The Tax Cuts and Jobs Act of 2017 imposed a tax on the investment income of a small number of private nonprofit colleges and universities with large endowments. This action followed years of grumbling in Congress about wealthy institutions, their endowments, and their tuition prices. Understanding how endowment assets are distributed across institutions, why institutions build endowments, and the arguments for and against subsidizing higher education by exempting endowment income from taxation sheds light on the merits of this policy change.

As with many other issues, the discussion of college endowments is too often based on extremes. Either nonprofit postsecondary institutions bestow large social benefits and any effort to tax them diminishes their capacity to generate these benefits, or wealthy colleges and universities are gouging students, accumulating inordinate wealth, and exacerbating inequality in the United States. A more nuanced approach would recognize the complexity of the issues and provide stronger grounding for engaging in a more productive discussion of public policy and its impact. The question is not whether colleges and universities—or the spending from their endowments—further the public good. The question is whether the current subsidies that support endowment growth are appropriate, given the dramatic inequality of resources across postsecondary institutions, and whether modifying this policy is a promising route to accomplishing positive social change.

The imposition of taxes on selective educational institutions appears to be at least partially politically motivated, arising out of partisan anger at colleges and universities. But some advocates of these policies are trying to design incentives to change institutional behaviors, generating lower tuition prices, more generous financial aid, or more socioeconomic diversity on campuses. Others argue that the public subsidies represented by the tax exemption should be redirected to have a greater impact on social welfare.
Colleges and universities are concerned about losing funds that could otherwise be devoted to their educational mission, but they also see this tax as a foot in the door, setting a precedent for further compromising the tax-exempt status of nonprofit higher education institutions and for federal attempts to control their decisions.

The discussion in this brief and the analysis on which it is based lead to the conclusion that it is vital that the inequality of resources across educational institutions be diminished. But if the goal is to increase college access, affordability, and success, taxing endowments is unlikely to be effective. Instead, the focus should be on increasing subsidies to low- and moderate-income students and the institutions that educate them.

A Small Number of Colleges and Universities Hold Most of the Endowment Assets

A few colleges and universities have large endowments, but most have small endowments that do not contribute substantially to their annual revenues. At the end of academic year 2015–16, US colleges and universities held endowment assets totaling more than $530 billion. About 40 percent of these assets belonged to 20 private nonprofit research universities, and 20 percent of the total belonged to just four institutions.

Ten institutions (out of 3,300 public and private nonprofit colleges and universities), including three public university systems, had endowments exceeding $10 billion, and 100 had endowments greater than $1 billion.¹

In other words, endowment assets are unequally distributed across higher education institutions. Based on typical annual spending rates of about 4.5 percent of the endowment’s value, the endowments of the 11 wealthiest private research universities, enrolling 10 percent of students in the sector, provide an average of about $67,000 per student per year. But the institutions with the lowest endowments, where half of this sector’s students are enrolled, average less than $2,000 per student in income to the annual budget from this source. Endowment wealth at private bachelor’s colleges is similarly skewed. At master’s universities, where there is less wealth and the gaps are smaller, average endowment income in the top 10 percent is still almost nine times the average for the bottom half.

The endowments of the wealthiest public research universities, enrolling 10 percent of students in the sector, provide about $6,200 per student per year. Those in the lower half of the distribution ranked by endowment per student, where 50 percent of this sector’s students are enrolled, have, on average, about $400 per year per student to spend from this source.

Measuring Endowments

Endowments may be measured in dollars, in dollars per student, or relative to annual spending. An endowment of a given size provides greater opportunities to small colleges than to larger institutions,
and research university endowments support a wider range of activities than the endowments of undergraduate colleges. Moreover, there is wide variation in the debt levels of institutions with similar endowments, creating significant differences in their actual wealth.

Ranking institutions by endowment per student is different from looking only at the total size of their endowments. For example, Harvard University’s $36 billion endowment in fiscal year 2017 was one-third larger than Yale University’s (second on the list at $27 billion) and 50 percent larger than Princeton University’s (fifth on the list at $24 billion). But because Harvard enrolls almost four times as many students as Princeton,² its endowment per student was about 60 percent less. Moreover, about two-thirds of Harvard’s students are graduate students, compared with just one-third of Princeton students. Because graduate students are more expensive to educate, even this comparison understates Princeton’s wealth relative to Harvard’s.

