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Before the House Ways and Means Committee Subcommittee on Oversight

Hearing on the Rising Costs of Higher Education and Tax Policy

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Thank you, Chairman Roskam, and members of the subcommmittee, for inviting me to speak today, and for holding this hearing. My testimony focuses on the relationship between federal tax law and (1) the spending and endowment policies of U.S. colleges and universities; (2) the compensation of top college and university administrators; and (3) both of those and the costs of higher education.

Rising Education Costs

By nearly any measure, American colleges and universities are the best in the world. In the past decade or two, however, the costs of obtaining a college degree have grown substantially. In my research I find that net tuition, or tuition minus financial aid, grew by over 30% in real terms over a decade at a sample of selective colleges and universities.[2]

The rise in the costs faced by students track a growth in the costs universities themselves face. The Higher Education Price Index ("HEPI") is a measure of inflation for the basket of goods and services usually purchased by colleges and universities. Since the beginning of the millennium, HEPI has grown at about twice the rate of inflation in the overall economy.

Scholars who study education attribute this rapid inflation in large part to a problem known as cost disease. Briefly, cost disease occurs when productivity in some sectors of the economy rises slower than in others. In our modern era, this usually happens when one sector is highly dependent on skilled human inputs that can't easily be replaced or supplemented with automation. Health care is another major example of an industry that suffers cost disease.

As in health care, relatively weak mechanisms for price competition may also contribute to higher education's costs. It is difficult for "consumers" of education to directly observe education quality until they have already "consumed" it, and many of education's biggest benefits inure to those, such as employers and society at large, who do not pay directly for it. Prospective students often don't learn about

[1] Professor of Law, Georgetown University Law Center.

[2] Brian Galle & David Walker, *Nonprofit Executive Pay as an Agency Problem: Evidence from U.S. Colleges & Universities*, 94 B.U. L. REV. 1881 (2014). The sample covered 387 colleges and universities over a ten-year period from 1997 to 2007.

financial aid awards until quite late in the school application process. These factors make it difficult for schools to compete on price. Therefore it is not surprising that the "sticker" price for tuition before financial aid falls within a relatively narrow band for almost all private schools.

Relatedly, education costs may in some measure be driven by the preferences of college and university decision makers, rather than the consumers. Universities are mostly controlled by faculty and administrators with little oversight by outsiders, and studies suggest these insiders often prefer to compete on the basis of "prestige" and other measures of quality rather than on cost.

Effect of Endowments and Agency Problems on Student Costs

The cost factors I have described so far are deeply embedded in the nature and institutional arrangements of modern higher education. It is not obvious that government policies can have much short- to medium-term impact on these cost drivers. There may be other contributors, however, that could be more susceptible to influence from policy makers. Some of these more accessible cost-drivers, in fact, are arguably caused by existing, misaligned, government-made incentives.

The first of the misaligned incentives is university endowment policy. An "endowment" is simply a pool of savings that has been set aside, either by donors or the institution, for use in the future.[3]

Most colleges and universities have spending policies that are designed to keep the school's endowment growing, in real terms, forever. According to the National Association of College & University Business Officers ("NACUBO"), the average private school spends less than five percent of its net investment assets each year.[4] If you make a gift to your alma mater, and you restrict that gift to a particular purpose, most schools have a rule that will prohibit themselves from spending more than 5% of the gift in any year. These rules are intended to preserve the real, after-inflation, spending power of the initial gift or set-aside funds. In effect, the school is only spending investment earnings, and is never spending the gift principal.

Further, schools generally refuse to budget expenditures out of expected gifts. That is, even if the university has reason to expect that donations will increase, it

[3] Funds that are voluntarily set aside by the institution itself are sometimes referred to as "quasi-endowment" or "temporarily restricted" because in theory the institution could remove its own use restrictions, although this is very rarely done. According to NACUBO, quasi-endowment represents about 45% of endowment balances at private schools, and about 20% of endowment balances at publics.

[4] The most recent NACUBO study can be found at http://www.nacubo.org/Research/NACUBO-Commonfund_Study_of_Endowments.html.

spends only out of funds that have already been pledged. The result is that new gifts always expand the budget.

Overall, these growth plans appear to be working to create larger and larger endowments. Data from the U.S. Department of Education and NACUBO suggest that university assets and investment assets have grown a bit faster than HEPI on average, and accordingly more than twice as fast as overall inflation.[5]

Obviously, when an institution chooses to set aside some of its present revenues for the future, current students and other beneficiaries lose out. Money reserved for endowment could instead be spent on need-based financial aid, outreach to underserved communities, new teaching technologies, even cutting-edge research.

