U.S. Tax Policy, Research Grants and Higher Education: The Undebated Billions

by Wick Sloane, Research Fellow & Jonathan Leirer, Research Assistant

Columbia University has announced a $1-billion—or 246,913 Pell Grant—raid on the U.S. Treasury. Cornell University has also joined the game, taking away another $1 billion dollars in possible taxes. These raids have the blessings of the Secretary of the Treasury, of both Houses of Congress, and of you and me.

By titling the raid a "$4 billion capital campaign" Columbia and Cornell can proceed without further approval. In principle, Columbia will take $4 billion off the taxable income of the donors. In a conservative estimate, this translates into at least $1 billion less federal taxes collected.

This paper asks why, in seeking funds, the public debate omits the substantial subsidies from our current federal policies on taxes for education and sponsored research. The issue is not that we are reaching the wrong decisions on allocating resources, but we are not even talking about the right questions.

Founded in 2006, The Center for College Affordability and Productivity (CCAP) is dedicated to research and recommendations on the issues of rising costs and stagnant efficiency in higher education, with special emphasis on the United States. The Center is an independent nonprofit based in Washington, DC.

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Perspectives on Higher Education

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Columbia University has announced a $1-billion – or 246,913 Pell Grant – raid on the U.S. Treasury. Cornell University has also joined the game, taking away another $1 billion dollars in possible taxes. So have the University of Virginia and Yale which are in for $3 billion each. A $5 billion drive by Harvard is said to be in the wings. These raids have the blessings of the Secretary of the Treasury, of both Houses of Congress, and of you and me.

By titling the raid a "$4 billion capital campaign", Columbia and Cornell can proceed without further approval. We, the people, have deemed contributions to such campaigns are deductible from our income taxable by the Internal Revenue Service. In principle, Columbia will take $4 billion off the taxable income of the donors. In a conservative estimate, this translates into at least $1 billion less federal taxes collected.

This $4 billion, along with the $25 billion generous people donate to U.S. colleges and universities each year, is not on the policy tables as the nation, again, has frozen Pell Grants at a maximum of $4,050 per year. That's less than an Ivy League meal plan. Pell Grants are a major funding source for low-income students trying to complete college.

With the report in September from the federal Commission on the Future of Higher Education (Spellings Commission) comes a recommendation to increase Pell Grants. Even state college tuitions average now $5,800 (College Board, 2006 report).

Higher education leaders are already lauding the proposed increase and pressuring the federal government to find the funds. This places the burden of the solution on the government, absolving higher education of any independent action. What higher education is hiding from the public is the array of federal funding beyond the federal Department of Education.

A modest proposal: How could the US increase Pell Grants without increasing spending? Answer: Start the discussion by putting 2,043,407 (Table 1) new Pells on the table, from credible modification of current tax policies. As of 2004, the U.S. spends $12 billion dollars on Pell Grants, from total Department of Education higher education discretionary funding of $16.5 billion.

Table 1: Found Pells

Modify donations tax policy	981,481
Cut Research Overhead by 50%	951,852
Taxing Elite Subsidy as Income	44,444
1% Endowment Income Tax	65,629
	2,043,407

This paper asks why, in seeking funds, the public debate omits the substantial subsidies from our current federal policies on taxes for education and sponsored research. The aim of this paper is to open the debate on the magnitude and use of total federal funds now available for higher education. To put it differently, we are trying to expose some disconnects in our national assumptions about education.

Analytic Frame

Federal tax policy, via tax-free endowments, tax-deductible gifts, and research funds, provides substantial subsidies to U.S. higher education, public and private. The question is not whether this is good or bad public policy per se, but rather why these policies receive scant review, alongside other federal appropriation and budget spending decisions for the Department of Education.

The web of federal policies regarding higher education is complex. Many small unrelated decisions and details add up to a massive investment of which the Department of Education is by no means the largest. And funding also comes through unrelated agencies ranging from the National Endowment for the Arts to the National Institutes of Health and the Department of Defense.

