Date: 24 November 2005

Security Level: **IN CONFIDENCE**

Report to: Minister of Finance
Minister for Social Development and Employment

REVIEW OF NEW ZEALAND SUPERANNUATION – TREATMENT OF OVERSEAS PENSIONS AND PAYMENT OVERSEAS

Executive Summary

Background

1 This report was requested by Cabinet in May 2005. The Ministry of Social Development and the Treasury, along with other relevant officials, were directed to report to the Ministers of Finance and Social Development and Employment on options for two aspects of New Zealand Superannuation (NZS):

- modernising the current policy of 'direct deduction' of NZS where a superannuitant has an overseas pension similar to NZS
- addressing issues associated with the payment of NZS overseas.

2 This report could also form the basis for the review of this topic set out in the Confidence and Supply Agreement with New Zealand First. The agreement provides a commitment to 'investigate ways to improve options for senior citizens who may be eligible for foreign pensions as well as New Zealand Superannuation'.

Superannuitants receive a lower level of NZS if they have an overseas pension, or live overseas

3 NZS is payable to a person who is 65 years or older, has spent at least 10 years in New Zealand after the age of 20 (five years of which must be since their 50th birthday), and who is resident within New Zealand when they apply. Under current rules superannuitants who have a pension from another country, or who live in another country, frequently receive a rate of payment which is lower than the standard rate they would otherwise qualify for.

The rules governing the treatment of overseas pensions

4 The 'direct deduction' policy results in superannuitants who are living in New Zealand, but who are eligible for a public pension from another country, receiving a lower rate of NZS. Where the overseas pension forms part of a programme administered by or on behalf of the overseas government providing benefits, pensions or periodic allowances for any of the contingencies for which benefits, pensions or periodic allowances are provided under New Zealand social assistance legislation, the amount of the overseas pension is deducted dollar for dollar from the ordinary level of NZS and other benefits that would be otherwise payable to the superannuitant concerned.

5 The direct deduction policy is a long standing policy (implemented in 1938) and is set out in legislation.

6 There are approximately 51,000 New Zealanders who receive overseas pensions that are directly deducted from NZS. The majority of these people have been in New Zealand for more than 30 years and are living on modest incomes. Seven percent of these people were born in New Zealand. Currently the direct deduction policy produces annual savings for the government of $174 million.

The rules governing the payment of NZS overseas

7 Many people eligible for NZS, but who choose to live outside New Zealand for longer than six months in every year also receive a lower rate of payment. There are a variety of rules determining the exact level of payment:

- the general portability rules state that a person can receive only 50% of NZS if residing in a country with which New Zealand does not have a social security agreement. The person also has to be resident in New Zealand at the time he/she applies
- enhanced payments are available to eligible persons in the Pacific Islands and to persons covered by eight social security agreements.

8 The rules governing the payment of NZS overseas are also set out in legislation. Approximately 7,000 people are paid NZS overseas at a cost of $48 million per year.

The direct deduction and portability rules are problematic and increasingly unpopular

9 The direct deduction and payment overseas rules are an increasing source of dissatisfaction amongst superannuitants. This is partly because of increasing international mobility, which means more people are affected by these rules.

10 The original rationale for direct deduction was to ensure that all New Zealanders received the same level of government funded retirement income. However advocates for affected superannuitants argue that:

- superannuitants with overseas pensions have qualified for NZS just as other recipients have and should therefore receive the full entitlement
- many of the overseas pensions that are directly deducted are not similar to NZS because they are contributory pensions under which workers contribute to their pensions, often through a social security tax.

11 In addition, government officials perceive a significant amount of evasion of the direct deduction policy. Foreign governments dislike the policy which presents risks for international relations and limits the government's ability to conclude social security agreements. Lastly, the policy is difficult to administer because it is not always clear which pensions should be deducted.

12 The original rationale for 50% portability, introduced in 1990, was that pensions paid overseas were not subject to the surcharge or New Zealand taxation. However advocates for affected superanuitants argue that:

- the rationale for the 50% rate is no longer relevant given the abolition of the surcharge

- the 50% rate is insufficient to allow most superannuitants to contemplate retiring overseas.

13 Many New Zealanders are unable to comfortably retire in the country of their choice because the rate of NZS paid overseas under general portability rules is insufficient, and the residence rules restrict payment to people who leave New Zealand after the age of 65 and who apply before leaving the country (ie the rules do not allow a person to apply from overseas). In addition, entitlement to payment of New Zealand Superannuation overseas is tied to the country for which the application was made, which precludes long term travel to a number of countries.

Options

14 This paper sets out a range of specific options for changes in the area of both direct deduction and payment of NZS overseas. None of the options lead to superannuitants receiving reduced entitlements after the change. Options are evaluated against criteria including:

- enhanced opportunities for superannuitants (ie improved incomes or ability to live in the country of their choosing)
- fiscal costs
- income redistribution
- susceptibility to risks of migrants exploiting the relative generosity of the New Zealand social security system
- low compliance cost and ease of administration.

Options for Treatment of Overseas Pensions

15 We have developed nine options to amend the direct deduction provisions. The options involve higher expenditure on New Zealand superannuitants with overseas pensions[1].

Table 1: Direct deduction options

Option	Fiscal cost	Impacts and implementation Issues	Works with portability options
1. Remove direct deduction	$88m in 2006/2007 rising to $186m in 2009/2010	*Positive*: Easy to administer, good for international relations, good fit with Positive Ageing Strategy. *Negative*: Expensive, creates overlap with foreign systems, possibility of benefit shopping, not equitable for lifelong New Zealand residents	All

[1] For the purpose of costing the options, the date of 1 January 2007 has been used as the implementation date. All costings are indicative and the amounts provided are net of tax. All options would result in some changes to administrative costs which have not been estimated at this stage. The 2004/2005 operating budget of International Services which is the business unit of Ministry of Social Development which administers the direct deduction policy and payment of NZS overseas was approximately $10m.

Table 1: continued

Option	Fiscal cost	Impacts and implementation Issues	Works with portability options
2. Remove direct deduction and increase residence criteria for New Zealand Superannuation	Same fiscal cost as option 1 however, $100m from year 2016 if 15 years residence option chosen, and savings of $20m from year 2021 if 20 year residence option chosen	*Positive*: easy to administer, good for international relations *Negative*: Expensive, changes core New Zealand Superannuation rules, increased uptake of other benefits, not equitable for lifelong New Zealand residents	10, 11,14
3. Choice of proportional payment of New Zealand Superannuatioon or a directly deducted payment, whichever option is most advantageous to individual pensioners	$63m in 2007 rising to $70m in 2011	*Positive*: Good for international relations, will address concerns of most clients *Negative*: administratively complex, non-indexation of United Kingdom pensions a problem	13
4. Phasing out of direct deduction based on length of residence in New Zealand	$80m in 2006/2007 rising to $167m in 2009/2010	*Positive*: Easy to administer, acceptable to most clients *Negative*: Expensive	None, would need development of a matching portability option
5. Direct deduction of only universal flat rate state pensions that are similar to New Zealand Superannuation	$70m a year	*Positive*: Limited alleviation of clients' dissatisfaction *Negative*: Administratively difficult, effect not equitable	All
6. Free zone where a certain amount of overseas pension is not deducted	$18m in 2006/2007 rising to $37m in 2009/2010	*Positive*: Easy to administer *Negative*: Unlikely to be acceptable to clients or other governments	All
7. Targeted deduction based on the level of income of the pensioner	$27m in 2006/2007 rising to $58m in 2009/2010	*Positive*: Some alleviation of clients' dissatisfaction *Negative*: Additional administration, expensive	All
8. Modified status quo	Approximately $5m	*Positive*: Limited cost, resolution of some minor policy issues *Negative*: probably not acceptable to clients/other governments, most current admin and policy difficulties continue	All
9. Status quo	Nil	*Positive*: No fiscal cost *Negative*: not acceptable to clients/other governments, all current admin and policy difficulties continue	All

16 The modifications proposed in option 8 would be necessary should some form of the direct deduction policy be retained, ie if you choose one of options 3 to 8. Annex III sets out some possible changes to clarify the existing legislation and fix some on-going problems. These potential changes would require further policy work.

