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WITH ‘G’ GREATER THAN ‘R’, SHOULD WE BE BORROWING TO INCREASE IRISH HOUSING SUPPLY?

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ABSTRACT

In this Article, we address one of the major policy issues in the Irish economy at present, namely the undersupply of residential housing. Particularly given the recent, adverse impacts of pandemic-related public health restrictions on housing supply, we argue that a significant increase in the provision of publicly provided housing is now required to help bridge the growing gap between actual supply levels and the structural demand for housing. To investigate the public financing of such an investment we examine the future conduct of Irish fiscal policy. Given the expected strong post-COVID-19 performance of the Irish economy and the likely continued low cost of sovereign debt, we argue that the adoption of a consistently negative Government primary balance can be pursued under a prudent and sustainable set of conditions. Such a policy could provide the Exchequer with an additional annual amount of between €4 billion and €7 billion.

1. INTRODUCTION AND HOUSING MARKET PRESSURES

Arguably, one of the most significant long-lasting effects of COVID-19 on Irish society is the adverse impact on the provision of housing. While the introduction of significant fiscal support payments such as the Pandemic Unemployment Payment and the Employment Wage Subsidy Scheme have to a large extent cushioned income levels (see Doorley et al., 2020 for more on this), and hence affordability on the demand side of the housing market, the nature of the public health restrictions has had a particularly adverse impact on residential supply.

As noted in a wide variety of studies, a significant imbalance had already existed in the Irish housing market between supply and demand; however as pointed out in Allen-Coghlan et al. (2020), the relatively slow response of the supply side of the Irish housing market to a significant shock risks exacerbating this imbalance in a post-COVID world. Housing demand has not diminished as is evident from the

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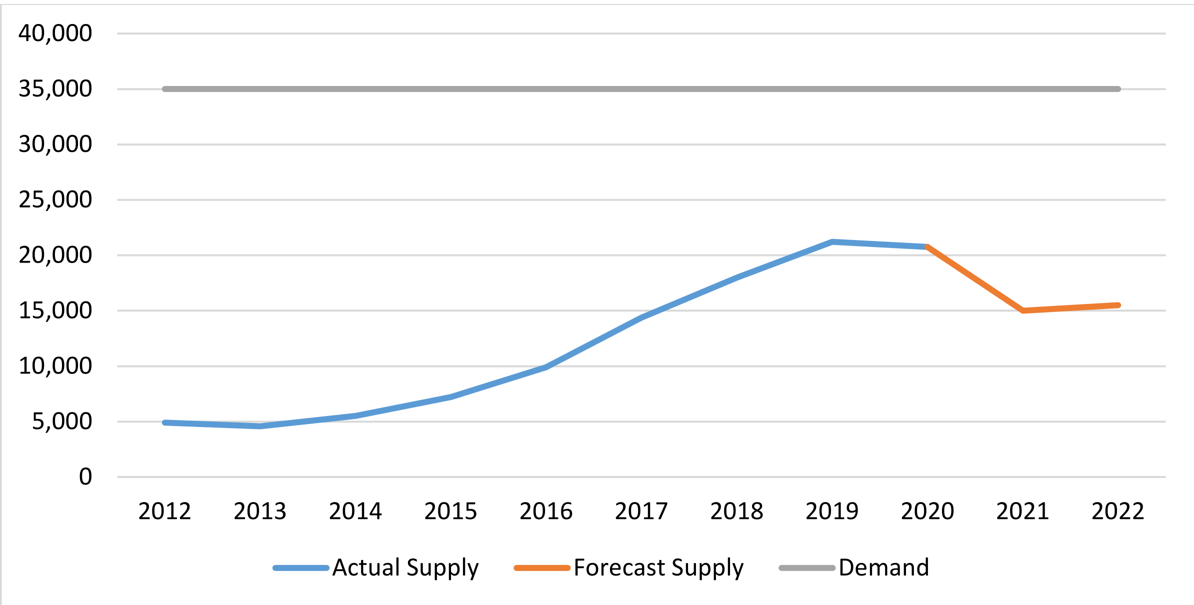
annual increases observed in house prices for February 2021, however housing supply may take some time to recover.

