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New Zealand Superannuation and Overseas Pensions: Reform Option 2

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Abstract

As populations become more mobile, pension portability becomes more important. Most countries accrue a citizen's entitlements to a state-provided pension by reference to contributions, periods of employment, pay or other similar measures. A 'complete' record produces a full pension. When there is a reciprocal agreement between the countries involved, periods in different countries can be accommodated. New Zealand's universal age pension requires only a relatively brief period of residence after age 20 so, on grounds of fairness, rules are in place to reduce the New Zealand pension where a claimant has accrued entitlements to a state pension in another country.

Currently, those rules are opaque and inconsistent. A number of solutions are possible. Reform Option 1 (Dale and St John 2012) suggests a 25 year qualifying period for New Zealand Superannuation.

Reform Option 2 suggests changing the design of New Zealand Superannuation for immigrants with an entitlement to another country's Tier 1 pension from an 'all or nothing' pension to one that accrues over 45 years.

Under both Option 1 and Option 2, the amount of any other state pension and the terms on which it may be payable then cease to be a concern when calculating the immigrant's New Zealand Superannuation.

Some suggest more radical reform of New Zealand Superannuation entitlements that would affect all applicants, not just those with an overseas pension entitlement. That is described, for consistency, as Reform Option 3.

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 Direct Deduction Policy (DDP) has been reviewed on a number of occasions but has remained unchanged despite clear, acknowledged difficulties in its application.

The three most common perceived injustices in the application of the DDP are, firstly, application of the DDP to private retirement savings. This difficulty is supported the other governments, the Human Rights Commission, and the RPRC: the DDP is applied to pensions that are not analogous to NZS.

Secondly, inequity occurs when for example, a husband has accumulated a large overseas pension, and the DDP is applied to his NZS entitlement, and any remainder of his overseas pension amount is applied to his wife's NZS entitlement. Although she may have worked here for 25 years before her retirement, her 'universal' right to NZS is ignored. That is clearly a breach of the spouse's human rights to be treated without discrimination.

Thirdly, there is a widespread misperception, encouraged by the wording in official documentation including information brochures for immigrants, that people with overseas state age-pension entitlements would receive that pension income *in addition* to NZS.

Changes to the New Zealand Superannuation and Retirement Income Act 2001 addressed the situation for pensioners who emigrate after qualifying for NZS (after age 65), but not the issues faced by New Zealand residents with entitlements from overseas state systems.

Since 2007, and working closely with the Human Rights Commission, five Retirement Policy and Research Centre (RPRC) Working Papers and a 2012 journal article have researched this complex issue, and made recommendations for a more equitable policy:

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), by Dale, Lazonby, St John and Littlewood, surveyed academic and government publications in New Zealand and overseas relating directly and indirectly to pension portability and migration.
3. Dale, St John and Littlewood *New Zealand Superannuation and Overseas Pensions: Issues and Principles for Reform*, (2009) 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. It identified two possible policy options for addressing the problems.
4. Dale, St John, Littlewood & Smith (2011) *Overseas Pensions Policy: the next steps*. The paper suggested two levels of proposed changes. The first group could be implemented promptly as they would involve modest cost while they would greatly improve the equity of New Zealand's overseas pensions policy. The second group of changes on Australia and longer-view options needs a fully researched, open discussion with all affected parties, including potentially affected pensioners.
5. Dale & St John (2012) *New Zealand's Overseas Pensions Policy: Enduring Anomalies and Inequities* suggested that the starting point for the necessary debate is a discussion about the residency requirement. Raising this to a meaningful level, from 10 years to 25 years, will help address the fiscal risk posed and the intergenerational burden imposed by an age pension that, in international comparisons, is both generous and accessible.

The two policy options canvassed by Dale, St John and Littlewood (2009) are, in brief:

Reform Option 1:

Increase the Residency Requirement for NZS from the current 10 years with at least five of those after age 50 (the 10(5) Residency Requirement) to 25 years after age 20 that must be achieved by the qualifying age (65 years) for all claimants.

Where the pension-originating country has a Social Security Agreement (SSA)³ with New Zealand, totalisation of years of residence may be possible but it is likely that these agreements would need renegotiation.

If the 25 years of residency is achieved by age 65, any overseas pension income is ignored, except for income tax purposes. If totalisation is required to meet the 25 years, the overseas pension associated with the period in the Agreement country would be payable to the New Zealand government.

If 25 years had not been completed by the NZS qualifying age of 65 years (and totalisation is not practicable), an income-tested welfare pension might be payable.

³ Among other purposes, SSAs define cost-sharing arrangements for payment of social welfare benefits and taxes.

Detail on Option 1 is provided in Dale and St John's *New Zealand's Overseas Pensions Policy – Enduring Anomalies and Inequities* (2012) (available [here](#)).

Reform Option 2:

If the applicant for NZS has an analogous pension from overseas, the NZS amount would accrue on residence only in New Zealand between ages 20-65. The full NZS would be payable after 45 years' (540 months') residence in New Zealand up to age 65.

The amount of the overseas pension would not directly affect the calculation of NZS.

This Working Paper looks at Option 2 in more detail.

This paper expands on Dale and Littlewood's *New Zealand Superannuation and Overseas Pensions: Reform Option 2* (2010) and covers some of the same ground as Dale and St John (2012).

Reform Option 3: one rule for all?

Not previously discussed by the RPRC is a third option. Given the difficulties with section 70 and the DDP, Option 3 would change the rules governing the entitlement to NZS for everyone: the 1/540th accrual rule would apply to all applicants for NZS. Only if an applicant could demonstrate 540 months' residence in New Zealand (45 years) before age 65 would they become entitled to NZS in full. This option is discussed separately.

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1. Introduction

Under section 70 of the Social Security Act 1964 (SS Act), the Direct Deduction Policy⁴ (DDP) is applied by the New Zealand's Ministry of Social Development's (MSD) Chief Executive to payments of New Zealand Superannuation (NZS). The DDP has long been a source of controversy: the Chief Executive determines what overseas pensions will and will not count under the DDP and is not obliged to publish the rationale behind those decisions.

