

A Study of the Feasibility of the IRS Collecting Repayments of Federal Student Loans



Department of the Treasury



Department of Education

June 1995



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

SECRETARY OF THE TREASURY

June 28, 1995

The Honorable Albert Gore, Jr.
President of the Senate
Washington, D.C. 20510

Dear Mr. President:

The Conference Report accompanying Public Law 103-66, The Omnibus Budget Reconciliation Act of 1993, directs "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. . . . The feasibility study and any plan that is developed, together with any legislative recommendations that the Secretaries may deem advisable, should be submitted to the Congress. . . ."

Pursuant to that provision, we hereby submit "A Study of the Feasibility of the IRS Collecting Repayment of Federal Direct Student Loans."

A similar letter is being sent to the Honorable Newt Gingrich, Speaker of the House of Representatives.

Sincerely,

Robert E. Rubin
Secretary of the Treasury

Richard W. Riley
Secretary of Education

Enclosure



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EXECUTIVE SUMMARY

A centerpiece of the Administration's efforts to promote national service and make paying for college easier was fulfilled through the enactment of the Student Loan Reform Act of 1993 (Title IV of the Omnibus Budget Reconciliation Act of 1993--OBRA '93), and its companion legislation, the National and Community Service Trust Act of 1993.

The conference report accompanying the Student Loan Reform Act directed the Departments of the Treasury and Education to study the feasibility of implementing a wage withholding system and involving the Internal Revenue Service in servicing and collecting payments on student loans. A team from the Departments of the Treasury and Education was formed to carry out the study. Using the following criteria, the study identified and evaluated a number of scenarios: customer service, default rate, impact on collections and budget, and burden on business. At least five concerns voiced by the Conference Report were also addressed and evaluated:

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

Potential IRS participation in direct lending was also examined within the context of the existing IRS systems and programs. The IRS, however, is in the process of undergoing a major change. The IRS is modernizing its 1960's tax systems and reinventing tax administration. Voluntary compliance, tax refund fraud, and IRS efforts to deal with these problems continue to receive intense review from both the Administration and the Congress. For example, improving total collections to 90 percent of the true total tax liability is a major IRS goal. Despite Congress's interest in and demand for these improvements, full funding for the Tax Systems Modernization (TSM) Program has not been provided because of overall budgetary concern.

Because resources are finite, the IRS concentrates its collection resources on higher dollar-value tax delinquent cases than ED does for defaulted loans (which deals with an average

defaulted student loan debt of \$2,800). The IRS does not, cannot within its current system, and will not under TSM as presently designed, be able to maintain monthly account data on taxpayer status. Validation of taxes paid and owed, reflecting reconciliation of employer reported data and individual tax returns, does not now occur until some six months after the close of the tax year. To maintain real time data on taxpayers, tax withholding and reporting requirements would have to be changed for all employers. Nevertheless, as discussed below, several approaches were identified that could further involve the IRS in student loan collection to varying degrees without requiring such broad (and costly) revision of the tax withholding and reporting system.

Four feasible options were analyzed and evaluated:

Option 1. IRS Student Loan Special Operations. (Using Federal FTE or contractors). Education would originate the loan. IRS would then provide borrowers the full range of services - from billing through collection. Work would be performed by IRS staff or contractors. A separate system of wage withholding would be established outside the tax system. Employers would be required to offer borrowers wage withholding and would transfer payments to the IRS.

Option 2. Split Servicing: IRS uses the tax system for wage withholding. IRS would collect loans through the tax system whenever borrowers elected to repay through employer wage withholding. Loans repaid by all methods other than wage withholding would be collected by Education. Education would service all borrower accounts.

Option 3. Education administers loan programs. IRS provides additional information to enhance Education's collection capability. Education would retain responsibility for all aspects of student loans - origination, collection and servicing. IRS would share additional tax return information to enhance Education's collection capability. Employers would not be required to offer wage withholding, but Education would provide incentives to employers to do so. If employers did offer wage withholding, they would transfer payments directly to Education.

Option 4. Education carries out all functions. Mandatory wage withholding for firms with ten or more employees. This option closely parallels *Option 3*. The difference is that businesses with 10 or more employees would be required to offer wage withholding.

Treasury and Education have concluded that it is not feasible to expand the participation of the IRS in the collection of student loans. Further, the Departments also concluded that the Department of Education should continue to administer all aspects of the student loan program, as described in *Option 3*.

Option 3 would meet customer service goals by giving borrowers rapid access to account information and allowing them the flexibility to switch repayment plans. It does not have the drawbacks of other options, such as overtaxing IRS resources and decreasing tax collections of a higher dollar value. Voluntary employer participation would mean minimal opposition from the business community. This option would add no additional budget costs and does not require additional legislation.

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I. Student Loan Reform Act and the Study of IRS Involvement

A centerpiece of the Administration's efforts to promote national service and make paying for college easier was fulfilled through the enactment of the Student Loan Reform Act of 1993 (Title IV of the Omnibus Budget Reconciliation Act of 1993--OBRA '93), and its companion legislation, the National and Community Service Trust Act of 1993. Under the President's Direct Loan program, all aspects of the loan process are simplified and streamlined to better serve the needs of students and postsecondary education institutions, while saving taxpayer dollars. Specifically, under the Direct Loan Program, the complex array of lenders, servicers, secondary markets, and guaranty agencies are eliminated. Borrowers are provided with a variety of repayment plans to allow them to make career choices without undue concern over the level of post-graduate income needed to repay loans taken to finance a college education.

Before passing the Student Loan Reform Act, Congress deleted an Administration proposal that would have enabled the Internal Revenue Service (IRS) to participate in loan collection if the Secretaries of Education (ED) and Treasury believed it to be feasible. Congress then substituted a requirement that the two Departments study and report on the feasibility of IRS participation. 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". The Report asked that the study include analyses which would help determine:

1. *whether the IRS could implement such a system of student loan repayment 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;*
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; and,*
5. *the anticipated effect on the management of Federal student loan collections and on borrower repayment of such loans.*

The conference report required the Secretaries of Education and Treasury to submit the feasibility study, any implementation plan, and any legislative recommendations deemed advisable within six months of enactment of the legislation. Due to the complexities of the analyses, the Departments requested an extension. This report responds to the conference report mandate.

II. Direct Lending Reforms

The Direct Loan Program authorized by OBRA '93 is being phased in over five years beginning with fiscal year 1994 (FY94). Under current law, total direct lending is projected to rise from 5 percent of new student loan volume in FY94 to at least 60 percent of new student loan volume in the fifth year, or nearly \$18 billion. The new program improves loan access and borrower service, simplifies administration, reduces defaults, and improves collections. It also saves taxpayers money by eliminating middlemen and subsidies that do not directly benefit students.

Direct lending improves on the old guaranteed loan program by replacing the bank and state agency structure with a new program under which ED administers all aspects of loan origination, disbursement, accounting, and servicing through the use of competitive contracts. This permits efficient monthly tracking and billing, as well as frequent contact with borrowers. Frequent contact is essential to maximize customer service and to minimize defaults. Direct lending also maximizes program oversight since ED has timely access to program data.

To ease the financial burden of repaying their loans, direct lending offers borrowers the opportunity to tailor loan repayment to their career needs, and to take low-paying public service jobs without the danger of default. Direct lending offers borrowers several repayment plans: income contingent, graduated, extended, and standard-fixed. Borrowers are allowed to switch between plans as circumstances change and are also allowed to obtain deferments and forbearance. Borrowers are also offered several repayment methods such as coupon books, checks, and bank debits (which have the automatic repayment features of wage withholding). It is widely recognized that payments made automatically through wage withholding can reduce delinquencies and defaults. Furthermore, ED is developing a voluntary employer wage withholding program which will encourage widespread employer participation. The range of repayment options available to borrowers enables them to reap the benefits of their educational investment while allowing maximum flexibility in repayment.

ED cannot mandate participation in the Direct Loan Program by either students or schools. Voluntary participation relies on the key features of the Direct Loan Program: responsiveness to students, less burdensome administration and quick disbursement of loans. Although still in its early stages, student feedback and school participation rates suggest that the Direct Loan Program is a success. For example:

- At a recent round of national forums, student feedback was clearly enthusiastic, especially with regard to the flexible repayment plans. This was pointedly expressed at the Presidential roundtable at the University of Michigan.
- Currently, 104 schools are participating (representing the loan volume targeted by statute for academic year 1994-1995). Although approximately 2,300

schools applied to participate in the second year, ED could only select approximately 1,500. That was the number needed to meet the statute's goal of 40 percent of the loan volume. Other schools must wait for the next round beginning in July 1996.

Under the old program, 85 percent of borrowers made loan payments on schedule. Of the borrowers who do not pay their loans on time, many default or become seriously delinquent. However, defaults and serious delinquencies may be reduced in the Direct Loan Program. This may occur through the new income contingent "pay-as-you-can" plan, which at least 18 percent of all borrowers are expected to select. Payments contingent on the ability to pay should reduce the likelihood of nonpayment and result in increased collections over time. The ability to repay student loans through automatic payments such as wage withholding or electronic bank debits should also contribute to a decrease in defaults. Some of those who now cannot pay will be able to remain in good standing (albeit accruing interest).

The loan collection methods that have proven to be successful under the guaranteed loan program will be retained under direct lending. These currently include the most effective method, the Tax Refund Offset Program: whereby potential income tax refunds for referred defaulters are applied to the defaulted loans instead of being issued to the taxpayer. This program, which started in 1986, has increased collections of defaulted loans by 43 percent and yields over \$600 million annually. The IRS is also authorized to assist ED by performing a computer match to locate defaulted debtors. As a result of this matching program, overall collections have improved by 5 to 10 percent. Finally, ED is implementing its new administrative wage garnishment authority to further increase defaulted loan collections.

III. IRS Reforms Already Underway

Potential IRS participation in direct lending was also examined within the context of the existing IRS systems and programs. The IRS, however, is in the process of undergoing a major change. The IRS is modernizing its 1960's tax systems and reinventing tax administration. Voluntary compliance, tax refund fraud, and IRS efforts to deal with these problems will continue to receive intense review from both the Administration and the Congress. For example, improving total collections to 90 percent of the true total tax liability is a major IRS goal. Despite Congress's interest in and demand for these improvements, full funding for the Tax Systems Modernization (TSM) Program has not been provided because of overall budgetary concern.

