would ensure that the Government could respond to future crises in the way that it has been able to respond to Covid: by supporting the economy when it is weak.

The Government's response should be calibrated based on how the recovery evolves. Further stimulus might be warranted should the recovery falter or should other risks emerge, such as if vaccines were to prove ineffective over time. However, the extent and nature of any fiscal adjustment—upon the economy having recovered to a steady state—should be guided by credible medium-term fiscal plans.

## Box I: A bottom-up assessment of Ireland's structural primary balance

This box outlines an alternative, bottom-up approach to estimating Ireland's structural balance. The standard approach used by the Department of Finance and others, including the European Commission, relies heavily on the accuracy of two things: the output gap and a "top down" estimate of the relationship between the deficit and the output gap.

While the Council has undertaken considerable work in recent years to better assess Ireland's cycle (Casey, 2019) and its relationship with spending and revenue (Carroll, 2019), there is more scope to better understand how the structural balance is performing.

An alternative bottom-up approach can prove useful. This can be especially true when output gap estimates are prone to more error than usual, such as in times of significant economic change or when the public finances have been temporarily affected in ways that might not be captured by the usually assumed relationship. While the "top down" method leaves residual errors in the structural balance, it is less clear that this will be the case in the "bottom up" method.

### Structural revenue

To start with a bottom-up assessment, we consider what level of revenue would have been expected if the economy remained at its potential. To estimate structural revenue, revenue in 2019 is taken as a starting point. For 2019, the Department of Finance estimate that the output gap was approximately zero. As a result, a reasonable assumption is that in 2019, structural revenue equals actual revenue. At this point, general government revenue was approximately 41.7 per cent of GNI*.

Using an assumption that structural revenue grows in line with potential output growth, we can project forward sustainable revenue.[63] This sustainable revenue figure is then adjusted up or down based on new discretionary revenue measures introduced by the Department.[64] For instance, if the Government implements a tax cut, this revenue share of potential GNI* is adjusted down by the corresponding fiscal cost of the tax cut.

[63] Here we assume a constant medium-term growth rate of real potential output of 2.5 per cent over the medium-term, 2021-2025. This assumption is based on a combination of mechanical estimates and judgement. It is also assumed that prices grow in line with the Department's GNI* deflator for 2021-2025.

[64] This figure is also adjusted down based on the Department's assumptions around corporation tax receipts. The Department assume a loss in corporation tax receipts of €500 million each year from 2022-2025 as a result of the BEPS reforms (See Box F for details).

This bottom-up estimate of structural revenue is shown in Figure I.1A. In 2020, actual revenue fell below structural revenue by €4.3 billion. However, as the economy recovers over the medium-term, actual revenue converges towards the structural revenue estimate.

### Structural expenditure

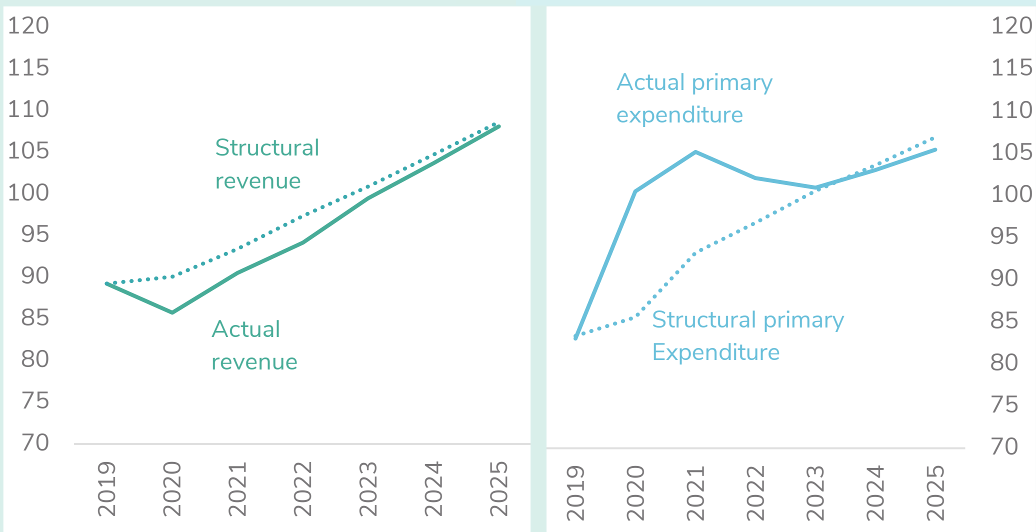
To arrive at a structural primary expenditure figure, all one-offs and temporary measures, and interest expenditure are excluded. The Council's estimates of Stand-Still costs —the cost of maintaining current policies into the future—are then incorporated into the expenditure figures (see supporting information section S11).[65] It is then assumed that unemployment-related expenditure is the only cyclical element of government spending. The estimate for cyclical unemployment expenditure used here is the same as the estimate used in constructing the measure "net policy spending" (see Supporting Information Section S9).

