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[Direct Loans] [3]

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REPAYMENT OF STUDENT LOANS THROUGH WITHHOLDING

Borrowers are offered a variety of convenient and easy ways to repay loans. One method is to withhold loan payments from the borrower's salary.

- Fulfills the President's goal
- Automatic deductions from salary have the advantage of being taken for granted; thus, withheld funds are not considered available when it comes time for borrowers to budget for personal expenses

A. **<u>Mandatory withholding for employers</u>**.

- Employers to establish system for student loan repayments separate from the current tax withholding system
- Requires more detailed and more frequent reporting
- Pros:
  1. Easy and convenient repayment method for borrowers
  2. Reduces defaults
  3. Minimal impact on large employers who now offer wage-withholding allotments
  4. Eliminates the need for U.S. Government to offer incentives or subsidies to employers
- Cons:
  1. Requires legislation and an enforcement mechanism
  2. Imposes a burden on employers, especially small businesses which would have to create necessary accounting systems
  3. Burden estimated to reach $5.8 billion
- Could discourage some businesses from hiring student loan borrowers.

B. **<u>Voluntary withholding</u>**. Employers would <u>not</u> be required to set up a system to withhold student loan repayments. Participation by employers would be voluntary, similar to the current system of employer allotments for charitable deductions.

- Pros:
  1. No legislation is required; borrower can elect immediately upon entering the job market
  2. Imposes smaller burden on employers
  3. Voluntary participation may meet less resistance from employers
- Cons:
  1. Employers may not voluntarily participate
  2. Could require an extensive PR campaign
  3. Burden estimated at $1.5 billion

AGENDA FOR JULY 13TH MEETING ON INCOME CONTINGENT REPAYMENT

1. Information made available to borrowers

2. Tax liability

3. Applicability of changes in the second-year regulation to first-year borrowers

4. Conditions for switching defaulted borrowers into income contingent repayment

5. Algorithm

6. Easing the minimum repayment burden for low income borrowers -- $25 minimum repayment

7. Capitalization of interest

8. Length of repayment

SUMMARY OF JULY 13TH DISCUSSION WITH NEGOTIATORS ON INCOME CONTINGENT REPAYMENT

1. Information made available to borrowers - Negotiators suggested that certain information be provided to borrowers when they are choosing a repayment plan. We agreed to provide that information.

2. Tax liability - Negotiators do not want the IRS to tax the forgiveness of loans after 25 years. Negotiators are worried that low income people who are not required to make payments under the income contingent repayment formula will accrue interest for 25 years and then be hit with a large tax bill after 25 years. The Department explained that it was beyond our jurisdiction to alleviate this problem, but we agreed to work within the administration to see if a legislative change could be made.

3. Applicability of changes in the second-year regulation to first-year borrowers - If we change the terms of the income contingent repayment plan between the first and second years of the program, negotiators want the changes to apply automatically to borrowers who borrowed in the first year of the program. We agreed to apply automatically any changes that would benefit all borrowers. If, however, there is value judgment attached to whether the new terms are beneficial, we will allow borrowers to choose which terms will apply.

4. Algorithm - Negotiators wanted to change the 12-year cap to a 10-year cap. We refused to make that change.

5. Length of repayment - Negotiators wanted to limit the number of years that a borrower can be in repayment to 25. They proposed to accomplish this by limiting the number of years of alternative repayment to 25 and by counting the years a borrower is under any repayment plan towards the 25-year forgiveness period under the income contingent repayment plan. We offered to limit the number of years a borrower can be in alternative repayment to 30. (A limit of 25 years would limit our ability to create alternative repayment plans for high debt borrowers who are already in 30-year repayment plans.) We also agreed to count the number of years a borrower is in the standard repayment plan towards the 25-year forgiveness period. (Counting the number of years a borrower is in extended or graduated repayment would open us up to borrowers avoiding repayment of their loans by gaming the system.)

6. Capitalization of interest - Negotiators want to reduce the amount of capitalization to 110 percent of the original principal (down from our current limit of 150%). We agreed to consider a lower limit than 150% , if cost savings can be found elsewhere. We have not been unable to find those savings and negotiators had no suggestions.

7. $25 cliff. - Negotiators submitted a proposal that fundamentally changes the current algorithm to reduce the minimum repayment burden for low income borrowers. We said that we are not able to make such fundamental changes, but we are willing to develop another solution. We proposed that $25 would be subtracted from each payment for borrowers who make less than $10,000; that $20 would be subtracted from each payment for borrowers with between $10,000 and $12,500 of income; that $15 would be subtracted from each payment for borrowers with between $12,500 and $15,000 of income; and that $5 would be subtracted from each payment for borrowers with between $17,500 and $20,000 of income.

AMERICAN COUNCIL ON EDUCATION

Division of Governmental Relations

Memo for: David Longanecker

From: Terry Hartle

Subject: Revised list of income contingent repayment concerns for Negotiated Rulemaking

Date: 3 July 1994

A number of the negotiators representing colleges and the students have met to discuss the issues that we plan to raise when negotiated rulemaking reconvenes on June 7th and 8th. This list updates the list that I faxed to you on June 28.

The issues we are most concerned about are as follows:

The algorithm -- There are continuing concerns that the revised algorithm (4 and .2) is inappropriate because of the 12 year cap. While a 12 year cap will save borrowers a minimal amount of money in the short run, it will extend their length or repayment by two full years. In the case of borrowers with debts of $2500, for example, the 12 year cap would save borrowers $3 a month but would extend repayment for an additional two years. In the case of a $5000 loan, the monthly savings are just $7. We believe that borrowers will be better served by paying off their loans earlier.

Length of Repayment -- With the exception of borrowers who select the 30 year extended repayment option, we do not believe that any borrowers should be in active repayment for a period longer than 25 years.

Capitalization of Interest -- We strongly believe that capitalization of unpaid interest should stop when the outstanding balance reaches 110 percent of the initial debt.

Easing the minimum repayment burden for low income borrowers -- The adoption of the $25 minimum repayment offset will be very helpful to low income borrowers. However, borrowers at or just above the $25 level will not derive any benefit from this and indeed will face a steep jump in the amount of money to be repaid. To mitigate this, will present options for reducing the "cliff" effect that is created by the $25 offset.

Information to be made available to borrowers -- We are interested in discussing the kinds of information that will be routinely made available to borrowers. We recognize that ED may not wish to specify this in the regulations, but we believe that it would be valuable to have some understanding of the types of information that we believe is important so that this could be mentioned in the preamble. We will have specific suggestions.

Tax Liability -- We know that the Administration intends to seek a legislative change to ensure will not have a tax liability if there loan is not repaid after 25 years. We would like to discuss t steps to minimize the impact on students -- such as an interest rate reduction -- in the event that this change is not enacted promptly. In addition, we want to be certain that students are informed about the uncertain tax status when they select income contingent repayment.

Changes in year 2 terms -- In the event that income contingent repayment terms are changed for year 2 and beyond in a way that makes the program more favorable to students, we would like borrowers who selected income contingent repayment in the first year to be given the improved terms. We believe that the negotiators will be able to make a clear decision about whether subsequent terms are an improvement for the borrowers and believe that automatically giving all borrowers the these terms would greatly simplify the administration of the program.

Conditions for Switching borrowers into income contingent repayment -- We would like to discuss the specific terms and conditions under which the Secretary will decide to move a defaulter into income-contingent repayment and the circumstances in which the Secretary will decide not to do this. We believe that information on the Secretary's plans in this area should be included in the regulatory package.

July 12, 1994

To: Gene
Fr: Sean
Re: Loan Repayment Regulations

This memo follows up on our conversation last night about the status of the current regulatory negotiations between the Department of Education and the educational associations. This morning I asked Professor Philip Schrag to write a memo summarizing the current state of the negotiations from his perspective. He has no affiliation to any agency or group involved in the negotiations, but has been participating in the sessions as a "citizen interested in making the new loan system more useful for people who think they will spend a substantial portion of their lives in relatively low-paying public service jobs."

Status of the Negotiations

In the attached memo, Professor Schrag characterizes the negotiations as "on the verge of breakdown." Apparently, last Friday's meeting resulted in the educational community negotiators unanimously agreeing to withdraw their opposition to the Department's 12-year (rather than 10-year) alternative optional amortization schedule for income contingent borrower, if the Department would accept the 110% cap on compounding interest (rather than the 150% cap) and two less contentious proposals (i.e. how to compute the 25 years). They offered to support the Department's entire package if the Department would agreed to this trade-off, and vowed unanimous dissent otherwise. The Department stated that it would not move on the cap. The two sides left Friday's meeting in a stalemate. Tomorrow (Wednesday, July 13) the two sides meet one more (final?) time to try to reach an agreement.

The Cap Issue

Professor Schrag believes that the cap issues is the central substantive dispute remaining. One important point that you should note: **the 150% cap has little real effect on the ultimate debt load of graduates who take low-paying jobs.** For example, a graduate who owes $100,000 borrowed at 8% and who takes a job paying $25,000 does not experience any relief after 10 years and only has their debt reduced by 7% after 15 years as compared to a system which has no cap on compounding the interest. In contrast, the 110% cap under the same scenario produces a 7.5% reduction in debt load after 10 years and a 19% reduction after 15 years from the no cap baseline. The primary concern is that the lack of relief associated with the 150% cap will discourage graduates from entering public service.

Possible Solutions

There are three alternative solutions that might be acceptable to either or both sides of this negotiation:

1) **110% Cap:** Provide a cap on compounding interest once the principal reaches 110% of the original debt. Note that the simple interest and the unpaid principal will be added indefinitely to the debt. Professor Schrag suggests that this alternative would cost around $400 million over a five year period, though we need to confirm that number with the Department. This provides the President the strongest possible claim regarding his desire to encourage public service among its citizens. The Department of Education has publicly rejected this option.

2) **125% Cap:** Strike a compromise between the 110% and 150% cap. The relief and costs would be reduced accordingly, however there is no guarantee that the educational associations will support this compromise.

3) **Job-specific Cap:** Provide a cap (probably 110%) for borrowers who are employed in categories of jobs listed as public service occupations by the new Corporation for National and Community Service. The Corporation's Vice President, Shirley Sagawa, has expressed a willingness to create and periodically update such a listing. This approach would substantially reduce the coverage and cost of the cap while still promoting the President's public service agenda.

Recommendation

I would suggest that **you call Undersecretary Mike Smith before tomorrow's meeting and push the job-specific cap described above.** It achieves three goals:

1) Addresses the educational community's concern about encouraging public service and hopefully secures their support.

2) Costs much less than the blanket 110% cap, though we should have the Department of Education estimate the actual cost.

3) Provides the President the opportunity to take credit for overhauling the student loan system in a way that not only makes education more accessible but also encourages public service careers.

I would like to continue to work on this issue, if possible. I would be glad to make calls to the Department of Education or do more research on it tomorrow if you feel it would be worthwhile.

GEORGETOWN UNIVERSITY LAW CENTER

Philip G. Schrag
Professor of Law

MEMORANDUM

TO: Mr. Gene Sperling

FROM: Philip G. Schrag

DATE: July 12, 1994

SUBJECT: Possible caps on compounding interest for student borrowers in the income-contingent loan repayment program

I am a law professor and the director of the Public Interest Law Scholars Program at Georgetown, which trains lawyers who plan public interest careers. I have no affiliation to any agency or group involved in the current direct lending regulatory negotiation, but I have been attending and speaking at the sessions as a citizen who would like to make the new system useful to people who think they will spend substantial portions of their lives in relatively low-paying public service jobs.

The Department of Education has done a wonderful job of developing a good regulation, and (unlike the trade associations) I have publicly praised the Department for its work. However, in one respect, the Department is making a serious mistake, one that seems inconsistent with the President's goal of encouraging public service.

The issue is the rule capping compounding interest. Under the Department's plan, endorsed by everyone, no income-contingent borrower will have to repay more than 15% of his income in a year. The difference between 8 1/2% and that capped amount will get added to his principal balance.

Of course that addition will cause the principal balance to balloon. At the 25 year mark, any principal balance still owing will be forgiven, but for any borrower thinking about doing public service for ten or fifteen years rather than for life, and therefore not certain he will reach the 25 year mark, the balloon is a strong disincentive to embarking on the path to public service.

The balloon will expand much faster if the Department compounds interest on the amount added. Everyone agrees there should be a limit to the compounding. The Department proposes (and the 1994-95 regulation now specifies) that although simple interest is to be added indefinitely, the compounding should stop when the balance hits 150% of the original balance. The negotiators unanimously support a 110% cap on compounding. The Department

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concedes that it has the legal authority to set the cap anywhere, but it refuses to lower it.

The chart at the end of this memo shows that a 150% cap is pretty illusory; it barely reduces the balloon. A 110% cap provides real relief. An alternative (at much less cost to the government) would be to provide a 110% cap -- or even a 100% cap (that is, no compounding), but only for borrowers who are employed in categories of jobs listed as public service occupations by the new Corporation for National and Community Service. You could call Shirley Sagawa, the Corporation's Vice President, to confirm the Corporation's willingness to make and periodically update such a listing.

The status of the negotiations

The regulatory negotiation is on the verge of breakdown, mostly over this issue. On Friday, the education community's negotiators unanimously proposed that they would withdraw their opposition to the Department's 12-year (rather than 10-year) alternate optional amortization schedule for income contingent borrowers, if the Department would accept the 110% cap and two less contentious proposals.[1] They offered to support the Department's entire package if the Department agreed to this trade-off, and vowed unanimous dissent otherwise. The Department said it would not move on the cap. (I have been told by a negotiator that the Department's opposition to moving on this issue originates with Undersecretary Mike Smith, but this is unconfirmed). Friday was billed as the final negotiation session, but one more attempt will be made, tomorrow, limited to five negotiators per side. A conversation between you and Mr. Riley or Mr. Smith before then might pry loose an agreement that will significantly advance the President's program.

Revenue impact

So far as I know, the Department has never released any papers showing the revenue impact of any cap or the studies on which revenue estimates are based. Yesterday I heard orally that the Department estimates the five-year cost of a 110% cap at 400 million. The cost of such a cap limited to borrowers in public service occupations designated as such by the Corporation for National and Community Service would be very much lower. So far as I know, the Department has done no study to indicate what if any changes could be made in other parts of the program to compensate for a revenue loss of $80 million/year or less.

Please call me at 662-9099 if you would like to discuss any of these issues.

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[1] One involves the computation of the 25 years for forgiveness, and the other deals with borrowers with extremely low repayment obligations.

Attachment

This chart shows, in hundreds of thousands of dollars, the approximate balance owing after 10 and 15 years, on $ 100,000 borrowed at 8%, with payback capped at $3750 (15% of a $25,000 income), and various caps on compounding the unpaid accrued interest.

	no cap on com-pounding	stop compounding at 150% of original loan (Dept. proposal)	stop it at 125%	stop it at 110%	don't compound at all
after 10 years	161	161	156	149	142
after 15 years	215	200	187	174	164

This chart shows, in hundreds of thousands of dollars, the approximate balance owing after 10 and 15 years, on $ 25,000 borrowed at 8%, with payback capped at $1232 (8.8% of a $14,000 income), and various caps on compounding the unpaid accrued interest.

	no cap on com-pounding	stop compounding at 150% of original loan (Dept. proposal)	stop it at 125%	stop it at 110%	don't compound at all
after 10 years	38	38	37	35	33
after 15 years	48	46	43	40	37

EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

June 3, 1994

TO: GEORGE MUÑOZ
JOSH STEINER

FROM: Christopher Edley, Jr.

SUBJECT: Treasury Fees and the Student Loan Study

1. I am hopeful that the efforts underway with the Senate to craft language allowing IRS to spend new and increased user fees will be successful, and understand that my staff is in close communication with Treasury folks. Let me know if there is something you want me, personally, to do. As to Customs fees, however, the picture appears less encouraging. Aggressive work is needed to preserve the Merchandize Processing Fee for the appropriators. It appears that Customs' energy has slacked because the House committee satisfied their requirements for funding ACS and NAFTA enforcement initiatives. It is important for Tax System Modernization that Customs and Treasury make every effort to secure the MPF in the Senate. My staff has tried, they believe without success, to urge Customs to redouble its efforts in the Senate.

2. Regarding the Student Loan Study, several OMB staff have reviewed recently prepared draft report language, and I have read the executive summary. The project is still seriously off track in conception. After a promising beginning, the report becomes an elaborate justification for the conclusion, and -- speaking plainly -- does not evidence a wholehearted effort to make the President's vision workable. The perspective is *bureaucratic* rather than *customer-oriented*. That is, the lodestar seems to be what makes most since from the perspective of administration, rather than what will make the most sense for students and families.

IRS and Education staff need to remember that the first audience for the study is not Congress but the White House. The President's original goal was a system that directly involved IRS in collecting student loans. If Treasury and Education are going to recommend an alternative approach, the summary briefing materials for the White House need to clearly and explicitly compare the advantages of the recommended option with the original goal. I hope this feedback is helpful.

cc: Belle Sawhill, Gene Sperling, Bill Galston

Section I

Feasibility of the IRS Collecting Direct Student Loans

Background and Introduction

To deal with the growing number of defaulted student loans, Congress and the Department of Education have been looking into various methods to reform the student loan system. A common feature of several Congressional proposals was to establish a centralized loan system that would replace the current system of private lenders. Furthermore, several proposals identified the Internal Revenue Service as the loan processing and collection agency for the Federal government.

As part of the Omnibus Budget Reconciliation Act of 1993 (OBRA '93), Congress established the Federal Direct Student Loan Program (FDSLP). Congress also gave the Department of Education the authority to expand the number of repayment options available to borrowers as a means to reduce the default rate. Borrowers can elect extended payments, graduated payments, or income-contingent payments as well as retaining the standard repayment plan. By allowing borrowers to select the repayment plan that best suits their financial circumstances, it is hoped that the number of defaults will be reduced and that borrowers will not find repayment too burdensome.

Several proposals have been made over the last few years that would charge the Internal Revenue Service with collecting loan repayments through the tax collection system. Congressman Petri and Senator Simon introduced the Income Dependant Education Assistance Act (IDEA) during the 102nd Congress. Under the IDEA program, Treasury would have been responsible for making loans to eligible students and collecting loan repayments through the Internal Revenue Service.

OBRA '93 Mandated Feasibility Study

The conference report accompanying OBRA '93 directed "the Treasury Department, in consultation with the Department of Education, to conduct a study of the feasibility of implementing a system for the repayment of Federal student loans through wage withholding or other means involving the IRS".[1] Analyses should be included with the study to determine:

1. *Whether IRS could implement such a system of student loan repayment system with its current resources and without adversely affecting its ability to collect tax revenues?*
2. *The cumulative impact of increased disclosure of tax information and increased IRS involvement in nontax collection activities on voluntary compliance with the tax laws.*

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[1] Appendix A contains the OBRA '93 Conference Report language.

3. *The ability of the IRS to enforce collection of student loans using an alternative system of dispute resolution, penalties, and collection devices.*
4. *The effect of separating student loan collection from other servicing functions.*
5. *The anticipated effect on the management of Federal student loan collections and on borrower repayment of such loans.*

To the extent that the study demonstrated the feasibility of IRS involvement in the student loan program, Treasury and Education are required to submit an implementation plan and legislative recommendations along with the feasibility study within 6 months of enactment of the legislation. Due to the complexity of the analyses, the Departments of Treasury and Education requested that the study deadline be extended until June 1994.[2]

Federal Direct Student Loan Program

The Student Loan Reform Act of 1993 (Title IV of OBRA 93) authorized the Department of Education to implement a Direct Loan Program. Under this program, the volume of student loans issued under the old system, where student loans are issued through banks and other intermediaries, would be reduced as more students take advantage of borrowing directly from the government. Under the Direct Loan Program, the Federal government (Department of Education) makes loans directly to students and assumes the primary responsibility for collecting and servicing loan payments and accounts.

Repayment Options

Under the old system of loans, known as the Federal Family of Education Loans (FFEL), borrowers had to repay their obligations within a fixed number of years. It is widely believed that the increase in the number of defaulted student loans is due, in part, to the fact that the standard repayment of a fixed amount every month does not account for important variables such as income, family size, and cost of living, and to the increasing expense of higher education. Accordingly, the Student Loan Reform Act of 1993 authorized the following repayment plans for Direct Loan borrowers:

- Standard Repayment
- **Extended Repayment**
- Graduated Repayment
- Income-Contingent Repayment

Borrowers have the option to switch repayment plans (up to a maximum limit to be defined in the regulations). For example, borrowers using the standard repayment plan may switch to income-contingent if their financial situations change. Similarly, borrowers may change from income-contingent repayment to one of the other plans. In theory, such mobility

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[2] Appendix B contains the extension letters.

between repayment plans further reduces the risk of default on student loans since borrowers can match their repayment plans to their financial situations.

As an incentive to bring defaulters from the FFEL Program into current repayment status, the Department of Education has the authority to place defaulters into income-contingent repayment under the Direct Student Loan Program. If the primary reason borrowers default is because of their inability to pay, then the number of borrowers in default should decrease significantly.

Other than varying the term of the loan or the repayment amount, the standard, extended, and graduated repayment plans are only marginally different from each other. All three repayment plans are modified fixed payment plans. On the other hand, the income-contingent plan changes the repayment from an amortization of principal over a period of time to basing the repayment, in part, on AGI as a proxy for ability to pay. Principal, interest rate, and time -- the usual determinants of a loan amortization plan -- are almost completely unrelated to the payment.

Standard Repayment

Under this repayment plan, a borrower makes equal monthly payments for a period of time not to exceed 10 years, and is generally subject to a minimum repayment of $50 per month or the balance of the borrower's Direct Loan, whichever is less. The standard repayment plan under the Direct Loan Program is identical to the standard repayment plan under the FFEL Program.

Extended Repayment

Under the extended repayment plan, a borrower makes equal monthly payments for a period of time that exceeds the repayment period under the standard repayment plan. Under the FFEL Program, the extended repayment plan is only offered to borrowers who have consolidated their loans.

Graduated Repayment

Under the graduated repayment plan, a borrower makes payments of two or more different amounts that increase at established intervals. Under the Direct Loan Program, the smallest payment must not be less than 50% of the standard repayment amount, and the largest payment may not exceed 150% of the standard repayment amount.

Income-Contingent Repayment

The income-contingent repayment plan is available to all Direct Loan borrowers except for Federal Direct PLUS loan borrowers. Under the income-contingent repayment plan, payments vary in relation to the Adjusted Gross Income (AGI) of the borrower and, if applicable, the borrower's spouse. Any balance remaining on a loan after 25 years of income-contingent repayment is canceled.