Because resources are finite, the IRS concentrates its collection resources on higher dollar-value tax delinquent cases than ED does for defaulted loans (which deals with an average defaulted student loan debt of \$2,800). The IRS does not, cannot within its current system, and will not under TSM as presently designed, be able to maintain monthly account data on taxpayer status. Validation of taxes paid and owed, reflecting reconciliation of employer reported data and individual tax returns, does not now occur until some six months after the

close of the tax year. To maintain real time data on taxpayers, tax withholding and reporting requirements would have to be changed for all employers. Nevertheless, as discussed below, several approaches were identified that could further involve the IRS in student loan collection to varying degrees without requiring such broad (and costly) revision of the tax withholding and reporting system.

IV. Policy Options for IRS Involvement

The Administration originally envisioned a direct loan program that would have involved the IRS by providing borrowers with the opportunity to repay their loans through the existing income tax system's wage withholding process. A team from Treasury and Education sought to determine how this approach could be implemented, analyzing and evaluating its benefits and drawbacks. A fundamental tenet is that any acceptable option must permit the borrower the freedom to choose from several repayment plans and methods that best meet that borrower's circumstances. Preservation of these choices will encourage loan repayment.

Within this context, the team expanded the scope of the study to determine how to implement wage withholding as a viable repayment mechanism and to determine the best role for the IRS in supporting direct lending. The team examined multiple options regarding the use of the IRS, as well as alternative means of providing wage withholding outside the current tax system. Ultimately, the team consolidated the possibilities into four options. In addition to the analyses required by the Congress, the team evaluated each option according to the following criteria: impact on customer service, default rate, impact on collections, budget consequences, and burden on businesses.

Four options for IRS involvement in the servicing and collecting of direct loans were considered: (1) IRS establishing a special student loan operation; (2) IRS using the current tax system for loans repaid through wage withholding only (ED doing all other functions); (3) ED running its current operation with incentives to business to maximize the availability of wage withholding; and (4) ED running the operation with a mandatory requirement on firms with ten or more employees to offer wage withholding. Each of these options incorporates additional IRS involvement and provides borrowers with the opportunity to repay loans through employer wage withholding or similar mechanisms. The options are described below, and appendices are attached which present these issues in detail: conference report language, collection methods, estimated costs for each option, and estimating the burden on businesses.

A. Option 1. IRS Student Loan Special Operations (Federal FTE or Contractors)

Proposal

Option 1 permits IRS involvement in all aspects of student loan collections, including current loans in repayment and default. This option provides all borrowers the full range of service from billing through collection.

As in all the options, ED would originate the loans. IRS would service and collect all repayments through a loan collection system separate from the tax system. This would offer borrowers maximum flexibility in terms of repayment plans and methods, including wage withholding.

This option could be implemented in phases. In Phase I, ED's direct loan contract would be transferred to the IRS for program administration. Under Phase II, the IRS either would create a new in-house system separate from the tax system or continue to contract student loan collecting and servicing. In Phase II, IRS would assume the old guaranteed loans, whether in repayment or default. All employers would be required to offer wage withholding and report student loan payments to the IRS separate from tax withholding. Employer withholding would be tracked on a real-time basis through frequent reports to both IRS and borrowers. These reports would also ensure a high level of employer compliance. In addition, assuming proper legislative authority, IRS could bolster collections through the use of tax data that it maintains but cannot presently disclose.

Evaluation

Customer Service: In Phase I, customer service would be comparable to that currently being provided by ED; in Phase II, all borrowers would have the option of wage withholding with the same access to information and flexibility to switch plans as borrowers who did not choose wage withholding.

Default Rate and Student Loan Collections Impact: Some anticipate that requiring borrowers to deal with the IRS may motivate them to repay, especially if borrowers believe that ED lacks the will or means to effect collections. In addition, mandatory employer wage withholding would capitalize on the likelihood that payments made automatically through wage withholding would reduce delinquencies and defaults.

Budget Consequences: IRS would need continuing additional resources so that its primary task--the collection of taxes--would not suffer. The estimated cost to IRS of establishing and operating such special operations is \$600 million for Fiscal Year 1999, based on the use of approximately 6,800 FTEs to collect 4.3 million loans in repayment and approximately one million defaulted loans. If, instead, IRS administered ED's contract, as in Phase I, the estimated annual cost is \$750 million (including \$400 million in collection costs paid out of amounts collected). ED estimates that its costs would likewise be reduced by \$750 million (of which only \$350 million is appropriated). Costs, but not FTEs, may be covered within ED's baseline funding for loan administration.

Required Resources and Impact on Tax Revenues: In Phase I, the IRS would assume management of ED's contract. If the costs and administrative FTEs are transferred from ED's baseline funding, then there would be no anticipated adverse impact on tax revenues.

Phase II represents a new line of business for the IRS. To successfully implement Phase II, the IRS would require significant additional resources as noted under Budget Consequences. Phase II creates, in effect, a mini-IRS dedicated solely to servicing and collecting student loans.

Impact of Increased Disclosure and Increased IRS Involvement in Nontax Collection on Voluntary Compliance: This option expands not only the universe of individuals with access to information that is considered confidential and sensitive, it also expands the use of that data. To the extent that tax information is abused, voluntary compliance may suffer. Also, IRS experience with nontax issues, such as tax refund offset programs, indicates that voluntary income tax compliance declines when the IRS attempts to collect nontax debts from taxpayers

The Ability of the IRS to Enforce Collection of Student Loans: During Phase 1 of *Option 1*, the IRS will continue to collect student loans using the system developed by ED. In effect, the system would be transferred to IRS and be operated separately from the tax collection system. As in Phase 2, however, all of the IRS collection tools would be available to ensure compliance. On balance, it is expected that the IRS would be more successful than ED in enforcing student loan collections.

Separating Loan Collection from Loan Servicing: This option does not separate loan servicing from loan collection.

Effect on the Management of Student Loan Collections: This option divides the responsibility for student loan program management between two agencies. ED would retain overall responsibility and continue to originate all loans, while the IRS would assume the responsibility for collecting and servicing loans.

Burden to Businesses: The estimated annual cost is \$1.7 billion spread over 1.2 million employers, assuming 6 million borrowers elect wage withholding.

B. Option 2. Split Servicing: IRS Uses the Tax System for Wage Withholding, Education is responsible for administering all other aspects of the Direct Loan Program.

Proposal

Option 2 provides that borrowers who earn wages may choose to repay student loans through the IRS tax system. Enabling legislation is required. Employers would not need to keep separate accounting records or provide loan information to either IRS or the borrowers.

Under this option, the IRS would collect loans whenever borrowers in the Direct Loan Program elect to repay through employer wage withholding. ED would continue: to collect loans under the guaranteed loan program and to service direct loans for borrowers electing all other repayment methods; would track borrowers financially unable to make payments;

and would perform record-keeping functions for all repayers, providing loan account data and counseling, processing deferments and forbearances, approving switches between repayment plans and methods, and notifying the IRS of loan payments due for those electing repayment under the IRS withholding system.

Borrowers choosing *Option 2* wage withholding would have to file a tax return to report the loan repayments as a tax. Upon filing, insufficient or delinquent tax payments would become an IRS tax responsibility.

Evaluation

Customer Service: Wage withholding, under this option, only benefits borrowers who have jobs and have sufficient taxes withheld from their salary to satisfy their total tax liability, including the loan repayment. Borrowers electing wage withholding would not be able to monitor or evaluate, on an ongoing basis, the effect of loan payments on principal and interest. This limitation could adversely affect their ability to change repayment plans, but the tradeoff is a convenient repayment process. In addition, the tax returns of borrowers who choose wage withholding would be more complicated, and borrowers would be subject to full IRS collection procedures if they underestimated either their loan or tax liabilities.

Default Rate and Student Loan Collections Impact: For those electing wage withholding, the possibility of student loan defaults as currently defined is eliminated. However, these borrowers might owe additional taxes. Low dollar delinquencies, which are now collected by ED, would not be subject to vigorous collection action because they would fall below the IRS delinquency threshold.

Budget Consequences: The IRS would need continuing additional resources so that its primary task--the collection of taxes--would not suffer. Using the tax system would require approximately 820 additional FTEs at a cost to the IRS of \$100 million in FY 1999. ED estimates its costs would be reduced by \$50 million. As in *Option 1*, non-FTE costs may be met by a transfer of funds already identified in the ED mandatory, direct loan administration fund.

Required Resources and Impact on Tax Revenues: To offset any potential impact on tax revenues, the IRS would require additional resources as outlined above. For borrowers electing to repay through wage withholding, the distinction between student loans and tax liabilities becomes blurred. While defaults for this group as currently defined are eliminated, there will likely be an increase in small dollar tax delinquent accounts. Low dollar delinquencies, which are now collected by ED, would not be subject to vigorous collection action because they would fall below the IRS delinquency threshold. This inaction may lessen taxpayers' perceived consequences of tax noncompliance.

Impact of Increased Disclosure and Increased Involvement in Nontax Collection on Voluntary Compliance: This option expands the universe of individuals with access to information that

is considered confidential and potentially sensitive, as well as the use of that data. To the extent that tax information is abused, voluntary compliance may suffer. As noted above, IRS experience with nontax issues, such as the tax refund offset program, indicates that tax compliance declines when the IRS attempts to collect nontax debts.

The Ability of the IRS to Enforce Collection of Student Loans: The IRS would be able to apply all its collection tools when necessary for borrowers electing to repay through wage withholding. ED would continue to have collection responsibility for all other repayment plans.

Separating Loan Collection from Loan Servicing: As noted above under Customer Service, borrowers electing employer wage withholding would lose flexibility in making changes in repayment amounts or repayment plans. This is because reconciliation of loan repayments by IRS takes place after returns are filed, usually about six months after the close of the tax year.

Effect on the Management of Student Loan Collections: This option divides the responsibility for student loan program management between two agencies. ED would retain overall responsibility and continue to originate all loans, while the IRS would assume the responsibility for collecting and servicing loans repaid through wage withholding. For borrowers electing wage withholding, the possibility of defaulting is eliminated. Instead, these borrowers become the IRS's problem. Underwithholding of loans and taxes becomes a tax compliance problem.

Burden to Businesses: This option poses no significant additional burden to employers.

C. Option 3. ED carries out all loan functions and provides incentives to business to maximize availability of wage withholding. The IRS enhances ED's debt collection capability.

