Regulatory Impact Statement – Transforming student loan administration

EXECUTIVE SUMMARY

1. Changes are proposed to Inland Revenue's administration of the student loan scheme, to improve the overall integrity of the scheme, and reduce compliance costs and administrative pressures.

2. The social policy programmes administered by Inland Revenue have, over recent years, greatly increased Inland Revenue's customer base: for example, there were 58,000 new student loan borrowers in the 2007–08 tax year. The current student loan system is complex, unwieldy, expensive to maintain, and has limited ability to accommodate further changes. Each policy change made has exposed underlying system issues, which require corrective action and have the potential to destabilise both the student loan and core tax collection systems. The student loan scheme represents a significant asset to the Government, which needs to be managed effectively to protect the value of this asset, and better manage the cost of the student loan scheme to the Crown.

3. The policy changes proposed include a move towards treating different forms of income differently, both in terms of repayment obligations and administrative process. This proposal requires an emphasis on "close enough is good enough" over accuracy.

4. The proposed reforms aim to improve the rate and timeliness of repayments, improve Inland Revenue's ability to handle growth in customer numbers, and enable the department to deliver new Government initiatives more efficiently.

5. The proposals will have an impact on borrowers. Most borrowers will benefit from the changes, but some will be disadvantaged. Proposals to reduce borrower debt, such as applying overpaid repayment deductions to the loan balance, will disadvantage some borrowers. Although this may be seen as having a negative impact on borrowers in the short term, it will ultimately benefit borrowers by reducing their debt level, thereby shortening their repayment times.

6. The policy changes proposed will increase student loan receipts – growing from $4 million in the 2012-13 year to $22 million in the 2014-15 and subsequent years[1]. Ministers have previously agreed to redesign the student loan computer system, and therefore the proposed changes will be implemented at the same time, with no further administrative costs.

[1] These figures differ from the original Statement in that they have been deferred one year. They have already been netted off against other aspects of the student loan policy reforms, which are incorporated, with the deferral, into the Budget 2010 baselines.

ADEQUACY STATEMENT

7. Inland Revenue has reviewed this Regulatory Impact Statement, and considers that the statement is adequate according to the Regulatory Impact Analysis adequacy criteria.

STATUS QUO AND PROBLEM

8. Since 1992, when the student loan scheme was introduced, borrowers have been required to square up their loan repayments made during the tax year. Salary and wage earners have student loan repayments deducted from their income each pay day. Borrowers with other income (who have residual repayment obligations over $1,000) have to make interim instalments three times a year. This is the process for collecting income tax. The process ensures accuracy but generates small over or under payments, with the majority of overpayments being applied to the loan and underpayments being collected by Inland Revenue. This results in both compliance and administrative costs.

9. The current system is based on a tax system, where accuracy is important, and timeliness and cost effectiveness are less so. This is appropriate where money is being transferred from an individual to the state. However, for student loan repayments, accuracy has an impact on the time required to repay the loan, and any money applied to the loan is to the benefit of the borrower.

10. In order for some borrowers to access a consolidated loan balance they have to interact with two agencies, increasing compliance costs. They contact StudyLink for the balance of amounts drawn down in the current year, and Inland Revenue for amounts drawn down in past years.

11. There are costs for both borrowers and Inland Revenue in undertaking the end-of-year square-up process. This is currently a paper-based process, which is similar to income tax and ensures accuracy. This system is costly to administer, and its growing borrower base reduces Inland Revenue's ability to handle this growth in the future.

12. Also, the end-of-year filing for student loans can conflict with other policies, such as the non-filing concept, which aims to remove the requirement for taxpayers to square up their income tax affairs at the year's end. Requiring student loan borrowers to file brings them back into the income tax return process.

13. The administration of the interest-free policy requires StudyLink to impose interest, which, for domestic borrowers, is written off by Inland Revenue. This imposes excessive administration costs.

14. There is a significant number of overseas-based borrowers who are not complying with their obligations. Inland Revenue's main channels for communicating with borrowers are by mail or by telephone. For overseas-based borrowers, these two methods are either not timely or convenient. As these borrowers move around a lot, it is difficult to keep track of their addresses.