The key part of section 70:

"70 Rate of benefits if overseas pension payable

(1) For the purposes of this Act, if—

(a) any person qualified to receive a benefit under this Act or under the Social Welfare (Transitional Provisions) Act 1990 or Part 6 of the War Pensions Act 1954 or under the New Zealand Superannuation and Retirement Income Act 2001 is entitled to receive or receives, in respect of that person or of that person's spouse or partner or of that person's dependants, or if that person's spouse or partner or any of that person's dependants is entitled to receive or receives, a benefit, pension, or periodical allowance granted elsewhere than in New Zealand; and

(b) the benefit, pension, or periodical allowance, or any part of it, is in the nature of a payment which, in the opinion of the chief executive, forms part of a programme providing benefits, pensions, or periodical allowances for any of the contingencies for which benefits, pensions, or allowances may be paid under this Act or under the Social Welfare (Transitional Provisions) Act 1990 or under the New Zealand Superannuation and Retirement Income Act 2001 or under the War Pensions Act 1954 which is administered by or on behalf of the Government of the country from which the benefit, pension, or periodical allowance is received—

[checked: that's what it says; the sentence starts on line 1 and both (a) and (b) are conditions that must be satisfied]the rate of the benefit or benefits that would otherwise be payable under this Act or under the Social Welfare (Transitional Provisions) Act 1990 or Part 6 of the War Pensions Act 1954 or under the New Zealand Superannuation and Retirement Income Act 2001 shall, subject to subsection (3), be reduced by the amount of such overseas benefit, pension, or periodical allowance, or part thereof, as the case may be, being an amount determined by the chief executive in accordance with regulations made under this Act:"

The RPRC's research concluded that New Zealand's overseas pensions policy requires urgent attention to address the current inequities and future potential problems as workers and pensioners become increasingly mobile. An earlier paper (Littlewood, St John and 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 alternative approaches were outlined, each of which could supersede the DDP as it currently 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 MSD agrees. Its 2007 preliminary report on section 70, made the following recommendations, among others, none of which has been implemented (Ministry of Social Development 2008, Paper Two, pp. 13-21):

- Remove foreign state pensions built up by voluntary contributions from the scope of section 70 of the SS Act;
- Discontinue the policy of deducting a person's overseas pension from their partner's NZS entitlement;

⁴ Words used with capital initial letters have the particular meanings described in the Appendix.

- Clarify the wording of section 70 so it is in plain English, and set out each country's pension regulations.

While the MSD's recommendations, if implemented, would improve the administration of section 70, even such improved arrangements no longer satisfy the needs of an open economy with a mobile workforce.

Experience of the DDP as it operates now shows that the MSD:

- Treats some 'private' savings as though they were public;
- Regards some '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.

In addition, following the changes in 2009,⁵ New Zealand now treats emigrants who have qualified for NZS before they emigrate in a completely different way from immigrants.

Previous RPRC papers have demonstrated that the integration of immigrants' pension entitlements with NZS is far from straightforward. Because of the way in which the current DDP is administered, there is a low level of understanding amongst those most affected (immigrants and returning New Zealanders) as to the rationale behind the DDP. Whether or not the current DDP persists, as the MSD has acknowledged, clarity about the policy must improve.

2. History of the DDP policy

Before 1938, the age pension residency requirement was 25 years, and the pension itself was income- and asset-tested (Archives New Zealand 2009). Overseas pensions were automatically deducted once total taxable income exceeded (for example, in 1926) £52 a year (equivalent to \$4,443 in 2012). The offset for income in excess of £52 was £1 for each £1 of the excess. When the 'Universal Pension' (neither income- nor asset-tested) was introduced in the Social Security Act 1938, a new approach was needed.

The 1938 Act gave the government the right to offset overseas pensions against any income benefit (including NZS) payable by the New Zealand taxpayers:

Notwithstanding anything in the foregoing provisions of this Part of this Act [that established pension and other welfare entitlements], if any person who for the time being is in receipt of an overseas pension is granted a benefit under this Part of this Act, the Commission may in its discretion, having regard to the circumstance of the case, reduce the rate of the benefit that would otherwise be payable under this Part of this Act, but so that the amount of the benefit payable for any period shall not in any case be less than the amount (if any) by which the benefit that would otherwise be payable for that period exceeds the amount of the overseas pension payable for the same period. (Social Security Act 1938, Section 65(2))

Section 65(1) of the 1938 Act defined "overseas pension" as a "pension or other periodic allowance granted elsewhere than in New Zealand". Importantly, the pension did not have to be payable by a government and could include private pensions.

The DDP therefore has a 74-year history of interaction with New Zealand's main welfare benefits, including NZS.

⁵ The changes that were part of the Social Assistance (Payment of New Zealand Superannuation and Veterans Pension Overseas) Amendment Bill.

The intention of the relevant legislation: the War Pensions Act 1954, the Social Welfare (Transitional Provisions) Act 1990, the New Zealand Superannuation and Retirement Income Act 2001, the Social Welfare (Transitional Provisions—Overseas Pensions) Amendment Act 2002, and the Human Rights Act 1993 (HRA)⁶ and the Bill of Rights Act 1990, should be to ensure the fair treatment of all citizens, including those older citizens who have lived and worked overseas.

3. Framing the overseas pension problem

As a general objective and with specific regard to NZS, the government should aim to ensure the fair treatment of all older citizens, including those who have lived and worked overseas. Equity is an important component of a sustainable retirement income system. However, that is being tested with increasingly mobile workforces. Whereas in the past there tended to be a dual potential pension entitlement with only two countries involved, the future will see more applicants for NZS having accrued pension entitlements in several countries. What is already complex will become more so.

There is a logic to the government's taking some account of overseas pensions that perform a similar role to NZS, irrespective of how they are funded. Some countries (for example the UK and the US) have identified 'contributions' that help finance public pensions. Even so-called 'private' provision often has a significant taxpayer-funded component as tax concessions are given in many countries to retirement saving. Consequently, the boundaries between social insurance, occupational and personal pensions are often blurred.

NZS is a Universal Pension and is not subject to a test against the recipient's other income or assets. A first, necessary step towards 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.⁷

The key differences between NZS and the pension practices of other countries are:

- (a) **The short residence requirements:** For NZS, only 10 years' residence in New Zealand after age 20 are required. There is no connection to an applicant's past employment, earnings' or contribution history. The residence requirements can also be achieved after the State Pension Age of 65 years – again, that is usually not possible in other jurisdictions. 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 example, the UK requires at least 30 years;⁸ and the maximum benefit under US Social Security requires a 35-year earnings' record.
- (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. In many other jurisdictions, including the US and the UK, there is a 'primary' entitlement with a supplement for a dependent spouse. In both these countries, the primary

⁶ See <http://www.hrc.co.nz/home/hrc/resources/resources.php#case> for HRC Complaints Information, and Fact Sheets covering discriminatory laws; discrimination by the public sector and the private sector; and discrimination in employment.

⁷ Appendix 1 includes a suggested definition of the Basic Pension.

⁸ In 2010, the UK reduced the minimum period of contributions from 44 years (males) and 39 years (females) to 30 years for both.

entitlement is higher on account of the dependency but the higher pension is payable to and remains the 'property' of the primary recipient.