Proposal

Option 3 builds on the current Direct Loan Program administrative structure. It would provide all borrowers the full range of service from billing through collection, including complete flexibility in choosing and changing repayment plans and methods. ED would have responsibility for all aspects of student loan collection and servicing, using its current system regardless of how borrowers elect to repay.

As part of *Option 3*, ED would launch a public information campaign encouraging employers to voluntarily provide wage withholding as an inexpensive employee benefit, similar to the savings bond program or bank debit option (which remains in effect even if jobs change).

Large employers (covering 80 percent of all employees) would likely participate because of their existing automated payroll capabilities. ED would provide software and technical

support to employers who requested such assistance.

Evaluation

Customer Service: Wage withholding would be available to approximately 80 percent of the borrowers. In contrast to *Options 1* and *2*, wage withholders would gain the same access to information and flexibility to switch plans as all other borrowers.

Default Rate and Student Loan Collections Impact: Since loan payments can be made automatically (by wage withholding or through automatic clearing house payments), delinquencies and defaults would be reduced.

Budget Consequences: Approximately the same as projected cost of current ED system (\$850 million in FY 99). Budget neutral; those costs are assumed in current baseline estimates. *Option 3* could require 20 additional FTEs and \$500,000 to pay for an incentive program that would encourage employers to offer wage withholding voluntarily.

Required Resources and Impact on Tax Revenues: The IRS would require minimal increases in resources to provide additional information. There would be no impact on tax revenues.

Impact of Increased Disclosure and Increased Involvement in Nontax Collection on Voluntary Compliance: The impact of increased disclosure would not be evident to borrowers because they would not be aware of any changes. IRS would not, therefore, be viewed as involved in nontax collections. There should be no impact on voluntary compliance.

The Ability of the IRS to Enforce Collection of Student Loans: The IRS has no direct role in the collection of student loan repayments.

Separating Loan Collection from Loan Servicing: There is no separation of functions as ED is responsible for servicing and loan collections.

Effect on the Management of Student Loan Collections: There is no change in the management of student loan collections.

Burden to Businesses: Based on the assumption that twenty million borrowers are in repayment, with 4.5 million eligible borrowers electing to repay through voluntary employer withholding, the estimated annual cost is \$0.5 billion (or slightly over \$100 per eligible borrower).

D. Option 4. ED Carries Out all Functions with Mandatory Participation for Firms with Ten or More Employees.

Proposal

This option closely parallels *Option 3*. The difference is that wage withholding is mandatory for businesses and, as a result, would be available to 85% of the borrowers who are employed as wage earners. Legislation would require businesses employing 10 or more employees to participate.

Employer reporting to ED would remain the same under a mandatory system as under a voluntary system, assuming close to full compliance with the law. Significant instances of noncompliance would require employers to report on compliance and to undergo compliance reviews.

Evaluation

Customer Service: Wage withholding would be an available option for an additional 5% of the borrowers than are likely to be covered under the voluntary system. In contrast to *Options 1* and *2*, wage withholders would gain the same access to information and flexibility to switch plans as all other borrowers.

Default Rate and Student Loan Collections Impact: Since loan payments can be made automatically (by wage withholding or through automatic clearing house payments), delinquencies and defaults would be reduced.

Budget Consequences: Approximately the same as projected cost of current ED system (\$850 million). Budget impact on ED is expected to entail a minimal increase, assuming close to full employer compliance. Employer noncompliance is expected to be modest.

Required Resources and Impact on Tax Revenues: The IRS would require minimal increases in resources to provide additional information. There would be no impact on tax revenues.

Impact of Increased Disclosure and Increased Involvement in Nontax Collection on Voluntary Compliance: The impact of increased disclosure would not be evident to borrowers because they would not be aware of any changes. IRS would not, therefore, be viewed as involved in nontax collections. There should be no impact on voluntary compliance.

The Ability of the IRS to Enforce Collection of Student Loans: The IRS has no direct role in the collection of student loan repayments.

Separating Loan Collection from Loan Servicing: There is no separation of functions as ED is responsible for servicing and loan collections.

Effect on the Management of Student Loan Collections: There is no change in the management of student loan collections.

Burden to Businesses: Assuming close to full compliance, the estimated annual cost is \$1.1 billion. Employers would consider this an unfunded mandate.

V. Summary Analyses

A. Customer Service.

- Except for *Option 2*, all options provide comparable borrower service.
- *Option 2* trades off reduced borrower service (no real time access to data) against the reduced cost to employers because of use of the regular tax withholding system. The use of the tax system may be viewed by some borrowers who would otherwise elect wage withholding as a negative customer service factor. Similarly, *Option 1* may be viewed negatively because of IRS involvement, even though in that option loan debt is not tax debt.
- Focus groups indicate borrowers like wage withholding, but are concerned about privacy (e.g., disclosing indebtedness to employers) and employer errors.

B. Default Rate and Collections Impact.

- It is anticipated that wage withholding, regardless of the method of administration, would increase collections and reduce defaults. Some believe that IRS administration of student loan collections in *Options 1* and *2* may also reduce loan defaults. However, IRS (unlike ED) does not focus its limited resources on collecting small debt, and voluntary compliance with the tax laws will decline. Under *Option 2*, where loan debt becomes tax debt, it is unlikely that delinquent debts will be collected. The great majority of defaulters do not have the money to repay, which leaves IRS in no better a position than ED as a debt collector.
- With legislation permitting the additional tax return information on income contingent and defaulted loan borrowers proposed under *Options 3* and *4*, ED would be able to improve default collections.

C. Budget Consequences

- Under *Options 1* and *2*, IRS requires continued new funding. Those resources would be taken from ED estimates in the mandatory baseline for loan administration.

- If under *Option 1* IRS establishes a separate unit with 6,800 Federal FTE, those FTE are above current estimates and would have to come out of some other agency's allocation to remain within the statutory government-wide FTE reduction rules. If *Option 1* is done by contractor, the FTE requirements are already in ED's ceiling. *Option 2's* FTEs would require ceiling adjustments, reducing other agencies' allotments by 4,500.
- *Option 3* is primarily ED's current system, and requires no new funding or FTEs. *Option 3* could require 20 additional FTEs and \$500,000 to pay for an incentive program that would encourage employers to offer wage withholding voluntarily.

D. Required Resources and Impact on Tax Revenues

- *Option 1* would require additional resources. So long as these were forthcoming there would be no impact on tax revenues.
- Additional resources would be required under *Option 2* in order to avoid any adverse impact on tax revenues.
- Neither *Option 3* nor *Option 4* require additional IRS resources, and there is no impact on tax revenues.

E. Impact of Increased Disclosure and Increased Involvement in Nontax Collection on Voluntary Compliance

- *Options 1* and *2* expand the universe of individuals with access to information that is considered confidential and sensitive, and also expands the use of that data. To the extent that there is abuse of that information, voluntary compliance may suffer. Also tax compliance declines when the IRS attempts to collect nontax debts.
- In *Options 3* and *4* the impact of increased disclosure would not be evident to borrowers because they would not be aware of any changes. IRS would not, therefore, be viewed as involved in nontax collections. There should be no impact on voluntary compliance.

F. The Ability of the IRS to Enforce Collection of Student Loans

- Phase 1 of *Option 1* requires that the IRS service and collect direct student loans using the system developed by ED, and the IRS should be as successful as ED in enforcement of student loan collections. The IRS would be able to apply all its collection tools as necessary.

- Under *Option 2*, the IRS would be able to apply all its collection tools when necessary for borrowers electing to repay through wage withholding. ED would have collection responsibility for all other repayment plans.
- Under *Options 3 and 4*, the IRS has no direct role in the servicing and collection of student loan repayments.

G. The Effect of Separating Loan Collection from Loan Servicing

- *Options 1, 3 and 4* do not separate loan servicing from loan collection; the IRS has responsibility for both under *Option 1*; ED is responsible for both under *Options 3 and 4*.
- Under *Option 2*, borrowers who choose wage withholding by employers would lose flexibility in making changes in repayment amounts or repayment plans. This is because reconciliation of loan repayments by IRS takes place after returns are filed, usually about six months after the close of the tax year.

H. The Effect on the Management of Student Loan Collections

- Under *Option 1*, the responsibility for student loan program management is split between two agencies. ED would retain overall responsibility and continue to originate all loans while the IRS would assume the responsibility for collecting and servicing loans.
- *Option 2* also splits responsibility between two agencies. ED retains overall responsibility and continues to originate all loans. IRS would assume responsibility for collecting and servicing loans repaid through wage withholding; ED would collect and service loans repaid through all other methods. For borrowers electing wage withholding, the possibility of default is eliminated. These borrowers become the IRS's problem as underwithholding of loans and tax becomes a tax compliance problem.
- Under *Options 3 and 4*, there is no change in the management of student loan collections.

I. Burden to Businesses.

- The business community will argue that the burden is an unfunded mandate and will object.
- While *Option 2* is mandatory on businesses because it involves the tax system, no additional burden would be imposed.

- In *Option 3*, there is no mandatory requirement or employer burden. The perception changes from a government mandate to an inexpensive employee benefit.

VI. Policy Implementation

As a result of this study, the Secretaries of Education and Treasury are implementing *Option 3*. ED, with continued assistance from IRS, retains the responsibility to service and collect student loans. ED will continue to administer the Direct Loan Program using competitively bid contracts. ED will also develop a voluntary wage withholding system to be marketed to public and private sector employers. In conjunction with voluntary wage withholding, ED will market alternative payment methods such as automatic electronic bank debits.

Option 3 is the only option which gives choices to borrowers, provides clear lines of accountability, maximizes customer service, minimizes employer burden, saves taxpayer dollars, and reduces defaults. This option meets the important customer service goals without presenting serious drawbacks. Eventually, it is expected that wage withholding will be available to 80 percent (or more) of all borrowers. All borrowers will have the same rapid access to information and flexibility to switch repayment plans. There should be minimal opposition from the business community, no additional budget costs, and no need for additional legislation to make the program work.

Option 3 potentially enhances ED's debt collection capabilities through the proposed disclosure to ED of additional tax return information on borrowers for problem cases (wages, employers) and income contingency loans (wages).

In contrast, direct IRS involvement or compulsory employer participation in a new wage withholding system would present serious drawbacks. The options which envisioned direct IRS involvement would strain IRS resources, interfere with its primary mission, and decrease higher dollar value tax collections, without improving student loan program administration or customer service. The possibility of a greater IRS role is not being foreclosed. The IRS system is changing, and technological advances of the future may make this an attractive option.