To put the imbalance in the housing market in some perspective; a recent study by Bergin and Garcia-Rodriguez (2020) estimates that the structural demand for housing in the Irish economy is approximately 35,000 units per annum. This demand for housing is largely a function of population growth and housing preferences, and population growth is largely determined by economic conditions. This estimate tallies with previous work by Duffy et al. (2016) and Byrne et al. (2014). Estimates of housing demand are of course particularly sensitive to assumptions concerning migration and headship rates. For example, Conefrey and Staunton (2019) conduct a scenario where they assume that Irish headship rates converge to UK rates; this results in an estimate of 47,000 units per annum over the period 2020-2029.

Figure 1 summarises housing completions and the structural demand estimate. It includes actual completions from 2012 to 2020 and forecasts from the latest *QEC* for 2021 and 2022. The lower forecasts for 2021 and 2022 reflect the trends in leading indicators for the residential sector such as commencement data and planning permissions. Also, under the new guidelines for the Level 5 lockdown restrictions introduced in early January 2021, construction work was no longer deemed essential and did not commence again until April 2021.

FIGURE 1 ACTUAL AND FORECAST HOUSING COMPLETIONS AND ESTIMATE OF STRUCTURAL DEMAND



Sources: CSO, *QEC* calculations and Bergin and Garcia-Rodriguez (2020).

It is clear from the graph the scale of the imbalance and the growing nature of the divergence in coming years. This is likely to result in further upward pressure on house prices and rent levels. Any such increase in housing costs comes in the context of significant existing affordability challenges in the Irish residential market. Two recent studies of housing affordability pressures (Corrigan et al., 2019; O'Toole et al., 2020) document the high share of households facing high housing costs; prior to the pandemic approximately one-in-three households who were not in receipt of State housing supports were classed as having insufficient income after housing costs to afford a standard basket of goods and services. Indeed Corrigan et al. (2019) note that these affordability challenges are a structural feature of the Irish housing market. Separately, Honohan (2021) identifies the elevated cost of housing in Ireland as one of the main reasons for the relatively high domestic cost of living when compared with other Euro Area countries.

In this paper, we examine whether the State can afford to significantly increase the provision of housing. Using plausible future values for key fiscal parameters in the domestic context, we examine what future Irish fiscal policy could look like after the pandemic. We examine whether it is possible for the State to run a persistent negative Government primary balance in a sustainable and prudent manner over the medium term.

2. FUTURE IRISH FISCAL POLICY

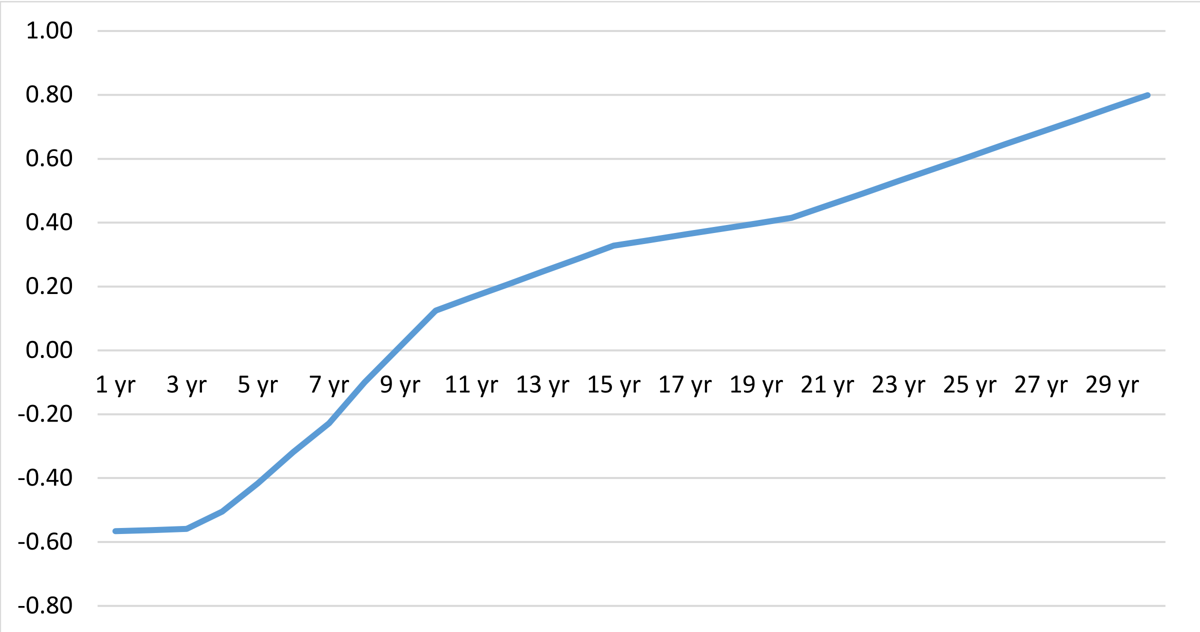
From a cross-country perspective, one of the more significant economic impacts of the COVID-19 pandemic has been the sizeable increase in borrowing and hence sovereign debt levels which has occurred. In the European Union, for example, the fiscal rules framework introduced as part of the Stability and Growth Pact (SGP) in 2011 have been formally suspended, thereby enabling Member States to increase substantially their levels of public sector borrowing.