Options for Payment of NZS Overseas

17 We have developed six options for payment of NZS overseas:

Table 2: Options for payment overseas

Option	Fiscal cost	Impacts and implementation Issues	Works with direct deduction options
10. Full rate of New Zealand Superannuation is paid overseas	$12.m in 2006/2007 rising to 32.9m in 2010/2011	*Positive*: Creates uniform portability system, equitable *Negative*: Relatively expensive, payment levels in agreements and Special Portability Arrangement need to be increased	All except 3 and 4
11. Full rate of New Zealand Superannuation is portable, residence requirement is increased to 15 or 20 years	$12.m in 2006/2007 rising to 33m in 2010/2011, but change in residence could reduce cost to zero by 2017	*Positive*: Creates uniform portability system, equitable *Negative*: Relatively expensive, payment levels in agreements and Special Portability Arrangement need to be increased	All except 3 and 4
12. Special portability formula is extended to all New Zealand Superannuation payments overseas	$7m in 2006/2007 rising to $20m in 2010/2011	*Positive*: Creates uniform portability system, equitable *Negative*: payment levels in agreements need to be increased	1, 5-9
13. Proportional portability using formula of 1/45 of NZS for each year of New Zealand residence	$12m in 06/07 rising to $50m in 2010/2011	*Positive*: Consistent with agreements *Negative*: Inconsistent with special portability, portability system cannot be made uniform, need to amend New Zealand Superannuation residency rules	1,3, 5-9
14. Retain portability arrangements and pursue new social security agreements	$0.75m a year	*Positive*: No fiscal cost *Negative*: Does not solve problem, not acceptable to clients not covered by social security agreements, increases benefit and health expenditure	All except 3 and 4
15. Retain portability arrangements and no new social security agreements	Nil	*Positive*: No fiscal cost *Negative*: Does not solve problem, not acceptable to clients, not good for international relations increases benefit and health expenditure	1, 5-9

Packaging the options

18 In reviewing the direct deduction and payment overseas rules, you are being asked to decide whether to enhance the generosity of NZS to individuals with overseas pensions, or superannuitants who want to live overseas. To illustrate this point, we have packaged the options into four broad approaches as illustrated in table 3 below.

Table 3: Broad packages of options

Approach	Details	Fiscal cost	Impacts (compared to status quo)
Fully international approach	• No direct deduction policy (options 1 and 2) • NZS fully portable to other countries (options 10 and 11)	Maximum cost of approximately $207m (if options 1 and 10 were chosen)	Expensive if NZS residence qualification rule is not amended, good for labour market mobility, gives superannuitants more choice, good for international relations, susceptible to exploitation by migrants seeking more generous provisions
Partial international approach	• Reduction in extent of direct deduction (options 3-7) • Enhance general portability rules (options 12 and 13)	Maximum cost of approximately $205m (if options 4 and 12 were chosen)	Expensive (but less so than fully international approach), some modest labour mobility gains, gives superannuitants more choice, modest gains for international relations
Modified status quo	• Clarify rules for direct deduction (option 8) • Enhance portability on a country-by-country basis through social security agreements (option 14)	Approximately $5m a year	Small cost, direct deduction easier to administer, gives superannuitants covered by social security agreements more choice
No change	• Options 9 and option 15	Nil	None

Next steps

19 Once you have agreed on your preferred options, we will prepare a Cabinet paper for submission to the Cabinet Social Development Committee in February 2006. We recommend that the paper seek decisions in principle, as the proposed changes will need financial approval and legislation and might usefully be the subject of consultation with affected groups.

Recommended Actions

We recommend that you:

1 **note** that it has been agreed in the Confidence and Supply Agreement with New Zealand First that the Government will investigate ways to improve options for senior citizens who may be eligible for foreign pensions as well as New Zealand Superannuation

2 **note** that on 11 May 2005 Ministers reported to the Cabinet Policy Committee on progress on the Review of New Zealand Superannuation policy [POL Min (05) 11/7] and noted that they have instructed officials to commence phase two of the Review and provide a range of options that focus on solving the problems around payment of New Zealand Superannuation overseas and considering ways in which the direct deduction policy can be modernised

3 **note** that overseas pensioners receive less NZS than other superannuitants and that there are the following issues around direct deduction:

(a) the policy is widely disliked by recipients of overseas pensions in New Zealand and for many overseas pensioners it comes as a surprise that they will lose part or all of their New Zealand Superannuation payment

(b) the policy poses ongoing policy issues and administrative difficulties, due to attempted evasion of the deduction by recipients of overseas pensions, and the difficulties Work and Income have in identifying which overseas pensions should be deducted

(c) other governments dislike the policy, which in some cases creates a difficulty for New Zealand's international relations

4 **note** that we have identified nine options for change to the direct deduction policy with costings based on an implementation date of 1 January 2007

5 **note** that there are the following issues around payment of New Zealand Superannuation overseas:

(a) many New Zealanders are unable to retire comfortably in the country of their choice because the 50% general portability rate is insufficient to allow many migrants to return to their country of birth to retire

(b) entitlement to payment of New Zealand Superannuation overseas is tied to the country for which the application was made, which precludes long term travel to a number of countries

(c) the rule that a person must apply while resident in New Zealand and qualify for NZS before leaving the country means that persons who leave New Zealand prior to age 65 receive no payment at all from New Zealand

6 **note** that we have identified six options for the provisions for payment of New Zealand Superannuation overseas (under options 10 to 14 applicants will be able to apply for New Zealand Superannuation from overseas provided they left New Zealand after the date of the law change)

7 **note** that all options would require legislative changes, renegotiation of the Social Security Agreement with the United Kingdom, potential changes to the manner in which NZS payments are administered, and that costings for each option are indicative and will need to be refined once preferred options are identified

8 **note** that officials have indicated broad packages of direct deduction and payment overseas options

9 **agree** to meet with officials to discuss this paper, and indicate which one of the options from 1-9 and which one of the options 10-15 you consider warrant further development for a Cabinet paper in February 2006

AGREE / DISAGREE | AGREE / DISAGREE

10 **agree** to refer this paper to the Minister of Foreign Affairs, the Minister for Senior Citizens, the Minister of Veteran's Affairs and the Minister of Pacific Island Affairs.

AGREE / DISAGREE | AGREE / DISAGREE

Mark Sowden | Date
Manager
Labour Market and Income
For Secretary to the Treasury

24 November, 2005

Peter Hughes | Date
Chief Executive
Ministry of Social Development

Hon Dr Michael Cullen | Date
Minister of Finance

23.11.05

Hon David Benson-Pope | Date
Minister for Social Development and Employment

Proposal

1 This report proposes options to address issues around the treatment of overseas pensions paid to recipients of New Zealand Superannuation (NZS) and the payment of NZS to New Zealanders resident overseas. The scope of the paper includes Veterans Pensions, but does not include income tested benefits. We propose that you direct the Ministry of Social Development and the Treasury to draft a Cabinet paper for consideration by Cabinet Committee in February 2006 to seek decisions in principle on your preferred options.

Background

2 This report was requested by Cabinet in May 2005. The Ministry of Social Development and the Treasury, along with other relevant officials, were directed to report in November to the Ministers of Finance and Social Development and Employment on two aspects of NZS:

- modernising the current policy of 'direct deduction' of NZS where a superannuitant has an overseas pension similar to NZS
- addressing issues associated with the payment of NZS overseas.

3 The issues canvassed in this paper are also the subject of commitments in the Confidence and Supply Agreement with New Zealand First. The agreement sets out a commitment to "investigate ways to improve options for senior citizens who may be eligible for foreign pensions as well as New Zealand Superannuation".

Context

New Zealand Superannuation

4 NZS is a universal pension paid to all eligible New Zealanders over the age of 65. To be eligible for NZS a person must:

- be a New Zealand citizen or permanent resident
- have been resident and present in New Zealand for not less than ten years since the age of 20, of which five years or more must be since the age of 50
- generally be ordinarily resident in New Zealand on the date of application.

5 NZS is paid at a standard amount unrelated to previous earnings. It is not subject to means testing. The amount paid depends only on marital status and living arrangements. There are currently three basic rates: the married person rate, the single sharing rate, and the single living alone rate. From 1 April 2005 these rates are as set out in table 4 below.

Table 4: NZS rates and approximate number of recipients

Living Arrangement	Net weekly rate of New Zealand Superannuation	Approximate number of recipients
Married/De facto	$196.78	271,000
Single sharing	$236.14	68,000
Single living alone	$255.81	131,000
		Total 470,000

6 Currently NZS costs the Crown approximately $5.4 billion a year (net).

The direct deduction policy

7 The direct deduction policy is the policy mechanism which deals with people who are eligibile for NZS, and are also eligible for a pension payment from another country. The direct deduction policy reduces a superannuitant's NZS by the amount of his/her (or his/her partner's) overseas social security pension. The effect of this on superannuitants' NZS payments is shown in table 5 below.

Table 5: Effect of direct deduction on NZS payments

Living Arrangement	Average net weekly rate of NZS	Average weekly direct deduction	Approximate number of recipients
Married/De facto	$141.72	$55.06	34,000
Single sharing	$193.41	$62.40	12,000
Single living alone	$174.40	$61.74	5,000
			Total 51,000

Payment overseas of NZS

8 The payment overseas policy allows superannuitants to be paid overseas under certain circumstances. The main ways NZS can be paid overseas are:

- temporary absence provisions which allow a superannuitant to leave New Zealand for six months and receive full NZS
- payment under social security agreements made with other countries where NZS is based on the number of year's residence in New Zealand up to a maximum payment of 100% (New Zealand currently has eight social security agreements)
- payment in Pacific countries where NZS is paid at 50% after 10 years residence in New Zealand, rising to 100% after 20 years residence
- payment to all other countries at a flat rate of 50%

9 Approximately 7000 people are paid under these arrangements at a cost of $48 million a year[2] (refer table 6).

Table 6: Number of recipients under portability arrangements by average weekly rate and annual cost

Payment Arrangement	Numbers of recipients	Gross weekly rate of NZS[3]	Annual cost
Social Security Agreements	6357	$122.58	$41.423m
Special Portability Arrangement for the Pacific	454	$248.82	$5.874m
General Portability	190	$124.98	$1.231m
Total	7001		$48.528m

Broad nature of the problem

10 NZS is recognised by the Organisation for Economic Cooperation and Development (OECD) as a good first tier pension system which is simple, relatively inexpensive and excellent at preventing poverty. Nevertheless, a key disadvantage of NZS is that it is out of step with most other countries retirement systems, which makes the interface between NZS and foreign pension systems problematic. Most other countries have pension systems in which a retiree's level of entitlement is based on social security contributions made by that person over the period of their working life. By contrast, NZS has a gateway of 10 years residence and presence, plus five years residence and presence after age 50, and an 'all or nothing' entitlement. New Zealand's policy settings are not well suited to situations where people move between countries because they do not lend themselves easily to the sharing of pension costs between countries. Increasing international mobility means that this problem is unlikely to diminish.