The Department of Education is proposing an income-contingent plan in which the borrower will repay a small percentage, adjusted for the amount of debt the borrower has accumulated at the time the repayment period begins, of his or her income. Specifically, the annual repayment obligation equals a percentage of the borrower's AGI. The base payback rate is 3% and increases by .2% for each $1,000 borrowed. The maximum payback rate occurs at a debt of $61,000. Any calculated monthly payment amount less than $50 ($25 if the borrower is unmarried and has no dependents) is waived. However, borrowers would be given the option of paying the calculated amount to minimize negative amortization.

For married borrowers, the repayment amount also depends on whether the spouse has a Direct Student Loan. If there is only one borrower in the family, then the repayment amount would be the same as that for a single person with the same debt and AGI. However, if there are two debts, then the average debt level would be used to determine the payback rate.

Common Assumptions Between Agencies Concerning IRS Involvement

In developing the various options for IRS involvement in the direct student loan program, several assumptions were agreed to by Treasury, Education and IRS. Tax-related variable definitions would conform to IRS standards. Furthermore, the following three assumptions provided the common framework for discussion:

1. *The Department of Education will maintain and service direct student loan accounts.*
2. *There will be no changes in the current tax withholding system (i.e., employers would not be required to differentiate student loan payments from income tax withholdings).*
3. *Student loan repayments taken over by IRS will be treated as income tax liabilities, subject to income tax penalties and interest.*

Relaxing of any one of these assumptions makes IRS involvement in the Direct Loan Program infeasible.

The collection and servicing of student loans is distinctly different from the collection and servicing of individual income taxes. Taxes are assessed on income earned during a narrowly defined period of time, typically a calendar year. Student loan repayment amounts vary according to the principle, interest rate, and duration. Under the income-contingent repayment option, additional variables such as family size and AGI are included in the repayment formula.

Traditionally, loan servicing entails much more than the processing of payments and default collection. Loan servicing involves a high degree of customer service. Borrowers should be able to access information about their loan balance, repayment schedule, and other related issues on a timely basis. Furthermore, reliable and timely customer service should result in a prompt reconciliation of debts. If IRS were to assume responsibility for maintaining and servicing student loan accounts, IRS would have to develop new systems to account for loan repayments and defaulted debt collection. These systems would impact not only current systems, but also the Tax Systems Modernization Program.

In order to provide a reliable and timely customer service for the Direct Loan Program, the tax collection system would need to be changed. Because the withholding system would have to be modified to differentiate student loan repayments from tax withholdings, employers would have to radically change their accounting systems in order to provide IRS with tax withholding and student loan repayment information for each employee for each pay period. Changing the withholding system and Federal Tax Deposit requirements to allow IRS to properly post student loan repayments and distinguish loan payments from tax payments would be extremely burdensome to employers.

In addition to the employer burden caused by the change in reporting requirements, IRS would also have to change its systems in order to process, store, and use the additional information. While IRS is in the process of a major systems modernization effort, there are no plans to capture data from employers at the level of detail necessary to track and report student loan collection.

Finally, if the tax collection system is changed to easily identify student loan repayments, particularly income-contingent repayments, IRS would be in a position to treat student loans differently from tax payments. However, then IRS processing of repayments and collection of defaulted loans would be subject to the laws and regulations pertaining to the student loan program. Moreover, to utilize IRS' enforcement tools, the laws regulating the student loan program as well as the Internal Revenue Code would have to be amended to authorize IRS collection of student loans.

The relaxation of any one of the three common assumptions makes IRS involvement infeasible. While greater IRS involvement offers the attractiveness of greater efficiency (only one agency) in administering the student loan program, that efficiency would not be realized unless IRS could use all of its enforcement tools to ensure compliance. Furthermore, the mission of the Internal Revenue Service would be fundamentally altered. In order for the IRS to collect student loans without these assumptions, the Internal Revenue Code would require a major overhaul. While there are a number of potential options, greater involvement by IRS in administering the Direct Loan Program could prevent the Service from fulfilling its primary mission as the tax collector.

Options for IRS Involvement

An oversight group with representatives from the Internal Revenue Service, the Office of the Secretary of the Treasury and the Department of Education was established to coordinate the study. While the conference report language suggests that the study should concentrate on the use of the withholding system in repaying student loans, the oversight group decided that the study should examine a range of possible involvement by the IRS.

Current law limits the role of the Internal Revenue Service in the direct student loan program to sharing certain information (i.e., name, address, taxpayer identification number, adjusted gross income and filing status of student loan recipients) with Education and to administering the refund offset program for student loan defaulters. Based on the direction received from the oversight group, working groups from IRS and Education developed and analyzed five major options for long-run IRS involvement . These options ranged from the current statutory requirements to IRS processing all direct loan payments. The options considered were:

Option 1 — *Program as currently authorized (i.e., IRS shares name, address, TIN, AGI, and filing status with Education).* Under this option, Education would administer student loan repayments. IRS would continue the refund offset program for student loan defaulters.

Option 2 — *Increased Information Sharing.* This option is similar to the first option; however, Education would use limited additional return information (based on a demonstration of need) to administer an income-contingent repayment system and aid in default collection. IRS would continue the refund offset program for student loan defaulters.

Option 3 — *IRS Collects Defaulted Debt.* Under this option, Education would administer the student loan repayment system and refer defaulted debtors to the IRS for debt collection (requiring an administrative judgement from Education to treat defaulted debt as a tax).

Option 4 — *IRS Collects Income-Contingent Student Loans.* This option would require legislation for IRS to handle repayment of student loans through wage withholding or estimated payments, for debtors who select income-contingent repayment. In addition, IRS would collect defaulted debt.

Option 5 — ***IRS Collects Direct Student Loans, Regardless of Repayment Plan.*** **Under this** option, legislation would be required to allow IRS to administer repayment of all direct student loans, regardless of the repayment plan selected by the debtor (i.e., income-contingent, fixed payment). In addition, IRS would collect defaulted debt.

In addition to the five issues specifically required by the OBRA conference report, several criteria were developed to analyze these options. First, the Department of Education developed a theoretical description of the ideal student loan repayment system. This theoretical description provided a standard by which all proposals could be compared. In addition, the strengths and weaknesses of each option were identified. Each option was developed in sufficient detail to allow for preliminary program cost estimates.

Each option was analyzed using the framework mentioned above. Only after fully analyzing all the available data did the oversight group recommend the option for IRS involvement that best served the interests of the public and the Federal government.

One word of caution should be stated concerning the analyses performed for this study. The five options were developed and analyzed only in sufficient detail to allow for preliminary cost estimates and the identification of the major administrative and policy issues. Detailed developmental work was not included as part of this study. The Implementation Plan identifies much of the work necessary to begin the recommended option. It is expected that IRS and Department of Education would require at least three years from the date of enactment to implement any program that requires substantial IRS involvement (Options 3, 4, or 5).

Short-Run Versus Long-Run IRS Involvement

By law, the Internal Revenue Service plays an important role in the Federal Direct Student Loan Program. Option 1 describes the current direct loan program. Within the confines of the Internal Revenue Code's disclosure provisions, IRS would share limited income tax information with the Department of Education. In addition, IRS would continue to offset refunds for taxpayers, referred to IRS by Education, who have defaulted on their student loans and provide information, as authorized by Internal Revenue Code Section 6103, to assist Education in locating defaulted borrowers.

This report looks beyond the current program to study the feasibility of IRS involvement in the long-run. In the long-run, Option 1 is only one of five options under consideration. The following sections provide the framework to evaluate each of the five options for long-run feasibility.

Report Outline

Section II represents the Department of Education's description of the ideal student loan servicing and collection system. Section III is the Executive Summary from a report of focus groups conducted on behalf of the Department of Education. Section IV describes the five options for IRS involvement in some detail with the major advantages and disadvantages. It also provides the summary of the costs for each option. Section V specifically addresses the areas of analysis mandated by the OBRA conference report. Section VI contains the recommendation of the Departments of Treasury and Education as well as a broad implementation plan and legislative issues which would have to be addressed. The Appendices to this report contain the conference report language, focus group report, and IRS cost estimation methodology.

Section II

The Ideal System For Servicing and Collecting Student Loans[1]

Introduction

The Student Loan Reform Act of 1993 requires the Secretaries of Education and Treasury to develop a plan to involve the Internal Revenue Service in the collection of student loan repayments. This paper outlines the Department of Education's preliminary thoughts on what should be included in the Federal Government's "ideal" student loan repayment system. This paper is intended to provide a starting point from which Treasury and Education can work together to develop a cost-effective repayment system that best serves the needs of students and the Federal Government. Along with this repayment system, the Department of Education will continue to carry out its statutory responsibility of loan origination, institutional oversight and monitoring, and general program evaluation and management activities.

In summary, an ideal repayment system would have three main components:

- Simplicity in administration and clear lines of accountability. One entity should manage all student loan repayments regardless of borrower payment method. This would mean that one agency oversees the Federal Government's student loan repayment system -- servicing, collecting, tracking, recordkeeping, accounting, and enforcement.

- Customer service. Accurate, up-to-date data on student loan accounts should be available on a continuing basis to borrowers, schools, Congress, and the Department of Education. The system must be responsive to the data requirements of these different entities.

- Minimize burden. The system should be simple and straightforward for borrowers and should not be burdensome for employers.

Although this paper does not analyze the feasibility of designating IRS, Education, or some other entity to carry out these responsibilities in the future, the effectiveness of each approach must be evaluated by how well it meets the criteria of an ideal system. At least initially, Education will continue to use its current servicing and repayment system to service and collect loans, and will use income information from IRS, as provided by statute, to implement income contingent loans. Education will implement an income contingent repayment program by July 1994.

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[1] United States Department of Education. December 1993.

Simplicity in Administration and Clear Lines of Accountability

Managing student loan servicing and repayment issues in a more coordinated and cost-effective manner calls for increased centralized program oversight. A single entity for managing student loans would ensure that policy objectives are achieved, borrowers are treated fairly and consistently, and quality control is the highest. This would improve loan servicing and collection effectiveness, reduce default costs, assign lead responsibility for performance outcomes, and improve accountability by making the lines of responsibility clear and unambiguous. This is particularly critical given concerns about the management of student loans reflected in GAO reports and congressional hearings.

- A student loan management information system is needed for record keeping, accounting, institutional oversight, and program evaluation and management activities. To manage effectively, information is needed on each borrower: who repays, when payments are made, how much is collected (portion that goes for principal and interest, collection costs and penalties), when the loan is fully repaid, who does not repay because his/her income is too low, and who is in default.

- Ideally, the entity tracking loan repayments and maintaining borrower records would also service all loans and would oversee the collection function on defaulted loans.

- Accountability measures should not be directed solely at "defaulters" or "uncollectibles," but also on the day-to-day operation of the program to run more smoothly and efficiently for borrowers, schools, and the Federal Government. Currently, approximately 80 percent of all borrowers pay their student loans on time. With the introduction of income contingent loans, fewer borrowers will be classified in default because individuals with insufficient income will not be required to make loan payments. However, the cost to the Federal Government of loans not fully paid may not change significantly.

- Because students with small loan balances ($2500) are more likely to default than those with higher balances, any collection system must be able to focus collection resources on loans of this size. Otherwise, losses could be higher in the new system, especially if borrowers realize that small loans do not receive high priority.

Customer Service

In an ideal system, borrowers should be able to access information about their loan balance, repayment schedule, and other related issues on a timely basis. Customer service must be a high priority. Reliable and timely customer service should result in prompt reconciliation of debts. An ideal customer service system would emphasize timeliness, reliability, and accessibility. Such a system should include:

- A 24-hour automated helpline for borrowers, employers, and educational institutions where customers can obtain information about loan balances, etc.

- An on-line interface in which all relevant agencies can access a single system for the specific data relevant to their immediate tasks.

- A dispute resolution mechanism whereby borrowers' problems can be promptly resolved.

- Publications that describe the various repayment plans and collection procedures in simple terms.

- Periodic customer satisfaction surveys to determine customer reaction and any need for changes.

During the month of December, Education and IRS jointly convened focus groups to obtain the views of students, borrowers, and the financial aid community regarding income contingent repayment and IRS involvement in servicing and collecting student loans. This information will be helpful in factoring in public acceptance as the new student loan servicing and repayment system is designed and implemented.

Minimizing Burden

An ideal student loan servicing and repayment system should impose minimal burden on borrowers, employers, and financial aid institutions. By streamlining the system and thereby eliminating complicated procedures and unnecessary reporting requirements, borrowers can better understand their loan obligations and avoid delinquencies. In a ideal system, a borrower will have the ability to choose a plan with manageable repayment terms that comports with his/her general economic circumstance.

<u>IRS Wage Withholding</u>

- IRS wage withholding could be the most convenient for the borrower because the repayment amount would automatically be deducted from an employee's paycheck. Wage withholding is not reconciled for 18 months following the beginning of the tax year, however. If this system were adopted for student loan repayment, the reconciliation issue would have to be addressed, as well as the additional burden that wage withholding could impose on employers. The burden on employers would depend on whether employers had to keep track of loan payments or if borrowers were entirely responsible for increasing their withholding to cover loan obligations.

- Some borrowers are outside the IRS withholding system. At this time, it is difficult to predict how many borrowers fall into this category and whether there will be an inherent compliance problem with self-employed borrowers.

- Some borrowers are required to file, and do not. For this group, it may be necessary for IRS to use its normal enforcement mechanism to ensure that tax obligations and student loan payments are met. Alternatively, a different repayment plan could be selected for this group.

- For non-filers who have very low incomes and are not required to file, the annual loan payment could be deferred, under income contingency. Many individuals in this category may have taxable income during later years.

IRS Tax Form 1040

- Some have suggested using annual payments at tax time through the IRS Tax Form 1040. This repayment method is used by other countries. The advantages to this approach are that it would impose minimal burden on borrowers and employers, and be the most convenient system to implement. However, it would not allow for continuous tracking of repayments, proper allocation to principal, interest and collection costs on specific loans, nor timely detection of defaulting loans.

Automatic Payroll Deduction

- Another repayment option is an automatic payroll deduction or bank-administered automatic withdrawal system. Under this approach, a borrower would either request that the employer deduct his student loan payment each pay period or instruct his bank to make periodic payments. In either case, the payment would be credited to a central loan repayment account.

- Using this approach, the collection and servicer agent would be paid immediately and the payments would be easy to track on a continuous up-to-date basis. However, this system would not address the needs of many of the hardest-to-track borrowers (self-employed, unemployed, multiple part-time jobholders). Under this option, there would be an additional burden to employers, particularly small businesses, who would have to adjust their payroll systems as a result of the added payroll deduction.

Monthly or Quarterly Checks

- This option gives borrowers control over when and how their student loan are repaid. Despite the convenience of employer wage withholding, some borrowers may prefer this option to preserve their privacy regarding outstanding debts.

Section III

Focus Group Executive Summary[1]

Scope of Project

The Department of Education is implementing a direct loan process in which post secondary student loans will be administered directly by the government. This system may include the involvement of the Internal Revenue Service in the collection of these loans. Four repayment options are being considered:

- **Standard Repayment** - fixed payment each month for ten years
- **Extended Repayment** - fixed payment each month for twenty years
- **Graduated Repayment** - smaller payments in early years and larger payments in later years
- **Income Contingent Repayment** - payments which vary annually based on income of borrower and that of his or her spouse

In addition, three payment methods are being considered:

- **Check** - Write a check each month to the government
- **Employer Withholding** - Have employer withhold part of paycheck, similar to the way they withhold taxes and Social Security; borrower would reconcile under-payment or over-payment at the end of the year on their tax form
- **Electronic transfer** - Have borrower's bank automatically transfer funds each month to the government

These focus groups were designed to help the Department of Education better understand the perceived advantages and disadvantages of each repayment option and payment method among current borrowers and financial aid advisors, as well as their attitudes toward IRS involvement in the collection of student loans. A total of nine focus groups were held. The focus group locations and participant criteria are summarized in the following table.

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[1] Prepared by Price Waterhouse under contract to the Department of Education.

CITY	PARTICIPANT GROUP
Washington, DC	(Pre-test) Current students, two-year, proprietary, four-year and graduate schools Current students, proprietary & 2-year schools Former students, proprietary & 2-year schools
Atlanta, GA	Current students, proprietary & 2-year schools Financial aid advisors representing two-year, proprietary, four-year and graduate schools
Columbus, OH	Current students, 4-year colleges Former students, 4-year colleges and graduate programs
Los Angeles, CA	Current students, graduate schools Defaulters

Key Findings

Repayment Schedules

Participants seek flexibility and a variety of options to choose from when it comes to repaying their student loans. Their choice of repayment schedules seems to depend mostly on the amount borrowed, their anticipated income and their general outlook for the future. Many are concerned about potential financial problems and would like to choose the plan that they think can best help them to endure their difficulties.

The least favored repayment plan was the extended plan, with participants seeing twenty years as too long a period of time to repay a student loan. This option was also perceived as very costly in terms of interest paid. It may have some appeal to students with very large debts.

The standard repayment plan was appealing to participants because it makes the task of budgeting easier, and payments are perceived to be manageable in most cases. However, if financial hardships occur, participants believe this repayment plan could be burdensome. Many former students are currently repaying their loans on this plan. Ten years may actually be too long a period of time for those with small debts.

The graduated repayment plan gives students some time to get established before having to make large loan payments. While some participants believe they will be in a better position to make larger payments later, others aren't so optimistic about the future, or believe their expenses will increase along with their income as they take on family obligations. They are concerned that payments at the end may become too large, and a large amount may be spent on interest because of the smaller payments in early years.

The income contingent plan allows borrowers to pay off their loan as they can afford to do so. However, most participants object strongly to the inclusion of a spouse's income in the equation, and believe repayment amounts should be based solely on their individual income. Participants would also like this repayment plan to be based on current income, not last year's income, anticipating that less income this year than last could result in economic hardship. They would also like this repayment plan to take into account current expenses, and be based on discretionary income rather than gross income. Participants recognize that determining borrower's income could add to administrative expenses for this option. They also believe this option has the greatest potential for fraud. When asked if they would voluntarily report their income to the Department of Education under this option, they note that people might voluntarily report their income, but it would probably not be their whole income.

Participants would like to see the option of repaying loans through work or community service programs, particularly for those who are unemployed.

Repayment Methods

Participants are most concerned with control and convenience in selecting a repayment method. Although many are wary about letting a bank or employer make their loan payment for them, they like the convenience associated with having one less bill to pay.

Writing a monthly check and employer withholding were the most popular payment methods. Those who prefer to write a check every month feel they maintain more control over their finances that way. More specifically, they can pay more when they are able and withhold payment when necessary. The check also serves as documentation that a payment was made, should a question ever arise. Those who dislike the idea of writing a check every month find they may forget to do it, or see it as just one more thing they have to do.

Employer withholding was perceived as an easy and convenient payment method by many participants. The payment is made without any thought or effort on the borrower's part, once withholding is set up. Also, payments are much less painful than writing a check. That is, the borrower feels that money was never theirs so they don't miss it. Participants would particularly like this method of withholding if it were done on a pre-tax basis. Concerns about this method center on employer fraud and mistakes, and privacy issues. Some participants worry employers would withhold the money, but not pay the government. Others worry that mistakes made by the employer would be difficult to trace and correct, while they would still be responsible for the payment. Some participants object to their employer knowing about their financial obligations. Participants also wonder how they would know what their outstanding balance is with this method.

While electronic transfers are also seen as an easy and automatic method of payment by some, the majority of participants don't like the loss of control over their finances envisioned with this method. While they wouldn't forget to make the payment with this method, they worry that they wouldn't know exactly when the money would be taken out of their account, and they would have to remember to have the funds in the account to cover the payment. This method was also seen as making it difficult to keep track of their account balance. They are also afraid of mistakes being made with this method, and of having no way of documenting that payments were made.

Loan Processing/Servicing Agency

Participants felt that customer service and efficiency are the most important qualities that a loan processing agency should have. They expressed concerns about poor customer service received in the past from the different organizations that they have dealt with, as well as some apprehension about what organization could administer the program most efficiently.

Organizations mentioned by participants as possible contenders for loan processing and servicing were the Department of Education, the Internal Revenue Service, private contractors (such as banks), Sally Mae, the Federal Credit Union, and educational institutions. While the Department of Education was mentioned most frequently and was thought to be most empathetic to the student perspective, some participants do not see loan processing as the Department's area of expertise. Some participants also think the Department of Education has more important responsibilities on which it should focus its attention. And while the Department of Education was expected to be the most knowledgeable of the student perspective, those who have had direct experience with the Department (including financial aid advisors) do not necessarily find its staff knowledgeable or accommodating.

Private industry was the second most often mentioned loan processing and servicing agency. Private contractors were thought to be more customer service oriented than governmental agencies, although some participants were skeptical about having only one organization provide the services. Rather, they would like to see several private contractors provide services so that the element of competition is not removed from the mix. Banks in particular are thought to have the appropriate expertise.

Those who favor the IRS as the loan processing and servicing agency see it already having the necessary expertise, infrastructure and access to information. Participants predict default rates would decline if the IRS were involved, and that they would be effective at collecting from defaulting borrowers. On the down side, many participants perceive the IRS as a strong-arming organization that would not understand a late payment or do much to renegotiate loan terms if necessary. The IRS is also seen by some as inefficient, difficult to navigate, and lacking in a customer service orientation. Some participants suggest if the IRS is to be involved, that a separate division be created specifically for dealing with student loans, and that personnel be trained specifically for dealing with student loan issues. Some suggest the IRS should only be involved with late payers and defaulters.

Most participants say that the loan processing and servicing agency which is chosen will not affect their choice of loan repayment plan.

Pursuing Those Who Do Not Repay Their Student Loan/IRS Involvement

Participants vacillate between harshness and leniency when asked how the government should handle those who do not repay their loans. While on the one hand, the vast majority of participants want to see the loans repaid, they also believe leniency is in order for those who are communicating with the government and letting them know if they are having financial difficulty. Little or no leniency was suggested for those who have the means to repay their loans and simply refuse to do so, with renegotiation of loan terms being the first choice, but seizing assets acceptable in "hard core" cases. Reporting late payments and non-payment to credit bureaus was seen as particularly harsh, especially for those having financial difficulties or those who may be applying for a deferment that may take many months to obtain.

Many participants believe that not repaying a student loan is just as serious as, or more serious than, not paying taxes, although they believe the consequences for non-payment of taxes are much more severe than for non-payment of student loans. They believe more stringent IRS enforcement of student loan payments would decrease the default rate, but it may also discourage some students from taking loans and pursuing an education or as much education as they might like. Some participants believe IRS enforcement would cause students to take the loans more seriously in the first place, and those who are unlikely to repay them might also be less likely to accept them. Participants believe IRS enforcement would have a limited impact on tax filing behavior, with most participants conveying that filing a tax return is something that they just have to do.

Section IV

Options for IRS Involvement

Options 1 through 5 are presented in a progressive format. Option 1 calls for the minimal amount of IRS involvement while Option 5 serves as the maximum extent that the Service can be involved short of a massive overhaul of the processing system.

