Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Patrick Honohan *Governor*

T +353 1 224 6001 F +353 1 671 6528

Bosca OP 559, Sráid an Dáma, Baile Átha Cliath 2, Éire.
PO Box No. 559 Dame Street, Dublin 2, Ireland.

www.centralbank.ie

Mr Michael Noonan, TD
Minister for Finance
Government Buildings
Upper Merrion Street
Dublin 2

22 September 2014

Dear ~~Minister~~ Michael,

With *Budget 2015* imminent, it is time for me to write to you with views on relevant economic and fiscal matters.

Overall situation

The smooth exit from the EU/IMF Programme and the return to more normal financing conditions (as evidenced by the bond market spreads and rating agency upgrades of Irish sovereign debt) have created a more favourable environment. The domestic economic recovery has become more broad-based with a gradual recovery in incomes and employment. On the fiscal side, the on-going improvement in the public finances, the decline in contingent liability exposures and a strengthened fiscal framework are all solid achievements of the past few years. Recent trends in the Exchequer data this year have also been favourable and indicative of the improvement in the economy. I note that annualised tax revenue has returned to levels not seen since late 2007/early 2008. The continued restraint in public spending, despite pressures in key sectors, is also testament to the progress in budgetary planning and execution.

Still, the economy is operating well below full capacity and a sizable number of risks remain. Household and financial sector balance sheets remain impaired and fragile. With employment one-eighth below its - admittedly unsustainable - peak, levels of long-term unemployment remain high. Furthermore, the competitiveness challenge posed by a high domestic cost base persists.

The economy remains acutely susceptible to developments in the wider international economy. The anaemic conditions and prospects in the euro area are a particular concern. In addition, the current abnormally low yields on sovereign debt cannot be expected to last and could indeed snap back suddenly when the remarkable risk appetite now being displayed in global financial markets is sated and when monetary policy in the US and elsewhere is tightened.

Given these risks and uncertainties, it is important the budget is based on a prudent economic outlook.

Budget deficit and debt ratio reduction over time

In considering the appropriate degree of consolidation for *Budget 2015*, it is important to stress that the 3 per cent EDP deficit ratio is not an end-point. Rather *Budget 2015* will be the first in a sequence of post-Troika budgets that will need to ensure that Ireland moves progressively towards meeting the medium-term budgetary objectives.

In the short-term, doing more than the minimum necessary to attain a budget deficit of clearly below 3 per cent of GDP in 2015 will provide an important safety margin or buffer in the event of any negative surprises or shocks to growth.

With no external oversight to give them confidence, markets will scrutinise this Budget more closely than those adopted under the Troika. This first post-programme budget offers the opportunity to further solidify Ireland's creditworthiness. It is important that this opportunity is taken.

The level of public debt remains one of the highest in the euro area. It is imperative that sustainable and lasting solutions are taken to ensure the delivery of primary surpluses, so as to facilitate the return of the economy to lower and safer levels of debt. Securing debt sustainability through a sequence of primary surpluses is necessary to underpin a more durable recovery. It will in particular also reinforce market confidence in Ireland's creditworthiness and maintain favourable access to market funding.

In public statements up to recently, the Central Bank has not explicitly recommended a deficit target lower than the 3 per cent EDP level for 2015. However, just as unexpectedly unfavourable macro-economic developments were absorbed by uncovenanted debt increases in the past few years, the windfall of a now faster-than-anticipated recovery should be used in part to reduce that debt.

In addition, with the unexpected profitability of recent bond sales by the Central Bank likely to impact the budgetary arithmetic in a favourable way, it is important to recognize the source of these profits. They arise in part from the working out of the IBRC liquidation and the associated financial transactions: to that extent, they should go towards offsetting the huge debt increase incurred as a result of the 2008 bank guarantee. This means aiming now for a surplus of less than 3 per cent for 2015.

I would therefore also strongly urge that you treat any eventual increase in Central Bank surplus income (over the record levels of about a billion achieved on average over the past five years) as being something that should be applied to reducing debt rather than reducing taxation or increasing spending. A failure to adopt such a policy would mean unnecessarily embedding increases in debt arising from the banking collapse and the bank guarantee into the current level of the Government's debt, making debt reduction much more difficult to achieve over time.

Bear in mind also that neither financial market participants nor our official partners will be impressed by a 3 per cent deficit that is achieved only because of one-off factors including atypically high Central Bank profits.

Indeed, in the medium-term, Ireland's expanded commitments under the new fiscal framework mean that increasing attention will be paid by external observers to the both the structural budget balance (given the Medium-term Objective) and the growth in underlying expenditure (given the Expenditure Benchmark). While the 2014 Stability Programme Update outlined a central scenario to 2018, the first post-programme budget offers the Government the opportunity to set out an updated medium-term path for the economy. The European Commission and the markets will focus on sustainable improvements in the public finances. While the Government has had recourse to a number of temporary measures in recent years, namely receipts from the sale of state assets as well as bank guarantee fees, the fiscal rules imply that such measures will be excluded from any assessment of the underlying fiscal position. Temporary budgetary measures are also likely to be closely scrutinized by the markets. For these reasons, it would be beneficial for the budget to clearly document permanent as opposed to temporary measures.

