LIFE AFTER TAX REFORM
FOR HIGHER EDUCATION

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As the process of tax reform unfolded last year, representatives of higher education no doubt looked on with a mixture of fascination and dread. During the previous four years of debate and positioning over "fundamental tax reform," a number of proposals had been put foward that, if adopted, could have undercut existing important tax advantages enjoyed by colleges and universities. The Ways and Means Committe bill, approved in November, 1985, contained some of the most objectionable features for higher education, including caps on tax-exempt borrowing, limits on retirement accounts, and the taxation of scholarships and of capital gains on some gifts of appreciated property. Despite reversals on these issues in the Finance Committee bill, the compromise that emerged from the conference committee to become law from the Congress confirmed many of the worst fears those in higher education. According to one Stanford official, "We took a bath on the tax bill....We lost on every major issue."[1]

The Tax Reform Act of 1986, the culmination of an unprecedented political thrust for basic reform of the income tax system and easily the most sweeping change in the income tax since its introduction in 1913, is now law. It is therefore an appropriate time to step back and assess its likely impact on higher education. This paper begins by sketching the background of the tax reform movement before turning to the specific provisions of the 1986 law. It then discusses the likely impact of the law on colleges and universities.

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The paper concludes by considering possible opportunities presented by the law.

Antecedents of Tax Reform

It is useful to begin by thinking back and remembering how this extraordinary legislation came to be a possibility. Although "tax reform" has been a semi-annual subject of discussion on Capitol Hill for a long time (usually during non-election years), the notion of "fundamental" tax reform as a serious effort is relatively new. Jimmy Carter's attack on the tax system as "a disgrace to the human race" was taken up by Ronald Reagan, bolstered by a concern about tax shelters, inefficient use of capital, and, most important, inequity. In a 1985 poll, 72 percent of those questioned agreed with the statement: "The present tax system benefits the rich and is unfair to the ordinary working man or woman."[2]

The tax reform debate of the 1980s was characterized by the joining of two previously unconnected themes. The first was the public finance objective of "comprehensive taxation," the notion that all income should be taxed at the same rate, implying therefore a broad definition of taxable income. Traditionally backed by liberals such as Joseph Pechman of the Brookings Institution, this theme implied, for example, the elimination of preferential taxation of capital gains and tax-shelter income.[3] The second theme was supply-side economics and its call for low marginal tax rates to boost productive economic activity. Inspired by conservatives such as Milton Friedman and Arthur Laffer, the supply-side vision of the world captured the imagination of the Reagan administration and seems to have been central to Mr. Reagan's own insistence on cutting marginal tax rates, particularly at the top brackets. Probably because of this unusual ancestry, the notion of fundamental reform gained support from both parties. From the Congress came a

raft of bills to rewrite the nation's income tax law. First came simple "flat-rate" plans with few if any deductions, then more involved schemes, such as the Bradley-Gephardt plan, first introduced in 1982. All of the proposals called for reductions in marginal tax rates. But to do so without sacrificing revenue required in each case a broadening of the income tax base.

The rest is legislative history and will no doubt receive careful analysis from policy analysts. What is important for assessing the impact on higher education, and indeed the impact on the nonprofit sector in general, is that the reduction in marginal tax rates embodied in all the tax reform bills required a broadening of the tax base, and this broadening could be accomplished only by taxing more sources of inco e or e i inating some deductions. In ways appreciated only in hindsight, higher education and other nonprofits derived important benefits from the old tax law. After months of waiting for the other shoe to drop, colleges and universities heard it come down with a resounding thud.

The New Law

The new tax law contains nine major provisions affecting colleges and universities:

1. Marginal tax rates are reduced at all income levels. For the wealthiest taxpayers, the rate is cut from 50 percent to 28 percent, although many middle- and upper-income taxpayers will face a marginal rate of 33 percent.

