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Chairman
Select Committee on Budgetary Oversight
Leinster House
Dublin 2
D02 XR20

Re: Residential premises rental income relief and the mortgage interest tax relief in Budget 2024.

Dear Deputy Cowan,

I am writing to you in relation to your request seeking the Central Bank's views on the Mortgage Interest Relief (MIR) and the Residential Rental Income Relief (RRIR) schemes announced in Budget 2024, particularly their impact on the housing market and the public finances.

Before referring to the specific reliefs that are the focus of this submission, it is useful to consider the role of tax reliefs in general. Tax reliefs reduce the breadth of the tax base and can introduce distortions that influence taxpayer behaviour, deviating from the concept of tax neutrality. A careful evaluation of such reliefs, especially in light of the known medium-term challenges facing the public finances as set out, for example, in the recent Commission on Taxation and Welfare report[1], is something the Central Bank would endorse.

As outlined in the Department of Finance's guidelines on the evaluation of tax expenditures[2], it may be appropriate to consider using tax reliefs in the presence of specific market failures. A market failure is typically defined as a situation where the market forces of supply and demand for specific goods or services do not lead to efficient economic outcomes. For example, it is typically the case that private investment in new technologies – which entail society-wide benefits – tends to be under-supplied. In that context, R&D tax credits seek to increase the level of private innovation investment across the economy.

[1] Commission on Taxation and Welfare (2022) "Foundations for the Future: Report of the Commission on Taxation and Welfare".
[2] Department of Finance (2014) "Report on Tax Expenditures: Incorporating Department of Finance Guidelines for Tax Expenditure Evaluation".

In the case of MIR and, to an extent, RRIR, the market failure that is being addressed needs to be clarified. For example, it is not obvious how the existence of such reliefs would lead to the production or consumption of housing and financial services in a more economically efficient way.

More broadly, in the context of mortgaged households, it also important to highlight that loan restructuring options under the Code of Conduct on Mortgage Arrears (CCMA) and the Mortgage Arrears Resolution Process (MARP) frameworks continue to be available to borrowers facing financial distress, providing an avenue for repayment relief, in a targeted fashion, through the banking system and other lenders.

Of course, within the constraints of an appropriate and sustainable overall fiscal stance, it is reasonable for governments to seek to ease the burden of accessing housing services or the cost of servicing debt for particularly vulnerable households. In such circumstances, and to avoid the drawbacks of inappropriately using tax reliefs, a direct expenditure approach targeting the most vulnerable would be more suitable. This could be achieved, for example, through social protection expenditure.

In the main, I will focus on the MIR scheme, given the greater potential for negative externalities depending on how the scheme evolves over time. The RRIR is a direct tax relief against earnings from private rental income, lowering landlord costs. Given the stark supply and demand imbalance in the rental market, it is uncertain if the relief will significantly affect rental prices, although it may encourage smaller landlords to stay in the rental market, which could somewhat counteract the downward trend in the number of tenancies registered with the Residential Tenancies Board (RTB)[3]. Overall, this measure relates to the provision of a particular housing tenure, rather than directly addressing the underlying imbalance between the supply and demand for housing services across the economy. It is that imbalance that lies at the heart of affordability pressures for housing services, whether for renters or prospective homeowners.

Mortgage Interest Relief in response to cost of living pressures

Since the onset of the pandemic, the cost of living has significantly increased for households across Europe, including Ireland. Monetary policy has responded to bring inflation in the euro area back to target, with the ECB Governing Council increasing policy interest rates by 4.5 percentage points since last summer. Monetary policy affects the economy through several channels, including by directly increasing the cost of borrowing for households.

Inflation harms everybody in society, but impacts vulnerable households the most. Given the recent resilience of the economy in aggregate, and as monetary policy is set at the level of the euro area as a whole, it is important that domestic economic policy avoids working at cross purposes to monetary policy. A risk with actions such as widespread, untargeted MIR, is that they may delay the pass-through of the ECB's actions to the Irish economy, increasing the risk that high inflation will

[3] Number of tenancies registered with RTB fell by 73,000 between 2016 and 2022.

be with us for longer. To avoid slowing down the ECB's attempts to tackle inflation, domestic policy responses would be more effective when focussed on targeting supports to the group of households most at risk from cost of living pressures, or in the case of mortgaged households, most at risk of missing mortgage payments as a result of recent interest rate increases.

It is the Central Bank's view that the recent MIR scheme, which provides for relief to a relatively broad group of borrowers experiencing increases in interest rates over the course of the past year, cannot be said to be targeted directly at the most indebted or most vulnerable households. There are a number of evidential points to make in this regard:

- In aggregate, mortgage borrowers tend to be a higher-income cohort than private renters and those in social housing.
- The design of the scheme means that greater relief will be provided to those that have seen larger interest rate increases this year. But this is not necessarily the same cohort of borrowers that are in the most vulnerable financial position.
- Specifically, the relief will predominantly accrue to tracker mortgage customers:
    - These customers took out mortgages before 2008, with many having repaid a significant amount of their outstanding loan over this period and, therefore, have smaller loan balances remaining than other mortgage borrowers.
    - While tracker borrowers have seen significant increases in repayment burdens due to rising interest rates, they also entered this period with significantly lower repayment to income ratios than other mortgage borrowers.
    - Survey data suggests that tracker mortgage households are less likely to be in the lower-income cohorts of borrowers in the mortgage market. This likely relates to the fact that these households tend to be older and have benefited from a period of nominal income growth since mortgage origination.
    - Of course, within the cohort of borrowers with tracker mortgages, it is undoubtedly the case that some are in more difficult financial position, with some having already experienced financial difficulties during the 2008-2013 period.

