Testimony for the Record
Submitted to the
United States Senate Committee on Finance
for the September 26, 2007
Hearing on Offshore Tax Issues: Reinsurance and Hedge Funds

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October 10, 2007

Introduction

On behalf of the higher education associations listed above representing approximately 4,300 two- and four-year public and private colleges and universities, we are submitting this written testimony on college and university endowments for the September 26, 2007 hearing record. We appreciate the opportunity to submit this testimony to address testimony received by the Finance Committee which presented an incomplete and inaccurate picture of college and university endowments. In addition, we are responding to public policy proposals offered in witness testimony that would significantly harm the ability of colleges and universities to effectively manage their finances for the benefit of current and future students and faculty and the public good that higher education serves. While it is helpful that we are given the chance here to address the hearing testimony, it is unfortunate that the higher education community was not permitted the opportunity to present a live witness with experience and expertise managing endowments to the Finance Committee.

Endowments and Their Importance to Higher Education

Endowments are critical to sustaining high quality and excellence in American higher education. For over 350 years, endowments have supported the mission of colleges and universities by providing funding to: assist students; hire faculty; conduct research; construct facilities; and carry out other educational activities that would not have been possible if institutions had to rely solely on tuition, direct private philanthropy, or government funding.

Testimony by Jane Gravelle of the Congressional Research Service and Lynne Munson of the Center for College Affordability and Productivity created the mistaken impression that endowments function like simple savings accounts for colleges and universities that can be spent by an institution however and whenever it chooses. This is simply inaccurate. In fact, an endowment typically consists of hundreds - and in many cases, thousands - of individual funds provided by charitable gifts, as well as some institutional funds that are invested to support the institution's mission in perpetuity. An endowment provides donors the opportunity to transfer private dollars to public purposes with the assurance that their charitable gifts will serve these purposes for as long as the college or university exists.

A significant portion of an endowment is usually restricted by donors for specific educational or research purposes. A typical endowment gift includes legal restrictions regarding the use of the funds and the spending of revenue generated by the invested gift. At public institutions, an average of 80 percent of endowment assets were restricted in 2006, and at private institutions, an average of 55 percent of endowment assets were restricted. (See National Association of College and University Business Officers (NACUBO) 2006 Endowment Study). While some may mistakenly believe institutions "hide" or "hoard" money in restricted accounts to avoid spending it, colleges and universities actually prefer unrestricted donations which provide them with the greatest flexibility to use funds that best achieve their mission over time.

Donor restrictions are included in the legal documents that establish an endowment fund, creating binding terms for the manner in which the college or university may spend the donor's gift. For example, an institution is legally prohibited from spending funds on student financial aid from revenue generated from an endowment fund established by a donor to support cancer research or a professorship in a particular subject. In addition to donor imposed restrictions, there are also external restrictions that affect the payout of endowments. For example, the Uniform Management of Institutional Funds Act (UMIFA) has been recently amended and has already been adopted as modified by several states. UMIFA was modified to provide that if a payout from a fund exceeds seven percent, the fiduciary to the fund may be in violation of the Act's prudent management standards.

Moreover, of the approximately 4,300 U.S. nonprofit colleges and universities, most do not have endowments. Institutions that have most vibrant endowments are typically public or private research universities or private liberal arts colleges. For institutions with an endowment in 2006, the median endowment value was $79.8 million. (See 2006 NACUBO Endowment Study).

How Endowments Function

Endowment funds are typically created and managed to exist in perpetuity. A college or university manages its many individual endowment funds for the long-term by investing in a variety of financial instruments in order to control risk and provide for sustained returns that will support the educational and research missions of the institution. College and university endowments typically comprise some balance of the following type of investments: bonds, mutual funds, stocks, hedge funds, real estate, natural resources, and venture capital.

Institutional trustees charged with managing endowments are obligated to fulfill their broader fiduciary duties to their institution and seek to balance competing needs for the benefit of the institution. They must balance current spending needs and operations while seeking to provide for future needs. Most trustees and university endowment managers for the past few decades have strived to achieve what is known as "intergenerational equity," the principle that future students should be able to benefit from an endowment to the same degree that current students do.