- (c) **Poverty alleviation:** When compared with basic 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 from other countries with respect, specifically, to the state entitlements that cover all/most citizens aged 65+ (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 mobile populations and 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. For that reason, in some countries, including Australia, the US, and Canada, the Basic Pension is means-tested. In New Zealand, the universal age pension, NZS, provides a reasonable replacement rate for low-income people, albeit with a relatively low rate for middle and higher income people. As long as a pensioner owns a debt-free home, NZS alone can provide a modest but adequate standard of living.

The current DDP 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 design conflict between the treatment of pensioners who live in New Zealand and those who, having qualified for NZS, choose to live overseas.

The current DDP is perceived as increasingly anachronistic and out of step with other countries' policies. Almost 60,000 people with overseas pensions are affected by section 70 (Ministry of Social Development 2011, p. 318), and many have a strong sense of injustice regarding their treatment. As populations become even 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; Ministry of Social Development 2005; Ministry of Social Development 2008).

3. Two options for reform

3.1 The two options summarised (and a third possibility)

The RPRC proposes two possible options for reform:

- (a) Option 1 would extend the current 10-year residency requirement to 25 years and is discussed in detail in Dale and St John (2012).
- (b) 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, an SSA may have additional or replacement conditions. Both Options also retain the individual basis of entitlement.

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 domestic 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 DDP. It is left, in all cases, to the discretion of the MSD's Chief Executive to decide which pensions provided by or on behalf of another government are similar to NZS, with no direct guidance being given in section 70. If Option 2 were adopted, this lack of clarity and consistency would be corrected.

Dale and St John (2012) details the workings of Option 1. This Working Paper examines the implications of implementing Option 2.

A third possibility would see the basis for entitlements to NZS re-written for all applicants, not just those with an entitlement to an overseas pensions, based on the Option 2's 1/540th apportionment rule. For convenience, this is named 'Option 3'. Because it would apply to all applicants, there would be no need for section 70 and the DDP rules. We describe how that might work in paragraph 3.17 below.

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. As noted, the 2009 Amendment now allows all emigrants, whether they were in receipt of a full NZS payment or not, to take a 1/540th apportionment of NZS with them if they leave New Zealand after becoming entitled to NZS. Option 2 proposes applying that same approach to immigrants who arrive in New Zealand before the State Pension Age and who have an entitlement to an overseas Basic Pension.

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.

3.3 Option 2's application to pensioner's NZS entitlements

Here is how section 70 would be re-framed if Option 2 were adopted:

Prospective pensioners applying for NZS with an entitlement to a Basic Pension from another country would receive a reduced amount of NZS. The reduction will be:

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

What follows looks at some of the detail of the way Option 2 might work. For convenience of reference, the proportion of NZS remaining payable after applying the above formula will be called the "NZS Proportion".

3.4 The 'Basic Pension'

There are two pieces of information that the MSD's Chief Executive will require to implement an Option 2 apportionment, including the calculation of the NZS Proportion. The first of these is whether or not the applicant has a Basic Pension entitlement from another country. As Appendix 1 suggests, this is the state pension to which all the

citizens and permanent residents of that country may be entitled. It will not necessarily be a Tier 1 pension like NZS. For example, the appropriate Basic Pension in the US is what is known as 'Social Security' at Tier 2 rather than the heavily income- and asset-tested Supplementary Security Income (SSI) at Tier 1 to which only US residents may be entitled.

The Option 2 framework will see the MSD establish whether a country has a Basic Pension. Any entitlement to that Basic Pension for the applicant for NZS will be a question of fact, either 'yes' or 'no'. If the answer is 'yes', Option 2 is automatically triggered. If a bilateral SSA is in place, the MSD could determine that fact in respect of a particular applicant without needing to ask the applicant.⁹

Also, there may not be a direct entitlement to a Basic Pension in a case where a dependent spouse/partner qualifies the pension's main recipient for an additional allowance. The pension is still payable to the main recipient and so is not the direct income of the spouse/partner. For Option 2, the additional allowance would be regarded as the spouse/partner's Basic Pension.

3.5 Residence that counts

The period of residence outside New Zealand would also be a question of fact, evidenced by border crossings. It would include only periods when the applicant is 'ordinarily resident' outside New Zealand. Holidays and short-term visits while preserving a home in New Zealand would not interrupt that.

The concept of 'ordinarily resident' already applies in a number of different situations. For example, a New Zealand taxpayer must declare worldwide income as part of their taxable income if they are ordinarily resident in New Zealand. If they are not ordinarily resident in New Zealand, the taxpayer needs to include only New Zealand-sourced income in their New Zealand tax return. Similarly, Accident Compensation coverage applies only to people who are ordinarily resident in New Zealand (section 17 of The Accident Compensation Act 2001). The concept of 'ordinarily resident' also applies to the calculation of NZS for a person who emigrates after becoming qualified.¹⁰

To aid clarity, this report recommends the adoption of a formal definition of 'ordinarily resident' along lines that are already used in the Accident Compensation Act.

It follows that if there is no overseas Basic Pension entitlement, the issue of 'ordinarily resident' is not relevant. It then falls for the applicant to satisfy the normal residency requirement. Paragraph 3.11 below suggests that this need not be the current 10(5) Residency Requirement.

3.6 Subsequent changes to entitlements

The Option 2 test ignores the intricacies of the other countries' arrangements because the formula used to work out the NZS Proportion will be driven entirely by New Zealand-derived information: NZS itself and the period of non-residence. That contrasts with the present position that depends entirely on either accurate information from the applicant

⁹ Section 4 looks at the practical implications of Option 2 for a range of countries.

¹⁰ Appendix 2 (paragraph 2.4) explains how that applies and the discretion reserved to the MSD's Chief Executive in that regard. Appendix 2, paragraph 2.2 reproduces section 17 of the Accident Compensation Act and then adapts it (paragraph 2.3) to the purpose of establishing whether an applicant for NZS has been ordinarily resident in a country other than New Zealand. The period of 'ordinary residence' outside New Zealand will be the sole determinant of the NZS Proportion on the assumption that during those periods, the applicant has accrued entitlements to the 'Other Country's' Basic Pension.

or on information-sharing under a Social Security Agreement. There are possibly superannuitants receiving overseas pensions that would be subject to the DDP who are not so affected because the MSD does not know about the pensions.

The NZS Proportion will also be unaffected by changes to the rules that apply to either the overseas Basic Pensions or NZS itself, either before or after either country's State Pension Age. That also contrasts with the current DDP where changes to either country's arrangements from New Zealand's State Pension Age or from the other countries' State Pension Ages (if later) affect the net amount of NZS received for the whole of the pension period.

3.7 Currency changes

Under the current section 70/DDP arrangements, because the amounts of the qualifying pensions directly reduce NZS, it follows that currency movements during a year continuously affect the net amount payable under NZS.

