Regulatory Impact Statement

Transforming student loans — excess repayment bonus for student loans and other issues

Agency Disclosure Statement

1. This Regulatory Impact Statement has been prepared by the Policy Advice Division of Inland Revenue and considers two student loan areas: the excess repayment bonus and operational issues.

Excess repayment bonus

2. With pay-period based student loan repayments, there is an issue of how to ensure that borrowers who make voluntary repayments on their student loans continue to receive the 10% excess repayment bonus. Options focus on accurately targeting the bonus to those who make a conscious voluntary payment (currently, overpayments caused by the PAYE system are also eligible for the bonus).

Operational issues

3. Several operational issues arose during the Student Loan Scheme Act rewrite project, including:

- At what rate should the late payment interest rate be set? (Cabinet agreed that penalty rates should be lowered (CAB Min (09)33/12 refers).)
- In what circumstances should shortfall and criminal penalties apply?
- Should there be a threshold below which late payment interest is not charged?

4. We have identified and considered a range of options that are set out in the attached Statement. Any significant gaps, assumptions, dependencies, constraints or uncertainties are set out in this Disclosure Statement.

5. Key dependencies of these student loan areas include the policies:

- Pay-period based student loan repayments (Cabinet has previously agreed that the amount deducted from a borrower's salary should be their full and final repayment obligation with no annual square-up, for those borrowers whose income is largely from salary and wages (CAB Min (09) 33/12 refers)); and
- The 10% excess repayment bonus (as enacted, borrowers making excess repayments receive a 10% repayment bonus).

6. Although we consulted with borrowers on the original student loan proposals, due to time constraints, we have consulted only with a number of Government departments in the development of these latest proposals:

- We consulted with the Ministry of Education and the Treasury;

- We have incorporated feedback from the Ministry of Social Development on the proposals; and
- We have agreed with Te Puni Kōkiri that strong coercive measures (such as criminal penalties) should be used only in very serious cases of non-compliance.

7. We believe that the proposals set out in the Regulatory Impact Statement are robust and reasonable, and are consistent with the Government Statement on Regulation.

Craig Latham
Group Manager, Policy Advice
Inland Revenue
4 June 2010

Status quo and problem definition

Background

8. Cabinet has agreed to several major proposals to reform the administration of student loan repayments (CAB Min (09) 33/12 refers). The majority of the proposals centre on a change from an annual system of calculating student loan repayments for borrowers, whose income is largely from salary and wages, to a pay-period based system.

9. Under the pay-period based system, what is deducted from a borrower's salary each pay-period will be their full and final repayment obligation. This will mean that the current system of an end-of-year "square-up" will cease. This will significantly reduce compliance costs for borrowers, and will allow Inland Revenue to redirect administrative resources to create a more efficient repayment system. It should also accord better with a borrower's ability to pay back their loan. The proposals for reform are being incorporated into a rewrite of the Student Loan Scheme Act, which is proposed to be introduced into Parliament in July 2010.

Excess repayment bonus

10. At the same time that Cabinet agreed to these policy proposals, the Student Loan Scheme (Repayment Bonus) Amendment Act 2009 was approaching its final reading. This Act carried into effect a policy whereby excess repayments of $500 or more in an income year, over and above the borrower's repayment obligation, attracted a bonus of 10% of the excess repayment.

11. The aim of the excess repayment bonus, as originally envisaged, was to encourage borrowers to make a certain level of voluntary payments each year, in order to repay their student loans faster. However, in the interests of administrative simplicity, the bonus was also extended to payments other than voluntary payments, such as inadvertent over-deductions made from salary and wages. This was necessary to make the rules administratively practical and fair to borrowers.

12. Cabinet noted in September 2009 that officials were "working through options to ensure borrowers can still receive the voluntary repayment bonus on voluntary repayments" (CAB Min (09) 33/12 refers). This Statement and the accompanying report are the outcomes of that direction.

