WHY ARE COLLEGES AND UNIVERSITIES EXEMPT FROM TAXES?

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I. Introduction

I've been asked to address the rationale for tax exemption for nonprofit colleges and universities. This assignment presents two challenges. The first is that my two fellow panelists, Harvey Dale and Eugene Steuerle, are much better informed on the topic than I am, and should rightfully be the ones to speak first. The second challenge is that the most basic of the tax exemptions available to institutions of higher education, namely the exemption from the federal corporate income tax, seems thoroughly entrenched politically for the foreseeable future, making discussion of the policy rationale for the exemption a largely academic exercise. I'll consequently turn much of my attention to the boundaries of the exemption, and to the likely evolution of the exemption in the more distant future when the organization of higher education in general is likely to undergo some substantial changes.¹

Private nonprofit colleges and universities in the United States are generally free, not just from the federal corporate income tax, but also from state corporate income tax and from state and local property tax, and are often free as well from state and local sales tax on items that they purchase and/or sell. In addition, interest on bonds they issue is often exempt from federal and state income taxation. These various forms of tax exemption have different effects, and in important respects they need to be analyzed separately. I'll begin, however, by discussing tax exemption in general under the assumption that, all else equal, it is generally a financial benefit to the organization to be exempt rather than nonexempt.

More particularly, I'll begin by discussing tax exemption as a subsidy, and only later consider the question "with respect to what is the exemption a subsidy?" The question we begin with, then, is whether higher education in general is an appropriate target of public subsidies.

II. Should Higher Education Be Subsidized?

A variety of justifications have been offered for public subsidies to higher education in general, and to private nonprofit colleges and universities in particular. Some of these justifications are more convincing than others.

*Positive Externalities.* Public subsidies to higher education are frequently justified on the grounds that higher education offers benefits to society as a whole, and not just the students who receive the education. But this is a dubious rationale. Most of the returns to an education surely accrue to the individual who receives it, whether we look at its consumption good aspects (such as learning for its own pleasures, socializing, or playing sports) or its production good aspects (such as acquiring skills and contacts that will increase one's expected earning power). While there are surely some external benefits when an individual gets a good education, the ratio of social to private benefits is arguably not much different than when an individual buys a house for their family or a truck for their work.

*Imperfect Collateral in Human Capital.* A stronger argument is that, although most of the benefits of higher education flow to the student, many students and their families have insufficient wealth to pay the cost of higher education out of pocket, while borrowing on the private market is inefficiently constrained because human capital, being largely impossible to foreclose upon, provides poor collateral. Thus, even students for whom the expected financial return to a higher education will vastly exceed the cost of providing that education can find themselves unable to borrow enough to pay that cost. Government subsidies can promote efficiency by bringing down the private cost of higher education to a level that can be privately financed.

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Risk. Beyond the problem of collateral, there is a problem of risk that interferes with private financing of higher education. There is substantial probability that, though the returns to higher education are on average high, the outcome realized by any particular student may be poor. Thus, for the individual student, as well as for a potential lender to that student, the risk that the student will not be able to repay the loans that financed her education may be forbidding. Yet the overall risk to society may be very low: for a given generation of students as a whole, higher education may exhibit very little social risk. If private lenders cannot diversify their portfolios of student loans adequately, there is an argument for government subsidies that effectively socialize much of the risk involved. Whether this remains a major problem now that student loans can be placed into large bundles and securitized is subject to argument.

Redistribution. It is often said that public subsidies to higher education are an important means of redistributing wealth and opportunities in favor of the less prosperous members of society. But it is unclear whether, in fact, subsidized higher education serves an appealing redistributive role beyond that which is necessarily served by dealing with the two preceding efficiency justifications for subsidy, both of which call for greater subsidies for the poor than for the rich.