Option 1 - Information Sharing as Currently Authorized

Description

In the short-run, Option 1 is the only option. It is the Direct Loan Program as currently authorized by law. The Omnibus Budget Reconciliation Act of 1993 authorized the Internal Revenue Service to share limited individual income tax information with the Department of Education for the purpose of establishing income-contingent repayments under the Federal Direct Student Loan Program. Option 1 represents minimal involvement by IRS. Option 1 comes close to emulating the ideal student loan system outlined in Section II.

Under this option, the Department of Education retains complete control over the student loan program. Not only does the Department of Education oversee the policy and regulatory process, it would be solely responsible for originating and servicing Direct Loans. Included with this responsibility, but not limited to, would be:

- establishing regulations and procedures
- issuing loans
- maintaining records
- periodic billing (including income-contingent repayment amounts)
- processing payments
- posting accounts
- handling borrower inquiries
- issuing deferments or forbearances
- resolving disputes
- collecting defaulted accounts[1]
- **monitoring program**

In addition to processing and program management responsibilities, the Department of

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[1] The refund offset program, administered by IRS, is included in each of the five options. Under the refund offset program, the IRS offsets the refunds of taxpayers, referred by participating agencies, in order to satisfy individuals' nontax Federal debts. Participating agencies refer taxpayers to IRS for refund offset when other debt collection efforts have failed.

Education would be responsible for maintaining a high degree of customer service. Because only one agency would be involved, the lines of accountability are very clear.

The Department of Education is required to have the first year regulations for the Direct Loan Program in place by May 1994 so that it can begin to issue loans in July 1994. Education is also required to have subsequent year regulations in place by December. Because this is a new program, the Department of Education expects that there will be changes between the initial and final regulations. As part the evolutionary regulatory process, Education is required to use negotiated rulemaking in developing the final regulations. To minimize changes in the regulations, the Department of Education is planning to incorporate the results of the negotiated rulemaking sessions into the first year program.

While income-contingent is only one of many repayment options under the Direct Loan Program, it provides several challenges to implement. Income-contingent repayment is not dependent on the tax system (e.g., wage withholding, estimated payments) for payment processing. Income-contingent means that repayment should be based, in part, on the ability to pay. *Method of payment is not, nor should it be, entered into the equation as a precondition for income-contingent repayment.* Repayments can be made either by writing a check or transferring funds electronically as long as the repayment amount is based on ability to pay.

Initially, the Department of Education intends to base repayment on prior year's adjusted gross income (AGI) and amount borrowed. Education has contracted with a private vendor to administer the Direct Loan Program. Involvement by the Internal Revenue Service is strictly limited to sharing information from individual income tax returns (e.g., name, address, taxpayer identification number, filing status and adjusted gross income) with employees of the Department of Education as authorized by the Omnibus Budget Reconciliation Act of 1993. While this information can be provided on a regular basis, due to IRS processing constraints, data from the most recent tax year would not become available until July or August of the following year.

Advantages

Option 1 is the least disruptive option for the IRS to implement. Since IRS currently offsets refunds of taxpayers referred by the Department of Education, all Option 1 adds to IRS is the sharing of limited information.

Option 1 also emphasizes customer service, one goal of the ideal student loan system. Students, or borrowers, no longer need to depend on banks for their education loans. This effectively eliminates problems associated from having loans at multiple banks. Furthermore, since IRS participation in the program remains in the background, borrowers only interact with one agency.

Disadvantages

The major disadvantage of Option 1 stems from a conflict between Education's processing method and Internal Revenue Service's disclosure provisions (Section 6103 of the Internal Revenue Code). The conflict stems from the use of contractors. Education has awarded a servicing contract to a private vendor to administer the Direct Loan Program. IRS is authorized to disclose tax information to employees of the Department of Education, but not to its agents (contractors).

Because IRS disclosure provisions prohibit sharing tax return information with contractors, the Department of Education may not be able to offer income-contingent repayments as an option to borrowers. Even if the Department of Education calculated income-contingent repayments and provided the results to the contractor, §6103 would be violated. To comply with §6103, the Department of Education may have to service loans for borrowers electing the income-contingent repayment option. Since the standard, extended and graduated repayment plans do not depend on tax return information, Education's contractor could service loans under those repayment plans.

To resolve the conflict between Education's reliance on contractors to administer the Direct Loan Program and §6103 disclosure provisions, Education is planning to offer income-contingent repayment on a conditional basis. Income-contingent will be dependent on the borrower signing a waiver which allows IRS to provide the direct loan servicing contractor with AGI, filing status, and entity information for the purpose of determining the required repayment amount. While the use of a waiver allows the IRS to legally release return information to the contractor, it greatly complicates the operational process of information sharing.

Option 2: Increased Information Sharing

Description

Option 2 builds on Option 1. As in the first option, the Internal Revenue Service would continue to play a passive role in the Federal Direct Student Loan Program. The role of the IRS would be limited to sharing tax return information and offsetting refunds.

In terms of structure and organization, Option 2 is identical to Option 1. The Department of Education retains complete control over the student loan program. Not only does the Department of Education oversee the policy and regulatory process, it would be solely responsible for originating and servicing Direct Loans. Included with this responsibility, but not limited to, would be:

- establishing regulations and procedures
- issuing loans
- maintaining records
- periodic billing (including income-contingent repayment amounts)
- processing payments
- posting accounts
- handling borrower inquiries
- issuing deferments or forbearances
- resolving disputes
- collecting defaulted accounts
- monitoring program

In addition to processing and program management responsibilities, the Department of Education would be responsible for maintaining a high degree of customer service. Because only one agency would be involved, the lines of accountability are very clear.

There are three variations of Option 2:

- Option 2(a): Expansion of tax return information that can be shared with the Department of Education based on demonstrated need.
- Option 2(b): Expanding the scope of the waiver to include additional information to Education's contractor based on demonstrated need.
- Option 2(c): Joint IRS/Education developed system to manipulate return information so that there is no disclosure of return information to contractors.

These three variations of an increased information sharing are designed to allow Education access to additional information which would aid in administering income-contingent repayments and in the collection of defaulted debt. The exact information that would be included in the enhanced program would be determined based on a need demonstrated by the Department of Education.

In Option 2(a), legislative changes would be required. Under Option 2(a), IRS and Education would have to work together to determine the additional information to be specified under §6103 which could aid Education in administering the direct loan program. Additional tax return information could be useful to Education in several ways. Under the proposed Direct Loan Program, borrowers who elect income-contingent repayment will be required to provide information such as family size and marital status to the contractor as variable which influence the repayment amount. If Education were to process the repayment formula in-house, then IRS may be able to legally provide the additional information and eliminate the need to go to the borrower for the information. The use of additional tax variables in the repayment formula may prevent the contractor from backing out the individual pieces of return information.

In addition to providing Education with additional information to support the income-contingent repayment plan, Option 2(a) could also include information that may be beneficial to Education in collecting defaulted debt. Although Education also uses contractors for much of their debt collection activities, IRS and Education could work together to determine if additional information could be used to determine defaulters' financial situation prior to establishing installment agreements.

Under Option 2(b), the scope of information included in the waiver would be expanded to allow IRS to release more tax return information to Education's direct loan servicing contractor for the purposes of administering income-contingent repayments. As in Option 2(a), the additional information to be included in the waiver would be based on a demonstrated need by the Department of Education.

Option 2(c) would consist of a joint IRS/Education system which would manipulate tax return information so that there would be no disclosure of return information. As part of Option 2(c), IRS could act in an "advisory" capacity to the Department of Education. The IRS has historical knowledge of collection and processing functions. The IRS also knows how to use income tax information. The Department of Education recently was provided with additional collection tools such as wage garnishment. IRS could assist Education in the implementation of wage garnishment as an effective defaulted student loan collection technique based on its experience in collecting delinquent taxes. IRS also has a long history in processing information from a variety of sources. IRS may be able to assist Education and its contractor in improving their payment processing system. Such an ongoing partnership between the two agencies could end up being of mutual benefit. For example, Education may be able to assist IRS by providing information on borrowers entering repayment so that the IRS can make a proactive contact (i.e., sending tax packages to borrowers entering repayment status) to help eliminate potential nonfilers.

Advantages

The increased information sharing under Option 2, like Option 1, is least disruptive to IRS operations. Since IRS currently offsets refunds of taxpayers referred by the Department of Education, all Option 2 adds to Option 1 is the expansion of return information that can be shared with the Department of Education.

Option 2 also emphasizes customer service, one goal of the ideal student loan system. Students, or borrowers, no longer need to depend on banks for their educational loans. This effectively eliminates problems associated from having loans at multiple banks. Furthermore, since IRS participation in the program remains in the background, borrowers only have to interact with one agency.

Option 2 allows Education to make income-contingent repayments even more equitable. Additional tax return information can be used to develop a repayment plan that comes closer to representing ability to pay. In addition to AGI, selected line items, such as number of dependents, could provide a more realistic repayment scheme.

Disadvantages

With the institutionalizing of consents (waivers), one concern is that the public will lose confidence in the integrity of the tax system. With other agencies (and contractors) having access to tax information, the potential for abuses of such information increases dramatically. Coupled with the integrity issue is the "big brother" perception and privacy concerns. One result from the focus groups conducted as part of this study is that the public already thinks that the IRS knows everything about taxpayers. With the increased sharing of information, this information then becomes the property of the Federal government, not just IRS. Knowledge of this information could lead to violations of privacy or discriminatory treatment.

Option 3: IRS Collects Defaulted Debt

Description

Option 3 builds on either of the previous two options. Like Options 1 and 2, the Department of Education retains almost complete control over the student loan program. Not only does the Department of Education oversee the policy and regulatory process, it would be solely responsible for originating and servicing Direct Loans. Included with this responsibility, but not limited to, would be:

- establishing regulations and procedures
- issuing loans
- maintaining records
- periodic billing (including income-contingent repayment amounts)
- processing payments
- posting accounts
- handling borrower inquiries
- issuing deferments or forbearances
- resolving disputes
- monitoring program

All of these responsibilities belonged to the Department of Education under Options 1 and 2 as necessary functions for a competently run program.

However, the role of the Internal Revenue Service fundamentally changes under this option. In this scenario, IRS would move from being a passive partner to active participation as legislation would be enacted that would authorize IRS to collect defaulted student loans for the Department of Education. In effect, IRS becomes the primary collector of defaulted loans.

Under Option 3, the Department of Education continues to determine when a debtor enters default status. Once a debtor defaults, the Secretary of Education declares the entire outstanding principle to be defaulted and refers the remaining balance to the IRS *using an administrative judgement that allows the IRS to treat the defaulted debt as if it were a tax.*

As a tax, a defaulted student loan would be subjected to the same collection procedures used to collect delinquent individual income taxes. IRS collection personnel would not be aware that they were collecting an assessment that had once been a defaulted student loan. The first step in the IRS collection process consists of a series of computer generated notices requesting payment. Some taxpayers respond to the notices either by complying with the notice and others partially comply or fail to comply with the notice. If taxpayers do not respond to the notices, these cases would enter Tax Delinquent Account (TDA) status. Resolution of TDAs begins at the Automated Collection Service (ACS) call sites. ACS is a relatively low cost collection system. A series of phone calls are made at the

ACS call sites to taxpayers requesting payments. If these phone calls do not resolve the TDAs, the cases enter a queue and are electronically prioritized. Cases with the highest priority are assigned to a Revenue Officer (RO). Those cases not assigned to an RO remain in the queue until all cases with a higher priority have been assigned. Revenue Officers use a variety of activities from phone calls to personal interviews to resolve the TDAs and are responsible for the cases until they close.

To maximize customer service and minimize problems with IRS using its collection authority, the Department of Education will perform dispute resolution to the same degree it currently does prior to refund offset referrals. The accounts referred to the IRS should be as "clean" as possible. IRS personnel are trained to collect taxes under the Internal Revenue Code. Student loans are subject to different statutes and regulations. By trying to resolve disputes with defaulters prior to referral to IRS, potential problems with IRS collection are minimized. While the IRS does have an appeals process and problem resolution program to handle disputes, these programs are geared towards tax collection, not debt collection. Employees of the Department of Education (or its contractors) should be more responsive to the needs of its borrowers. Education has the expertise and knowledge of the student loan process and the regulations pertaining to their programs. Rather than being referred to IRS, a defaulter may be entitled to a forbearance or deferral. In addition, a defaulter may enter voluntary repayment rather than be subjected to IRS collection.[2] Finally, if disputes are resolved prior to referral, then the impact on IRS operations are minimized.

Since IRS would collect defaulted student loans as if they were delinquent taxes, the avenues available to resolve problems after referral would be identical to the mechanisms used to resolve tax disputes. Taxpayers have the problem resolution program, appeals and Tax Court available to resolve disputes with IRS. While the dispute resolution mechanisms for taxes could be used to solve defaulted student loan problems, borrowers, Education and IRS would be better served if disputes were resolved prior to referral.

As stated earlier, the IRS would assume responsibility for collecting all defaulted student loans regardless of originating loan program (Federal Family of Education Loans or Direct Loan Program).[3] Depending on the year of implementation, the IRS could eventually pick up the 7 to 10 million defaulted accounts from the Federal Family of Education Loans. The $22 billion accounts receivables would become part of IRS's accounts receivable inventory. To ensure integrity and accountability in the student loan system, the IRS would

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[2] Under the refund offset program, the Department of Education issues a 60 day notice to defaulters of their intent to refer their account to the IRS for refund offset. For the 1994 filing season (through February 22, 1994) $30,432,984 was received in voluntary payments and $130,234,311 was offset for the Department of Education.

[3] IRS would assume responsibility for collecting <u>all defaulted debt</u> under Options 4 and 5 as well as under Option 3.

have to develop internal accounting routines that would track student loan collection efforts separately from normal tax collection. Furthermore, IRS must be able to notify the Department of Education when the defaulted debt has been paid in full. In determining the success of the Direct Loan Program, the Department of Education must be able to measure the impact on defaults and the ability to collect defaulted debt. Finally, for program integrity, Education also must be able to track default information by individual since borrowers in default are not eligible to receive further assistance from the Department.

As in Options 1 and 2, the Internal Revenue Service will continue to offset refunds to pay defaulted debt. In addition to the refund offset program, the IRS will submit the defaulted debt to the same activity used to collect delinquent taxes. In fact, IRS will not discriminate against defaulted debt or treat it any differently from tax collection. Defaulted student loans will receive the same series of notices that are sent due to delinquent tax cases. The deferral level that applies for tax cases will also apply to student loans.

While defaulted student loans will be collected as delinquent tax liabilities, IRS Collection function will have to develop an effective collection strategy. If student loan cases are assigned priority in collection workload selection, then defaulted student loan cases may be worked ahead of higher value tax cases. The average defaulted student loan balance is approximately $3,700. The average value of tax collection cases referred to the field is much higher. Assigning priority would allow more student loan cases to be worked, which may result in higher defaulted loan collections. If defaulted student loan cases are not assigned priority, then many of the cases would wind up in the queue and remain there until the 10 year statute of limitations expires. Assigning workload priority to defaulted student loans ensures that these cases will be actively worked.

While assigning priority represents one extreme of collection workload management strategies, the other extreme is allowing student loans to be worked on the same criteria as income tax cases. Compliant taxpayers may become noncompliant based on their experience with IRS collecting student loans. IRS loan collection may leave defaulters with the impression that the IRS is soft on student loan collections. This attitude could spill over to their perceptions of IRS tax collections.

In addition to the concern about compliance, collection prioritization may be increased for defaulted student loans to reflect the age of the accounts. Defaulted student loans from the FFEL Program already have been worked extensively by banks, guaranty agencies and Education's debt collection contractors. These defaulted accounts have received a number of notices and telephone contacts as well as tax refund offset. Because they have been worked extensively, a higher percentage of defaulted student loan cases may be referred to Collection Field personnel than if they were delinquent tax cases.

Defaulted student loans would be added to any delinquent taxes. The coupling of student loans and delinquent taxes would serve to increase the priority of the collection effort. From the Revenue Officers' perspective, student loans would be indistinguishable from delinquent taxes. However, from a program accountability perspective, student loan collections should be tracked separately from tax collections. Therefore, in cases where a taxpayer has both a defaulted student loan and delinquent taxes, payments will have to artificially allocated between taxes and student loans. If taxes are paid first, then the borrower would not be eligible for another student loan until all delinquent taxes and student loans are paid. If student loan accounts are credited first, then borrowers would be eligible for additional loans even though they have delinquent tax accounts. The prioritization of defaulted student loan or delinquent tax payments needs to be determined prior to IRS involvement in defaulted student loan collection.

Advantages

The major advantage of Option 3 is that since defaulted debt can be treated like a tax, the Internal Revenue Service can use its full collection powers. With the use of increased enforcement powers, the size of the defaulted student loan portfolio should gradually be reduced. IRS does have more powerful collection devices available than the Department of Education. Besides wage garnishing (levy), IRS has the authority to levy bank accounts and seize physical property. The Service also uses the refund offset mechanism to apply payments to delinquent tax accounts. Because IRS would be treating defaulted loans like a tax, all of these collection mechanisms would be available for use on accounts which meet the requirements.

Based on historical tax collection data, the Service collects approximately 70% of the original assessed dollars in tax cases within the first three years. Approximately 70% of eventual collections are received during the first year. Between the banks, guaranty agencies and the Department of Education, approximately 60% of defaulted student loans eventually are collected.[4] Between the guaranty agencies and the Department of Education, approximately $22 billion in student loans are currently in default. Loans are different from taxes; therefore, it is unclear whether IRS would have a higher collection rate than Education.

An additional advantage of using the IRS as the default collection agency concerns defaulters who also have outstanding tax liabilities. IRS assigns workload selection priorities to delinquent cases based on a number of factors. One of the factors is the size of the delinquent account. The addition of defaulted debt to the amount of delinquent taxes will increase the collection priority of those borrowers. Furthermore, the defaulter only has to deal with one agency rather than two.

Option 3 has the potential of another advantage to the IRS. There is the possibility that some defaulters will turn out to be individuals for whom IRS has no prior tax filing

[4] This includes collections from the refund offset program administered by the Internal Revenue Service.

record. Since the population of borrowers in repayment status tends to be mobile, the Department of Education could have information on potential noncompliant taxpayers.

Disadvantages

There are major disadvantages to using the Internal Revenue Service as the defaulted student loan collection agency arising from the following:

- A high percentage of defaulted loan balances fall below the IRS deferral level.
- There are approximately 7 million current defaulters in FFEL and approximately 650,000 defaulters added annually.
- Unless IRS receives very substantial increments of resources, collection of student loans will divert resources from tax collections.

Each of these factors creates large workload management problems for IRS Collection.

To aid collection workload management, the IRS established a deferral level which fluctuates depending on the inventory of cases and available resources. Cases under the deferral level receive the normal stream of collection notices and refund offset. After the final notice, collection efforts are placed on hold until additional delinquent taxes and interest raise the account above the deferral level. While the notice stream is an effective collection tool, taxpayers (or borrowers, in this scenario) may perceive the IRS as being soft on compliance.[5] After all, these defaulters have already received a number of notices from banks, guaranteed agencies, and Education.

The collection of defaulted student loans will greatly impact IRS workload management. Based on department of Education statistics, there are approximately 7 to 10 million borrowers currently in default with an additional 650,000 defaulters expected each subsequent year through 2000. All of the currently defaulted loans and the majority of the expected defaulted loans are from the Federal Family of Education Loans (FFEL). Only a small percentage of projected defaulters are expected to be from direct loans.

Since the majority of the defaulted loans are held by guaranteed agencies, the cost analysis assumes that IRS would not receive the entire portfolio at once. Instead, IRS expects 2.05 million defaulters each year for the first five years. To work these cases, IRS would require a substantial increase in resources. Furthermore, collection resources required for active work beyond the notice stream and refund offset would have to be increased substantially.[6]

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[5] See the Compliance Analysis section for further details.

[6] See the cost analyses for further details.

All of this means that there will be large opportunity costs associated with IRS collecting defaulted student loans. To handle the increased workload, IRS would require additional resources. However, instead of applying the additional resources to student loan cases, the IRS could use the resources to collect delinquent taxes. On average, student loans balances are lower than delinquent taxes. If the additional resources were applied to outstanding taxes cases currently in IRS' inventory instead of defaulted student loans, approximately $770 million per year in tax revenues could be collected.

Furthermore, regardless of how payments are divided between defaulted loans and delinquent taxes, the prioritization scheme will be artificially derived. While treating defaulted student loans as if it were a tax for collection purposes minimizes problems for IRS' collection personnel, it does not allow the Service to accurately separate collections from individuals who defaulted on a student loan and have outstanding tax liabilities.

Finally, student loans are different from taxes; therefore, IRS' ability to collect defaulted student loans will be different from its ability to collect delinquent taxes. Tax liabilities are based on income, so there should be a high probability of eventual collection. On the other hand, defaulted student loans are not income dependent. Loans are offered as a means to enable students to afford post-secondary education.

Based on studies conducted by the General Accounting Office and various guaranty agencies, defaults are more likely among those attending proprietary schools and community colleges, independent students, freshman, dropouts, students with meager financial resources, and those who do not receive loan counseling. In 1989, the Department of Education analyzed the effects of five variables on default status: type of institution attended, AGI, independent/dependent status, years of schooling completed, and enrollment status (i.e., graduated, withdrawn). Statistical analyses indicated that AGI, type of institution, and years of schooling were highly correlated with default. Because the correlation between AGI and default status was negative, the collection of defaulted debt by the IRS poses a high degree of risk.

Option 4: IRS Collects Income-Contingent Direct Student Loans

Description

Option 4 builds on Option 3. In addition to collecting defaulted debt, Option 4 requires that the Internal Revenue Service process all income-contingent Direct Student Loan repayments through the tax system. All other Direct Loan repayments will be handled by the Department of Education or its Direct Loan Servicing Contractor. This option requires that the Internal Revenue Service be granted the legislative authority to collect student loan repayments as if they were taxes.[7]

Income-contingent repayment schedules are based on the borrowers' ability to pay. Borrowers would estimate the additional wage withholdings or estimated quarterly payments necessary to meet their required repayments. The estimated withholding or quarterly payment for student loan repayment would be based on a worksheet or formula provided to the borrower by the Department of Education. For wage earners, borrowers could either specify the additional withholdings or adjust their allowances on Form W-4, Employee's Withholding Allowance Certificate. Self-employed taxpayers would have to increase their quarterly estimated tax payments.

The reconciliation between required and actual payments and liabilities would occur on the annual individual income tax return. In principle, this reconciliation would be similar to the reconciliation between tax payments and tax liabilities. The most likely method for handling student loan reconciliations would be through the creation of a new schedule and the addition of new lines on Form 1040.