Framing the budget in an overall strategic vision

Related to this, I believe that public acceptance of budgetary policy would be enhanced if the Budget set out a clear vision for the envisaged policy strategy for attaining multi-year budget objectives consistent with requirements under the new fiscal framework. In particular, the path set out for government spending to 2018 in the stability programme implied a sustained fall in primary expenditure, at a time of increasing demand for public services. The budget could be used by the Government to be explicit about the elements of retrenchment it views as lasting and corrective, and those elements which it would like to do more on as resources improve. Such a policy could facilitate more informed debate of policy options as well as improving the credibility of the overall budget.

One of the lessons from the crisis was the benefit of having sufficiently detailed, measurable and attainable budgetary plans that were both politically and economically feasible. There is no question that confidence levels domestically as well as market perceptions improved as Ireland undertook measures to meet requirements under the plan agreed with the Troika. The first post-Programme budget offers the opportunity to provide more detail on planned adjustments going forward.

A more detailed budget would also allow households and firms to plan accordingly through reducing levels of uncertainty. I have argued before and continue to believe that budgetary measures should be assessed by reference to three main touchstones: (i) does it contribute to a return towards what were sustainable (and acceptable) tax and spending structures during the period of high and balanced growth of the 1990s or, if not, (ii) does it represent a definite improvement in the economic and social efficiency of fiscal structures?, and (iii) are proposed measures fair? These three criteria should help guard against implementation risk and ensure that the reforms will be lasting. Perhaps it was inevitable that budgetary strategy during the Troika period was not evidently framed in such a way. Now it could be.

As an example, which I hope will not be taken as straying too far outside the remit of the Central Bank, might I mention the current discussion of income tax levels. The structure and rates of income tax are of course entirely a matter for Government and the Central Bank would not wish to trespass into this area. But it is interesting to compare the current income tax structure to that of the late 1990s, often seen as a near-ideal era of budgetary policy. As shown in the attached chart, although much higher than they were in 2007, the current average rates of income tax (including USC) across most levels of taxable income are actually quite close to what they were in 1999. (To be sure, other related elements, such as PRSI have also changed, but the comparison nevertheless seems instructive).

Housing

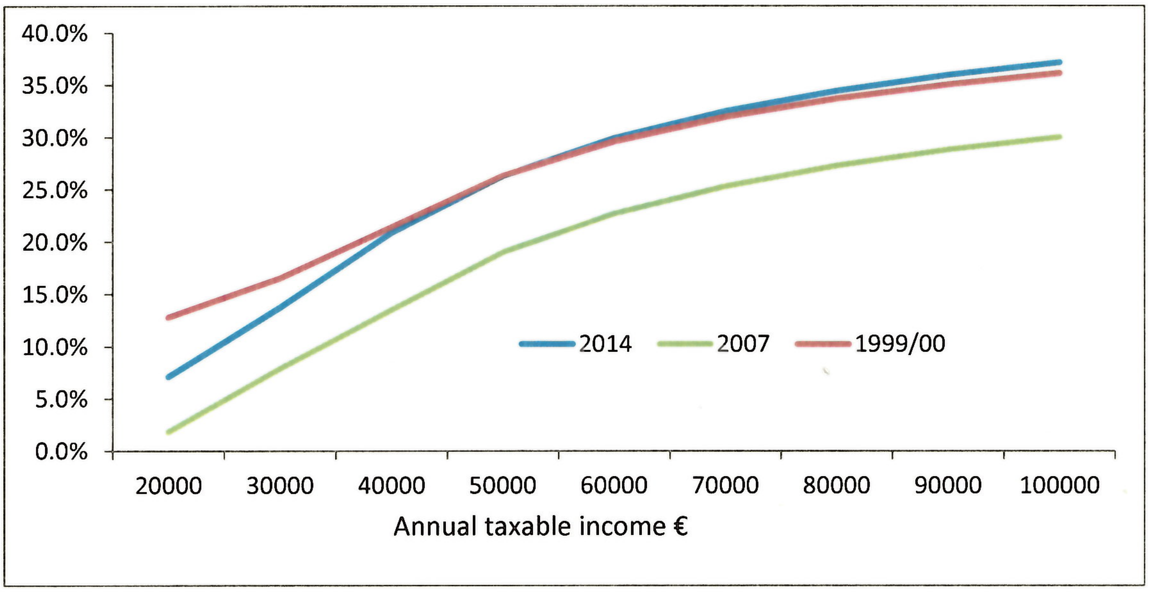
The Central Bank continues to keep the housing market situation under close review, especially with regard to the potential influence of credit conditions. The strong increase in housing prices in the Dublin region mainly reflects supply shortages calling, as you recognize, for a range of supply-side measures. Meanwhile, policy initiatives that aim at increasing demand are likely to put further upward pressures on prices. In this context, the ending of the Capital Gains Tax relief scheme scheduled for this year will be a step in the right direction.

I hope that these remarks are of assistance in drawing up the Budget.

Yours sincerely,

Pa[illegible]

Comparison of Average Tax Rates, 1999 and 2014



The chart presents average income tax rates (including the USC, but not PRSI) for a single worker on taxable incomes of €20,000 to €100,000 for three time periods; 1999, 2007 and 2014. Thresholds and allowances/credits have been inflation-adjusted for the older time periods.

The data shows that average income tax rates for middle and higher income workers are now back to the level experienced in 1999. This is partly due to the introduction of the USC which adds between 4 and 6 per cent to tax rates over the income distribution