The interruption in the conduct of European fiscal policy has given rise to a growing debate about the future of the fiscal rules, especially when the effects of the pandemic have started to subside. This debate has been further stimulated by the particularly low rates of interest on sovereign debt which have been observed in recent years. Indeed, it can be argued that the European fiscal rules were originated and devised under the standard assumption that such interest rates would equal if not exceed the rate of growth of the respective economy in question; namely that:

$$r - g \geq 0 \qquad (1)$$

where r is the interest rate on government debt and g is the nominal rate of economic growth. However, even before the onset of COVID-19, interest rates, on an international basis, had been declining on a persistent basis. As noted by Furman and Summers (2020), the neutral safe real rate (the rate which maintains aggregate demand at potential output) across countries has been consistently falling since the 1980s. Within a Euro Area context, the low cost of borrowing for sovereigns has also been greatly facilitated by the policies initiated and maintained by the European Central Bank (ECB) since 2012 (see Schnabel, 2020, for more on these). These policies have kept the yield curves for Member States relatively flat even in the presence of the increased borrowing necessitated by COVID-19.

FIGURE 2 IRISH GOVERNMENT YIELD CURVE (%): APRIL 2021



Sources: Bloomberg and author's calculations.

The present low cost of borrowing in a domestic context can be observed from Figure 2, which plots the Irish yield curve for sovereign bonds. Irish yields are negative up to eight years, the 20-year yield is 0.4 per cent while the 30-year yield is just 0.8 per cent.

This low cost of borrowing is in contrast to the expected growth outlook for the Irish economy over the next ten years. Bergin et al. (2021) have outlined a series of post-COVID-19 scenarios for the Irish economy on the basis of COSMO – the large scale macro-econometric model of the Irish economy. These and other scenarios are discussed in Allen-Coghlan and McQuinn (2020) and Allen-Coghlan and McQuinn (2021). Under a recovery scenario Bergin et al. (2021) forecast that the Irish economy will average a 4.5 per cent growth rate between 2024 and 2030.

To investigate the impact of these likely trends in *r* and *g* for future Irish fiscal policy, we avail of the well-known steady-state relationship between Government debt and the primary balance ratio:

$$b = s\left(\frac{1+g}{r-g}\right), \text{or equivalently } s = b\left(\frac{r-g}{1+g}\right) \qquad (2)$$

As outlined in Blanchard et al. (2021), for a specific level of the primary balance *s*, there is a debt-to-GDP ratio *b*, which if exceeded will cause the debt level to explode. Similarly, for any debt-to-GDP ratio *b*, there is a primary balance *s*, which if the actual balance is lower than *s*, then the debt will again explode.

In the present context we specify a specific debt-to-GDP ratio and solve for the corresponding primary balance ratio *s*. This is because we believe a small open economy such as Ireland's should set the debt-to-GDP ratio on a relatively conservative basis. The unprecedented nature of the pandemic and the costs associated with it highlight the importance of an economy such as Ireland's having a sufficient buffer established in case of such emergencies. Consequently, we set as a baseline ratio b_{base} = 45 per cent. Pre-pandemic, government policy had stated that 45 per cent of GDP was the relevant medium-term target for Ireland (Budget 2017).