15. Where a borrower fails to make their student loan repayments, they are subject to a compounding late payment penalty of 1.5 percent per month, which equates to 19.56 percent per annum, and can escalate outstanding debt to a point where the amount cannot be repaid, and either it remains unpaid or hardship relief is provided.

16. There are currently over 530,000 student loan borrowers, and the nominal value of the scheme is $9.573 billion. The student loan portfolio is growing rapidly and is forecast to grow to $14.5 billion by 2014–15. Currently, lending exceeds repayments, with the total amount borrowed in 2007–08 being $1.2 billion, and total repayments of approximately $550 million. A large and growing student loan debt is likely to have an impact on the decisions of overseas-based borrowers on whether to return to New Zealand.

17. The penalties imposed on student loans are outdated, and can provide an incentive to pay other outstanding taxes, with higher penalties, ahead of student loans.

OBJECTIVE

18. The main objectives are to:

- Increase administrative efficiency by redeploying resources from the end-of-year square-up to higher value activities, such as debt collection and enhanced services to borrowers.
- Reduce the growth in outstanding debt.
- Enable borrowers to self-manage their loan through online services.
- Reduce overall compliance costs for borrowers.

ALTERNATIVE OPTIONS

19. Retaining the status quo and retaining the end-of-year square-up was considered as an option, but discarded as the current compliance and administrative costs will remain for the majority of borrowers (salary and wage earners) and will retain the current risks to Inland Revenue.

20. Also considered was the option of relying on the changes to the student loan scheme computer system and retaining the end-of-year square-up for salary and wage earners with higher thresholds. Although moving to a new computer system will produce administrative gains and reduce the problems in the short term, the underlying problems of a growing borrower population and increasing student loan debt will remain. Addressing these problems requires a fundamental review of the administrative legislation, focusing on reforming the basis of assessment by moving to a more frequent assessment period.

PREFERRED OPTION

21. The preferred option is to move towards a pay-period basis of assessment for salary and wage earners. The key features of this option are as follows:

- Removing the end-of-year square-up for salary and wage earners, with student loan liabilities being based on the amount deducted each pay. This will reduce administration and compliance costs.
- For salary and wage earners, significant underpayments will be collected from future pays, reducing the extent of outstanding debt.
- Salary and wage earners who have interest, dividend and Māori Authority income below a combined threshold of $1,500 will not be subject to a repayment obligation on this income.
- Borrowers with other income will continue to have an end-of-year square-up, and one- third of their liability will be due on each of three interim repayment dates during the year.
- The Commissioner of Inland Revenue will be given a wide discretion to set the thresholds for taking corrective action in relation to under-deducted repayments from salary and wages. This will enable the Commissioner to allocate resources to higher value activities, especially with a growing borrower base.
- The vast majority of interactions between borrowers and Inland Revenue will be electronic, to reduce compliance costs for borrowers and enable Inland Revenue to cope with a growing borrower base.
- The charging of interest will be the sole responsibility of Inland Revenue. This will address the current problem where interest is charged by StudyLink on student loans and then, for most borrowers, is written off by Inland Revenue.
- StudyLink will share information with Inland Revenue on loans drawn down, in order to provide borrowers with a consolidated loan balance in one place.
- Reducing borrowers' exposure to penalties by replacing late payment penalties with a more moderate interest charge, but otherwise aligning incentives to pay the correct amount on time with those for the payment of income tax.
- All borrowers will be able to undertake a wider range of activities in a new portal environment, and will have the ability to see a consolidated loan balance in one place. This will increase the extent to which borrowers can self-manage their affairs, and will reduce the growing administrative pressure on Inland Revenue.

<u>Benefits</u>

22. The proposals will be a significant step in enabling Inland Revenue to:

- Protect Government revenue and improve the integrity of the tax system.
- Focus its resources on higher value tasks rather than manual processing, to cope more efficiently with an expanding borrower base, reduce compliance costs, and deliver better services to borrowers.
- Respond to, and deliver, new Government initiatives more efficiently than now.