As shown in Figure I.1B, in 2019, there was only a minimal gap between structural primary expenditure and actual primary expenditure. As a result of the pandemic, a large gap opened up between structural primary expenditure and actual primary expenditure, with a €14.9 billion difference in 2020. This gap is forecast to fall slightly to €12 billion in 2021, and with the unemployment rate forecast to be 6.7 per cent by 2023, this gap is largely closed. Structural primary expenditure rises above actual primary expenditure in 2024 and 2025 as the Government's forecasts for actual expenditure do not fully incorporate the costs of current policies.

**Figure I.1: Bottom-up structural revenue and expenditure**

€ billion

**A. Structural revenue** **B. Structural primary expenditure**




Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Structural primary expenditure = Actual expenditure – One-offs – Cyclical unemployment expenditure – intere
costs + additional Stand-Still costs. Get the data.

### The bottom-up structural balance

Figure I.2 shows the budget balance that arises from combining the bottom-up approaches for structural revenue and structural primary expenditure after forecast interest costs are added back in. The structural balance was 0.5 per cent of GNI* in 2020. A large deterioration occurred in 2021, with the structural balance falling to -1.5 per cent of GNI*, largely as a result of a €7.7 billion increase in permanent expenditure, included in *Budget 2021*. For comparison, the standard, top-down approach to estimating the structural balance is shown in pink. This estimate shows an implausibly large deterioration in the structural balance of 3.2 percentage points in 2020. Taking

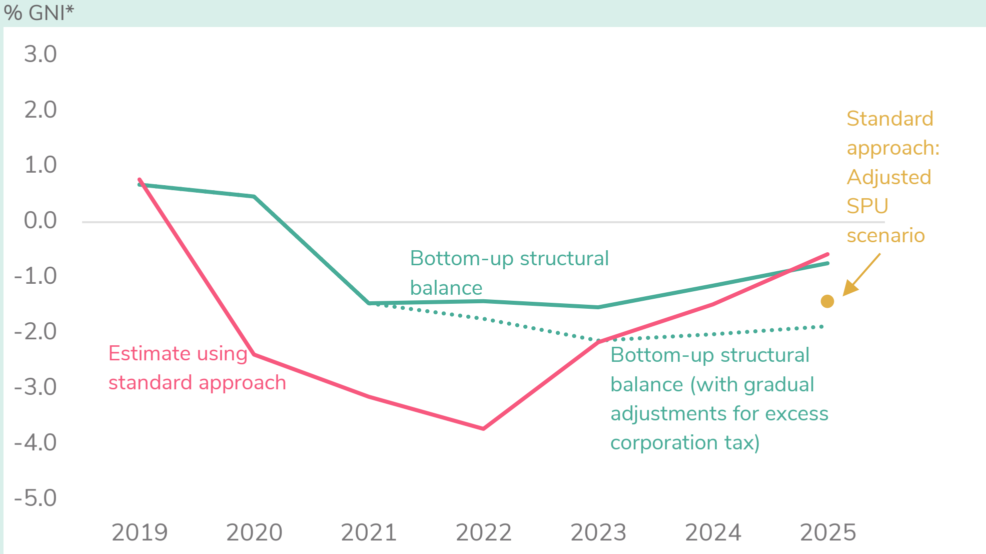
[65] More specifically, where the Department's forecasts of spending do not cover Stand-Still costs fully, these additional costs are added on to the forecast expenditure figures.

the Council's adjusted SPU scenario (See Table 2.3), and applying the top-down approach, the structural deficit in 2025 is 1.4 per cent of GNI*, 0.8 percentage points worse than the SPU forecasts suggest.

However, one factor that has recently flattered the picture for the structural balance is the corporation tax receipts that are largely unexplained by domestic economic activity, and as a result, may ultimately prove transitory (see Section S10). To account for this, we phase in downward adjustments to the structural balance in line with the Council's central estimate of excess corporation tax of €4.8 billion.[66] The dashed line in Figure I.2 shows the structural balance that incorporates the reduction of this excess corporation tax. In this case the structural balance is largely unchanged from 2023-2025 at around -1.9 per cent of GNI*.

The Council believes this bottom-up approach to the structural primary balance is a more accurate reflection of the structural position of the State's finances and can provide a better steer on the fiscal stance. Going forward, the Council will continue to develop and refine this approach.

**Figure I.2: Bottom-up structural balance**




Sources: CSO; Department of Finance; and Fiscal Council workings.
Note: Corporation tax is adjusted in the second set of estimates of the bottom-up structural balance (depicted by the dashed line). The adjustments phase in the gap between the Council's central estimate of excess corporation tax of €4.8 billion and the Department's assumed reductions of €2 billion over the period 2022–2025 as downward adjustments of €0.7 billion per annum. The "adjusted SPU scenario" is set out in Section 2. Get the data.

[66] The phasing in of this adjustment is assumed to take place gradually and equally over the period 2022–2025. That is the same time period over which the Department assumes that corporation tax receipts fall by €2 billion due to changes in the international tax environment. As the bottom-up structural balance already incorporates a €2 billion adjustment, the additional adjustment applied here is €2.8 billion.