2. The charitable deduction for nonitemizers, which became fully phased-in in 1986, is eliminated.

3. For the first time, there is a provision to tax capital gains on some appreciated property given as charitable gifts. This provision applies only to a comparatively few wealthy taxpayers subject to the alternative minimum tax.

4. The law severely limits the ability of taxpayers to shelter income by assigning income to children and having income be taxed at the child's tax rate through custodial accounts and Clifford trusts, mechanisms widely used to save for college expenses. Most of such income will now be taxed at the parents' tax rate.

5. When fully implemented, the law will eliminate the deductibility of student loan interest, although home-equity loans can be used for college expenses.

6. Scholarships and fellowships are taxable to the extent that they cover living expenses.

7. Colleges and universities are now subject to a cap of $150 million per institution on tax-exempt bond financing.

8. The law places new limits on tax-deferred retirement plans and imposes non-discrimination requirements affecting the ability of institutions to offer plans to faculty and administrators. In particular, the ability of employees of nonprofit institutions to use supplemental retirement accounts (SRA's) in effect as tax-sheltered savings accounts is eliminated by the new law.

9. Four-fifths of entertainment expenses paid by individuals, all other employee expenses, and miscellaneous expenses are combined into one itemized deduction subject to a 2 percent of income floor.

What is the likely impact of this bill on colleges and universities? Although it is certainly much too early to know the full effect of such a sweeping piece of legislation, it is possible to hazard a preliminary guess on what some of the most important effects will be. Probably the most visible effect will be a reduction in donations below the levels that would have been achieved under the old law. This effect, the result of the first three provisions, will be most evident for upper-income donors. Provisions 4

through 6 will raise a family's cost of sending a child to college. The last three provisions, along with the sixth, will raise the cost of operating colleges and universities.

Fewer Contributions

No one--not even economists--believe that taxes are the only or the most important reason why people make charitable donations. But there is a great deal of evidence that taxes affect the amount that people give. Because of the deduction, a dollar of contribution costs less than a dollar once the tax reduction is counted. If a taxpayer's marginal tax rate is 50 percent, each dollar "costs" only 50 cents. To economists, this is the "price" of giving, just like 49 cents might be the price of a pound of bananas. The new tax bill raises the price of giving in two ways: by lowering marginal tax rates and by decreasing the number of taxpayers eligible for a deduction. The cut in tax rates causes the wealthiest taxpayers to experience an increase in the price of giving of 44 percent--their tax rate will fall from 50 percent to 28 percent, so their cost of giving cash will rise from 50 to 72 cents per dollar. Because marginal rates are cut at all levels, however, virtually all taxpayers will experience an increase in the net cost of making donations.

Equally important will be the number of taxpayers for whom contributions will no longer be deductible. Of course the nonitemizer deduction has been eliminated, and this will be more serious for some charities than others. The real sleeper here is the reduction in the number of itemizers. Because of the increase in the standard deduction and the reduction in deductible items, fewer taxpayers will find it advantageous to itemize. The bill raises the price for middle and upper income taxpayers the most, despite the end of the nonitemizer deduction. Because colleges and universities depend especially on high-income donors, this will make the impact on higher education greater than

in other sectors, such as religious giving.

<u>The size of the impact: using econometric estimates.</u> In order to assess the magnitude of the impact of the new tax law on contributions by individuals, it is possible to employ estimated econometric models, based on past behavior, to ask the counter-factual question: what if everything else were the same except the tax law--what difference would it make? I have chosen to compare hypothetical levels of contributions for 1988, based on projections of incomes, prices and population. I compare the new tax law with the 1985 version of the old tax law--the one in which nonitemizers received a deduction for 50 percent of their charitable contributions. (Given the tenuous status of that provision and the likelihood that nonitemizers never really fully adjusted to the full deduction available only in 1986, one can argue that the 1985 law is a more reasonable benchmark for comparisons.) I also compare "long-run" levels of giving under each law, the levels that would theoretically be reached after taxpayers had adjusted their behavior and expectations to the tax law hypothetically in force. I look only at donations by individuals. The tax law reflected in the computer model represents the major provisions related to charitable contributions and the calculation of tax liability, but the model does not account for the effects of the alternative minimum tax. Finally, my projections use two alternative models. One model assumes the responsiveness to tax changes follows a fixed formula for all income classes. The other assumes this formula varies over the income scale, with high-income taxpayers being proportionately more sensitive to tax rate changes than those at the lower end.[4]