11 Due to increased international mobility of both working age people and retirees there are increasing numbers of New Zealand residents having spent periods of their working life overseas, and many New Zealanders and other ex-New Zealand residents now resident overseas having spent periods of their working life in New Zealand. There are a number of persistent issues around providing pensions for these people:

Treatment of overseas pensions

- the direct deduction policy is widely disliked by recipients of overseas pensions in New Zealand and for many overseas pensioners it comes as a surprise that they will lose part or all of their NZS payment because they receive an overseas pension
- the direct deduction policy poses ongoing policy issues and administrative difficulties, due to attempted evasion of the policy by recipients of overseas pensions, and the

[2] Data on numbers of people receiving payment under temporary absence provisions is not available.
[3] NZS payments overseas are not taxed in New Zealand.

difficulties the Ministry of Social Development have in identifying which overseas pensions should be deducted

- other governments dislike the policy, and in some cases it is an irritant in New Zealand's international relations and can make conclusion of social security agreements difficult or impossible.

Payment of NZS overseas

- many New Zealanders are unable to retire comfortably in the country of their choice because the 50% general portability rate provides insufficient income
- entitlement to payment overseas of NZS is tied to the country for which the application was made, which precludes long-term travel to a number of countries
- the rule that a person must apply while resident in New Zealand and qualify for NZS before leaving the country means that persons who leave New Zealand prior to age 65 receive no payment at all from New Zealand.

The direct deduction policy

12 Rules governing the treatment of overseas pensions paid into New Zealand are found in sections 69G, 69H, and section 70 of the Social Security Act 1964 and Article 15 of the Social Security Agreement with the United Kingdom, and are known as the 'direct deduction policy'. Sections 69G and 69H provide that applicants for NZS must take reasonable steps to obtain an overseas pension to which they may be entitled, and provide information to the Ministry of Social Development on the rate of any overseas pension granted to them.

13 Section 70 is as follows:

"[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 under 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 of that person's dependants, or if that person's spouse 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—

[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 under Part 6 of the War Pensions Act 1954] [or under the New Zealand Superannuation Act 2001] shall, subject to subsection (3) of this section, 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]:"

14 The provisions of section 70(1) are broadly mirrored in Article 15 of the Social Security Agreement with the United Kingdom.

15 Section 70(1) and Article 15 of the Social Security Agreement with the United Kingdom requires the Chief Executive of the Ministry of Social Development to reduce a beneficiary's entitlement to a New Zealand benefit by the amount of any overseas benefit, pension, or periodical allowance that the beneficiary receives or is entitled to receive that in the opinion of the Chief Executive forms part of a programme providing benefits, pensions, or periodical allowances administered by or on behalf of the government from which it is received for any of the contingencies for which New Zealand benefits are paid.

16 The effect of section 70 and Article 15 is that in general first tier pensions (ie basic, universal, flat rate, state pensions) and second tier pensions (ie contributory, earnings related state pensions) that are paid into New Zealand by other governments are deducted. For example, state pensions paid into New Zealand by Australia (first tier), the United Kingdom (first and second tier) and the United States (second tier) are deducted. Where the pension is mandated by a government but is nevertheless private in nature, eg pensions paid from the Chilean scheme in which workers make compulsory contributions into private accounts, it is not deducted. Annex II shows the ten countries paying the highest number overseas pensions into New Zealand, and the type of pensions that are deducted and not deducted.

Direct deduction rationale

17 The direct deduction policy was introduced in 1938 and, while some amendments have been made since that time, it remains essentially unchanged. The policy was included in the text of the Social Security Agreement between New Zealand and the United Kingdom during the 1970 revision of the Agreement.

18 The rationale behind the direct deduction policy is to ensure that all New Zealand residents receive an equitable level of pension. The policy has also come to be seen as a way of sharing the burden of social security costs between New Zealand and an individual's home country.

19 NZS is relatively generous because it is paid in full after 10 years of qualifying New Zealand residence and presence (and five years residence and presence after age 50). In most other countries the level of a retirement pension is based on the number of contributions a person has made to a scheme during their working life. This means that a person will often not receive full social security coverage unless they have contributed to a social security scheme for between 40 to 50 years. In effect, most countries do not pay any pension for periods where contributions have not been made (or a person has not been present).

20 When a person migrates to New Zealand, or returns home after a period overseas, they may bring with them a partial entitlement to a pension from another country. After only 10 years New Zealand residence they will become entitled to full NZS. If a person were to receive a partial overseas pension entitlement as well as their NZS, they would be financially advantaged in comparison with a person who has lived all their life in New Zealand, paid their taxes and retired here. The amount of any social security based overseas pension similar to NZS is therefore deducted from a person's New Zealand entitlement.

Population Affected by the Direct Deduction Policy

21 At 1 September 2005, eleven percent of all NZS recipients had an overseas pension that was being deducted from their New Zealand entitlement. In total (NZS and other means tested benefits), there were 51,618 New Zealanders receiving overseas pensions that were being direct deducted from their entitlement. Annex II shows the numbers of people and pension amounts paid by these countries.

22 The majority of overseas pensions received by New Zealand residents are paid into New Zealand by:

- the United Kingdom (42,976 pensions amounting to $143 million a year)
- the Netherlands (3,754 pensions at a value of $14.3 million a year)
- Australia (2,832 pensions amounting to $8 million a year)
- United States, Canada, Ireland, Germany, Jersey and Guernsey, Switzerland and Fiji (a combined total of 1,446 pensions amounting to approximately $7 million a year).

23 Approximately seven percent of overseas pensioners are New Zealand born individuals who have spent some portion of their working life overseas.

24 The average value of overseas pensions paid into New Zealand is $3,377 a year. New Zealand pays each overseas pensioner an average of $10,100 a year in NZS and other income tested benefits.

25 A significant majority of overseas pensioners have been resident in New Zealand for a considerable length of time. Eighty five percent of overseas pensioners have lived in New Zealand for 30 years or more. It is this group of pensioners who strongly disagree with the direct deduction policy because they believe they have earned the right to receive the full rate of NZS.

26 Overseas pensioners typically belong to low income households. Over sixty percent of overseas pensioners have an income level below the threshold which would preclude entitlement to a Community Services Card.

Problems with the policy

27 At the time that the direct deduction policy was introduced (1938), the majority of immigrants to New Zealand were from the United Kingdom. However, New Zealand now receives migrants from a wide variety of countries (key migrant source countries now include China, South Africa and India), and retirement pensions are paid into New Zealand from a wide variety of types of pension systems.

28 The direct deduction policy presents a number of policy and administrative issues:

- *Inequity in the treatment of overseas pensions.* In 1978, the United Kingdom introduced provisions that allow a person to "contract-out" of the state earnings related pension scheme and join an occupational pension scheme. United Kingdom state earnings related pensions are deductible under the direct deduction policy but occupational pensions are not. This inequity irritates United Kingdom pensioners, many of whom chose to remain covered by the state earnings related scheme, and therefore have the amount of these pensions deducted.

- *Determination of the type of pensions to be deducted.* As overseas pension systems evolve and their nature changes it can be difficult to determine the deductibility of pensions.

- *Administration of the policy.* Administration presents a number of difficulties taking into account the policy problems, because it is not always clear what pensions should be deducted and therefore decisions made by Ministry of Social Development officials are highly contestable. Significant administration time is spent in dealing with reviews and appeals made by clients who disagree with the Ministry of Social Development decision about their individual case. The OECD estimates that the average life of a pension system is 15 years which means that pension systems continually have to be reassessed in the light of section 70.

Payment overseas

Payment overseas rules

29 Sections 21 to 35 of the New Zealand Superannuation and Retirement Income Act 2001 provide rules governing payment of NZS overseas.

30 NZS is paid to superannuitants resident overseas under five separate provisions:

- The general portability provisions at a flat rate of 50% of the gross full rate, provided that the person applies for NZS while resident in New Zealand, and qualifies for NZS before leaving New Zealand (sections 21 to 29 of the New Zealand Superannuation and Retirement Income Act 2001).

- The Special Portability Arrangement for persons retiring to a Pacific Island country, which allow a person to receive up to 100% of NZS if they have 20 years' residence in New Zealand (sections 30 to 35 of the New Zealand Superannuation and Retirement Income Act 2001).