Because the Department of Education would retain responsibility for overseeing the entire Direct Loan program and would maintain and service accounts, the IRS would have to be notified on an annual basis to expect student loan repayments. The IRS would then:

- Compare the sum of required loan payments and tax liabilities to total actual payments (the sum of withholding, estimated payments and remittances with the return).
- Issue notices and notify Education of underpayments (nonpayments).
- Refund overpayments.

If a borrower fails to pay or underpays the required repayment for that year, IRS would issue a balance due notice and attempt to collect the delinquent amount through normal collection procedures. However, the Department of Education, not IRS, would make the determination of when the debtor entered default status. Education would then accelerate the outstanding loan balance and refer it to IRS for collection as if it were a tax.

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[7] In effect, income contingent repayments would be a surtax under this option.

Advantages

This option has several distinct advantages over the first three options. It leverages an existing system for collecting revenue based on income. As with the income tax system, income-contingent student loans could be repaid through wage withholding, estimated quarterly payments and a remittance filed with the tax return (subject to a potential penalty for underpayment). If wages are the primary source of income, borrowers can either use an existing line on Form W-4 to specify additional withholdings or decrease the number of allowances to cover their student loans. If a borrower is self-employed, then additional calculations would be necessary to determine the additional payment to include with the quarterly return.

Because no changes to the withholding system are planned, burden on employers is minimized. In fact, the burden and responsibility rests with the borrower. Employers would not be able to, nor would they be required to, separate withholdings for student loans from withholdings for taxes. While there will have to be some changes to the existing individual income tax forms as well as the addition of another schedule, employers would not have to develop or change existing accounting systems to handle income-contingent repayments.

Using the existing system also benefits the government as opposed to changing the tax system. While IRS would have to make extensive changes in processing and accounting, they pale in comparison with the changes that would be necessary to accommodate an overhaul of the withholding system.

Disadvantages

Because Option 4 incorporates Option 3, the disadvantages of Option 3 also apply to Option 4. Since Option 3 contains a full description of these disadvantages, the discussion of drawbacks to Option 4 will focus on the income-contingent portion that is unique to IRS involvement.

The weaknesses of Option 4 flow directly from its strengths. Option 4 uses the existing tax collection system to collect income-contingent student loans. One consequence of this option is that the Direct Loan Program goal for program accountability is not fully met. Because payments are not separated by account category, *loan payments* for individuals' choosing income-contingent repayment are indistinguishable from *tax payments*. This has serious consequences if either the loan or tax is underpaid or not paid. For example, a borrower underwithheld taxes and correctly adjusted withholdings for the student loan. Loan payments and student loan payments are inseparable. Which account is fully credited? It becomes an prioritization issue of how payments are allocated between income taxes or student loans. Regardless of the borrower's intent, Option 4 requires that an artificial prioritization between student loan and tax accounts be developed.[8]

While spousal income is included as a basis for income-contingent student loan repayment under all options, it becomes a particularly significant problem when IRS is involved in collection. The individual income tax system is a progressive tax system which means that the marginal tax rate increases as income increases. Tax withholdings are based in part on filing status; however, the potential exists that married borrowers could have taxes withheld at a lower marginal rate and then be liable at the higher marginal tax rate. Therefore, even though a married borrower could have adjusted withholdings to account for the income-contingent student repayment, the borrower (and spouse) may be underwithheld for taxes. Therefore, the amount that was intended to be student loan payments may be used to offset the delinquent tax

From the point of view of traditional loan servicing, an additional disadvantage with Option 4 is that the Department of Education will not know how much has been repaid until loan and tax withholdings have been reconciled with the required liabilities on the individual income tax return. This reconciliation occurs only once a year. Approximately 18 months could pass before an underpayment is noticed. This is a serious weakness.

Option 4 has one final disadvantage that stems from using the tax system for collecting payments. As stated earlier, reconciliation between payments and liabilities occurs once a year. Furthermore, payments are posted only once a year. Therefore, this plan really amounts to an annual payment. While this does not matter on the surface, it does matter over the course of the repayment schedule. On a conventional loan, the amount borrowed is amortized over a fixed period at a fixed interest rate. Varying the repayment frequency can vary the payment amount and the total interest as well as the term of the loan. More frequent payments reduces the total interest paid on a loan. From a borrower's perspective, payments coincide with paydays. Borrowers paid on a monthly basis should conform to borrowers who do not choose income-contingent. However, not all borrowers are paid on a monthly basis. Many payrolls are based on bimonthly, biweekly, or weekly basis. These more frequent payments should result in a quicker repayment schedule. However, the existing tax collection system precludes crediting individual accounts during the course of the year.

To the extent that student borrowers underreport their income to IRS, income-contingent repayments will be incorrectly calculated. To the extent that they fail to pay their taxes, they will fail to repay their student loans.

[8] Under refund offsets, outstanding tax liabilities receive first consideration.

Option 5: IRS Processes All Federal Direct Student Loans

Description

Option 5 builds on Option 4. In Option 5, the Internal Revenue Service would collect defaulted student loans and process all direct student loan repayments, regardless of repayment method. Option 5 requires that Congress pass legislation which would allow the Internal Revenue Service to:

- use its enforcement functions to collect defaulted or delinquent student loans;
- use its tax collection system to collect income-contingent direct student loans; and,
- process all other direct student loan payments (e.g., standard, extended or graduated repayments).

Under this option, the IRS becomes the primary student loan collector for the Federal government.

The underlying assumptions that were discussed in Option 4 are retained in this option. The Department of Education retains overall responsibility for the Federal Direct Student Loan Program (FDSLP). Included with this responsibility is the maintaining and servicing of student loan accounts. Furthermore, the Department of Education is responsible for determining when borrowers enter default status. For payment processing and default collection purposes, the Internal Revenue Service would treat loan repayments like a tax.

Based on Department of Education projections, the income-contingent repayments constitute only 20% of all direct loans. The income-contingent portion would be handled according to the system described under Option 4. As in Option 4, the IRS would not distinguish income-contingent loan payments from tax payments.[9]

The remaining 80% of student loans would be repaid via standard, extended, or graduated payments. From a processing point of view, there is virtually no difference between standard, extended, or graduated payments: they are all variations of a fixed payment plan. Since the Department of Education would remain responsible for maintaining and servicing accounts, all that IRS would require from Education is the payment amount for the coming year. **Payments could be received either through additional withholdings or** estimated payments, similar to the income-contingent repayment option, or IRS could issue a coupon book to each borrower with the monthly payments for the coming year. By using coupon books, IRS would then be in a position to track payments and issue reminder notices when payments are behind schedule.

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[9] This means that the IRS would treat nonpayment or underpayment of student loans identically to nonpayment or underpayment of taxes.

For borrowers electing a repayment plan other than income-contingent and electing to use coupon books, IRS would be able to identify student loan payments. IRS would be able readily distinguish student loan repayments from tax receipts. Since payments are already separated from normal tax collection, IRS can track individual payments. For example, if a borrower misses a payment, IRS can issue a reminder notice and notify Education of the account status. Under income-contingent, it is impossible to identify underpayments or nonpayments until the tax return is filed.

If borrowers elect to repay their student loan through adjusted withholdings or estimated quarterly payments even though they elected standard, extended, or graduated payments, the reconciliation between required and actual payments and liabilities would occur on the annual individual income tax return. This reconciliation would be similar to the reconciliation performed by borrowers who selected the income-contingent repayment option.

Advantages

This option has the same advantages as Option 4 with respect to income-contingent repayments. The addition of IRS processing fixed payments add several benefits to the Federal government.[10]

Income-Contingent Repayments

Like Option 4. Option 5 leverages an existing system for collecting revenue based on income. As with the income tax system. there are three ways to pay the yearly liability:

1. wage withholding
2. quarterly payments
3. payment filed with return (subject to a potential penalty for underpayment)

If wages are the primary source of income. borrowers use an existing line on Form W-4 to specify additional withholdings to cover their student loans. If a borrower is self-employed. then additional calculations would be necessary to determine the additional payment to include with the quarterly return.

Because no changes to the withholding system are planned, burden on employers is minimized. In fact, the burden and responsibility rests with the borrower. Employers would not be able to. nor would they be required to. separate withholdings for student loans from withholdings for taxes. While there will have to be some changes to the existing individual income tax forms as well as the addition of another schedule. employers would not have to develop or change existing accounting systems to handle income-contingent repayments.

10 Fixed payments consist of the standard. extended and graduated repayment plans.

Using the existing system also benefits the government as opposed to changing the tax system. While IRS would have to make extensive changes in processing and accounting, they pale in comparison with the changes that would be necessary to accommodate an overhaul of the withholding system.

Fixed Repayments

IRS processing of fixed repayments offers additional benefits. The IRS is already in the business of processing large volumes of information. The addition of student loan processing represents a marginal increase in business over current tax return processing.

Disadvantages

The disadvantages of Option 4 also apply to Option 5. In addition, Option 5 generates some equity issues. Borrowers, whether they opted for income-contingent or fixed repayment, who elect to repay through the tax system will be treated differently from borrowers who use coupon books. In the case of underpayment or nonpayment of student loans or taxes, borrowers using the tax system would be subject to an artificial allocation of payments. For borrowers selecting coupon book repayments, IRS would know where the underpayment or nonpayment occurred. IRS can track payments using coupon books. While this unequal treatment of borrowers exists under Option 4, Option 5 centralizes it within one processor. The public perception of IRS processing student loan payments maybe extremely negative.

Section V

OBRA Conference Report Issues

Introduction

Section IV provided a brief description of the five options developed for determining the feasibility of IRS involvement in the Federal Direct Student Loan Program (FDSLP). In addition to the descriptions, the major advantages and disadvantages (from the Federal government's perspective) and program cost estimates were addressed. In addition to developing alternative roles for IRS involvement, the OBRA '93 conference report specifically requires that the Departments of Treasury and Education address five issues concerning the involvement of the Internal Revenue Service in the FDSLP. In this section, each issue is examined in the context of each option. The five options for IRS involvement which were developed in Section IV are:

Option 1 — *Information sharing as currently authorized (i.e., name, address, TIN, AGI, and filing status).* Under this option, Education would administer student loan repayments. IRS would continue the refund offset program for student loan defaulters.

Option 2 — *Increased Information Sharing.* This option is similar to the first option; however, additional legislation would be requested to allow Education to use additional income and employment information to administer an income contingent repayment system. IRS would continue the refund offset program for student loan defaulters.

Option 3 — *IRS Collects Defaulted Debt.* Under this option, Education would administer the student loan repayment system and refer defaulted debtors to the IRS for debt collection (requiring a administrative judgement from Education to treat defaulted debt like a tax).

Option 4 — *IRS Collects Income Contingent Student Loans.* This option would require legislation for the IRS to handle repayment of student loans through wage withholding or estimated payments, for debtors who select income-contingent repayment. In addition, IRS collects defaulted debt.

Option 5 — *IRS Collects Direct Student Loans, Regardless of Repayment Plan.* Under this option, legislation would be required to allow IRS to handle repayment of <u>all direct student loans</u>, despite the repayment plan selected by the debtor (i.e., income contingent, fixed payment). In addition, IRS collects defaulted debt.

Whether IRS could implement such a system of student loan repayment system with its current resources <u>and</u> without adversely affecting its ability to collect tax revenues?

The Internal Revenue Service could implement Options 1 and 2 with minimal resources. The Service currently performs refund offsets for the Department of Education and will continue to do so under the direct loan program. In addition, the Internal Revenue Service is working with the Department of Education on the sharing of tax return information for the purposes of administering income contingent repayments.

From an operational perspective, Option 2 represents a minor extension of Option 1. In Option 2, IRS would continue to provide passive support for Education's direct loan program. Besides providing additional tax return information for administering income contingent repayment, IRS would continue to act as the collection agency of last resort through the refund offset program. In Options 1 and 2, IRS plays a supportive role, yet remains in the background. Options 1 and 2 are reimbursable programs for IRS, meaning Education reimburses IRS for the services performed.

On the other hand, Options 3, 4, and 5 represent significant new activity for IRS in collecting student loans. The role of IRS changes from being the collector of last resort to being the government's primary student loan collector. The costs of these options are significant, particularly labor costs. Furthermore, IRS costs are extremely sensitive to the volume of defaulters and the percentage of defaulted accounts that are handled through the Automated Collection System (ACS) and Revenue Officers in the field. Minor increases in the percentage of cases being worked in those functions significantly increase costs. Processing costs are also sensitive to the volumes of direct student loans, particularly the lockbox costs.

In addition to the direct costs, there are substantial opportunity costs associated with IRS involvement in the student loan program. Without additional resources, tax collections from delinquent tax accounts would suffer. If the additional resources were applied to outstanding tax cases currently in the queue instead of defaulted student loans, approximately $770 million per year in tax revenue could be collected. Given the size and distribution of IRS accounts receivables as compared with Education's portfolio of defaulted debt, collecting defaulted student loans could be construed as a mis-allocation of IRS's resources. That is, the marginal revenue to cost ratio will generally be higher for collecting tax delinquencies than for collecting defaulted student loans.

The cumulative impact of increased disclosure of tax information and increased IRS involvement in nontax collection activities on voluntary compliance with the tax laws.

This requirement addresses two separate issues. The first is the impact of increased disclosure of tax information. The Internal Revenue Service is authorized to disclose limited tax return information to other agencies as specified by §6103 of the Internal Revenue Code. To protect taxpayer privacy and ensure the integrity of the tax system and voluntary compliance, the Service strictly administers the disclosure provisions.

Since Options 1 and 2 are primarily exchanges of tax return information with the

Department of Education, the impact of increased disclosure on voluntary compliance is of significant concern. Under the current program, Option 1, §6103 does allow IRS to disclose taxpayer entity information, adjusted gross income, and filing status to Education; however, this information cannot be released to the direct loan servicing contractor. To resolve the conflict between Education's reliance on contractors to administer the Direct Loan Program and §6103 disclosure provisions, Education is planning to offer income-contingent repayment on a conditional basis. Income-contingent repayments will be dependent on the borrower signing a consent at the time of repayment which allows IRS to provide the contractor with AGI, filing status, and entity information for the purposes of determining the required repayment amount. The contractor may have other lines of financial business. If the borrower has dealings with the contractor's other lines, then the contractor may be tempted to use the tax return information.

The second issue concerns the impact of increased IRS involvement in nontax collection activities on voluntary compliance with the tax laws. This issue applies to Options 3, 4 and 5. Historically, the Internal Revenue Service has been concerned about involvement in nontax debt collection. The mission of IRS is collecting tax revenues owed to the Federal government. The Service is concerned that increased nontax debt collection activity eventually could undermine taxpayers' confidence in the tax system, resulting in an erosion of voluntary compliance.

In the Omnibus Budget Reconciliation Act of 1981, Congress authorized IRS to offset refunds for taxpayers owing support debt to families receiving Aid to Families with Dependent Children. Since then, Congress expanded the refund offset program to encompass all Federal nontax debt. In order to determine whether refund offsets negatively influence voluntary compliance, IRS conducted a comprehensive long-term study. The final results of that study, released in February 1993, concluded that the program did have a long-term negative impact on compliance. However, the program benefits outweighed the costs.[1] The dollars offset for delinquent debt were greater than the estimated loss in tax revenues.

The General Accounting Office also studied the impact of refund offsets on voluntary compliance. In a study of guaranteed student loan defaulters, GAO agreed with IRS's general conclusion that there is a decline in compliance in the year immediately following an offset. However, GAO concluded that it was only a one year decline. Both IRS and GAO agreed that the refund offset program has yielded a net benefit to the Federal government despite the decline in compliance. However, if the impact on compliance is long-term, as indicated by IRS research, then the decline in compliance eventually could result in a net loss to the

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[1] A total of approximately $719 million was lost due to the decreased compliance for taxpayers offset for the first time in 1985, 1986, 1987 and 1988. Of that $719 million, $621 million was attributed to the increase in nonfilers and approximately $98 million was attributed to the increase in balance due filers. Over the same period, about $1.3 billion was offset from the same population.

Federal government.[2]

Based on IRS's experience in offsetting refunds to satisfy nontax debt, Option 3 should result in a net decline in voluntary compliance with the tax laws. Option 3 restricts IRS activities to defaulters. For the 1994 filing season, the Department of Education referred over 2.9 million defaulters to IRS for offset with total outstanding liabilities exceeding $11.5 billion. Under Option 3, IRS would eventually receive the entire portfolio of 7 to 10 million defaulters for collection activities. The refund offset program would be a major tool in trying to collect that debt. In the years following the offset, compliance would decline. Because Options 4 and 5 retain the defaulted debt collection effort, the decline in compliance attributable to refund offset also applies.

IRS collection of defaulted debt raises other concerns. Defaulted student loans tend to be old debt. Defaulted debt, under the FFEL program can be two or three years old before Education receives it from the guarantee agency. Defaulters have already received a number of notices from the originating bank, guarantee agency and Education. In addition, defaulted student loans tend to have small balances (average is approximately $3,700). Because defaulted student loans are old and have small balances, it can be questioned whether IRS will be more capable of collecting them. A large percentage of defaulted accounts fall below IRS deferral levels. Until these accounts (along with any accrued delinquent taxes) rise above the deferral level, IRS collection efforts would be restricted to refund offset and the notice stream. On the other hand, if these accounts were to remain with the Department of Education, they would still be subject to refund offsets and Education's contractor would continue to actively work the defaulted accounts.[3] The lack of IRS activity on the large inventory of accounts below the deferral level could send the wrong message. If the IRS is soft on collecting student loans, then it may be soft on taxes. Voluntary tax compliance may suffer in the long-run.

Advocates of increased IRS involvement argue that the "fear factor" from IRS involvement would reduce future defaults and accelerate current default collections. However, fear of IRS can act as a double-edged sword. Some taxpayers are compliant

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[2] **For further information concerning the impact of the refund offset program on** voluntary compliance see:

United States General Accounting Office. Tax Policy: Refund Offset Program Benefits Appear to Exceed Costs. GAO/GGD-91-64, May 1991.

Internal Revenue Service, Research Division. The Impact of Nontax Refund Offsets on Voluntary Compliance. October 1992 (Revised February 1993).

[3] The department of Education's debt collection contractor uses telephone contacts to secure additional payments.

because they are afraid of being caught while others remain out of the system out of fear. These taxpayers are of afraid of the consequences of coming back into the system. The IRS has a "bad guy" reputation. Once taxpayers become nonfilers, they remain out of the system due, in part, to the fear having to pay the accrued penalties and interest that have accrued on prior years accounts.

The ability of the IRS to enforce collection of student loans using an alternative system of dispute resolution, penalties, and collection devices.

This issue is not applicable to any of the five options. Options 1 and 2 rely on the Department of Education to administer the direct loan program with IRS playing a supportive role through information sharing. In Option 3, the Department of Education refers defaulted debt to IRS for collection as a tax. At that time, it becomes subject to IRS interest and penalties. In Options 4 and 5, it is envisioned that IRS will use existing processing and collection systems, apply statutory tax penalties and interest, and not distinguish student loan repayments from tax payments.

The effect of separating loan collection from other loan servicing functions.

To be supplied by the Department of Education

The anticipated effect on the management of Federal student loan collections, and on borrower repayment of such loans.

To be supplied by the Department of Education

ROLE OF IRS IN STUDENT LOAN PROGRAMS

***PURPOSE OF MEETING*: To present recommendation from the Departments of Education and Treasury, and IRS and to reach agreement on forwarding the recommendation to the President and Congress.**

Key Features of an Ideal Student Loan System

- *Up-To-Date (Real Time) Information.* Real time information is necessary for public and private entities involved in overseeing student loans to effectively manage the program. Up-to-date information is key to providing quality customer service to borrowers.

- *Burden on Employers.* Repayment methods (including withholding loan payments from a borrower's salary) should impose a minimal burden on employers.

- *Use of Federal Employees.* The loan servicing and collection system should allow for fluctuations in the program and not require a large increase in FTEs.

SIX OPTIONS FOR IRS INVOLVEMENT

1. INFORMATION SHARING WITH NON-IRS WITHHOLDING
   - Option 1: As Currently Authorized
   - Option 2: With Additional Information
2. USING THE CURRENT TAX SYSTEM
   - Option 3: IRS Collects All Defaulted Debt
   - Option 4: IRS Collects Income Contingent Repayments All Defaulted Debt
   - Option 5: IRS Collects All Direct Loan Payments All Defaulted Debt
3. SEPARATE FROM THE TAX SYSTEM
   - Option 6: IRS Collects, Services All Direct Loans and Collects All Defaulted Debt -IRS Develops a Withholding System Separate From the Tax System

ADVANTAGES/DISADVANTAGES OF OPTIONS

Information Sharing with Non-IRS withholding--(ED/Treasury Recommended Option)

PROS

- Provides up-to-date (real time) information to borrowers
- Borrowers have the opportunity to repay either through a "withholding" system or automatic payments to bank.
- Maximizes customer service
- Promotes effective administration of program by having same agency originate and service loans
- Minimal impact on employers who currently offer wage withholding allotments (if voluntary)

CONS

- o Wage withholding may not be available to all borrowers if employers do not participate in withholding systems.
- o Will involve some costs to employers

Using the Current Tax System

PROS

- o Withholding would be available to all borrowers
- o No new burden would be imposed on employers, if companies are not required to provide additional information on tax forms.
- o Student loan would be treated as a tax; IRS could use full enforcement powers to collect delinquent student loans

CONS

- o Lack of real time information hampers effective program management
- o Difficulty in managing the system when borrowers want to switch repayment plans as their circumstances change.
- o Potential defaults would not be detected until 6 months after the end of the tax year
- o Tax payments would be indistinguishable from student loan payments creating problems if either is underpaid
- o Shared responsibility between ED and IRS could reduce accountability.
- o Would require increased FTEs.

Separate from the Tax System

PROS

- o Withholding would be available to all borrowers
- o Real-time information promotes quality customer service and effective program management
- o Enhances customer service by having one entity service and collect student loans after borrower choose repayment plan

CONS

- o Burden on employers to participate in the new system could reach $5.8 billion.
- o Would require congressional authorization to establish, staff and fully fund a new withholding system.
- o Would require increased FTEs

UNITED STATES DEPARTMENT OF EDUCATION
OFFICE OF POSTSECONDARY EDUCATION

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DATE: August 31

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TO: Gene Sperling - 456-2878

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ELLEN TAYLOR__
JUANA HARDWICK__
PJ SANDERS__
SANDY WOOD__

MESSAGE

Draft outline of decision memo to POTUS on using wage withholding system to collect student loan payments.