Table 1 presents the results of the simulation of (2) under a variety of different growth rates and three different interest rates. While the 30-year yield on Irish bonds is short of 1 per cent, we take a range from 1 to 2 per cent as our interest rates for the scenarios. We take a relatively conservative path for the interest rate as Blanchard et al. (2021) acknowledge 'economists have little sense of the right magnitudes' in terms of the impact of additional borrowing on the sovereign's interest rate. However, Blanchard et al. (2021) do argue that the impact is likely to be smaller for countries in the European Union (EU) due to the EU's highly integrated nature.

To demonstrate the sensitivity of the results, we also include the simulations with a debt-to-GDP ratio of 60 per cent (b_{alt}).

For the nominal growth rate of the Irish economy (*g*), we again take a relatively conservative range of 4.0 to 6.0 per cent. The 4.5 per cent growth rate forecast in Bergin and Garcia-Rodriguez (2020) is a real growth rate whereas '*g*' is a nominal rate. If we assume a rate of inflation of approximately 1 per cent, this means the equivalent real output growth range is between 3.0 and 5.0 per cent.

TABLE 1 FUTURE FISCAL POLICY SIMULATIONS FOR THE IRISH ECONOMY (%)

		r=1		r=1.5		r=2	
45	***g***	***s***	**€bn**	***s***	**€bn**	**s**	**€bn**
	4.0	-1.3	5.13	-1.1	4.27	-0.009	3.42
	4.5	-1.5	5.95	-1.3	5.10	-1.1	4.25
	5.0	-1.7	6.77	-1.5	5.93	-1.3	5.08
	5.5	-1.9	7.58	-1.7	6.74	-1.5	5.90
	6.0	-2.1	8.38	-1.9	7.55	-1.7	6.71
b_{alt}	***g***	***s***	**€bn**	***s***	**€bn**	**s**	**€bn**
60	4.0	-1.7	6.84	-1.4	5.70	-1.2	4.56
	4.5	-2.0	7.94	-1.7	6.80	-1.4	5.67
	5.0	-2.3	9.03	-2.0	7.90	-1.7	6.77
	5.5	-2.6	10.11	-2.3	8.99	-2.0	7.86
	6.0	-2.8	11.18	-2.5	10.06	-2.3	8.94

Source: Author's analysis.
Note: The additional revenue generated (€ billion) is in terms of 2021 GDP (€395 billion).

The results in the table indicate that, even under prudent assumptions, the Irish Exchequer would be able to raise approximately €4 billion to €7 billion each year in additional resources for the State while still keeping the public finances on a sustainable and prudent path. The latest Stability Programme Update (SPU) released by the Department of Finance[2] expects a General Government Balance (GGB)[3] of €0.8 billion by 2025.

3. FUNDING CAPITAL INVESTMENT

In the present year, the Exchequer's capital allocation for housing as set out in Budget 2021 is €2.0 billion. This is forecast to add 12,750 additional units to the social housing stock. Of this, 9,500 are to be built, with 800 targeted acquisitions and 2,450 leased homes. However, given the supply and demand data presented in Figure 1, this will still leave a significant imbalance in the residential market over

2 Available online at: https://www.gov.ie/en/publication/d3e2f-stability-programme-update-2021/.
3 Note the GGB measures the fiscal performance of all arms of government. It provides an accurate assessment of the fiscal performance of a more complete government sector, whereas the primary balance is Government net lending excluding interest payments on consolidated government liabilities.

the medium term. Additionally, even if housing supply were to approximate the level of structural demand in a given year, this does not allow for the imbalances which have accumulated over the past ten years.