- Temporary absence provisions which allow superannuitants who leave the country for up to six months to receive NZS at the full rate provided their absence does not exceed 30 weeks or absence beyond 30 weeks is due to unforeseen circumstances beyond the superannuitant's control (section 22 of the New Zealand Superannuation and Retirement Income Act 2001)

- Social security agreements which modify the rules in legislation by allowing persons covered to receive up to 100% of NZS while they are resident overseas and overseas residents to apply for New Zealand benefits. Social security agreements also allow contributions to a foreign pension system to count as New Zealand residence for the purposes of qualifying for a New Zealand benefit, and for New Zealand residence to count as contributions and/or residence in the other country (known as 'totalisation'). Social security agreements cover many of New Zealand's major migrant source countries such as the United Kingdom, Australia and the Netherlands, but there is limited scope for extending the agreements network to some other major migrant source countries such as China, India and South Africa because these countries do not have sufficiently developed social security systems to be agreement partners.

- Provisions for aid workers which provide full payment of NZS for up to 52 weeks, which Cabinet recently agreed to increase to 156 weeks (section 24 of the New Zealand Superannuation and Retirement Income Act 2001).

Payment overseas rationale

31 During the past 50 or 60 years, many countries have become aware of the need to pay their pensions overseas, due to increasing international mobility of working age and retired people. These countries began to negotiate cost-sharing social security agreements to ensure seamless social security coverage (whereby each country pays a person the rate of pension they would have received if they had remained resident in their home country, and the two pensions add up to a full pension entitlement).

32 Until the late 1980s, New Zealand's social security system covered only on New Zealand residents. Although people could receive payment while outside of New Zealand, entitlement to payment of NZS was restricted to periods of absence of up to 26 weeks, provided that a person returned to New Zealand within 30 weeks of their departure.

33 By the late 1980s, New Zealand's migration patterns had diversified. Migrants were coming to New Zealand from countries other than the traditional European migrant source countries, and New Zealanders were emigrating in larger numbers to a greater variety of countries. Overseas born New Zealand residents reaching retirement age who wished to retire in their countries of origin lobbied for a change in the payment overseas rules. In 1988 the government agreed to allow the payment of NZS overseas under social security agreements and New Zealand has since entered into seven[4] such agreements with Australia, Canada, Denmark, Greece, Jersey and Guernsey, the Netherlands and the Republic of Ireland.

34 In 1990 Cabinet sanctioned the payment overseas of NZS to all countries, at 50% of the full rate. A variation of this provision was negotiated in 1993 with the Cook Islands, Niue and Tokelau (which was extended to most other Pacific countries in 1999 at a more generous rate). The Special Portability Arrangements are designed to recognise the contribution Pacific people make to New Zealand and the inability of Pacific countries to fulfil the reciprocal obligations necessary to conclude social security agreements with New Zealand.

[4] New Zealand also has a social security Agreement with the United Kingdom but this Agreement was last revised in 1983 and does not provide for payment of NZS to New Zealanders resident in the United Kingdom.

Population affected by the payment overseas policy

35 At 1 September 2005, NZS was paid to 7,001 New Zealanders living overseas.

36 The majority of payments overseas (4,651) are made to New Zealanders resident in Australia and these figures are increasing by approximately 220 per month.

37 New Zealanders who receive payments overseas under social security agreement provisions, other than under the Australian agreement, account for an additional 1,706 payments and these numbers increase by an average of 16 per month. Table 7 shows the numbers NZS recipients in an agreement country at 1 September 2005 and the value of the payments.

Table 7: NZS paid in social security agreement countries by numbers of persons and annual value/cost at 1 September 2005

Agreement country	Number of superannuitants*	Cost
Australia	4651	$29.788m
Canada	330	$1.696m
Denmark	49	$0.249m
Greece	231	$1.272m
Ireland	99	$0.962m
Jersey and Guernsey	54	$0.112m
The Netherlands	943	$7.344m
Total	6,357	$41.423m

*There are an additional 20,000 approximately former New Zealand residents who are paid UK and Australian pensions overseas under the terms of a previous social security agreement with Australia and the current agreement with the UK

38 Table 8 shows that the Special Portability Arrangement for Pacific Countries provides 454 payments (this number increases by an average of seven per month).

39 By comparison, the number of New Zealanders who are applying under the general payments overseas rules remains fairly static with an average increase of one person per month. The low number of applicants for payment of NZS overseas indicates that the rate of payment of 50% and the restrictive residence rules do not is not make this option attractive to potential applicants.

Table 8: Payment overseas under general portability and the Special Portability Arrangement

Payment Arrangement	Number of superannuitants	Annual cost to Crown
Special Portability Arrangement for the Pacific	454	$5.874m
General portability	190	$1.231m
Total	644	$7.105m

Problems with the policy

40 There are two key problems with this policy:

- The requirement to be 'ordinarily resident' in New Zealand on the date of application for payment overseas. This rule means that a person cannot leave New Zealand to retire to another country before the age of 65. Even where a person turns 65 overseas and returns to New Zealand to apply he/she will still be judged ineligible under the current rules which require a person to intend to remain in New Zealand permanently in order to be deemed 'ordinarily resident'.

- The flat rate payment of 50% deters some older New Zealanders from retiring overseas because it provides insufficient income to allow a reasonable standard of living in retirement in most countries. The Ministry of Social Development receives a number of complaints each year about this issue.

The way forward

41 The broad policy goal of NZS is to provide a basic but adequate standard of living in retirement.

42 The current policy goal of direct deduction is to ensure that persons with overseas pensions receive the same level of social security income as lifelong New Zealand residents. If the problems with direct deduction are to be solved the goal of the policy will need to be adjusted. We suggest that the goals of direct deduction should be:

- to provide an interface between New Zealand and overseas social security systems that provides a fair sharing of social security costs between countries

- to protect the standard of living of superannuitants at a basic but adequate level

- to ensure that the level of NZS is fiscally sustainable to the crown

- to ensure that the treatment of overseas pensions paid to New Zealanders is equitable for New Zealanders who have lived and worked in New Zealand all their lives.

43 These goals are not necessarily mutually compatible. For example, it could be argued that it is not possible to provide a fair sharing of social security costs between countries while maintaining a system which is equitable for lifelong New Zealand residents. Ministers will therefore need to consider which of these goals have a higher weighting.

44 The goal of payment of NZS overseas is to allow New Zealanders to retire overseas with an adequate standard of living, ie New Zealanders have a choice about where they retire while receiving a satisfactory level of pension income from New Zealand.

45 In achieving these specific goals there are some tradeoffs eg the cost of options. We have set out a range of options below and we have used the following criteria to assess these options. The criteria are based on the objectives as well as considerations of implementation feasibility and the extent to which they solve the problem:

- enhanced opportunities for superannuitants (ie improved incomes or ability to live in the country of their choice)

- fiscal cost
- poverty alleviation
- income redistribution
- potential disadvantages for other parts of the system ie what are the other impacts?
- Susceptibility to risks of migrants exploiting New Zealand's relatively generous social security provisions
- whether the option allows international labour mobility
- low compliance costs and ease of administration
- extent to which policy creates a reduction in entitlement for some superannuitants (no losers)

46 Not all direct deduction options will be able to be operated alongside all payment overseas options. We have summarised the compatibility of the options in Annex I.

47 We have presented indicative costings for all options. Ministers should note that these costings only indicate the relative fiscal cost of each option and do not include costs for the New Zealand Superannuation Fund contributions. More detailed costings would need to undertaken once preferred options are selected. The costings exclude potential costs/savings associated with changes in the delivery of NZS. We currently spend $10m a year on administration of the direct deduction policy and payment overseas.

Options to amend the direct deduction policy

48 Currently, New Zealanders receive a lesser rate of NZS if they are also entitled to an overseas pension. The direct deduction policy was originally designed to ensure that all New Zealanders receive the same total amount of public pension, ie a person with an overseas pension entitlement is not financially advantaged in comparison with someone who has lived only in New Zealand.

49 Some of the options presented involve a shift away from this principle. Overseas pensioners with access to both NZS and an overseas public pension may be financially advantaged in comparison to life-long New Zealand residents who have access only to NZS. Most options will involve spending additional amounts on NZS in respect of overseas pensioners, some of whom may already have relatively high incomes [5].

50 It is difficult to solve the issues around treatment of overseas pensions paid into New Zealand. This is principally because the current policy settings for NZS of full payment after 10 years residence and the lack of an income or asset test leave little room for development of policy options that do not result in significant additional expenditure, or require changes to core NZS entitlements.

51 Should amendments to section 70 be made, amendments to Article 15 of the social security Agreement between New Zealand and the United Kingdom would also need to be made. Article 15 mirrors the direct deduction provisions in section 70 and it is under this Article,

[5] MSD does not hold accurate data on the income of superannuitants because NZS is not income tested.

rather than section 70, that United Kingdom pensions paid into New Zealand are deducted from New Zealand entitlements.

Option 1: Removal of the direct deduction provisions for NZS and Veterans Pension (VP)

The direct deduction policy would no longer apply to the majority of overseas pensioners who would be able to receive the full rate of NZS entitlement in addition to an overseas pension.