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

DRAFT

MEMORANDUM FOR: JOSHUA L. STEINER
CHIEF OF STAFF

MARGARET M. RICHARDSON
COMMISSIONER, INTERNAL REVENUE SERVICE

MAUREEN MCLAUGHLIN
DEPUTY ASSISTANT SECRETARY
(POSTSECONDARY EDUCATION)

LOWELL DWORIN
DIRECTOR, OFFICE OF TAX ANALYSIS

FROM: George Muñoz
Assistant Secretary (Management)

SUBJECT: The Internal Revenue Service (IRS) and the Direct Student Loan Program

We decided on August 23, 1994, that the Departments of Treasury and Education would follow-up with a memorandum that summarizes the agreed-upon course of action with respect to the student loan study. We are to prepare a decision memorandum for the President that outlines the means by which his vision for the student loan program can be realized. It is our understanding that the President envisioned a loan program that:

a. would simplify the application process for borrowers and reduce the paperwork for educational institutions by eliminating the middleman. This would enable the government to offer loans at low interest rates and reduced fees while saving the taxpayers billions of dollars in interest payments;

b. would offer borrowers an array of flexible repayment plans, including the income-contingent plan that links payments to income. Borrowers would also can change repayment plans; and,

c. would offer all borrowers the opportunity to repay their loans using a variety of easy and convenient methods, including wage withholding. While wage withholding may be a natural choice for borrowers electing income contingent payments, it may also be used as a repayment method for all direct loans.

DRAFT

The President's loan program would make higher education more affordable to millions of Americans by reducing the burden of student loan repayment. The Student Loan Reform Act of 1993 established the Direct Loan Program that meets the first two elements of his vision. Congress subsequently asked the Departments of Treasury and Education to study the third element, i.e., if it would benefit borrowers and the government to use the IRS's wage withholding system to collect student loan payments.

Attached is a draft outline of the decision document that will provide the President with information on options to realize the goal of providing withholding to the maximum number of borrowers. Also attached is a copy of the work plan that outlines the anticipated tasks and time required to complete the decision document.

Treasury and Education will continue working on this outline so that it eventually evolves into the final document. For this work to be meaningful, it is essential that we have a common understanding of our goal, and that we all agree on the means to reach that goal. Please review the attached documents and provide comments to my office by COB, AUGUST 31, 1994.

Attachments

DRAFT

The Direct Student Loan Program and the Internal Revenue Service

I. The President's Vision (To offer borrowers a variety of flexible repayment plans and a convenient and easy way to automatically repay their loans.)

A. Direct Loans To Borrowers From The Federal Government

B. Form of Payment Options Which Are Easy To Meet, Including Payroll Withholding.

II. Implement the President's Vision with Mandatory Withholding

A. Option 1: Using the current tax system and the Internal Revenue Service (IRS)

1. Description of process from the borrower's perspective

2. Description of process from the employer's perspective

3. Benefits to the borrower

4. Benefits to all others (e.g., government, employers, etc.)

B. Option B: Implementing Mandatory Withholding Outside the Current Tax System (Using either Education or the IRS)

1. Description of process from the borrower's perspective

2. Description of process from the employer's perspective

3. Benefits to the borrower

4. Benefits to all others (e.g., government, employers, etc.)

III. Considerations

A. Is any additional burden placed on employers?

1. Description of system and procedures

2. Using the Tax System

DRAFT

Outline, IRS & The Direct Student Loan Program, continued

3. Outside the Current Tax System

B. Can Accounts be easily reconciled?

1. Description of system
2. Using the Tax System
3. Outside the current Tax System

C. Ability of borrowers to switch repayment plans

1. Description
2. Using the Tax System
3. Outside the Current Tax System

D. What are the administrative costs?

1. Description
2. Using the Tax System
3. Outside the Current Tax System

E. How will compliance be ensured?

1. Employer preparedness
   a. Using the Tax System
   b. Outside the Current Tax System

2. Accurate withholding and reporting
   a. Using the Tax System
   b. Outside the Current Tax System

3. Employee/borrower compliance
   a. Using the Tax System
   b. Outside the Current Tax System

DRAFT

Outline, IRS & The Direct Student Loan Program, continued

IV. Voluntary Withholding: A Viable Means of Reaching the President's Vision

A. Description

B. Benefits

C. Constraints

D. Estimate of potential participation by employees

V. Political Considerations

A. Omnibus Budget Reconciliation Act of 1993

B. Congress and the General Accounting Office

C. Tax Systems Modernization

D. Other roles of the IRS

1. Health Care

2. Welfare

3. Other Federal debt

E. Impact on voluntary compliance with income tax

F. Public perception

G. Possible subsidies, tax credits/tax expenditures

VI. Recommendation

August 29, 1994

DRAFT

WORKPLAN FOR PREPARATION OF MEMORANDUM TO THE PRESIDENT OF THE UNITED STATES

TASK Note: POTUS = President of the United States Note: During steps 1 through 4 staff continues to flesh out outline	RESPONSIBILITY T = Treasury E = Education ALL = White House and OMB	DUE DATE
1. Draft Outline/Workplan	T & E	8/26
2. Circulate Draft for Comments (internal to IRS, T & E)	T	8/29
3. Comments returned to Treasury	T, E	8/31
4. Transmit final Draft Outline/Workplan to White House and Office of Management & Budget (OMB) for comment	T	9/1
5. Comments returned to Treasury or Education	All	9/7
6. Transmit Revised Outline/Workplan	T	9/9
7. Transmit Draft POTUS Memorandum to Treasury & Education for Comment	T & E	9/14
8. Comments returned to Treasury on draft POTUS memo	T & E	9/19
9. Meeting if necessary	T & E	9/20
10. Transmit revised draft POTUS memo to all for comments	T	9/21
11. Comments returned to Treasury	All	9/21
12. Meeting if necessary	All	9/26
13. Decision memo to POTUS	T & E	9/30

August 26, 1994

Section I

Feasibility of the IRS Collecting Direct Student Loans

Background and Introduction

To deal with the growing number of defaulted student loans, Congress and the Department of Education have been looking into various methods to reform the student loan system. A common feature of several Congressional proposals was to establish a centralized loan system that would replace the current system of private lenders. Furthermore, several proposals identified the Internal Revenue Service as the loan processing and collection agency for the Federal government.

As part of the Omnibus Budget Reconciliation Act of 1993 (OBRA '93), Congress established the Federal Direct Student Loan Program (FDSLP). Congress also gave the Department of Education the authority to expand the number of repayment options available to borrowers as a means to reduce the default rate. Borrowers can elect extended payments, graduated payments, or income-contingent payments as well as retaining the standard repayment plan. By allowing borrowers to select the repayment plan that best suits their financial circumstances, it is hoped that the number of defaults will be reduced and that borrowers will not find repayment too burdensome.

Several proposals have been made over the last few years that would charge the Internal Revenue Service with collecting loan repayments through the tax collection system. Congressman Petri and Senator Simon introduced the Income Dependant Education Assistance Act (IDEA) during the 102nd Congress. Under the IDEA program, Treasury would have been responsible for making loans to eligible students and collecting loan repayments through the Internal Revenue Service.

OBRA '93 Mandated Feasibility Study

The conference report accompanying OBRA '93 directed "the Treasury Department, in consultation with the Department of Education, to conduct a study of the feasibility of implementing a system for the repayment of Federal student loans through wage withholding or other means involving the IRS".[1] Analyses should be included with the study to determine:

1. *Whether IRS could implement such a system of student loan repayment system with its current resources and without adversely affecting its ability to collect tax revenues?*
2. *The cumulative impact of increased disclosure of tax information and increased IRS involvement in nontax collection activities on voluntary compliance with the tax laws.*

---

[1] Appendix A contains the OBRA '93 Conference Report language.

3. *The ability of the IRS to enforce collection of student loans using an alternative system of dispute resolution, penalties, and collection devices.*
4. *The effect of separating student loan collection from other servicing functions.*
5. *The anticipated effect on the management of Federal student loan collections and on borrower repayment of such loans.*

To the extent that the study demonstrated the feasibility of IRS involvement in the student loan program, Treasury and Education are required to submit an implementation plan and legislative recommendations along with the feasibility study within 6 months of enactment of the legislation. Due to the complexity of the analyses, the Departments of Treasury and Education requested that the study deadline be extended until June 1994.[2]

Federal Direct Student Loan Program

The Student Loan Reform Act of 1993 (Title IV of OBRA 93) authorized the Department of Education to implement a Direct Loan Program. Under this program, the volume of student loans issued under the old system, where student loans are issued through banks and other intermediaries, would be reduced as more students take advantage of borrowing directly from the government. Under the Direct Loan Program, the Federal government (Department of Education) makes loans directly to students and assumes the primary responsibility for collecting and servicing loan payments and accounts.

Repayment Options

Under the old system of loans, known as the Federal Family of Education Loans (FFEL), borrowers had to repay their obligations within a fixed number of years. It is widely believed that the increase in the number of defaulted student loans is due, in part, to the fact that the standard repayment of a fixed amount every month does not account for important variables such as income, family size, and cost of living, and to the increasing expense of higher education. Accordingly, the Student Loan Reform Act of 1993 authorized the following repayment plans for Direct Loan borrowers:

- Standard Repayment
- Extended Repayment
- Graduated Repayment
- Income-Contingent Repayment

Borrowers have the option to switch repayment plans (up to a maximum limit to be defined in the regulations). For example, borrowers using the standard repayment plan may switch to income-contingent if their financial situations change. Similarly, borrowers may change from income-contingent repayment to one of the other plans. In theory, such mobility

[2] Appendix B contains the extension letters.

between repayment plans further reduces the risk of default on student loans since borrowers can match their repayment plans to their financial situations.

As an incentive to bring defaulters from the FFEL Program into current repayment status, the Department of Education has the authority to place defaulters into income-contingent repayment under the Direct Student Loan Program. If the primary reason borrowers default is because of their inability to pay, then the number of borrowers in default should decrease significantly.

Other than varying the term of the loan or the repayment amount, the standard, extended, and graduated repayment plans are only marginally different from each other. All three repayment plans are modified fixed payment plans. On the other hand, the income-contingent plan changes the repayment from an amortization of principal over a period of time to basing the repayment, in part, on AGI as a proxy for ability to pay. Principal, interest rate, and time -- the usual determinants of a loan amortization plan -- are almost completely unrelated to the payment.

Standard Repayment

Under this repayment plan, a borrower makes equal monthly payments for a period of time not to exceed 10 years, and is generally subject to a minimum repayment of $50 per month or the balance of the borrower's Direct Loan, whichever is less. The standard repayment plan under the Direct Loan Program is identical to the standard repayment plan under the FFEL Program.

Extended Repayment

Under the extended repayment plan, a borrower makes equal monthly payments for a period of time that exceeds the repayment period under the standard repayment plan. Under the FFEL Program, the extended repayment plan is only offered to borrowers who have consolidated their loans.

Graduated Repayment

Under the graduated repayment plan, a borrower makes payments of two or more different amounts that increase at established intervals. Under the Direct Loan Program, the smallest payment must not be less than 50% of the standard repayment amount, and the largest payment may not exceed 150% of the standard repayment amount.

Income-Contingent Repayment

The income-contingent repayment plan is available to all Direct Loan borrowers except for Federal Direct PLUS loan borrowers. Under the income-contingent repayment plan, payments vary in relation to the Adjusted Gross Income (AGI) of the borrower and, if applicable, the borrower's spouse. Any balance remaining on a loan after 25 years of income-contingent repayment is canceled.

The Department of Education is proposing an income-contingent plan in which the borrower will repay a small percentage, adjusted for the amount of debt the borrower has accumulated at the time the repayment period begins, of his or her income. Specifically, the annual repayment obligation equals a percentage of the borrower's AGI. The base payback rate is 3% and increases by .2% for each $1,000 borrowed. The maximum payback rate occurs at a debt of $61,000. Any calculated monthly payment amount less than $50 ($25 if the borrower is unmarried and has no dependents) is waived. However, borrowers would be given the option of paying the calculated amount to minimize negative amortization.

For married borrowers, the repayment amount also depends on whether the spouse has a Direct Student Loan. If there is only one borrower in the family, then the repayment amount would be the same as that for a single person with the same debt and AGI. However, if there are two debts, then the average debt level would be used to determine the payback rate.

Common Assumptions Between Agencies Concerning IRS Involvement

In developing the various options for IRS involvement in the direct student loan program, several assumptions were agreed to by Treasury, Education and IRS. Tax-related variable definitions would conform to IRS standards. Furthermore, the following three assumptions provided the common framework for discussion:

1. *The Department of Education will maintain and service direct student loan accounts.*
2. *There will be no changes in the current tax withholding system (i.e., employers would not be required to differentiate student loan payments from income tax withholdings).*
3. *Student loan repayments taken over by IRS will be treated as income tax liabilities, subject to income tax penalties and interest.*

Relaxing of any one of these assumptions makes IRS involvement in the Direct Loan Program infeasible.

The collection and servicing of student loans is distinctly different from the collection and servicing of individual income taxes. Taxes are assessed on income earned during a narrowly defined period of time, typically a calendar year. Student loan repayment amounts vary according to the principle, interest rate, and duration. Under the income-contingent repayment option, additional variables such as family size and AGI are included in the repayment formula.

Traditionally, loan servicing entails much more than the processing of payments and default collection. Loan servicing involves a high degree of customer service. Borrowers should be able to access information about their loan balance, repayment schedule, and other related issues on a timely basis. Furthermore, reliable and timely customer service should result in a prompt reconciliation of debts. If IRS were to assume responsibility for maintaining and servicing student loan accounts, IRS would have to develop new systems to account for loan repayments and defaulted debt collection. These systems would impact not only current systems, but also the Tax Systems Modernization Program.

In order to provide a reliable and timely customer service for the Direct Loan Program, the tax collection system would need to be changed. Because the withholding system would have to be modified to differentiate student loan repayments from tax withholdings, employers would have to radically change their accounting systems in order to provide IRS with tax withholding and student loan repayment information for each employee for each pay period. Changing the withholding system and Federal Tax Deposit requirements to allow IRS to properly post student loan repayments and distinguish loan payments from tax payments would be extremely burdensome to employers.

In addition to the employer burden caused by the change in reporting requirements, IRS would also have to change its systems in order to process, store, and use the additional information. While IRS is in the process of a major systems modernization effort, there are no plans to capture data from employers at the level of detail necessary to track and report student loan collection.

Finally, if the tax collection system is changed to easily identify student loan repayments, particularly income-contingent repayments, IRS would be in a position to treat student loans differently from tax payments. However, then IRS processing of repayments and collection of defaulted loans would be subject to the laws and regulations pertaining to the student loan program. Moreover, to utilize IRS' enforcement tools, the laws regulating the student loan program as well as the Internal Revenue Code would have to be amended to authorize IRS collection of student loans.

The relaxation of any one of the three common assumptions makes IRS involvement infeasible. While greater IRS involvement offers the attractiveness of greater efficiency (only one agency) in administering the student loan program, that efficiency would not be realized unless IRS could use all of its enforcement tools to ensure compliance. Furthermore, the mission of the Internal Revenue Service would be fundamentally altered. In order for the IRS to collect student loans without these assumptions, the Internal Revenue Code would require a major overhaul. While there are a number of potential options, greater involvement by IRS in administering the Direct Loan Program could prevent the Service from fulfilling its primary mission as the tax collector.

Options for IRS Involvement

An oversight group with representatives from the Internal Revenue Service, the Office of the Secretary of the Treasury and the Department of Education was established to coordinate the study. While the conference report language suggests that the study should concentrate on the use of the withholding system in repaying student loans, the oversight group decided that the study should examine a range of possible involvement by the IRS.

Current law limits the role of the Internal Revenue Service in the direct student loan program to sharing certain information (i.e., name, address, taxpayer identification number, adjusted gross income and filing status of student loan recipients) with Education and to administering the refund offset program for student loan defaulters. Based on the direction received from the oversight group, working groups from IRS and Education developed and analyzed five major options for long-run IRS involvement . These options ranged from the current statutory requirements to IRS processing all direct loan payments. The options considered were:

Option 1 *Program as currently authorized (i.e., IRS shares name, address, TIN, AGI, and filing status with Education).* Under this option, Education would administer student loan repayments. IRS would continue the refund offset program for student loan defaulters.

Option 2 *Increased Information Sharing.* This option is similar to the first option; however, Education would use limited additional return information (based on a demonstration of need) to administer an income-contingent repayment system and aid in default collection. IRS would continue the refund offset program for student loan defaulters.

Option 3 *IRS Collects Defaulted Debt.* Under this option, Education would administer the student loan repayment system and refer defaulted debtors to the IRS for debt collection (requiring an administrative judgement from Education to treat defaulted debt as a tax).

Option 4 *IRS Collects Income-Contingent Student Loans.* This option would require legislation for IRS to handle repayment of student loans through wage withholding or estimated payments, for debtors who select income-contingent repayment. In addition, IRS would collect defaulted debt.

Option 5 *IRS Collects Direct Student Loans, Regardless of Repayment Plan.* Under this option, legislation would be required to allow IRS to administer repayment of all direct student loans, regardless of the repayment plan selected by the debtor (i.e., income-contingent, fixed payment). In addition, IRS would collect defaulted debt.

In addition to the five issues specifically required by the OBRA conference report, several criteria were developed to analyze these options. First, the Department of Education developed a theoretical description of the ideal student loan repayment system. This theoretical description provided a standard by which all proposals could be compared. In addition, the strengths and weaknesses of each option were identified. Each option was developed in sufficient detail to allow for preliminary program cost estimates.

Each option was analyzed using the framework mentioned above. Only after fully analyzing all the available data did the oversight group recommend the option for IRS involvement that best served the interests of the public and the Federal government.

One word of caution should be stated concerning the analyses performed for this study. The five options were developed and analyzed only in sufficient detail to allow for preliminary cost estimates and the identification of the major administrative and policy issues. Detailed developmental work was not included as part of this study. The Implementation Plan identifies much of the work necessary to begin the recommended option. It is expected that IRS and Department of Education would require at least three years from the date of enactment to implement any program that requires substantial IRS involvement (Options 3, 4, or 5).

Short-Run Versus Long-Run IRS Involvement

By law, the Internal Revenue Service plays an important role in the Federal Direct Student Loan Program. Option 1 describes the current direct loan program. Within the confines of the Internal Revenue Code's disclosure provisions, IRS would share limited income tax information with the Department of Education. In addition, IRS would continue to offset refunds for taxpayers, referred to IRS by Education, who have defaulted on their student loans and provide information, as authorized by Internal Revenue Code Section 6103, to assist Education in locating defaulted borrowers.

This report looks beyond the current program to study the feasibility of IRS involvement in the long-run. In the long-run, Option 1 is only one of five options under consideration. The following sections provide the framework to evaluate each of the five options for long-run feasibility.

Report Outline

Section II represents the Department of Education's description of the ideal student loan servicing and collection system. Section III is the Executive Summary from a report of focus groups conducted on behalf of the Department of Education. Section IV describes the five options for IRS involvement in some detail with the major advantages and disadvantages. It also provides the summary of the costs for each option. Section V specifically addresses the areas of analysis mandated by the OBRA conference report. Section VI contains the recommendation of the Departments of Treasury and Education as well as a broad implementation plan and legislative issues which would have to be addressed. The Appendices to this report contain the conference report language, focus group report, and IRS cost estimation methodology.

Section II

The Ideal System For Servicing and Collecting Student Loans[1]

Introduction

The Student Loan Reform Act of 1993 requires the Secretaries of Education and Treasury to develop a plan to involve the Internal Revenue Service in the collection of student loan repayments. This paper outlines the Department of Education's preliminary thoughts on what should be included in the Federal Government's "ideal" student loan repayment system. This paper is intended to provide a starting point from which Treasury and Education can work together to develop a cost-effective repayment system that best serves the needs of students and the Federal Government. Along with this repayment system, the Department of Education will continue to carry out its statutory responsibility of loan origination, institutional oversight and monitoring, and general program evaluation and management activities.

In summary, an ideal repayment system would have three main components:

- <u>Simplicity in administration and clear lines of accountability</u>. One entity should manage all student loan repayments regardless of borrower payment method. This would mean that one agency oversees the Federal Government's student loan repayment system -- servicing, collecting, tracking, recordkeeping, accounting, and enforcement.

- <u>Customer service</u>. Accurate, up-to-date data on student loan accounts should be available on a continuing basis to borrowers, schools, Congress, and the Department of Education. The system must be responsive to the data requirements of these different entities.

- <u>Minimize burden</u>. The system should be simple and straightforward for borrowers and should not be burdensome for employers.

Although this paper does not analyze the feasibility of designating IRS, Education, or some other entity to carry out these responsibilities in the future, the effectiveness of each approach must be evaluated by how well it meets the criteria of an ideal system. At least initially, Education will continue to use its current servicing and repayment system to service and collect loans, and will use income information from IRS, as provided by statute, to implement income contingent loans. Education will implement an income contingent repayment program by July 1994.

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[1] United States Department of Education, December 1993.

Simplicity in Administration and Clear Lines of Accountability

Managing student loan servicing and repayment issues in a more coordinated and cost-effective manner calls for increased centralized program oversight. A single entity for managing student loans would ensure that policy objectives are achieved, borrowers are treated fairly and consistently, and quality control is the highest. This would improve loan servicing and collection effectiveness, reduce default costs, assign lead responsibility for performance outcomes, and improve accountability by making the lines of responsibility clear and unambiguous. This is particularly critical given concerns about the management of student loans reflected in GAO reports and congressional hearings.

- A student loan management information system is needed for record keeping, accounting, institutional oversight, and program evaluation and management activities. To manage effectively, information is needed on each borrower: who repays, when payments are made, how much is collected (portion that goes for principal and interest, collection costs and penalties), when the loan is fully repaid, who does not repay because his/her income is too low, and who is in default.

- Ideally, the entity tracking loan repayments and maintaining borrower records would also service all loans and would oversee the collection function on defaulted loans.

- Accountability measures should not be directed solely at "defaulters" or "uncollectibles," but also on the day-to-day operation of the program to run more smoothly and efficiently for borrowers, schools, and the Federal Government. Currently, approximately 80 percent of all borrowers pay their student loans on time. With the introduction of income contingent loans, fewer borrowers will be classified in default because individuals with insufficient income will not be required to make loan payments. However, the cost to the Federal Government of loans not fully paid may not change significantly.

- Because students with small loan balances ($2500) are more likely to default than those with higher balances, any collection system must be able to focus collection resources on loans of this size. Otherwise, losses could be higher in the new system, especially if borrowers realize that small loans do not receive high priority.

Customer Service

In an ideal system, borrowers should be able to access information about their loan balance, repayment schedule, and other related issues on a timely basis. Customer service must be a high priority. Reliable and timely customer service should result in prompt reconciliation of debts. An ideal customer service system would emphasize timeliness, reliability, and accessibility. Such a system should include:

- A 24-hour automated helpline for borrowers, employers, and educational institutions where customers can obtain information about loan balances, etc.

- An on-line interface in which all relevant agencies can access a single system for the specific data relevant to their immediate tasks.

- A dispute resolution mechanism whereby borrowers' problems can be promptly resolved.

- Publications that describe the various repayment plans and collection procedures in simple terms.

- Periodic customer satisfaction surveys to determine customer reaction and any need for changes.