Direct IRS involvement would be opposed by student and higher education groups. Further, many students are concerned that the IRS would treat student loans like taxes and that borrowers would lose the flexibility and customer service they now have under direct lending. Compulsory employer participation would face stiff opposition from a business community already opposed to another costly, unfunded Government mandate. *Option 3* will avoid these problems while meeting the Administration's vision for a model direct student loan program.

Appendix 1

**Conference Report Language: Omnibus Budget
Reconciliation Act of 1993**

**Conference Report Language: Omnibus Budget
Reconciliation Act of 1993**

Title IV - Student Loan and ERISA Provisions¹

IRS Study

House Bill

Section 4032 of the House bill directs the Secretary of Education in consultation with the Secretary of Treasury to conduct a study on the feasibility of having IRS collect student loans, the results of which the Secretary of Education shall report to Congress in 6 months.

Senate Amendment

Section 457 directs the Secretaries of Education and Treasury to submit a plan to the President to provide for IRS collection of student loans and to evaluate other options for wage withholding. If the President determines that options contained in the plan would further the purposes of this part, the Secretaries of Education and Treasury would implement those options. The Senate amendment further provides a method for funding the implementation of the plan.

Conference Agreement

The conference agreement deletes both provisions. Accordingly, the managers request that the Secretaries of Education and Treasury jointly develop a plan for the involvement of the Internal Revenue Service in the collection of student loans, including an analysis of its feasibility, the additional resources that would be required for the IRS, the enforcement procedures that should be used, the effect on the collection of ordinary income taxes, and the effect on the management of Federal student loan collections and on borrower repayment of such loans. The Secretaries are further requested to submit to the Congress the plan for implementing such a collection system, together with the results of the feasibility analysis and any legislative recommendations they may deem advisable, no later than six months after the date of enactment of this bill.

¹U.S. House of Representatives, Committee on the Budget, Omnibus Budget Reconciliation Act of 1993, Conference Report of the Committee of the Budget, House of Representatives, to Accompany H.R. 2264, 103d Cong., 1st Sess., 1993, p. 466.

Title XIII - Revenue, Health Care, Human Resources, Customs and Trade Provisions, Food Stamp Program, and Timber Sales Provisions²

Evaluation of Student Loan Repayment Through Wage Withholding

With respect to this provision, the conference agreement does not include the provisions in sections 4032, 4033, or 14402 of the House bill or sections 12011 or 12055 of the Senate amendment.

The conferees direct 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. Such study should include an examination of: (1) whether the IRS could implement such a system of student loan repayment 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, (3) the ability of the IRS to enforce collection of student loans using an alternate system of dispute resolution, penalties, and collection devices, (4) the effect of separating loan collection from other loan servicing functions, and (5) the anticipated effect on the management of Federal student loan collections and on borrower repayment of such loans. If the study concludes that IRS collection is feasible, the Treasury Department and the Department of Education should develop a plan to implement such a collection system. The feasibility study and any plan that is developed, together with any legislative recommendations that the Secretaries may deem advisable, should be submitted to the Congress within six months of the date of enactment.

Effective date

The provisions in the conference agreement are effective on the date of enactment.

²U.S. House of Representatives, Committee on the Budget, Omnibus Budget Reconciliation Act of 1993, Conference Report of the Committee of the Budget, House of Representatives, to Accompany H.R. 2264, 103d Cong., 1st Sess., 1993, pp. 725-28.

Appendix 2

**RECOMMENDATIONS FOR THE DEPARTMENT OF EDUCATION
FROM FINANCIAL MANAGEMENT SERVICE,
DEPARTMENT OF THE TREASURY
JUNE 1994**

DIRECT FEDERAL STUDENT LOANS

REPAYMENT: FUNDS COLLECTION METHODS

**RECOMMENDATIONS FOR THE DEPARTMENT OF EDUCATION
FROM FINANCIAL MANAGEMENT SERVICE,
DEPARTMENT OF THE TREASURY
JUNE 1994**

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Funds Collection Options for Repayment of Direct Federal Student Loans

Background

The Financial Management Service supports the Department of Education in its initiative to offer a variety of ways for Direct Federal Student Loan borrowers to remit payments, especially using electronic funds transfer.

Just as with the "repayment plan" options, there are several convenient and appealing funds collection options which can be offered to borrowers for initiating their loan repayment remittances.

AUTOMATED CLEARING HOUSE (ACH)

The Automated Clearing House network is a funds transfer system which provides for the interbank clearing of electronic entries for participating financial institutions. There are 26,522 participating financial institutions.

ACH is inexpensive, reliable and improves funds availability. Also, once the borrower sets up the ACH service, the chances of full collection are improved since the borrower doesn't have to write a check each month. ACH transactions can be originated by a borrower directly, or can be originated by a borrower's employer, and then deducted out of the employee's pay, using common wage-withholding practices.

Borrowers and bill payers have been demonstrating a rapidly growing interest in making payments automatically and electronically. Automatic electronic payments (using ACH) are easy, save time, and are not dependent on the borrower being at a certain place or having to write a check, address an envelope and get it into the postal system. Some borrowers perceive ACH payments involving a degree of lost control over their money. This is a perception issue which has no basis in fact, since the consumer must authorize any electronic activity occurring through his or her bank account. The ACH network has made a lot of progress overcoming the perception; however, some still remains.

Because of the savings derived from using ACH, the agency should either mandate its use or offer borrowers incentives to sign up for ACH. Mandates are generally used in conjunction with other actions, such as a non-payment judgment. For the majority of cases, where repayment is expected, a voluntary program is recommended, with incentives offered to increase enrollments. Incentives for repayment by electronic funds, normally ACH, are common in the consumer loan industry. Three suggestions for incentives are:

- Interest rate concessions, such as 25 or 50 basis point reductions, are offered if the borrower uses ACH for repayment. (Rate concessions would need to be evaluated to determine at what point they lose cost effectiveness. They may also require legislation).
- Later payment due dates, such as one or two day delays in the monthly due date (which is when the ACH transaction would settle against the borrower's bank account).
- Multiple payments during a month, such as twice-monthly when the borrower is paid by his or her employer. The amount paid during a given month equals the monthly payment, but by splitting it into increments, consistent with the way the borrower's wages are paid, the loan is paid down faster.

ACH Options

ACH payments can take two general forms:

ACH Debit - is originated by the agency (based upon the borrower's authorization) and settles through the Federal Reserve system as a credit to the agency (through the Treasury General Account, or TGA) and a debit against the borrower's bank (account). If there are insufficient funds in the borrower's bank account, the bank will return the entry to the Federal Reserve, where it will be debited to the agency (through the TGA) with information provided back to the agency, for further collection action.

ACH Credits - is originated by the borrower, his or her employer, or his or her bill-payment servicer, and settles through the Federal Reserve as a debit against the borrower's bank (account) and a credit to the agency (through the TGA). Since the borrower originated the entry, the bank will only send it if funds are available in the borrower's account.

In addition to accelerated availability of funds (when compared to checks), ACH also enables the agency to automatically update accounts receivable and accounting records from the electronic payment records which are originated into, or received from, the ACH network. This fact is one of the primary reasons that ACH brings so much cost savings to an organization.

FMS will assist the agency in developing a marketing program using an appealing name, like "Easy Payment", for the ACH programs. This might include a public service television campaign, similar to Social Security's Direct Deposit campaigns, to promote ACH as an "easy and convenient" method of repaying student loans.

The debit and credit forms of ACH are discussed below, with proposed uses by the Department of Education in offering an array of "Easy Payment" services to Direct Federal Student Loan borrowers.

ACH Pre-Authorized Debits

Pre-authorized debits, or PADs are electronic debits to a receiver's (borrower's) bank account. They must be authorized by the receiver (borrower) in writing, normally as part of the loan repayment set-up process. PADs are best suited for recurring, fixed dollar amount transfers, such as loan repayments, because, once the authorization is established, the lender can automatically generate the ACH debits each month, without the remitter needing to take further action.

At the time the loan repayment agreement is negotiated, Department of Education, or its servicing agent, would obtain a signed authorization from the student allowing the agency to directly debit the loan repayments from the student's bank account. In the near future, the agency may also be able to avail itself of an "Automated Enrollment" method, whereby the borrower would request his/her financial institution to initiate a zero-dollar ACH transaction to Department of Education coded to notify the agency to establish the borrower as a pre-authorized debit remitter. The financial institution would be responsible for maintaining a record of the written authorization. The Social Security Administration has been testing Automated Enrollments and has enrolled over 150,000 recipients in Direct Deposit using that method. The operating rules for the transaction, necessary for nationwide application, should be finalized later this year.

The Department of Education will need to maintain a database of pertinent information on borrowers enrolled in the pre-authorized debit option, including the borrower's bank account information (the routing and transit number of the bank and the account number). The agency will also need to establish a method for ensuring that borrowers provide updates whenever they change bank accounts. Under income-contingent repayment plans, the borrowers can take up to 25 years to repay loans. The transient nature of recent graduates will also create complications. Automated Enrollment services, discussed in the paragraph above, may provide solutions.

On a pre-established schedule, the agency will originate a file of debit transactions, for processing by FMS or an agent bank. This file will be converted into ACH transactions and processed through the ACH network, to the student's bank account. ACH debits must be originated into the ACH network one day prior to the settlement date.

Pre-authorized debits can also be originated on a "single-entry" basis. An authorization system would need to be established using voice response or PC technology. The Department of Education could even utilize a public access network, such as Internet, to provide access to the authorization system. A standing written agreement and password-

security would be established in advance. The borrowers access the authorization system each time they are making a payment and provide authorization for Department of Education to debit their bank account for the full or partial amount of the loan. Pre-formatted screens can be created for the borrower to "fill-in-the-blanks" with bank instructions, amount, etc. The agency would use the authorization to generate ACH pre-authorized debit entries.

ACH Credits

Wage-withholdings from employers - The agency provides the borrowers with information to take to their employers to set up payroll-deductions. The employer automatically deducts payment amounts from the employee's wages and originates ACH credits through the ACH network to the Treasury/Department of Education, for benefit of the borrower. (It could be compared to a "Christmas Club" arrangement.) This is certainly one of the easiest ACH collection methods, and employer participation could be voluntary or mandatory.

Mandatory wage-withholding would place an additional burden on businesses and could make the prospective employee with a student loan a less desirable job candidate.

FMS recommends voluntary employer compliance and believes if the Department of Education offers borrower incentives, as discussed on page 2, that employers will also have an incentive to volunteer. Employers will want to support their employees' opportunity to take advantage of incentives, especially something like a rate concession.

