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New Zealand Superannuation and Overseas Pensions: Reform Option 2

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Preface

Section 70 of the Social Security Act 1964 requires abatement of New Zealand Superannuation (NZS) by overseas pensions that are deemed analogous to NZS. The present section 70/Direct Deduction Policy has been reviewed on a number of occasions by the Ministry of Social Development (MSD) but has remained unchanged despite the difficulties in its application. Those difficulties are evidenced by the many complaints brought to the MSD, as well as to the Human Rights Commission (HRC), the Retirement Policy and Research Centre (RPRC), Members of Parliament and the media.

Recent amendments to the New Zealand Superannuation and Retirement Income Act 2001 have addressed the situation for pensioners who leave New Zealand after they qualify for NZS, but ignored the very real inconsistencies and inequities for those who stay. Those inconsistencies were in fact magnified by the recent changes.

This Working Paper builds on three earlier RPRC Working Papers:

1. Lazonby's *Passing the Buck*, (2007), found that New Zealand's pension policy varies considerably depending on personal circumstance and the complexities of the other (sometimes several) countries' pension systems.

2. The *Literature Review,* (2009, p. 29), by Dale, Lazonby, St John and Littlewood, surveyed recent academic and government publications in New Zealand and overseas relating directly and indirectly to pension portability and migration.

3. Dale, St John and Littlewood's *New Zealand Superannuation and Overseas Pensions: Issues and Principles for Reform,* (2009b) analysed existing complaints, policy, and legislation on the treatment of overseas pensions and of NZS overseas. It also provided supporting material and a comparative discussion of the relevant aspects of New Zealand's reciprocal Social Security Agreements. This was the foundation for discussion of suitable principles to guide future decision-making and policy formation in this area. Finally, two possible policy options for addressing the problems identified around pension portability were proposed.

The two policy options are, in brief:

Option 1: Increase the residency requirement for entitlement to NZS from the current 10(5) Residency Requirement from age 65 onwards to 25 years that must be achieved by age 65. Where there is a Social Security Agreement, totalisation of years of residence would be possible. Where 25 years had not been completed by age 65, an income-tested welfare pension might be payable.

Option 2: If the applicant for NZS has a pension from overseas that is analogous to NZS, the entitlement to NZS would be 1/540th of NZS for each month of residence in New Zealand between ages 20-65, and the overseas pension would be paid in full. Usual income tax rules would apply to the total income received.

This Working Paper looks at Option 2 in more detail.

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1. Introduction

The Direct Deduction Policy[3] (DDP) is applied by the New Zealand's Ministry of Social Development's (MSD) Chief Executive under section 70 of the Social Security Act 1964 to payments of New Zealand Superannuation (NZS) and has long been a source of controversy. The Chief Executive determines what will and will not count under the DDP.

The research by the RPRC: Lazonby (2007); Dale, Lazonby, St John and Littlewood (2009), and Dale, St John and Littlewood (2009b), has concluded, in summary, that the current policy with respect to the treatment of overseas pensions in New Zealand requires urgent attention. An earlier paper (Littlewood, St John, & Dale, 2010) drew the threads of that discussion together as background material to focus discussion at an RPRC forum on 24 February 2010. In those 'Notes', two suggested replacements were outlined, each of which could supersede the DDP as it operates under section 70.

This Working Paper looks at Option 2 – the 'Apportionment Basis' – in more detail.

The RPRC suggests that retaining the DDP on its current basis is no longer an option. The present arrangement no longer satisfies the needs of an open economy with a mobile workforce. Experience of the DPP as it operates now shows that the MSD:

- Treats some essentially private savings as though they were public;
- Regards some essentially public provision as though it were private;
- Applies inconsistent standards to otherwise similar benefits offered by different countries and
- Applies the discretion given in section 70 on a 'less than open' basis.

As well, following the changes in 2009[4], New Zealand now treats emigrants who have qualified for NZS before they emigrate in a completely different way from immigrants.

As previous RPRC papers have demonstrated, the integration of immigrants' pension entitlements with NZS is far from straightforward. Because of the way in which the DDP is administered, there is a low level of understanding amongst those most affected (immigrants) as to the rationale behind the DPP. That must change, even if the current DDP persists.

This paper agrees with the principles behind the need to integrate NZS on some basis with other equivalent public provision but suggests there is a need to approach that problem in a different manner from the present DDP.

2. Framing the overseas pension problem

On behalf of taxpayers, the New Zealand government has a role to ensure the fair treatment of older citizens, including those who have lived and worked overseas. Therefore, there is logic to the state's taking some account of the entitlements to

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[3] Words used with capital initial letters have the particular meanings described in the Appendix.
[4] The changes that were part of the Social Assistance (Payment of New Zealand Superannuation and Veterans Pension Overseas) Amendment Bill.

overseas pensions that perform a similar role to NZS, regardless of the way in which those pensions have been framed or funded; or are paid.

The structure of pension systems is not standard and there is no international agreement on either the terms used to describe them or the systems themselves. For example, as discussed in RPRC's Working Paper 2009-2 and in the attached Appendix, some countries and researchers prefer to discuss three 'tiers' of pensions; others find a framework of a spectrum of government interventions is more useful, and the World Bank since 2005 has used a model of "five pillars" (Holzmann, Robalino, & Takayama, 2009, pp. 85-86). Discussions on international pensions require a common understanding of concepts and technical expressions that is currently lacking.

