceptable investment sector.

Many sovereign funds engage in international collaboration and participate in initiatives to share best practices and enhance governance standards. The International Forum of Sovereign Wealth Funds provides a platform to exchange experiences, discuss governance challenges, and develop common principles and guidelines. International collaboration fosters learning and promotes higher standards of governance across funds globally.

Some concluding remarks and some open questions

This development is welcome. Multiple pools of capital are a good thing. There is a national portfolio in construction. The government can decide to take out distributions from any fund. Many sovereign wealth funds took funds out during the 2008 financial crisis and again during the COVID crisis. The intent however, is to perpetually reinvest. Sovereign wealth funds tend to have a 'DNA' that matches the personality of the state. In Singapore, everything is planned. People take an incrementalist approach where change is telegraphed ahead of time. This has advantages and disadvantages. Ireland's approach may well be different but the overriding goal is to stop short term financial decisions taking place.

Aligning the fund's objectives with its investment strategy with the individual incentives of those people working on the fund will be key. For example, ensuring part of their compensation is much longer dated, for example, including up to 8 to 12 years in duration, means their compensation will be much smoother and their behaviour consequently quite different to (say) private equity.

Finally, some open questions:

1. Why is there an upper limit on the fund? Norwegian, Singaporean, and Canadian funds are in principle unbounded in size.
2. Withdrawal rules should be set up so as to effectively ringfence any removal of underlying capital under all but the most emergent of scenarios, requiring an Oireachtas super majority for example to be used.
3. The sources of the funds are assumed to be simply windfall corporate taxes of between €4 and €18 billion per year. What about revenues from (say) offshore wind?
4. This proposal, while welcome, should be seen as just part of the development of the financial architecture of the State in the 21st Century. It begs the final question: where is the rest of the blueprint?

I thank the Committee for its time and attention.