Under Option 2, exchange rates are irrelevant to the calculation of the NZS Proportion. Eliminating currency as a consideration will considerably simplify the current administration arrangements and reduce confusion amongst pensioners.

3.8 Multiple entitlements

Applicants for NZS will increasingly have entitlements to more than one Basic Pension as a result of working in different countries. That will not matter for Option 2 because the NZS Proportion will be unaffected by the intricacies of multiple entitlements. Only the overall total period of non-residence will matter.

At present, all analogous pensions are subject to the DDP, and multiple currencies magnify the adjustment process during each year. It is not difficult to imagine a situation where one currency is strengthening against the New Zealand dollar while another is weakening. All those changes currently affect the amount to be paid as NZS.

3.9 Differences in State Pension Ages

If the overseas country's State Pension Age is later than New Zealand's, and the person met the residency requirements for NZS, then NZS would be paid in full until the Option 2 calculation applied from that country's later State Pension Age. This is because the individual would have no current entitlement to an overseas Basic Pension at the date of application for NZS. That changes (and would trigger the Option 2 deduction) when the overseas Basic Pension starts. The NZS Proportion then established will continue to apply for the remainder of the pensioner's retirement while living in New Zealand.

On the other hand, if an individual can defer the starting date of the overseas Basic Pension, the Option 2 calculation would apply from the other country's State Pension Age, whether or not the pension is actually paid.

The US Social Security pension illustrates this point. The US State Pension Age is currently 66 and will increase gradually between 2020 and 2027 to age 67. A beneficiary can choose to start the pension from age 62 but on an actuarially reduced basis. The 'normal' pension from age 66 can be deferred until age 70 with an appropriate actuarial increase to reflect the reduced period for which the pension is paid. Option 2 would apply from the earliest age that the 'normal' (unadjusted) pension can start, that is (currently) age 66. An applicant's decision to defer the starting age to, say, age 70 would not affect the calculation of the NZS Proportion at the appropriate US State Pension Age.

On the other hand, if the applicant chose to start the US pension from age 62 then the Option 2 calculation will be triggered when the applicant applies for NZS at age 65. That is because there is a Basic Pension payable, albeit at a lower rate than might have applied from age 66.

3.10 Couple's entitlement

If the overseas Basic Pension is higher because the 'primary 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 primary recipient because the amount of the overseas Basic Pension is disregarded under Option 2.

However, that enhanced entitlement would affect the spouse's entitlement to NZS. Although, with direct respect to the spouse, the additional amount paid to the primary recipient is not a Basic Pension to which the spouse is entitled, it arises in respect of the spouse.

In that situation, the NZS Proportion will be calculated separately for the primary recipient and the spouse. If they have been married for the whole of the period of overseas residence, the NZS Proportion will be the same for each because their periods of being ordinarily resident overseas are likely to be the same.

On the other hand, if the spouse married the primary recipient after the accrual of the Basic Pension but has never been ordinarily resident in another country, the spouse's NZS Proportion could be as much as 100%. That could be seen as 'double-dipping' but the principles of separate entitlement that are a feature of NZS are triggered by the periods of ordinary residence, rather than the design of the overseas Basic Pension.

If the spouse has been ordinarily resident overseas without accruing direct entitlements to a Basic Pension, the NZS Proportion will be less than 100% but the primary recipient will be receiving a spousal entitlement.

If, after the NZS Proportion is calculated for a couple, they separate, the NZS Proportion should be reviewed. The rules governing the overseas pension may change the way in which it is paid, for example by removing the primary recipient's spousal allowance. If that happened, the non-recipient's Basic Pension may become zero and the NZS Proportion would become 100%.

3.11 Survivor's entitlements

Where the overseas Basic Pension carries with it a survivor's entitlement on the death of the 'primary recipient', 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 unless there was a spousal supplement of the kind described in paragraph 3.10.

3.12 10(5) Residency Requirement no longer applies

Under Option 2, the NZS Proportion calculation will relate to 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, a requirement for five years' residence 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.

3.13 Section 70 does not need amendment, but...

Section 70 and the DDP apply to all equivalent overseas social welfare benefits, including age pensions.

Although implementing Option 2 would not necessarily require an amendment to the Social Security Act 1964, we would recommend changes to section 70. Without such changes, the MSD's Chief Executive could, as now, establish the presence of an overseas Basic Pension and then reduce the recipient's entitlement to NZS "...by the amount of such overseas benefit, pension, or periodical allowance, or part thereof, as the case may be, being an amount determined by the chief executive in accordance with regulations made under this Act..." (Section 70). The existing regulations would be amended to simply state the Option 2 principles:

- Every country's Basic Pension would be identified;
- If an applicant for NZS had an entitlement to an overseas Basic Pension, the entitlement to NZS would be reduced on the 540th principle.

However, given section 70's history of controversy, we recommend that the new principles on the basis of which NZS interacts with the overseas Basic Pension should be spelt out in a replacement section 70. This would include, as now, a power to make regulations in accordance with those principles. The regulations should not try to codify the process in respect of every Basic Pension that might be relevant. As is apparent from the work done by the RPRC, state pensions are complex, often based on different principles from NZS, and are constantly changing. Regardless of the basis adopted for the recognition of overseas pensions in the future, the replacement regulations should be principles-based, and the decisions made by the Chief Executive of the MSD, and the rationale, should be published.

3.14 Social Security Agreements no longer directly relevant to age pensions

Option 2 does not depend on having reciprocal Social Security Agreements (SSAs)¹¹ with other countries because, in the presence of an overseas Basic Pension, New Zealand will disregard residence that was not in New Zealand: totalisation¹² is no longer relevant.

There will still be advantages in having SSAs. 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, as now, for the individual to apply for the overseas pension.

The RPRC has previously noted other countries' antipathy towards New Zealand's DDP policy (Dale, St John, Littlewood and Smith 2011). It is the probable reason for New Zealand only achieving eight SSAs.¹³ 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.

¹¹ The coverage of Social Security Agreements is much wider than age pensions and usually cover all welfare benefits. The proposed reforms would allow reference to age pensions to be excluded for such reciprocal agreements.

¹² That allows periods of residence in two countries to be aggregated to establish entitlements to benefits in one of those countries (or both). The totalisation rules are usually detailed in the appropriate SSA.

¹³ There are currently only eight Social Security Agreements covering nine countries, plus one agreement covering 22 Pacific countries. Those countries, and the dates of the Agreements are: Australia (2002); the United Kingdom (1990); the Netherlands (2003); Canada (1996); Greece (1993); Ireland (1994); Denmark (1997); and Jersey and Guernsey (1995), Pacific countries (2009).

3.15 SSA – choice of one or two pensions

Where there is an SSA, individuals could be given the choice between one or two pensions. This would not affect the total amount payable but would make administrative and tax arrangements simpler for the pensioner.