During the month of December, Education and IRS jointly convened focus groups to obtain the views of students, borrowers, and the financial aid community regarding income contingent repayment and IRS involvement in servicing and collecting student loans. This information will be helpful in factoring in public acceptance as the new student loan servicing and repayment system is designed and implemented.

Minimizing Burden

An ideal student loan servicing and repayment system should impose minimal burden on borrowers, employers, and financial aid institutions. By streamlining the system and thereby eliminating complicated procedures and unnecessary reporting requirements, borrowers can better understand their loan obligations and avoid delinquencies. In a ideal system, a borrower will have the ability to choose a plan with manageable repayment terms that comports with his/her general economic circumstance.

IRS Wage Withholding

- IRS wage withholding could be the most convenient for the borrower because the repayment amount would automatically be deducted from an employee's paycheck. Wage withholding is not reconciled for 18 months following the beginning of the tax year, however. If this system were adopted for student loan repayment, the reconciliation issue would have to be addressed, as well as the additional burden that wage withholding could impose on employers. The burden on employers would depend on whether employers had to keep track of loan payments or if borrowers were entirely responsible for increasing their withholding to cover loan obligations.

- Some borrowers are outside the IRS withholding system. At this time, it is difficult to predict how many borrowers fall into this category and whether there will be an inherent compliance problem with self-employed borrowers.

- Some borrowers are required to file, and do not. For this group, it may be necessary for IRS to use its normal enforcement mechanism to ensure that tax obligations and student loan payments are met. Alternatively, a different repayment plan could be selected for this group.

- For non-filers who have very low incomes and are not required to file, the annual loan payment could be deferred, under income contingency. Many individuals in this category may have taxable income during later years.

<u>IRS Tax Form 1040</u>

- Some have suggested using annual payments at tax time through the IRS Tax Form 1040. This repayment method is used by other countries. The advantages to this approach are that it would impose minimal burden on borrowers and employers, and be the most convenient system to implement. However, it would not allow for continuous tracking of repayments, proper allocation to principal, interest and collection costs on specific loans, nor timely detection of defaulting loans.

<u>Automatic Payroll Deduction</u>

- Another repayment option is an automatic payroll deduction or bank-administered automatic withdrawal system. Under this approach, a borrower would either request that the employer deduct his student loan payment each pay period or instruct his bank to make periodic payments. In either case, the payment would be credited to a central loan repayment account.

- Using this approach, the collection and servicer agent would be paid immediately and the payments would be easy to track on a continuous up-to-date basis. However, this system would not address the needs of many of the hardest-to-track borrowers (self-employed, unemployed, multiple part-time jobholders). Under this option, there would be an additional burden to employers, particularly small businesses, who would have to adjust their payroll systems as a result of the added payroll deduction.

<u>Monthly or Quarterly Checks</u>

- This option gives borrowers control over when and how their student loan are repaid. Despite the convenience of employer wage withholding, some borrowers may prefer this option to preserve their privacy regarding outstanding debts.

Section III

Focus Group Executive Summary[1]

Scope of Project

The Department of Education is implementing a direct loan process in which post secondary student loans will be administered directly by the government. This system may include the involvement of the Internal Revenue Service in the collection of these loans. Four repayment options are being considered:

- **Standard Repayment** - fixed payment each month for ten years
- **Extended Repayment** - fixed payment each month for twenty years
- **Graduated Repayment** - smaller payments in early years and larger payments in later years
- **Income Contingent Repayment** - payments which vary annually based on income of borrower and that of his or her spouse

In addition, three payment methods are being considered:

- **Check** - Write a check each month to the government
- **Employer Withholding** - Have employer withhold part of paycheck, similar to the way they withhold taxes and Social Security; borrower would reconcile under-payment or over-payment at the end of the year on their tax form
- **Electronic transfer** - Have borrower's bank automatically transfer funds each month to the government

These focus groups were designed to help the Department of Education better understand the perceived advantages and disadvantages of each repayment option and payment method among current borrowers and financial aid advisors, as well as their attitudes toward IRS involvement in the collection of student loans. A total of nine focus groups were held. The focus group locations and participant criteria are summarized in the following table.

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1 Prepared by Price Waterhouse under contract to the Department of Education.

CITY	PARTICIPANT GROUP
Washington, DC	(Pre-test) Current students, two-year, proprietary, four-year and graduate schools Current students, proprietary & 2-year schools Former students, proprietary & 2-year schools
Atlanta, GA	Current students, proprietary & 2-year schools Financial aid advisors representing two-year, proprietary, four-year and graduate schools
Columbus, OH	Current students, 4-year colleges Former students, 4-year colleges and graduate programs
Los Angeles, CA	Current students, graduate schools Defaulters

Key Findings

Repayment Schedules

Participants seek flexibility and a variety of options to choose from when it comes to repaying their student loans. Their choice of repayment schedules seems to depend mostly on the amount borrowed, their anticipated income and their general outlook for the future. Many are concerned about potential financial problems and would like to choose the plan that they think can best help them to endure their difficulties.

The least favored repayment plan was the extended plan, with participants seeing twenty years as too long a period of time to repay a student loan. This option was also perceived as very costly in terms of interest paid. It may have some appeal to students with very large debts.

The standard repayment plan was appealing to participants because it makes the task of budgeting easier, and payments are perceived to be manageable in most cases. However, if financial hardships occur, participants believe this repayment plan could be burdensome. Many former students are currently repaying their loans on this plan. Ten years may actually be too long a period of time for those with small debts.

The graduated repayment plan gives students some time to get established before having to make large loan payments. While some participants believe they will be in a better position to make larger payments later, others aren't so optimistic about the future, or believe their expenses will increase along with their income as they take on family obligations. They are concerned that payments at the end may become too large, and a large amount may be spent on interest because of the smaller payments in early years.

The income contingent plan allows borrowers to pay off their loan as they can afford to do so. However, most participants object strongly to the inclusion of a spouse's income in the equation, and believe repayment amounts should be based solely on their individual income. Participants would also like this repayment plan to be based on current income, not last year's income, anticipating that less income this year than last could result in economic hardship. They would also like this repayment plan to take into account current expenses, and be based on discretionary income rather than gross income. Participants recognize that determining borrower's income could add to administrative expenses for this option. They also believe this option has the greatest potential for fraud. When asked if they would voluntarily report their income to the Department of Education under this option, they note that people might voluntarily report their income, but it would probably not be their whole income.

Participants would like to see the option of repaying loans through work or community service programs, particularly for those who are unemployed.

Repayment Methods

Participants are most concerned with control and convenience in selecting a repayment method. Although many are wary about letting a bank or employer make their loan payment for them, they like the convenience associated with having one less bill to pay.

Writing a monthly check and employer withholding were the most popular payment methods. Those who prefer to write a check every month feel they maintain more control over their finances that way. More specifically, they can pay more when they are able and withhold payment when necessary. The check also serves as documentation that a payment was made, should a question ever arise. Those who dislike the idea of writing a check every month find they may forget to do it, or see it as just one more thing they have to do.

Employer withholding was perceived as an easy and convenient payment method by many participants. The payment is made without any thought or effort on the borrower's part, once withholding is set up. Also, payments are much less painful than writing a check. That is, the borrower feels that money was never theirs so they don't miss it. Participants would particularly like this method of withholding if it were done on a pre-tax basis. Concerns about this method center on employer fraud and mistakes, and privacy issues. Some participants worry employers would withhold the money, but not pay the government. Others worry that mistakes made by the employer would be difficult to trace and correct.

while they would still be responsible for the payment. Some participants object to their employer knowing about their financial obligations. Participants also wonder how they would know what their outstanding balance is with this method.

While electronic transfers are also seen as an easy and automatic method of payment by some, the majority of participants don't like the loss of control over their finances envisioned with this method. While they wouldn't forget to make the payment with this method, they worry that they wouldn't know exactly when the money would be taken out of their account, and they would have to remember to have the funds in the account to cover the payment. This method was also seen as making it difficult to keep track of their account balance. They are also afraid of mistakes being made with this method, and of having no way of documenting that payments were made.

Loan Processing/Servicing Agency

Participants felt that customer service and efficiency are the most important qualities that a loan processing agency should have. They expressed concerns about poor customer service received in the past from the different organizations that they have dealt with, as well as some apprehension about what organization could administer the program most efficiently.

Organizations mentioned by participants as possible contenders for loan processing and servicing were the Department of Education, the Internal Revenue Service, private contractors (such as banks), Sally Mae, the Federal Credit Union, and educational institutions. While the Department of Education was mentioned most frequently and was thought to be most empathetic to the student perspective, some participants do not see loan processing as the Department's area of expertise. Some participants also think the Department of Education has more important responsibilities on which it should focus its attention. And while the Department of Education was expected to be the most knowledgeable of the student perspective, those who have had direct experience with the Department (including financial aid advisors) do not necessarily find its staff knowledgeable or accommodating.

Private industry was the second most often mentioned loan processing and servicing agency. Private contractors were thought to be more customer service oriented than governmental agencies, although some participants were skeptical about having only one organization provide the services. Rather, they would like to see several private contractors provide services so that the element of competition is not removed from the mix. Banks in particular are thought to have the appropriate expertise.

Those who favor the IRS as the loan processing and servicing agency see it already having the necessary expertise, infrastructure and access to information. Participants predict default rates would decline if the IRS were involved, and that they would be effective at collecting from defaulting borrowers. On the down side, many participants perceive the IRS as a strong-arming organization that would not understand a late payment or do much to renegotiate loan terms if necessary. The IRS is also seen by some as inefficient, difficult to navigate, and lacking in a customer service orientation. Some participants suggest if the IRS is to be involved, that a separate division be created specifically for dealing with student loans, and that personnel be trained specifically for dealing with student loan issues. Some suggest the IRS should only be involved with late payers and defaulters.

Most participants say that the loan processing and servicing agency which is chosen will not affect their choice of loan repayment plan.

Pursuing Those Who Do Not Repay Their Student Loan/IRS Involvement

Participants vacillate between harshness and leniency when asked how the government should handle those who do not repay their loans. While on the one hand, the vast majority of participants want to see the loans repaid, they also believe leniency is in order for those who are communicating with the government and letting them know if they are having financial difficulty. Little or no leniency was suggested for those who have the means to repay their loans and simply refuse to do so, with renegotiation of loan terms being the first choice, but seizing assets acceptable in "hard core" cases. Reporting late payments and non-payment to credit bureaus was seen as particularly harsh, especially for those having financial difficulties or those who may be applying for a deferment that may take many months to obtain.

Many participants believe that not repaying a student loan is just as serious as, or more serious than, not paying taxes, although they believe the consequences for non-payment of taxes are much more severe than for non-payment of student loans. They believe more stringent IRS enforcement of student loan payments would decrease the default rate, but it may also discourage some students from taking loans and pursuing an education or as much education as they might like. Some participants believe IRS enforcement would cause students to take the loans more seriously in the first place, and those who are unlikely to repay them might also be less likely to accept them. Participants believe IRS enforcement would have a limited impact on tax filing behavior, with most participants conveying that filing a tax return is something that they just have to do.

Section IV

Options for IRS Involvement

Options 1 through 5 are presented in a progressive format. Option 1 calls for the minimal amount of IRS involvement while Option 5 serves as the maximum extent that the Service can be involved short of a massive overhaul of the processing system.

Option 1 - Information Sharing as Currently Authorized

Description

In the short-run, Option 1 is the only option. It is the Direct Loan Program as currently authorized by law. The Omnibus Budget Reconciliation Act of 1993 authorized the Internal Revenue Service to share limited individual income tax information with the Department of Education for the purpose of establishing income-contingent repayments under the Federal Direct Student Loan Program. Option 1 represents minimal involvement by IRS. Option 1 comes close to emulating the ideal student loan system outlined in Section II.

Under this option, the Department of Education retains complete control over the student loan program. Not only does the Department of Education oversee the policy and regulatory process, it would be solely responsible for originating and servicing Direct Loans. Included with this responsibility, but not limited to, would be:

- establishing regulations and procedures
- issuing loans
- maintaining records
- periodic billing (including income-contingent repayment amounts)
- processing payments
- posting accounts
- handling borrower inquiries
- issuing deferments or forbearances
- resolving disputes
- collecting defaulted accounts[1]
- monitoring program

In addition to processing and program management responsibilities, the Department of

[1] The refund offset program, administered by IRS, is included in each of the five options. Under the refund offset program, the IRS offsets the refunds of taxpayers, referred by participating agencies, in order to satisfy individuals' nontax Federal debts. Participating agencies refer taxpayers to IRS for refund offset when other debt collection efforts have failed.

Education would be responsible for maintaining a high degree of customer service. Because only one agency would be involved, the lines of accountability are very clear.

The Department of Education is required to have the first year regulations for the Direct Loan Program in place by May 1994 so that it can begin to issue loans in July 1994. Education is also required to have subsequent year regulations in place by December. Because this is a new program, the Department of Education expects that there will be changes between the initial and final regulations. As part the evolutionary regulatory process, Education is required to use negotiated rulemaking in developing the final regulations. To minimize changes in the regulations, the Department of Education is planning to incorporate the results of the negotiated rulemaking sessions into the first year program.

While income-contingent is only one of many repayment options under the Direct Loan Program, it provides several challenges to implement. Income-contingent repayment is not dependent on the tax system (e.g., wage withholding, estimated payments) for payment processing. Income-contingent means that repayment should be based, in part, on the ability to pay. *Method of payment is not, nor should it be, entered into the equation as a precondition for income-contingent repayment.* Repayments can be made either by writing a check or transferring funds electronically as long as the repayment amount is based on ability to pay.

Initially, the Department of Education intends to base repayment on prior year's adjusted gross income (AGI) and amount borrowed. Education has contracted with a private vendor to administer the Direct Loan Program. Involvement by the Internal Revenue Service is strictly limited to sharing information from individual income tax returns (e.g., name, address, taxpayer identification number, filing status and adjusted gross income) with employees of the Department of Education as authorized by the Omnibus Budget Reconciliation Act of 1993. While this information can be provided on a regular basis, due to IRS processing constraints, data from the most recent tax year would not become available until July or August of the following year.

Advantages

Option 1 is the least disruptive option for the IRS to implement. Since IRS currently offsets refunds of taxpayers referred by the Department of Education, all Option 1 adds to IRS is the sharing of limited information.

Option 1 also emphasizes customer service, one goal of the ideal student loan system. Students, or borrowers, no longer need to depend on banks for their education loans. This effectively eliminates problems associated from having loans at multiple banks. Furthermore, since IRS participation in the program remains in the background, borrowers only interact with one agency.

Disadvantages

The major disadvantage of Option 1 stems from a conflict between Education's processing method and Internal Revenue Service's disclosure provisions (Section 6103 of the Internal Revenue Code). The conflict stems from the use of contractors. Education has awarded a servicing contract to a private vendor to administer the Direct Loan Program. IRS is authorized to disclose tax information to employees of the Department of Education, but not to its agents (contractors).

Because IRS disclosure provisions prohibit sharing tax return information with contractors, the Department of Education may not be able to offer income-contingent repayments as an option to borrowers. Even if the Department of Education calculated income-contingent repayments and provided the results to the contractor, §6103 would be violated. To comply with §6103, the Department of Education may have to service loans for borrowers electing the income-contingent repayment option. Since the standard, extended and graduated repayment plans do not depend on tax return information, Education's contractor could service loans under those repayment plans.

To resolve the conflict between Education's reliance on contractors to administer the Direct Loan Program and §6103 disclosure provisions, Education is planning to offer income-contingent repayment on a conditional basis. Income-contingent will be dependent on the borrower signing a waiver which allows IRS to provide the direct loan servicing contractor with AGI, filing status, and entity information for the purpose of determining the required repayment amount. While the use of a waiver allows the IRS to legally release return information to the contractor, it greatly complicates the operational process of information sharing.

Option 2: Increased Information Sharing

Description

Option 2 builds on Option 1. As in the first option, the Internal Revenue Service would continue to play a passive role in the Federal Direct Student Loan Program. The role of the IRS would be limited to sharing tax return information and offsetting refunds.

In terms of structure and organization, Option 2 is identical to Option 1. The Department of Education retains complete control over the student loan program. Not only does the Department of Education oversee the policy and regulatory process, it would be solely responsible for originating and servicing Direct Loans. Included with this responsibility, but not limited to, would be:

- establishing regulations and procedures
- issuing loans
- maintaining records
- periodic billing (including income-contingent repayment amounts)
- processing payments
- posting accounts
- handling borrower inquiries
- issuing deferments or forbearances
- resolving disputes
- collecting defaulted accounts
- monitoring program

In addition to processing and program management responsibilities, the Department of Education would be responsible for maintaining a high degree of customer service. Because only one agency would be involved, the lines of accountability are very clear.

There are three variations of Option 2:

- Option 2(a): Expansion of tax return information that can be shared with the Department of Education based on demonstrated need.
- Option 2(b): Expanding the scope of the waiver to include additional information to Education's contractor based on demonstrated need.
- Option 2(c): Joint IRS/Education developed system to manipulate return information so that there is no disclosure of return information to contractors.

These three variations of an increased information sharing are designed to allow Education access to additional information which would aid in administering income-contingent repayments and in the collection of defaulted debt. The exact information that would be included in the enhanced program would be determined based on a need demonstrated by the Department of Education.

In Option 2(a), legislative changes would be required. Under Option 2(a), IRS and Education would have to work together to determine the additional information to be specified under §6103 which could aid Education in administering the direct loan program. Additional tax return information could be useful to Education in several ways. Under the proposed Direct Loan Program, borrowers who elect income-contingent repayment will be required to provide information such as family size and marital status to the contractor as variable which influence the repayment amount. If Education were to process the repayment formula in-house, then IRS may be able to legally provide the additional information and eliminate the need to go to the borrower for the information. The use of additional tax variables in the repayment formula may prevent the contractor from backing out the individual pieces of return information.

In addition to providing Education with additional information to support the income-contingent repayment plan. Option 2(a) could also include information that may be beneficial to Education in collecting defaulted debt. Although Education also uses contractors for much of their debt collection activities. IRS and Education could work together to determine if additional information could be used to determine defaulters' financial situation prior to establishing installment agreements.

Under Option 2(b), the scope of information included in the waiver would be expanded to allow IRS to release more tax return information to Education's direct loan servicing contractor for the purposes of administering income-contingent repayments. As in Option 2(a), the additional information to be included in the waiver would be based on a demonstrated need by the Department of Education.

Option 2(c) would consist of a joint IRS/Education system which would manipulate tax return information so that there would be no disclosure of return information. As part of Option 2(c), IRS could act in an "advisory" capacity to the Department of Education. The IRS has historical knowledge of collection and processing functions. The IRS also knows how to use income tax information. The Department of Education recently was provided with additional collection tools such as wage garnishment. IRS could assist Education in the implementation of wage garnishment as an effective defaulted student loan collection technique based on its experience in collecting delinquent taxes. IRS also has a long history in processing information from a variety of sources. IRS may be able to assist Education and its contractor in improving their payment processing system. Such an ongoing partnership between the two agencies could end up being of mutual benefit. For example, Education may be able to assist IRS by providing information on borrowers entering repayment so that the IRS can make a proactive contact (i.e., sending tax packages to borrowers entering repayment status) to help eliminate potential nonfilers.

Advantages

The increased information sharing under Option 2, like Option 1, is least disruptive to IRS operations. Since IRS currently offsets refunds of taxpayers referred by the Department of Education, all Option 2 adds to Option 1 is the expansion of return information that can be shared with the Department of Education.

Option 2 also emphasizes customer service, one goal of the ideal student loan system. Students, or borrowers, no longer need to depend on banks for their educational loans. This effectively eliminates problems associated from having loans at multiple banks. Furthermore, since IRS participation in the program remains in the background, borrowers only have to interact with one agency.

Option 2 allows Education to make income-contingent repayments even more equitable. Additional tax return information can be used to develop a repayment plan that comes closer to representing ability to pay. In addition to AGI, selected line items, such as number of dependents, could provide a more realistic repayment scheme.

Disadvantages

With the institutionalizing of consents (waivers), one concern is that the public will lose confidence in the integrity of the tax system. With other agencies (and contractors) having access to tax information, the potential for abuses of such information increases dramatically. Coupled with the integrity issue is the "big brother" perception and privacy concerns. One result from the focus groups conducted as part of this study is that the public already thinks that the IRS knows everything about taxpayers. With the increased sharing of information, this information then becomes the property of the Federal government, not just IRS. Knowledge of this information could lead to violations of privacy or discriminatory treatment.

Option 3: IRS Collects Defaulted Debt

Description

Option 3 builds on either of the previous two options. Like Options 1 and 2, the Department of Education retains almost complete control over the student loan program. Not only does the Department of Education oversee the policy and regulatory process, it would be solely responsible for originating and servicing Direct Loans. Included with this responsibility, but not limited to, would be:

- establishing regulations and procedures
- issuing loans
- maintaining records
- periodic billing (including income-contingent repayment amounts)
- processing payments
- posting accounts
- handling borrower inquiries
- issuing deferments or forbearances
- resolving disputes
- monitoring program

All of these responsibilities belonged to the Department of Education under Options 1 and 2 as necessary functions for a competently run program.

However, the role of the Internal Revenue Service fundamentally changes under this option. In this scenario, IRS would move from being a passive partner to active participation as legislation would be enacted that would authorize IRS to collect defaulted student loans for the Department of Education. In effect, IRS becomes the primary collector of defaulted loans.

Under Option 3, the Department of Education continues to determine when a debtor enters default status. Once a debtor defaults, the Secretary of Education declares the entire outstanding principle to be defaulted and refers the remaining balance to the IRS *using an administrative judgement that allows the IRS to treat the defaulted debt as if it were a tax.*

As a tax, a defaulted student loan would be subjected to the same collection procedures used to collect delinquent individual income taxes. IRS collection personnel would not be aware that they were collecting an assessment that had once been a defaulted student loan. The first step in the IRS collection process consists of a series of computer generated notices requesting payment. Some taxpayers respond to the notices either by complying with the notice and others partially comply or fail to comply with the notice. If taxpayers do not respond to the notices, these cases would enter Tax Delinquent Account (TDA) status. Resolution of TDAs begins at the Automated Collection Service (ACS) call sites. ACS is a relatively low cost collection system. A series of phone calls are made at the

ACS call sites to taxpayers requesting payments. If these phone calls do not resolve the TDAs, the cases enter a queue and are electronically prioritized. Cases with the highest priority are assigned to a Revenue Officer (RO). Those cases not assigned to an RO remain in the queue until all cases with a higher priority have been assigned. Revenue Officers use a variety of activities from phone calls to personal interviews to resolve the TDAs and are responsible for the cases until they close.