To see the issues involved, imagine Harvard University under two different student aid regimes. In the first, Harvard charges all students the full cost of higher education, thus rendering it impossible for students from impecunious families to attend, and leaving those students to attend a state university that charges minimal tuition. In the second regime, Harvard charges full cost only to students prosperous enough to pay on their own, and uses a federal subsidy to finance grants and subsidized loans, targeted to less prosperous students, that suffice to overcome the problems of collateral and risk discussed above, hence making it feasible for even the poorest students to attend Harvard. How much redistribution is accomplished by moving from the first regime to the second regime? Perhaps rather little. A student who has the attributes necessary to be accepted by Harvard -- high intelligence, ambition, self-discipline, capacity for hard work, and a record of sustained educational accomplishment -- is not likely
to end up among the dregs of society whether she goes to Harvard or to the state university.\(^3\) Rather, she seems likely to end up at least among the upper middle class in any event -- the top 2% of the income distribution, let us guess -- though she would do even better if she goes to Harvard, reasonably expecting, to guess again, that she would then end up in the top 0.1% of the income distribution. In other words, no matter how poor her family, by the age of 18 she has effectively secured entry to the top 2% of society. The government subsidy that lets her attend Harvard thus permits her to move from the top 2% of the income distribution to the top 0.1%. The difference will of course be quite meaningful to her personally. But do we want to use money obtained from the average taxpayer to subsidize redistribution among members of the top 2% of society?

Simply providing adequate subsidies to provide for the efficient financing of higher education will, in itself, result in substantial redistribution, since at present only the rich can easily purchase the efficient amount of higher education. But it isn't clear that redistribution itself is a persuasive justification for public subsidies to higher education.

Indeed, as is often remarked, the extreme case of providing publicly subsidized free or low-cost higher education to all qualified students regardless of wealth -- a practice that is disappearing in the U.S., largely owing to state budget pressures, but is still common in Europe -- is surely regressive, since a substantially larger fraction of prosperous children than of poor children attend college or university, and hence benefit from the subsidy.

**Paternalism.** A final justification commonly offered for public subsidies to higher education is that prospective students and their families will mistakenly undervalue the future benefits of higher education, and will therefore consume

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\(^3\) See Stacy Berg Dale & Alan B. Krueger, *Estimating the payoff to attending a more selective college: An application of selection on observables and unobservables*, 117 Q. J. ECON. 11491 (2002). Dale and Krueger examine this precise question, looking at the outcomes of students who were accepted to the same colleges, but chose to attend different schools. They find that choosing to attend the more selective school (in terms of SAT score) makes relatively little difference in future earnings.
too little of it if the education is sold at full cost, even if adequate financing is available. Hence, goes the argument, higher education must be subsidized to induce individuals to consume enough of it even from their own entirely selfish perspective.

There is probably some truth in this argument, though it is difficult to evaluate. Among other problems, casual empiricism suggests that students often take the price of education as an indication of its value, and invest too little of their own effort in it if it's significantly underpriced.

Based on the preceding, I'll proceed from here on the assumption that obstacles to efficient private financing are the principal general justification for governmental subsidies to higher education. There are other considerations, of course, that are important as well with regard to particular forms of exemption, to which we will return.

III. Subsidizing Nonprofits

The basic tax exemptions provided for private colleges and universities today are confined to nonprofit institutions. As a matter of tax administration, similar exemptions could easily be extended to for-profit colleges and universities. If the quality and cost of producing higher education were the same for both nonprofit and for-profit institutions, then – assuming that the reasons for subsidy are as discussed above – there is as good reason for exempting for-profit institutions as for exempting nonprofit institutions. Or at least that is true for exemptions from sales and property taxation; exemption from income taxation affects nonprofit institutions a bit differently than it does for-profit institutions, as we will discuss below. For the moment, we will ignore this difference in effects, and simply ask: is there a good reason to subsidize nonprofit institutions and not for-profit institutions?