The ratio of endowment value to annual spending varies quite a bit, even among institutions with the largest endowments. For example, Princeton’s endowment is about 12 times its annual budget, but Harvard’s and Yale’s are about 7 times as large, and Stanford University’s is a little more than 4 times as large as the budget. Pomona College’s ratio is close to 10, but Bowdoin College’s and Wellesley College’s are about 6.

Because most colleges and universities have small endowments, institutions in the private nonprofit sector cover most of their budgets with tuition revenues, with small supplements from endowment income, which, on average, covers less than 10 percent of the total. But Harvard and Yale cover about one-third of their annual budgets, and Pomona covers about 40 percent of its budget, with the earnings from their endowments.

**Student Incomes, Financial Aid, and Net Prices**

In both the public and private sectors, well-endowed institutions enroll smaller shares of students whose low incomes qualify them for federal Pell grants than less-affluent institutions. In the private nonprofit four-year sector, nearly half of students at institutions in the lowest decile based on endowment per student receive Pell grants. In contrast, 15 percent of students at the wealthiest colleges and universities are low income. The pattern is the same at public four-year institutions, though the range is smaller (figure 1).
FIGURE 1A
Share of Students Receiving Pell Grants, by Deciles of Endowment Assets per Student, Private Nonprofit Four-Year Institutions

FIGURE 1B
Share of Students Receiving Pell Grants, by Deciles of Endowment Assets per Student, Public Four-Year Institutions

Note: FTE = full-time equivalent.
But the wealthiest institutions provide generous need-based aid to the low-income students they do enroll, charging considerably lower net prices to these students than they would pay at other colleges and universities (figure 2). High-endowment schools charge very different net prices to low-income and high-income students. High-income students at the wealthiest schools, on average, paid more than $40,000 for tuition and fees, books and supplies, room and board, and other living expenses in 2015–16. The lowest-income students at the same institutions paid an average of less than $7,000. The pattern in the public sector is similar. Low-income students who enroll at wealthy, selective institutions pay less than their more affluent peers and less than they would pay at public institutions with smaller endowments.

**FIGURE 2**

Average Net Price by Family Income and Decile of Endowment per Full-Time Equivalent Student, Private Nonprofit Four-Year Institutions, 2015–16


Note: Average net price is total cost of attendance less average grant aid from federal and state governments, in addition to institutional grant aid.
As the differences in net prices resulting from financial aid policies indicate, the share of students receiving Pell grants, even if it were a perfect measure of the share of low-income students on campus, would not be an adequate measure of the extent to which colleges and universities subsidize low- and moderate-income students. Moreover, institutions with large per student endowments, which draw income from their endowments to add to their operating budgets, provide significant subsidies to all enrolled students, including both those who pay the full sticker price without the benefit of financial aid and those who can afford to attend only with generous financial aid.

Nonetheless, it is clear that students attending institutions with large endowments are disproportionately academically well-prepared students from households that are not near the lower end of the income distribution. There may be limits on how much institutions can change this pattern without changing their admissions criteria, but there is strong evidence that many qualified low-income students do not enroll in the selective institutions for which they would qualify (Hoxby and Avery 2013; Pallais and Turner 2006; Winston and Hill 2005).

**Why Do Colleges and Universities Accumulate Endowments?**

Colleges and universities use their endowments to support a wide range of activities with social benefits. In addition to educating undergraduates from diverse socioeconomic backgrounds, many institutions subsidize research, public service, and graduate students, activities that are central to the charitable mission of higher education.

Like other private nonprofit and public entities, educational institutions build and maintain endowments to supplement other revenues in supporting current expenditures and to protect against temporary declines in revenues, disruptions in financial markets, and unanticipated major expenses. Endowments ensure that institutions can maintain their operations over the long run, enabling them to subsidize the education of successive generations of students. If they were to spend down their endowments, these supplementary revenues would no longer be available. Endowments can also, especially at large universities, help finance the expansion of an institution’s activities.

**Why Is the Income from College and University Endowments Exempt from Income Taxation?**

The tax exemption on endowment income is a subsidy in the form of a tax expenditure, affecting the federal budget the same way direct payments to these institutions would. Colleges and universities with large endowments would have large tax bills in an alternative universe where charitable organizations paid taxes on their investment income. The federal treasury is sacrificing that income in the interest of subsidizing charitable activity. But it provides little subsidy to institutions with minimal endowments.
This distribution of subsidies across institutions raises questions regardless of the extent of the social benefits colleges and universities generate. But understanding those social benefits, which extend beyond the provision of opportunities to low-income students, is critical to evaluating the tax exemption on endowment income.