Indicative Fiscal Implications (Direct NZS costs only) ($/m)			
2006/2007	2007/2008	2008/2009	2009/2010
88	180	183	186

52 Option 1 would result in a net fiscal loss. However, some of the fiscal cost would be offset because overseas pensions would count as income for other benefits received by superannuitants such as a Disability Allowance and an Accommodation Supplement.

53 This option provides a solution to a majority of the issues around the direct deduction policy. It would be popular with overseas pensioners and would find favour with other governments. A number of countries who have previously declined to enter into social security agreements with New Zealand because of the direct deduction policy (Germany, Switzerland, Austria, Sweden, Finland) might now be prepared to negotiate a social security agreement with New Zealand. This option increases the income of superannuitants with overseas public pensions, 60% of whom are on moderate incomes.

54 Option 1 has some disadvantages. Due to the nature of NZS whereby the full rate is payable after ten years' residence, New Zealand would effectively be providing social security payments to many pensioners for periods which overlap with periods of coverage they have already accrued in an overseas social security system. This would not be equitable for people who have spent their entire working lives in New Zealand. There is a slight risk that this option could encourage migrants to seek to exploit New Zealand's relatively generous social security provisions.

55 It would not be possible to remove the direct deduction completely as it would need to be retained for people who receive NZS due to the totalisation provisions in social security agreements as these people have not met the minimum residence requirement for NZS[6]. There are approximately 5,000 people who have used totalisation provisions to qualify for NZS.

56 This option will require changes to the Social Security Act 1964 and the Social Security Agreements with Australia and the United Kingdom.

[6] Social security agreements allow contributions or residence in an agreement country to count as residence in New Zealand for the purposes of qualifying for NZS, and for residence in New Zealand to count as contributions or residence in the other country. This is known totalisation.

Option 2: Remove direct deduction and amend residency

- The direct deduction policy would no longer apply to the majority of overseas pensioners who would be able to receive the full New Zealand entitlement in addition to an overseas pension from January 2007.
- Minimum residence for NZS would be increased to 15 years in 2012 or 20 years in 2017

Indicative Fiscal Implications (Direct NZS costs only) ($/m)			
2006/2007	2007/2008	2008/2009	2009/2010
88	180	183	186

57 This option is the same as option 1 but with the addition of accompanying amendments to the minimum residence requirements to qualify for NZS. We propose two options for amending the residence requirements:

- increase minimum residence required to 15 years after the age of 20 commencing on 1 January 2012 (this date provides lead-in time); or
- increase minimum residence required to 20 years after the age of 20, commencing on 1 January 2017 (this date provides lead-in time)

58 The fiscal implications are the same as option 1 in the forecast period, however the proposed residence changes could reduce the cost of this option to $100m in 2016 if a 15 year residence requirement is selected, and create $20m in savings in 2021 if a 20 year residence requirement is selected.

59 Despite the residence period for NZS being increased, this option would address concerns raised by most affected clients because 85% of overseas pensioners have lived in New Zealand for 30 or more years. Other governments would also find this option to be acceptable for the reasons outlined for option 1. Option 2 would also reduce problems around overlapping periods of social security coverage and benefit shopping because of the longer residence qualification for NZS.

60 A disadvantage of this option is that new migrants excluded from NZS by the new residence provisions may in many cases access alternative New Zealand benefits such as Emergency Benefit. Currently approximately 5,500 persons who are 65 years of age or older receive Emergency Benefits. The majority of these people do not meet the residential qualifications for NZS.

61 Option 2 would require changes to the Social Security Act 1964 and the New Zealand Superannuation and Retirement Income Act 2001 and the Social Security Agreements with Australia and the United Kingdom.

Option 3: Dual system of proportionalisation and direct deduction for overseas pensioners only

A dual system of proportionalisation and direct deduction that would only apply to overseas pensioners. An overseas pensioner could choose the system that is most beneficial to their own circumstances.

Indicative Fiscal Implications (Direct NZS costs only) ($/m)			
2007/2008	2008/2009	2009/2010	2010/2011
63	65	69	70

62 Under the proportional system 1/45 of NZS would be paid for each year of residence in New Zealand between the ages of 20 and 65. Any overseas pension would not affect the amount of NZS. Alternatively, the overseas pensioner could choose to continue in the direct deduction system if this is more beneficial for them.

63 Under option 3, we estimate that 37,000 overseas pensioners would no longer be subject to the direct deduction policy but would receive a proportionalised rate of NZS.

64 This option has some disadvantages. The direct deduction policy would not be removed so most of the difficulties around policy and administration would remain for people who choose the direct deduction option. Operating this option would be administratively complex where clients elect one option and then wish to move to another option because their circumstances change. There would also be additional administrative complexity around verifying the residence of people who choose the proportional option.

65 There would be difficulties posed by United Kingdom pensioners who comprise around 75% of overseas pensioners, all of whom receive non-inflation indexed (frozen) pensions[7]. The proportionalised option would not be attractive for some United Kingdom pensioners because electing this option would result in a gradual decline in their overall pension income due to the United Kingdom frozen rate policy. As in options 1 and 2 United Kingdom pensioners would want some pressure placed on the United Kingdom Government to unfreeze the rates of United Kingdom pensions paid in New Zealand. Option 3 would be an excellent option for pensioners from countries that pay larger pensions into New Zealand.

66 Option 3 would require changes to the Social Security Act 1964 and the New Zealand Superannuation and Retirement Income Act 2001 and the Social Security Agreements with Australia and the United Kingdom.

Option 4: Phased-out direct deduction

This option involves a three phase direct deduction system. Persons with 10-19 years residence in New Zealand since the age of 20 would continue to be covered by the full direct deduction. Those with 20-29 years residence would have 50% of their overseas pension direct deducted, and those with 30+ years residence would not be subject to direct deduction.

[7] The United Kingdom does not increase in line with inflation pensions paid into mainly Commonwealth countries including New Zealand, Australia, Canada and South Africa.

Indicative Fiscal Implications (Direct NZS costs only) ($/m)			
2006/2007	2007/2008	2008/2009	2009/2010
80	164	166	167

67 We estimate that approximately 90% of overseas pensioners would no longer be subject to the direct deduction policy under this option.

68 This option is relatively easy to understand and would find favour with pensioners who have lived in New Zealand for 30 or years more which is currently 85% of the overseas pensioner population. This option recognises that people who have lived in New Zealand for a long period of time have made a significant contribution to the country and therefore ought to receive full NZS entitlement. The most fervent opponents of the direct deduction policy tend to be those people who have significant periods of residence in New Zealand.

69 Option 4 would provide a partial solution to the issues with section 70 but the administrative difficulty of determining the deductibility of particular types of overseas pensions would remain. There are still likely to be clients who are dissatisfied because they feel it is their right to receive both full NZS and full overseas pension after ten years New Zealand residence.

70 Option 4 would not be compatible with the Special Banking Option[8] but this would affect a relatively small number of clients, as many clients who currently use the option would no longer be directly deducted and therefore would not need the option. There would be no other impacts on the social security system.

71 Option 4 would require changes to the Social Security Act 1964 and the Social Security Agreements with Australia and the United Kingdom.

Option 5: Deduction of first tier pensions only

Only first tier basic social security pensions from other countries would be deducted from NZS.

Indicative Fiscal Implications (Direct NZS costs only) ($/m)				
2006/2007	2007/2008	2008/2009	2009/2010	2010/2011
70	70	70	70	70

72 We estimate that this option would benefit approximately 43,000 overseas pensioners (principally from the United Kingdom and Canada) because their second tier pensions would not be deducted. Approximately 4,000 overseas pensioners would no longer be subject to the direct deduction policy.

[8] The Special Banking Option is a system whereby overseas pensioners can choose to have their overseas pension paid directly into a special bank account. The overseas pensioner cannot access the funds in the special bank account – instead these amount are periodically withdrawn by MSD. In turn, the overseas pensioner receives the regular full payment of NZS and therefore does not have to deal with the issues associated with having two separate payments, tax on the overseas pension, and exchange rate fluctuations.

73 This option is designed to ensure that only overseas pensions that are similar to NZS are deducted. Many countries have introduced "tiered systems" in which universal, flat rate, state pensions similar to NZS are complemented by additional state pensions which are contributory and earnings-based (including mandatory private savings). Currently section 70 authorises the direct deduction of second tier earnings related pensions, despite the fact that, other than being administered by the state, they have little resemblance to NZS.

74 Ten countries account for nearly 99% of overseas pensions direct deducted from NZS (United Kingdom, Australia, Netherlands, United States, Canada, Ireland, Germany, Jersey and Guernsey, Switzerland and Fiji). The United Kingdom and Canada pay first and second tier pensions into New Zealand, so second tier pensions from these countries would no longer be deductible while first tier pensions would remain deductible. The United States, Germany and Fiji pay only second tier pensions into New Zealand so payments from these countries would no longer be deductible. First tier pensions paid by the remaining countries would continue to be deductible.

75 This option provides only a partial solution to the issues. One of the key problems would be the difficulty in determining what are first and second tier pensions. Many organisations such as the OECD, World Bank and International Labour Organisation (ILO) have attempted to create simple and comprehensive classification systems for pension systems. There have been many hurdles in this process since pension systems can differ so enormously across countries and the difference between tiers is often blurred in some countries.