It is sometimes argued that endowment savings allow for greater long-run expenditures, as the investment earnings, when added up over time, eventually exceed the nominal value of the original gift. As Henry Hansmann, a professor at Yale Law School, has shown, this argument is wrong-headed.[6] Given that HEPI is rising faster than inflation, endowment savings are simply trading off cheap present purchases for more expensive future consumption. We can think of his point in terms of shopping for a new rug. The schools' policy is like saving up during a rug sale so that we can afford to buy the rug later at full price.

Endowments also do not manage themselves. Data on endowment management costs are not directly collected by any government agency, and so are limited to inference and anecdote. Recent popular press accounts suggest, however, that some schools pay more of their endowment funds to investment managers than they allocate to financial aid. The larger the endowment, the greater these costs become.

The appeal of endowments for university administrators may not just be their supposed power to expand future output. As David Swenson, the famed Yale endowment manager, has written, endowments give administrators relative freedom from dependence on government funders, current donors, and other "outside" influences.[7]

This freedom certainly has some virtues, but it also has costs. In my work with David Walker of Boston University, we find that college and university presidents with greater endowment wealth to draw on, or who are otherwise less

[5] Authors's calculation, based on the NACUBO-Commonfund 2014 study and the 2000–2010 Delta Public Release data from the National Center on Education Statistics.
[6] Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUDIES 3 (1990).
[7] David F. Swenson, PIONEERING PORTFOLIO MANAGEMENT 10–14 (revised & updated ed. 2009).

dependent on current donors, are more highly compensated than others.[8] Prior researchers have made similar findings.[9] While there can be several possible explanations for these results, one plausible story is that administrators with fewer constraints feel freer to take higher salaries and more perks.

Of greater concern, administrators' desire for the freedom to receive more compensation may drive policies that increase some aspects of education spending. For example, Professor Walker and I also find a correlation between gross and net tuition and president's compensation. Presidents who are under more pressure from donors, we find, also tend to expand enrollment, perhaps as a way of justifying their award packages or of collecting more total tuition dollars.[10]

Federal Tax Law Contributes to University Endowment Policies

Federal policies intended to underwrite charitable activity have had the inadvertent effect of encouraging donors and the institutions they support to postpone the expenditure of donated dollars. The federal government and most states allow taxpayers to reduce their taxable income by the amount of any donation to an eligible charity.[11] Similarly, decedents' estates can deduct the amount of any money left to charity from the amount subject to federal tax.[12] Donors receive these deductions at the time of the donation, regardless of when the donee charity actually expends the funds (and regardless of any restrictions on sale the donor may impose on the gifted assets). Charitable organizations, including most colleges and universities, are also exempt from the federal corporate income tax. This allows for tax-free growth of endowments.

As Professor Daniel Halperin has shown, this combination of rules strongly incentivizes delayed spending.[13] By contributing their investment assets to a foundation earlier than they want the funds spent, donors can allow those investments to grow tax-free. In contrast, if they held the investment themselves, they would often have to pay tax on any appreciation. The longer the university,

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[8] Brian Galle & David Walker, *Nonprofit Executive Pay as an Agency Problem: Evidence from U.S. Colleges & Universities*, 94 B.U. L. REV. 1881 (2014).
[9] *E.g.*, John E. Core et al., *Agency Problems of Excess Endowment Holdings in Not-for-Profit Firms*, 41 J. ACCT. &
ECON. 307 (2006).
[10] Brian Galle & David Walker, *Donor Reactions to Salient Disclosures of Nonprofit Executive Pay: A Regression-Discontinuity Approach*, 44 NONPROFIT & VOLUNTARY SECTOR Q. __ (forthcoming 2015).
[11] IRC § 170(a).
[12] *Id*. § 2055.
[13] Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 TAX L. REV. 283 (2011).

rather than the donor, holds the assets before spending, the larger is this tax subsidy.[14]

A less-familiar aspect of the rule allowing full deductibility for restricted gifts is that it facilitates tax planning. Donors can contribute at the moment that the deduction will generate maximum value—usually when their tax rate is highest or the value of the assets they are contributing is at its peak—without having to trade off that goal against their preference for when to fund charitable projects. Similarly, a donor who otherwise intends to fund projects arising after her death can double her tax benefit by making a restricted gift during life, allowing her to reduce both income and estate taxes.

Why Congress Should Reduce Tax Incentives that Increase Endowment at the Expense of Current Education Consumers

Whether or not endowments are a good idea for universities, Congress should reconsider the tax rules I've just described. In general, in a well-functioning market we should expect private actors to make decisions that maximize their own welfare. Current tax law distorts the decisions of educational institutions and their supporters, to no apparent good policy goal.