A precondition for a fair and practical integration of superannuitants' overseas pension entitlements with NZS requires identifying overseas pensions that are equivalent. Because of the design of NZS, and because there is no international benchmark Basic Pension, that is not straightforward. The Appendix includes a suggested definition of the Basic Pension.

The key differences between the pension practices of other countries with respect to comparisons with NZS are:

(a) **The short residence requirements:** Most schemes similar to NZS base their entitlements on years of work or contributions over a full career (potentially, as many as 45 years) up to the local State Pension Age. For NZS, only 10 years' residence in New Zealand after age 20 are required, with at least five of those after age 50 (the 10(5) Residency Requirement). The residence requirements can also be achieved after the State Pension Age of 65 years.

(b) **The individual entitlement:** NZS is payable to each superannuitant in his/her own right. Although there is a specified 'couple rate', each partner of a married couple receives an individual pension that is taxed along with other individual income.

(c) **Poverty alleviation:** When compared with age pensions internationally, and with other welfare benefits domestically, NZS is relatively generous. As a consequence, New Zealand enjoys very low rates of pensioner poverty and hardship in contrast to many other countries (Perry, 2009). By definition, that means New Zealand does things rather differently than other countries with respect, specifically, to the state entitlements that cover all/most citizens (the Basic Pension).

These key aspects of NZS contribute to retirement in New Zealand being relatively attractive by comparison with some other countries. They also contribute to fiscal risks that need to be managed especially in light of significant population ageing.

The purpose of the Basic Pension in most countries is to satisfy a country's welfare obligation to its retired citizens and to prevent or ameliorate poverty among senior citizens. In New Zealand, NZS provides a reasonable replacement rate for low-income people, if a relatively low rate for middle and higher income people.

The introduction of the state-subsidised KiwiSaver in 2007 potentially signals that supplementation of the Basic Pension, especially for those in the workforce, is expected. It remains to be seen whether that will have an eventual impact on pension policies as expressed currently by the design of NZS.

As the Working Paper (Dale et al. 2009b) outlines, there is a complex spectrum of state interventions in pensions, including subsidisation of private provision. When New Zealanders are encouraged to have KiwiSaver in addition to NZS, but migrants lose other payments from abroad under the DDP that may appear similar, policy can seem arbitrary and lacking in principle. Those gaps have been emphasised by the 2009 changes to the NZS entitlements for emigrants. There is now a clear conflict between the treatment of pensioners who live in New Zealand and those who choose to live overseas.

The current DDP with respect to overseas pensions fails to acknowledge these issues and is perceived as increasingly anachronistic and out of step with other countries' policies. About 51,000 people with overseas pensions are affected by section 70 and many of them have a strong sense of injustice as to how they have been treated. As populations become more mobile, this group can be expected to grow and instances of multiple entitlements to overseas age pensions of a variety of kinds are likely to increase.

As the RPRC's earlier papers have stated, New Zealand's current overseas pension and pension portability policies fall short of the principles of equity, transparency, sustainability, economic efficiency and administrative simplicity in a variety of ways. Many of these shortcomings were also noted and repeated in the MSD Reviews of pension policy (Ministry of Social Development, 2004, 2005, 2008).

2.2. The 2009 Amendment: a policy contradiction emerges

The 2009 Social Assistance (Payment of New Zealand Superannuation and Veterans Pension Overseas) Amendment Act (the '2009 Amendment) has changed NZS by extending pension portability to non-agreement countries.[5] These 2009 changes raised new anomalies, without addressing the problems already identified in the MSD's reviews, and in numerous submissions on the Bill, including Dale, St John, & Littlewood (2009a), and White (2009).

However, principles underpinning the 2009 Act may provide the basis for a reform of the DDP.

3. Two options for reform

3.1 The two options summarised

The RPRC proposes two possible options for reform. Option 1 proposes extending the current 10 year residency requirement to 25 years and is discussed in detail in St John & Dale's Working Paper, 2010-2, available online.

Option 2 would apportion entitlement to NZS based on the 540 month system that now applies to emigrants from New Zealand after age 65 under the 2009 Amendment.

In either case, a Social Security Agreement may have additional or replacement conditions. Both options also retain the individual basis of entitlement.

[5] These are countries with which New Zealand does not have a reciprocal social security agreement. The 2009 changes made the relationship with 22 Pacific nations even more favourable for their citizens, and for New Zealanders retiring there, although New Zealand has a special relationship with only three of those countries (Dale, St John et al., 2009b, pp. 20 - 21).

Each Option recognises that different countries have different ways of organising their retirement income systems but that there are some fundamental principles that are relatively common. Nearly all countries have a basic entitlement to a state-provided income once the local State Pension Age is attained. NZS fulfils that role in New Zealand. To 'integrate' overseas state-provided entitlements with NZS, it is important to know what the Basic Pension is in other countries.

