Other papers in this volume address the question of the appropriate endowment payout rates that universities and colleges should use in supporting their annual operating budgets. Tim Warner’s paper also makes a strong case that trustees and their institutions are surprisingly unimaginative and unyielding in their use of higher education endowments.

This paper builds on those comments both directly and tangentially with some other thoughts about endowment use and about the way endowments get built, and one or two observations about suboptimal financial management of colleges and universities.

**Discounted Cash Flow Investment Analysis**

The usefulness of analyzing proposed investments using well-accepted discounted cash flow (DCF) techniques is well established. Despite being widely taught in our business and engineering schools, the techniques seem to be seldom used by higher education, private or public, in analyzing its investments.

The argument, of course, is that not-for-profit higher education institutions are not businesses and few higher education investments have positive returns on investments. True, but the same can be said for many investments that businesses must make. In not-for-profits with reasonable endowments, an alternative use of funds is always available—the endowment—and analysts can estimate rather well what the long-term return on endowment investments will be.

On higher education campuses we tend to construct buildings that will have substantially longer lives than run-of-the-mill commercial or industrial buildings. That may well make sense, given our lower cost of capital, but a more rigorous financial analysis would almost certainly better inform our decisions. If we select a lower-investment option to accomplish a certain objective, we can reasonably assume that the difference can be invested in the endowment with a quite predictable return. That return is the rate at which we should discount the cash flows of the project.

Why aren’t DCF analyses more frequently used? Probably because in private higher education essentially all investment funds come in the form of gifts—except for the minor amounts that we borrow, and we borrow at a subsidized, tax-free rate. We must be assuming that such gift funds have an essentially zero cost of capital. Is that really the way we should treat resources that our donors and taxpayers entrust to us?

This question is forcefully brought to mind by Stanford University’s decision to spend roughly $90 million to rebuild its football stadium to decrease its size. Yes, decrease its size from about 85,000 capacity to 50,000. To be sure, the Stanford football stadium is uncomfortable, and an 85,000-seat stadium is a bit of an embarrassment in light of attendance in recent years, but $90 million to make it more “intimate”? When some have suggested that this project seemed to be an extravagant use of funds, the response from both university administrators and football enthusiasts is, “What do you care? It will be paid for by gift funds.”

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To be sure, if the stadium project doesn’t go forward, the lead donor is very unlikely to give the same amount to, say, the humanities departments. But what kind of message does this send to other donors and to the less affluent corners of the university? And isn’t there an assumption behind the tax advantages given charitable contributions that such contributions will benefit society, thus relieving the government of the obligation to provide the benefit? A more intimate football stadium at Stanford University doesn’t seem to meet that test.

A quick back-of-the-envelope calculation might assume that the cost of capital for this project is the real earnings rate on Stanford’s endowment, the life of the project is 25 years, five or six football games are played annually in the stadium, the new-improved stadium will increase attendance by 10,000 per game, and the improved ambiance will permit $10-per-ticket higher prices. On a DCF basis, the inherent subsidy is about $1.0 million per game for 25 years. It’s hard to imagine that intangible benefits from this project can approach $1 million per game.

My primary argument is that tax-advantaged funds—project-specific gifts or former gifts—are being used inappropriately.

Winner-Take-All Syndrome

I’ve spent the last 20 years of my life as a fundraiser, first as a vice president for development and then as a college president. Fundraising is an honorable, valuable, and necessary activity, but I’m developing some worries.

My greatest worry is what Bob Frank and Philip Cook (1995) call the winner-take-all syndrome. The rich get richer, and the gap widens between the well-endowed, elite schools and the rest—and that includes the vast majority of institutions. As Business Week reported in a piece titled “Rich College, Poor College,” “Fever pitch fundraising at top-tier universities leaves the others way behind.” (Dec. 20, 2004.)

