EXTENDED TESTIMONY OF RICHARD K. VEDDER
DIRECTOR, CENTER FOR COLLEGE AFFORDABILITY AND PRODUCTIVITY
SUBCOMMITTEE ON OVERSIGHT, COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
WASHINGTON, D.C., OCTOBER 7, 2015

Higher Education in the U.S. Federal Tax System

Using standard criteria to evaluate the U.S. system of income taxation, it is usually found deficient on three important grounds: it is excessively complex, raising administrative costs as well as problems of non-compliance; it is extremely inefficient, leading to distortions in the allocation of resources and ultimately lower rates of economic growth; and in some ways it is perceived as unfair, certainly violating generally accepted standards of horizontal equity (treating everyone of similar economic circumstance the same) if not vertical equity. The treatment of higher education in the tax code aggravates and magnifies these deficiencies in my judgement.

Let me name a few explicit examples, mainly related to endowments and gifts. Individuals who buy and sell securities are subject to capital gains taxes that effectively have rates as high as 23 percent; universities, by contrast, that buy and sell securities pay nothing. This adds to complexity (some gains are taxable, others are not), perhaps creates vertical inequities (some pay the tax, others are exempt), and even inefficiencies as the lack of a level playing field favors some investors over others, potentially distorting the allocation of resources.

Similarly, donations to universities are tax-exempt, whereas the gift of a few dollars to a beggar on the streets or to an impoverished relative is generally not. Donations to fund purely non-academic facilities are tax-exempt if made through universities, but taxable if done by for-profit firms providing similar services to the public. Thus there are examples of university housing facilities where the cost per bed exceeds $300,000 –more than many luxury hotels cost. The donor has his or her tax liability reduced by millions, but for what social purpose? Similarly, many decry spending on fancy athletic facilities, including stadium sky boxes, on similar grounds. Why should a person be able to reduce her or his taxes by supporting ball throwing contests?

But these more egregious examples of potential misuse of the tax code are quantitatively probably far less important than activity that seemingly supports arguably highly legitimate academic functions. In this testimony, I look only at one category, university endowments, for reasons of space and time, not examining non-endowed gifts to schools. My testimony is somewhat tentative, in that my research into the subject is continuing and not complete. But early findings are still interesting and worth some discussion.

