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Who Loses When Endowments Are Taxed?

By N. GREGORY MANKIW

The tax legislation approved this week by Congress is a mixed bag. It combines some badly needed reforms with various messy provisions seemingly designed to keep accountants and tax lawyers fully employed. But the part of the bill that most disappoints me is a small, simple change in policy: a new tax on large university endowments.

True, I am not completely objective here. I have spent the past forty years of my life at three of the targeted institutions, as an undergraduate at Princeton, graduate student at the Massachusetts Institute of Technology, and faculty member at Harvard.

And the tax is not huge. It is a mere 1.4 percent of investment income and is expected to raise only $1.8 billion over 10 years. Because it applies only to universities with endowments of more than $500,000 per student, just a few dozen schools are affected.

But this new tax is not trivial. Take Princeton. It has an endowment of $24 billion. If it earns a 10 percent return, the annual cost of the tax will be roughly $34 million, more than $4,000 per student (including both undergraduate and graduates students).

I try to see both sides of an argument, but it is hard to justify this policy. It seems inconsistent with the stated objectives of Republican leaders.

The tax bill, we are told, aims to promote economic growth by creating an environment more favorable to investment. That is the main argument for the cut in the corporate tax rate from 35 to 21 percent.

But the investment that leads to growth is not just in plant and equipment. It also includes human capital, which means educating our labor force. And it includes the knowledge that flows from basic research. The United States is an economic superpower in part because we have the best university system in the world. The tax bill undermines that.

Republican leaders say that they want to help the middle class. They claim that over time, as corporate tax cuts encourage investment and increase productivity, the benefits will accrue not only to wealthy shareholders but also to workers in the form of higher wages. I believe that, but I also believe that for many people, the surest route to higher wages is increased skills.

My life is a case in point. Neither of my parents were college graduates. But they always stressed the importance of education. Today I am more economically secure than they were throughout their lives because of the skills I acquired in school.

The elite universities targeted by the endowment tax are not perfect institutions. But to their credit, they use their resources to achieve something that all schools aspire to but few can afford: need-blind, full-need admissions.

That means that students are admitted without considering whether their families can afford the cost of the school. And after students are admitted, the university promises to provide all the financial aid they need to attend.

At Princeton, for example, about 60 percent of undergraduates get financial aid. This aid covers the entire cost of tuition, room and board for students from families with income below $65,000 a year.

Thanks to large endowments, financial aid is increasingly generous. In recent years, these universities have started offering larger grants and reducing reliance on student loans. At Princeton, 82 percent of students graduate debt-free, and of those who borrow, the average debt at graduation is only $8,900.

So, if well-endowed universities are engines of economic growth and opportunity for the middle class, why have Republicans targeted them in their tax bill? I have yet to see them offer a principled defense of the policy.

I found a clue, however, in a recent interview with Senator John Kennedy, a Republican from Louisiana. Talking with MSNBC's Chuck Todd, Senator Kennedy did not mention the endowment tax. But to argue for the tax bill, Senator Kennedy quoted a study by Harvard professor Robert Barro and his student Charles Redlick, which used historical data to estimate how much high marginal tax rates depress G.D.P.

Senator Kennedy then continued: "And they're from Harvard. For all I know they are a bunch of weenie liberals. Probably were if they're from Harvard."

Is the endowment tax nothing more than tribal politics? Conservatives are now in control, so let's tax those liberals!

As it turns out, Senator Kennedy was wrong in this case. Professor Barro has been my friend and colleague for thirty years, and I can attest that his political views are well to the right of center. (I won’t address whether he is a weenie.)

Senator Kennedy may be correct that most faculty members at elite universities are liberal. But so what? Most professors leave their ideology at the door when they teach the next generation of leaders. And even if they don’t, students are smart enough to think for themselves.

Senators Tom Cotton, Ben Sasse, and Patrick J. Toomey, as well as Supreme Court Justices Samuel A. Alito Jr., Neil M. Gorsuch, and John G. Roberts Jr. all have degrees from these schools. And yet they went on to become prominent conservatives.

Republican lawmakers, I fear, too often view elite universities as part of the opposition. They are mistaken. If inclusive prosperity is our goal, the tax on university endowments is a step in the wrong direction.