At present, there is no clearly stated definition of the pensions that are affected by the section 70/DDP policy. It is left, in all cases, to the discretion of the MSD's Chief Executive. This lack of clarity and consistency needs to change and, if either Option 1 or Option 2 were adopted, it must change.

3.2 Option 2: move to a 1/540th apportionment

Option 2 would take a pro-rata approach for any New Zealand resident applying for NZS and who is entitled to receive an overseas Basic Pension (see the Appendix for a definition of this). As already noted, the 2009 Amendment now allows all emigrants, whether they were in receipt of a full NZS payment, to take a 1/540th apportionment of NZS with them if they leave New Zealand after becoming entitled to NZS.

Under Option 2, each country would pay the pension that accrued during the period the pensioner lived/worked in that country. Adding those entitlements together would give a full, blended pension without any country 'subsidising' another. With NZS in its current form, that blending is not possible. The basis on which the entitlement to NZS is calculated for individuals who have an overseas Basic Pension must therefore change.

3.2.1. Option 2's application to pensioner's NZS entitlements

If a prospective pensioner applying for NZS had an entitlement to a Basic Pension from another country, they would receive a reduced amount of NZS. The reduction will be:

$$\frac{\text{NZS}}{540} \times \text{months' residence outside New Zealand between ages 20-65}$$

This simple test ignores the intricacies of the other countries' arrangements and exchange rates, and would not be affected by changes to any of those, either before or after either country's State Pension Age. Under the current DDP, both affect the net amount of NZS received and, in the case of exchange rate movements, on a continuous basis.

The proportion of NZS thus established at age 65 would apply for the whole of the pensioner's retirement while living in New Zealand. If the overseas country's State Pension Age is later than that of New Zealand, the test would apply from that country's later State Pension Age. At the date of application for NZS, the individual would have no current entitlement to an overseas Basic Pension. That changes (and would trigger the Option 2 deduction) when the overseas Basic Pension starts.

3.2.2 Where dependant's pension

Where the overseas Basic Pension carries with it a survivor's entitlement, on the death of the 'primary' pensioner, the Option 2 rule would then apply to the survivor's NZS entitlement once that started. Until the 'primary' pensioner died, there would be no Basic Pension payable to or for the survivor.

3.2.3 Couple's entitlement

If the overseas pension is higher because the recipient has a dependant (as is the case, for example, with the UK's Basic State Pension and the US's Social Security pension), that will not affect the amount of NZS payable to the New Zealand resident pensioner because the overseas Basic Pension itself is disregarded under Option 2; neither will that enhanced entitlement of itself affect the spouse's entitlement to NZS because that is not a Basic Pension to which the spouse is entitled. In the spouse's case specifically, Option 2 will not be triggered unless the spouse receives a Basic Pension directly.

3.2.4 10(5) Residency Requirement no longer applies

Under Option 2, the annual amount of NZS will be calculated in relation to just the period of residence in New Zealand. There is therefore no longer any need for the existing 10(5) Residency Requirement where an overseas Basic Pension is payable. However, a reduced version of that could remain as an initial filter while New Zealand gathers the relevant information about the immigrant. That could be, say, five years' residence required before applying for NZS.

However, where there was no Basic Pension, the 10(5) Residency Requirement can continue to discourage 'gaming' against the NZS system.

3.2.4 Social Security Agreements no longer directly relevant

Option 2 does not depend on having reciprocal Social Security Agreements (SSAs) with other countries because, in the presence of a foreign Basic Pension, New Zealand will disregard residence that was not in New Zealand: totalisation[6] is no longer relevant.

However, from New Zealand's perspective, the data-sharing aspect of an SSA will ensure the New Zealand government is informed about immigrants with Basic Pension entitlements. In such cases, the presence of a potential entitlement to a Basic Pension in the other country would be sufficient. With that information, New Zealand can initiate the Option 2 process locally and would not need to wait for the individual to apply for the overseas pension.

The RPRC has noted other countries' antipathy towards New Zealand's DDP policy. That probably explains the fact that New Zealand has been able to reach agreement on only eight SSAs[7]. If either Option 1 or Option 2 replaced the current DDP, it is possible that many more SSAs would follow. That would be a positive result of reform.

3.2.5 SSA: one or two pensions

Where there is an SSA, individuals could be given the choice between one or two pensions. If they chose one pension, the New Zealand government would collect the

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[6] That allows periods of residence in two countries to be aggregated to establish entitlements to benefits in one of those countries (or both).

[7] There are currently only eight Social Security Agreements covering nine countries. The dates of the Agreements, and those countries are: Australia (1994); the United Kingdom (1990); the Netherlands (2003); Canada (1996); Greece (1993); Ireland (1994); Denmark (1997); and Jersey and Guernsey (1995).

foreign Basic Pension and would pass that on to the pensioner along with the proportion of NZS to which the pensioner was entitled. This would not affect the total amount payable but would make administrative and tax arrangements simpler for the pensioner.

If retirees chose two pensions, they would have responsibility for collecting their own foreign pension.

3.2.6 Some specific country issues

In some countries, but not all, the Basic Pension is analogous to NZS, regardless of the way in which the pension is described, the entitlements accumulate or the benefits are financed. As Holzmann et al. (2009, pp. 103 - 104) note, the size and shape of Tier 1 schemes are often influenced by the size and shape of Tier 2 and even sometimes Tier 3.