The Argument Against Endowments: Adam Smith

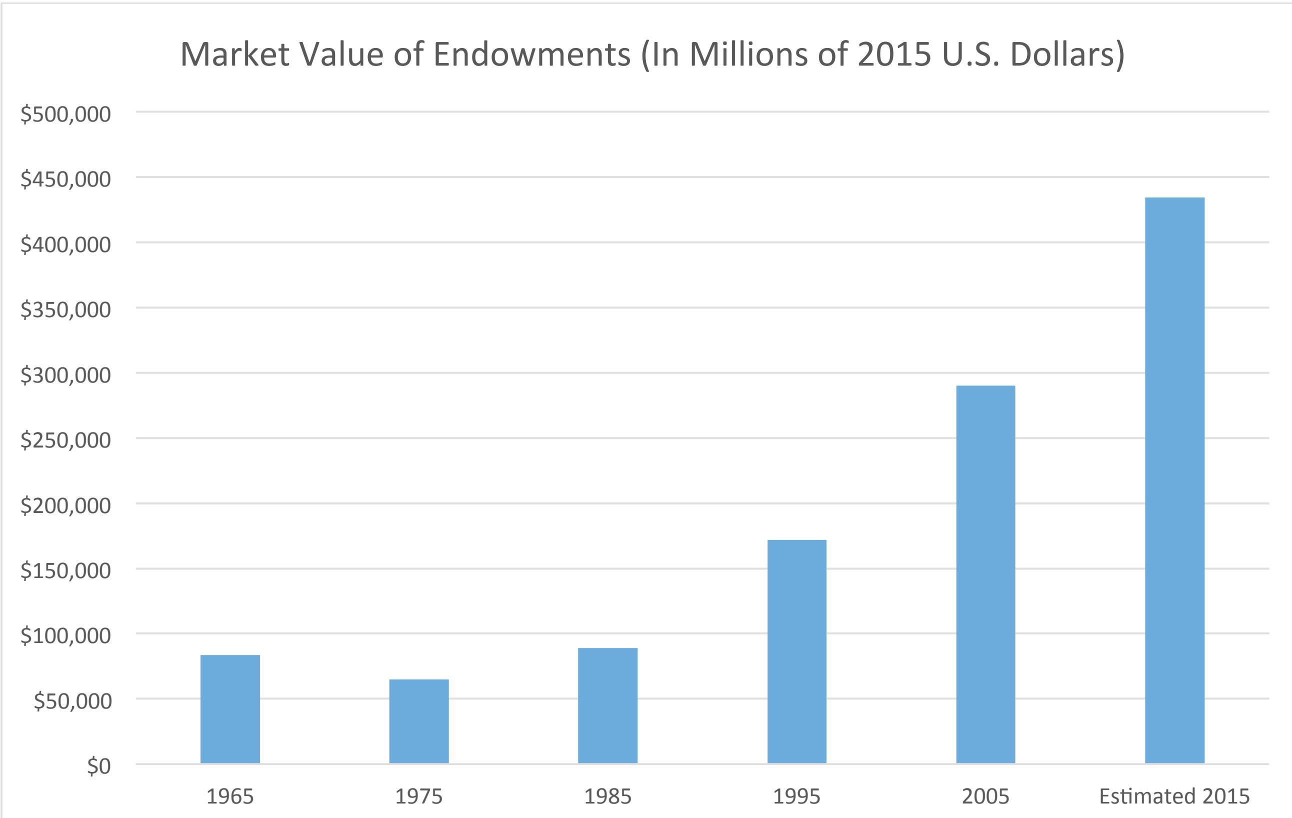
In the first great book in economics written in the year of our independence (1776), Adam Smith said: "have…endowments contributed in general to promote the end of their institution? Have they contributed to encourage the diligence and to improve the abilities of the teachers? Have they directed the course of education towards objects more useful, both to the individual and to the public, than those to which it would naturally have gone of its own accord?" Smith then goes on for several pages to argue the answer to these questions is "no." Endowments work to make professors less diligent, for example, since the subsidies from endowments mean there are no consequences from bad teaching, unlike in a world where professors depend on student fees directly for their income. Oxford University had given up the practice of individual professors charging student fees, relying instead largely on endowments. Smith's concluded as a consequence "the greater part of the …professors...have…given up altogether the pretence of teaching."

Endowments in America: Some Tentative Evidence

Was Smith onto something when he argued that endowment subsidies, like other subsidies, often encourage inefficiencies, because they reduce the financial need for providers to be responsive to customer needs? Certainly endowments have grown dramatically over time, even after correcting for inflation, as Figure 1 indicates. While the 2015 figure is partially estimated, the evidence suggests more than complete recovery from the considerable endowment drop associated with the 2008 financial crisis. Endowments have risen over five-fold after adjusting for inflation over the past half century and, as Figure 2 shows, fairly considerably even after adjusting for enrollment growth.

Endowments are very unequally distributed among schools, as Figure 3, using U.S. Department of Education data, indicates. Just 30 universities have collectively larger endowments than all other universities combined. Roughly one-third of endowments are in the top 10 schools. Table 1 provides details as of 2014. Harvard's endowment as of June 30, 2015 totaled $37.6 billion, more than *100 times as large* as that at many other universities, both public and private, of similar size.