If they chose one pension, the New Zealand government would collect the overseas Basic Pension and would pass that on to the pensioner along with the proportion of NZS to which the pensioner was entitled. If retirees chose two pensions, they would have responsibility for collecting their own overseas pension.

3.16 SSA – Funding arrangements irrelevant

Option 2 (and Option 1) 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 on the benefit itself and the key issue is whether the other pension qualifies as a Basic Pension, analogous to NZS. The MSD can establish that for every country without regard for individual circumstances or particular entitlements.

3.17 Option 3: one rule for all?

Some suggest that the difficulties with section 70 and the DDP indicate that the rules governing the entitlement to NZS should change for everyone. One recommendation would see the 1/540th accrual rule apply to all applicants for NZS, as now applies to pensioners with an entitlement to NZS retiring outside New Zealand. Only if the applicant could demonstrate 540 months' residence in New Zealand (45 years) before age 65 would they become entitled to the full amount of NZS.

Although only about 10% of all superannuitants have an overseas pension that is affected by section 70 and the DDP, the 'Option 3' requirement would affect a much larger number of applicants. Everyone who has lived for any time outside New Zealand would see a less-than-full NZS, even if they had not qualified for another country's Basic Pension. That is a potential difficulty as many countries (for example, the UK) have minimum periods of contributions or employment periods before there is any pension payable.

Option 3 has the superficial attraction of applying to everyone but, if it is intended as an answer to the section 70/DDP issues we have described, the cost and complexities involved in dealing with every new application for NZS seem difficult to justify. Directly addressing affected pensioners seems the more practical answer.

4 Some specific country issues: testing Option 2 in practice

In some countries, but not all, the Basic Pension is analogous to NZS, regardless of the way in which the pension is described, the way the entitlements accumulate, and the benefits are financed.

4.1 Current issues with section 70 (SS Act 1964) and the DDP

Currently, the way in which countries' different arrangements are taken into account in fixing the amount of NZS is inconsistent. If Option 2 were adopted as a replacement for

the current section 70/DDP arrangement, it will be vital to the new policy's success to establish precisely what the Basic Pension is in each country from which New Zealand has drawn immigrants. Given the complexity of pension arrangements, a 'simple' rule will be inadequate. In each case, it will be important to understand the role of each component of a country's retirement income arrangements.

Six examples illustrate countries' different pension arrangements as they interact with the current DDP:

- **Australia's** Tier 1 (the Age Pension) is in principle similar to NZS but, as with Chile, is 'integrated' with Tier 2 (the Australian compulsory, tax-subsidised Superannuation Guarantee scheme). However, unlike Chile, Australia's means tests also include all other income and assets. When New Zealand currently calculates what should count in the DDP, 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. On the other hand, if the Australian means test would have eliminated entitlement to the Age Pension had the applicant stayed in Australia, it would seem wrong under Reform Option 2 to assume there is no Basic Pension in respect of an applicant for NZS. Australia is a special case and demands particular attention.
- **Canada's** Tier 1 Guaranteed Income Supplement is directly analogous to NZS. Therefore, although they are both government-administered (an important component of the test under the current DDP policy), the Tier 2 Canada Pension Plan (CPP) and Quebec Pension Plan (QPP) should not be included when describing the state's retirement income-support obligations to citizens. The CPP and QPP are analogous to occupational pension schemes rather than to NZS and should not be seen as part of Canada's Basic Pension.
- In **Chile**, Tier 1 is a minimum pension that supports the compulsory, pre-funded, essentially private Tier 2 pension: entitlements to a Tier 2 'private' pension offset entitlements to the state's Tier 1 pension. While Tier 2 may be administered by privately owned providers, they operate under rules which are as intricate as the relationship between Tiers 1 and 2. Despite this relationship between Tier 1 and Tier 2 age pensions, at present, only the Tier 1 pension is captured under the DDP.
- In **Greece**, the Tier 1 pension may currently 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 DDP to recognise the Greek pension, it is inconsistent to assume as now 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 DDP. Tier 1 is clearly the 'Basic State Pension', with the full benefit payable after 30 years of contributions.¹⁴ 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, giving some justification for the current inclusion of the S2P in calculations under New Zealand's DDP.

¹⁴ Prior to 6 April 2010, the calculation of the Basic Pension depended on the individual's own contribution record of up to 45 years for males and 39 years in the case of females. There are also complex rules that allow certain periods during which contributions are not made (unemployment, family duties, ill health) to be counted as though contributions had been made.

The philosophical difficulty with regard to the present DDP 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 contracted-out '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.

- Tier 1 in the **United States** (the Supplemental Security Income or SSI), is a poverty-alleviation, non-portable age pension that is paid to very few people.¹⁵ In principle, it is not possible to describe the state's income-support obligation to its retired citizens without recognising the state-administered 'Social Security' at Tier 2. The current DDP includes Social Security age pensions.

It is also important to recognise that countries are always changing their pension systems and will continue to do so in the face of the cost pressures from ageing populations. Under the present DDP, the MSD is obliged to keep up with the detail of those changes as they affect pensions that are analogous to NZS.

The variety of possible arrangements and the constant changes mean the MSD needs a level 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.

4.2 Creating the knowledge base

One of the major difficulties with the present DDP is its lack of transparency. Decisions are made based solely on the "opinion of the [MSD's] chief executive" (Section 70, SS Act 1964). 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 the Basic Pension is determined for each country, the DDP decision would then apply to all cases where a pensioner had an entitlement to that pension from that country. The only individual determination would be: 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.

4.3 Effect of Option 2 on different countries' entitlements

What follows looks briefly at the six countries referred to in paragraph 4.1 above; also at selected countries that are the source of immigrants to New Zealand. In each case, the summary looks at retirement income provisions. In every case, individuals will also have 'retirement wealth' derived from other assets like investments, real estate etc.

¹⁵ Of all age benefits payable under the US system, only 9% received just the Tier 1's SSI. A further 5% received the SSI and some proportion of the Tier 2 'Social Security' pension (Social Security Administration 2010).

(a) Australia

Tier	In brief	Basic Pension rule
1	Age Pension, payable from 65, of similar value to NZS and after 10 years' residence is income- and asset-tested. The State Pension Age for women will be 65 from 2014 and, from 2017 will increase to age 67 for all.	The Age Pension, like NZS, does not accrue but is payable to those who qualify. It may be reduced to nil because of income- and asset-tests, nevertheless it qualifies as a Basic Pension.
2	The Superannuation Guarantee (SG) scheme requires employers to contribute 9% (increasing to 12%) to a qualified, tax-favoured Defined Contribution scheme.	
3	Tax-subsidised occupational schemes and personal equivalents.	
Social Security agreement?	Yes (2002): residence in each country counts. Because of the income- and asset-tested Tier 1, there is a significant pension imbalance between the countries.	

