Commission on Taxation & Welfare
An Coimisiún um Chánachas ⁊ Leas

Briefing Paper

Overview of economic principles and fundamentals of a tax system

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Subject	Overview of economic principles and fundamentals of a tax system
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Version	Final
Date	18 June 2021

Key Points

- The OECD defines taxes as *"compulsory, unrequited payments to general government."*
- The primary objective of taxation is to fund Government expenditure (including public services and other Government outlay). The tax system may also seek to address other public policy objectives such as economic growth, social equity and sustainable development.
- A number of key principles guide the design of a tax system. Ideally the tax system would perfectly align with these principles, however trade-offs arise and a balance must be struck between application of the principles and other objectives and obligations.
- The imposition of tax measures can distort choices relating to work and leisure, as well as consumption, investment and utilisation of resources. As such, tax measures should be carefully designed to ensure their objectives are achieved in a manner that addresses market failure without other unintended consequences.

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1 Executive summary

This paper sets out the principles and other criteria which guide the design of a tax system.

Although ideally the tax system would perfectly align with the principles, trade-offs arise and application of the principles is often constrained by certain policy objectives, international commitments or obligations and sometimes by the underlying principles themselves.

Irish tax provisions must also comply with the provisions of the Constitution of Ireland as well as European law.

As such, a careful balance must be struck. The tax system needs to be carefully designed to ensure it meets its objectives, and tax expenditures should be evaluated to ensure that they do not give rise to significant distortion.

2 What is tax?

The Organisation for Economic Co-operation and Development (OECD) defines taxes as *"compulsory, unrequited payments to general government…"* (OECD Revenue Statistics (2020)).

Taxes are *compulsory* as they are obligations imposed by Governments to pay specified amounts. Governments set the rules that determine the tax base and the rates that are applied to same.

Taxes are *unrequited* as the benefits provided are not normally proportionate to the contributions made by taxpayers. There must be a redistributive element in order for a payment to be a tax.

Taxes are paid to *general government*, which is defined by the OECD to include:

- the central administration and agencies whose operations are under its effective control
- state and local governments and their administrations
- social security funds/schemes, and
- autonomous government entities.

2.1 Are compulsory social security contributions a tax?

Compulsory social security contributions, such as Pay-Related Social Insurance (PRSI), are also treated as taxes under the OECD definition above as they are in the nature of compulsory payments to general government. Although such contributions differ from other taxes as the level of associated benefits available are contribution dependent, the size of these benefits is not necessarily proportionate to the contributions made. As such, these payments are also unrequited in nature and therefore designated as a tax by the OECD.

Although such compulsory payments are within the remit of a tax per the OECD, the designation of PRSI payments as a tax is not without doubt. The 1982 Commission on Taxation determined that social insurance is a form of taxation. The Commission on Social Welfare (1986), took issue with this categorisation, regarding PRSI as having a significant insurance dimension, despite the lack of an actuarial link between benefits and contributions.

The 2009 Commission on Taxation engaged in significant debate as to whether PRSI was in the nature of an insurance arrangement or a tax. No definitive conclusion was reached on this matter by the Commission, however some elements of PRSI were reviewed by the Commission as the charge had some of the characteristics of a tax.

2.2 Objective of taxation

The primary objective of taxation is to fund Government expenditure (including public services and other Government outlay). The taxation system should aim to fund this expenditure in a manner that is economically sustainable, administratively feasible and politically acceptable.

The tax system (in conjunction with public spending) may also seek to address other public policy objectives such as economic growth, social equity and sustainable development. For example, in the case of income tax, the system also seeks to redistribute resources among the population and incentivise desired outcomes, such as participation in the labour force.

Tax can address public policy objectives by influencing decisions relating to the following:

- Employment
- Investment
- Savings
- Consumption

This is because the imposition of taxes distorts choices made relating to work and leisure as well as consumption and investment. These decisions are affected by the rate of tax, the tax mix and the manner in which the taxes themselves are designed.

3 Principles of taxation design

There are a number of principles, which should guide the design of a tax system. These principles have their foundations in the canons of taxation as well as optimal tax theory.

Canons of taxation

These have their foundations in the canons of taxation originally set out in Adam Smith's book The Wealth of Nations (1776).