To further encourage voluntary participation by employers, the Department of Education might allow employers to charge employees a nominal fee per transaction to cover the cost of handling the payments for the employee.

Wage-withholding is being used successfully by the Administration for Children and Families for collecting child support payments. Legislation was enacted to mandate employer participation to withhold from wages of delinquent obligors. However, many obligors participate voluntarily, requesting their employers to deduct and send the support payments for them. If the Department of Education elects to implement a wage-withholding program, a working relationship should be developed with the Administration for Children and Families to learn from their efforts.

Bill Payment Services

Again, the agency would provide borrowers with information, which would be required to set up their student loans on a bill payment service that might be offered through the borrowers' bank or bill payment service. On a monthly, or recurring basis, the borrowers authorize payments through their bill-payment servicer using a touch-tone phone or PC access. The services use the authorizations to debit borrowers' bank accounts and originate ACH credits to the Department of Education, for benefit of the borrower. In addition, most

services allow for standing orders for payments which occur automatically unless their customers intervene. This is appealing to many remitters because they can exercise a greater degree of control.

The Department of Education should establish "strategic alliances" with the major bill payment service providers and large regional banks where concentrations of borrowers are located. Such alliances can be beneficial to both parties for at least two reasons:

(1) The Department of Education can provide bill payment services with billing files, which are used to create messages/reminders to borrowers and request authorization for making payments. This enhances the bill payment services' offering and will encourage prompt payment to the Department of Education.

(2) Joint marketing campaigns can be initiated with the agency and the bill payment servicer/banks to get the word out that student loan payments can be made through these services.

PAPER CHECKS INTO A LOCKBOX

A lockbox is a post office box which is maintained for the Government by a Treasury designated financial institution (F) for the purpose of accelerating the receipt and clearing of paper check remittances on behalf of a Federal agency. The F receives the remittances by mail from the post office frequently during the day. The F opens the envelope, extracts the check and any accompanying documentation, records the amount of the check, processes the check for clearing in the banking system, and reports the deposit information to Treasury. The funds are transferred to Treasury's account at the Federal Reserve Bank of New York via ACH the next business day, and the agency location code (ALC) is credited the next business day following the date the deposit is reported to Treasury. The F also captures the accounting information, and passes this, along with a record of the check payment to the agency. The agency updates its accounting records from the information supplied by the Lockbox bank.

Checks are not the preferred method of collection, but unless the Department of Education is going to mandate electronic funds transfer (EFT) in the Direct Student Loan Program, collection arrangements must accommodate checks. To effect the payment, the student writes out a check and sends it, along with a scannable remittance document, to a post office box address supplied by the agency. The agency supplies the remitter with a monthly notice or a coupon (book) to return with the remittance. Whether a monthly bill or a coupon is used, the return document must be machine scannable, since the volumes will be high.

SUMMARY

The Financial Management Service (FMS) recommends that ACH be cited as the "preferred payment method". This infers that, unless requested otherwise, the borrower will be expected to pay by ACH. This approach is used by the Social Security Administration under a plan called "Preferred Direct Deposit". Unless the beneficiary requests otherwise, an application for benefits is handled assuming Direct Deposit will be the payment mechanism.

Many of the recommended ACH collection options can be established very easily through use of arrangements already in place under the FMS umbrella of services. Some of the steps involved are outlined below:

- Education provides data on the volume and dollar amount of the collections to FMS.
- FMS and Education meet to discuss Education's requirements for additional data and remittance processing.
- FMS selects the optimal processor(s) for the collection methods chosen as the most viable.
- FMS, Education, and the collections processor(s) meet to discuss Education's collections needs and design information interfaces.
- Education and the collections processor(s) establish testing schedule and conduct testing.
- Education and collections processor(s) develop standard procedures for operating the collection systems.
- FMS prepares a memorandum of understanding and signs it along with Education and the collections processor(s).
- FMS sets up the Department of Education program into its deposit reporting system.
- Education provides information to borrowers on the various collection options, and has the borrowers decide on a repayment plan. Education also obtains a signed authorization form for ACH debits, if necessary.
- For ACH preauthorized debits, Education creates a database of financial institution information on borrowers paying by ACH debits. Education must send prenotifications on ACH preauthorized debits 10 days before sending live entries.

Appendix 3

IRS Cost Methodology

IRS Cost Estimation Methodology

Summary

Four options for the future administration of the Federal student loan program have been extensively studied by the Departments of Treasury and Education. In particular, Treasury and Education have worked to analyze options for implementing wage withholding as a viable option for student loan repayment and whether it is feasible to implement wage withholding through the Internal Revenue Service. The four options range from the program as it is currently being implemented including the planned use of a voluntary wage withholding system administered by the Department of Education (ED) to an IRS take-over of all servicing, processing, and collecting of student loans. Because potentially greater IRS involvement in the student loan program would have significant operational implications, cost estimates were developed for the contemplated new IRS loan operations. Specifically, detailed cost estimates were developed for two options:

- Option 1, IRS Student Loan Special Operation (using Federal FTEs)¹
- Option 2, IRS Using the Current Tax System for Wage Withholding Only

With the establishment of the direct loan program by the Student Loan Reform Act of 1994, ED has developed and implemented a new loan collecting and servicing system. Within the context of the four options, Option 3 represents the current program with two improvements. First, ED will have completed and implemented a voluntary employer wage withholding program to enable direct loan borrowers to repay through payroll withholding. Second, the IRS would share additional income and employment information with ED to assist in the defaulted loan collection process. While this methodology does summarize ED's costs, the detailed program administration cost estimation methodology is not included as part of this methodology. However, ED's approach used the projected program costs through fiscal year 1999 (FY99) based on contract data for direct lending and default collection.

Because the issue of using the IRS to collect student loans currently in default status has not been decided, the IRS costs were estimated under two different sets of assumptions. Under the first set of assumptions, the IRS would collect loans currently in default (from both the Federal Family Education Loan Program (FFEL) and the Direct Loan Program). Under the second set of assumptions, ED would retain responsibility for collecting defaulted FFEL loans. For both Options 1 and 2, the operational cost impacts for the IRS were estimated for the following major functional areas:

¹ This option can be implemented either by using Federal employees or by contracting with a private vendor. Presumably, the cost estimate for student loan collection and servicing using a vendor would be similar to the program administration costs projected by ED. Therefore, this analysis is restricted to the case where Federal employees are used.

- Information Systems (computer systems development and maintenance)
- Payment Processing
- Customer Service
- Default Collection
- Chief Counsel and Appeals (Option 1 only)

For the first few years, the most significant cost for Option 1 would be the cost of collecting the existing defaults under the FFEL program. Estimates are that this effort will require an increase of approximately 2,800 Collection FTE per year in the FY98-FY02 period. Under Options 1 payment processing costs eventually become the most significant cost, requiring an increase of 1,800 FTEs for FY98 and 7,500 FTEs when the program reaches its sized capacity of 20 million borrowers in repayment. To meet the servicing goals of Option 1 ,customer service costs become significant.

Using Federal employees, Option 1 costs for FY99 total \$528 million. Option 2 costs for FY99 total \$54 million. At the designed systems capacity of 20 million borrowers in repayment, Option 1 costs would be approximately \$1 billion per year while Option 2 costs would be approximately \$500 million per year.

It should be emphasized that major operational and design decisions have not been made; therefore, these costs estimates should be regarded as preliminary and subject to modification as the systems design and underlying assumptions become more clear.

Limitations and Assumptions

IRS costs were estimated for the FY95-FY00 period in order to conform with the loan volume projections provided by ED. In creating these estimates, it was assumed that major operational involvement by the IRS would not begin before the start of FY98, although systems development would begin in FY95. It was assumed that the IRS would require 3 years to complete the systems development and testing.² Costs were also estimated under at the student loan system's maximum capacity of 20 million borrowers in repayment.

Costs were developed for the key functions performed by the IRS for these options-- Information Systems, Payment Processing, Customer Service, and Default Collections. Additional administrative costs to cover support functions such as Finance and Human Resources were assumed to be 15 percent of the direct requirements.

² These estimates assume that IRS would become operational in FY98. These estimates were originally developed assuming that the IRS would begin systems development in FY95. Since that is no longer a valid assumption, these estimates serve as illustrative examples of the costs.

Costs for each key function were developed separately. Wherever possible, staff costs were converted into dollars by use of the 1995 Unit Cost Rate handbook. Out-year costs were adjusted by the use of OMB Gross Domestic Product (GDP) inflator percentages for the FY94-FY99 period. The OMB GDP inflator is approximately 3% per year.

ED data, as of mid-March 1994, were used to estimate overall loan volumes for the Direct Loan program, as well as the total number of FFEL defaults. From its experience in tax administration, the IRS has solid cost models which could be used to estimate the administrative costs for direct lending. Many of the tasks required for processing tax information are similar to processing loan information. Because these costs models were in terms of taxpayers, it was necessary to know the number of borrowers. However, ED does not track student loans on the basis the number of borrowers. The IRS student loan costs are dependent on the number of borrowers.³

For IRS cost estimation purposes, it was necessary to determine the number of individual borrowers rather than overall numbers of loans. Therefore, ED loan volume projections were converted into number of borrowers based on the distribution of loans (percent with only one loan, percent with two loans, etc.) for a particular loan cohort. The procedure used to convert loans into borrowers was agreed to by both ED and IRS. These estimates could not be validated for the purposes of these cost projections.

The projected percentage of total Direct Loan borrowers who will request the income-contingent repayment option (18%) was also based on ED projections. It was further assumed that 30% of all direct loan borrowers would elect to repay their student loans through wage withholding. Changes in these estimates would significantly impact the cost estimates.

Collection estimates were based on ED estimates that there are approximately 7 million FFEL cases currently in default and that approximately 900,000 cases default each year. This number is projected to slowly drop towards the late 1990's. Two major assumptions were used in developing the IRS estimates under the defaulted loan collection scenarios. The first assumption was that the current FFEL default inventory would still exist at its current level in FY98. The second assumption was that the Service would absorb this backlog into five annual classes, for work beginning in FY98.

These estimates also assume that the default rates for the new Direct Loan program would be equivalent to FFEL during the period in question. These estimates also include the assumption that the IRS would be as successful in collecting defaulted loans as ED. In other

³ IRS estimates its processing costs on the expected number of returns which translates into the number of borrowers. It should be noted that there is not a one-to-one correlation between number of loans and borrowers. Borrowers may have more than one loan.

words, the ability to collect defaulted loans is agency neutral. These assumptions should be treated with caution and represent the major risks in this analysis.