76 This option would provide a solution to the current inequity in the treatment of the United Kingdom second tier pensions where pensions arising from the State second tier scheme are deductible but the pensions arising from contracted-out occupational schemes are not. However, this option is likely to be seen as more inequitable than the current policy where one country pays only a second tier pension overseas, whereas another pays first and second tier pensions overseas. There are also differences in the way that entitlements to pensions from second tier schemes are calculated which would give rise to inequity of treatment.[9] While the rate of NZS would increase for some older people receiving overseas pensions, pensioners groups receiving overseas pensions from countries with significant first tier pensions and no second tier pensions which are currently deducted would see no gain from this option (ie Australia, Netherlands and Ireland).

77 As with option 4, the Special Banking Option would no longer be viable. This is more of issue than under option 4 because the majority of special banking option clients are persons who receive a first tier United Kingdom pension. Loss of the special banking option would seriously inconvenience these clients.

78 Option 5 would require changes to the Social Security Act 1964 and the Social Security Agreements with Australia and the United Kingdom.

[9] As an example, a person can contribute to the civil service scheme in the Netherlands, thereby gaining entitlement to a second tier civil service pension. The Netherlands statutory Old Age Pension scheme gives rise to a first tier pension, the amount of which is then effectively deducted from the second tier civil service entitlement. In effect, the first tier Netherlands pension will be deducted twice - once by the civil service organisation in the Netherlands and then again under New Zealand legislation. This contrasts with pension entitlement in the United Kingdom where there is no reduction in the rate of the second tier pension as a result of entitlement to the first tier pension.

Option 6: Direct deduction free zone

A 'free zone' implemented so that a percentage of overseas pensions would not be deducted, with the remainder being deducted on a dollar-for-dollar basis.

Indicative Fiscal Implications (Direct NZS costs only) ($/m)				
	2006/2007	2007/2008	2008/2009	2009/2010
Free zone of 10%	9	18	18	19
Free zone of 20%	18	36	37	37

79 Under this option the direct deduction policy is maintained, but with a degree of moderation. The free zone could be set at any level. We have illustrated the costs and implications of free zones of 10% and 20% of the rate of overseas pensions for indicative purposes.

80 Option 6 would not reduce the number of clients subject to direct deduction but would provide some relief to all overseas pensioners. The free zone option does not provide a solution to the policy issues associated with direct deduction and would not alleviate any of the current administrative issues. There would be a small increase in incentives to apply for or declare overseas pensions. This option would not be popular as many overseas pensioners believe that they should receive their full NZS entitlement because they have met the residence criteria for NZS. Option 6 is also unlikely to be seen favourably by other governments. As with options 4 and 5, the Special Banking Option would no longer be viable under this option. This would seriously inconvenience the 35,000 clients currently using the option.

81 Option 6 would require changes to the Social Security Act 1964 and the Social Security Agreements with Australia and the United Kingdom.

Option 7: Targeted direct deduction

Direct deduction of overseas pensions remains for all overseas pensioners whose total annual income, including the amount of NZS and overseas pension, is above a predetermined level.

Indicative Fiscal Implications (Direct NZS costs only) ($/m)			
2006/2007	2007/2008	2008/2009	2009/2010
27	56	57	58

82 For the purpose of illustrating the cost of this option we have fixed the income level cut out point as that applicable for entitlement to a Community Services Card (married couple $32,000 a year, single living alone $21,478 a year). The income level cut out point could be set at any level as determined by Ministers. Overseas pensioners whose total income is below the predetermined level would only have a certain percentage of their overseas pension deducted from their NZS entitlement. However, those overseas pensioners, whose combined income was above the predetermined level, would have the entire amount of overseas pension deducted from their NZS entitlement.

83 Option 7 would reduce the number of clients subject to full direct deduction by approximately 34,000.

84 Option 7 would provide a partial solution to the policy and administrative issues associated with direct deduction. The current difficulty in determining the deductibility of particular types of overseas pensions would remain. In addition, the administrative issues would significantly increase as income data, which is not currently collected or stored because NZS is not income tested, would have to be obtained and income assessments would need to be undertaken for all overseas pensioners to determine whether a partial or full deduction would be applied. The option presents equity issues as persons just above the cut-out point would be worse off than people just below it. Pensioners who are subject to a partial deduction would not be able to utilise the Special Banking Option.

85 This option is reasonably easy to understand and may be favourably received by those overseas pensioners whose combined income is below the predetermined amount. However, it is likely that some overseas pensioners, even those who would receive some financial relief from this option, will still be dissatisfied because they feel it is their right to receive the full rate of both NZS and their overseas pension. The option will not be liked by those whose income is above the predetermined level and who will receive no financial relief from this option. There is also the risk that overseas pensioners might alter their financial circumstances in order to avoid the full deduction and that the general public will regard this option as setting a precedent for other forms of income testing NZS.

86 Option 7 would require amendments to the Social Security Act 1964 and the Social Security Agreements with Australia and the United Kingdom.

Option 8: Modified status quo

The direct deduction policy would be retained substantially in its current form but a range of amendments to the policy would be made to improve its operation.

Indicative Fiscal Implications (Direct NZS costs only) ($/m)			
2006/2007	2007/2008	2008/2009	2009/2010
5	5	5	5

87 There are several proposals within this option which would solve some minor issues arising from the direct deduction policy. Most of the proposals in this option would have a small fiscal or administrative impact either because they affect a small number of overseas pensioners or because they are merely clarifying existing policy or reflecting current administrative practice. Because these types of proposals will offer only a limited amount of relief to a small number of people, they are unlikely to gain much public acceptance.

88 Some of the proposals within this option that will make the policy and administration issues associated with direct deduction more difficult. Nevertheless, attempting to address these issues is necessary due to decisions made by the Social Security Appeal Authority. One such proposal, which would exempt that part of an overseas pension based on voluntary contributions to an overseas social security scheme from the direct deduction policy, will be difficult to administer as it is not always possible to identify the voluntary component of an overseas pension. As an example, the Department for Work and Pensions in the United

Kingdom have advised that they cannot identify any potential voluntary component as this information is neither collected nor stored anywhere in their system.

89 This proposal will be popular with a small number of affected overseas pensioners but will have no impact for the rest of the overseas pensioner population. It is unlikely that this proposal will alleviate any of the unpopularity of the direct deduction policy.

90 This option would be required should you selection one of the options from 3–7.

91 Option 8 would require amendments to the Social Security Act 1964 and the Social Security Agreements with Australia and the United Kingdom.

Option 9: Status quo

The direct deduction policy is retained in its current form.

Indicative Fiscal Implications (Direct NZS costs only) ($/m)			
2006/2007	2007/2008	2008/2009	2009/2010
Nil	Nil	Nil	Nil

92 The current policy and administrative issues as set out on pages 15 and 16 would remain. No legislative changes would be required.

Options for payment of NZS overseas

93 The current provisions for payment of NZS overseas were developed in the context of the residence-based nature of the New Zealand social security system and more limited global movement of people. The options presented move away from the principle of NZS for New Zealand residents only and recognise the contribution made to New Zealand of persons who have lived and worked in the country for some period of time but may not necessarily retire here.

94 Any increase in the generosity of payment overseas provisions will involve some deadweight loss, because many people who receive a higher level of payment would have left New Zealand anyway under the current provisions. Nevertheless, to the extent that more generous provisions encourage more people to retire overseas, health and other resources will be freed up for each person who leaves New Zealand. The average amount spent on health costs for individuals over 65 years is approximately $7,500 per year which is approximately half of the amount spent on NZS.

95 We have identified six options for improving payment of NZS overseas. These options principally concern amendments to the general payment overseas provisions. Our options have maintained the relative generosity of the Special Portability Arrangement. In addition, where an option has provisions that are superior to those in the Special Portability Arrangement, the provisions are also applied to the Arrangement. The Special Portability Arrangement provides 50% of the rate of NZS after ten years residence, rising to 100% after 20 years residence.

96 All options allow a person to apply from overseas provided they left New Zealand after the new provisions become law. Allowing persons to apply from a country with which New Zealand does not have a social security agreement presents administrative difficulties. Where a person applies under an agreement, the social security authority in the Agreement country will verify that person's identity, bank account details and other critical data of the applicant which allows entitlement to NZS to be determined. Such administrative assistance will not be available for clients who are paid under general portability provisions. Officials will need to identify alterative methods for verifying relevant client details where applicants are resident overseas.

Option 10: Payment of full rate of NZS overseas

The full rate of NZS is paid overseas once a person fulfils the minimum residence requirements. Applications would be allowed from overseas residents who leave New Zealand after the date the legislation comes into force.

Indicative Fiscal Implications (Direct NZS costs only) ($/m)				
2006/2007	2007/2008	2008/2009	2009/2010	2010/2011
12	27	29	31	33

97 Option 10 would provide the majority of superannuitants with an adequate income and would have a small a positive effect on international labour mobility. Option 10 would also have the advantage of creating a uniform portability system and would be the easiest to understand and administer. This option would facilitate payment of United States pensions to New Zealanders who have left the United States.[10]

98 A disadvantage of this option is that it would be inconsistent with social security agreements and the Special Portability Arrangement both of which would need to be amended to provide the more generous level of payment with a consequent increase in fiscal cost (these additional costs are reflected in the indicative fiscal implications table). The Special Portability Arrangement would also need to be modified to allow applications from persons resident overseas.