The original four canons of design, which continue to influence modern taxation design are:

1. *Equality* – that citizens should contribute in proportion to their revenue.
2. *Certainty* – that the amount each individual is required to pay should be certain and not arbitrary.
3. *Convenience of payment* – that taxes should be levied in the manner that is most convenient for the contributor to pay.
4. *Economy of collection* – that taxes should be easy and cheap to collect.

Optimal Tax Theory

From an economic perspective, taxation collection and revenue expenditure should aim to maximise the welfare of society as whole subject to economic constraints.

In theory, buyers and sellers make rational decisions and markets are efficient (i.e. markets are competitive and facilitate the allocation of economic resources in an optimal manner). Prices convey information and people rationally adjust their behaviour according to incentives.

By inflating prices beyond their non-tax price, taxes prevent transactions from happening in the market that would have otherwise occurred in the absence of the tax. This creates a distortion which can hinder the allocation of resources such as labour or capital, which ultimately adversely affects societal welfare.

With this in mind, policymakers typically try to design taxes that limit the distortions to economic choices while also achieving the desired levels of redistribution and revenue. The economic theories which underpin this approach are called the theories of optimal taxation. These have a long history, dating back to Ramsey (1927) for commodity taxes and include an influential contribution on labour taxes by Mirlees (1971).

It is worth noting that while taxes can adversely affect welfare by preventing transactions that would otherwise occur, the collection of tax, the expenditure it funds and the behaviours it encourages can also contribute to the process of maximising societal welfare.

The principles guiding the design of a tax system, which have evolved from both the canons and optimal tax theory are outlined below.

3.1 Equity

The principle of Equity, which builds on the canon of equality is that people should be taxed based on their ability to pay. There are typically two elements to equity:

- *Horizontal equity:* this concerns the idea that two persons of similar income should pay the same portion of that income in taxes.
- *Vertical equity:* this is the idea that those with larger incomes should pay a greater proportion of their income in tax.

Equity may also refer to inter-nation equity. Inter-nation equity is concerned with the allocation of national gains and losses in an international context and aims to ensure that each country receives an equitable share of tax revenues from cross-border transactions.

The degree of equity in a tax system generally depends on the extent to which a country wishes to reduce income inequality and whether vertical equity should be applied to income earned in a specific period or to lifetime income.

Concepts relating to equity include:

- *Progressive taxation:* those with higher incomes pay a higher proportion of their income in taxes. Income tax and the USC are examples of a progressive tax, where higher rates of tax are paid as income levels increase.
- *Regressive taxation:* low and high-income earners pay the same amount of tax in euro terms. This means that low-income individuals will pay proportionately higher rates of tax as a percentage of their income. Regressive taxes include excise duty and VAT, where the amount of tax charged does not take account of the taxpayer's income level.
- *Proportional taxation:* low and high-income earners pay the same in proportional terms. These are also known as flat taxes. An example of a proportional tax would be an income tax system with only one rate of tax.
- *Intergenerational equity:* this relates to fairness between current and future generations and suggests that taxpayers in a generation should (as a whole) contribute to public expenditure in accordance with the share of benefits they derive from that expenditure i.e. they should 'pay their way', without either subsidising, or being subsidised by taxpayers in other time periods.

Ireland's income tax system has a high degree of vertical equity. Ireland's distribution of household income is the most unequal in the EU before taxes and benefits. However due to the degree of progressivity in the Irish tax system, income inequality in take-home income is very close to the EU average[1]. Scope for further increasing the level of vertical equity in income tax while raising revenue in Ireland may be limited as income tax revenues are now very concentrated among higher earners.

3.2 Simplicity

The principle of simplicity draws on the canons of certainty and economy of collection. Simplicity requires that tax system should be coherent and straightforward. Simplicity is achieved where both of the following are low:

- the administrative costs of collection relative to the amount collected, and
- the compliance costs for taxpayers, in terms of money and effort.

Tax rules should be clear and easy to understand. A tax system must be acceptable to the general public and the tax authorities must be accountable to the electorate. Neither can occur if the system is not understood. As such, the system should be designed so that individuals, households and businesses know their obligations and entitlements.

Simplicity makes it easier for actors to make decisions in accordance with the policy intention.

A lack of simplicity may require increased costs of consultation with tax advisors in order to meet basic compliance requirements. In a worst case scenario, the introduction of complex rules can facilitate aggressive tax avoidance.