(b) Canada

Tier	In brief	Basic Pension rule
1	A two-layered Guaranteed Income Supplement (GIS) payable from 65 after at least 10 years' residence includes an income-tested Old Age Security benefit (OAS).	The OAS is not a Basic Pension as any entitlement ceases after six months' absence from Canada. The GIS accrues at 1/40 th for each year and is payable abroad if the individual lived in Canada for at least 20 years after age 18. It is Canada's Basic Pension.
2	The compulsory, pre-funded Canada or Quebec Pension Plan (CPP or QPP) – a capped Defined Benefit pension based on covered earnings and years of membership.	
3	Tax-subsidised occupational schemes and personal equivalents.	
Social Security Agreement?	Yes (1996).	

(c) Chile

Tier	In brief	Basic Pension rule
1	A Solidarity Pension is payable from age 65 with at least four of the last five years' residence in Chile. This a minimum pension is offset against all pension income at rates from initially 100% but gradually reducing to 32%.	Together, the Chilean arrangements at Tiers 1 and 2 constitute a Basic Pension. The social obligation is delivered at Tier 2, an entitlement the pensioner can preserve if living in another country.
2	A compulsory, pre-funded, privately managed system of Defined Contribution schemes, requiring employees to pay 10% of covered earnings plus insurance premiums. At 65, the account is converted to a pension.	
3	Supplementary saving schemes were crowded out by Tier 2 and also by past economic uncertainty. A tax-favoured, voluntary, accessible <i>Ahorro Voluntario</i> started in 2002. The occupational <i>Ahorro Previsional Voluntario Colectivo</i> started in 2008.	
Social Security Agreement?	No.	

(d) China

Tier	In brief	Basic Pension rule
1	A small Tier 1, universal pension started in 2009 for 'rural' residents (about \$US8 a month). There is a 'central government guideline' to deliver 'basic pension insurance' from age 60 that is between 40-60% of the local average wage. State governments set the local rules.	The Tier 1 'basic pension insurance' is the Basic Pension and is payable after at least 15 years' contributions. However, there is no real national pension and special conditions will need to be settled for immigrants.
2	A 'mandatory individual account' (another central government guideline requires employee contributions of 8% of covered pay). Though supposedly compulsory, only 24% of employees apparently belong.	
3	There are no formal arrangements at Tier 3.	
Social Security Agreement?	No.	

(e) Germany

Tier	In brief	Basic Pension rule
1	There is no statutory minimum pension.	Tier 2 is Germany's Basic Pension. It is payable after at least five years' contributions.
2	A complex, contributory, points-based, pay-related, Defined Benefit pension is payable from age 65. The State Pension Age is rising from 65 to 67 between 2012 and 2029. Special supplements apply to low-income earners, periods of child-care and special conditions apply to some self-employed, miners, civil servants and farmers.	
3	Occupational schemes and other tax-favoured private provision.	
Social Security Agreement?	No.	

(f) Greece

Tier	In brief	Basic Pension rule
1	An income-tested 'solidarity grant' can be payable from age 60 to a Greek resident.	Tier 2 is Greece's Basic Pension. It requires at least 12 years' contributions and is payable abroad under an SSA.
2	A pay-related, Defined Benefit pension is payable from age 65 for men and 60 for women calculated in relation to capped pay in the five years before retirement. Special 'systems' apply to farm workers, civil servants, doctors, dentists, architects, notaries, commercial motor vehicle operators, shipping agents, tradesmen and craftsmen. Minimum and maximum pensions apply.	
3	Private retirement saving schemes had no special tax treatment until 2002 and, with the generous Tier 2, meant that Tier 3 arrangements were relatively insignificant.	
Social Security Agreement?	Yes (1993).	

(g) United Kingdom

Tier	In brief	Basic Pension rule
1	Basic State Pension, a modest pension from age 65.	The Basic State Pension accrues over, now, 30 years' contributions. The minimum contribution period is 10 years for any entitlement. [Yes it is]
2	State Second Pension (S2P) a modest occupational top-up to Tier 1. It is possible to 'contract-out' of this at Tier 3	
3	Significant occupational pensions including some that 'contract out' of the S2P in exchange for lower 'National Insurance contributions'.	
Social Security Agreement?	Yes (1990); residence in each country counts.	

(h) United States

Tier	In brief	Basic Pension rule
1	A very modest, heavily income- and asset-tested 'Supplementary Security Income' (SSI) is payable to US residents over the State Pension Age.	The SSI is not portable. Social Security pensions (SS) require a minimum contribution period of 10 years and represent the Basic Pension despite being financed other than through taxes.
2	Social Security (SS) provides a relatively generous, income-related pension based on career-average, inflation-adjusted, capped income over 35 years. Spousal allowances can apply.	
3	Tax-subsidised occupational schemes and personal equivalents.	
Social Security Agreement?	No.	

5. Strengths and weaknesses of the Option 2 policy proposal

5.1 Strengths of Option 2

- (a) **Simple and transparent:** The main strength is Option 2's relative simplicity and transparency by comparison with the current DDP. 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* any NZS entitlement. This would reinforce the sharing principles inherent in SSAs.
- (c) **Residence to 65:** Only residence to age 65 will count in the calculation of NZS. At present, residence after age 65 can be counted. The age 65 test draws a line under the numerator used to work out the NZS proportion. It answers the question 'how many months was the applicant not ordinarily resident in New Zealand before 65?'

If the State Pension Age changes, the formula will adjust to the new age. For example, if it increased to age 67, the denominator in the NZS Proportion formula would be 564 instead of the current 540.

- (d) **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 1/540th apportionment rule because of the changes that were made in the 2009 Amendment.

5.2 Weaknesses of Option 2

- (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/DDP policy.
- (b) **Lump sum Tier 1 schemes:** A weakness with the current DDP policy¹⁶ is that it does not address the issue of lump-sum superannuation payouts or retirement benefits such as apply in schemes like Fiji's Provident Fund. There would be no Basic Pension at the date of application for NZS and the applicant may have already spent the Provident Fund's benefit.

Whether or not Option 2 is adopted, in principle, such Provident Funds' benefits should be included as the local equivalent of a Basic Pension. There are many, mainly Asian and Pacific, countries that have such arrangements, for example, Indonesia, Malaysia, Hong Kong, Samoa, and Kiribati.