Certainly there is no obvious argument for why society would prefer that colleges and universities save *more* than those institutions would themselves choose. Most of the institution's constituents have reasons to desire some level of precautionary savings. Students and alumni, for example, know that their alma mater's name will appear on their resume for most of their life. They want some assurance that the school will maintain or increase its quality and reputation over time. And administrators, we saw, may have their own reasons for wanting to build endowment.

Furthermore, gifts that are held perpetually in an endowment are not a cost-effective way to subsidize charity. The tax cost to the government of a perpetually restricted gift, in present-value terms, can be as much as double the cost of an unrestricted gift. Most current estimates of the cost-effectiveness of the charitable

[14] Prof. Halperin acknowledges the counter-argument that other tax rules might allow for effectively the same treatment, but this is an unnecessary concession. Donors who contribute publicly-traded stock to a foundation can deduct the full value of the gift without paying tax on their built-in gains, seemingly achieving the same end result as early contribution. To avoid all tax on her donated assets, though, the donor must never exchange them, from the day she acquires them until the day they are donated. This lock-in is itself economically costly, since it prevents the donor from switching away from under-performing investments. At the margin, we would expect donors to accept a lock-in cost of just a hair short of the full amount of the tax saved. So the ability to contribute built-in gain securities with no tax is less valuable than it appears at first glance.

contribution deduction suggest that the deduction on net delivers more than a dollar of charity for each dollar of government subsidy, but only barely so.[15] Halving the deduction's efficacy would leave it far short of that important policy threshold.

I do not mean to suggest that universities should not have endowments. It is entirely sensible for an organization with a large, relatively fixed budget to maintain a pool of money set aside for future needs, in case times get tight. But modern universities are taking their rainy day savings to absurd extremes. Consider Harvard's 2013 tax return, the most recent available. Harvard reports roughly $4 billion in annual expenditures against about $49 billion in investment assets. If Harvard ceased bringing in any revenue of any kind tomorrow—perhaps shifting all its investments to cash, and declaring that all students will attend for free—it could still keep spending at 2013 levels for another *12 years*. And this ignores Harvard's considerable ability to borrow against existing capital assets and future potential revenues. It is, in other words, hard to imagine that endowments of this size can be justified by any realistic "rainy day" scenario.

Endowments are also a means of transferring current wealth, including taxpayer supports, to the future, but it is unclear either why we would want such transfers, or why we would choose endowment savings as a way to make them. Future society is likely to be considerably wealthier than ours is today, increasing money available to donate to higher education, increasing demand for education, and perhaps reducing its marginal returns. If anything, this implies that schools today should be borrowing against future wealth.

Moreover, even if transfers to the future were desirable, we have much better investments available than endowment savings: today's students. Studies suggest that the future social returns on expanding access to higher education can exceed financial returns by a good bit, especially when one accounts for the cost of seeking out and managing those financial returns. Need-based aid and outreach to underserved communities can pay much better than a hedge fund can.

Policies to Increase College & University Spending on Current Needs

Congress has several alternatives for mitigating existing tax incentives for endowment build-up. While there are strengths and weaknesses of each approach, I would recommend emphasizing options that focus on reducing the value of charitable contribution deductions tied to gifts that will be spent out over long periods.

[15] Jon Bakija, *Tax Policy and Philanthropy: A Primer on the Empirical Evidence for the United State and Its Implications*, 80 SOC. RESEARCH 557 (2013).

Under this proposal, a donor's charitable contribution deduction would be reduced by some fraction, perhaps 100%, of the excess tax value created by any time restrictions attached to the gift by the donor or the donee institution. For example, government might calculate how long it will take to spend out a gift at current spending levels, compute the present value of the extra tax benefit (relative to immediate spending) the donor is getting as a result, and multiply this amount by some fraction, such as 50 or 100%. The resulting amount is subtracted from the amount deductible. Because of the relative complexity of this method, it might be applied only to gifts of some size, such as $10,000 or above, for which the donor can be presumed to have sound legal advice.

To illustrate, suppose that in year one donor A makes a restricted gift of $1 million to a university Z. University Z has a rule under which only 10% of the value of a restricted gift may be spent in a given fiscal year. Under prevailing rates of return, this gift will take, say, 20 years to spend. Let us assume that the discounted present value of exempting 20 years of investment returns is $100,000. Donor A would reduce her charitable contribution deduction in year one from $1 million to $900,000.

A simpler but otherwise less appealing policy would be to impose a tax on "excess" endowment balances.[16] An "excess" balance can be defined as an amount above the amount needed to sustain current spending for some period in the event of reasonably expectable declines in the institution's revenues. A typical reserve fund of this kind might hold on the order of fifty percent of a full year's expenditures.