Moreover, colleges and universities typically employ endowment spending or payout rules that seek to provide predictable and sustained funding for campus operations and the programs and activities for which donors restricted their gifts. Spending rules help to insulate institutions from the effects of market volatility on investment returns while also permitting sufficient reinvestment of revenue so that the endowment can retain its value relative to inflation. According to NACUBO, the most common spending rule adopted by institutions is to spend 5 percent of the three-year average of an endowment's market value. Such a spending rule is also know as a "smoothing" rule because it bases spending on a multi-year time frame that allows an institution to smooth out year to year market fluctuations affecting annual investment returns. College and university endowment spending rates have averaged between 4.5 and 5.1 percent of market value over the last decade. For the 765 institutions who participated in NACUBO's 2006 endowment study, the average spending rate was 4.6 percent.

The investments of college and university endowments must perform consistently well to meet current spending needs and achieve intergenerational equity for future generations. An annual investment return of approximately 9-10 percent is needed to: achieve the typical spending or payout rate goal of 5 percent; reinvest part of the investment earnings to maintain the endowment's value relative to inflation (2.5-3.5 percent); and pay for investment management costs (1-2 percent). In recent years, average investment returns have been strong. For 2005-2006, the overall average rate of investment return was 10.7 percent. Institutions with the smallest investment pools had an average rate of 7.8 percent and institutions with largest investment pools had an average rate of 15.2 percent. However, one only has to go back to 2000-2001 and 2001-2002 to find examples of when returns were not so rosy. In 2000-2001, the average return was -3.6 percent and in 2001-2002 the average return was -6.0 percent (See 2001 and 2002 NACUBO Endowment Studies).

Endowment spending is important, complex, and carefully managed. College and university trustees, leaders, and endowment managers take very seriously their legal and moral responsibilities to be good stewards of the charitable and other assets of their institutions. They seek to use endowment income to provide consistent and sustainable support for the educational and research missions of their institutions. Due to institutional endowment spending and smoothing rules, weak investment returns due to poor market conditions do not usually result in significant decreases in endowment spending. Moreover, increased endowment spending often trails behind increased investment returns so as to ensure benefits in the future that can be sustained. Taken together, these spending strategies provide stable funding and benefits over time and they often lead to real growth in the endowment that provides for additional benefits to students and society.

Endowment Uses and Benefits

Endowments enable colleges and universities to aim high and achieve their educational and charitable purposes more effectively. Endowments provide for a stable funding source, particularly during difficult economic times or in the event of natural or other catastrophes, and a degree of confidence about the future. Students and society are well-served by the fact that endowments allow institutions to deliver greater value and attain a higher level of quality in teaching and research that would not otherwise be possible from other sources of revenue such as tuition, government funding, or annual charitable gifts. They help institutions sustain quality and meet financial commitments to current and future students and faculty, as well as to society. Endowments also afford the valuable benefit of long-term planning to accommodate growth and improve academic and research programs. Additionally, in light of diminished commitments by government, endowments are a reliable source of funding to finance expensive construction and infrastructure needs.

Among the many academic programs, activities, and responsibilities of a modern higher education institution, the reliable source of funding that endowments provide permit colleges and universities to:

- provide or increase student financial aid;
- enhance undergraduate teaching;
- initiate pioneering research;
- renovate and maintain educational and research facilities;
- construct state of the art classrooms and scientific laboratories;
- invest in new information technologies;
- attract or retain talented faculty;
- increase public service activities of students and faculty; and
- offer new majors to reflect changing national or societal needs.

Of particular interest to many are the benefits endowments provide to make college affordable for students from low and moderate-income families. We are especially disturbed and concerned by the testimony of Ms. Munson and Ms. Gravelle at the September 26th hearing regarding university and college endowments and student financial aid. They painted an incomplete and disingenuous picture of colleges and university endowments and student aid.

The witnesses' testimony fails to examine the significant efforts of colleges and universities to provide increased institutional aid to students based upon need, and instead offers only broad generalities about endowment payout rates and increased tuition. Most – if not all – colleges and universities with the largest endowments are already providing a substantial amount of aid to students from low-income families. The average grant at most of these schools is above the cost of tuition and covers expenses including room and board, books, etc.