In general, there seems no reason to believe that the social cost of producing education in a nonprofit organization is less than in a for-profit
institution. So, if there is a difference between the two, it is presumably because for-profit institutions produce lower quality. That in itself would be no reason for distinguishing between nonprofit and proprietary institutions in terms of subsidies. Rather, it becomes a problem when the quality offered by proprietary institutions is lower than that which prospective consumers expect. More precisely, the problem arises when there is asymmetric information between the college and the prospective student as to the real costs and benefits of seeking an education at the college. For example, the college may know that, with respect to what the student believes (and perhaps was induced to believe by the organization’s marketers), the college offers lower-quality instruction, costs more, and teaches skills less suited to the demands of the current job market.

A familiar benefit of nonprofit institutions in such a situation is that they have less incentive to take advantage of the prospective students’ vulnerability, and greater incentive to meet their needs. Whether these benefits are sufficient, when combined with the limitations of the nonprofit form, to render nonprofits systematically superior to proprietary institutions in higher education is an empirical question.

A. Experience with Proprietary Institutions

The United States has experimented with proprietary higher education at three different points in time. These three experiments offer the best evidence available as to the seriousness of the quality problem presented by proprietary institutions, and to the effectiveness of dealing with the problem by granting subsidies to nonprofit but not proprietary institutions.

The first experiment took place in the latter 19th century, when there arose – without benefit of subsidy – a number of proprietary institutions offering higher education, including conspicuously many medical schools and law schools. The number of these institutions evidently declined substantially in the early 20th

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century, in part as a consequence of pressure from professional associations.\textsuperscript{5} Whether the resulting turn toward nonprofit institutions of higher education represented an improvement in social welfare is, unfortunately, too difficult to assess from this distance.

The second experiment took place in the late 1940s and early 1950s, when proprietary institutions were initially included among the institutions that were eligible to enroll students who were receiving benefits under the GI Bill of 1944. Over the succeeding five years, more than 5000 proprietary institutions were formed. In response to the impression that many of these schools were charging prices far out of line with the education they were providing, Congress amended the law in 1952 to provide that proprietary schools were eligible to enroll students subsidized by the GI Bill only if at least 15% of their student body was comprised of students not benefiting from those subsidies. In the Higher Education Act of 1965 – Title IV of which remains the principal source of federal student aid for higher education – Congress, still dissatisfied with the performance of proprietary institutions, went even further and explicitly denied federal financial aid to students enrolled in proprietary colleges and universities.\textsuperscript{6}

The third experiment began shortly thereafter when, in 1972, Congress eliminated the blanket exclusion of proprietary schools from participation in federal financial aid programs, and then further liberalized participation by for-profit institutions in 1979 and 1986. This experiment continues today. As under the first GI Bill, the result has been rapid growth in the proprietary sector, which was 30 times larger in 2009 than it had been in 1974, accounting for roughly 10% of all students enrolled in higher education the United States, and one third of all students enrolled in private (nongovernmental) institutions of higher education.\textsuperscript{7}

\textsuperscript{5} See, e.g., Craig A. Honick, The Story Behind Proprietary Schools in the United States, 23 New Directions for Community Cs. 27, 31-36 (1990).

\textsuperscript{6} See Hansmann, supra note 1, at 166-67.

\textsuperscript{7} See id. at 167-68.
This third experiment has brought a return to many of the problems experienced during the second. One difference, however, is that the proprietary schools now include some large institutions that are much more susceptible to legal and reputational sanctions that are their smaller counterparts. As of 2010, 14 of these institutions were in fact publicly traded. The University of Phoenix alone has in recent years maintained an aggregate enrollment of nearly 500,000 students.8

As many have suggested, there may be a speculative bubble behind this rapid growth. Nearly all of the proprietary institutions involved are heavily dependent upon federal student aid, and would collapse without it.9 However that may be, the long run seems to hold the prospect of a much larger proprietary sector in higher education than we have experienced in the past. It will probably remain rooted principally in skills-based professional education, but may ultimately make substantial inroads as well into general higher education. The reasons for its growth seem to be a much more rapid response to increased demand than nonprofit organizations exhibit, an ability to adapt to changing needs in the educational market much more quickly than public community colleges, faster acceptance of new educational technologies – such as MOOCs and the Internet in general -- than public or nonprofit institutions, and increasingly effective – though still very underdeveloped – federal and state regulation of the price, quality, and utility of the education provided by proprietary schools.