13. The problem to be addressed is how to apply the bonus in the pay-period system.

Other operational issues

14. This Statement also covers a number of other, minor operational issues that have come to light in the preparation of the legislation.

15. <u>Late payment interest</u> – Cabinet has previously agreed to reduce the penalty imposed on borrowers who do not pay on time (CAB (09) 33/12). Currently, the rate of penalty is 1.5% per month compounding, which works out to almost 20% per annum. The problem to be resolved is to find an appropriate rate of interest that

provides an incentive for borrowers to meet their obligations on time, without being unduly harsh.

16. Imposition of shortfall and criminal penalties – Officials have previously reported to Cabinet that shortfall and criminal penalties would be imposed only in situations where a non-compliant borrower has been issued with a special assessment. The problem to be resolved is whether the issuing of a special assessment should be the trigger for these penalties, or if they should be applied to situations of serious non-compliance generally.

17. Late payment interest threshold on interim repayments – Borrowers with significant extra income derived from a source that is separate to salary and wages are required to make interim repayments during the year. This is similar in nature to provisional tax payments. Late payment interest is typically charged on short-paid amounts. The problem to be solved is whether to introduce a threshold below which this interest will not be charged, similar to that which applies to provisional tax payments.

18. Late payment interest on small amounts outstanding – Currently, the Commissioner of Inland Revenue is not required to impose any late payment penalty if the penalty amount is $5 or less. The problem to be solved is whether to increase this amount to an appropriate level, given the compliance and administrative costs of collecting very small amounts of interest.

Excess repayment bonus

Objectives

19. The outcome that the Government is seeking is for the bonus to be amalgamated into the pay-period system in a way that is consistent with the underlying objectives of both policies, and yet is also administratively feasible and has low compliance costs. There are no risk-related objectives.

20. The basis for undertaking the analysis was the undertaking by the Minister of Revenue to report back to Cabinet on the options regarding merging these two policies (CAB Min (09) 33/12 refers).

21. The only constraint on the analysis was that time was limited, in order that the policy be incorporated into the Student Loan Scheme Bill, which will be introduced into Parliament in July 2010. The time constraint was not significant, as the requirement to meet the two policy objectives, of full and final student loans and the voluntary bonus, limited the number of possible policy options.

22. The time constraint did, however, affect the level of consultation. As there are over half a million student loan borrowers, consultation with borrowers is major work, and is generally reserved for major policy changes. Although consultation with borrowers was undertaken for the major policy reforms, it was not undertaken for the changes in this Statement, as they are relatively minor. However, consultation was undertaken with a limited number of Government departments and agencies.

Regulatory impact analysis

Non-regulatory options

23. Non-regulatory options are not capable of achieving the above objectives. This is because taxation (or in this case, the repayment of student loans) must have a legislative authority.

Alternative regulatory options

24. There was one other regulatory measure that was considered and rejected. This was to retain the annual system of "squaring up" at the end of the income year. The initial decision to extend the bonus to involuntary over-deductions that were detected as part of the annual square-up process was made in the interests of administrative simplicity. It differed significantly from the Government's intent to reward borrowers with a bonus when they made voluntary extra payments towards their loan.

25. This option was rejected, as it is in conflict with the new policy of pay-period based student loan repayments. Retaining the annual square-up for salary and wage earners would undermine the new policy.

Preferred regulatory option

26. The preferred regulatory option is to exclude involuntary over-deductions caused by the PAYE system from the 10% excess repayment bonus. This is consistent with the Government's original intent to reward intentional overpayments with a 10% bonus, and is also consistent with the policy to remove the annual system in favour of a pay-period based system.

27. Significant errors that result in overpayments and underpayments of student loan repayments will continue to be detected and corrected. In the case of an overpayment, if a borrower (first) chooses not to have the overpayment refunded, and (secondly) meets the $500 threshold, the excess repayment bonus will apply. However, small overpayments will not be squared-up at the end of the year, and therefore will not be counted towards the excess repayment bonus.