To maximize customer service and minimize problems with IRS using its collection authority, the Department of Education will perform dispute resolution to the same degree it currently does prior to refund offset referrals. The accounts referred to the IRS should be as "clean" as possible. IRS personnel are trained to collect taxes under the Internal Revenue Code. Student loans are subject to different statutes and regulations. By trying to resolve disputes with defaulters prior to referral to IRS, potential problems with IRS collection are minimized. While the IRS does have an appeals process and problem resolution program to handle disputes, these programs are geared towards tax collection, not debt collection. Employees of the Department of Education (or its contractors) should be more responsive to the needs of its borrowers. Education has the expertise and knowledge of the student loan process and the regulations pertaining to their programs. Rather than being referred to IRS, a defaulter may be entitled to a forbearance or deferral. In addition, a defaulter may enter voluntary repayment rather than be subjected to IRS collection.[2] Finally, if disputes are resolved prior to referral, then the impact on IRS operations are minimized.

Since IRS would collect defaulted student loans as if they were delinquent taxes, the avenues available to resolve problems after referral would be identical to the mechanisms used to resolve tax disputes. Taxpayers have the problem resolution program, appeals and Tax Court available to resolve disputes with IRS. While the dispute resolution mechanisms for taxes could be used to solve defaulted student loan problems, borrowers, Education and IRS would be better served if disputes were resolved prior to referral.

As stated earlier, the IRS would assume responsibility for collecting all defaulted student loans regardless of originating loan program (Federal Family of Education Loans or Direct Loan Program).[3] Depending on the year of implementation, the IRS could eventually pick up the 7 to 10 million defaulted accounts from the Federal Family of Education Loans. The $22 billion accounts receivables would become part of IRS's accounts receivable inventory. To ensure integrity and accountability in the student loan system, the IRS would

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[2] Under the refund offset program, the Department of Education issues a 60 day notice to defaulters of their intent to refer their account to the IRS for refund offset. For the 1994 filing season (through February 22, 1994) $30,432,984 was received in voluntary payments and $130,234,311 was offset for the Department of Education.

[3] IRS would assume responsibility for collecting <u>all defaulted debt</u> under Options 4 and 5 as well as under Option 3.

have to develop internal accounting routines that would track student loan collection efforts separately from normal tax collection. Furthermore, IRS must be able to notify the Department of Education when the defaulted debt has been paid in full. In determining the success of the Direct Loan Program, the Department of Education must be able to measure the impact on defaults and the ability to collect defaulted debt. Finally, for program integrity, Education also must be able to track default information by individual since borrowers in default are not eligible to receive further assistance from the Department.

As in Options 1 and 2, the Internal Revenue Service will continue to offset refunds to pay defaulted debt. In addition to the refund offset program, the IRS will submit the defaulted debt to the same activity used to collect delinquent taxes. In fact, IRS will not discriminate against defaulted debt or treat it any differently from tax collection. Defaulted student loans will receive the same series of notices that are sent due to delinquent tax cases. The deferral level that applies for tax cases will also apply to student loans.

While defaulted student loans will be collected as delinquent tax liabilities, IRS Collection function will have to develop an effective collection strategy. If student loan cases are assigned priority in collection workload selection, then defaulted student loan cases may be worked ahead of higher value tax cases. The average defaulted student loan balance is approximately $3,700. The average value of tax collection cases referred to the field is much higher. Assigning priority would allow more student loan cases to be worked, which may result in higher defaulted loan collections. If defaulted student loan cases are not assigned priority, then many of the cases would wind up in the queue and remain there until the 10 year statute of limitations expires. Assigning workload priority to defaulted student loans ensures that these cases will be actively worked.

While assigning priority represents one extreme of collection workload management strategies, the other extreme is allowing student loans to be worked on the same criteria as income tax cases. Compliant taxpayers may become noncompliant based on their experience with IRS collecting student loans. IRS loan collection may leave defaulters with the impression that the IRS is soft on student loan collections. This attitude could spill over to their perceptions of IRS tax collections.

In addition to the concern about compliance, collection prioritization may be increased for defaulted student loans to reflect the age of the accounts. Defaulted student loans from the FFEL Program already have been worked extensively by banks, guaranty agencies and Education's debt collection contractors. These defaulted accounts have received a number of notices and telephone contacts as well as tax refund offset. Because they have been worked extensively, a higher percentage of defaulted student loan cases may be referred to Collection Field personnel than if they were delinquent tax cases.

Defaulted student loans would be added to any delinquent taxes. The coupling of student loans and delinquent taxes would serve to increase the priority of the collection effort. From the Revenue Officers' perspective, student loans would be indistinguishable from delinquent taxes. However, from a program accountability perspective, student loan collections should be tracked separately from tax collections. Therefore, in cases where a taxpayer has both a defaulted student loan and delinquent taxes, payments will have to artificially allocated between taxes and student loans. If taxes are paid first, then the borrower would not be eligible for another student loan until all delinquent taxes and student loans are paid. If student loan accounts are credited first, then borrowers would be eligible for additional loans even though they have delinquent tax accounts. The prioritization of defaulted student loan or delinquent tax payments needs to be determined prior to IRS involvement in defaulted student loan collection.

Advantages

The major advantage of Option 3 is that since defaulted debt can be treated like a tax, the Internal Revenue Service can use its full collection powers. With the use of increased enforcement powers, the size of the defaulted student loan portfolio should gradually be reduced. IRS does have more powerful collection devices available than the Department of Education. Besides wage garnishing (levy), IRS has the authority to levy bank accounts and seize physical property. The Service also uses the refund offset mechanism to apply payments to delinquent tax accounts. Because IRS would be treating defaulted loans like a tax, all of these collection mechanisms would be available for use on accounts which meet the requirements.

Based on historical tax collection data, the Service collects approximately 70% of the original assessed dollars in tax cases within the first three years. Approximately 70% of eventual collections are received during the first year. Between the banks, guaranty agencies and the Department of Education, approximately 60% of defaulted student loans eventually are collected.[4] Between the guaranty agencies and the Department of Education, approximately $22 billion in student loans are currently in default. Loans are different from taxes; therefore, it is unclear whether IRS would have a higher collection rate than Education.

An additional advantage of using the IRS as the default collection agency concerns defaulters who also have outstanding tax liabilities. IRS assigns workload selection priorities to delinquent cases based on a number of factors. One of the factors is the size of the delinquent account. The addition of defaulted debt to the amount of delinquent taxes will increase the collection priority of those borrowers. Furthermore, the defaulter only has to deal with one agency rather than two.

Option 3 has the potential of another advantage to the IRS. There is the possibility that some defaulters will turn out to be individuals for whom IRS has no prior tax filing

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[4] This includes collections from the refund offset program administered by the Internal Revenue Service.

record. Since the population of borrowers in repayment status tends to be mobile, the Department of Education could have information on potential noncompliant taxpayers.

Disadvantages

There are major disadvantages to using the Internal Revenue Service as the defaulted student loan collection agency arising from the following:

- A high percentage of defaulted loan balances fall below the IRS deferral level.
- There are approximately 7 million current defaulters in FFEL and approximately 650,000 defaulters added annually.
- Unless IRS receives very substantial increments of resources, collection of student loans will divert resources from tax collections.

Each of these factors creates large workload management problems for IRS Collection.

To aid collection workload management, the IRS established a deferral level which fluctuates depending on the inventory of cases and available resources. Cases under the deferral level receive the normal stream of collection notices and refund offset. After the final notice, collection efforts are placed on hold until additional delinquent taxes and interest raise the account above the deferral level. While the notice stream is an effective collection tool, taxpayers (or borrowers, in this scenario) may perceive the IRS as being soft on compliance.[5] After all, these defaulters have already received a number of notices from banks, guaranteed agencies, and Education.

The collection of defaulted student loans will greatly impact IRS workload management. Based on department of Education statistics, there are approximately 7 to 10 million borrowers currently in default with an additional 650,000 defaulters expected each subsequent year through 2000. All of the currently defaulted loans and the majority of the expected defaulted loans are from the Federal Family of Education Loans (FFEL). Only a small percentage of projected defaulters are expected to be from direct loans.

Since the majority of the defaulted loans are held by guaranteed agencies, the cost analysis assumes that IRS would not receive the entire portfolio at once. Instead, IRS expects 2.05 million defaulters each year for the first five years. To work these cases, IRS would require a substantial increase in resources. Furthermore, collection resources required for active work beyond the notice stream and refund offset would have to be increased substantially.[6]

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[5] See the Compliance Analysis section for further details.

[6] See the cost analyses for further details.

All of this means that there will be large opportunity costs associated with IRS collecting defaulted student loans. To handle the increased workload, IRS would require additional resources. However, instead of applying the additional resources to student loan cases, the IRS could use the resources to collect delinquent taxes. On average, student loans balances are lower than delinquent taxes. If the additional resources were applied to outstanding taxes cases currently in IRS' inventory instead of defaulted student loans, approximately $770 million per year in tax revenues could be collected.

Furthermore, regardless of how payments are divided between defaulted loans and delinquent taxes, the prioritization scheme will be artificially derived. While treating defaulted student loans as if it were a tax for collection purposes minimizes problems for IRS' collection personnel, it does not allow the Service to accurately separate collections from individuals who defaulted on a student loan and have outstanding tax liabilities.

Finally, student loans are different from taxes; therefore, IRS' ability to collect defaulted student loans will be different from its ability to collect delinquent taxes. Tax liabilities are based on income, so there should be a high probability of eventual collection. On the other hand, defaulted student loans are not income dependent. Loans are offered as a means to enable students to afford post-secondary education.

Based on studies conducted by the General Accounting Office and various guaranty agencies, defaults are more likely among those attending proprietary schools and community colleges, independent students, freshman, dropouts, students with meager financial resources, and those who do not receive loan counseling. In 1989, the Department of Education analyzed the effects of five variables on default status: type of institution attended, AGI, independent/dependent status, years of schooling completed, and enrollment status (i.e., graduated, withdrawn). Statistical analyses indicated that AGI, type of institution, and years of schooling were highly correlated with default. Because the correlation between AGI and default status was negative, the collection of defaulted debt by the IRS poses a high degree of risk.

Option 4: IRS Collects Income-Contingent Direct Student Loans

Description

Option 4 builds on Option 3. In addition to collecting defaulted debt, Option 4 requires that the Internal Revenue Service process all income-contingent Direct Student Loan repayments through the tax system. All other Direct Loan repayments will be handled by the Department of Education or its Direct Loan Servicing Contractor. This option requires that the Internal Revenue Service be granted the legislative authority to collect student loan repayments as if they were taxes.[7]

Income-contingent repayment schedules are based on the borrowers' ability to pay. Borrowers would estimate the additional wage withholdings or estimated quarterly payments necessary to meet their required repayments. The estimated withholding or quarterly payment for student loan repayment would be based on a worksheet or formula provided to the borrower by the Department of Education. For wage earners, borrowers could either specify the additional withholdings or adjust their allowances on Form W-4, Employee's Withholding Allowance Certificate. Self-employed taxpayers would have to increase their quarterly estimated tax payments.

The reconciliation between required and actual payments and liabilities would occur on the annual individual income tax return. In principle, this reconciliation would be similar to the reconciliation between tax payments and tax liabilities. The most likely method for handling student loan reconciliations would be through the creation of a new schedule and the addition of new lines on Form 1040.

Because the Department of Education would retain responsibility for overseeing the entire Direct Loan program and would maintain and service accounts, the IRS would have to be notified on an annual basis to expect student loan repayments. The IRS would then:

- Compare the sum of required loan payments and tax liabilities to total actual payments (the sum of withholding, estimated payments and remittances with the return).
- Issue notices and notify Education of underpayments (nonpayments).
- Refund overpayments.

If a borrower fails to pay or underpays the required repayment for that year, IRS would issue a balance due notice and attempt to collect the delinquent amount through normal collection procedures. However, the Department of Education, not IRS, would make the determination of when the debtor entered default status. Education would then accelerate the outstanding loan balance and refer it to IRS for collection as if it were a tax.

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[7] In effect, income contingent repayments would be a surtax under this option.

Advantages

This option has several distinct advantages over the first three options. It leverages an existing system for collecting revenue based on income. As with the income tax system, income-contingent student loans could be repaid through wage withholding, estimated quarterly payments and a remittance filed with the tax return (subject to a potential penalty for underpayment). If wages are the primary source of income, borrowers can either use an existing line on Form W-4 to specify additional withholdings or decrease the number of allowances to cover their student loans. If a borrower is self-employed, then additional calculations would be necessary to determine the additional payment to include with the quarterly return.

Because no changes to the withholding system are planned, burden on employers is minimized. In fact, the burden and responsibility rests with the borrower. Employers would not be able to, nor would they be required to, separate withholdings for student loans from withholdings for taxes. While there will have to be some changes to the existing individual income tax forms as well as the addition of another schedule, employers would not have to develop or change existing accounting systems to handle income-contingent repayments.

Using the existing system also benefits the government as opposed to changing the tax system. While IRS would have to make extensive changes in processing and accounting, they pale in comparison with the changes that would be necessary to accommodate an overhaul of the withholding system.

Disadvantages

Because Option 4 incorporates Option 3, the disadvantages of Option 3 also apply to Option 4. Since Option 3 contains a full description of these disadvantages, the discussion of drawbacks to Option 4 will focus on the income-contingent portion that is unique to IRS involvement.

The weaknesses of Option 4 flow directly from its strengths. Option 4 uses the existing tax collection system to collect income-contingent student loans. One consequence of this option is that the Direct Loan Program goal for program accountability is not fully met. Because payments are not separated by account category, *loan payments* for individuals' choosing income-contingent repayment are indistinguishable from *tax payments*. This has serious consequences if either the loan or tax is underpaid or not paid. For example, a borrower underwithheld taxes and correctly adjusted withholdings for the student loan. Loan payments and student loan payments are inseparable. Which account is fully credited? It becomes an prioritization issue of how payments are allocated between income taxes or student loans. Regardless of the borrower's intent, Option 4 requires that an artificial prioritization between student loan and tax accounts be developed.[8]

While spousal income is included as a basis for income-contingent student loan repayment under all options, it becomes a particularly significant problem when IRS is involved in collection. The individual income tax system is a progressive tax system which means that the marginal tax rate increases as income increases. Tax withholdings are based in part on filing status; however, the potential exists that married borrowers could have taxes withheld at a lower marginal rate and then be liable at the higher marginal tax rate. Therefore, even though a married borrower could have adjusted withholdings to account for the income-contingent student repayment, the borrower (and spouse) may be underwithheld for taxes. Therefore, the amount that was intended to be student loan payments may be used to offset the delinquent tax

From the point of view of traditional loan servicing, an additional disadvantage with Option 4 is that the Department of Education will not know how much has been repaid until loan and tax withholdings have been reconciled with the required liabilities on the individual income tax return. This reconciliation occurs only once a year. Approximately 18 months could pass before an underpayment is noticed. This is a serious weakness.

Option 4 has one final disadvantage that stems from using the tax system for collecting payments. As stated earlier, reconciliation between payments and liabilities occurs once a year. Furthermore, payments are posted only once a year. Therefore, this plan really amounts to an annual payment. While this does not matter on the surface, it does matter over the course of the repayment schedule. On a conventional loan, the amount borrowed is amortized over a fixed period at a fixed interest rate. Varying the repayment frequency can vary the payment amount and the total interest as well as the term of the loan. More frequent payments reduces the total interest paid on a loan. From a borrower's perspective, payments coincide with paydays. Borrowers paid on a monthly basis should conform to borrowers who do not choose income-contingent. However, not all borrowers are paid on a monthly basis. Many payrolls are based on bimonthly, biweekly, or weekly basis. These more frequent payments should result in a quicker repayment schedule. However, the existing tax collection system precludes crediting individual accounts during the course of the year.

To the extent that student borrowers underreport their income to IRS, income-contingent repayments will be incorrectly calculated. To the extent that they fail to pay their taxes, they will fail to repay their student loans.

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[8] Under refund offsets, outstanding tax liabilities receive first consideration.

Option 5: IRS Processes All Federal Direct Student Loans

Description

Option 5 builds on Option 4. In Option 5, the Internal Revenue Service would collect defaulted student loans and process all direct student loan repayments, regardless of repayment method. Option 5 requires that Congress pass legislation which would allow the Internal Revenue Service to:

- use its enforcement functions to collect defaulted or delinquent student loans;
- use its tax collection system to collect income-contingent direct student loans; and,
- process all other direct student loan payments (e.g., standard, extended or graduated repayments).

Under this option, the IRS becomes the primary student loan collector for the Federal government.

The underlying assumptions that were discussed in Option 4 are retained in this option. The Department of Education retains overall responsibility for the Federal Direct Student Loan Program (FDSLP). Included with this responsibility is the maintaining and servicing of student loan accounts. Furthermore, the Department of Education is responsible for determining when borrowers enter default status. For payment processing and default collection purposes, the Internal Revenue Service would treat loan repayments like a tax.

Based on Department of Education projections, the income-contingent repayments constitute only 20% of all direct loans. The income-contingent portion would be handled according to the system described under Option 4. As in Option 4, the IRS would not distinguish income-contingent loan payments from tax payments.[9]

The remaining 80% of student loans would be repaid via standard, extended, or graduated payments. From a processing point of view, there is virtually no difference between standard, extended, or graduated payments: they are all variations of a fixed payment plan. Since the Department of Education would remain responsible for maintaining and servicing accounts, all that IRS would require from Education is the payment amount for the coming year. Payments could be received either through additional withholdings or estimated payments, similar to the income-contingent repayment option, or IRS could issue a coupon book to each borrower with the monthly payments for the coming year. By using coupon books, IRS would then be in a position to track payments and issue reminder notices when payments are behind schedule.

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[9] This means that the IRS would treat nonpayment or underpayment of student loans identically to nonpayment or underpayment of taxes.

For borrowers electing a repayment plan other than income-contingent and electing to use coupon books, IRS would be able to identify student loan payments. IRS would be able readily distinguish student loan repayments from tax receipts. Since payments are already separated from normal tax collection, IRS can track individual payments. For example, if a borrower misses a payment, IRS can issue a reminder notice and notify Education of the account status. Under income-contingent, it is impossible to identify underpayments or nonpayments until the tax return is filed.

If borrowers elect to repay their student loan through adjusted withholdings or estimated quarterly payments even though they elected standard, extended, or graduated payments, the reconciliation between required and actual payments and liabilities would occur on the annual individual income tax return. This reconciliation would be similar to the reconciliation performed by borrowers who selected the income-contingent repayment option.

Advantages

This option has the same advantages as Option 4 with respect to income-contingent repayments. The addition of IRS processing fixed payments add several benefits to the Federal government.[10]

Income-Contingent Repayments

Like Option 4, Option 5 leverages an existing system for collecting revenue based on income. As with the income tax system, there are three ways to pay the yearly liability:

1. wage withholding
2. quarterly payments
3. payment filed with return (subject to a potential penalty for underpayment)

If wages are the primary source of income, borrowers use an existing line on Form W-4 to specify additional withholdings to cover their student loans. If a borrower is self-employed, then additional calculations would be necessary to determine the additional payment to include with the quarterly return.

Because no changes to the withholding system are planned, burden on employers is minimized. In fact, the burden and responsibility rests with the borrower. Employers would not be able to, nor would they be required to, separate withholdings for student loans from withholdings for taxes. While there will have to be some changes to the existing individual income tax forms as well as the addition of another schedule, employers would not have to develop or change existing accounting systems to handle income-contingent repayments.

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[10] Fixed payments consist of the standard, extended and graduated repayment plans.

Using the existing system also benefits the government as opposed to changing the tax system. While IRS would have to make extensive changes in processing and accounting, they pale in comparison with the changes that would be necessary to accommodate an overhaul of the withholding system.

Fixed Repayments

IRS processing of fixed repayments offers additional benefits. The IRS is already in the business of processing large volumes of information. The addition of student loan processing represents a marginal increase in business over current tax return processing.

Disadvantages

The disadvantages of Option 4 also apply to Option 5. In addition, Option 5 generates some equity issues. Borrowers, whether they opted for income-contingent or fixed repayment, who elect to repay through the tax system will be treated differently from borrowers who use coupon books. In the case of underpayment or nonpayment of student loans or taxes, borrowers using the tax system would be subject to an artificial allocation of payments. For borrowers selecting coupon book repayments, IRS would know where the underpayment or nonpayment occurred. IRS can track payments using coupon books. While this unequal treatment of borrowers exists under Option 4, Option 5 centralizes it within one processor. The public perception of IRS processing student loan payments maybe extremely negative.

Section V

OBRA Conference Report Issues

Introduction

Section IV provided a brief description of the five options developed for determining the feasibility of IRS involvement in the Federal Direct Student Loan Program (FDSLP). In addition to the descriptions, the major advantages and disadvantages (from the Federal government's perspective) and program cost estimates were addressed. In addition to developing alternative roles for IRS involvement, the OBRA '93 conference report specifically requires that the Departments of Treasury and Education address five issues concerning the involvement of the Internal Revenue Service in the FDSLP. In this section, each issue is examined in the context of each option. The five options for IRS involvement which were developed in Section IV are:

Option 1 — *Information sharing as currently authorized (i.e., name, address, TIN, AGI, and filing status).* Under this option, Education would administer student loan repayments. IRS would continue the refund offset program for student loan defaulters.

Option 2 — *Increased Information Sharing.* This option is similar to the first option; however, additional legislation would be requested to allow Education to use additional income and employment information to administer an income contingent repayment system. IRS would continue the refund offset program for student loan defaulters.

Option 3 — *IRS Collects Defaulted Debt.* Under this option, Education would administer the student loan repayment system and refer defaulted debtors to the IRS for debt collection (requiring a administrative judgement from Education to treat defaulted debt like a tax).

Option 4 — *IRS Collects Income Contingent Student Loans.* This option would require legislation for the IRS to handle repayment of student loans through wage withholding or estimated payments, for debtors who select income-contingent repayment. In addition, IRS collects defaulted debt.

Option 5 — *IRS Collects Direct Student Loans, Regardless of Repayment Plan.* Under this option, legislation would be required to allow IRS to handle repayment of <u>all direct student loans</u>, despite the repayment plan selected by the debtor (i.e., income contingent, fixed payment). In addition, IRS collects defaulted debt.

Whether IRS could implement such a system of student loan repayment system with its current resources <u>and</u> without adversely affecting its ability to collect tax revenues?

The Internal Revenue Service could implement Options 1 and 2 with minimal resources. The Service currently performs refund offsets for the Department of Education and will continue to do so under the direct loan program. In addition, the Internal Revenue Service is working with the Department of Education on the sharing of tax return information for the purposes of administering income contingent repayments.

From an operational perspective, Option 2 represents a minor extension of Option 1. In Option 2, IRS would continue to provide passive support for Education's direct loan program. Besides providing additional tax return information for administering income contingent repayment, IRS would continue to act as the collection agency of last resort through the refund offset program. In Options 1 and 2, IRS plays a supportive role, yet remains in the background. Options 1 and 2 are reimbursable programs for IRS, meaning Education reimburses IRS for the services performed.