- (c) **'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 reaching 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 would, however, end up with a lower total state pension than currently applies.
- (d) **Insufficient residence in particular cases:** A pensioner may have a Basic Pension from one country to trigger the calculation of the NZS Proportion. However, part of the pensioner's residence overseas may have been in more than one country and, in individual cases, may have been insufficient to qualify for a Basic Pension in the second and subsequent countries. In principle, that need not be a New Zealand public policy concern but it could lead to financial hardship in some cases. Two possible responses are, first (and preferable): address that possibility in the SSA between New Zealand and each other country, perhaps under 'totalisation' arrangements. The second possibility could give a specific discretion to the MSD's Chief Executive to ignore residence in one or more 'non-qualifying' countries, thus reducing the number of months of overseas residence that counts in the calculation of the NZS Proportion.

6. Discussion

In most other countries, state-provided pensions are far more complicated than NZS's simple, elegant benefit design. That simplicity raises fiscal risks for New Zealand

¹⁶ Lump sum retirement payouts are ignored under the DDP arrangements as long as the benefit is received before the pensioner comes to New Zealand.

taxpayers in an increasingly mobile world. Immigrants will tend to choose a country for their retirement based in part on the state pension arrangements.

6.1 Those affected by the three options

The three possible replacements for the current DDP discussed are:

- Option 1 would extend the current 10-year residency requirement to 25 years;
- Option 2 would apportion entitlement to NZS based on the 540-month system where there was an overseas Basic Pension payable.
- Option 3 would apportion entitlement to NZS for all applicants, based on the 540-month system.

In each case, the test would apply at age 65, the present State Pension Age; periods of residence after age 65 would not count.

For about 90% of those currently over age 65, there would be no change to their current benefits under either Option 1 or Option 2 because there is no pension to which the current DDP might apply. For the remainder, and probably an increasing proportion of future pensioners, the impact on their NZS entitlement will depend on individual circumstances.

However, the possible 'Option 3' (see paragraph 3.17 above), would potentially affect everyone, including those who have no overseas Basic Pension.

A forthcoming working paper will compare Options 1, 2 and 3.

6.2 Some 'occupational' pensions may be Basic Pensions

We have suggested that, under the definition of the Basic Pension suggested in Appendix 1, the US Social Security pension at Tier 2 would be included as part of the Basic Pension. The same applies to Tier 2 entitlements in Germany, Greece and Chile and in other countries as well. We recognise that many will argue that the US Social Security entitlement, for example, is an 'occupational' arrangement that provides an income or contribution-based pension relating directly to the individual's employment (unlike NZS). On the face, the government does not contribute with the benefits being financed through 'contributions' from employers and employees. It is therefore arguably 'private' property and should not be taken into account in the calculation of NZS.

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 US 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 private 'occupational schemes' (based on work status or income from employment) that are part of an employer's remuneration arrangements. Again, there are many different ways other countries do that. At Tier 2, they can be pension or lump-sum; Defined Benefit or Defined Contribution, and 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 UK and Ireland).

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

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, it effectively helps pay 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 schemes 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 DDP), 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, under Option 2 the New Zealand system ignores any overseas age pension entitlements and re-calculates NZS based on how many months the individual has lived in New Zealand between ages 20-65.

6.3 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. Here are some general comments on cost considerations:

- (a) Option 2 may cost more:** At present, the section 70 DDP claims a full offset for 'analogous' pensions. Under Option 2, there will be a lesser reduction based on the NZS Proportion (see paragraph 3.3 above). However, the new arrangements will probably see a greater number of overseas Basic Pensions declared or identified under SSAs.
- (b) Administration savings:** Option 2 will be simpler to administer than the DDP and less open to appeals.
- (c) Overall impact of Option 2:** The effect of Option 2 on the net cost of NZS will depend on:
 - The number of pensioners for whom a 100% offset already applies (the net cost will increase for them because NZS will be higher), balanced by...
 - The relative value of each month's accrual of the overseas Basic Pension compared with 1/540th of NZS. Where the overseas pension is relatively small, the reduction in NZS will be greater for the affected period so reducing the net cost of NZS. On the other hand, if the overseas Basic Pension is relatively generous (and the DDP currently 'claims' the full amount), the pensioner will receive a net increase in NZS.

- The number of 'new' Basic Pensions that are uncovered by the new administration arrangements.

6.4 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'. 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.

Appendix 1: Terminology

(A) State pensions

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.

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,¹⁷ 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 DDP, 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.

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.

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.

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.¹⁸ The MSD deducts the US Tier 2 Social Security under the current DDP. We agree 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

¹⁷ 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.

¹⁸ SSI payments are made to only about 14% of US citizens over State Pension Age. SSI is not payable to non-residents.

2 entitlement even though that may be in a privately managed account in the pensioner's name (e.g Chile's AFPs).¹⁹ 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, separate recognition of a basic age pension welfare obligation. Those state's social and 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.

(B) Other expressions associated with overseas pension entitlements and used with particular reference in this Working Paper (with capital initial letters)

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.

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 and is functionally an accounting artifice. 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.

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.

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.

¹⁹ 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.

NZS Proportion: This is central to the proposed Option 2. If a prospective pensioner applying for NZS has an entitlement to a Basic Pension from another country, they would receive a reduced amount of NZS. The reduction will be:

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

The proportion of NZS remaining payable after applying the above formula is the NZS Proportion, being the amount deemed to have accrued as a result of the period of residence in New Zealand between ages 20-65.

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.

Social Security Agreement (SSA): a bilateral agreement coordinating the tax and social security systems, including age pension benefits, of two countries, and detailing the cost-sharing arrangements for payment of those benefits.

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.

State Pension Age: the age from which the 'normal' 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.

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.

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

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 DDP 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.

Appendix 2 “ordinarily resident”

2.1 Formalising ‘ordinarily resident’

Option 2 would require the Chief Executive to establish periods during which an applicant for NZS was not ordinarily resident in New Zealand.

The concept of being ‘ordinarily resident’ is used in a number of sections of the New Zealand Superannuation and Retirement Income Act 2001. For example, an applicant for NZS must be ordinarily resident at the application date (section 8(a))²⁰; an applicant who is overseas may apply for NZS in exceptional circumstances but, despite being overseas, must be ordinarily resident at the date of application (section 27).

If Option 2 were adopted, the significance of the period during which an affected applicant is ‘ordinarily resident’ increases. That seems to justify a definition for the specific purposes of calculating the entitlements to NZS. Currently, whether someone is ‘ordinarily resident’ is decided by the MSD’s Chief Executive. For Option 2, that discretion should be removed and replaced by a regulatory definition that allows people to understand their likely position.