In addition to this funding, unexamined policies allocate billions in public capital to higher education, public and private. This paper uses Pell Grants as an example of an often-identified shortage. How many Pell Grants could be created with alternative policies regarding the tax treatment of gifts to higher education? The point is to illustrate the magnitude of resources that could be on the policy table, *not* to evaluate the effectiveness of Pell Grants or even advocate an expansion of that program.

This paper looks at higher education in the context of federal non-profit status, which governs donations, endowment income, and tax status. Private universities and colleges hold this status. Public colleges and universities are often state agencies with fundraising and endowment arms set up as independent nonprofits. The following discussion could apply to all non-profits falling one way or another under federal 501 c 3 tax status, ranging from hospitals to museums and orchestras.

Current U.S. Education Policy and Plan

Amidst the Spellings Commission discussions and all the debate in recent years is always the question of whether the U.S. should have a national higher education policy at all. Seldom stated is that the U.S. already has national policy, legislated and codified and in force, on higher education. This policy was not consciously set in a coherent fashion based on a consensus educational policy, but rather was backed into in a series of policy actions over the years, but nonetheless, a policy it is.

Our national policy is to believe that the Founders, who didn't mention education in the Constitution, left higher education to the states. This ties the hands of anyone trying to devise a national higher education policy. Our current national higher education policy seems to be that we will ignore the poor. Our national policy is to let Medicaid and rising medical costs crowd higher education out of state budgets. We know this, yet we don't have a plan. Our policy is to leave the problem to strapped statehouses. Our national policy is to wring our hands about a lack of budget and appropriations for federal student aid while giving away the store through the back door, with federal tax policy and current methods of research funding.

Federal Tax Policy on Donations and Endowments

Generous donors gave $25.6 billion to colleges and universities in 2005. (Council on Aid to Education.) Under current federal tax policy, these are tax-deductible dollars. Current policy makes no distinction on the uses of the gifts. Athletics, new buildings, and scholarships, for example, have equal deductibility rules. At least $295 billion in U.S. college and university endowments (NACUBO 2005) earn income that current policy exempts from federal taxation. That policy makes no distinction in the relative wealth of the college – endowment per student, for example, or in relation to operating budget. The implications of both policies are substantial. (Table 2)

Table 2: Policy Effect for Donations and Endowments

Annual donations	$ 26,500,000,000
(2005 CAE)	
Tax rate	30%
If same amount not donated, taxed as income.	$ 7,950,000,000
Change Tax Policy by	
50%	$ 3,975,000,000
Full Pell Grant	4,050
New Full Pells Available	981,481
Estimated Higher Ed Endowments	$ 295,332,375,000
(NACUBO 2005)	
NACUBO Average Rate of Return	9%
Annual Income	26,579,913,750.00
Tax Rate	30%
Foregone Tax	$ 7,973,974,125
New Pells Available	1,968,883
New Pells Available at tax of:	
1%	65,629

We will illustrate by picking on the schools attended by the senior author, Williams College and Yale. The implied federal tax subsidy, via tax policy, at these schools, is $30,000 to $41,250 per student. (Table 3) This at least three times the full cost per student at a community college. Or about seven to nine full Pell Grants at current funding levels. Take the untaxed endowment income of those schools and then the forgone tax revenue from tax-deductible donations. Divide that by the number of students. While one can quarrel over methodology (e.g., even the definition of students), the per student funding by any calculation is very large.

Our national policy, then, is that the indoor golf driving nets at Williams, built with tax-deducted dollars, are more important than Pell Grants for community college students. The problem is even more pronounced when these large gifts are specifically targeted for athletic programs and facilities. Should million dollar skyboxes at football stadiums really receive the same tax emption as money donated to the school library? Rep. Bill Thomas (R-CA) is asking that question, but few others are (and, unfortunately, Rep. Thomas is retiring at the end of this year). Should a dollar in Williams' current $400 million capital campaign be worth the same deduction as a dollar to Friends of The Library at Bunker Hill Community College?