The results of applying the simulation model to the 1986 law are striking. The model suggests that total charitable contributions would be some 15 to 16 percent lower in 1988 under the new law than they would have

been had the 1985 law continued to be in place. In dollar terms, this amounts to a difference of about $12 billion. These projections do not necessarily imply that contributions will decrease even in real terms, only that giving will be lower than it would otherwise have been.

Before turning to the distributional impact of this decline in individual giving, it is useful to note the likely effect of the new tax act on corporate contributions. The law reduces the top marginal tax rate in the corporate tax from 46 to 34 percent. Based on available econometric evidence, the resulting increase in the net cost of making gifts will result in a modest decline in corporate giving, on the order of 5 percent.[5] Increases in the aggregate tax burden on corporations will also tend to depress corporate contributions, but the magnitude of these changes will probably not be great relative to the change in giving by individuals.

Components of the decline. As large as the overall decline in giving may be -- relative to its level had the law not gone into effect -- it is the composition of that decline that stands as the biggest problem facing higher education. The size of the tax rate cuts at the highest income levels implies a large reduction in the incentive to make contributions for upper-income donors. The models of contributions imply that gifts by the 1.5 percent of taxpayers with highest incomes -- those making about $95,000 or more in 1988 -- will reduce their giving by 30 percent or more in comparison to what they would have donated under the old tax law. That declines of this magnitude are plausible is suggested by the pattern of contributions following the 1981 tax act, a law that reduced the top tax rate from 70 to 50 percent. Following that change, average giving in the highest income classes fell markedly while contributions at lower and middle incomes showed little change.[6]

Because contributions to colleges and universities tend to come preponderantly from middle- and upper-income donors, this differential effect

will be especially apparent. Table 1 shows estimates of the percentage change in contributions to different kinds of organizations based on the simulated effect of the new tax law. Organizations that rely more heavily on wealthy donors, such as higher education and cultural institutions, show the largest projected declines. For colleges and universities, the percentage declines based on the two models are about 24 and 30 percent. In dollar terms, these declines are on the order of $1 to $1.5 billion. To repeat, one should not expect changes of this magnitude immediately; these differences refer to long-run levels of giving under two alternative tax regimes. In fact, the immediate impact of the new tax law is likely to be an <u>increase</u> in giving in 1986, as donors sought to pre-pay on contributions in order to receive larger deductions. Although the dust is just now settling, early indications do indeed suggest such a surge. At Duke, for example, total contributions received in the second half of 1986 exceeded those during the same period in 1985 by some 25 percent. Gifts from individuals during the same period increased by over 50 percent.

The significant implication of this kind of analysis is, however, the likely decline in the long-run level of contributions received by colleges and universities. Although there are a number of possible sources of error regarding the specific percentage decline, it seems likely that a substantial decline will occur if there is no change in donor behavior. But then the question becomes, what is likely to be the impact of a decrease in contributions of, say 25 percent, on the programs and financial well-being of colleges and universities? The answer--not surprisingly--is, more for private than public institutions. If one looks at general fund revenues plus endowment income (excluding auxillaries and hospitals), one finds that voluntary support makes up a small but significant portion of college and

Not surprisingly, it is more important in private than in public institutions. Current gifts and grants plus endowment income (the annual flow from past gifts of capital) comprise roughly 4 percent of general fund income in public institutions and about 18 percent in private institutions.[7] If all of these sources declined by 25 percent, the budgetary impact would therefore be on the order of 1 percent for public institutions and 4.5 percent for private ones. Quantitatively, this would certainly not be a tremendous impact for public institutions, but in private colleges and universities it would likely be felt over time in areas of discretionary spending and new initiatives. However, if private grants and corporate gifts do not decline at the same rate, the overall impact would be less severe.