Colleges and universities educate graduate students, produce and disseminate research, promote intellectual inquiry and cultural engagement, and contribute to their communities. Their educational mission defines colleges and universities as charitable organizations. Improving the circumstances of the less privileged members of society contributes to, but does not determine, this status. Many charitable organizations disproportionately serve affluent people. Public subsidies to museums, orchestras, operas, and other cultural organizations serve an important purpose. But they do not target the neediest members of American society.

Because of the long-standing tax exemption on income from the endowments of charitable organizations, it is not surprising that higher education administrators view the idea of any tax on this income as a penalty and an abrogation of important principles. Singling out colleges and universities, as opposed to other nonprofits, contradicts the established definition of charitable organizations, which is clear about the centrality of education.

But some observers contend that current students are poorly served by underspending from endowments and that the federal government should not encourage institutions to direct resources away from the provision of educational opportunities for current students. In particular, if institutions cut their budgets in economic downturns to protect their endowments, they may not be allowing these funds to serve their intended purpose. The social benefits of increasing educational attainment are high, and the return to need-based aid and expanded enrollment and success among underserved students could accelerate growth and options for future financing.

Some studies suggest that institutions do cut spending in the face of negative shocks to the endowment but leave spending unchanged when endowments experience high rates of return (Brown et al. 2014). But between 2009 and 2011, average spending rates at high-endowment institutions rose, indicating an effort to maintain spending levels in the face of endowment losses.

Endowment income supports subsidies to all students, allowing colleges to charge prices that do not cover the full cost of education. Comparisons across types of institutions within the private nonprofit four-year sector shed light on the relationship between endowment levels and the subsidies benefiting students. In 2015–16, on average, at private research universities, where endowments averaged $206,000 per student (with a median of $55,000), net tuition and fee revenue covered only 54 percent of education and related expenditures, with students receiving a subsidy covering the remaining 46 percent. In contrast, at private master’s universities, where endowments averaged only $21,000 per student (with a median of $14,000), tuition and fees covered 84 percent of education and related expenditures, and students received a subsidy covering only 14 percent of the total.

Another perspective on these subsidies comes from comparing their value to total expenditures. In most sectors, the average share of total expenditures covered by savings from tax exemptions is less
than 25 percent (table 1). At high-endowment private nonprofit institutions, close to half of expenditures may be covered by the savings. These estimates suggest that a significant portion—but far from all—of these institutions’ budgets would have to be devoted to charitable activities to justify the subsidy from the government.

### TABLE 1
Estimated Revenues from Donations and Exemption from Corporate Income Tax Relative to Selected Expenditures

<table>
<thead>
<tr>
<th></th>
<th>Implicit subsidy from exemption of income from endowments from federal corporate income tax</th>
<th>Private gifts</th>
<th>Corporate income tax exemption plus private gifts</th>
<th>Expenditures on education and related activities, research, and public service</th>
<th>Subsidy/expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public research universities</td>
<td>$894</td>
<td>$5,810</td>
<td>$6,704</td>
<td>$115,882</td>
<td>6%</td>
</tr>
<tr>
<td>Private nonprofit research universities</td>
<td>$3,887</td>
<td>$11,294</td>
<td>$15,181</td>
<td>$71,139</td>
<td>21%</td>
</tr>
<tr>
<td>Private nonprofit master’s universities</td>
<td>$289</td>
<td>$2,308</td>
<td>$2,597</td>
<td>$26,877</td>
<td>10%</td>
</tr>
<tr>
<td>Private nonprofit bachelor’s colleges</td>
<td>$799</td>
<td>$3,765</td>
<td>$4,564</td>
<td>$18,681</td>
<td>24%</td>
</tr>
<tr>
<td>Average of sample of highest-endowment private nonprofit institutions</td>
<td>$217</td>
<td>$312</td>
<td>$529</td>
<td>$1,140</td>
<td>46%</td>
</tr>
</tbody>
</table>

Source: Author’s calculations from Integrated Postsecondary Education Data System data.
Note: Values are in millions of dollars.

**Why Is There a New Tax on Endowment Income, and Where Might It Lead?**

Criticism of large endowments and the way they are managed comes from all parts of the political spectrum. The notion that the new endowment tax may result from Republicans wanting to punish what they perceive to be left-leaning institutions does not explain the views of those on the left who wish to tax endowments as a strategy for reducing inequality and increasing social mobility.