23. Borrowers will benefit from the proposals and will have reduced compliance costs in the following circumstances:

- Borrowers, who have an underpayment below the level set by the Commissioner, will not be required to repay the underpayment in the current year.
- For borrowers who have an outstanding liability, the interest rate charged will be lower than the current late payment penalty rate.
- Borrowers with interest, dividend income and Māori Authority distributions below $1,500 will not be required to make repayments on this income.
- All overseas-based borrowers will be able to contact Inland Revenue 24/7 from anywhere in the world.
- All borrowers will be able to access a greater amount of information on their loan, have a consolidated view of their loan balance in one place, and be able to self-manage their loan.
- Borrowers whose sole earnings are from salary and wages will not be required to undergo an end-of-year square-up.
- Borrowers will no longer face automatic late payment penalties equivalent to 19.56% per annum, but will pay a smaller interest charge on underpayments.
- Penalties for borrowers will be the same or similar to those for tax, reducing the number of rules borrowers need to understand.
- The remission and instalment options in the Tax Administration Act will be available to borrowers.

24. Freeing up resources from the end-of-year square-up will enable Inland Revenue to concentrate on higher value activities, such as ensuring the accuracy of pay-period deductions, which will benefit borrowers and provide enhanced services to borrowers.

<u>Costs/risks</u>

25. Ministers have previously agreed to increase funding to redesign the student loan computer system. The proposals outlined in this statement relate to policy changes, which will be implemented at the same time as the redesign of the computer system, and will therefore have no additional administrative costs.

26. The proposed changes will increase student loan repayments by approximately $4 million in the 2012-13 year, growing to approximately $22 million in the 2014-15 and subsequent years[2].

27. The proposals represent a fundamental change in the student loan scheme and its administration. The scale of change will affect existing frameworks and processes in different ways. It needs to be recognised that it is not possible to replicate current outcomes in the proposed new structure without undermining the overall intention of the reforms.

[2] These figures differ from the original Statement in that they incorporate further policy refinements and a deferral until the 2012 income year. The policies were all incorporated into the Budget 2010 baselines.

Those facing higher repayments under the proposals

28. Borrowers who may face higher repayment costs are those:

- who currently have a refund and who do not apply this refund to the loan (approximately 20% of cases as approximately 80% of borrowers currently have their refund applied to the loan);
- who work part-time or for part of the year and are under the current annual repayment threshold but are above the new pay-period threshold will be required to make repayments;
- Borrowers with other income will pay interest on underpayments from the first instalment date, in the same way as provisional tax, whereas the current “underestimation penalty” effectively allows deferral to the third instalment; and
- who are non compliant will potentially face higher penalties.

Borrowers who are currently studying

29. If Ministers agree to impose repayment obligations on students who earn under the current annual repayment threshold but above the new pay-period repayment threshold these students will face higher repayment costs.

30. However, all borrowers who face higher repayments in the short term will also benefit, by having a reduced level of debt and repaying their loan sooner.

31. There is a risk that repayment obligations will increase for some borrowers compared with the current annual assessment system. It does not matter what period of assessment is adopted, there will be inconsistencies between borrowers. However, a pay-period basis is considered to be a better indicator of ability to pay than other longer periods such as a tax year. All borrowers who earn solely salary and wage income and who earn the same income in a pay period are treated equally.

32. Student loans are income contingent for New Zealand-based borrowers and therefore it is not inconsistent to base repayments on the same basis as benefits which have a real-time basis of assessment to reflect current needs rather than an annual assessment basis.

33. The Ministry of Social Development (MSD) has advised that, while removing the year-end square-up makes the scheme more affordable for some borrowers, it may increase cash flow difficulties for others, who may call on MSD for additional financial assistance. This could happen regardless of the relief that will continue to be available for borrowers who face financial hardship.

34. Ministers are asked to decide whether or not to impose repayment obligations on borrowers who are full-time students. If Ministers decide to impose repayment obligations on full-time students, Inland Revenue will include students in its communication campaign, advising borrowers of the changes from an annual to a pay-period basis of assessment.

35. If Ministers decide to make an exception for full-time students there is an incentive for students to incorrectly claim full-time status and their level of expected earnings to avoid making repayments. To mitigate this risk, Inland Revenue will adopt a risk based assessment approach that will identify anomalies in the information it receives (as opposed to a full data match) in order to detect misuse of the declaration system for students.