Figure 1
Growth of Endowments, Inflation-Adjusted, 1965-2013

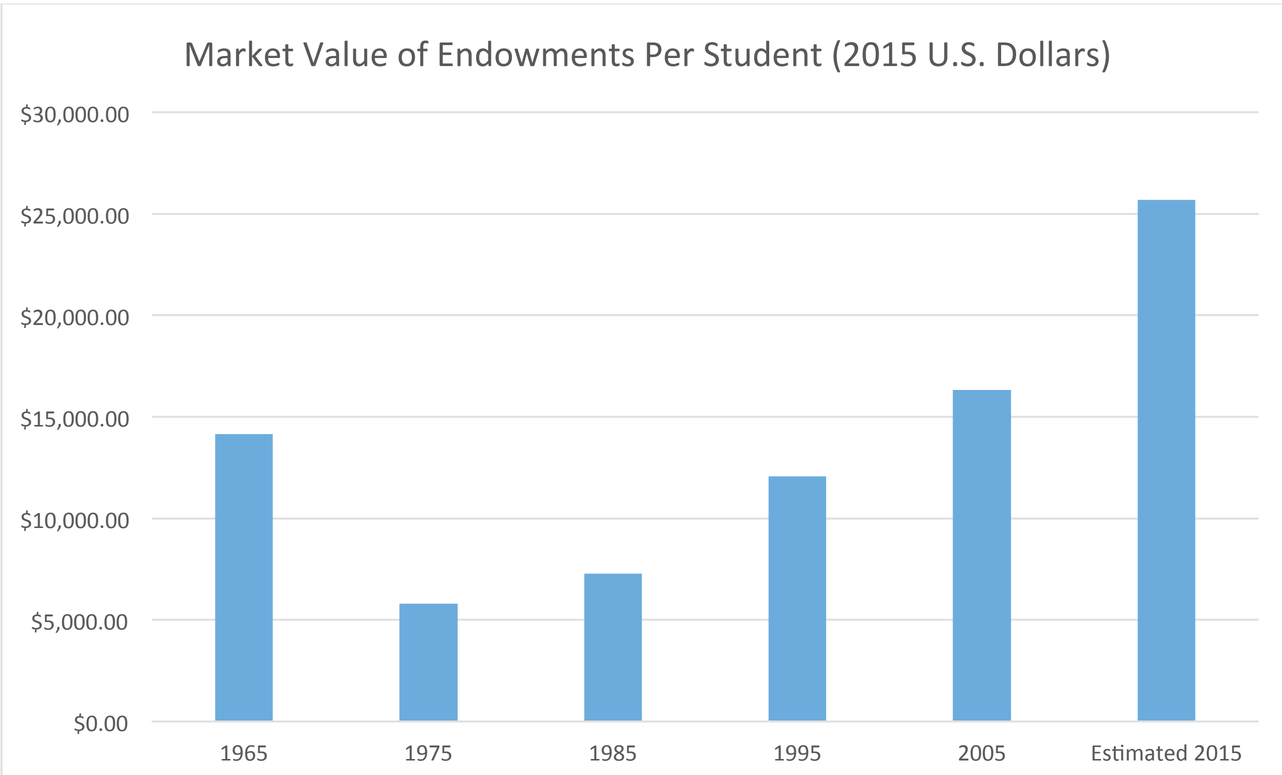


Source: U.S. Department of Education, National Association of College and University Business Officers (NACUBO)

The assistance to universities provided by tax preferences is thus very heavily skewed, favoring a relatively small number of mostly highly selective private universities that some might regard as elitist or exclusionary, especially since these schools generally have admissions preferences for children of alumni under so-called legacy provisions. Endowments provide colleges with roughly $20 billion of income, about four percent of all college revenues, but roughly 35 percent at some highly endowed institutions. In general, endowments have grown faster than revenues over time.

With the assistance of an economics and statistics undergraduate student at Ohio University, Justin Strehle, I have used data provided annually by the National Association of College and University Business Officers, NACUBO. The NACUBO survey records information on over 800 endowments, some of them non-university or Canadian institutions. For a majority of those institutions, the research organization that I direct, the Center for College Affordability and Productivity (CCAP), collects extensive data in the process of ranking the nation's best colleges for *Forbes* Magazine. For most of the analysis reported here, there are 467 schools in the sample, including every large American university endowment reported by NACUBO.