Currently, whether or not countries' different arrangements are taken into account in setting New Zealand's pension obligations under NZS is inconsistent.

For example:

- Tier 1 in the **United States** (the Supplemental Security Income or SSI), is a poverty-alleviation, non-portable assistance payment only that is, in fact, paid to very few people.[8] In principle, it is not possible to describe the state's income-support obligation to its citizens without recognising the state-administered 'Social Security' at Tier 2.

- On the other hand, **Canada's** Tier 1 is analogous to NZS and there is no need to include the Tier 2 Canada/Quebec Pension Plan when describing the state's income-support obligations to citizens. This is despite the fact that the CPP/QPP are administered by the government (an important component of the test under the current DPP policy).

- In **Chile**, Tier 1 is effectively a minimum pension that supports the compulsory, pre-funded, essentially private Tier 2 pension. Entitlements to a Tier 2 'private' pension therefore offset entitlements to the state's Tier 1 pension. In the context of the DPP, it seems inconsistent to include only the Tier 1 pension because that might be subsumed by the Tier 2 entitlements.

- **Australia's** Tier 1 (the Age Pension) is in principle similar to NZS but, as with Chile, is 'integrated' with Tier 2 (the compulsory SG scheme). However, unlike Chile, Australia's means tests also include all other income and assets. When New Zealand calculates what should count in the DPP, it seems inconsistent to assume that the Tier 1 pension is payable in full even though the pensioner may have lost it under the income/asset tests if resident in Australia.

- In **Greece**, the Tier 1 pension may allow a continuation of the retiree's economic status with an underpinning minimum within the scheme itself that serves the state's welfare role. The Greek pension overcomes any need for private provision, even at Tier 3. So, while it is reasonable for the DPP to recognise the Greek

[8] Of all benefits payable under the US system, only 9% received just the Tier 1's SSI. A further 5% received the SSI and at least some of the Tier 2 'Social Security' pension (Social Security Administration, 2010).

pension, it is inconsistent to assume that the whole, undivided pension is equivalent to NZS.

- The **United Kingdom** presents an interesting pension environment to test the philosophical underpinnings of any policy, including the current DPP. Tier 1 is clearly the 'Basic State Pension', the calculation of which once depended on the individual's own contribution record of up to 45 years, in the case of males and 39 years in the case of females. From 6 April 2010, the full benefit will be payable after 'only' 30 years' contributions. However, as with the US, accumulation of entitlements to the Tier 2 State Second Pension (S2P) since 1978 have 'allowed' the government to gradually lower the real value of the Basic State Pension. There is therefore some justification for the inclusion of the S2P in calculations under New Zealand's DDP.

  The philosophical issue with regard to the DPP is that an occupational scheme can 'contract out' of the S2P and provide equivalent benefits through a private arrangement. In exchange, the employer and employee pay lower National Insurance contributions to help the scheme pay for the 'equivalent pension benefits'. If there were any logic to including the S2P in the section 70 DDP offset, that same logic should apply to the private, contracted-out equivalent. That it does not illustrates the problems of the current approach.

Also, countries are always changing their pension systems and will continue to do so in the face of the cost pressures from ageing populations.

The MSD needs to have an element of discretion in identifying whether a country has a Basic Pension system analogous to NZS. It is impossible to have a detailed policy in respect of every country from which emigrants to New Zealand have come. However, the principles that are used to arrive at a decision in any case need to be clearly stated. In this area, a principles-based regulatory framework is more likely to be successful than a rules-based approach.

3.2.7 Funding arrangements irrelevant

Option 2 does not require the New Zealand system to enquire into the way that the Basic Pension entitlement arose. It would not matter whether the Basic Pension was pre-funded or financed by 'Pay as You Go'; whether paid for by personal contributions or by the employers (or by both, as is usually the case). Neither would it matter whether there were identified contributions or whether the scheme was administered by the other government or by some other entity.

The focus of Option 2 is instead on the benefit itself and the key issue is whether the other country's arrangements are analogous to NZS.

3.2.8 Creating the knowledge base

One of the major difficulties with the present DDP arrangements is its lack of transparency. That leads, inevitably, to suspicion from affected pensioners because each case seems to have been determined independently (and can be subject to costly, time-consuming individual appeals).

A necessary element of Option 2 would be to publish a list of all countries and to specifically identify the Basic Pension in each case. That process would be principles-based rather than rules-based and would itself be potentially subject to appeal.

Once finally determined for each country, that decision would then apply to all cases where a pensioner had an entitlement to benefit from that country; and that would be the only individual determination – is there an entitlement? The answer to that question could be supplied either by the individual or by the government of the affected country. It would be preferable if the country itself confirmed the entitlement under the appropriate provisions of the SSA.

3.3 Strengths of the Option 2 policy proposal

An assessment of the possible strengths and weaknesses of Option 2 includes:

(a) **Simple and transparent:** The main strength is simplicity and transparency. Potential immigrants could readily understand the rules and make their retirement and saving decisions with regard to the impact this policy would have on their pension entitlements.