Approach

Information Systems

Although specific architectures and processing requirements have not yet been defined for this potential program, the IRS systems cost estimates were developed based on the following assumptions:

- **Option 1**
 - Cost Estimates were based on purchasing the equivalent computing capacity bid under ED's direct loan servicing contract.
 - Development (information engineering design and programming) would require a total of 2 fiscal years. However, the costs for development have been rolled into the initial year. Those costs are 658 FTEs (\$62 million). Maintenance programming has been estimated at a rate of 40% of development cost (263 FTEs). These estimates are tentative and depend on scheduling and design decisions that have not yet been made.

- **Option 2**
 - A Student Loan Master File (SLMF) would be created and linked with the appropriate tax data systems.
 - The Department of Education would be responsible for case creation and data feeds to the SLMF.
 - Data would be retained in the SLMF for at least 10 years after repayment.
 - The average record size would be 14 kilobytes.
 - The SLMF would initially be sized to contain 20 million records, with a total storage requirement of 280 gigabytes.
 - Development (information engineering design and programming) would require a total of 3 fiscal years. During the initial year a total of 40 FTE would be needed for design and programming support, plus 10

non-programming IS staff, plus 8 FTE for Resource Management support (total of 58 FTE). This number would increase to 72 FTE in Year 2, and decline to 43 FTE in Year 3. These estimates are tentative and depend on scheduling and design decisions that have not yet been made. These estimates also depend on the assumption that the Tax Systems Modernization effort remains on schedule.

- Hardware costs also depend on design decisions. For estimation purposes it is assumed that FY95-FY00 mainframe processing costs will range from \$5 million to \$15 million and that lifecycle connectivity/ telecommunications costs will range from \$1 to \$3 million.

Payment Processing

- **Option 1**

- Costs are projected based on tax return processing costs.
- Volumes for processing payments/returns based upon borrowers in repayment status. Since the Department of Education does not possess this statistic (it measures volumes by loans rather than by individuals), the IRS converted loan volumes to volumes of individuals using formulas on the percentage of individuals from a cohort who takes 1, 2, 3, etc. loans. The conversion formulas assume 1) that individuals receiving direct loans will only receive direct loans and 2) that individuals receiving multiple loans will do so in consecutive years.
- Volumes and percentage rates for defaults were also based on Department of Education statistics of defaults.
- It is anticipated that 30% of all direct loan borrowers will elect to repay through wage withholding with the annual reconciliation on the tax return.
- Data entry rate assumed to be at the same rate as data entry of individual income tax returns.
- Error rate assumed to be same as the Form 1040 average (20%).
- Correspondence/adjustment volume assumed to be 40% of borrowers in repayment status.

- For Direct Loan borrowers who are delinquent with either their income or student loan tax payments (i.e., the new version of defaulters), six notices including the default notice would be sent. For borrowers currently in default for FFEL loans, only the default notice will be sent.
- Monthly notices showing balance due and repayments would be sent to borrowers in repayment.
- Employers would file a form similar to Form 945. It was assumed that the payments would be sent approximately 26 times per year.
- A 12% error rate was assumed for processing the employer withholding form.
- Advance staffing was assumed necessary for training and piloting purposes. One half of anticipated first year processing FTEs would be hired in FY96; the rest in FY97.

- **Option 2**

- Costs are projected based on tax return processing costs.
- Volumes for processing payments/returns based upon borrowers in repayment status. Since the Department of Education does not possess this statistic (it measures volumes by loans rather than by individuals), the IRS converted loan volumes to volumes of individuals using formulas on the percentage of individuals from a cohort who takes 1, 2, 3, etc. loans. The conversion formulas assume 1) that individuals receiving direct loans will only receive direct loans and 2) that individuals receiving multiple loans will do so in consecutive years.
- Volumes and percentage rates for defaults were also based on Department of Education statistics of defaults.
- It is anticipated that 30% of all direct loan borrowers will elect to repay through wage withholding with the annual reconciliation on the tax return.
- Data entry rate assumed at be at the same rate as data entry of individual income tax returns.
- Error rate assumed to be same as the Form 1040 average (20%).

- Correspondence/adjustment volume assumed to be 40% of borrowers in repayment status.
- For Direct Loan borrowers who are delinquent with either their income or student loan tax payments (i.e., the new version of defaulters), six notices including the default notice would be sent. For borrowers currently in default for FFEL loans, only the default notice will be sent.

Collection

- **Options 1 and 2**

- The total default caseload was based on Department of Education estimates and include two major elements: a backlog of approximately 7 million cases and an annual increment of 900,000 cases. It was assumed that the annual increment would slightly increase during the FY98 - FY05 period, although the direct loan/FFEL mix of defaults would change as the Direct Loan program expands. Different workload assumptions would have a dramatic impact on Collection costs.
- The current backlog of 7 million defaulted cases would be worked in 5 annual classes beginning in FY98.
- Since Options 1 and 2 involve collection of defaulted loans, collection costs remain constant for these options. The same applies when FFEL loans are excluded. Collection costs do not vary by option.
- Collection cases are assumed to proceed through the IRS Collection process in a manner similar to tax cases-- notice stream (up to 5 notices), with Service Center Collection Branch (SCCB) answering any correspondence, followed by attempted telephone contacts through the Automated Call System (ACS) and finally, if the case is still unresolved, personal contact by Revenue Officers in the Collection Field Function (CFf).
- All cost estimates assume that internal IRS resources would be used for collecting defaulted loans.
- Fallout rates-- the percentage of cases which are not resolved at each point and therefore pass to the next stage-- these rates are higher than the rates generally used for tax cases, since the current FFEL cases are

all already in default (*Note: this is an unverified assumption*). It is assumed that IRS would have to expend a higher level of effort to collect student loans than taxes because of the differences between defaulted debt and taxes. The scenario used for overall cost estimates assumes that 45% of all the cases receiving initial notices will require additional correspondence work by SCCB, 40% of all cases will go to ACS, and that 15% will require work by the Collection field function. In this scenario, the 7 million FFEL-case backlog would be allocated over 5 years. Other, equally plausible, assumptions would significantly impact estimated costs.

- Option 1: Collection would require 2,797 FTEs each year through FY02.
- This analysis assumes that the current FFEL backlog will be resolved by the end of FY02).
- Option 2: If FFEL defaults are not included, the Collection FTE requirements are:

FY98: 128
FY99: 179
FY00: 233
- Dollar costs were derived by using the 1995 UCR handbook "Tax Examiner" expansion rates for SCCB employees, "Other Permanent" expansion rates for ACS, and "Revenue Officer" expansion rates for CFf. All rates were adjusted for inflation. However, to build-in additional costs for administrative or HR support, or for additional facilities, a conservative approach of adding 15% to listed dollar costs for these factors, increasing the Collection FY98 - FY00 estimate by \$37 million a year.
- Most Collection costs would be incurred in CFf. Regardless of the assumptions used, however, a large percentage of cases would inevitably end up in "currently not collectable" status. This analysis does not attempt to deal with the consequences of this situation for Account Receivable Delinquent Inventory, etc.
- Revenue neutrality was assumed across all options.
- Opportunity Costs:
 - With FFEL Default Collections:

- Average Tax Collected per FTE: \$430,000
- Average Number of FTEs per year: 2,800
- Opportunity Costs: \$1,200,000,000

- Without FFEL Default Collections:
 - Average Tax Collected per FTE: \$430,000
 - Average Number of FTEs per year: 26
 - Opportunity Costs: \$11,800,000

Note: Given the size of the IRS' Accounts Receivables, the marginal gain in revenue from adding an FTE is equal to the average gain in revenue from adding an FTE.

Customer Service

- **Option 1**

- Both default-collection and loan servicing will generate additional workload for the Customer Service function. Although this option calls for the IRS to assumed the role of primary contact point for all borrowers, some borrowers will contact ED.

- In developing the Customer Service estimates, the following assumptions were used:
 - FFEL default cases:
 - 15% will make telephone contact each year
 - 1% will have written correspondence each year
 - 5% will generate walk-in traffic each year

 - New Direct Loans:
 - 15% will make telephone contact each year
 - 1% will have written correspondence each year
 - 5% will generate walk-in traffic each year

 - Repayment Plans:
 - Income Contingent--
 - 5% will make telephone contact each year
 - 0.5% will have written correspondence each year
 - 1.7% will generate walk-in traffic each year

- All other repayment plans--
 - 10% will make telephone contact each year
 - 1% will have written correspondence each year
 - 3.4% will generate walk-in traffic each year
- The average time per contact was estimated based on time per contact for current Taxpayer Services experiences:
 - Telephone: 0.22 hours
 - Correspondence: 0.44 hours
 - Walk-Ins: 0.29 hours
- 1995 Unit Cost Rate Taxpayer Service Representative (Permanent) expansion rate numbers were used to convert workload to dollar costs. Rates were adjusted in the out-years using the GDP inflator. A 15% resource management (RM) overhead factor was added to final cost projections.
- Additional costs would be incurred for correspondence and notices required while loan recipients remain in school or otherwise in deferral status (i.e. contacts with the schools and students, additional inquiries by students and schools). Per estimates from ED's direct loan servicing contract, the best available data source since the IRS performs no comparable function as part of tax administration, the cost of these customer services would be approximately \$10 per individual in deferral status. While FTEs were not determined, if the production rate for these services were equivalent to those for Taxpayer Services, the FTEs required would be approximately 1,100 in FY98.

- **Option 2**

- Both default-collection and loan servicing will generate additional workload for the Taxpayer Service function. Although this option calls for ED to retain the primary responsibility for customer contact and dispute resolution, some borrowers will contact the IRS for information.
- In developing Taxpayer Service estimates, the following assumptions were used:

- FFEL default cases:
 - 15% will make telephone contact each year
 - 1% will have written correspondence each year
 - 5% will generate walk-in traffic each year
- New Direct Loans:
 - 15% will make telephone contact each year
 - 1% will have written correspondence each year
 - 5% will generate walk-in traffic each year
- Repayment Plans:
 - Income Contingent--
 - 5% will make telephone contact each year
 - 0.5% will have written correspondence each year
 - 1.7% will generate walk-in traffic each year
 - All other repayment plans--
 - 10% will make telephone contact each year
 - 1% will have written correspondence each year
 - 3.4% will generate walk-in traffic each year
- The average time per contact was estimated based on time per contact for current Taxpayer Services experiences:
 - Telephone: 0.22 hours
 - Correspondence: 0.44 hours
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- 1995 Unit Cost Rate Taxpayer Service Representative (Permanent) expansion rate numbers were used to convert workload to dollar costs. Rates were adjusted in the out-years using the GDP inflator. A 15% RM overhead factor was added to final cost projections.