Table 3: Individual College Example

Williams College Example		
Endowment	$ 1,500,000,000	
Estimated annual return, untaxed	10%	
	150,000,000	
Reasonable Tax Rate	30%	
Foregone Tax	45,000,000	45,000,000
Annual donations		
From 2004 990	50,000,000	
	30%	
Foregone tax	15,000,000	15,000,000
Total Annual Forgone Tax		$60,000,000
Number of students	2,000	
Annual tax subsidy per student		$ 30,000
At Endowment return of	15%	$ 41,250

What is the total impact of the golf nets and the $26.5 billion donations in federal tax deducted dollars, to colleges and universities? Assume a 30% average tax rate for the donors. This policy results in $7.9 billion in forgone tax revenues. As context, remember that total 2004 federal discretionary spending from the DOE on higher education was $16.5 billion, including $12 billion for Pell grants. So the implicit "tax expenditure" from these tax policies is to reduce possible discretionary spending on higher education in the U.S. Department of Education by close to 50 percent.

The current tax policy does not distinguish between the gift for the golf nets and a gift for a scholarship or for faculty salaries. Different institutions have different needs and few are as wealthy as Williams. None of the current debate on higher education, in the recent Spellings Commission, or in trade groups, including student associations, has this $7.9 billion from tax policy on the table.

We do *not* make the assumption that more money is the solution for educating more people. But under current policy, neither higher education leaders, nor anyone else, have any idea of the magnitudes or the effect of the current public capital allocated to higher education. However, there is good reason to believe that more money under current rules ensures raising tuitions (Vedder 2004). The policy Holy Grail is to improve student aid without the croupiers at the colleges and the universities raking in the new money to meet new self-created costs.

College Admission and Lottery Winnings

Tax policy also figures into rising tuitions. Many colleges dismiss public criticisms of tuitions of $30,000 and more, arguing that the cost per student is higher than what's called the "sticker price." Yale or Stanford, for example, have full tuition, room, and board at more than $40,000 per year. This is cheap, the explanation goes, because the cost per undergraduate is closer to $80,000. Income from endowments and from donations makes up the difference, $40,000 a student or even sometimes more. Gordon Winston of Williams College, arguably the dean of higher education economists, notes that this is evidence that the elites are, in effect, paying for talent through this endowment/gift subsidy. (Winston, 2000)

As a national policy, generated through tax-exempt dollars, the question is whether that benefit should be taxable. Since a large portion of students at elite universities like Williams and Yale come from upper income families, current tax policy favors this group rather than those coming from more modest backgrounds. In a fundamental sense, this is the equivalent of a highly regressive tax that soaks the poor relative to the rich.

A family with an income of $250,000 at Princeton receives that large $40,000 subsidy, the same as a family with income of $40,000. Current tax laws permit this. What's the difference, though, between this income and other in-kind benefits that are taxable? Why not take this subsidy to the elites and count it as taxable income to the family? Remember, the decision not to do so reduces federal revenues that might otherwise go to Pell Grants. (Table 4)

Table 4: Effect from Untaxed Cost Subsidy

Williams and Ivy Example		
Annual Undergrad Cost	80,000	
Annual Full Tuition	40,000	
Untaxed Benefit	$ 40,000	
		30%
Foregone tax	12,000	
Total, with 1,000 at full tuition 1,000		
Students	$ 12,000,000	
New Pells per school		2,963
	15	
For 15 Ivies, Elites	44,444	

At a job, subsidized parking and some expense allowances are a taxable benefit, as is going on vacation on the corporate jet. These fall within employment relationships, though, while attending Yale or Williams is not. The benefit is exclusive to a lucky few. Given the nature of admissions at elite colleges, why not tax the differential as lottery winnings? (26USC3402(q))

Federal Research Funding In Higher Education

The federal government spends at least $25 billion per year funding independent research, mostly at universities. The situation is complicated. For example, these funds are dispersed at the expense of those without time or lobbyists.