If nonprofits could compete on equal terms with the rapidly expanding proprietary sector in higher education, then one could perhaps leave it to the market to choose between the two types of organization as the number and range of proprietary firms expands. But until effective quality and price regulation is developed for higher education, prospective students may not know what they don’t know about the trade-offs among proprietary, nonprofit, and governmental educational institutions, and this may argue for continued tax

8 See id. at 168.
9 See id.
exemption for the nonprofits both as a means of encouraging their expansion (a point we will emphasize in the next section) and as a symbolic statement that the society views them as more trustworthy than proprietary institutions in what they offer.

In any event, it seems entirely possible that the recent rapid expansion of the proprietary sector in higher education is not a flash in the pan, but presages an increasing reliance upon investor-owned firms in the industry as a whole. This would mean that the services offered by proprietary institutions come closer and closer to those provided by nonprofit institutions, and the argument for subsidizing one form as against the other begins to disappear. The federal government has already begun to use student aid to subsidize patronage of for-profit institutions on roughly the same terms as nonprofit institutions. The same equality of treatment could well come to be appropriate, at some point in the future, for subsidizing nonprofit and for-profit institutions via exemption from taxation. The hospital industry is already further along down that path than is higher education, and there has been increasing pressure in recent years to eliminate tax exemptions for nonprofit hospitals – just as it was eliminated 25 years ago for nonprofit health-insurance companies – on the grounds that the services offered by nonprofit hospitals are not meaningfully different from those offered by for-profit hospitals.

B. Supply-Side Versus Demand-Side Subsidies

Tax exemptions are supply-side subsidies. They reduce the cost to the institution of producing goods and services. Student aid – such as grants, below-market-rate loans, and loan insurance that the student can use to pay costs at the college of her choice – are demand-side subsidies. So, too, are tax credits and deductions for college tuition, and tax-sheltered savings plans for college expenses such as 529 plans.

From an economic point of view, demand-side subsidies are generally superior, because they reinforce market selection. Or at least that is the case if potential customers (students in our case) can distinguish accurately among the
services offered by competing institutions. Even in the latter case, however, supply-side subsidies may have some special advantages and disadvantages where nonprofit producers are involved. We will explore this further in the next section.

In the meantime, it is appropriate to say something about property taxes. Exemption from property taxes, though in most respects similar in its effects to exemption from corporate income taxes, also brings a disadvantage that is much less evident in income tax exemption. That disadvantage is that the burden of property tax exemption is generally felt at the level where the tax is levied, which commonly includes the local municipality where the exempt institution is located. This means that many small towns with large universities are starved for tax revenue. As a consequence, when proprietary institutions mature to the point where they begin to offer services comparable to those offered by nonprofit organizations, withdrawal of exemption from the nonprofits should start with the property tax exemption, not the corporate income tax exemption. This seems, in fact, to be the pattern developing with nonprofit hospitals.

IV. Tax Exemption as a Subsidy

Tax exemptions are a particular type of subsidy. And exemption from different kinds of taxes has different types of effects upon the institutions involved. I will focus here principally upon exemption from the corporate income tax. I will also say a few words, however, about exemption from property taxes and sales taxes.

For a nonprofit corporation, exemption from the corporate income tax principally bears on investments. A nonprofit organization is constrained, in the long run, to dedicate 100% of its income to pursuit of its charter purposes. Consequently it should have no profits in the long run. Exposure to the corporate income tax would, nonetheless, often extract revenue from a nonprofit
college or university, assuming that ordinary tax accounting would apply. There are two reasons for this.