What is particularly clear from recent trends in the housing market is that the private sector, on its own, is struggling to meet current housing demands. Indeed, combining the forecast provision of State housing along with the overall forecast of 15,000 units indicates that private sector housing supply is likely to be less than 10,000 units for both this and next year. A number of reasons have been advanced for the inability of the private sector to increase its scale of production; changes in the nature of financing after the great financial crisis (GFC) means that developers now have to provide a significant amount of equity funding up front before developments are green-lighted by financial institutions; other commentators have cited the relatively high cost of construction in the Irish market as a potential reason.[4] Either way, even in the presence of particularly high house price levels, when compared with other Western economies (see Bricongne et al., 2019, for more on this), it is evident that the domestic construction sector is unable to meet the scale of production required.

Our analysis indicates that between €4 billion and €7 billion could be generated on an annual basis through such a policy. One proposal, therefore, is to double the existing capital investment in State provided housing to €4 billion per annum. Based on current production levels, this would have the potential to deliver approximately 18,000 units per annum.

Clearly, such a significant increase in activity would bring sizeable challenges in terms of ensuring efficient delivery of the extra units. Who would build these extra units, for example? Could the private sector be engaged by the State to deliver the extra housing? More activity in the housing sector may lead to an increase in inflationary pressures more generally. It would almost certainly involve an expanded mandate for State agencies such as the recently initiated Land Development Authority (LDA) to identify suitable sites and coordinate on a nationwide basis the delivery of the units. As part of any relationship between the State and the private sector in providing housing units, capacity constraints in the domestic labour market would have to be carefully considered. One potential risk concerning any sizeable increase in State investment is the potential for 'crowding out'. However, one could argue in the present case, given the relatively low level

[4] One difficulty in this regard is even getting agreement on the actual cost of building a residential unit in the Irish market. See https://www.irishtimes.com/business/construction/idea-that-only-councils-should-build-social-housing-is-nonsense-1.4440399 for example.

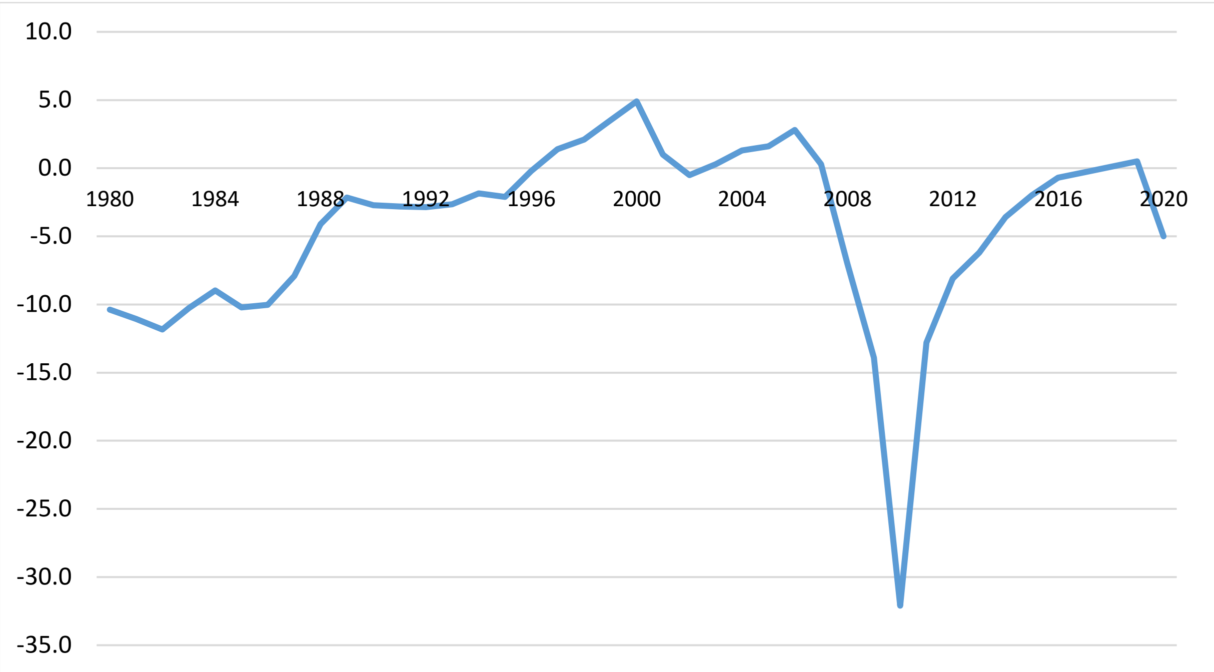
of supply in the private sector, increased State involvement in the supply side of the market could 'crowd in' as opposed to' crowd out' residential investment.