99 An additional disadvantage is that the relative generosity of this option could encourage migrants to exploit the New Zealand social security system.

100 This option would require amendments to the New Zealand Superannuation and Retirement Income Act 2001 and all social security agreements.

Option 11: Full portability with increased residence requirement

The full rate of NZS is paid overseas once a person fulfils the minimum residence requirements. The minimum residence requirement is increased to 15 or 20 years. Applications are allowable from overseas residents who leave New Zealand after the date the legislation comes into force.

[10] The United States does not currently pay Social Security benefits to New Zealanders who reside outside of the US. This is because US law provides that US Social Security benefits can only be paid to citizens of countries that pay full entitlements to US citizens who leave those countries.

Indicative Fiscal Implications (Direct NZS costs only) ($/m)				
2006/2007	2007/2008	2008/2009	2009/2010	2010/2011
12	27	29	31	33

101 This option is the same as option 10 but with the addition of accompanying amendments to the minimum residence requirements to qualify for NZS. We propose two options for amending the residence requirements:

- increase minimum residence required to 15 years after the age of 20 commencing on 1 January 2012 (this date provides lead-in time); or
- increase minimum residence required to 20 years after the age of 20, commencing on 1 January 2017 (this date provides lead-in time).

102 Fiscal implications are the same as option 10 in the forecast period, however the proposed residence changes could reduce the cost of this option to zero by 2017.

103 This option would be likely to address the concerns of most clients and is reasonably easy to understand. Option 11 would require all social security agreements to be amended to allow a more generous payment level, therefore expenditure under social security agreements would increase (this has been taken into account in the costs shown in the indicative fiscal implications table. However, an advantage of amending all the agreements is that a uniform portability system would be created. Option 11 would provide the majority of superannuitants with an adequate income and would have small a positive effect on international labour mobility. However, the relative generosity of this option could encourage migrants to exploit the New Zealand social security system.

104 Option 11 would require amendments to the New Zealand Superannuation and Retirement Income Act 2001 and all social security agreements.

Option 12: Extend the Special Portability Arrangement formula to portable payments

The Special Portability Arrangement formula is extended to all clients paid NZS overseas. Applications from overseas residents would be allowed, provided the applicant left New Zealand after the date the legislation comes into force.

Indicative Fiscal Implications (Direct NZS costs only) ($/m)				
2006/2007	2007/2008	2008/2009	2009/2010	2010/2011
7	16	18	19	20

105 Under the Special Portability Arrangement, persons retiring to Pacific Island countries are able to receive up to 100% of NZS. Payment rates are based on a formula which starts at 50% after ten years residence in New Zealand, rising at 5% a year to reach 100% after 20 years residence in New Zealand.

106 Option 12 is likely to be acceptable to clients. A key benefit is that it would create a uniform portability system whereby all persons receiving NZS overseas would receive the same

rate. This is because the special portability formula is more generous than both the general portability rate and the formula in social security agreements, therefore the rates of both these provisions would need to be increased. However, this means that expenditure under social security agreements would need to be increased.

107 A disadvantage of option 12 is that administering applications from overseas residents would be difficult. Another disadvantage is that the relative generosity of this option could encourage migrants to exploit the New Zealand social security system.

108 This option would require amendments to the New Zealand Superannuation and Retirement Income Act 2001 and all social security agreements.

Option 13: Proportional portability

Superannuitants receive 1/45 of the full rate of NZS for every year of New Zealand residence after the age of 20 (this is the payment formula in New Zealand's social security agreements). A person would need at least 10 years of New Zealand residence to receive an NZS payment. Applications from overseas residents would be allowed provided the applicant left New Zealand after the date the legislation comes into force.

Indicative Fiscal Implications (Direct NZS costs only) ($/m)				
2006/2007	2007/2008	2008/2009	2009/2010	2010/2011
13	41	44	47	50

109 The current general portability provisions provide a flat rate 50% payment. This means that implementing a 1/45 formula would reduce the level of payment available to new applicants with between 10-22.5 years residence. Therefore we propose that the minimum payment under the formula should be 50%. This would mean that all applicants for general portability with 10 to 22.5 years residence would receive 50%, thereafter they would receive an additional 1/45 of NZS for each year of residence.

110 In order to ensure that persons receiving portable pensions under the Special Portability Arrangement would not be disadvantaged, the provision allowing applications from overseas residents would also be extended to persons who leave to reside in a Pacific Island country after the law change. Special Portability clients who apply from Pacific Island countries after the law change takes effect would receive payment under the Special Portability Arrangement formula.

111 A major disadvantage of option 13 is that NZS residence rules would need to be amended to allow it to operate. Current NZS residence rules are that applicants must have 10 years residence and presence in New Zealand since attaining age 20, and five years residence and presence in New Zealand after the age of 50. The five years over 50 rule is not consistent with a proportional formula (and the rule is therefore modified under New Zealand's social security agreements). Removal of the five years over 50 rule would cost $12 million in 2006/07, rising to $47 million in 2010/11 (these costs are reflected in the indicative fiscal implications table). This option would also set up an inconsistent system because the Special Portability formula would remain more generous if it is left unchanged.

112 This option would require amendments to the New Zealand Superannuation and Retirement Income Act 2001.

Option 14: Status quo for portability arrangements and pursue new social security agreements

The current payment overseas provisions would be retained (a payment rate of 50% and applicants must apply while resident in New Zealand). The social security agreements network would be enlarged to cover a greater number of significant migrant groups.

Indicative Fiscal Implications (Direct NZS costs only) ($/m)				
2006/2007	2007/2008	2008/2009	2009/2010	2010/2011
0.75	0.75	0.75	0.75	0.75

113 A programme to increase the social security agreements network would to some extent provide acceptable portability provisions to affected clients, but only to those people who wish to migrate to a country with which it is feasible for New Zealand to conclude a social security agreement. It is doubtful that the government could conclude agreements with some key migrant countries such as China and India as both have relatively undeveloped social security systems.

114 Implementation of a each new social security agreement would cost in the region of $0.75m. There may be small offsetting savings as agreements generally facilitate additional foreign pension payments to New Zealand residents.

115 Option 14 does not require any legislative changes.

Option 15: Status quo and no new social security agreements

The current payment overseas provisions would be retained (a payment rate of 50% and applicants must apply while resident in New Zealand).

Indicative Fiscal Implications (Direct NZS costs only) ($/m)				
2006/2007	2007/2008	2008/2009	2009/2010	2010/2011
Nil	Nil	Nil	Nil	Nil

116 Option 15 would result in some older New Zealanders continuing to find it financially difficult to retire in the country of their choice. Closing off the social security agreements network would end the government's ability to modify the portability rules on a case-by-case basis for countries that are willing to enter into an agreement. This would have negative consequences for New Zealand's international relationships and labour mobility.

117 This option would not require any legislative changes.

Packaging the options

118 In reviewing the direct deduction and payment overseas rules, Ministers are being asked to decide whether to enhance the generosity of NZS to individuals with overseas pensions, or who want to live overseas. To illustrate this point we have packaged the options into four broad approaches as shown in Table 9 below.

Table 9: Broad packages of options

Approach	Details	Fiscal cost	Impacts (compared to status quo)
Fully international approach	• No direct deduction policy (options 1 and 2) • NZS fully portable to other countries (options 10 and 11)	Maximum cost of approximately $207m (if options 1 and 10 were chosen)	Expensive if residence is not amended, good for labour market mobility, gives superannuitants more choice, good for international relations, highly susceptible to benefit shopping
Partial international approach	• Reduction in extent of direct deduction (options 3-7) • Enhance general portability rules (options 12 and 13)	Maximum cost of approximately $205m (if options 4 and 12 were chosen)	Expensive (but less so than fully international approach), some modest labour mobility gains, gives superannuitants more choice, modest gains for international relations
Modified status quo	• Clarify rules for direct deduction (option 8) • Enhance portability on a country-by-country basis through social security agreements (option 14)	Approximately $6m a year	Small cost, direct deduction easier to administer, gives superannuitants covered by social security agreements more choice
No change	• Options 9 and option 15	Nil	None

Next steps

119 We recommend that you meet with officials and identify a preferred package of direct deduction and payment overseas options. Annex I illustrates all the combinations of options that are feasible.

120 Once you have agreed on preferred options, we will prepare a Cabinet paper for submission to Cabinet Social Development Committee in February 2006. We recommend that the

paper seek decisions in principle – as the proposed changes will need financial approval and legislation, and might usefully be the subject of consultation with affected groups.

Consultation

121 The Ministry of Foreign Affairs and Trade, Veteran's Affairs New Zealand, the Ministry of Pacific Island Affairs, the Ministry of Women's Affairs, the Department of Prime Minister and Cabinet, the Department of Labour, and the Office of the Retirement Commissioner have been consulted. The Ministry of Foreign Affairs and Trade has advised that it has not had time to review the paper.