Harvard and Stanford are apparently both gearing up campaigns with targets north of $4 billion, notwithstanding their endowments of about $27 billion and $13 billion respectively and, importantly, with no plans to expand enrollment by a single student. Twenty-two universities are now in campaigns with targets of $1 billion or more; many are aiming for more than $2 billion. Every Ivy League institution not now in such a campaign is planning one—again, with one or two exceptions, with no plans to increase enrollments. As corporate CEOs compete in the market capitalization of their companies, university presidents and trustees compete in size of campaigns goals and total endowments accumulated—a rather unbecoming competition!

The American public decries the widening disparity in personal incomes, blaming the phenomenon on weak corporate governance and tax cuts for the wealthy. Yet the same conditions in higher education draw little notice, certainly not by the faculty at the wealthy institutions. Indeed, pending fundraising campaigns suggest the disparity in wealth between rich and poor colleges will widen.

Top-tier institutions will devote some endowment funds to research, scholarships for needy students, and other purposes with a social benefit. But ambitious facilities construction programs prevail, and student amenities such as sumptuous food services, opulent student lounges, and exercise facilities that rival exclusive private clubs will proliferate on wealthy campuses—while facilities at the poorer institutions accumulate deferred maintenance. At the wealthy institutions, student financial aid plans will be further sweetened—while poorer colleges succumb to deep tuition discounting to maintain enrollment or increase student quality. Meanwhile, the competition for admission to prestigious, wealthy colleges, already at fever pitch, continues to ratchet upward. One-million-dollar compensation “packages” for university presidents spread, and the salary gap between top-tier universities and state universities or church-related colleges widens.

Could “winner” institutions spend gifts in ways promising broader societal benefits? Indeed, and a small fraction

Should colleges and universities be allowed to amass endowments without limit? Institutions with large endowments keep getting richer and have more resources to invest in students, faculty, and facilities. This widens the gap between the “haves” and the “have-nots.” It also makes it more and more difficult for the poorly endowed colleges and universities to continue to provide access to low-income students, as their resources are being stretched by trying to keep up programmatically with the well-endowed schools. The continued compounding of endowments along with aggressive fundraising to increase them leads to an ever-widening gap between rich and poor colleges and universities.

—Lucie Lapovsky, Mercy College
will be spent that way—to pursue medical research, advances in science and engineering, or improved K–12 education. What about other opportunities? Could top schools deliver their quality educational programs—perhaps electronically—to a larger fraction of the public? MIT and Columbia have made some moves in that direction. Opening branch campuses in underserved parts of the world? Developing innovative programs that will entice more U.S. students to pursue science, engineering, and mathematics degrees?

An old and accurate adage says universities and colleges raise all the money they can, and spend all the money they raise. So what’s wrong with that? If Harvard already has more than $1 million of endowment per student enrolled, lucky Harvard; Princeton has even more endowment per student. This is a free country, and if donors want to lavish gifts on institutions that, by most objective standards, don’t need them, so be it.

The Risks of Lavish Spending

Fair enough, but the well-endowed colleges and universities should recognize several risks.

First, the student access problem will get worse. Since higher education is the gatekeeper for upward mobility, income disparity worsens when a declining percentage of young people attend elite institutions. And, moreover, if as a society we seek to improve access to higher education, is it better that another $10 million of gifts goes to Harvard so it can raise the family income threshold for financial aid to $100,000 or to a “lesser” but excellent college to move closer to need-blind admissions?

Second, public attitudes, and therefore legislation and regulation, may turn against such increasingly wealthy institutions. Tax advantages for charitable gifts may be jeopardized. Several years ago Congress pondered a small tax on large endowments. Might that initiative reappear? Universities pursuing giant fundraising goals benefit disproportionately from federal research funding that includes recovery of overhead (indirect costs). This recovery could be sharply reduced by government-mandated changes in cost accounting assumptions.

Third, the arms race for student admissions will accelerate. Won’t this result in still more mental health problems for our youth?