On the other hand, Options 3, 4, and 5 represent significant new activity for IRS in collecting student loans. The role of IRS changes from being the collector of last resort to being the government's primary student loan collector. The costs of these options are significant, particularly labor costs. Furthermore, IRS costs are extremely sensitive to the volume of defaulters and the percentage of defaulted accounts that are handled through the Automated Collection System (ACS) and Revenue Officers in the field. Minor increases in the percentage of cases being worked in those functions significantly increase costs. Processing costs are also sensitive to the volumes of direct student loans, particularly the lockbox costs.

In addition to the direct costs, there are substantial opportunity costs associated with IRS involvement in the student loan program. Without additional resources, tax collections from delinquent tax accounts would suffer. If the additional resources were applied to outstanding tax cases currently in the queue instead of defaulted student loans, approximately $770 million per year in tax revenue could be collected. Given the size and distribution of IRS accounts receivables as compared with Education's portfolio of defaulted debt, collecting defaulted student loans could be construed as a mis-allocation of IRS's resources. That is, the marginal revenue to cost ratio will generally be higher for collecting tax delinquencies than for collecting defaulted student loans.

The cumulative impact of increased disclosure of tax information and increased IRS involvement in nontax collection activities on voluntary compliance with the tax laws.

This requirement addresses two separate issues. The first is the impact of increased disclosure of tax information. The Internal Revenue Service is authorized to disclose limited tax return information to other agencies as specified by §6103 of the Internal Revenue Code. To protect taxpayer privacy and ensure the integrity of the tax system and voluntary compliance, the Service strictly administers the disclosure provisions.

Since Options 1 and 2 are primarily exchanges of tax return information with the

Department of Education, the impact of increased disclosure on voluntary compliance is of significant concern. Under the current program, Option 1, §6103 does allow IRS to disclose taxpayer entity information, adjusted gross income, and filing status to Education; however, this information cannot be released to the direct loan servicing contractor. To resolve the conflict between Education's reliance on contractors to administer the Direct Loan Program and §6103 disclosure provisions, Education is planning to offer income-contingent repayment on a conditional basis. Income-contingent repayments will be dependent on the borrower signing a consent at the time of repayment which allows IRS to provide the contractor with AGI, filing status, and entity information for the purposes of determining the required repayment amount. The contractor may have other lines of financial business. If the borrower has dealings with the contractor's other lines, then the contractor may be tempted to use the tax return information.

The second issue concerns the impact of increased IRS involvement in nontax collection activities on voluntary compliance with the tax laws. This issue applies to Options 3, 4 and 5. Historically, the Internal Revenue Service has been concerned about involvement in nontax debt collection. The mission of IRS is collecting tax revenues owed to the Federal government. The Service is concerned that increased nontax debt collection activity eventually could undermine taxpayers' confidence in the tax system, resulting in an erosion of voluntary compliance.

In the Omnibus Budget Reconciliation Act of 1981, Congress authorized IRS to offset refunds for taxpayers owing support debt to families receiving Aid to Families with Dependent Children. Since then, Congress expanded the refund offset program to encompass all Federal nontax debt. In order to determine whether refund offsets negatively influence voluntary compliance, IRS conducted a comprehensive long-term study. The final results of that study, released in February 1993, concluded that the program did have a long-term negative impact on compliance. However, the program benefits outweighed the costs.[1] The dollars offset for delinquent debt were greater than the estimated loss in tax revenues.

The General Accounting Office also studied the impact of refund offsets on voluntary compliance. In a study of guaranteed student loan defaulters, GAO agreed with IRS's general conclusion that there is a decline in compliance in the year immediately following an offset. However, GAO concluded that it was only a one year decline. Both IRS and GAO agreed that the refund offset program has yielded a net benefit to the Federal government despite the decline in compliance. However, if the impact on compliance is long-term, as indicated by IRS research, then the decline in compliance eventually could result in a net loss to the

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[1] A total of approximately $719 million was lost due to the decreased compliance for taxpayers offset for the first time in 1985, 1986, 1987 and 1988. Of that $719 million, $621 million was attributed to the increase in nonfilers and approximately $98 million was attributed to the increase in balance due filers. Over the same period, about $1.3 billion was offset from the same population.

Federal government.[2]

Based on IRS's experience in offsetting refunds to satisfy nontax debt, Option 3 should result in a net decline in voluntary compliance with the tax laws. Option 3 restricts IRS activities to defaulters. For the 1994 filing season, the Department of Education referred over 2.9 million defaulters to IRS for offset with total outstanding liabilities exceeding $11.5 billion. Under Option 3, IRS would eventually receive the entire portfolio of 7 to 10 million defaulters for collection activities. The refund offset program would be a major tool in trying to collect that debt. In the years following the offset, compliance would decline. Because Options 4 and 5 retain the defaulted debt collection effort, the decline in compliance attributable to refund offset also applies.

IRS collection of defaulted debt raises other concerns. Defaulted student loans tend to be old debt. Defaulted debt, under the FFEL program can be two or three years old before Education receives it from the guarantee agency. Defaulters have already received a number of notices from the originating bank, guarantee agency and Education. In addition, defaulted student loans tend to have small balances (average is approximately $3,700). Because defaulted student loans are old and have small balances, it can be questioned whether IRS will be more capable of collecting them. A large percentage of defaulted accounts fall below IRS deferral levels. Until these accounts (along with any accrued delinquent taxes) rise above the deferral level, IRS collection efforts would be restricted to refund offset and the notice stream. On the other hand, if these accounts were to remain with the Department of Education, they would still be subject to refund offsets and Education's contractor would continue to actively work the defaulted accounts.[3] The lack of IRS activity on the large inventory of accounts below the deferral level could send the wrong message. If the IRS is soft on collecting student loans, then it may be soft on taxes. Voluntary tax compliance may suffer in the long-run.

Advocates of increased IRS involvement argue that the "fear factor" from IRS involvement would reduce future defaults and accelerate current default collections. However, fear of IRS can act as a double-edged sword. Some taxpayers are compliant

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[2] For further information concerning the impact of the refund offset program on voluntary compliance see:

United States General Accounting Office, Tax Policy: Refund Offset Program Benefits Appear to Exceed Costs, GAO/GGD-91-64, May 1991.

Internal Revenue Service, Research Division, The Impact of Nontax Refund Offsets on Voluntary Compliance, October 1992 (Revised February 1993).

[3] The department of Education's debt collection contractor uses telephone contacts to secure additional payments.

because they are afraid of being caught while others remain out of the system out of fear. These taxpayers are of afraid of the consequences of coming back into the system. The IRS has a "bad guy" reputation. Once taxpayers become nonfilers, they remain out of the system due, in part, to the fear having to pay the accrued penalties and interest that have accrued on prior years accounts.

The ability of the IRS to enforce collection of student loans using an alternative system of dispute resolution, penalties, and collection devices.

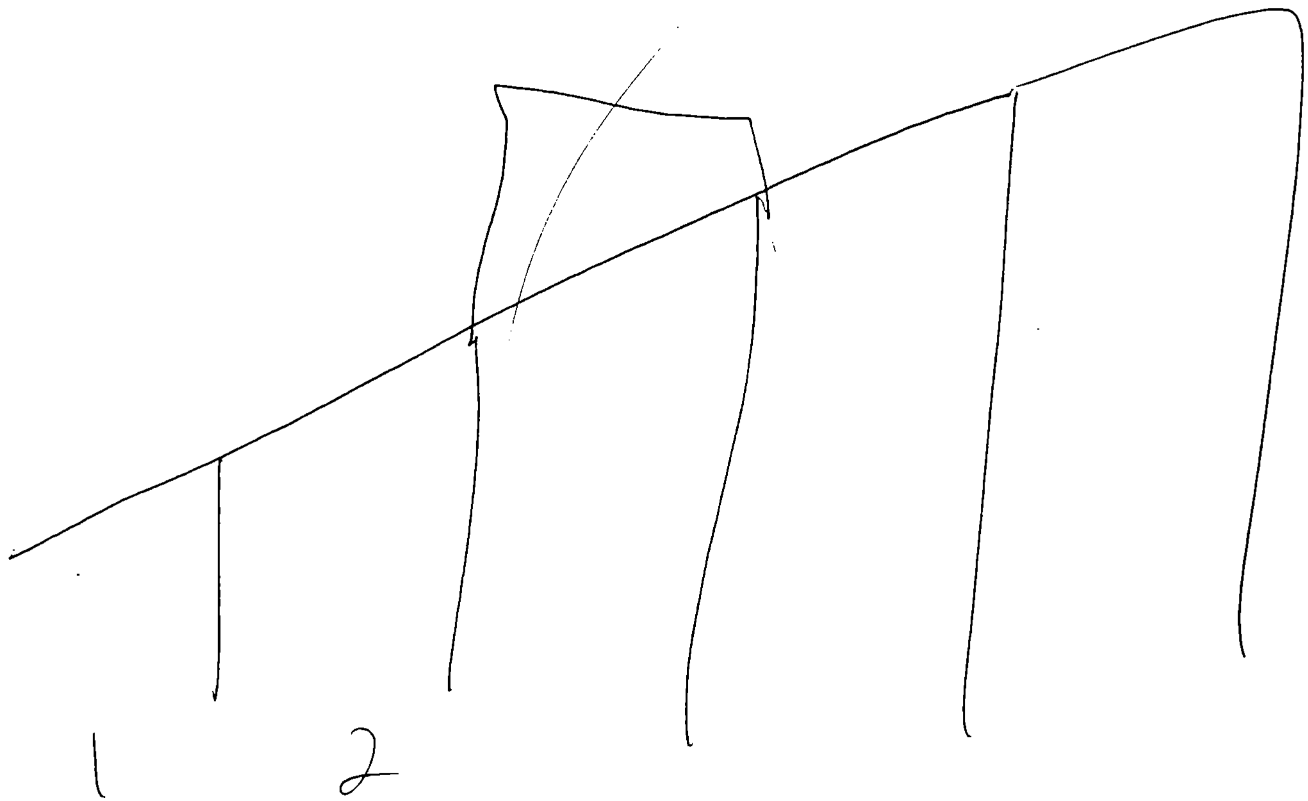
This issue is not applicable to any of the five options. Options 1 and 2 rely on the Department of Education to administer the direct loan program with IRS playing a supportive role through information sharing. In Option 3, the Department of Education refers defaulted debt to IRS for collection as a tax. At that time, it becomes subject to IRS interest and penalties. In Options 4 and 5, it is envisioned that IRS will use existing processing and collection systems, apply statutory tax penalties and interest, and not distinguish student loan repayments from tax payments.

The effect of separating loan collection from other loan servicing functions.

To be supplied by the Department of Education

The anticipated effect on the management of Federal student loan collections, and on borrower repayment of such loans.

To be supplied by the Department of Education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OCT 19 1994

Student Loan Repayment Through Wage Withholding

Option to implement the President's Vision Using Mandatory Wage Withholding Administered by the Department of Education

- Note: A voluntary system using wage withholding administered by Education would operate in the same manner as the mandatory system. In all cases the borrower can choose the means of repayment (wage withholding, bank account electronic funds transfers, checks, etc.).

- Builds on the widespread existing system of the employer effecting voluntary deductions from wages, such as deductions for charitable contributions, for 401(k)-type retirement programs, or for savings and savings bond programs.

- Utilizes the Education loan collection apparatus already in place.

- Is borrower focused, meaning that the amount withheld and reconciliation of amounts withheld are the responsibility of the borrower in communication with the Department of Education, similar to other borrower initiated wage deductions.

- A borrower focused system eases employer compliance, since ED would not require employer reports to demonstrate the status of revenue collections. Borrowers, notified of missing payments, would be an automatic compliance check.

- **Mechanics of the process:**

    - Education's contracted loan servicer (servicer) would furnish employers a description of the wage withholding program and all information necessary to make deductions and forward payments to the servicer.

    - The servicer would provide all student loan borrowers information regarding repayment options, including repayment methods, payment plans, and the amount of the monthly payment based on their choice of payment plan and other factors.

    - The borrower would notify his/her employer how much to withhold on a monthly basis, then the employer would begin salary deductions and forward payments monthly via EFT or check (can be a batch payment with individual breakout) to an address furnished to the borrower by the servicer.

    - The servicer would provide borrowers with periodic statements of the amounts received and the status of the account so the borrower could notify the employer and/or the servicer of any discrepancies.

- Education would set up appropriate internal controls to identify missing payments and ensure employer and borrower compliance.

- The borrower would be relieved of all liability for payments withheld by the employer that were not forwarded to Education.

- **Costs:**

  - Monetary cost to employers using the wage garnishment model is estimated at $2.5 billion per year.

  - Using the ED system, data processing costs are relatively inexpensive, even if mandated. However, other significant costs occur due to back end transactions: coordination between payroll and personnel management; keeping and maintaining records; setting up and revising accounting system changes; resolving reconciliation problems; and fees for legal and professional advice.

  - The method should not involve significant government administrative costs but would require additional oversight related to employer compliance.

  - Political costs are significant, with the principal one being the cost burden placed on employers, especially small businesses. Payroll associations report widespread dissatisfaction with the increased number of government mandated wage withholdings and the complexity involved.

  - A second political cost is perceptions of federal intrusion that accompany a federal mandate. Employers perceive a mandate quite differently than an invitation to offer the same thing under the umbrella of an employee benefit.

  - A borrower focused wage withholding system administered by Education affords maximum convenience to the borrower, employer and the government and uses systems and technology already in place.

  - Legislation is required to mandate employers to withhold for student loan payments when requested by an employee.

Option to implement the President's Vision
Through Split Loan Servicing

- Borrowers can repay their loans according to 5 repayment plans: standard repayment plan (fixed payments for 10 years); extended repayment plan (fixed payments for 12 to 30 years depending on amount borrowed); graduated repayment plan (increasing payment amounts for 12 to 30 years depending on the amount borrowed); income contingent (varying payments for up to 25 years depending on amount of income, with forgiveness of balance at 26th year); alternative plan (unspecified conditions to meet special circumstances).

- For those borrowers who chose the income contingent repayment plan, IRS would collect loan payments on Education's behalf through additional tax withholdings specified by the borrower. Education would service all loans and collect loans under other repayment plans directly through (a) contracted servicer(s).

- Borrowers would reconcile tax withholdings between student loan and income tax liabilities on their income tax returns, and remit any differences, then IRS would remit collected amounts to Education's servicer.

- **Advantages:**

    - The borrower has the benefits of automatic wage withholding and loan payments with little or no inconvenience to the employer.

    - This method builds on an existing framework that all employers and employees are required to use.

    - The employer has no significant additional cost or administrative burden.

    - IRS could administer the system with little change in its present structure and could use the existing structure to respond to employer concerns and to enforce employer and borrower compliance provisions.

    - Although legislation would be required, the system could be effected soon after enactment.

- **Disadvantages**

    - Borrower focus groups and student associations have expressed clear opposition to IRS involvement in loan collections, which factor may make income contingent loan repayment less attractive.

    - Results in critical disparities in treatment between income contingent loan borrowers, other direct loan borrowers and guaranteed student loan borrowers that would be capitalized upon by banks and guaranty agencies to discourage participation in the direct loan program, such as:

- Borrowers enduring significant income loss (unemployment, job change, child birth) would have an 18 month lag until prior loan payments could be adjusted against current loan repayment obligations. All borrowers would have to endure the inconvenience of later reconciliations when switching plans and could switch only one time a year at reconciliation.

- Loan repayment shortfalls would be treated as tax liabilities subject to all the IRS collection tools.

- Borrowers would not be able to easily monitor the effect of monthly payments on principal reduction, which information might prompt them to change to more advantageous payment plans.

- Seriously hampers the ability of Education (and IRS) to reconcile payments with liabilities due to an 18 month lag in receiving payment information and need to segregate student loan payments from universe of tax receipts.

- Education would not become aware of defaults until up to 18 months after the event.

- Education would not be able to comply with financial management requirements specified in the Credit Reform Act of 1990 or the Chief Financial Officer's Act of 1990 because of the 18 month lag.

- Critics and analysts have pointed out repeatedly that to prevent fraud and abuse, Education needs access to real time data for efficiency in loan servicing, monitoring of school performance, budget forecasting, and financial management purposes.

- IRS involvement in collection activities not related to tax collection has resulted in a decline in voluntary tax compliance.

- IRS has not established a good record in collecting the relatively small debts represented by Education loans.

Service Delivery Advantages and Disadvantages: IRS vs ED

- **Note:** The following discussion assumes that IRS would use the tax system to collect student loan payments through wage withholding using the income contingent repayment plan.

- **IRS Advantages**

  - The payroll deductions are automatic from the borrower's perspective and pose nearly no additional burden from the employer's perspective.

- **IRS Disadvantages**

  - Student loan borrowers do not want IRS involvement in loan collections.

  - Many borrowers would be limited to wage withholding under the income contingent repayment plan even if other plans were more advantageous.

  - Unless IRS set up a customer service operation, IRS could not provide the borrower with advice and counsel, the key aspect of service.

  - Borrowers could not monitor payments on an ongoing basis and evaluate the effects of payments on interest and principle until well over a year passed.

  - Reconciliation of taxpayer accounts by taxpayers to segregate tax and student loan liabilities is certain to cause the borrower frustration, especially in the event of shortfalls, when the shortfall becomes a tax liability subject to imposing tax collection rules.

  - Reconciliation of payment data between IRS and Education, coupled with a large lag time, is certain to delay accurate postings to many student accounts.

- **ED Advantages**

  - The borrower could use wage withholding to repay loans under the most advantageous loan repayment plan, not only the income contingent plan.

  - The borrower's payments would be made automatically, but the borrower would have the advantage of following his/her account balance and monitoring the effect of payments on principal and interest.

  - From the student's perspective, ED is perceived as consumer oriented and customer friendly.

  - ED can provide one-stop shopping. ED would be accountable for customer service for all aspects of student financial assistance administration and ED will be able to control the outcomes.

- ED would be able to provide the borrower more relief in the event of a loan repayment shortfall than would be available to the borrower incurring a tax liability.

- Because there are necessary linkages between aspects of program administration and subsequent loan service and collection, customer service would be strengthened if responsibilities for it are carried out by a single agency.

- With its close relationship to the schools and the continuous relationship it establishes with the students beginning in the earliest stages of the loan cycle, together with its familiarity with the programs it administers, ED is in the best position to advise a student on loan repayment throughout the repayment process.

- In general, withholding the payments and forwarding them to ED would be no more difficult than the common practice of withholding charity contributions or payments to a credit union, which is not possible with an IRS tax based system.

- The Department of Education has developed the infrastructure necessary to administer a centralized loan program that includes wage withholding as an option.

- Through its experience with the guaranteed loan program and the Perkins Student Loan program, ED has gained the institutional knowledge that would permit effective administration, with servicers to provide state of the art operational capability.

- **ED Disadvantages**

  - In terms of service delivery, there are no disadvantages to using ED as the primary servicer.

Carrot and stick options for ED mandatory and voluntary options

- **Mandatory option carrots**

  - Excluding employers with fewer than 10 employees from the requirement would exempt over 75 percent of the employers but reach about 85 percent of the employees.

  - Reimburse employers for all or a portion of costs. Note: (Reimbursements would increase administrative burden considerably because of unavoidable government accountability standards. In addition to the budget impact, increasing direct loan program expenses has a high political cost).

- **Mandatory option sticks**

  - Obtain legislation providing for civil penalties for non-compliance.

- **Voluntary option carrots**
  - About 80 percent of the employees in the U.S. are employed by businesses that participate in the savings bond program. Interest level in wage withholding to repay student loans should be higher than interest in savings bond participation, which would increase demands on employers.

  - In terms of number of employees, only the top 25 percent of the employers have to participate to afford wage withholding to 85 percent of the employees.

  - Employers could be offered cash incentives to cover expenses (Note: subject to the cautions cited under mandatory carrots.)

  - Using a wage withholding system based on the model of voluntary deductions from salary as an employee benefit.

  - Initiate public service advertising campaign, utilizing trade and payroll providers and associations, to promote wage withholding as a public service and employee benefit.

  - Prepare instructional and software packages to assist employers in effecting the option.

  - Enlist payroll servicers, such as ADP, to assist ED in developing the operational aspects of the voluntary option as a simple and inexpensive service.

- **Voluntary option sticks** are not necessary.

Wage Withholding from the Student's Perspective

- Initially and at intervals, all borrowers will be thoroughly advised about repayment options and plans. They will be specifically advised about short and long run costs of different repayment plans.

- A voluntary or mandatory system of wage withholding as an automatic monthly loan repayment method, whether administered by ED or IRS, produces the same results from the borrower's perspective.

- Many borrowers would feel burdened using the IRS tax system, when tax returns were filed. They may be confronted with perceptibly large tax deductions. In addition, they may be confronted by unanticipated underpayments.

- Borrowers using the IRS tax system, who encountered problems, would have to coordinate between IRS and ED, both of which may not be coordinated with the other because of the volume of filers at tax time, but especially because of the 18 month information lag. Borrowers would be very frustrated.

- A borrower using the ED administered system would receive periodic updates, at least quarterly, on the status of his/her account, including interest and principle.

- With current account information and only one point of contact, borrowers under an ED administered system would be able to easily change payment plans, yet continue to use wage withholding.

- Borrowers under an ED administered plan could easily stop wage withholding without enduring later reconciliations.

- Under the ED administered system, a borrower/employee could have all of the benefits of wage withholding, without dealing with the bureaucracy of the employer's personnel office, by authorizing the employer to pay salary through electronic funds transfer to the employee's bank account and authorizing the bank to transfer funds to an ED account. ADP advises that a large percentage of businesses use electronic funds transfers to pay employee salaries.

STUDENT LOAN REPAYMENT AND WAGE WITHHOLDING MEETING
AGENDA
OCTOBER 19, 1994

- Progress report
- Work product review
  - Cost methodology
    - Explain current analysis
    - Develop alternative methodologies
  - Analyze and explain the Mandatory DoE option
  - Describe split servicing between IRS and DoE
  - Compare service delivery advantages and disadvantages between IRS and DoE
  - Develop a blend of carrot and stick options for the DoE mandatory and voluntary options
  - Develop a menu of options from the student's perspective: choice set
- Next steps
  - Improvements to slides
  - Meeting with Sperling and Galston scheduled for October 24th, 10:00 a.m. (Treasury, DoE to attend)
  - Follow-up questions to agencies as necessary

Cost methodology -- Explain current analysis (Methodology #1)

Describe all of the assumptions, formula and calculations used to develop the cost figures that we used in the most recent draft of the PDM on Student Repayment and wage withholding for each of the six costed options.

For example, here is how we did it: X number of borrowers, y number of businesses, z frequency of activity. This is step 1. This is step 2. Here is the conclusion. Here is how we would analyze it. The kinds of conclusions that can be drawn from this option are N. Here is a unusual property of this model O.