(b) **Assures other countries of 'fairness':** Other countries with residency-based or contributions-based pension entitlements could see that their former citizens were receiving their accrued entitlements *in addition to* the NZS entitlement; that means the sharing principles inherent in SSAs would be reinforced.

(c) **Consistency with emigrants' treatment:** Option 2 is consistent with the new basis for paying NZS overseas to emigrants who leave New Zealand after becoming entitled to NZS. This means that a pensioner who is in receipt of an Option 2-adjusted NZS can leave New Zealand after age 65 with no change in the annual amount of NZS payable. Under Option 2, NZS would continue to be payable under the same $1/540^{th}$ apportionment rule because of the changes that were made in the 2009 Amendment. There would therefore be a smooth transition where the immigrant subsequently leaves New Zealand.

3.4 Weaknesses of the Option 2 policy proposal

(a) Two classes of NZS recipient: The main weakness is that Option 2 will create two classes of NZS entitlement: those who are on the full pension and those who receive only a proportion. However, that is similar to the current application of the section $70^{/D}$DP policy.

(b) Residence to 65: As with Option 1, only residence to age 65 will count in the calculation of NZS. If the State Pension Age changes, the formula will adjust to the new age.

Under the current 10(5) Residency Requirement, periods of residency after the State Pension Age now count.

(c) **Lump sum Tier 1 schemes:** A weakness with both Option 2 and the current DDP policy[9] is that they do not address the issue of lump-sum superannuation payouts as retirement benefits such as apply in schemes like Fiji's Provident Fund. Unless some form of lump sum/pension equivalence is created, Option 2 would not automatically include that kind of benefit.

(d) **'Inadequate' benefits:** A pensioner with a long period of residence in another country with low Basic Pension entitlements; and a relatively short period in New Zealand before the State Pension Age could have a low total income. As long as the position has been made clear to new immigrants (once Option 2 has been implemented) the New Zealand government could argue that it is not New Zealand's responsibility to make up for the deficiencies of the other country's arrangements. A person in that situation could, however, end up with a lower total state pension than now.

4. Discussion

In other countries, state-provided pensions are always a lot more complicated than NZS's simple, elegant benefit design. There are some aspects of other countries' arrangements that need to be included in any debate about reform.

4.1 Marital/dependency status

Some Basic Pensions include a specific supplement to recognise the recipient's marital/dependency status (The UK's Basic State Pension is an example). Option 2 recognises only the individual entitlement rather than the household's entitlement. It would therefore treat that spouse's addition as part of the individual's Basic Pension. Unless spouses have a Basic Pension in their own right, their entitlement to NZS would be unaffected by the 1/540th offset rule of Option 2. This supports the fundamental principle of the design of NZS that an individual has the right to be treated as a separate person, rather than part of an economic unit.[10]

4.2 Section 70/DDP no longer needed

Under Option 2, section 70 and the DDP would no longer be required. The fairness, simplicity and transparency of the Option 2 may encourage more countries to sign Social Security Agreements with New Zealand.

4.3 Some Tier 2 pensions may be Basic Pensions

Under the definition of the Basic Pension suggested in the Appendix, the US Social Security pension at Tier 2 would be included as part of the Basic Pension. We recognise that many will argue that this is an 'occupational' arrangement that provides an income or contribution-based pension relating directly to the individual's employment (unlike NZS). It is therefore 'private' property and should not be taken into account in the calculation of NZS.

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[9] Lump sum retirement payouts are ignored under the DDP arrangements as long as the benefit is received before the pensioner comes to New Zealand.

[10] See Appendix 5, Working Paper 2009-2. In Bredmeyer v DWI, the Crown Law Office defended DWI's decision not to pay NZS to someone living in an agreement country (Australia) because they would be advantaged.

This is an issue that goes to the heart of the reason for having some form of inter-country pension recognition when calculating NZS.

Most governments have decided that there is a fundamental welfare-style obligation to support citizens above a particular age, regardless of their individual history (work, health, family) before the State Pension Age. There are different ways of expressing the objectives of this Tier 1 but words like "alleviating poverty", "preventing poverty" or allowing "participation and belonging" are often used to reflect different levels of support at Tier 1. The SSI in the United States falls into the lowest of these and NZS into the highest.

Beyond that, governments also become involved in what, in New Zealand, we would tend to label 'occupational schemes' (based on work status or income from employment). Again, there are many different ways other countries do that from compulsory Tier 2 arrangements (that can be pension or lump; Defined Benefit or Defined Contribution; privately or publicly funded). The involvement also usually extends into offering tax incentives for voluntary saving at Tier 3 or even the now fashionable auto-enrolment, opt-out arrangements like KiwiSaver (also soon to be introduced in the United Kingdom and Ireland).

Generally, this second group of 'occupational pensions' should have nothing to do with Option 2 (or even the current DDP policy) but even this is not clear-cut.

Australia is a good case in point. The Age Pension is very like NZS, more so than any other Tier 1 pension. However, because of the income/asset test, fewer Australians will receive that in full and that will be partly due to the growing significance of the Tier 2 arrangements (the compulsory SG scheme). That is because the government lays down what citizens must do and, more than that, effectively pays them to do that through tax concessions on the contributions and investment accumulation. We suggest that it is not possible to look at Tier 1 in Australia without also looking at Tier 2. That will become increasingly the case.