Taxes on endowment have several potentially serious economic side-effects. An endowment tax, if imposed without any additional correctives, could actually reduce current spending levels. Managers with a target level of endowment might "pay" the tax out of current expenditures, rather than out of endowment earnings. In addition, an endowment tax may reduce managers' incentives to invest the endowment at the optimal level of risk, and to err instead on the side of excess conservatism.

A third alternative, previously considered by this body in 2007 and 2008, would be extend to universities the private foundation rules requiring an annual minimum payout of net investment assets. I believe that minimum payouts are an important constraint on private foundations, and indeed that current required payout levels are probably so low that they are allowing the private foundation

[16] Taxes on endowment balances are clearly superior to taxes on endowment returns. *See* Daniel Halperin, *Tax Policy and Endowments: Is Excessive Accumulation Subsidized? (Part II)*, 67 EXEMPT ORG. TAX REV. 125 (2011). A tax on endowment returns of any significant size will, like any tax on capital, distort the institution's choice of investments and the timing of their purchase and sale.

sector to grow excessively large.[17] Further, minimum payouts should be extended to organizations that largely mimic the purposes and functioning of private foundations, such as the so-called donor advised funds.

However, payouts may not be an ideal fit for operating charities. Again, colleges and universities have large and relatively inflexible annual budget commitments. A private foundation can simply curtail its grant-making activities if its budget drops unexpectedly and there are not adequate reserves; universities cannot easily cut enrollment or payroll. Payout floors arguably might not provide adequate fiscal flexibility in those circumstances, even if calculated on a rolling average of several years rather than the current one-year period.

Payout floors may be a useful complement to an endowment-balance tax, however. To the extent that endowment taxes may tend to depress spending out of endowment, a mandatory payout could reduce the degree to which taxes displace endowment spending.

Tax Policy and Executive Compensation

As I discussed earlier, both government tax policy and university endowment policy are intertwined with pay practices for top administrators. Endowments and tuition payments each may tend to facilitate greater pay awards, and administrators may manage their institution in ways that maximize cash flows that are most likely to allow the administrator to maximize pay. Pay of top college and university executives has grown quite rapidly in the past decade and a half. In the sample of colleges and universities I studied, total compensation rose by an average of about seven percent per year in real dollars over the period 1997 to 2010.

Federal tax law may have contributed to this growth both indirectly, through its effects on endowments, and also more directly as well. In 2001 the IRS finalized regulations interpreting section 4942 of the Internal Revenue Code, the so-called "intermediate sanctions" regime. These are the rules that say a private school can pay a penalty for over-paying its top administrators. Under the regulations, schools get the benefit of the doubt if they can show that the board of trustees examined other presidents' compensation awards and determined that their own executive's was "comparable" to the others'. Of course, no one wants to announce to the world that their president is below average, and so there is a tendency for a ratcheting effect. My research with Professor Walker shows pay started going up much faster

[17] Brian Galle, *Pay It Forward? Law and the Problem of Restricted-Spending Philanthropy*, 92 WASH. UNIV. L. REV. __ (forthcoming 2016).

in 2002, after the IRS issued that rule.[18] This may be a coincidence, of course, but the timing is at least rather suggestive.

This is an area where my research suggests the market, with some small assistance, might work as well or better than government oversight. Professor Walker and I find that when we make it easy for donors to know what the president of the institution they support is being paid, they will respond fairly quickly if they think she's getting too much.[19] Instead of asking schools to construct elaborate evidence of "comparable" pay, the law might simply do more to encourage timely and complete disclosure of president's pay packages, including items that currently are usually highly opaque, such as housing, travel, and some retirement benefits. For instance, a revised section 4942 might make such disclosures, rather than reliance on "comparables," the basis for a presumption that the president's pay is reasonable.

Under present law this solution will work only for private universities. The 4942 regulations exempt public universities from the intermediate sanctions regime entirely. The reasons for that exception are unclear, but appear to derive from comments during the rule-making process in which some public universities argued that they would be able to obtain tax-exempt status as an arm of their respective states, rather than under section 501(c)(3). Congress should clarify that, whatever the source of an organization's tax exemption, eligibility for deductible contributions carries with it the obligation to comply with the rules against self-dealing and excessive compensation set out in section 4942.

Conclusion

Thank you again for inviting me to testify today. I hope that my perspective on these issues helps the Committee as it thinks about the difficult problem of higher education expenses.

[18] Brian Galle & David Walker, *Nonprofit Executive Pay as an Agency Problem: Evidence from U.S. Colleges & Universities*, 94 B.U. L. REV. 1881 (2014).
[19] Brian Galle & David Walker, *Donor Reactions to Salient Disclosures of Nonprofit Executive Pay: A Regression-Discontinuity Approach*, 44 NONPROFIT & VOLUNTARY SECTOR Q. __ (forthcoming 2015).