Increasing the Cost of College Attendance

The second major impact of the bill is to raise a family's cost of sending a child to college. Obviously, the partial taxation of scholarships and fellowships will have an impact on families of students on full scholarships and on some graduate students. To the extent that undergraduates and their families are affected, this provision is likely to felt most by families at lower and middle incomes. Ending the deductibility of interest on student loans will affect many of the same taxpayers, though the size of the impact is uncertain since home equity loans will be available to take the place of student loans.

The tighter taxation of custodial accounts will tend to hit taxpayers at higher levels of income, but for many of those taxpayers there will be a significant increase in the cost of a college education. As Table 2 shows, the tax rates on income from custodial accounts will increase, depending on the age and income of the child. For a child under 14 whose account yields annual income of about $2000 and whose parents are subject to a marginal tax

rate of 28 percent, for example, the new law triples the average tax rate on the income of the custodial account, increasing it from about 6 percent to about 18 percent. As a percentage of total college costs, this increased taxation may be significant. Consider a couple wanting to put money aside at a child's fourth birthday in order to have $30,000 when the child is 14. If the interest rate is 8 percent, this new tax treatment increases the amount they will have to put aside by 10 percent, from roughly $14,400 to $15,800. If, say, half of a child's college costs were financed in this way, this one change would increase the total cost of college by 5 percent.

There are ways of blunting this impact, however. By investing in low-yield growth stocks while the child is young, for example, a taxpayer could enjoy unrealized and untaxed capital gains during the high-tax period before the child reaches age 14.

Increasing Operating Costs

The third major effect of the tax bill will be to increase the cost of operating colleges and universities. The cap on tax-exempt borrowing will affect only the handful of major private universities that have been large borrowers in the past. However, these institutions are among the most important research universities and for them the impact will surely be noticeable. Among major research universities, this provision cannot help but give added impetus to the efforts of state universities to become leaders in research, especially in the sciences, where new facilities are so important.

Both the nondiscrimination provisions on retirement plans and the taxation of fellowships will affect all institutions in making it more difficult to attract faculty and graduate students without higher salaries and stipends. To the extent that academics have few non-academic job opportunities, the effect here is just to lower real academic salaries. The

likely long-run result will be to reduce the flow of talented people into academic work, although this effect will probably not be that large. Likewise, ending SRA's as tax-sheltered savings accounts marginally increases the relative taxation on faculty (and, incidentally, increasses the costs of sending their own children to college), but this effect is also likely to be small.

The change in the miscellaneous deduction may become an unanticipated source of mischief. Because most faculty will not have sufficient deductions to exceed the floor, business and professional expenses will no longer be deductible. (It is unclear at this point how expenses claimed against consulting or royalty income will be handled, but I assume some sort of prorating will be required, leaving the bulk of employee business expenses nondeductible.) Thus the net cost of subscribing to journals or having students over for a meal will increase. A $40 membership fee or entertainment bill used to cost, say, $26 for a professor in the 35 percent tax bracket. Under the new law unless that professor has miscellaneous expenses equal to 2 percent of income, which seems unlikely in most cases, the cost will be the full $40. In the case of large expenditures, such as travel associated with research and sabbatical leaves, the impact of this change may be quite large. Although it is impossible to quantify precisely the effects of this provision, the likely consequence is a reduction in such professional expenditures. Because many of these are vital in professional development or in the maintenence of close faculty-student contact, this change in incentives could well be damaging.

On the Bright Side

In reciting this litany of effects, it is possible to lose sight of some of the benefits of tax reform as well as some of the opportunities opened up

by this tax change. One reason is that the beneficial effects of tax reform are largely indirect, and hence less self-evident than its possible harmful effects in specific sectors of the economy. To counteract the inherent tendency towards gloom, therefore, it is useful to note several relatively bright spots in tax reform as it affects higher education.