The US is another case in point. Its SSI at Tier 1 is a small, poverty alleviation benefit that very few people actually receive –in 2010, that was the only source of income for only 9% of pensioners (another 5% received SSI and some Tier 2 Social Security pension). The main reason for the size and shape of Tier 1 in the US is the Tier 2 'Social Security' system. That is not 'universal' (in that way that NZS is) but it is a great deal more so than Tier 1's SSI. So, it is not possible, philosophically, to think about just Tier 1 in the US, in the context of Option 2, without also looking at Tier 2.

When New Zealand tries to compare systems for the purposes establishing the comparator Basic Pension (also for the purposes of section 70 and the DPP), what matters are the benefits not the way they are accumulated or paid for.

Unlike most other countries, New Zealand has no identified contributions for NZS so contributions are not the benefit driver. So-called 'contributions' in nearly all other countries are almost always only another way of counting and collecting tax. Those 'tagged taxes' are usually highly regressive (hurt the poor), unlike most ordinary income taxes. They also cost a lot to count, collect and record.

Option 2 requires an 'in principle' comparison of government-provided pensions. It is not possible to precisely match systems around the world. Having identified the comparable arrangement, Option 2 suggests that the New Zealand system then ignores the overseas entitlements (and there could be more than one style of benefit from a country and more than one country involved) and re-calculates NZS based on what New Zealand can find out easily enough – how many months the individual has lived in New Zealand between ages 20-65. That approach means New Zealand does not need to concern itself with the overseas scheme's benefits or contributions, or even whether they are defined as 'basic', 'occupational', compulsory, voluntary, or contributions-based.

4.4 Cost

It is beyond the scope of this paper to estimate the cost implications of Option 2 by comparison with the current section 70/DDP arrangements. That would require access to information that is not public. We do acknowledge, however, that the cost implications of changing to a fairer and more transparent system do require investigation as part of the public discussion.

4.5 Transition

If section 70 and the DDP are changed as suggested to Option 2, there will need to be careful attention to transition issues. Those currently in receipt of NZS, but not entitled, to the full pension under Option 2 may need to be 'grand-parented'. Many will be better off under Option 2 by comparison with their current benefits (the total of the overseas pension and the remaining NZS). However, those who have emigrated from countries, like China, with low public pensions after long periods of residence could be worse off. Some form of income-tested pension may be needed as part of the transition.

Every pensioner with an overseas Basic Pension could potentially be affected by a change to Option 2. Pensioners who would be better off under Option 2 would want to move to the new basis (at a higher cost to the taxpayers). Others could be worse off, particularly those who to date have not reported their overseas Basic Pension entitlement. Again, the transition arrangements will require careful handling and phasing in.

4.6 'Paid for entitlements'

Option 2 will not answer those who say they have 'paid for' their Basic Pensions (such as in the UK with 'National Insurance contributions' or the US with 'Social Security contributions') so they may continue to think their entitlements are being effectively taken away. This is connected with the comments in section 4.3 about Tier 2 entitlements being potentially included in the Basic Pension.

As stated (paragraph 3.2.7 above), the way in which the Basic Pension is paid for in the other country is not relevant to the test under the proposed Option 2.

This is an issue that can be resolved by each country undertaking a public education campaign to ensure their pension system is understood, and by each country ensuring the information available to prospective immigrants is accurate and easy to understand.[11] New Zealand can (and should) attend to only the second of these.

4.7 Consequential policy implications

If Option 2 were adopted then the calculation of entitlements to NZS would be on a consistent basis for both immigrants (at any age) and emigrants, but only for those who

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[11] The RPRC recommends *Social Security Programs Throughout the World*, a US government website that provides reliable, comparable information on social security arrangements for each country: http://www.ssa.gov/policy/docs/progdesc/ssptw/.

leave New Zealand after age 65[12]. That will immediately raise the issue as to whether emigrants before age 65 should take with them some entitlement to a share of the full future NZS based on the months of residence up to the date of leaving.

If Option 1 (raising the residency requirement to 25 years) were adopted instead, it may be easier to resist calls to establish an entitlement for younger emigrants. That is because Option 1 is essentially an 'all or nothing' test that applies at the State Pension Age. The concept of benefit 'accruals' is not part of the design philosophy.

Regardless of the option chosen, it seems possible that other governments may resist entering into SSAs until New Zealand recognises some form of accruing entitlement for all emigrants and immigrants. If that is to include young emigrants, the cost implications are likely to be very significant.

[12] Or, more accurately, after NZS starts because that can be after age 65 for someone who has not satisfied the 10(5) Residency Requirement by age 65.

Appendix: Terminology

The 'Basic Pension'

Identifying the Basic Pension in any country is not necessarily straightforward. Generally it is the state pension to which all the citizens and permanent residents of that country may be entitled.

Analogous to NZS: The most similar arrangement to NZS is Australia's income- and asset-tested Age Pension. In the cases of Canada's Old Age Security benefit, Denmark's Universal Pension, Ireland's State Pension (contributory) and the Netherlands' Algemene Ouderdomswet (AOW), they are generally of a lower equivalent value than NZS but they perform a similar social and economic function (see Appendix 4, Working paper 2009-2).