First, if a university chooses to save some of its current income -- for example, by putting it into the university's endowment -- the amount saved would, absent exemption, be subject to current taxation.

Second, even if the institution spends all of its income currently, investments in long-lived assets, such as buildings, would -- absent exemption -- generally subject the institution to current taxation because the investment could not be deducted immediately; rather, the expense involved would need to be amortized over the imputed life of the investment.

We will take these two in turn, starting with the latter.

A. **Investment in Productive Assets**

In a growing industry like higher education, nonprofits tend to be capital constrained in the sense that, because they are limited in the amount of capital they can obtain from private sources of finance, nonprofits have investment opportunities that they cannot exploit even though those investments would produce a return higher than the market return on capital. The principal reasons for the limited access to private capital is that, by virtue of their basic structure, nonprofits cannot raise equity capital and -- because their assets are not easily redeployable, and because lenders don't relish foreclosing on charities -- they also have difficulty issuing debt. Government can increase social efficiency, therefore, by supplying the capital directly. We can see corporate tax exemption as serving this function. Of course, it's a very crude form of capital subsidy, providing too much to some firms and too little to others, even if on balance it represents an improvement.\(^{10}\)

Much the same can be said of exemption from property taxes, which burden investments in real estate, and tax exemption of bonds issued by

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nonprofits. Exemption from sales taxes on inputs or outputs, in contrast, is tied more generally to the overall level of the organization's production.

B. Investment in Endowment

There is reason to be more skeptical about college and university investments in financial assets, and particularly in the building of an endowment. Current income that is put into the endowment – whether that income is from tuition, donations, or earnings on the endowment itself – is income that is not invested in the provision of higher education. An endowment is effectively a savings account. It is sensible to put money into that account rather than spend the money currently only if the rate of return on the endowment is higher than the rate of return on funds spent currently on education. If the rate of return on the endowment is 15%, for example, it may make sense to put, say, $1 million of current income into the endowment, since – so long as the University's time rate of discount is less than 15% – it is worth sacrificing $1 million of education today in return for being able to provide $1.15 million worth of education next year.

There are several reasons why the rate of return on financial assets might exceed the rate of return on teaching or research in any given year. The first is risk. Nonprofits need to protect their fixed investments – in buildings that are not redeployable, faculty that are tenured, and students that have four-year contracts – from large short-term fluctuations in the amount of income or expense they encounter (as, for example, when the OPEC oil crisis raised costs dramatically in the early 1970s). Put differently, when such a bad year strikes, the return on spending money to maintain those fixed assets rather than sacrifice them while the crisis lasts may be very high, making it worthwhile to save some funds currently for expenditure in such a rainy day.

A second reason for capital accumulation is to save up for a large investment, such as a new building complex, which can’t – for the reasons discussed earlier – be financed immediately simply by going to the capital markets.
And a third reason for capital accumulation is that there is reason to believe that returns to teaching or research will be higher at some point in the future than they are at present.

All three of these reasons call for spending down the endowment at some point in the future, when the day of higher returns arrives. But, for many colleges and universities that have accumulated endowments, that day never comes. Rather, the institutions simply keep accumulating endowment, putting into it every year more than they take out of it. In part this is the result of restrictions imposed by donors, and in part it is a result of choice on the part of the college or university. Whatever the source of the behavior, it makes sense only if the marginal rate of return on teaching and research is always below the rate of return on the capital markets. And if this is not the case, further endowment accumulation serves no social purpose. The endowment is just a perpetual drag on the institution's finances, putting money away in a piggy bank that will never be opened up.\textsuperscript{11}

To be sure, so long as the managers of university endowments are at least as capable as other investors in choosing where to invest – and the evidence suggests this may well be true today – then there is no necessary social harm to building an endowment; the funds are producing a decent social rate of return, and this is superior to wasting the money on low-return teaching and research. But one worries that the availability of large endowments will lead to their being spent, in the long run, not when the returns to higher education are distinctly higher than the returns to investments in financial assets, but rather when the returns to the institution's teaching and research are so low – perhaps because of changes in educational technology – that the only way for the institution to survive is to spend down its endowment. That is, the endowment involves a shift of resources from a time (today) when the returns to investment in teaching and research are high to a time in the future when those resources

will be wasted in perpetuating, for a few decades, the life of anachronistic institutions.