In the last five years alone, many of the universities and colleges with the largest endowments have created new or enhanced existing student financial aid programs to ensure that low- and even some middle-income students can access their institutions and graduate debt free. Qualified students are provided with a combination of federal, state, and institutional grants and in some cases work study opportunities in order to finance all of their tuition and living expenses. A free, top quality education is truly part of the American dream and institutions such as the following are making this possible each year for thousands of low-income students: the University of North Carolina at Chapel Hill; Emory University; the University of Washington; Stanford University; the University of Maryland at College Park; Princeton University; the University of Florida; Yale University; the University of Pennsylvania; Indiana University; Harvard University; Davidson College; Columbia University; Amherst College; and the University of Virginia. Harvard University, for example, covers all expenses for students from families making $60,000 or less.

In addition, many other institutions have, with endowment funding, created new or strengthened existing student financial aid programs to significantly increase institutional grants to offset tuition costs and reduce loan debt for both low and middle income students. Moreover, at a number of colleges and universities, endowment spending already contributes significant resources toward operating budgets, and in some cases, may be the largest source of revenue for the institution. In this way, endowment spending already serves to hold tuition rates below the level necessary if tuition alone paid the true cost of educating a student.

Proposals to Change Federal Tax Laws Affecting College and University Endowments

The public policy rationale for government support of colleges and universities is that higher education serves a public good, including educating citizens and conducting research that advances knowledge, spurs innovation, and contributes to our nation's economic prosperity. Colleges and universities clearly understand and appreciate the responsibilities that come with the significant support they receive from government as nonprofit entities that are exempt from most forms of taxation. College and university leaders and administrators take very seriously the educational, research, and public service missions of their institutions, and they strive to be responsible stewards of their institutions' endowments and finances.

The following addresses three proposals to federal tax law that would affect college and university endowments.

1. Rising Costs and Tuition – A Minimum Mandatory Endowment Spending Rate

The information and opinions offered by Ms. Gravelle and Ms. Munson at the September 26th hearing mischaracterized how college and university endowments function and their uses and benefits. Indeed, their descriptions were both incomplete and misleading. Both witnesses noted that tuition has been increasing faster than inflation. This is in fact the case, and increasing tuitions are a direct function of a combination of realities including: decreased state support for public institutions; increased federal, state, and regulatory requirements; increased health care and other employee benefits costs; increased energy costs; the demand and need for up-to-date information technology; and, student and family demands for increased services and amenities. However, their testimony also left the Committee with the impression that institutions are doing little to control costs or to increase student financial aid for individuals from low and moderate income backgrounds. This is simply not true.

Colleges and universities are implementing cost-saving measures continuously, and as previously described, institutions are creating new and enhancing existing student financial aid programs. It is part of their institutional mission and the fiduciary responsibility of trustees and administrators to make the institution accessible to qualified students. With respect to cost-saving measures, institutions are:

- replacing older high maintenance and high energy cost buildings with low-maintenance and low-energy consuming new facilities;
- using consolidated purchasing agreements;
- consolidating programs;
- outsourcing non-academic functions;
- providing incentives to employees to reduce costs;
- streamlining benefits administration;

- reorganizing administrative structures and reducing staff;
- increasing teaching requirements for faculty; and
- employing energy saving technologies.

These cost saving measures are only a sample of the ways institutions are attempting to reduce their costs so as to restrain tuition increases. Can colleges and universities do more to reduce costs? Yes, more can and should be done and institutions are actively and constantly looking to undertake cost saving measures that will work for their institutions. However, we should note that a significant share of the increasing costs of higher education cannot be controlled by universities. The persistent growth of federal, state, and local regulation is among the costs colleges and universities do not control but must deal with every year when crafting their budgets and determining tuition.

Ms. Gravelle and Ms. Munson both proposed the imposition of a mandatory minimum five-percent endowment spending rate to force colleges and universities to stop "hoarding" their resources and to spend more on student financial aid. On the surface, this proposal sounds like a reasonable and simple solution which institutions would have an apparently easy time implementing - it is modeled on the current law requirement for private charitable foundations to pay out a mandatory minimum of five-percent of the value of their endowments. However, it ignores the complexity of endowments, their restrictions, and the fiduciary responsibilities of institutions to preserve intergenerational equity.