2.2 Accident Compensation’s definition

Here is how section 17 of the Accident Compensation Act defines ‘ordinary residence’ for the purpose of establishing whether someone is entitled to Accident Compensation coverage:

“17 Ordinarily resident in New Zealand

- (1) A person is ordinarily resident in New Zealand if he or she—
 - (a) has New Zealand as his or her permanent place of residence, whether or not he or she also has a place of residence outside New Zealand; and
 - (b) is in one of the following categories:
 - (i) a New Zealand citizen;
 - (ii) a holder of a residence class visa granted under the Immigration Act 2009;
 - (iii) a person who is a spouse or a partner, child, or other dependant of any person referred to in subparagraph (i) or (ii), and who generally accompanies the person referred to in the subparagraph.
- (2) A person does not have a permanent place of residence in New Zealand if he or she has been and remains absent from New Zealand for more than 6 months or intends to be absent from New Zealand for more than 6 months. This subsection overrides subsection (3) but is subject to subsection (4).
- (3) A person has a permanent place of residence in New Zealand if he or she, although absent from New Zealand, has been personally present in New Zealand for a period or periods exceeding in the aggregate 183 days in the 12-month period immediately before last becoming absent from New Zealand. (A person personally present in New Zealand for part of a day is treated as being personally present in New Zealand for the whole of that day.)
- (4) A person does not cease to have a permanent place of residence in New Zealand because he or she is absent from New Zealand primarily in connection with the duties of his or her employment, the remuneration for which is treated as income derived in New Zealand for New Zealand income tax purposes, or for 6 months following the completion

²⁰ Although, interestingly, the 10(5) requirement in section 8(b) and (c) refers to “resident and present in New Zealand” for the two periods of ten and five years. That is a different and stricter test than ‘ordinarily resident’. Section 9 allows some exceptions to the ‘physical presence’ requirement.

of the period of employment outside New Zealand, so long as he or she intends to resume a place of residence in New Zealand.

(5) A person is not ordinarily resident in New Zealand if he or she is in New Zealand unlawfully within the meaning of the Immigration Act 2009. Any period during which a person is in New Zealand unlawfully is not counted as time spent in New Zealand for the purposes of subsection (3)."

2.3 Adapting the Accident Compensation definition to Option 2

Whereas section 17 is designed to establish whether someone is covered by Accident Compensation, the equivalent provision under Option 2 is designed to establish the periods during which the applicant was **not** resident in New Zealand. Here is how that might look:

"Not ordinarily resident in New Zealand

(1) A person is not ordinarily resident in New Zealand if he or she—
(a) has at any time during the period between the dates of the person's 20th and 65th birthdays had another country, other than New Zealand as his or her permanent place of residence (referred to after this as "the Other Country" which for this purpose shall include more than one country, if appropriate), whether or not he or she also has a place of residence inside New Zealand; and
(b) is in one of the following categories:
(i) has been a citizen of the Other Country;
(ii) has been a holder of a residence class or work class visa granted by the Other Country under the Other Country's equivalent of the Immigration Act 2009.

(2) A person does not have a permanent place of residence in the Other Country if he or she has been and remains absent from the Other Country for more than 6 months or intends to be absent from the Other Country for more than 6 months. This subsection overrides subsection (3) but is subject to subsection (4).

(3) A person has a permanent place of residence in the Other Country if he or she, although absent from the Other Country, has been personally present in the Other Country for a period or periods exceeding in the aggregate 183 days in the 12-month period immediately before last becoming absent from the Other Country. (A person personally present in the Other Country for part of a day is treated as being personally present in the Other Country for the whole of that day.)

(4) A person does not cease to have a permanent place of residence in the Other Country because he or she is absent from the Other Country primarily in connection with the duties of his or her employment, the remuneration for which is treated as income derived in the Other Country for the Other Country's income tax purposes, or for 6 months following the completion of the period of employment outside the Other Country, so long as he or she intends to resume a place of residence in the Other Country.

(5) For the purposes of this section it does not matter whether the person is in the Other Country unlawfully.

(6) The period during which a person is not ordinarily resident during the period between the dates of the person's 20th and 65th birthdays shall be counted in complete months and proportions of months where a day shall be one thirty-first of a month."

2.4 The current provision for emigrants

Option 2 already applies in principle to emigrants who, having qualified for NZS then leave New Zealand. Section 26A of the Act applies the 1/540th rule to the amount that becomes payable after the emigrant has been absent for 26 weeks or intends to be absent for at least 26 weeks.

Section 26A calculates the NZS Proportion for the emigrant:

“26A Calculation of amount of New Zealand superannuation payable overseas

- (1) The proportion referred to in section 26(6) is to be calculated by—
 - (a) treating each period during which the person concerned has resided in New Zealand while aged 20 or more and less than 65 as whole calendar months and (where applicable) additional days; and
 - (b) adding the number of additional days (if any), dividing the total by 30, and disregarding any remainder; and
 - (c) adding the number of calendar months and the quotient calculated under paragraph (b); and
 - (d) dividing by 540 the total calculated under paragraph (c).

- (2) In the determination for the purposes of subsection (1) of the periods during which a person has resided in New Zealand, no account is to be taken of—
 - (a) any period of absence from New Zealand of a kind described in section 9(1); or
 - (b) any period of absence from New Zealand—
 - (i) while the person was engaged in missionary work as a member of, or on behalf of, any religious body; or
 - (ii) while the person’s spouse or partner was engaged in missionary work as a member of, or on behalf of, any religious body, and the person was with his or her spouse or partner; or
 - (c) any period of absence from New Zealand while the person was (by virtue of section 79(1)(a) of the Social Security Act 1964) deemed to have been resident in New Zealand; or
 - (d) any period of absence from New Zealand while, as the spouse or partner of a person deemed by section 79(1)(a) of the Social Security Act 1964 to have been resident in New Zealand, the person was also (by virtue of section 79(1)(b) of the Social Security Act 1964) deemed to have been resident in New Zealand.

- (3) Subsection (2) applies to a period of absence only if the chief executive is satisfied that during it the person concerned remained ordinarily resident in New Zealand.

- (4) Subsection (2)(b) applies to a period of absence only if the chief executive is satisfied that the person concerned either was born in New Zealand or—
 - (a) in the case of a person to whom subsection (2)(b)(i) applies, was ordinarily resident in New Zealand immediately before leaving New Zealand to engage in the missionary work concerned;
 - (b) in the case of a person to whom subsection (2)(b)(ii) applies, was ordinarily resident in New Zealand immediately before leaving New Zealand to accompany or join his or her spouse or partner.”

In summary, the period that counts as the numerator is the period that the applicant has actually lived in New Zealand (“resided in New Zealand”) between ages 20 and 65. There are some exceptions, such as “missionary work ...[for]... a religious body” but only if the “...chief executive is satisfied that during [the period] the person concerned remained ordinarily resident in New Zealand.” (sub-section (3)).

Once the number of months is calculated as the numerator, the NZS Proportion is the months divided by 540. Each month counts as 1/540th.

Option 2 suggests the adaption of the current provision for emigrants.

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