Finally, perhaps before such scenarios come to fruition, large donors will begin to question whether huge gifts to already-wealthy institutions represent the highest and best use of their resources. Many foundations have already reached that conclusion. One foundation president recently told me, “Elite educational institutions are neither a problem that needs solving nor a solution to any of the problems that we care about.” Our world is not short of opportunities for donors to make productive philanthropic investments. For donors, those may trump the opportunities to make small incremental improvements in the education (and pleasure) of an elite few students in an elite few institutions.

Why the Preoccupation with Gifts to Endowment?

Fundraisers and trustees seem to view gifts in perpetuity as the gold standard of gifts. Given arguments elsewhere in this volume that payout rates for endowment are stingy, and my concerns about the excessive pile-up of university endowments, it’s reasonable to question whether gifts that add to “true” or “pure” endowment—that is, gifts in perpetuity, which is, after all, a very long time—should be considered the gold standard. Given that operating budgets are always tight, why do we fundraisers and administrators encourage donors to make their gifts to true endowment? Why not make them expendable, not in a single year but perhaps over 10 years? By the way, some institutions call such funds “wasting endowments.” My marketing instincts tell me that we can come up with a considerably more appealing name than that!

One reason is that donors are attracted to the immortality aspects of an in-perpetuity naming gift. But an equal number are frustrated by the low endowment payout rates at those universities where they want their endowment gifts to make a difference now.

If we really believe that the opportunity that we are presenting to the donor is of very high priority, why shouldn’t we want to front-load the benefit to the early years of the project? This approach wouldn’t eliminate the naming opportunity.

Are we being honest with donors when we say that the particular opportunity we are presenting to them will remain high priority in perpetuity? Probably not, or our institutions lack dynamism in the worst way. The Harvard alumni magazine recently reported that Harvard’s medical school finally killed a department of legal medicine—that is, forensic investigation—that had been endowed in 1931 by one Ms. Frances Glessner Lee. We can probably assume that she is unaware of this breech of the in-perpetuity promise.
As women’s sports become increasingly similar to men’s sports, will we always offer women’s field hockey, and do we really want to endow in perpetuity the coach for that sport? Identifying a particular professorship that may go out of fashion could get one in trouble, but how about Buddhist-American studies or the sociology of college campuses?

Further, we have other donors coming along to help identify emerging priorities. Some sophisticated donors such as George Soros understand the changing environment and are beginning to make large gifts in the form of term endowment.

Some Suggestions

Other papers in this volume suggest that institutions should manage their endowments more strategically and with more flexibility.

Elite institutions could well use the enormous endowments they are accumulating to increase their enrollments—on their primary campus or on branch campuses. To my mind this is the only possible way that such institutions can simultaneously and honestly pursue both access and excellence.

We all need to get on the bandwagon of discouraging merit-based financial aid because of its perniciousness for our student population as a whole and for our society—despite the short-term benefits this kind of financial aid may provide to individual schools.

We have an obligation to donors and to society in general to seek higher-return investment opportunities at our wealthy institutions, not just more student amenities and smaller football stadiums! Outreach opportunities in this country and abroad should earn some handsome returns.

And, finally, we better start preparing for a decline in the public’s opinion of higher education in this country. It’s coming, and we’re vulnerable.

Some Linger ing Questions

Higher education’s somber claims of being dedicated simultaneously to the pursuit of access and equity are beginning to sound a bit hollow. What are we really doing about making room for more talented, less well-off students at our best institutions? When the next rounds of multi-billion-dollar fundraising campaigns are announced by institutions whose endowments already require 11 digits to value, is there not a good chance that our publics—our many publics—will rise up and say, “Enough!”? And if so, will the next generation—the group to whom enormous wealth will be transferred in the next few decades—be as generous to our institutions as we seem to expect? Indeed, might the public and Congress become so disenchanted with wealthy “charities” that the law will change in such a way that some of this new wealth will no longer enjoy its current income tax advantages? Higher education’s leaders must both prepare for this decline in public opinion and address its underlying causes.

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