The rate of return to college and university endowments is generally high – and there is a thus a correspondingly strong temptation to put income into the endowment rather than spending it on research and teaching – in part because the institutions’ exemption from corporate income tax extends to endowment accumulation. It does this in two ways. First, income received by the University and put into endowment rather than spent currently is not taxed as net income. Second, returns on the endowment investments themselves – interest, dividends, and capital gains – are also free of taxation. If we view corporate income tax exemption as a subsidy, then the government is effectively subsidizing endowment accumulation, and a substantial fraction of the money in university endowments essentially comes from taxpayers.

While the basic tax exemption for nonprofit colleges and universities seems both economically justified and – at least until the proprietary institutions constitute a much larger fraction of the industry – politically untouchable, the same is not true of endowments. The economic case for subsidizing endowment accumulation is weak, as we have just discussed. And, as a matter of politics, the huge endowments accumulated by lending private institutions of higher education have attracted a good bit of unfavorable public attention. Public resentment of endowment accumulation has in substantial part been focused on the high tuition that generously endowed institutions continue to charge. And, in response to this public sentiment, the leading private universities have in recent years become much more generous in their tuition subsidies. This in itself seems a misguided response. The institutions involved were already, in general, providing substantial financial aid to students who could not otherwise afford to pay tuition, room, and board. Increasing financial aid therefore had little effect upon attendance at those institutions. Rather, it simply put more money in the pockets of students (or the families of students) who were going to end up among America’s elite if they were not already there. To the
extent that the money involved came from tax subsidies, it represented a redistribution from the average taxpayer to the social and economic elite, which is presumably not what the populist political sentiment against endowment accumulation contemplated. However that may be, popular resentment was strong enough to stimulate Senator Grassley, then ranking Republican on the Senate Committee on Finance, together with Democratic Representative Peter Welch of Vermont, to hold a “roundtable” on endowment accumulation in September of 2008. This political initiative was stifled when, within a matter of weeks after the roundtable, the financial markets collapsed. But, following the subsequent market rebound, Senator Grassley has raised the issue once again, and the political potential for federal regulation of endowment accumulation via the tax code apparently remains alive.12

And what form might that regulation take? There are various possibilities, some politically or administratively more workable than others. At one extreme it could involve treating all additions to endowment – indeed, all investment in financial assets beyond what is needed for short-term liquidity – as taxable unrelated business income. A more moderate approach would retain the general exemption for endowment investments and accumulation, but deny exemption for "excessive" endowment accumulation. For this purpose, accumulation might be considered excessive where the investments involved were not segregated into distinct funds maintained at actuarially reasonable levels to either serve as a sinking fund for designated future investments (such as new science buildings or undergraduate dormitories) or as a buffer against future fluctuations in income or expenses (which, to be credible, would presumably need to be accompanied by a policy setting forth the conditions under which expenditures would be made from the buffer fund, to prevent it from being treated, in practice, as just another continually growing investment pool). It might also be thought reasonable to allow universities to accumulate endowment funds for the sake of covering the ongoing costs of long-term investment commitments, such as tenured

professorships and buildings requiring substantial ongoing maintenance. But for modern universities and colleges that engage in more or less continuous fund-raising, as opposed to receiving occasional large and widely staggered public and private grants as was common in the 19th century, this may be inappropriate. With allowance for short-term fluctuations of a few years, or at most decades, colleges and universities should perhaps be expected to cover their current costs with current income.