It could have been worse. As one considers the doleful implications of econometric models for charitable giving in the wake of the tax reform act, it is fitting to reflect on the fact that things could have been worse. The same model that implies roughly a 24 percent reduction in contributions to colleges and universities as a result of the 1986 tax reform act[8] shows that most of the other major tax reform proposals would have led to even larger declines. Only the President's proposal would have decreased giving by less, with a predicted 21 percent reduction in giving using that model. But under the Treasury's original plan, the drop would have been 27 percent. This model shows that the Bradley-Gephardt plan would have led to a decline on the order of 36 percent and that the DeConcini-Hall-Rabushka proposal, which would have eliminated the deduction altogether, would have brought about a decline of more than 40 percent.[9]

Gifts of appreciated propery retain favorable treatment. The decline in the incentive to make contributions will not be great in all cases. In particular, for most taxpayers the advantages of giving appreciated property will still exist. Indeed, the comparative advantage in giving appreciated property will increase due to the increase in the capital gains tax rate. Consider, for example, a taxpayer with income around $75,000 in 1988. For this taxpayer the new tax law will increase the price of giving cash by 17 percent. However, the price of giving an asset whose value has doubled will increase only one-fifth as much.[10] Thus it will behoove colleges and universities to continue to remind potential donors about the tax advantages

of gifts of appreciated property.

Professional expense accounts for faculty. The new law presents colleges and universities with an incentive to alter the way they compensate faculty, which I believe is also an opportunity to increse productivity. Because of the new floor for miscellaneous deductions, many faculty will no longer receive a tax subsidy for purchases of academic journals, the cost of having students over to dinner, and other such business-related expenditures. One way of allowing them to continue to have this (very proper and certainly efficient) incentive is to divert a small portion of faculty salary funds and set up -- on some basis -- small accounts from which faculty can charge professional expenses related to research and teaching. While such accounts would not normally be large enough to cover business-related expenses for all faculty, they could reasonably cover ordinary professional expenses for most faculty. Such accounts would not only maintain the incentive that the current law offers, they would also create a powerful new incentive to spend money on professional development. Not inconsequentially, any faculty member who would have made the expenditures anyway on a nondeductible or partially-deductible basis will be better off after taxes if salary money is diverted into such expense accounts. There seems to be the potential here, then, for a change that will improve incentives within institutions and increase the level of real compensation at the same time.

Wider benefits of tax reform. Finally, the new tax law makes the income tax both fairer and more efficient for the economy as a whole. The broader definition of income used in the law means that taxpayers with the same income are more likely to pay the same tax. Granted, some of this broadening--from the taxation of fellowships to the revised treatment of custodial accounts--come at the expense of former tax advantages enjoyed by higher education. But

in listing the effects of tax reform it would be wrong to ignore the equity considerations underlying some provisions. There are also likely to be widespread economic benefits from the tax reform act, including the cut in tax rates on labor and investment income and a reduction in the incentive to engage in socially wasteful activities such as tax shelters and extravagant business entertainment. At this point, no one has a very good idea of what the broader effects of this kind of sweeping tax legislation will be. But it is quite likely that there will be significant shifts in spending patterns, and one byproduct may be spillover benefits for higher education.

Conclusion

Tax reform promises to bring important benefits--including increased fairness and improved efficiency. But it will also create a new and challenging environment for colleges and universities. The 1986 law will reduce private donations, raise the cost of college to families, and raise the cost of operating institutions of higher education. It is quite possible that the predictions of decline in contributions, based as they are on past behavior, will prove to be pessimistic, especially if institutions rise to the challenge with increased, more effective solicitations and if donors see that colleges and universities are in greater need. But a reduction in the level of private contributions of some magnitude seems quite likely indeed. This plus the other effects will make it all the more important for colleges and universities to explore alternatives to current methods of financing--including deferred payment plans and income-contingent loans. It may also require reexamination of tuition policy. As unpleasant as the thought of further belt-tightening may be, such a prospect seems an unavoidable outcome of tax reform.

