The Treasury

Budget 2017 Information Release

Release Document July 2017

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Reference: T2016/1991 TF-4-7

Date: 17 October 2016

To: Minister of Finance
(Hon Bill English)

Deadline: None
(if any)

Aide Memoire: Clawback rate update

Introduction

This aide-memoire updates you on improvements to the way the clawback rate is calculated. The clawback rate is used to estimate the additional revenue that the Government receives from a personal tax cut or welfare transfer increase, which is largely due to increased spending that generates GST. It is calculated by estimating the proportion of disposable income households spend on goods and services subject to GST and excise taxes. This calculation excludes household expenditure on non-GST items such as housing costs. Clawback works in reverse for a tax increase or transfer reduction.

Clawback is an adjustment we make to the costings associated with tax and welfare policy changes. The improvements to the clawback rate calculation use more reliable data that is also used by Taxwell, Treasury's microsimulation model. Taxwell is used to cost tax and welfare policy changes.

The new estimate of the clawback rate is lower than that used previously, which will increase the costing of tax and transfer policy options. Clawback is now estimated by income band, which enables us to undertake distributional analysis associated with tax policy changes. It also shows that the clawback rate drops as income increases.

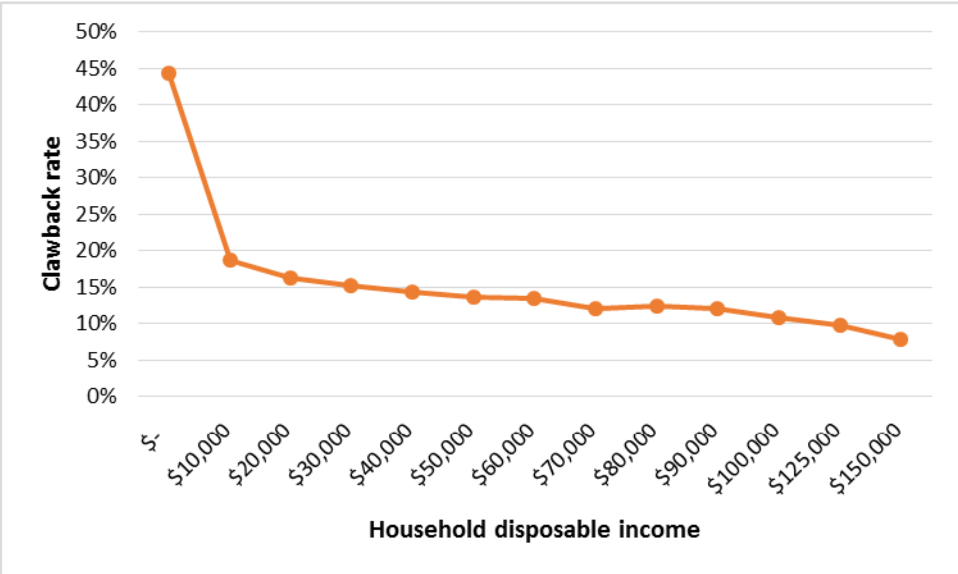
The previous clawback rate estimated all of the tax clawback received (lost) by Government from a transfer to (from) households. The proposed new methodology focuses solely on the clawback directly received (lost) from households and as such excludes second-order effects like extra (less) business tax associated with increased (decreased) profits.

What is new in the clawback calculation?

The new clawback rate is calculated using Household Economic Survey (HES) data. The clawback rate is calculated from a ratio of household expenditure on goods and services, which generate GST, to disposable income and a ratio of household expenditure on goods with excise duties to disposable income. Using HES data, we remove household expenditure on non-GST items like housing costs. By capturing each household's specific housing costs we better account for variation in household spending.

Since expenditure varies considerably by income, we estimate the clawback rate using income bands. The Graph 1 below illustrates variation of clawback rates by income band. It shows that as household income increases, the clawback rate drops. A significant drop of clawback at the very low end of income band from 44% to 19% is associated with a larger proportion of disposable income of these households spent on goods subject to excise duties.

Graph 1. Clawback rate variation by income distribution



Using the new method, we compare three policy scenarios:

1. Giving a dollar to every household the clawback rate would be approximately 10%, which means that for each dollar spent by the Government it receives $0.10 back from households.
2. An increase to all core benefit rates of $10 a week net. This is meant to show the clawback rate for a policy targeted towards the lower end of the distribution. The effective clawback rate would be approximately 12%.[1]
3. A tax cut that reduces all tax rates by 1%, so 9.5% from 10.5%, 16.5% from 17.5%, 29% from 30%, and 32% from 33%. This is meant to show a policy change that is targeted towards the higher end of the distribution, since higher income households will have more taxable income and therefore receive a larger cut in terms of total dollars. The effective clawback rate would be approximately 7%.

[1] Job seekers support (JSS), Supported living payment (SLP), Sole Pare Support (SPS)

Why has the new clawback rate dropped?

Previously we used a clawback rate of approximately 17%. This estimate was based on macroeconomic data and included an estimate of the additional business tax associated with the additional household spending (15% came from indirect consumption tax and 2% from business tax).

In calculating the clawback rate, we previously assumed a 5% savings rate, which implies that 95% of every dollar received was spent on goods and services that generate GST and other taxes. Our analysis of both the HES and National Accounts (SNA) data shows that, after accounting for spending on housing and other non-GST generating expenditure, 95% is far too high estimate. SNA estimates in average are closer to 85% annually.

The previous clawback rate also included additional tax revenue generated from customs and excise duties, transport-related levies and fees and gaming duties. The new method focused on GST and excise duties, because expenditure on goods and services that generate GST and excise duties for each household is relatively straightforward to determine from the HES data.

Other forms of indirect taxes are harder to identify at the household level and are relatively minor in comparison. So it was decided to exclude them in the interests of making the clawback rate easy to comprehend, and more robust in its application to individual households.

We have also excluded the small amount of clawback associated with increased company taxes from higher profits that may result from increased expenditure. This was excluded because it changes with business cycles and it is difficult to quantify.

Using updated macroeconomic data we calculated the clawback rate under the old methodology. This results in an average clawback rate of 12.3% (including indirect and business taxes) which is comparable to 17% clawback rate we used previously. Of this 10.1% is associated with household expenditure on goods and services generating GST, which is broadly consistent with the clawback rate derived from our new method.

Conclusion

We have adopted a new methodology based on more detailed household expenditure data to calculate the clawback rate. As a result, the average clawback rate dropped from 17% to 10%. It is important to note that the new method allows for better cross sectional and distributional analysis of tax and transfer policy options, and means that the overall clawback rate associated with a tax or transfer policy option will depend on which parts of the income distribution the policy affects. A lower clawback rate also implies that tax and transfer policy costings will be higher.

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