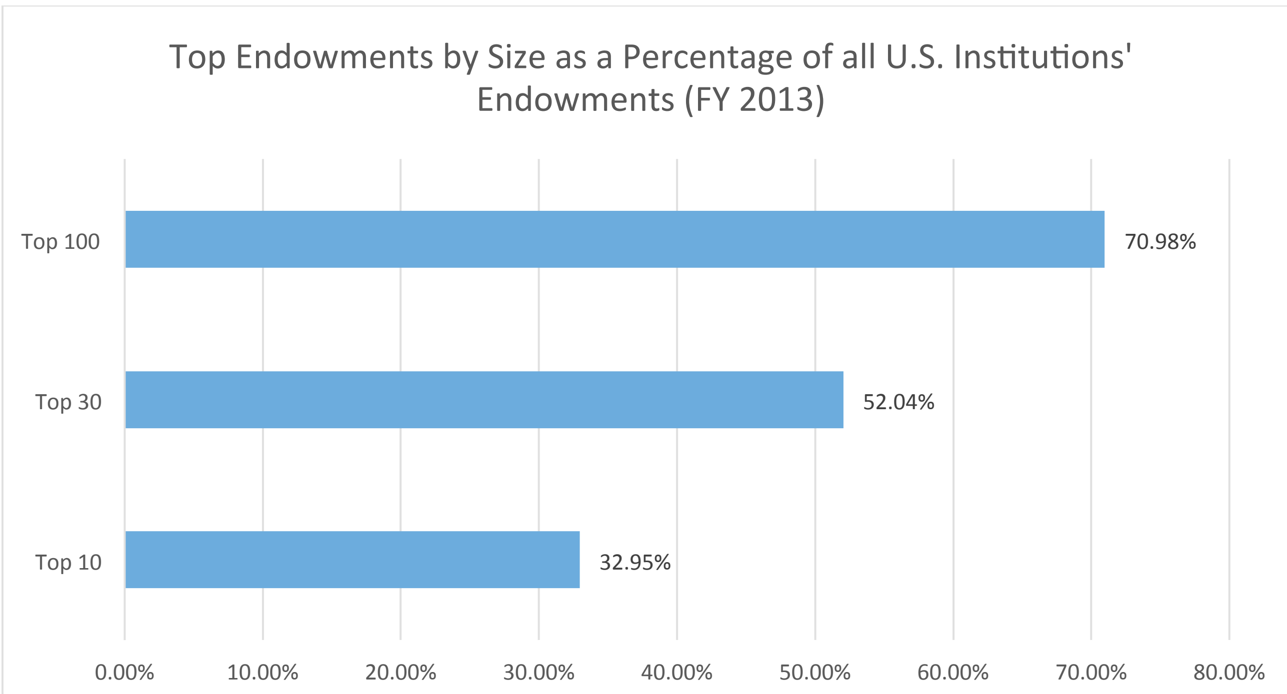
Figure 2



Source: U.S. Department of Education, NACUBO

As indicated, endowments provide colleges with about $20 billion of income available for expenditure, independent of annual changes in the value of investment portfolios resulting from changing market valuations. These changes, largely but not entirely reflecting capital gains, are often very sizable –Harvard's endowment rose about $1.7 billion (or nearly $100,000 per full-time student studying in Cambridge), despite a generally disappointing rate of return on investments in fiscal year 2015. In general, endowments have grown faster than revenues over time. Moreover, statistics on the rate of return on college endowments in recent years have generally shown that the rate of return on endowment income has been higher at the schools with large endowments. Those schools, with huge endowment incomes, can more readily afford to take relatively large risks, and can make investments of say $250 million or more in a single security or piece of real estate with high potential, something small endowed schools cannot safely do. It is therefore probably true that the tax-free nature of capital gains income for universities works to help the wealthier schools relative to the less affluent ones who tend to earn lower rates of return on investments. It is also worth noting that at least one account suggests that the investment fees to top managers at large university endowments have been known to exceed $100 million annually, so one might argue that huge investment gains enabled by tax privileges have led to extremely high incomes to a very few individuals. It has been argued that in some cases investment managers make more than the university expends on endowed scholarships payments to students.

Figure 3



Source: Author's Calculations, U.S. Department of Education data

Returning to the analysis of endowments, Mr. Strehle and I used multiple regression techniques to assess the relationship between endowments and a number of variables that some consider important. We have asked, for example, about the relationship between student tuition fees and endowments, whether there seems to be a strong relationship between institutional quality and endowment size, and whether compensation of faculty is positively associated with the size of university endowments.