The UK provides a Basic State Pension that is less than half the value of NZS in real terms. The earnings-related Tier 2 pension (SERPS or S2P) can be replaced by a private, equivalent, contracted-out pension. Together, the full Basic State Pension and the S2P entitlement (or its private equivalent) would, for some people, still be less in total than the real value of NZS. Not all UK residents are entitled to the State-mandated and administered S2P,[13] as they may not have worked or earned sufficient to qualify; or they may be entitled to the private, contracted-out equivalent delivered through occupational pension schemes at Tier 3. This fact disqualifies the Tier 2 entitlement from being part of the Basic Pension because it is not analogous to NZS. Under the current DPP, S2P entitlements are included but the alternative private, contracted-out pension is not.

Whether the analogous pension is financed by mandated or voluntary contributions, or from general tax revenue, is not relevant to the definition of the Basic Pension.

Tier 2 pension: In some cases the state's basic social and welfare-related obligations are satisfied by a combination of Tier 1 and Tier 2 benefits that can be structured in a variety of ways. For example, in the US, there is a relatively low level, heavily income-tested Supplemental Security Income (SSI) at Tier 1. The Social Security benefits that require 'contributions' from both employers and employees are provided at Tier 2. Because of the income/asset test at Tier 1, most US retirees receive no SSI.[14] The MSD deducts the US Tier 2 Social Security under the current DPP. We also suggest that US Social Security pensions be included as the Basic Pension.

In other cases, where there is a compulsory, pre-funded Defined Contribution scheme at Tier 2 that directly replaces the state's Tier 1 pension through an income test (such as in Chile and most of the rest of South America), the Basic Pension needs to include the Tier 2 entitlement even though that may be in a privately managed account in the pensioner's name (e.g Chile's AFPs).[15] In such cases, an individual's Tier 2 entitlement would satisfy the Option 2 test for the Basic Pension.

Earnings-related pension: Some countries, such as Greece and France, do not have formal recognition of a basic age pension welfare obligation. Those state's social and

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[13] Even after a lifetime's residence in the UK, they may not be entitled even to the full 'Basic State Pension' because of an incomplete contribution record.
[14] SSI payments are made to only about 14% of US citizens over State Pension Age. SSI is not payable to non-residents.
[15] In this regard, the MSD's current distinction between public schemes (included in the DPP) and private schemes (not included) would no longer be relevant, even if that were currently supportable.

welfare obligations are met through an occupational superannuation scheme, run by the state or a state agency. In Greece, a 40 year, full career employee can retire with as much as 80% of their final five-year-average pay. Although there is no separate state pension, an underpinning 'social solidarity benefit' delivers a minimum. In such cases, in Option 1 where totalisation is needed to reach the 25 year residency test, the pensioner may prefer not to apply for NZS. A generous Tier 1 pension would automatically trigger the application of Option 2.

Other expressions associated with overseas pension entitlements

Public or private Defined Benefit (DB): NZS is a DB scheme, as are nearly all governments' basic age pension schemes. NZS benefits are linked to the average wage. A private DB retirement benefit scheme provides benefits based typically on annual pay/earnings of the recipient or the recipient's spouse/partner, either near retirement or over a working life; and length of membership.

Public or private Defined Contribution (DC): KiwiSaver and the Australian compulsory SG schemes at Tier 2 are DC. A DC retirement benefit scheme provides benefits based on individual contributions from the member, employer and/or the government, plus investment returns.

Means-Tested Pension: A government often provides benefits that are targeted to the poor, or that exclude the wealthy, by making payment after retirement conditional on earnings, income, or assets. Such means-tests can be either 'income tests' or 'asset tests' or both, as with Australia's Age Pension. NZS and the UK's 'Basic State Pension' are not means-tested. The US Supplementary Security Income (SSI) is heavily income- and asset-tested. The US Social Security pension at Tier 2 is not means-tested.

Notional Defined Contribution (NDC): A government may provide a Pay-As-You-Go (PAYG) pension scheme that provides benefits based on individual contributions plus notional interest credited on these contributions (sometimes called an 'unfunded defined contribution'). Sweden has a PAYG NDC scheme. The Swedish scheme's 'member accounts' with interest earnings added each year do not mean it is Pre-funded (see below). Benefits are administered through 'member accounts', so such schemes are *Notional* Defined Contribution schemes.

Occupational Scheme: An Occupational Scheme is normally a voluntary contributory scheme that is specific either to a single employer or a group of employers. It can be either DB or DC and can provide either lump sum or pension benefits. It normally requires both employee and employer contributions, and will usually be Pre-Funded.

It may be government-run if it is solely for government employees, like the New Zealand Government Superannuation Fund. In this case, it will probably be either PAYG or partially Pre-Funded.

Note: a pay-related state scheme such as the UK's SERPS/S2P or the US Social Security is not an Occupational Scheme despite its contribution and benefit connections to pay. Also, the UK's National Insurance and the US Social Security schemes, although depending on payroll-based 'contributions', are not Occupational Schemes. Such 'contributions' are no more than a dedicated tax.