Overall, the Central Bank's view is that a more effective fiscal response to pressures facing individual mortgage holders would involve implementation of supports through the social welfare system, where means-testing and targeting are more feasible.

Mortgage interest and rental income relief from a budgetary perspective

The RRIR was included in a package of Housing Supports in Budget 2024. The relief will be €3,000 for 2024, €4,000 for 2025 and €5,000 for 2026 and 2027, which is equivalent to a tax credit for landlords of up to €600, €800 and €1,000 respectively. The Department of Finance estimates the measure will cost €45 million in 2024, rising to €160 million annually in 2026 and 2027.

The MIR measure in Budget 2024 was included as part of the Government's broader cost of living package of expenditure increases and tax cuts amounting to €2.9 billion. The Department of

Finance estimates the measure will cost €125 million in 2024. As is the case for the other parts of the cost of living package, the Budget 2024 documentation states that mortgage interest tax relief is intended to be temporary. Under the measure, relief will be available at the standard income tax rate in respect of the increase in the interest paid between the calendar year 2022 compared to the calendar year 2023, capped at a maximum of €1,250 per property.

If the measure is withdrawn after one year, as is currently envisaged, then the resulting one-off estimated cost of €125 million would not pose material risks for fiscal sustainability. However, past experience in Ireland demonstrates that fiscal measures initially intended to be temporary can sometimes remain in place for longer than originally anticipated. So a key risk from a fiscal perspective is the potential for the scheme to remain in place for longer than the envisaged lifespan set out in Budget 2024 and/or that it is extended to a wider pool of qualifying mortgage holders, thereby increasing the cost to the public finances.

The previous system of mortgage interest relief, for example, existed over an extended period, back to at least the 1970s.[4] The phasing out of the previous MIR scheme was announced in 2008, at which point its estimated fiscal cost was over €700 million per annum, and was originally planned to conclude in 2017, but later extended until 2020. In addition, several recent budgetary measures introduced in response to cost of living pressures, initially intended to be temporary/ one-off, have been retained. For example, the reduction in VAT on electricity and gas, initially due to expire on 31 October 2022, has been extended three times and will remain in place until October 2024.

If the mortgage interest relief were to be continued forward in next year's budget, a range of factors pose upward risks to the scheme cost over the medium term:

- Over 2023 and 2024, about one-fifth of all mortgages will have rolled off short-term fixations and onto higher-cost loans, potentially becoming eligible.
- The large stock of SVR loans, which has experienced lower pass-through of ECB rates up to now, may also experience interest rate increases over the next year, even in the absence of further ECB rate increases, depending on lenders' pricing decisions. Evidence of such increases is beginning to emerge, with a number of financial institutions announcing increases for their stock of SVR loans in recent months.
- The future path of monetary policy is uncertain, and tracker mortgage loans could experience further increases if additional monetary policy tightening was deemed warranted by the ECB.

Therefore, while the new system of MIR announced in Budget 2024 is intended to be temporary, if it were maintained for longer than planned, it would represent a recurring and growing cost to the Exchequer. To avoid creating a structural gap in public finances, the revenue lost from the relief would need to be offset by an increase in tax revenue from another source or changes in

[4] See: https://www.ucd.ie/geary/static/publications/workingpapers/gearywp201306.pdf

expenditure elsewhere in the budget. More broadly, and as previously discussed by the Commission on Taxation and the Bank, government revenue as a share of national income will need to rise over time to maintain fiscal sustainability in the face of looming challenges from population ageing and the climate change transition.[5] In this context, it is important that any measures that permanently reduce government revenue are carefully considered to ensure they maintain the ability of the public finances to address known future challenges sustainably.

Broader Considerations

A policy such as a MIR scheme requires careful consideration of institutional behaviour and potential negative externalities. For example, the presence of relief may increase lenders' incentives to raise non-tracker interest rates, if they were to conclude that government supports could soften the effect of higher interest rates on borrower repayment capacity. Under such a scenario, the relief would not necessarily result in lower repayment burdens for borrowers.

The mortgage interest relief scheme outlined in Budget 2024 applies only to pre-existing borrowers, which mitigates the impact on the housing market. However, if such a scheme were to be extended to apply to new lending, similar to the historical Irish scheme and several international variations, there could be a significant impact on the housing market. A large body of international policy assessments from the OECD and others shows that MIR provides a subsidy to homeowners, who are more likely to have higher incomes than renters or those in social housing, at significant fiscal cost. Therefore, it can be defined as regressive. These studies also point out that mortgage interest relief (when applied to new mortgages) raises home prices without increasing homeownership rates, thus raising household debt levels and macro-financial vulnerabilities.

In this regard, the Central Bank would have deep reservations if the scheme's scope were to be widened to include new lending, as it would provide additional pro-cyclical demand-side stimulus in a housing market already characterised by constrained supply. The existence of the Help to Buy scheme, the First Home Equity Loan Scheme, and any potential further provision of MIR would also have the potential to interact, creating additional demand pressures in the housing market with adverse implications for affordability. The underlying structural issues in housing remain on the supply side of the market and the delivery of additional housing units to meet demand.

[5] See https://www.gov.ie/en/publication/7fbeb-report-of-the-commission/#executive-summary and https://www.centralbank.ie/docs/default-source/publications/quarterly-bulletins/quarterly-bulletin-signed-articles/managing-the-public-finances.pdf?sfvrsn=cee59e1d_10

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I hope this information and assessments are of assistance and we remain available to discuss these important policies with you at any stage.

Yours sincerely

Vasileios Madouros
Deputy Governor – Monetary and Financial Stability