File Reference : SO/RE/4/1/2/05/100

Annex I: Compatibility of portability and direct deduction options

	1. Remove direct deduction	2. Remove deduction and amend residence	3.Proportional-isation for overseas pensioners	4. Phased direct deduction[11]	5. 1st tier direct deducted only	6. Free zone	7.Targeted deduction	8. Modified status quo	9. Status quo
10. Full portability	✓	✓	☒	☒	✓	✓	✓	✓	✓
11. Full portability and amend residence	✓	✓	☒	☒	✓	✓	✓	✓	✓
12. SPP formula	✓	☒	☒	☒	✓	✓	✓	✓	✓
13. Proport-ional portability	✓	☒	✓	☒	✓	✓	✓	✓	✓
14. Status quo and new agreements	✓	✓	☒	☒	✓	✓	✓	✓	✓
15. Status quo	✓	☒	☒	☒	✓	✓	✓	✓	✓

✓ denotes options are compatible

☒ denotes options are not compatible

[11] It would be technically possible to operate this option alongside all portability options except option 13, but the policies would not be a good fit and would send mixed messages to superannuitants about their entitlements. If you choose a phased direct deduction system we suggest that you use a portability system that matches the direct deduction system ie this could be 50% portability after 10-19 years residence, 75% portability after 20–29 years residence, and 100% portability after 30+ years residence.

Annex II: Countries paying most pensions into New Zealand by total deduction, number of people, and type of pensions deducted/not deducted

Country	Total NZS deducted/yr	No of people	Type of pension deducted	Pensions not deducted
United Kingdom	$143.018m	42,796	- Retirement Pension: a contributory, flat rate, pay-as-you-go pension - State Second Pension: a contributory earnings related pay-as-you-go pension	- 'Contracted-out' pensions (into an occupational or personal pension) - Pension Credit: a means tested flat rate pension (not exported)
Netherlands	$14.340m	3,754	- AOW: a universal, flat rate, pay-as-you-go, state pension	- Means tested, flat rate pay-as-you-go, state pension (not exported) - Compulsory/ voluntary tax incentivised occupational pensions (not nationally compulsory but mandatory in some industries)
Australia	$8.099m	2,832	- Age Pension: a means tested, flat rate, pay-as-you-go state pension	Superannuation Guarantee – a compulsory occupational tax incentivised pension
United States	$2.029m	258	- Social Security: a contributory, earnings related, pay-as-you-go, state pension	Means-tested, flat rate, pay-as-you-go, state pension (not exported)
Canada	$1.967m	500	- Old-age security: a universal, flat rate, pay-as-you-go, state pension - Canada Pension Plan: a contributory, earnings related, pay-as-you-go, state pension	Means tested, flat rate, pay-as-you-go, state pension (not exported)
Ireland	$0.773m	168	- Old-age Contributory Pension and Retirement Pension: contributory, pay-as-you-go, flat rate, state pensions	Old–age non-contributory pension: means tested, flat rate, pay-as-you-go state pension (not exported)
Germany	$0.653m	147	Contributory, earnings related, pay-as-you-go, state pension (there is no minimum pension)	Voluntary occupational/private tax incentivised savings

Country	Total NZS deducted/yr	No of people	Type of pension deducted	Pensions not deducted
Jersey & Guernsey	$0.547m	151	Contributory, pay-as-you-go, flat rate, state pensions	Means tested, flat rate, pay-as-you-go, benefit (not exported)
Switzerland	$0.507m	135	Base pension: contributory, pension formula has flat rate and earnings related component, pay-as-you-go, state pension	Mandatory occupational pensions – earnings related
Fiji	$0.476m	87	- Provident Fund: lump sums or optional pensions	

Annex III: Possible modifications to direct deduction policy

1. Amend the wording of S70 and specify treatment of each countries' pensions in regulations

This change would amend the wording of Section 70 so that it is written in "plain English" and would set out the treatment of each country's pensions in regulations.

The wording of section 70 is set out in paragraph 35 of this report. The wording has not been significantly altered since its introduction in 1938. Re-wording the section would help officials to administer the policy and would assist the public in understanding how the policy operates and what pensions government intends to deduct from New Zealand entitlements.

Determination of deductible and non-deductible foreign pensions is somewhat haphazard as decision makers have only the obscure wording in section 70 of the Social Security Act 1964 as a guide. This means that decisions are often not transparent and are frequently contested by clients. We consider that it would be worthwhile exploring the possibility of developing regulations which make the process of determination simpler to administer and transparent for clients.

2. Discontinue deduction of excess amount of overseas pension from spouse entitlement

This modification would involve amending section 70 so that where one partner in a relationship has an overseas pension which exceeds the half married rate of NZS, the amount of overseas pension over and above that rate would no longer be deducted from the other partner's NZS entitlement.

This provision is extremely unpopular and has been the subject of a number of Social Security Appeal Authority hearings. The deduction of the excess amount of overseas pension of one spouse from the entitlement of their partner is seen to be inconsistent with the belief amongst superannuitants that they qualify for NZS entitlement in their own right, rather than as a married couple.

Indicative costings suggest that this amendment would have a fiscal cost of around $2.7m a year.

3. Deduction of overseas pensions paid to a spouse not in receipt of NZS are deducted from their qualifying spouse's NZS entitlement

This modification would ensure that overseas pensions paid to a spouse not in receipt of NZS would not be deducted from the NZS entitlement of their spouse.

The direct deduction policy requires applicants and recipients of benefits, their spouses and their dependants to test their entitlement to overseas pensions. Where they are entitled to an overseas pension, Ministry of Social Development is required to deduct the value of that pension from any entitlement to NZS that they or their spouse or dependants receive. This requirement applies to the deduction of overseas pensions from a superannuitant, even though their non-qualifying spouse is not receiving NZS, but is receiving an overseas pension.

In this instance, section 70 views a married couple as a unit and this, like the deduction of spouse excess, is seen to be inconsistent with the belief amongst superannuitants that they qualify for NZS in their own right and not as a couple.

4. Ensure deduction of appropriate government occupational pensions

This change would ensure that government occupational pensions which are paid as an alternative to state pensions paid to the general population are captured by the direct deduction policy.

In 2002, the definition of the government occupational pension in legislation was amended in order that overseas pensions paid to former government employees that are paid as an alternative to similar pensions paid to the general population would be captured by the provisions of section 70. In a number of countries, civil servants and defence force staff have pension schemes separate to the social security schemes that apply to the rest of the population. Nevertheless, these pension schemes form part of the country's social security system.

The amendment did not fully cover all such alternative pensions and the definition needs to be amended so that all such pensions are captured.

5. Amend the regulations concerning bank fees and exchange rates

This modification involves reviewing the Social Security (Overseas Pension Deduction) Regulations 1996 which support section 70, to bring them up to date with the current operating environment.

The Social Security (Overseas Pension Deduction) Regulations 1996 contain the provisions specifying the type of exchange rates to be used when converting an overseas pension from source currency into New Zealand dollars and how any bank fees incurred in transmitting the pension will be treated. The type of exchange rate specified in these Regulations does not fit with current administrative practice and the regulations need to be amended so that this is the case. A similar amendment is required for the treatment of bank fees.

6. Special Banking Option (note: this is only relevant if the direct deduction policy is retained)

This modification would ensure that only one partner of a couple can join the Special Banking Option (SBO) if this is what the couple wish.

Currently, it is mandatory that, where one partner of a couple chooses to receive their overseas pension through the SBO, the other partner must also receive their overseas pension through the SBO. The requirement was included so that, in instances where the one spouse had an overseas pension entitlement that was paid at a rate higher than NZS and the other spouse wished to access the SBO, the provisions of section 70 were replicated in the Special Bank Option. In other words, to ensure that the joint income of a couple with overseas pension entitlement was not more than the joint income of a couple who had no overseas pension entitlements.

Should the requirement to deduct the excess overseas pension amount of one spouse from their partner's New Zealand entitlement be removed from section 70, the requirement for both partners to choose the SBO would no longer be necessary.

7. Deduction of the voluntary component of overseas pensions

This change would ensure that overseas pensions which are built up by voluntary rather than compulsory contributions to a pension scheme will not be covered by the direct deduction policy.

Many countries allow people to make voluntary contributions to their state pension schemes, for example where a person has left the country but wishes to continue contributing to ensure the maximum level of pension on retirement. Currently the direct deduction policy covers pensions built up by both compulsory and voluntary contributions.

Determination of the voluntary component of an overseas pension is not always possible. For example, the Department for Work and Pensions in the United Kingdom (DWP) have previously advised that they cannot easily obtain detailed information of contributions paid voluntarily for periods prior to 1975, when the recording system was computerised. Prior to that contribution records were maintained manually on individual ledgers that would now require separate scrutiny on a case by case basis in order for the contributions to be broken down by category and date. Seventy five percent of the overseas pensions paid in New Zealand are paid by United Kingdom, consequently 42,500 UK pensioners would not be able access this concession. While the vast majority of UK pensioners have not made voluntary contributions, those that have will find it extremely difficult, if not impossible, to obtain information from the UK on their voluntary contributions.