In order to analyze the relationship between endowments and, say, tuition fees, we have to control for other possible determinants of those fees. In the results discussed below, we have typically included a dozen or so of these control variables, such as whether a school is public or private, the extent it has high proportion of students of modest income (as measured by Pell Grants), the degree of selectivity of the institution (as measured by standardized test scores), the racial and ethnic composition of the student body, whether the institution is large or small, whether it is located in an urban area or rural area, and so forth.

Table 1

10 Largest Endowments: June 30, 2014

Institution	Endowment Size for FY 2014 (Thousands)
Harvard University (MA)	35,883,691
University of Texas System	25,425,922
Yale University (CT)	23,900,000
Stanford University (CA)	21,446,006
Princeton University (NJ)	20,995,518
Massachusetts Institute of Technology	12,425,131
The Texas A&M University System and Foundations	11,103,880
Northwestern University (IL)	9,778,112
University of Michigan	9,731,460
University of Pennsylvania	9,582,335

Source: National Association of College and University Business Officers (NACUBO)

A few conclusions have tentatively emerged. First, endowments are *not* generally used to lower the stated tuition fees of colleges. There is *no* statistically significant relationship between endowment size and tuition fees. There *are* exceptions –Berea College in Kentucky, the College of the Ozarks in Missouri, and, historically, Cooper Union in New York City have used investments to essentially eliminate student fees. At one time, Rice University was tuition free but that policy was abandoned decades ago. Using endowments primarily to keep student fees low is very rare -- as a rule, endowments add to university income, rather than lower student costs.

Second, having said that, however, there is one caveat. Endowments are used some to provide scholarships, effectively lowering the actual or net tuition fee paid by students. However, assuming a four or five percent payout rate, the evidence suggests typically that less than 20 cents out of every dollar of endowment income goes for this purpose –making college more affordable is not the dominant use of endowed resources.

Third, because of inherent measurement issues, it is difficult to assess the relationship between endowments and institutional quality. *Forbes* Magazine ranks schools mainly on how they satisfy student needs –do students like their professors, excel vocationally after graduation, avoid much debt, get nationally recognized academic awards or graduate in a timely manner? Controlling for other factors such as those discussed above, there is *no* statistically significant relationship between the quality of the institution (as measured by *Forbes*) and endowment size. A caveat is in order here: alternative measures of quality, such as those done by *US News & World Report* or by *Money Magazine*, might show a different result. Given the relatively high correlation between the various magazine rankings, however, it is unlikely that there is any strong positive relationship between a composite of magazine rankings and endowment size – endowments are almost certainly not a dominant determinant of perceived quality.

Fourth, there is some indication that some endowment funds go to increase faculty compensation at institutions. In some cases, this might lead to higher quality teachers and researchers, but it might also be accompanied by an excessive bureaucracy, or unjustified pay increases, rather than meeting student needs. The evidence here is necessarily somewhat murky, but raises real questions about whether endowment funds mainly serve social objectives justifying special tax treatment. Further analysis of the relationship between institutional expenditures and endowments is certainly needed.

Are College Tax Preferences Justified? Some Contrarian Thoughts

Governments either tax or subsidize almost all economic activities. Universities are typically subsidized, often directly, through governmental appropriations or grants, and/or indirectly, through various tax preferences (typically schools benefit from both subsidies and preferences). The justification for giving tax treatment to universities that is better than, say, given used car dealers or providers of mobile telephones, is that colleges have two special attributes. First, it is argued that higher education is a public good with large positive externalities or spillover effects. When a person goes to college, he or she likely benefits financially, but also others surrounding that person derive some benefits as well. For example, if a college educated person goes to work in an office, the non-college educated workers in the office may strive to succeed more to look good in relation to the college educated person.

Second, it is argued that in today's economy where human financial gain depends strongly on mental capacities and efforts, higher education is virtually a necessary condition for achieving economic advance. Therefore, individuals from lower income background trying to move up the financial ladder need special subsidization in order to allow them to at least attempt to achieve the American Dream.