Finally, there is the blunt but simple alternative of requiring that college and university endowments be treated like private foundations, and subjected to a minimum rate of payout on current endowment that is at least equal to, and preferably somewhat above, the long-run market rate of return on capital.

In addition to cutting back tax exemption for colleges and universities along these lines, similar adjustments might be made to the deductibility of donations made to colleges and universities. In particular, deductibility might be denied to donations subject to conditions that prevent expenditure out of capital for more than some reasonable length of time (perhaps 40 years).

As a matter of realism, just the threat of some such tax on excessive endowment accumulation might be sufficient to induce well-endowed institutions, and major donors, to think much more seriously about the purposes served by their choices between saving and spending, and to modify their practices accordingly. This is arguably what has happened as a consequence of Senator Grassley’s long-running threat to condition tax exemption for nonprofit hospitals – the other large class of American nonprofit institutions – on provision of charity care and community service at a level that represents a meaningful fraction of the institutions' income. The threat has apparently been sufficient to induce some action by nonprofit hospitals on their own, though the threat has been backed up modestly by provisions in the Affordable Care Act, inserted by
Senator Grassley, requiring nonprofit hospitals to make additional disclosures regarding the public benefits they provide. ¹³

V. Unrelated Business Income Tax

So long as nonprofit universities (or other types of nonprofits) are exempt from corporate income tax, it’s important to tax income that the institution receives from commercial activities that would not be exempt if conducted in isolation, even if formed as nonprofit corporations. Otherwise there is a strong opportunity for tax arbitrage, and an accompanying incentive for nonprofit organizations to become holding companies for industrial and commercial enterprise of every type – which may not be an activity at which universities and other nonprofits excel.

This leaves the question of which activities of colleges and universities should be considered unrelated. Where there may be economies of scope in undertaking jointly both an exempt activity and an activity that would not be exempt if pursued on its own, there is reason to be generous in extending the exemption to the latter activity. Obvious examples are the dormitories and dining halls operated by colleges and universities, which are services that on their own would be taxed like apartment buildings and restaurants. Economies of scope suggest that colleges and universities will provide these services whether taxed as unrelated business income or not, and accounting separately for costs and revenues is likely to be arbitrary and subject to manipulation.

As activities become larger, more separable, and more clearly undertaken in large part for the sake of revenue with which to fund other projects, however, there is more at stake. University research producing patentable results is a possible example.

One set of problems involving patents has arisen as a consequence of the Bayh-Dole Act, which gives universities all rights to patents produced by university researchers, even if the research was entirely funded by federal grants. (Common practice is apparently for the university to allocate one third of the royalties to the researcher(s), one third to the university department in which the researchers work, and one third to be retained by the University as a whole.) This seems to have some unfortunate consequences. One is that it creates a strong incentive for the university and its research faculty to use public funding to pursue research that will produce highly saleable patent rights rather than more fundamental research that is unlikely to be undertaken by proprietary firms. A second is that universities that already have strong research facilities are likely to have their relative advantage over other universities reinforced, as patent rights from their current research yield additional research funds for which they need not compete in a peer-reviewed process. And a third consequence is that the fruits of government-funded research not only need not be recycled to fund further peer-reviewed work at the University best qualified to do it, but that they need not be spent on research at all, instead being available to be used by the University for whatever purposes it wishes.

A second, related set of problems involves university research that is financed by commercial firms. Under current tax law, a pharmaceutical company can give a grant to a university to undertake research on issues designated by – and of commercial interest to – the company, and not only reserve to the company an exclusive right to put company scientists in the lab with the university’s scientists and to have unique access to the results of the research,

but also give the company full rights to any patents that emerge from the research, all without making any net income from the grant taxable to the university, much less threatening the university’s overall tax exemption.\footnote{\S 512(b)(8). That section provides: “In the case of a college, university, or hospital, there shall be excluded all income derived from research performed for any person, and all deductions directly connected with such income.”} There is, of course, something to be said for encouraging coordination and collaboration between universities and commercial firms in undertaking research. But the results of the tax regime just described arguably go further than necessary, creating an incentive for universities to, in effect, rent out their laboratories for industrial research on a tax-exempt basis.