36. Exempting full-time students will reduce the gains in student loan receipts and the resulting revenue gains will be approximately $1.6 million in the 2012/13 year growing to approximately $11.6 million in the 2014/15 and subsequent years[3].

37. Also, the proposal to specifically override the credit contracts legislation could be perceived as unfair by some borrowers, especially those not aware of the changes. To address this, Inland Revenue will endeavour to contact borrowers at their last known address to inform them of the changes. The proposed online services may also provide an opportunity for borrowers, who were previously not contactable, to re-establish contact.

How the changes will impact on the stock of regulations

38. The stock of regulations will remain the same, as the proposals will involve changes to the existing Student Loan Scheme Act. The Act will be rewritten to make it easier to understand, remove redundant provisions, and to re-order and renumber the Act.

CONSULTATION

39. The Government consulted on the proposals with interested parties by way of a discussion document and an online forum. The discussion document attracted 26 written submissions and the online forum attracted 75 submitters. Submitters were generally borrowers, although written submissions were also received from Business New Zealand, universities and student associations, and the New Zealand Federation of Business and Professional Women Inc.

40. Submitters saw the move to a pay-period assessment as a positive step for borrowers who have completed their study. However, most submitters were strongly opposed to students having to make repayments while studying and, to a lesser extent, the impact on borrowers who work part-time, casually, or experience large fluctuations in income. Requiring these people to make repayments could increase the financial strain on them. A number of submissions suggested that borrowers should be able to opt out of making repayments if they felt they will earn less in a year than the equivalent annual repayment threshold. Ministers are asked to decide whether to retain the status quo of not imposing repayment obligations on students or agree with the proposals to impose repayment obligations on them.

41. Submissions supported the proposal to ignore minor overpayments and underpayments. However, they agreed that refunds should be available for large

[3] These figures differ from the original Statement in that they have been deferred one year. They have already been netted off against other aspects of the student loan policy reforms, which are incorporated, with the deferral, into the Budget 2010 baselines.

overpayments resulting from employer errors. A few submissions thought that all overpayments should be refunded, as they lacked confidence in employers' or Inland Revenue's ability to ensure that repayment deductions would be made correctly. Inland Revenue considers that, over time, the accuracy of the student loan deductions will increase. The department intends to monitor employer deductions to ensure accuracy.

42. Submissions were generally supportive of the proposals to replace the late payment penalty with interest, and for borrowers with income other than salary or wages to have their underpayments collected over the next three instalments. There was also significant support for enhanced online services and the ability to communicate with Inland Revenue electronically, which was especially supported by overseas-based borrowers.

43. Inland Revenue has consulted with the following departments in the development of these proposals and in the preparation of the Cabinet paper: the Ministry of Education, the Treasury, the Ministry of Social Development (including StudyLink), the Ministry of Justice, the Ministry of Consumer Affairs, the Commerce Commission, and the Privacy Commissioner.

44. Their views have been incorporated into the paper. The consultation with departments raised three areas of concern, namely: the impacts on credit contracts law, the requirement to impose repayment obligations on borrowers who work part-time or part-year, including students and what payments qualify for the repayment bonus.

<u>Credit contracts issues</u>

45. Three credit contract issues arise. First, the move to electronic communication requires the consent of borrowers. Second, all overpayments are required to be refunded. Third, the changes proposed to existing contracts are not within the scope of variations permitted under the student loan contracts. Essentially, a trade-off is required between on the one hand, increasing the integrity of the student loan scheme, improving services to borrowers, improving administration, and maintaining open access to the scheme and on the other hand potentially confusing some borrowers and disadvantaging some borrowers.

<u>Consent to electronic disclosure</u>

46. The move to electronic administration of the scheme necessitates overriding credit contracts legislation, which requires that borrowers must consent to electronic communication and disclosure. However, doing so creates a risk that borrowers may be unaware of the changes before they come into effect. Nevertheless, officials recommend an explicit departure from the credit contracts legislation to implement these proposals, and consider that it is justified on the following grounds:

- Inland Revenue does not have current addresses for about 10-15 percent of borrowers, many of whom in this group are overseas-based. The transient nature of borrowers at the time they enter into the student loan agreement, and subsequently seek work and travel has, in the past, made it difficult to maintain accurate current address information.