One area where crowding in could occur is in the greater availability of finance for those engaged in construction in the private sector. In seeking to increase housing output, the State could commission greater levels of activity from those in the private sector. This, in turn, could enhance the ability of those in the private sector to secure development finance from financial institutions.

4. PREVIOUS EXPERIENCE OF IRISH PUBLIC SECTOR BORROWING

Attitudes amongst policymakers and analysts to public borrowing in an Irish context are somewhat conditioned by the adverse experience of the Irish State over the period 1977-1987. As can be seen from Figure 3, between 1980 and 1987 the GGB averaged over 10 per cent as the State engaged in a sustained bout of borrowing. The balance improved as the Celtic Tiger emerged in the early 1990s and actually reached a peak surplus of nearly 5 per cent in 2000.

FIGURE 3 IRISH GENERAL GOVERNMENT BALANCE (GGB) (%) 1980-2020



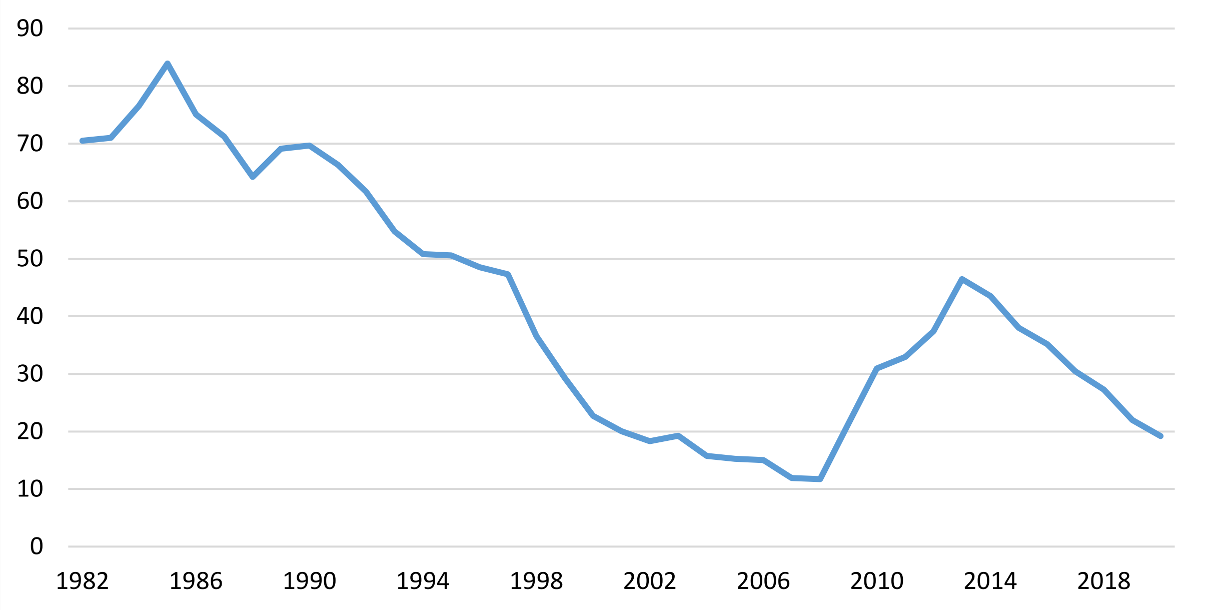
Source: Department of Finance.

The impacts of the GFC and the substantial loans provided to the banking sector are evident in the balances from 2008 to 2012, while the improvement in the public finances is again apparent from 2013 onwards. In 2020, a negative GGB of 5 per cent was recorded and a further negative balance of 4.5 per cent is forecast for

2021 (McQuinn et al., 2021). These latter deficits reflect the cost of the traditional and new welfare payments provided to support family incomes due to COVID-19.