Federal Office of Management and Budget Circular A-21 (Revised 05/10/04), available on the Web, is the 36,000-word (downloadable at 123 pages) rulebook on grant funding. The funding arrives at universities in two forms: direct research funding and indirect-cost reimbursement, known in lay terms as overhead. A scientist seeking to turn lead into gold would write a research budget covering the project costs, excluding items such as heat, light, electricity, the building -- the overhead. Say the scientist has a budget of $100 for his costs. The cost to taxpayer would be $100 plus the overhead that the particular university has negotiated with the federal government. This can range from 30% at a public university to more than 50% for the Ivy League. This is not a typo. Understanding and negotiating a nuclear arms treaty would be simpler than doing the same thing with federal research awards to a university.

The basic formula is the ratio of what the university spends to support research – buildings and all – divided by the total research funding the university receives. The original notion was to provide incentives for universities to invest in research. Fair enough. The situation has no cap and no scrutiny beyond the insiders. Basic math skills illustrate that the more that is spent on research, the higher the reimbursement percentage. In short the formula is an invitation to spend, not conserve resources. The incentive exists to spend money because the federal government will repay.

These funds do support scholars and often provide students with work that enhances their own education. Legions of lobbyists and university staff labor to bring these grants to their particular universities. Higher education does a poor job explaining the impact and implications of these research programs. These funds are the apples to the oranges of, say, teaching solid writing, thinking and problem solving skills to a community college student. The national debate too often swirls all this together, with no explanation of how university funding might go up while undergraduate aid goes down. The value of research versus undergraduate aid is an important debate – yet it is not discussed, in some cases no doubt because the prestige research universities do not want this information widely dispersed or a national dialogue on the research/teaching tradeoff.

The students and families looking at frozen Pell Grants, however, might look at opulent new laboratories and golf nets, and wonder about overhead charges that often exceed 40%. Higher education may be the only industry that regards overheard expenses of more than 15% acceptable. Higher education leaders howl that any tampering with research will undermine the economy and the strength of the nation.

Undebated policy questions are at least two. What about capping overhead at 15%? That could fund 951,852 Pell Grants! (Table 5) Then, what if five percent of health research, say from heart disease or lung cancer, shifted instead to community college workforce readiness – creating a 21st Century workforce, with high math skills. Would lifetime health costs to the government come down? It's a question worth exploring. The issue is *not* that we are reaching the wrong decisions on allocating resources, but *we are not even talking about the right questions*.

Table 5: Effect from Federal Research

2004 R & D Funding	$	25,700,000,000
Estimated Overhead Rate		30%
Amount spent on overhead	$	7,710,000,000
Cut Rate in Half to 15%		50%
	$	3,855,000,000
Current Full Pell Grant	$	4,050.0
New Pell Grants		951,852

So What? Why Focus On A Few Wealthy Institutions?

For better or worse, the elite universities set the pricing policies for the nation. A price hike in New Haven always finds its way to a community college in Iowa.

Put in terms of current performance measurement, if all the top colleges and universities are producing leaders with a responsibility to the public good, why is U.S. public education such a mess? The probable reply from the elites: “That’s not our mission”.

Again, so what? Through student loans, Pell Grants, research grants, and tax benefits, the elites receive billions per year in federal benefits. The avowed purpose of being a nonprofit institution of learning is the creation of some public good. Do institutions accepting these federal benefits have the right to pick and choose which national issues to tackle? For example, the Forum (not Commission) on the Future of Higher Education, is a registered non-profit organization with an annual Aspen Institute gathering of self-described elites. That group in September refused to invite Charles Miller, chairman of the Spellings higher education commission, to join their discussions. The Forum members represent billions in federal funding and benefits.

Should the Ivy League, Williams, Stanford and other private non-profits accept public dollars and opt out of essential national debates? If these institutions wish to opt out, so be it. Then the proper organizational form is a private club. Accept no public funds. Pay property tax. Be left alone. County clubs assess for buildings and repairs without tax benefits.

Otherwise, create a demonstrable public good for the nation, not just the immediate campus. Here is a possible solution: Effective immediately, the federal government eliminates the tax benefits for the Ivy League, and all liberal arts colleges with endowments greater than $500 million. The feds will restore benefits based on measurable results when US low-income students have literacy second to none.