Appendix 4

**Student Loan Repayment and Wage Withholding
Employer Reporting Burden**

Student Loan Repayment and Wage Withholding Employer Reporting Burden

Overview

This Appendix describes the methodology used to estimate employer reporting burden. This section provides a step-by-step explanation of the methodology used by Treasury and Education (ED) to estimate the cost to employers of withholding student loan payments from employees' wages in addition to the reporting and remitting of those payments to the student loan servicer.

Employer reporting burden represents the time (expressed in terms of money) and expenses incurred by employers for withholding, remitting, and reporting student loan payments to the Federal government. The burden experienced by employers will depend on the characteristics of the program, as set up by the government, the number of borrowers who choose to repay their loans through wage withholding, and the number of firms that are affected. Because the IRS and the Department of Education have proposed similar withholding systems, from the borrower's perspective, it is essential that the characteristics of each system and that the burden estimation methodology be thoroughly understood. Please see Exhibit A for a description of the components of employer burden.

The estimates of employer burden have been developed within the expected steady-state for the Direct Loan Program. Please see Exhibit B for estimates of employer burden. Under steady-state conditions, it is expected that there will be 20 million borrowers repaying their Direct Loans. As borrowers have a number of choices in repayment plans (standard, extended, graduated, and income-contingent), borrowers will also have a number of options in how they elect to repay their loans. Borrowers will be able to repay through monthly checks, automated bank debits, or wage withholding.

Internal Revenue Service

The Internal Revenue Service envisioned several ways of implementing a student loan repayment system using wage withholding. The first method involves using the current tax withholding system to collect student loan payments. The second method involves setting up a special operation within the IRS, yet separate from the tax system, for the collection and servicing of Direct Loans. Each method has its own distinct characteristics and implications for employer reporting burden.

Student Loan Repayment and Wage Withholding
Employer Reporting Burden - Summary

Components of Employer Reporting Burden

	Internal Revenue Service		Department of Education
	<i>Separate from the Tax System</i>	<i>Using the Current Tax System</i>	
Mandatory Employer Withholding	Total Burden = Fixed Costs + Variable Costs	<p align="center">Not Applicable</p> <p>In this system, employers would not know that they were withholding for student loans. Therefore, employers do not experience additional burden.</p>	Burden = Fixed Costs + Variable Costs
	<p>Fixed Costs = recordkeeping costs (accounting systems modifications and maintenance, data storage, etc) + the cost of generating summary withholding data (i.e., employer identifier, pay period covered, \$ remitted) + the cost of firms certifying that they were not required to participate</p> <p>Variable Costs = The cost to employer of reporting withholdings for each student loan borrower</p>		<p>Fixed Costs = the cost of having the necessary infrastructure to withhold student loans from an employee's paychecks and remit the amounts to Education. This cost consists of the system maintenance costs (record updates and other systems changes) and the cost of recordkeeping.</p> <p>Variable Costs = represents the transactions costs to the employer of actually withholding, reporting, and remitting payments to the Department of Education</p>
Voluntary Employer Withholding	Total Burden = Fixed Costs + Variable Costs	<p align="center">Not Applicable</p> <p>In this system, employers would not know that they were withholding for student loans. Therefore, employers do not experience additional burden.</p>	Burden = Fixed Costs + Variable Costs
	<p>Fixed Costs = recordkeeping costs (accounting systems modifications and maintenance, data storage, etc) + the cost of generating summary withholding data (i.e., employer identifier, pay period covered, \$ remitted)</p> <p>Variable Costs = The cost to employer of reporting withholdings for each student loan borrower</p>		<p>Fixed Costs = the cost of having the necessary infrastructure to withhold student loans from employee's paychecks and remit the amounts to Education. This cost consists of the system maintenance costs (record updates and other systems changes) and the cost of recordkeeping.</p> <p>Variable Costs = represents the transactions costs to the employer of actually withholding, reporting, and remitting payments to the Department of Education</p>

Note: Employers with fewer than 10 employees are exempted from mandatory withholding—Employers with 50 or more employees elect to participate under the voluntary program.

**Student Loan Repayment and Wage Withholding
Employer Reporting Burden - Summary**

Estimates of Employer Reporting Burden

	Internal Revenue Service		Department of Education
	Separate from the Tax System	Using the Current Tax System	
Mandatory Employer Withholding	<p>Total Burden = Fixed Costs + Variable Costs</p> <p>Fixed Costs = (1.2 million employers x 4.4 hours x \$10 per hour x 12 months) + (1.2 million employers x .04 hours x \$10 x 33 pay periods) + (4.8 million employers x .04 x \$10 x 12 months) = \$672 million</p> <p>Variable Costs = 6 million employees x .53 hours x \$10 per hours x 33 pay periods = \$1,050 million</p> <p>Total Burden = \$672 + \$1,050 = \$1.7 billion</p>	Not Applicable	<p>Burden = Fixed Costs + Variable Costs</p> <p>Fixed Costs = 1.2 million employers x \$42 per month x 12 months = \$605 million</p> <p>Variable Costs = 196 million transactions x \$2.5 per transaction = \$490 million</p> <p>Total Burden = \$605 + \$490 = \$1.1 billion</p>
Voluntary Employer Withholding	<p>Total Burden = Fixed Costs + Variable Costs</p> <p>Fixed Costs = (.174 million employers x 4.4 hours x \$10 per hour x 12 months) + (.174 million employers x .04 hours x \$10 x 33) = \$94 million</p> <p>Variable Costs = 4.5 million employees x .53 hours x \$10 per hours x 33 pay periods = \$787 million</p> <p>Total Burden = \$94 + \$787 = \$0.9 billion</p>	Not Applicable	<p>Burden = Fixed Costs + Variable Costs</p> <p>Fixed Costs = 174 thousand employers x \$42 per month x 12 months = \$88 million</p> <p>Variable Costs = 147 million transactions x \$2.5 per transaction = \$368 million</p> <p>Total Burden = \$88 + \$368 = \$0.5 billion</p>

Note: Employers with fewer than 10 employees are exempted from mandatory withholding—Employers with 50 or more employees elect to participate under the voluntary program.

Characteristics of the Proposed IRS Administered Programs

Using the Current Tax System

The following points highlight the student loan withholding system envisioned by the Internal Revenue Service as using the current tax withholding system:

- Employees increase the amount withheld by employers to cover both student loans and income taxes.
- Employers would not know that employees would be repaying Direct Student Loans through wage withholding.
- Reconciliation between student loan and income tax payments would be done on a new schedule attached to Form 1040.

Because employers would not be required to differentiate between income tax withholdings and student loan withholdings, this program would impose no additional burden on employers.

Separate from the Tax System

- Withholding program separate from the tax program
- Real-time reporting of individual employee's student loan payments made via wage withholding
- IRS compliance action centers on employers rather than the borrower
 - The IRS would contact the employer if nonpayment or underpayment is detected
 - Employers would be required to keep and submit detailed records with each transaction
 - The IRS would only contact the borrower if the employer demonstrated that the borrower did not specify enough withholding to cover the liability
- Program requires more stringent reporting by employers than what is currently required under the tax system.
- Increased employer reporting burden

Burden Estimation Methodology

Under the existing tax system, the IRS designed a program that would not require employers to differentiate student loan withholdings from income tax withholdings. Therefore, the following burden analyses applies only to IRS operating a special operation separate from the current tax system.

The estimate of employer reporting burden for a withholding system separate from the tax system is based on the following equation:

$$(4) \quad \text{Total Burden} = \text{Employer Burden}_A + \text{Employer Burden}_U$$

where

Employer Burden_A represents the costs incurred by employers in reporting student loan repayments to the Internal Revenue Service.

Employer Burden_U represents the burden experience by employers who do not have employees who repay student loans through wage withholding, yet have to certify to the IRS that withholding was not required. This burden would not be applicable to firms under a voluntary program.

Like the program administered by the Department of Education, burden under the IRS special operation can be expressed in terms of fixed and variable costs. Rewriting (4), burden is defined as:

$$(4)' \quad \text{Total Burden} = \text{Fixed Costs} + \text{Variable Costs}$$

where

Fixed Costs = Recordkeeping Costs (for firms affected) + Summary Reporting Costs + Certification Costs (for firms which do not have to withhold)

Variable Costs = Detailed Reporting Costs

Estimate of Fixed Costs under an IRS Administered Withholding Program Separate from the Tax System

From the basic definition of Total Burden, the first major component of Fixed Costs is the recordkeeping costs. Firms affected by the withholding requirement would be required to set up and maintain a withholding system, as was the case in the Education administered system. To comply with the Paperwork Reduction Act, the Service developed models to estimate the

time necessary to comply with Federal tax reporting requirements. The IRS estimates the average time for each IRS form. Not only does the IRS estimate the average time per form, but it also estimates the average time to perform subtasks. For example, the IRS estimates both the recordkeeping and reporting burden for all business tax forms. Extrapolating from known tax forms to what student loan requirements would necessitate permits the estimation of employer burden.

Fixed Costs for student loans are the sum of the recordkeeping costs, the summary reporting costs, and the cost of employers not affected by the withholding requirement to certify that they did not have to withhold.

The recordkeeping required for students loans would approximate what would be required by firms in filing the Form 941, Employers Quarterly Withholding. Therefore, recordkeeping for firms affected by the withholding requirement can be estimated by the following equation:

$$(5) \quad \text{Recordkeeping Costs} = \text{Time}_R \times \text{Freq}_R \times \text{Monetary Value} \times \text{number of employers affected}$$

where

$$\begin{aligned} \text{Time} &= 4.4 \text{ hours per month} \\ \text{Freq} &= 12 \text{ months per year} \\ \text{Monetary Value} &= \$10 \text{ per hour} \end{aligned}$$

or

$$\begin{aligned} \text{Recordkeeping Costs} &= 4.4 \text{ hours} \times 12 \text{ months} \times \$10 \text{ per hour} \times \text{number of employers} \\ &= \$528 \times \text{number of employers affected} \end{aligned}$$

Based on the analyses performed in estimating the Department of Education burden, the number of employers participating in a mandatory program is 1.2 million while the number of employers participating in a voluntary program is 174 thousand.