Ireland is generally perceived as a location where the payment of taxes is relatively straightforward and has been ranked first in the EU (and fourth worldwide) for ease of paying taxes for businesses in the 2020 PWC-World Bank Paying Taxes report[23] – a position it has held for several years. The ranking is based on a comparison of the taxation of businesses in 190 economies. Ireland is considered to have a competitive tax system in terms of cost and time to comply.

[1] 'Understanding Income Inequality in Ireland' Roantree (2020)
[2] PwC Paying Taxes 2020 report shows Ireland maintaining lead in the EU
[3] Paying Taxes 2020 - Overall ranking and data tables

3.3 Neutrality/efficiency

Neutrality relates to the idea that taxes imposed on a particular market should be designed in a way that minimises influencing the decisions of buyers and sellers in the market. As such, a neutral tax system does not create a bias that could influence a taxpayer to choose one course of action over another. Instead, decisions are made based on their economic merits rather than being influenced by tax considerations.

In practice, however, markets are never fully efficient. A person may act in their own self-interest or not be fully aware of the wider costs of their actions on other parties (externalities), which gives rise to inefficiencies which are often referred to as market failures.

For example, individuals are not always fully aware nor exposed to the costs of smoking due to their addictive nature which include:

- personal risk of illness and premature death,
- societal health risks arising from second-hand smoke, or
- increased monetary cost to the health service arising from the personal and societal health risks.

Similarly, a manufacturer may not be fully cognisant of the impact of the societal impact of their manufacturing choices where a low cost, high profit outcome is desired. Such costs can include:

- the impact of manufacturing emissions on the environment, or
- the societal costs of outsourcing elements of manufacturing (such as reduced participation in the labour force locally or an increased carbon footprint arising from importing materials or stock).

Therefore, efficiency (regarding the market allocation of resources) may be improved by a departure from neutrality. Where the market is not providing for a socially optimal outcome, the tax system can be used to encourage behaviour that corrects for this inefficiency by correcting for the costs that individuals and entities do not take into account.

A tax may be imposed on an activity which it is desired to discourage. For example;

- *Pollution taxes* (also known as *Pigovian taxes*) can be employed to discourage economic activity that negatively impacts on the environment, thus correcting for negative externalities. Examples include excise charges on natural gas and solid fuels.

- *Sin taxes* are imposed on products or activities that are perceived to be unhealthy or have a negative effect on society, such as cigarettes, alcohol and gambling. One example of a sin tax in Ireland is the excise charge on cigarettes.

Similarly, tax measures can be designed to incentivise individuals and firms to invest, consume or produce in a manner that would result in a more socially optimal outcome, by reducing their tax liability. For example the Research and Development (R&D) Tax Credit has the policy objective of increasing the level of private R&D as new technologies create societal benefits, which tend to be undersupplied in the absence of extra incentives.

Given the manner in which taxation can influence choice, taxation should not interfere with the market allocation of resources except where inefficiencies arise. Where "non-neutralities" are introduced into the system, wasteful scenarios may arise where persons transform the form and substance of their activities to benefit from such "non-neutralities" and reduce their tax burdens.

3.4 Effectiveness and fairness

A tax should avoid double taxation and unintentional non-taxation as far as possible. The potential for evasion and avoidance should be minimised. Where there is an inability to tax those who are subject to a given tax, the tax-paying public may perceive this as being ineffective and unfair.

The anti-hybrid rules introduced in Finance Act 2019 (which are expected to be further developed in Finance Act 2021) improve effectiveness and fairness as they address scenarios relating to double deductions and non-taxation. One such scenario relates to the payment of loan interest by a subsidiary wholly owned by a parent company in a different jurisdiction. The tax rules of the subsidiary jurisdiction may treat the payment as a deductible interest payment whereas the tax rules of the parent jurisdiction may view the payment as an exempt dividend payment (due to the 100% relationship between parent and subsidiary). In the absence of anti-hybrid rules, this would give rise to a *'deduction non-inclusion outcome'* as the payment has been deducted in one jurisdiction but it has not been taxed in the other. The anti-hybrid rules may seek to improve fairness by either taxing the dividend payment or denying the deduction of the interest payment, depending on the facts and circumstances of the transaction.