FOOTNOTES

[1] New York Times, August 21, 1986, p.37.

[2] ABC/Washington Post Poll, January 1985.

[3] For a treatment of the issues in comprehensive income taxation, see Joseph A. Pechman (ed.), Comprehensive Income Taxation (Washington: Brookings Institution, 1977.

[4] For a description of the model used, see Charles T. Clotfelter, "Tax Reform and Charitable Giving in 1985," Tax Notes (February 4, 1985b), pp.477-487 and Federal Tax Policy and Charitable Giving (Chicago: University of Chicago Press, 1985a.

[5]Price calculated at the maximum marginal tax rate increases 22 percent (.66/.54). If the price elasticity is -0.3, the implied reduction in contributions is 6 percent.

[6] Charles T. Clotfelter, "The Effect of Tax Simplification on Educational and Charitable Organizations," in Economic Consequences of Tax Simplification (Boston: Federal Reserve Bank of Boston, 1986), p.193.

[7] American Council on Education, Fact Book on Higher Education 1984-1985 New York: Macmillan, 1984?), pp. 46, 49. Figures are for 1980-81 and are endowment income and private gifts and grants as a percentage of current fund revenues minus auxillary enterprises and sales and services of hospitals. Because of the inclusion of foundation and corporate gifts and grants, it may be an overestimate of the support likely to be affected.]

[8] The constant-elasticity model. See Table 1 or Clotfelter (1985b).

[9] For a description of the simulation model including these proposals, see Clotfelter (1985b).

[10] In general, the analysis of incentives to make gifts of appreciated property is complicated by the need to consider what alternative use the asset would have had and the ratio of appreciation to its value at the time of sale or transfer.

In the present case, the following calculation is representative of the change in net price for one group of potential donors. The average marginal tax rate for a taxpayer with income of about $63,000 to $95,000 in 1988 ($50,000 to $75,000 in 1982 dollars) will decrease from .426 to .330 as a result of the tax reform law. This implies an increase in the price of giving cash of 17 percent (.574 to .670). If the expected gain-to-value ratio (Rg*) is 0.5 (see Clotfelter (1986)), the price of giving appreciated property increases only 3.3 percent (.489 [= 1-.426-(.5)(.4)(.426)] to .505 [= 1-.33-(.5)(.33)]).

For further discussion of tax effects on gifts of appreciated assets, see Clotfelter (1986), Gerald Auten and Gabriel Rudney, Tax Notes (October 20, 1986), p. 785, and Lawrence Lindsey, "Gifts of Appreciated Property; More to Consider," Tax Notes (January 5, 1987), pp. 67-70.

Table 1

Simulated Impact of the 1986 Tax Reform Act on Charitable Giving

	Percentage Change in Giving	
	Constant elasticities model	Variable elasticities model
Religion	-14	-12
Higher education	-24	-30
Other education	-24	-27
Combined appeals	-17	-17
Medical	-17	-17
Cultural	-31	-40
Other	-17	-18
Total	-16	-15

Note: The simulations were computed for 1988 and compared long-run levels of contributions between the new tax law and the 1985 law (indexed), in which nonitemizers received a deduction of half of all charitable gifts.

Table 2

Illustrative Tax Rates on Custodial Account Earnings
Under Old and New Tax Laws

Average Tax Rate (Percent)

Annual investment income	Old Law	New Law	
		Child under 14	Child 14 or older
$ 500	0	0	0
1000	0	7.5	7.5
1500	3.3	14.3	10.0
2000	5.5	17.8	11.3
4000	8.8	22.9	13.1

Note: Calculations assume 12% tax rate above $1080 under old law; 15% between $500 and $1000 and 28% over $1000 under new law.