- The student loan scheme is designed to support open access to education by providing financial support to students who might otherwise not be able to afford access. Repayments are largely income-contingent and the Ministry of Social Development has limited discretion to refuse to lend and cannot take into account the likelihood that borrowers will not meet their obligations, including providing contact information. The departure from credit contracts law is proposed to manage the resulting risk that borrowers default on their obligations, particularly given that some borrowers have little expectation of repaying their loans and avoid contact with Inland Revenue.
- There is no security for the loan. This also reduces incentives for borrowers to comply with their obligations to provide current contact information.
- The large number of borrowers, expected to be around 580,000 at the time the changes come into effect. Significant administrative costs will be incurred to gain active consent to the changes proposed.
- While there is the potential that some borrowers will be disadvantaged, the resulting improvement in services will be of benefit to the vast majority of borrowers, who will be able to better manage their loan.

47. Officials consider that the risk of borrowers not being informed of the changes could be mitigated to some extent through a programme of public communication, which Inland Revenue will undertake. Also, Inland Revenue will endeavour to contact borrowers at their last known address to inform them of the changes, and conventional services will be provided to those unable to use the new online services. The new online services should make it possible for significant numbers of borrowers who are no longer contactable by Inland Revenue to re-establish contact, and access information about their loans and the services provided by Inland Revenue. There is a trade-off between the risks to borrowers of not being informed of the changes with the objective of maintaining open access to student loans.

48. The Commerce Commission points out that the primary purpose of the credit contracts legislation is consumer protection and ensuring that consumers are aware of their liabilities and obligations prior to entering a contract. In the case of student loans, in all likelihood this will be the borrower's first major credit transaction, and accordingly it considers it critical that the borrower have the ability to be fully appraised and informed of the terms and conditions to which borrowers have to adhere. The Commission considers that having a different set of criteria for student loans from other domestic and personal loans significantly increases the chances of confusion amongst consumers over their rights and obligations.

<u>Refunds</u>

49. The credit contracts legislation also requires creditors to refund overpayments. This requirement is inconsistent with the proposal to ignore minor overpayments, which will be credited to the borrower's loan balance. It is also recommended that an explicit student loan exception be created to the credit contracts legislation rule that all overpayments must be refunded. The Commerce Commission has expressed concern that selective exemptions from the credit contracts legislation is cause for even greater uncertainty among borrowers. However, officials do not favour a

blanket exemption, as the student loan scheme should fit within the scheme of the legislation as far as possible.

Amending existing contracts

50. Variations to credit contracts are only permitted if both contracting parties agree or if the contract provides that specific obligations can be changed. Legislation implementing the proposals – moving to a pay-period basis and replacing penalties with interest – will need to prevail over contrary terms in existing contracts. This will disadvantage some borrowers, for example those who will be required to repay their loans earlier than under the current system.

51. The Commerce Commission is concerned that unilateral variation will undermine the consumer protection afforded by the legislation. The Commission considers that students will be in the category of consumers most in need of protection, given their limited access to funds and the significance of the decision to take a loan. The initial terms and conditions affect the decision to take a loan.

52. It is difficult to determine what impact these changes will have had on borrowers at the time they entered into loan contracts, had they been known – whether they will have entered into the loan agreements or not. The benefits of the proposals – the improved services to borrowers, reduction in compliance costs and improved administration – cannot be realized without amending current contracts. For example, the move to a pay-period concept allows administrative resources to be reallocated to provide better electronic services for borrowers. Overall, the benefits of the proposals will be severely limited if they applied only to future contracts. Prospective application will also increase complexity, administrative costs and inequity. Since the student loan scheme came into effect a number of changes have been made to existing contracts to the benefit of borrowers – for example, the remission of interest for New Zealand-based borrowers. The approach raised by the Commerce Commission will prevent the Government from making future policy changes affecting current contracts if they disadvantage any borrower. This outcome could be a significant impediment to the policy objectives of managing the loan asset and maintaining open access to tertiary education. Officials therefore recommend that legislation to implement the proposals should prevail over current contractual terms.

Voluntary repayments

53. The impact on voluntary repayments is an area where further work is required between officials to address the concerns raised. Officials will be reporting to Ministers in the New Year on possible options.