3.5 Flexibility

A taxation system should be dynamic to ensure that it maintains effectiveness and functionality in the face of technological and commercial changes. Recently, Ireland's PAYE modernisation project has integrated payroll taxes with the payroll process. As such, the mechanism for the operation of payroll taxes in a business can more effectively adapt to changes in that business.

Flexibility should also be considered in the context of budget volatility and the ability to raise one tax to compensate for a shortfall in another.

4 Other objectives and considerations

4.1 Stability

A tax system should draw from as broad a tax base as possible to ensure a sustainable flow of revenue. A diverse tax base mitigates against the risks associated with an over-reliance on a small number of tax heads as a means of funding public services.

In Ireland over-reliance on transaction taxes (such as stamp duty) in the late 2000s affected revenue stability – for example a decline in Exchequer yield of €1.16bn[4] from 2006 to 2009 arose from the significant reduction in the sale of new residential housing occurring in that period.

4.2 The Constitution of Ireland

The Constitution of Ireland, *Bunreacht na hÉireann*, represents the basic law of the State and it takes precedence over all other domestic legislation including the domestic Irish tax code.

All laws passed by the Government must comply with the Constitution. Article 15.4.1 provides:

> *"The Oireachtas shall not enact any law which is in any respect repugnant to the Constitution or any provision thereof."*

Tax legislation must therefore be capable of withstanding Constitutional challenge.

[4] TSG 10/09

4.3 Ireland's international position

In addition to the principles of taxation, Ireland must also always be cognisant of its:

- international obligations, and
- status as a small open economy,

when designing tax policy.

The Irish tax system must be designed in a manner consistent with our international obligations. Such obligations arise from our membership of the OECD, EU and World Trade Organisation (WTO), as well as the large number (74 signed with 73 in effect) of Double Taxation Treaties agreed with other countries.

4.3.1 Obligations arising from EU membership

As an EU member, Ireland cannot enact laws which are contrary to European law or case law of the Court of Justice of the European Union (CJEU). European law has supremacy over both domestic legislation and the Constitution of Ireland – this is specifically provided for in Article 29.4.10 of the Constitution.

EU obligations can limit Ireland's ability to introduce certain tax measures (as well as non-tax measures). Examples where EU obligations can give rise such limitations apply include:

- *Four Freedoms* – These are the basic principles underpinning the European Single Market, which restrict the creation or retention of obstacles to the free movement of goods, services, capital or people within the EU. Ireland cannot design measures that are in contravention with these principles.
- *State Aid rules* – European State Aid rules restrict Ireland's ability to give public assistance using taxpayer-funded resources to undertakings on a discretionary basis due to its potential to distort competition and affect trade between EU Member States.
- *Indirect taxation* – Some indirect taxes require a level of harmonisation with other Member States. For example, EU VAT law (such as the Recast Directive) takes precedence over national VAT legislation. These EU VAT Directives set out the underlying rules and principles of Irish VAT.

Amendments to EU tax rules require unanimous agreement from all Member States. Other non-tax measures may be agreed by qualified majority voting (QMV).

In recent years, Ireland's EU obligations have also impacted on direct taxation as a result of commitments made by the State. Ireland's commitment to the Anti-Tax Avoidance Directive (ATAD) and ATAD 2 required Ireland to adopt a number of direct taxation anti-abuse measures relating to:

- interest deductibility (*the Interest Limitation rule*)[5]
- prevention of the avoidance of tax when transferring assets from one jurisdiction to another (*Exit Taxation*)
- deterring the transfer of profits to lower tax jurisdictions (*the Controlled Foreign Company (CFC) rule*)
- cross-border transactions which give rise to tax advantages (such as double deductions of expenses or deduction in one jurisdiction without inclusion in the tax base of the other) due to different tax rules in each jurisdiction (*Anti-Hybrid rules)*, and
- combating other artificial arrangements entered into for tax purposes (*General Anti-Avoidance rules (GAAR))*.

The EU Commission issued the commutation "*Business Taxes in the 21st Century"* in May 2021[6].This communication sets out at a high-level a number initiatives relating to business and digital taxes as well as proposing further anti-avoidance rules. The communication also suggests that a review of the tax mix in the EU27 in light of changes to demographics and working patterns. The degree to which such proposals will be adopted by the EU27 is not yet known - each initiative proposed will require unanimous agreement by all Member States and can be further amended by each Member State. Ireland is unlikely to support any initiatives which impinge on Ireland's sovereignty in setting its corporate tax policy[7].