The Summary Reporting costs represent the cost of employers to summarize the withholdings each pay period. It was estimated that there would be 196 million transactions per year under a mandatory program administered by the Department of Education. Given 6 million employees, each employee is paid, on average, 33 time per year. The summary reporting costs can be estimated by the following equation:

$$(6) \quad \text{Summary Reporting Costs} = \text{number of employers affected} \times \text{time} \times \$ \text{ value} \times \text{frequency}$$

where

time = .04 hours (based on the time estimate for Federal Tax Deposits)
\$ value = \$10 per hour
frequency = 33 times per year
number of employers = 1.2 million, if mandatory (.174 million, if voluntary)

or

Summary Reporting Costs = number of employers affected x .04 x \$10 x 33
= number of employers affected x \$13.20

While not all firms would not necessarily be affected, the Service would still require that firms certify that they were not required to withhold for student loans (only under the mandatory program). Because employers would be the conduit for wage withholding, the IRS would begin investigating underpayments or nonpayments through employers. The certification cost is estimated by:

(7) Certification Costs = number of employers not affected x time x \$ value x frequency

where

time = .04 hours (based on Federal Tax Deposits)
\$value = \$10 per hour
frequency = 12 per year
number of employers = 4.8 million, if mandatory (5.83 million, if voluntary)

or

Certification Costs = number of employers not affected x time x \$value x frequency
= number of employers not affected x \$4.8

The estimate of Fixed Costs is based on the following equation:

Fixed Costs = Recordkeeping Costs + Summary Reporting Costs + Certification Costs
= \$528 x number of employers affected + number of employers affected x \$13.20
+ number of employers not affected x \$4.8

Therefore, it is estimated that the Fixed Costs are:

- Mandatory Withholding: \$672 million
- Voluntary Withholding: \$ 94 million

Estimate of the Variable Costs

The variable costs are dependent upon the number of employers for whom employers are required to withhold for the repayment of student loans. Under the IRS administered program, it is envisioned that employers would be required to submit W-2 type information every pay period. Therefore, variable costs can be estimated by the following equation:

$$(8) \quad \text{Variable Costs} = \text{number of employees} \times \text{estimated time} \times \text{number of pay periods} \times \$10$$

where

estimated time = .53 hours (based on Form W-2)

average number of pay periods per year = 33

number of employees = 6 million, if mandatory (4.5 million, if voluntary)

The estimated Variable Costs are:

- Mandatory Withholding: \$1,050 million
- Voluntary Withholding: \$787 million

Estimate of Employer Burden under the IRS Administered Program (Separate from the Tax System)

The preceding sections developed all of the necessary assumptions and inputs for estimating the total employer reporting burden for an IRS administered student loan collection and servicing system separate from the tax system. Recall the basic definition of employer reporting burden:

$$(4) \quad \text{Total Burden} = \text{Employer Burden}_A + \text{Employer Burden}_V$$

or

$$(4)' \quad \text{Total Burden} = \text{Fixed Costs} + \text{Variable Costs}$$

Based on this analysis, the estimates for employer reporting burden as administered by the Internal Revenue Service are:

- Mandatory Withholding:
- Fixed Costs: \$672 million

- Variable Costs: \$1,050 million
- Total Burden: \$1,722 million

- Voluntary Withholding:
 - Fixed Costs: \$ 94 million
 - Variable Costs: \$787 million
 - Total Burden: \$ 881 million

Department of Education

Characteristics of the Education Administered Program

The following points highlight the student loan withholding system envisioned by the Department of Education:

- Education envisions a withholding program similar to a savings bond campaign or employer charitable contribution program.
- Education's compliance efforts will be centered on the borrower
 - Education first contacts borrowers if either a nonpayment or underpayment is detected.
 - Borrower attempts to resolve issues with employers before involving Education.
- Education envisions a program that requires minimal reporting requirements by employers
- Borrowers will always have the ability to select the method of repayment that best suits their situations.

Burden Estimation Methodology

The estimate of employer burden is based on the following equation:

$$(1) \quad \text{Total Burden} = \text{Total Fixed Costs} + \text{Total Variable Costs}$$

where

Total Fixed Costs are the costs incurred by employers for having the necessary infrastructure to withhold student loan payments from employees' paychecks and remit the amounts to Education. This cost primarily consists of the system maintenance costs (updating of records and other changes to the system) and the cost

of recordkeeping. Total Fixed Costs for student loans is the cost over and above what the employer expends to comply with Federal tax requirements or other withholding programs.

Total Variable Costs represent the transaction costs to the employer of actually withholding, reporting, and remitting payments to the Department of Education. These costs are in addition to the burden experience by employers in complying with Federal tax requirements and other withholding programs.

The estimate of Total Fixed Costs is based on the following equation:

$$(2) \quad \text{Total Fixed Costs} = \text{number of employers} \times \text{Average Monthly Fixed Costs} \times 12 \text{ months}$$

where

$$\text{Average Monthly Fixed Costs} = \$42.00^1$$

The estimate of Total Variable Costs is based on the following equation:

$$(3) \quad \text{Total Variable Costs} = \text{number of transactions per year} \times \text{average cost per transaction}$$

where

$$\text{Average cost per transaction} = \$2.50^2$$

Number of transactions = f(number of employees participating, payroll frequency distribution)

Payroll frequency distribution:³

Weekly:	31.5%
Biweekly:	36.3%
Monthly:	7.0%
Bimonthly:	25.2%

¹ Per conversations with Automated Data Processing, Inc. (ADP), the American Payroll Association, and the American Society of Payroll Management, it was determined that the model for child support administrative wage garnishment was the closest model to the proposed Education student loan withholding system. The Average Monthly Fixed Cost was provided by ADP.

² Source: ADP, The transaction cost per employee for administrative wage garnishment.

³ Source: ADP's distribution of client pay cycles. Discussions with the American Payroll Association indicated that ADP's clients were representative of the employer population.

Therefore, to estimate the employer reporting burden under a program administered by the Department of Education, it is first necessary to determine:

- the number of employers affected
- the number of borrowers repaying through wage withholding
- the number of transactions per year

Estimated Number of Employers Affected by Student Loan Withholding

To estimate the Total Fixed Costs, it is necessary to first estimate the number of employers who withhold for student loans. Based on the IRS's employment tax reporting, approximately 6 million employers could be affected by a student loan wage withholding program. However, there is no reason to believe that all employers would be affected. It is reasonable to assume that the probability of employers having less than 10 employees would be affected, even under a mandatory program, would be almost zero. Based on an analysis of IRS, Census, and Department of Education data, it is expected that the maximum number of employers that potentially could be affected under a mandatory withholding program is 1.2 million employers.

With respect to the voluntary withholding program, one would expect that larger employers would be more willing to offer repayment of student loans through wage withholding as an employee benefit. While the average monthly fixed cost per employer and the average cost per transaction are identical under both the mandatory and voluntary programs, the perception changes. The mandatory withholding program would be viewed as another government mandate while the voluntary program permits businesses to decide whether to offer loan repayment via wage withholding to their employees. In other words, the business community could be viewed as a cost while the voluntary program is viewed as an employee benefit.

Based on conversations with United Way concerning employer participation in charitable withholding programs, and on Treasury statistics for the government savings bond program, our best estimate of the number of employers offering wage withholding on a voluntary basis is 174,000. This assumes that employers with fewer than 50 employees will elect not to participate.

To summarize, the projected number of employers participating in a wage withholding program for the repayment of Federal student loans are:

- Mandatory Withholding Program: 1.2 million employers
- Voluntary Withholding Program: 174 thousand employers

Estimated Number of Borrowers Participating in a Wage Withholding Program

Under the mandatory withholding program, it was estimated that 1.2 million employers would be affected by the requirement. Approximately 84% of all employees are employed under this employer subpopulation. Based on all available information, IRS, Treasury, and Education estimate that approximately 6 million borrowers would elect to repay their loans through wage withholding (including income contingent and all other repayment plans).

Because the number of firms electing to participate in a voluntary withholding program is considerably less, fewer borrowers will be able to repay student loans through wage withholding. Approximately 4.5 million employees would be able to participate under the voluntary withholding program.

To summarize, the best estimates for the number of borrowers electing to repay student loans through wage withholding are:

- Mandatory Withholding Program: 6.0 million borrowers
- Voluntary Withholding Program: 4.5 million borrowers

Estimated Number of Transactions Per Year

As stated in the methodology, the number of transactions is dependent upon the payroll frequency distribution and the number of employees participating. It is reasonable to assume that the payroll frequency distribution can be used to extrapolate how frequently employees are paid. Therefore the number of transactions per year can be estimated through the following equation:

$$(4) \quad \text{Number of Transactions} = \text{number of borrowers} \times \Sigma(\text{payroll frequency distribution} \times \text{number of pay cycles per year})$$

Using the estimate of 6 million borrowers under the mandatory withholding system the number of transactions per year would be:

- $6 \text{ million} \times (.315 \times 52 + .363 \times 26 + .07 \times 12 + .252 \times 24)$

or

196 million transactions under a mandatory program

Using the same approach for the voluntary withholding program, 4.5 million employees participating generates 147 million transactions.

Estimate of Employer Reporting Burden under an Education Administered Program

Recall that the employer reporting burden is represented by the following equation:

(1) **Total Burden = Total Fixed Costs + Total Variable Costs**

Both Total Fixed Costs and Total Variable Costs were also determined based on the analyses presented above.

(2) **Total Fixed Costs = number of employers x Average Monthly Fixed Costs x 12 months**

= number of employers x \$42 x 12 months

= number of employers x \$504

(3) **Total Variable Costs = number of transactions per year x average cost per transaction**

= number of transactions per year x \$2.50

Employer Burden under ED's Wage Withholding Programs

The preceding sections developed the inputs necessary to estimate employer burden under both a mandatory and voluntary program. Based on the assumptions and the analytical approach detailed above, the estimates for employer burden are:

● **Mandatory Withholding:**

-	Total Fixed Costs:	\$ 605 million
-	Total Variable Costs:	\$ 490 million
-	Total Burden:	\$1,095 million

● **Voluntary Withholding:**

-	Total Fixed Costs:	\$ 88 million
-	Total Variable Costs:	\$ 368 million
-	Total Burden:	\$ 456 million