The overall cost of debt to the State can be observed from Figure 4, which plots the ratio of debt interest payments to the total income taxation take. This is plotted from 1982 to 2020. The substantial pressure on the domestic Exchequer in the early to mid-1980s due to the high levels of borrowing and its relatively high cost are clear. In 1985 for example, the ratio of debt repayments to the income tax take was an enormous 84 per cent. Just prior to the GFC, the ratio had declined to just under 12 per cent. However, it is worth noting that even at the peak of the GFC, the resulting strain on income tax revenue at 47 per cent was still somewhat below the rates in the early 1980s.

FIGURE 4 RATIO OF DEBT REPAYMENTS TO INCOME TAXATION REVENUE (%) 1982-2020



Sources: Department of Finance and *QEC* calculations.

The political as well as economic difficulties in dealing with the deterioration in the public finances in the 1980s serve as a stark warning concerning the perils of over reliance on such a source of Government funding.

However, in considering a policy of a sustained negative primary balance ratio *s*, there are some significant differences between the present circumstance and the earlier period:

1. The Irish economy is arguably in a much more robust state at present than was the case in the 1980s;

2. This is particularly the case in terms of the performance of the Irish labour market and job creation generally;

3. There is a greater acceptance that sustained borrowing particularly for a small open economy such as Ireland's should only be for capital investment and *not* as it was in the 1980s for current expenditure purposes;

4. It should not be used, for example, to offset any shortfall which may arise due to a possible decline in current taxation receipts. For example, there has been growing concern (McQuinn et al., 2020; IMF, 2021) about the sustainability of the significant increase in Irish corporation tax receipts in recent years;

5. Ongoing analysis would assess whether a policy of sustained borrowing was having an impact on the sovereign's interest rate;

6. Any borrowing undertaken should be subject to relatively conservative fiscal assumptions as outlined in Table 1;

7. Borrowing for capital investment should prioritise projects which increase the productive capacity of the domestic economy.

This last point is of growing importance. It is clear that the high level of domestic housing costs is one of the main reasons for the increased cost of living in Ireland when compared with other countries (see Honohan, 2021 and Coffey, 2021 for more). The lack of adequate housing supply is, therefore, one of the biggest challenges to our competitiveness as an economy (see Ireland's Competitiveness Challenge, 2020). A sustained increase in housing supply should alleviate this persistent upward pressure on the cost of living.

It is true that higher levels of activity in the non-traded sector (housing) in the presence of frictions in the labour market could also damage our competitiveness. These inflationary pressures which would be more near-term in nature would have to be mitigated in some way by, for example, facilitating greater inward migration of workers with the requisite skill levels for the construction sector.

It should be noted as well that a sustained increase in housing supply and particularly in the provision of social and affordable housing could reduce expenditure by the State in other areas. In 2021, it is estimated that total State expenditure on housing assistant payments (HAP) will have come to €1.4 billion since the introduction of the scheme. This scheme enables local authorities to make a monthly payment to a landlord on behalf of a tenant who pays a weekly contribution based on their household income. Owing to the relatively low levels of housing supply available in the Irish market, this scheme has grown in popularity since its inception in 2014 when the initial budget outlay was €390,000. A sustained increase in affordable housing supply would reduce the necessity for such a scheme and, hence, the State's outlay on it.

5. CONCLUDING COMMENTS

It is increasingly clear that a long-lasting impact of COVID-19 on Irish society will be the reduced pace of housing supply. This outcome compounds an already pressing issue in Irish economic and social life. The analysis in the paper suggests that, given likely developments in the Irish economy over the medium term, it will be possible for the Government to generate additional funds through borrowing in a sustained but prudent manner. Crucially, this borrowing will still enable the State to have a fiscal buffer in place to meet either anticipated or unanticipated shocks to the economy.

While such a significant scaling up in publicly provided construction would generate sizeable challenges in terms of efficient delivery, it does appear that, as a society, we will fall significantly short of meeting the level of demand for accommodation in the absence of such investment.

There are, of course, many pressing demands for additional State capital investment in areas such as health, education and the adoption of green technologies and each of these must be evaluated on its own merits. However, without significant investment, we risk experiencing another decade of inadequate housing supply and resulting upward pressure on residential prices and rents.

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