Both of these arguments are at least debatable. If higher education has positive economic externalities (e.g., generally raising labor productivity), you would expect state and local governmental appropriations to higher education to have some positive effects on income creation –more per capita income. I have run hundreds of regression equations looking at the statistical relationship between state government university appropriations and the rate of economic growth and have observed no meaningful relationship or, worse, a negative relationship.

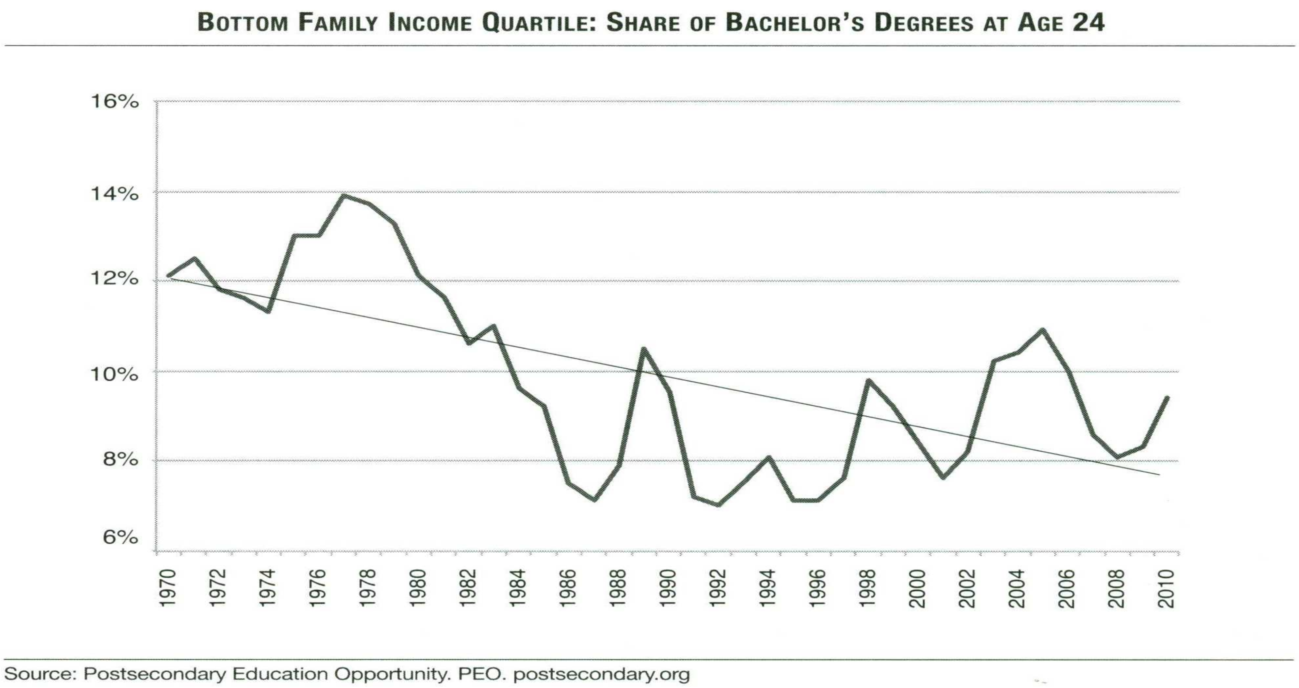
Higher education is a notoriously inefficient industry, and while productivity is hard to measure for several reasons, not even the most ardent advocate of spending more on universities argues that productivity in this sector is rising significantly. Under some reasonable sets of assumptions it is at best stagnant and more likely falling. University staff per student, for example, has risen over time, hinting that inputs could be rising faster than outputs –a sign of declining productivity. When we tax resources to fund university subsidies, and when we give universities tax preferences, we are taking resources from the highly productive, competitive and market-disciplined private sector and giving them to the far less productive, far less market-driven, and far less competitive higher education sector, perhaps explaining why it is not uncommon to find a negative association between higher education spending and economic growth. All in all, this statistical evidence makes it hard to believe that higher education produces meaningful positive economic externalities.

Probably the leading free market, libertarian-leaning American economist of the twentieth century was Milton Friedman. In *Capitalism and Freedom*, written in 1962, Friedman argued that government subsidies of universities were justified on positive externality grounds. When I asked him 40 years later about this, Friedman said that while some positive externalities existed, so did some negative ones, and he was uncertain whether we should tax or subsidize universities, arguing it was a matter for empirical examination. In Friedman's view, the long-held assumption that higher education needed subsidies certainly needed reexamination.