28. The impact of this decision is estimated to affect 6,500 (just over 1%) out of 530,000 student loan borrowers. These borrowers represent the number of borrowers who may incur over-deductions that would not otherwise be detected or prevented in some way. This group of borrowers will not receive the bonus of 10% of the excess payment, as the excess is caused by involuntary over-deductions.

Conclusions and recommendations

29. The recommended option is to focus the bonus on voluntary payments made through bank accounts, employers and directly to Inland Revenue, and to exclude involuntary over-deductions caused by the PAYE system from the 10% excess repayment bonus. This option will reduce the scope of the bonus and accords more closely with Government policy. It is proposed that this option would be

implemented alongside improved student loan deduction monitoring, which will aim to minimise the amount and extent of over-deductions. This option is the most consistent with the policy objectives.

Other operational issues

Objectives

30. These issues are all relatively minor and operational in nature. The objectives for solving these issues are to balance the administration and compliance costs with other issues, such as fairness to borrowers, and keeping the student loan rules simple to apply and easy to understand. These issues also had the same time constraint as the excess repayment bonus, again in order to incorporate them into the Student Loan Scheme Bill, which is planned for introduction in July 2010. As all of these issues are minor, the time constraint was not significant. Consultation with a limited number of Government departments and agencies was conducted contemporaneously with the excess repayment bonus issue.

Regulatory impact analysis

<u>Non-regulatory options</u>

31. As tax is created by legislation, the non-regulatory options available for these issues are limited, with the only alternative option being to retain the status quo and not change the law. However, as Inland Revenue is currently preparing a rewrite of the Student Loan Scheme Act, these issues can be incorporated into the new Act. This is also in line with the general aim of the rewrite project, which is to simplify student loan legislation and make it easier to apply and understand.

32. For the late payment interest issue, the regulatory option to change the existing penalties has already been agreed to by Cabinet. This is merely a further refinement of that decision.

<u>Analysis</u>

33. The following analysis covers the alternative regulatory options, the preferred regulatory options, and the final recommendations and conclusions, for each of the individual operational issues.

Late payment interest

34. The alternative regulatory option was to leave the late payment interest rates at the rates agreed to by Cabinet. This was rejected in favour of slightly different rates, which will provide better and more appropriate incentives to borrowers.

35. The preferred option is to make the late payment interest, for the non-payment of repayment obligations, the sum of the base interest rate plus a penalty of 4%. Given the current base interest rate of 6.6%, this would make the late payment interest 10.6% for both New Zealand and overseas-based borrowers who fail to pay on time.

36. In addition, in order to encourage borrowers to contact Inland Revenue and enter into an instalment arrangement, the penalty rate of 4% will be halved once such an arrangement commences. This would make the penalty rate for borrowers in instalment arrangements 8.6% (the base interest of 6.6% plus the reduced 2% penalty).

37. This is the preferred option, as it manages to strike a balance between lowering the current late payment penalties, which are currently close to 20% per annum, while still providing an incentive for borrowers to meet their repayment obligations.

38. This proposal is in line with Cabinet's intent to lower student loan penalties, but is targeted more appropriately. There are no additional risks to this proposal, beyond the initial risks involved with Cabinet's original decision to lower penalty rates.

Imposition of shortfall and criminal penalties

39. The alternative regulatory option was to retain the qualification of special assessments. This was rejected, as serious non-compliance should be the trigger for these penalties, instead of the administrative functions of Inland Revenue.

40. The preferred regulatory option is to apply these penalties in cases of serious non-compliance, regardless of whether a special assessment has been issued by Inland Revenue.

Late payment interest threshold on interim repayments

41. The alternative regulatory option was to apply late payment interest on any short-paid interim instalment. This was rejected as it was deemed to be unnecessary. The rules for calculating interim student loan repayments via the standard method will be very prescriptive, and the risk of taxpayers manipulating their repayments is low, therefore a penalty on short-paid amounts is not needed.

