



The Daily Dish

Taxing Endowments

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For a variety of reasons ranging from [high tuition](#) to [campus protests](#) to notions of [fairness](#), the idea of taxing college endowments has gained some attention recently, including in the form of legislative proposals to tax the [value](#) of the endowment or the [annual income](#) generated by the endowment. (As an aside, the 2017 Tax Cuts and Jobs Act required colleges and universities with more than 500 students and endowments larger than \$500,000 per student to pay a tax of 1.4 percent on endowment income. In 2021, [33 schools](#) paid the tax.)

How should one think about this idea? Let's start with the impact of a tax on the value of the endowment. What decisions does this affect and who bears the ultimate burden of such a tax?

Colleges operate like other firms in the economy, using capital and labor to produce goods and services. Specifically, a school takes tuition (net of financial aid) and donations and uses these resources to pay capital (classrooms, dorms, etc.) and labor (professors, administrators, maintenance, etc.) to produce education services.

Now, colleges could insist that all donations apply to each year and apply each year's receipts to that year's operating costs. But not all donors want to give a bit each year. For a variety of reasons, some donors want to give a large chunk of wealth at a single point. The school is happy to provide a second service: financial management services that accept the endowment of wealth and effectively transform it into an annuity that provides funds to cover operating expenses. This is the key insight: The endowment is the result of a service valued by the donors.

What happens if you levy a tax on the value of the endowment? In the absence of a way to give the money back to the donors and start over, the existing money in the endowment is "sunk" and cannot be changed. The tax will reduce the resources available from the annuity

and the shortfall will be shifted to either the labor (lower wages) or the students (higher tuition or lower financial aid).

What about new donations? Donors will still want to give in large chunks, but there will be no reason to rely on college-based endowment as the means to turn it into an annuitized gift. Some other financial entity can easily step in and provide such a service. The financial service of annuitizing the gifts will be shifted outside the colleges and universities and the annual gifts will flow unimpeded - and untaxed.

In short: In the near-term, the students and university employees will bear the brunt of the tax, while over the longer term the tax will fail to raise any revenue and will only make donors worse off by forcing them to re-configure their affairs with new financial management. (The same analysis will apply to a tax on the earnings from the endowment.)

This may not be what the proposal's authors had in mind. But it does raise a second important question: Should colleges be tax-exempt to begin with?

Tax scholar Scott Hodge recently kicked up a bit of a furor with his [paper](#) on taxing the non-profit sector. But at its core were two entirely sensible observations. First, "Many industries exempted from the income tax were designated as such in the Wilson-Gorman [Tariff Act](#) of 1894 and the Tax Act of 1909, but they reflect the social norms of the 19th century, not our 21st century economy." Second, "The tax-exempt sector is overdue for review and reform. The U.S. needs a principled, rules-based approach to 1) distinguish between benevolent organizations and tax-exempt businesses, and 2) level the playing field between the business activities of nonprofit and for-profit entities."

The tax treatment of endowments and endowment income should flow directly from such a re-classification, with those of social merit being tax-exempt and the remainder taxed under the same rules for taxing capital and capital income as other firms in the economy.

Tax policy inevitably boils down to a combination of value judgments and understanding the complex reactions of the overall system to a tax. Taxing endowments is no different.