What Is A Nonprofit? And What Is the Value of a Nonprofit? What is the Appropriate Tax Status?

"Nonprofit" is a misunderstood term that its industry wants to keep that way. Nonprofit does not mean an entity always operating at a cash deficit, while struggling to do God's work. Nonprofit only means that the founders did not create the entity with the purpose of generating profits to distribute to owners and shareholders. Law prohibits nonprofits from distributing profits or surplus cash to shareholders. That's all. Many, including Williams and Yale, have had income exceeding expense for years. And this is due to hard work and good management. The undebated policy question is whether donations to cash-surplus generating entities should continue unchecked in face of vast social needs in other sectors.

Should all nonprofit institutions have the same tax status regarding endowment income and donations? In a system where tax status varies by institution, factors in the determination of that status might be total wealth and surplus relative to operating budget, the number of need-based scholarships, or demonstrations of public service. Harvard, Yale, Williams, and others, have endowments generating enough income to eliminate tuition. This is due to hard work, immense alumni generosity, and superb investment management. Yet tuition rises and we continue to provide tax subsidies and freeze Pell Grants.

Harvard, for example, has great wealth, no known plans to educate more students, and low Pell Grants. Let them keep their money but make future donations only 25% tax deductible instead of 100%, and, say, tax five percent of endowment income. Almost all higher education classrooms are dark on evenings and weekends. As a policy, why not eliminate, for five years, tax benefits for donations on buildings? And, to create a deeper private resource pool for the nation, why not give donations to endow need-based scholarships a deduction of 125%?

With limited resources, should tax benefits accrue in equal measure to every institution? Our current national policy is a resounding "Yes." Home ownership, with deductible mortgage interest, is the major example of how federal tax policy can direct national priorities.

Nonprofits, Higher Education, and Endowments vs. Foundations

Also buried in the fine print is the distinction among nonprofits between endowments and foundations. For colleges and universities, among others, the portfolio of money and assets is an endowment. No federal regulations govern endowment growth and spending. Over the years, however, critics and Congress noted that many foundations, also tax exempt for donations and investment income, had growth in funds without increases in spending. Foundations are now subject to penalties if they fail to spend about five percent of their income per year. College and university endowments are not subject to this. No better illustration of the impact than from this September 25, 2006 press release announcing the 22.9% return on the Yale endowment, now $18 billion.

"*Spending from the Endowment in the University's 2006-7 fiscal year is expected to total $676 million, or approximately 34% of the University's net revenues. The Endowment is Yale's single largest source of budgetary support. The share of the operating budget provided by the Endowment has more than doubled in the last ten years.*"

What's unsaid: The $676 million is only a paltry 3.8% of the total endowment. (Table 6) The $676 million is a staggering sum, exceeding the total endowment of most U.S. colleges and universities. Contributing 34% to the university budget is substantial. The situation collapses, though, under any basic return on investment calculations, for financial or for moral capital. Over the past ten years, the Yale endowment has grown at an average rate, Yale says, of 17.2%. Undergraduate enrollment over the same period is flat, varying around 5,300. Graduate enrollment has risen from 10,964 to 11,483, including 24 students displaced by Katrina. With essentially no increase in the number of students attending Yale, why is this money piling up while Pell Grants freeze?

Table 6: Return on Assets

Yale Endowment Example	
Return for FY 2006	22.9%
Growing to	$ 18,000,000,000
Endowment Spending FY 06/07	$ 676,000,000
Percent of Net Yale Revenues	34%
Percent of endowment spend	3.8%
Growth over past ten years	17.2%
Undergrad enrollment growth over ten years	0%

A Modest Proposal: For Discussion Only

What's a tax policy that provides incentives for a population educated for the 21st Century? A tax policy as powerful as the mortgage interest deduction for home ownership? Not free PhDs for all, but just the basics.

Defining education is possible. Our proposal: A tax policy that ensures that 90% of US residents, by the time they are 20 years old, can pass the AP exams in English Language and Composition and in Statistics. That will put everyone on a path of their own choosing. Revising tax policy for private university contribution is one means of realizing this goal.

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