4.3.2 Obligations arising from OECD membership

Ireland's OECD commitments also affect how the Irish tax system is shaped. As part of the original Base Erosion and Profit Shifting (BEPS) project Ireland, in addition to committing to the initiatives which ultimately formed part of the EU ATAD and ATAD 2 processes, also committed to introducing:

- provisions to counter "treaty shopping" for tax benefits,
- new transfer pricing rules to ensure intragroup transactions are fairly priced for tax purposes,

[5] Expected to be introduced in Finance Act 2021
[6] Business Taxation in the 21st Century
[7] Tax Notes International – Irish Minister Finds New CCCTB Proposal Unfit

- requirements for certain information in respect of international groups (on a country-by-country basis) to be submitted annually to the tax authorities in the jurisdiction of the group headquarters[8],
- minimum standards for managing treaty disputes and arbitration,

as well as adopting an instrument to ensure double taxation treaties are fully up to date with BEPS commitments and agreeing to follow a common methodology for assessing harmful tax practices.

Ireland has also agreed to enter into a number of exchange and disclosure frameworks at OECD and EU level, which improve authorities (both Irish an international) understanding of certain taxpayers and transactions.

Commitments which may arise under the OECD Pillar one and Pillar two frameworks as part of the ongoing BEPS 2.0 project may further affect Ireland's tax base and potentially the minimum tax rate applicable in future years.

- The pillar one framework is examining tax allocation rules in a modern digital economy and proposes there be greater linkages between taxing rights and the source of the revenue (i.e. where the customers are located), which need not depend on physical presence in the jurisdiction.
- The pillar two framework is considering rules to ensure that all large internationally operating businesses pay a minimum level of tax calculated by reference to each jurisdiction in which they operate.

4.3.3 Non-binding international recommendations

Ireland should also be cognisant of non-binding tax recommendations made by the EU through such avenues as the European Semester process[9][10] and the Code of Conduct for Business taxes as well as recommendations made by other bodies such as the OECD and International Monetary Fund (IMF). Failure to address such recommendations could impact on Ireland's standing with such bodies and, in the case of the semester recommendations, impact on Ireland's access to the EU bloc's Covid-19 Recovery and Resilience Facility[11].

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[8] The EU agreed further country-by-country reporting rules requiring public reporting in June 2021
[9] The European Semester Process
[10] European Semester Documents for Ireland
[11] Recovery and Resilience Facility

4.3.4 Double taxation agreements (DTAs)

Double taxation is the imposition of a tax by two or more countries on the same person in respect of the same income or gains. This can occur where a person is considered resident in either:

- multiple jurisdictions, based on the local laws of those jurisdictions, or
- one jurisdiction, but their income or gains arise in another jurisdiction.

For example, double tax may arise if an individual is resident outside the State and is in receipt of Irish source income.

Jurisdictions may enter into tax treaties with other countries, known as Double Taxation Agreements (DTAs) or Double Taxation Treaties, which set out rules to avoid double taxation.

In addition to reducing double taxation, DTAs can help mitigate tax evasion, and encourage cross-border trade efficiency. Tax treaties improve certainty for taxpayers and tax authorities with regard to international trade.

Different countries have different positions on whether the terms of a DTA always override domestic law - Irish case law indicates that DTAs generally override domestic law[12].

4.3.5 Globalisation

As Ireland is a small open economy, consideration must also be given to the position in other countries. For example, when designing Irish tax policy, the following should be considered:

- the relative competitive position of Irish businesses which compete on international markets, and
- the mobility of capital and skilled labour, which may migrate if the fiscal climate becomes unattractive compared to other countries.

5 Striking the balance

Tax measures cannot always perfectly align with the principles of design, public policy objectives and international obligations. As such, a balance needs to be struck and trade-offs arise.