The income tax bill Congress passed in 2017 imposed a 1.4 percent tax on endowment income for private colleges with at least 500 students and at least $500,000 in endowment per student. Some proposed policies directed at colleges and universities with large endowments are designed to provide incentives for institutions to change their behavior. They may impose lower taxes on those that enroll more low-income students, provide more financial aid, or charge lower tuition prices. Others, such as the tax included in the 2017 bill, simply transfer funds from institutions to the government. Some proposals would earmark the revenue generated for spending designed to increase educational opportunities.
Even if there were consensus that at least some portion of the income of some institutions’ endowments should be subject to federal income taxation, the existing tax is poorly designed, incorporating sharp differences in treatment for institutions in similar circumstances. A small change in either the value of the endowment or the number of students enrolled can have a dramatic impact on the tax owed. An institution with a $600 million endowment and 1,200 students would pay a tax of more than $400,000. But an institution with the same endowment and 20 more students would pay no tax.

Policymakers, researchers, and others have offered numerous proposals, taking different approaches to designing a tax on endowment income as a strategy to convince institutions to do more to make college affordable or to increase socioeconomic diversity.

Rewarding institutions for spending a higher share of their endowment income on financial aid may sound like a good idea but is unlikely to increase educational opportunities. An institution that raises both its tuition price and its aid per student by $1,000, leaving its net tuition revenue unchanged, would end up with a higher share of its endowment income devoted to financial aid, but students would not pay lower prices. High-endowment colleges and universities could find more qualified students with financial need and spend more of their resources on educating those students, but simply requiring more spending on financial aid is unlikely to yield the desired effects.

Providing incentives for lower published tuition prices is even more problematic. The reality is that if Harvard, Yale, and Williams College were to reduce their sticker prices, only students who pay full price, who come from affluent families, would pay less than they now do. It is difficult to argue that this change would have a meaningful positive impact on the educational opportunities available to students with limited resources.

These proposals may be appealing in their explicit efforts to promote changes that would increase educational opportunities for disadvantaged students. But in addition to representing questionable intrusion into the operation of private nonprofit institutions, they would be ineffective. Any such provisions are likely to create a bureaucratic morass that adds to colleges’ administrative costs without generating meaningful new educational opportunities.

These arguments do not diminish the importance of reducing inequalities in educational opportunities based on socioeconomic background. Well-resourced institutions and government at all levels have a responsibility to more effectively address this problem. But attempts to use federal policy to reallocate institutional expenditures from one goal to another are not likely to be effective.

Conclusion

Colleges and universities should not assume that because they provide clear social benefits, all their revenues, expenditures, and activities should qualify for public subsidies. They should think about the arguments for and against basing the size of public subsidies on institutional wealth. Perhaps the most compelling argument for modifying public subsidies to colleges and universities through the tax system is that taxpayers are providing large subsidies to wealthy institutions that educate predominantly
students from affluent backgrounds and almost exclusively students with strong academic backgrounds who are likely to end up doing well financially. The tax system does not provide the same subsidies to students at less well-endowed private nonprofit and public institutions, which educate most students from less privileged backgrounds, many of whom will struggle even to complete college.

There would be a social benefit to increasing the number of low- and moderate-income students enrolled at high-endowment institutions that offer unique educational opportunities and award credentials that are well rewarded in the labor market, but changes in pricing and aid policies of the few wealthiest institutions will not bridge the gaps in educational opportunity facing students from disadvantaged backgrounds. For students with the most limited financial resources, the net price of attendance is frequently lower at these institutions than even at community colleges. Moreover, with few exceptions, the students who attend these institutions do well after college, regardless of their socioeconomic background, so providing this select group with more support is not likely to significantly reduce inequality or increase social mobility (Chetty et al. 2017).

Colleges and universities have broader missions than educating undergraduate students. Many also educate graduate students, conduct research, and engage in other public service activities. Subsidizing the education of low-income undergraduates represents only a fraction of the social benefits these institutions generate. Colleges and universities with significant financial resources could do more to address inequality, but taxing them is unlikely to be the most constructive way to accomplish this goal.

Federal expenditures are a more reasonable approach to furthering this effort. More generous public funding of underresourced institutions and their students, through increases in the Pell grant program or funding for institutions through new federal support programs, are more promising solutions.

The political opponents of higher education, the advocates for a laser focus on subsidizing low-income students, and the higher education community striving to protect its tax-exempt status could all benefit from thinking in a more nuanced way about endowments and public policy.

Notes


2 US Department of Education, College Navigator.

References


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