Some trends in higher education in the era of high endowments and growing use of tax preferences (among the most important of which are tax credits to effectively reduce tuition fees for students, and tax exemption of interest on some bonds issued, usually to fund capital outlays) add to my skepticism that endowments serve a clear positive social purpose. Take the goal of achieving greater intergenerational income mobility and reductions in measured inequality. In the last 40 years, income inequality has risen relatively steadily with growing endowments and university enrollments. Moreover, within higher education, *the proportion of recent American college graduates from the bottom quartile of the income distribution is lower today than in 1970* –not only before big endowments, but before large federal student financial assistance programs as well (see Figure 4).

Moreover, even forgetting the public good dimension of higher education, there is growing evidence that the perceived rate of return on higher education investment at the margin is becoming relatively low. If you view tax preferences as a means of increasing investment in human capital, the argument for doing so is markedly reduced if the incremental rate of return on that investment is perceived to be low. Recent college graduates certainly see the gains from a

Figure 4



college education to be far from strong, with fully one-half of recent graduates in the Purdue-Gallup annual poll of 30,000 alumni finding higher education not a particularly good investment. Beyond that, the New York Federal Reserve and others, including myself, have observed that conservatively 40 percent of recent college graduates end up taking jobs that historically have been filled by high school graduates. Should we be giving very valuable tax exemptions to schools that at extremely high cost educate many to become taxi drivers, baristas, retail sales clerks in discount stores, and janitors?

Some Concluding Thoughts

What should America do with respect to endowments? In a world where the federal government did not interfere in higher education markets at all, I would be inclined to say "do nothing." Individuals wishing to donate to their alma mater should be able to do so as part of the basic economic freedom generally accorded Americans. But the government is significantly interfering in those markets already with massive subsidies, tax preferences and regulations, mainly at the federal but also at the state and local level.

Looked from the broader view of American tax reform, I think a strong case can be made for eliminating most if not all higher education tax preferences. Economists are right in thinking that taxing a broad tax base at relatively low marginal rates is likely to have enhanced output effects relative to taxing a relatively narrow tax base at varying but sometimes high marginal rates. This is an argument for ending endowment related tax preferences.

Introducing equity into consideration, I am the first to argue that tax fairness is a highly subjective concept, and what is considered fair by one person may be perceived as unfair by another. That said, however, the current higher education tax preferences almost certainly benefit highly selective, mostly private schools with relatively low proportions of Pell Grant and other low income recipients despite their financial capacity to finance the education of many poorer students. The existence of admission legacy provisions means that to some extent the more elite schools have dimensions of a private club or a gated academic community, where money and who your parents are makes a difference. I believe purely private clubs should be able to exclude members on any basis, even ones that I personally find reprehensible. But I do not think that exclusionary principle applies when the club in question, be it Yale University or Slippery Rock State University, receives federal subsidies that arguably contribute to the perpetuation of non-merit based selection procedures advantaging mainly wealthy Americans.

It is possible, of course, to compromise. Keep endowment preferences up to a certain limit. Start to eliminate deductions for donations to institutions with more than $250,000 endowment per student, for example, probably phasing out the deductions over a fairly large range of endowment per student. One can argue about where to begin a phase-out, or whether or where even to implement an excise tax on endowment incomes. One can argue whether revenue enhancements from ending preferences should be used to reduce the budget deficit, lower taxes, or provide aid to augment endowments of poorer schools. I am not sure myself what optimal policy is, but I must say I am much more skeptical of the justification for current tax preferences towards higher education than I was when I first began studying this issue more than one half century ago.

Thank you.

Richard Vedder is Distinguished Professor of Economics Emeritus at Ohio University, Director of the Center of College Affordability and Productivity, and Adjunct Scholar at the American Enterprise Institute. He was immeasurably assisted by Justin Strehle, an economics and statistics undergraduate major at Ohio University. Regression results discussed in the testimony are available be request.