When evaluating a new tax policy proposal, the consideration of such trade-offs is not just limited to that proposal in isolation. Consideration also needs to be given to the incidence of the tax, being the final distribution of the tax on foot of any behavioural adjustments arising after the tax has been

[12] *Murphy v Asahi Synthetic Fibres (Ireland) Ltd [1985] 3 ITR 246*

imposed. The person whom a tax proposal is targeted at or levied on may not ultimately bear the burden. The imposition of such burdens may be inefficient or in contravention with other public policy objectives.

For example, trying to increase vertical equity for a cohort of the population by increasing the marginal rate of income tax may reduce the incentive to work in employment or develop one's own business as the monetary benefit for forgoing leisure time is reduced. This could lead to a reduction in overall economic activity which is in contravention to public policy objectives.

Conversely however, not addressing vertical equity may also be linked with reduced economic growth. This is because it can affect the ability of low income households to invest in education and social mobility, and might lead to political instability and social unrest.

Tax measures that seek to address inefficient uses or resources may be incompatible with the objective that tax system has a stable revenue base. This is because such policies seek to deter inefficient behaviours and address societal costs rather than raise revenue. Examples of such measures include, the environmental levy on plastic bags, the sugar-sweetened drinks tax and anti-avoidance rules. The incidence of such a measure needs to be carefully considered to ensure it properly targets the behaviour and that the burden is not suffered by the wrong audience. For example, the introduction of a corporate tax charge on emissions to meet climate change targets may lead to the company seeking to recover the extra costs through job cuts or price increases if not properly designed.

Similarly if Ireland was required to apply the standard VAT rate to an item under the Recast Directive rather than a reduced rate, consumption levels in the economy generally may be affected in a manner that impacts on economic growth as people forgo purchasing decisions due to increased costs.

Additionally, a taxation system with simple and clear rules may not be fully flexible in the face of technical and commercial change without redesign. Complexity may also facilitate increased equity in the system as extensive rules and groupings may better address the needs of disparate groups of people. For example, there are currently 11 PRSI classes (in addition to a number of subclasses) – the intent of this design was to better ensure contributions and associated benefits for each class (or subclass) were reasonable and equitable.

The extent to which such changes occur in reality, however, is unclear and it depends on people's responsiveness to marginal tax changes.

6 Evaluating tax measures - tax expenditure evaluation

Given the potential for distortion, taxation should not interfere with the market allocation of resources except where a market failure arises. Tax measures should be carefully designed to ensure their objectives are achieved in a manner that addresses such failures without other unintended consequences.

6.1 What is a tax expenditure?

A tax expenditure is an item that is not part of the essential structure of the tax system, but has been introduced into the code for some other reason, typically to achieve certain economic and social objectives, such as to reduce the tax burden for a particular class of taxpayer.

Tax expenditures reflect a choice by the State to incur a cost (rather than being inherent to the tax system). As such, they are considered equivalent to direct Exchequer expenditure. The term 'tax expenditures' was first coined by Stanley Surrey (1973) to highlight the similarity such arrangements have with direct expenditure programmes.

A tax expenditure may take the form of an allowance, exemption, credit, rate relief, deferral or other tax incentive.

6.2 Impact of tax expenditures

Tax expenditures erode the tax base in a manner which must be offset by higher rates of tax or additional taxes to ensure the necessary amount of revenue is raised to meet the cost of public services.

Such expenditures encourage a person to adjust their economic behaviours in line with Government objectives in order to avail of benefits arising from the tax expenditure. However, by placing a premium on specific behaviours, the allocation of resources is distorted in a manner that can depart from equity and neutrality principles.

Additionally, where tax cost associated with an asset declines as a result of a tax expenditure, the value of the asset may increase. This is known as tax capitalisation. For example, if rental income on a particular asset was subject to a lower tax charge as a result of a tax expenditure, the tax saving would be reflected in the future cash flows associated with that asset, thus increasing the value of the rented asset.

Poorly designed expenditures can give rise to the following consequences:

- Encouraging persons to engage in artificial steps in order to avail of benefits in a manner that does not align with the objective of the expenditure.
- Providing benefits to persons who would have engaged in the incentivised activity whether or not the expenditure existed (often referred to as deadweight).

As such, the Department of Finance has developed guidelines for tax expenditure evaluation,[13] which will be further outlined in later papers on the topic of Tax Expenditures.

[13] Report on Tax Expenditures - Incorporating Department of Finance Guidelines for Tax Expenditure Evaluation - October 2014