42. The preferred regulatory option is to introduce a threshold of $16,000, below which late payment interest will not be charged on short-paid interim instalments. The threshold will only apply to interim payers who use the standard method of calculation. This threshold will bring the treatment of interim instalments into line with that of provisional tax payments. It also reflects the reduced risk of manipulation of payments for the majority of taxpayers who use the standard method.

43. The threshold of $16,000 is preferred, as the current threshold for provisional tax is $50,000, which equates to a taxable income of about $180,000. Given a student loan repayment threshold of approximately $20,000, this would work out to $160,000 of income subject to student loan repayments, which are deducted at a rate of 10 cents per dollar.

Late payment interest on small amounts outstanding

44. The alternative regulatory option was to retain the current threshold of $5. Currently, if a penalty amount is below this, late payment interest will not be charged. This was rejected as it is too low a threshold. Imposing late payment interest on small amounts increases both compliance and administration costs, while collecting only small amounts.

45. The preferred regulatory option is to introduce a threshold of $500, below which late payment interest will not be charged. This is a more appropriate threshold than the present $5 of penalty interest, since, as noted, imposing late payment interest on very small amounts increases compliance and administration costs. The proposal is not to charge late payment interest on amounts outstanding of $500 or less, and for the outstanding amount to be added to the loan balance. Although this may have the risk that it does not provide an incentive for borrowers to make their full repayment, this risk is small, and is outweighed by gains in compliance and administrative costs.

Consultation

46. The following agencies have been consulted on the preferred options:

1. The Treasury was consulted and assisted in the development of these proposals.

2. The Ministry of Education did not consider that the policy required comment, beyond amendments to clarify the proposals.

3. The Ministry of Social Development was consulted on the proposals and provided feedback to clarify the proposals, which was incorporated into the final report.

4. Te Puni Kōkiri was provided with a copy of the report and did not have comment on the amendments proposed to the repayment bonus. However, Te Puni Kōkiri did note its agreement with the proposal not to charge late payment interest on amounts below $500. Te Puni Kōkiri also stated that it considered late payment penalties to be strong coercive measures in themselves, and that criminal penalties should be reserved for only very serious circumstances of non-compliance.

Implementation

47. The recommended options would be incorporated into the Student Loan Scheme Bill, which will be introduced in July 2010. This Bill is a rewrite of the Student Loan Scheme Act 1992. The recommended options would all apply from 1 April 2012, which is also when the new system of administering student loan repayments will take effect (pending Cabinet's agreement to the deferral of the application date of the Student Loan Scheme Bill). These options do not give rise to any need for transitional provisions.

48. Implementation risks will be managed primarily by the new system of administering repayments, which will monitor repayments closely and identify large errors. The recommended proposal for the excess repayment bonus will significantly reduce compliance costs, as it will not require borrowers to have to undertake the year's end "square-up" process. As this proposal will also coincide with the application of the new student loan policies, it will not interact with existing legislation.

49. Regarding late payment interest, there are no additional risks to the revised rates, beyond those identified at the time of Cabinet's original decision to lower penalties. There are no associated risks regarding the proposal to impose shortfall and criminal penalties in cases of serious non-compliance. The proposals not to apply late payment interest on amounts less than $500 generally, carry the risk of not providing an incentive for borrowers to pay the full, correct amount of their obligation. However, the opportunity for the threshold on interim repayments to be abused is very minor, as it will only apply to borrowers who use the standard method of calculation,

which is very prescriptive. The risk regarding the $500 threshold for late payment interest generally is small, and is outweighed by the gains in compliance and administration costs.

Monitoring, evaluation and review

50. The monitoring, evaluation and review of these proposals will take place under the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995. The final step in the process is the implementation and review stage, which involves a post-implementation review of legislation, and the identification of remedial issues. Opportunities for external consultation are also built into this stage. In practice, this will mean that these proposals, along with the rewrite of the Student Loan Scheme Act and the other student loan policy reforms generally, will be reviewed at a time after it has had time to work. Any changes that are needed to give the legislation its intended effect will be added to the Tax Policy Work Programme, and proposals will go through the GTPP.