Pay-As-You-Go (PAYG): PAYG is a method of financing in which current benefits are paid out of current revenues, often revenues from dedicated taxes/'contributions', and most often from payroll taxes. The collection of earmarked taxes; even the crediting of those contributions to a particular government account or agency does not make the scheme Pre-funded (see below). The US Social Security and the UK's National Insurance 'contributions' are dedicated taxes, and the schemes are not Pre-funded.

Funded or Pre-funded Pension: Prefunded pension schemes are usually private, but there are a few Pre-funded State schemes. State schemes like the US Social Security arrangements are not Pre-funded because the 'Social Security Trust Fund' is constituted solely of a special tranche of untradeable government bonds. Pre-funded schemes are usually based on an actuarial assessment of the obligations and have enough reserves in financial instruments (shares, bonds, other direct investments) to pay for all promised benefits.

State Pension Age: the age from which the state pension becomes payable. The State Pension Age in New Zealand is 65. In Australia, it is currently age 65 but will start increasing to age 67 from 2017.

Pension Pillars (World Bank, 2008) The World Bank has extended its earlier three pillars of retirement income provision to five, numbered zero to four:

> **Pillar 0:** non-earnings-related, non-contributory schemes.
>
> **Pillar 1:** mandatory, with contributions linked to varying degrees to earnings with the objective of replacing some portion of lifetime pre-retirement income.
>
> **Pillar 2:** mandatory, typically an individual savings account (i.e. Defined Contribution scheme) with a wide set of design options including options for the withdrawal phase. Defined Contribution schemes clearly link contributions, investment performance and benefits.
>
> **Pillar 3:** voluntary schemes taking many forms (e.g. individual savings for retirement, disability or death; employer-sponsored; Defined Benefit or Defined Contribution) but is essentially flexible and discretionary in nature.
>
> **Pillar 4:** non-financial, including access to informal support (e.g. family support), other formal social programmes (e.g. health-care and/or housing), and other individual financial and non-financial assets (e.g. home ownership and reverse mortgages).

Tiers of pensions: An alternative way to describe the framework of a country's retirement income arrangements focuses on "tiers":

> **Tier 1:** the state pension to which all the citizens and permanent residents of a country may be entitled. It is usually contributory but often counts periods out of the workforce if those are deemed to be socially contributive (such as caring for children). Tier 1 is almost always a Defined Benefit, PAYG pension. It does not have to be Universal (as with NZS) as it can be means-tested (as in Australia and the US).
>
> **Tier 2:** a mandatory, work-related benefit, normally contributory. It may be either Pre-funded (Australia, Chile) or PAYG (the US and most of Europe); and Defined Benefit (as in the US and most parts of Europe) or Defined Contribution (as in

Australia, Chile); and Privately managed (as in Australia, Chile) or publicly run (as in France, Germany) or both private and public (the UK's S2P and its contracted-out alternative); and delivered as a pension (as in the US, Europe) or a lump sum (as in Australia, Fiji). In some cases a Tier 2 pension may be a Basic Pension (as with the US Social Security pension).

Tier 3: covers all other voluntary retirement savings, whether through the workplace or directly; or through formal saving schemes or by direct investment. Although Tier 3 is essentially private, in most cases, the government participates indirectly through incentives, usually generous tax concessions that encourage particular types of retirement saving and prescribe the ways in which those savings can be accessed at retirement. The government, as employer, will often have Tier 3 retirement saving schemes. In no case would a Tier 3 pension be included as a Basic Pension.

Universal Pension: a flat-rate, age-based pension without income- or asset-tests; or requirement for individual contributions to a fund; or requirement to be retired from work. They are paid out of general taxation to all residentially qualified people. Universal Pensions are the least common form of public pension; and the most fiscally expensive way of providing a minimum income for retirees.

NZS is a Universal Pension because (section 70 and the DPP aside) everyone over age 65 is entitled to receive it on satisfying the residency test. Australia's Age Pension is income- and asset-tested, and is not a Universal Pension. The UK's Basic State Pension is not means-tested but is dependent on a contribution record, so is not a Universal Pension. Very few countries have a Universal Pension – they include Antigua, Bolivia, Denmark, Lesotho Mauritius, Mexico City, Namibia, Nepal, Samoa and South Africa. In all cases, these would be included in the definition of Basic Pension.

Special terms with respect to the Section 70 DDP

10(5) Residency Requirement: the residency condition for collecting NZS requires residence in New Zealand for at least 10 years after age 20, with at least five of those being after the age of 50.

Direct Deduction Policy (DDP): where the pension from another country is deducted in full from NZS under section 70 of the Social Security Act 1964.

General Portability Arrangement: enables New Zealanders who meet the 10(5) Residency Requirement and who are retiring where there is no reciprocal or special agreement to receive a proportion of their NZS in that country.

Social Security Agreement: a bilateral agreement coordinating the social security system, including age pension benefits, of two countries.

Special Portability Arrangement: enables New Zealanders retiring to one of 22 Pacific nations, who have lived in New Zealand for at least 20 years since age 20 with at least five of those years after the age of 50, to receive 100% of their NZS entitlement in that country.

Totalisation: a process under a reciprocal Social Security Agreement that counts time in one country towards the state pension entitlements of a second country.

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