Both sets of problems might be dealt with by altering the tax law. For example, patent royalties, or any sale of patent rights, might be made taxable to a university if the patent was the result in material part of research done at the university. With respect to the first set of problems, such a regime would return to federal taxpayers at least a portion of the return on the research they funded, while dampening a bit the tendency to make the rich research universities continually richer without having to compete for that part of their funds that comes from patent windfalls, and also dampening the incentive for universities to pursue commercial rather than basic research. And with respect to the second set of problems, taxation of returns on university-produced patents would also dampen incentives to emphasize commercial over basic research, at least so long as the "grants" given to university laboratories in return for all resulting patent rights is understood as an anticipatory sale of those rights, the income from which is taxable.

The first set of problems, to be sure, might be dealt with by amendments to Bayh-Dole rather than by restricting the scope of tax exemption. For example,
the university could be given the right to retain only half, rather than 100%, of the patent royalties it receives from patents developed with government funding. This would leave the university with an incentive to maximize the returns from patent licensing. And if the half that must be paid to the government is returned, in particular, to the program (such as NIH or NSF) that provided the initial funding, the research entrenchment effect referred to above will be moderated as the patent revenue finances more peer-reviewed grants. The downside is that returning patent royalties to a research funding program such as the NIH gives that program an incentive to fund research that will generate patents. And it is an important part to avoid just such an incentive on the part of grantee universities that returning 50% of the patent royalties to the government seems an attractive idea. So simply taxing the royalties, which will return them to the treasury rather than to the granting agencies, arguably has some overall advantages.

We are, of course, focusing here on the research activities of universities, as opposed to the teaching activities that were our initial focus. There are important reasons for treating these two activities distinctly in terms of tax exemption. This leads us to ask whether, for example, it might be possible to give a nonprofit college or university tax exemption on its research activities while denying an exemption for teaching activities. Without pursuing the question in detail, the answer is arguably yes. Four-year private colleges with no graduate programs could be taken as defining the scope of activities that are considered nonexempt, without trying to split the research and teaching activities of the faculty. Taxes would principally fall, as suggested above, just on investment behavior. For universities offering substantial research programs, those activities could be put into a separate subsidiary, much as medical schools commonly are today. The central administration would then become a holding company, managing an educational subsidiary and a research subsidiary (and perhaps a hospital subsidiary, etc.).
VI. Conclusion

It will probably be many years before basic tax deductions for nonprofit colleges and universities come under attack. The substantial reliance of these institutions on private donations is important evidence of that. While the motivation for such donations is complex, they will probably disappear, as they largely have for nonprofit hospitals, when and only when they no longer have a functional rationale, which at present is to help solve the problem of financing human capital formation – a problem that federal educational grants are still very far from solving. When the differences between the services offered by nonprofit and for-profit colleges come to be as difficult to detect as are the differences between nonprofit and for-profit hospitals, donations to the nonprofit colleges can be expected to fade away. Defending the charitable deduction for higher education will then be unimportant, because few persons will be making and deducting such donations.

If and when this will happen is very hard to predict. Higher education seems on the verge of experiencing its first real gains in productivity since the invention of moveable type. The result may be a complete reorganization of the industry, and possibly one that includes many more proprietary producers (though elimination of government demand-side subsidies seems likely to be slower in coming, if it comes at all). And by then the corporate income tax may have been abolished, changing the framing of the issues. It will be an interesting set of developments to observe, especially for those of us in higher education who can watch with the tranquility of tenure.