Private foundations and colleges and universities are very different kinds of tax-exempt institutions. In the case of a private foundation, the public has an interest in ensuring that, in return for the tax advantages granted to the donor, the foundation, which remains under private control, is adequately serving its charitable purposes by spending its funds in a timely fashion. For foundations, virtually all of their income comes from their endowments and the most effective way to ensure a significant charitable activity may be through a minimum payout requirement. In contrast, charitable donations to college and university endowments are typically given for the express purpose of supporting designated educational or scholarly activities over a long period of time. When a college or university executes its daily operations, it fulfills and engages in its charitable purpose with endowment funds and other sources of revenue. There are many constituencies that play a role in ensuring that these dollars are spent for their intended purposes, including the donors themselves, students, faculty, university administrators, alumni, local residents, and government agencies.

Moreover, the work of private foundations and colleges and universities are fundamentally different. Private foundations make project-focused discrete grants, while colleges and universities fund academic and research programs into perpetuity. For example, a charitable health foundation may award an organization (perhaps even a university) a three-year grant to research the spread of a communicable disease; whereas, a university will use its endowment to fund ongoing and future health research programs and the researchers that conduct underpinning science.

As discussed previously, most larger colleges and universities typically target a 5 percent spending rate and, on average, they effectively achieve this on annual basis. Some institutions exceed this threshold and others fall short in a given year. A spending rate for a specific year that is below the institution's targeted spending rate is usually explained by one or more of the following factors:

- insufficient endowment returns over time;
- intergenerational equity concerns which seek to ensure that spending on future generations is at least commensurate with current spending;
- the need to build up the corpus of individual endowment funds in order to earn a sufficient annual investment income that can support the intended purpose or restrictions of the endowed funds; and
- the inability to expend restricted endowment funds due to unmet conditions of the donor (for example, not awarding scholarships, fellowships, or professorships because qualified candidates who meet the donor's specifications could not be found, *e.g.* a donor might endow a scholarship for a low-income female student who majors in dance).

Requiring a minimum five-percent endowment spending rate would needlessly restrict and interfere with the ability of colleges and universities to meet both their near- and long-term fiduciary responsibilities and would likely create complex problems for higher education institutions as they seek to implement binding legal obligations for donor restricted endowment funds.

2. Taxation of Endowments

Ms. Gravelle suggested in her testimony that taxes be imposed on endowments if institutions increased their tuition by more than an appropriate rate such as inflation or the Consumer Price Index. Simply put, this is a form of a federal price control, which would put the federal government in the middle of college pricing decisions.

Throughout history governments have sought to impose price controls. Invariably price control efforts have led to shortages of the commodity or service in question and/or deterioration in quality.

Taxing an endowment's earnings would only increase the upward pressure on tuition and decrease the resources available to support institutional programs, including the student financial aid funds that are crucial to making higher education affordable for families from low- and middle-income backgrounds. In addition, taxing endowments would turn a donor-intended charitable gift into a source of government tax revenue.

3. Greater disclosure of endowment information, investments, and spending.

Ms. Munson and some members of the Finance Committee have called for increased disclosure of endowment information. As tax exempt organizations, the higher education community is committed to appropriate transparency and would support appropriate disclosure of key college and university endowment information.

In fact, prior to the Committee's September 26th hearing, the major higher education associations supported increased disclosure of endowment information in the comment letter submitted to the Internal Revenue Service on September 14, 2007 regarding proposed revisions to the IRS Form 990.

Conclusion

Endowments are critical to the colleges and universities that are fortunate to have them. While simplistic policy proposals to force colleges and universities to use their private endowment resources in ways some believe makes most sense may sound appealing, but they are short-sighted and would ultimately reduce the nation's educational resources and research. College and university trustees and administrators take seriously their fiduciary, legal, and moral responsibilities and duties to be long-term and prudent stewards of their institutions' endowments. They know intimately the academic, research, capital, faculty, and student needs of their institutions and communities, and they are best able to make endowment spending decisions for today, tomorrow, and beyond.

Endowments have aided institutions to sustain and improve their educational and research activities for hundreds of years, for many generations of students, through natural disasters, and through wars and economic recessions and depressions. Endowments are once again demonstrating their importance and value today – especially in light of declining public support for state institutions, and increasing national research needs.

The continuing success story of American higher education – and the fact that the U.S. is home to most of the leading colleges and universities in the world – is due in part to the growing and sustained financial resources endowments provide. Our nation continues to be well served by the charitable status colleges and universities receive and the independence afforded them to manage and use their resources as they determine will best meet their education, research, and public service missions.

We thank the Finance Committee for this opportunity to submit this statement for the hearing record.