Weak Link v. Strong Link –
How Can Large Charitable Gifts to Higher Education Be Better Utilized?

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I. INTRODUCTION

In 2016, the esteemed journalist, author and speaker, Malcolm Gladwell, released a series of podcasts called Revisionist History.[1] The purpose of the series was to examine significant past events in order to evaluate whether they had been properly understood by the public. Within the podcast series, Gladwell released a three-part mini-series that focused on the American education system. One of the podcasts, titled *My Little Hundred Million*[2], told the story of Hank Rowan, successful entrepreneur and owner of Inductotherm, who gave $100 million to New Jersey's Glasboro University in 1992. Rowan's donation was unique and significant for several reasons. First, the donation was one of the largest of its kind at the time and helped spawn a trend of donations in excess of $100 million for higher education coming from individual citizens. Second, and more importantly, the donation was aimed towards a small college with a middling academic reputation. Although the size of Rowan's donation was noteworthy, the most unique circumstance surrounding it was the fact that it did not go to Harvard, Yale, Stanford or a similarly situated school. Rowan's theory was that his contribution would make an enormous impact at Glasboro, while "[His] little 100 million would not have made a difference to MIT"[3], his alma matter. Rowan's theory helps beg a bigger question when viewed through the broader lens of financing higher education. Rowan is essentially wondering

[1] Malcolm Gladwell, My Little Hundred Million, Revisionist History (2016) http://revisionisthistory.com/episodes/06-my-little-hundred-million.
[2] *Id.*
[3] *Id.*

what is the best way to allocate the enormous amount of money that is donated to higher education each year.

This article will further explore Rowan's question of what is the best way to allocate donations made to universities. First, this article will look at the economic theories that support spreading resources from charitable donations around versus keeping that money concentrated at the finest institutions. Next, this article will examine university endowments and how they work. Finally, this article will discuss some of the complaints associated with endowments currently and possible policy changes with the goal of making each dollar donated to higher education as efficient as possible for students.

II. How Should Large Donations be Allocated? Weak Link v. Strong Link Theory

The first part of this article will examine the possible reasons why a wealthy individual may want to allocate his donations in a particular way. *My Little Hundred Million* uses an interesting frame of reference to explore why Rowan decided to spread his donation throughout an entire small university as opposed to donating to a small segment of an enormous endowment fund at a university like Harvard or Princeton. The theory discussed in the podcast was created when a group of economists looked at the most efficient way to build a successful soccer team and can be referred to as the weak link theory. The gist of the theory is that soccer is a weak link sport in which the most successful teams are not reliant on a singular star player, but instead are only as strong as their weakest player.[4] The economists who created the theory explain that soccer requires a number of beautiful passes in order to score a goal and if one weak player messes up a pass in the sequence that leads to the goal, then the opportunity for the goal will

[4] Malcolm Gladwell, My Little Hundred Million, Revisionist History (2016) http://revisionisthistory.com/episodes/06-my-little-hundred-million.

never exist. Basketball, on the other hand, is a strong link sport. In basketball, a team only needs one great player to be successful because one transcendent player will usually be able to score without the help of weaker teammates.[5]

My Little Hundred Million illustrates this theory in a different setting by asking the listener how they would solve the problems associated with air travel in the United States if they were given $50 billion.[6] It stands to reason that a person would not waste precious resources improving the nation's finest airports if they already operate efficiently. The most logical way to tackle this problem would be to allocate resources towards the *least* efficient airports responsible for causing delays which reverberate throughout the nation. By making the weakest links in the system stronger, the entire system becomes stronger.

Yet another way to frame the weak link versus strong link theory is to use it to explain why the industrial revolution started in England as opposed to another European country. The weak link theory supports the idea that the industrial revolution started in England not because there were a large amounts of geniuses living in the country, but because it had the greatest number of common engineers.[7] England's engineers during this period are equivalent to the weakest link on a great soccer team, they were competent at their job and made small contributions to help create the industrial revolution.

Rowan's decision to give money to a university where it would have an impact on the largest number of students possible shows his belief in the weak link theory. By donating to a school like Glasboro University, Rowan may not be helping the best and the brightest, but his donation may be more helpful to society as a whole because he is assisting a great number "weak

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[5] Malcolm Gladwell, My Little Hundred Million, Revisionist History (2016) http://revisionisthistory.com/episodes/06-my-little-hundred-million.
[6] *Id.*
[7] *Id.*

links" as opposed to a small number of "strong links" by donating to an enormous endowment fund at a school like Harvard. On an even grander scale, the weak link theory begs questions that can be applied to the entire education system. Will the United States be better off in the future if charitable donations are spread to as many universities and students as possible? Or is it in the country's best interests to invest heavily in our best and brightest?

Rowan's weak link viewpoint is opposed by Stanford's President John Hennessey, a strong link supporter. Hennessey's belief in strong leadership is evidenced by his creation of Stanford's Global Leadership Program. The Global Leadership Program, a graduate program serving 100 of the world's top students, was created when Hennessey was able to procure an $800 million donation from Nike CEO Phil Knight.[8] Based on the idea that a donation of this kind typically puts 5% of its principal to use per year, Stanford's Global Leadership Program is spending $400,000 per student per year.[9] On the opposite end of the spectrum, Rowan's donation, which was an eighth of the size of Knight's, helped build an engineering school which serves 750 students per year at annual tuition rate of $9,000.[10]

It is difficult to obtain definitive evidence that points to specific instances where use of the weak link approach versus the strong link approach renders a greater positive impact on society at large or vice versa. Gladwell, the creator of the podcast series, believes the we live in an interdependent society that is best served by spreading our resources and educating as many people as possible.[11] At the same time, it is easy to argue that society is pushed forward by great individuals who were properly guided in their formative years. It is interesting to note that the

[8] Malcolm Gladwell, My Little Hundred Million, Revisionist History (2016) http://revisionisthistory.com/episodes/06-my-little-hundred-million.
[9] *Id.*
[10] *Id.*
[11] *Id.*

economists who created the weak link theory had little success selling their idea to the owners of soccer clubs. Despite the logic of their theory, many of the owners refused to implement weak link strategy because investing money towards one or two superstar players as opposed to several serviceable players brought more notoriety to the team and put fans in the seats. The logic employed by the owners in this regard helps explain part of the reason why universities invest in curriculum like Stanford's Global Leadership Program. While the program may deploy an enormous number of assets to help only 100 students, the hope is that giving talented students tremendous resources will help produce the next US President, Nobel prize winner or Steve Jobs. If Stanford's Global Leadership Program produces this type of person, then the University will gain notoriety and always be able to point to them as evidence of the program's success. On the other hand, Glasboro's army of competent engineers could never illicit the same public enthusiasm as Stanford's famous tech billionaire or poet laureate.

III. WHAT ARE UNIVERSITY ENDOWMENTS AND HOW DO THEY WORK?

Since this article started by exploring the reasoning behind why wealthy individuals may choose to allocate their large donations in a particular way, this article will now look at how those donations are used within a university's endowment are and how endowments work generally.

An endowment is a collection of assets invested by a university to support its educational mission in perpetuity.[12] An institution's endowment is actually comprised of hundreds of individual endowments.[13] The principal from an endowment donation is placed into an array of

[12] *Understanding College and University Endowments*, American Council on Education, (2014) https://www.acenet.edu/news-room/Documents/Understanding-Endowments-White-Paper.pdf.
[13] *Id.*

investments, and the income generated from the investments is put toward the university's needs, ideally the endowment fund's principal will never be touched.[14] Endowment funds offer stability for projects that cannot be readily started and stopped such as student aid, faculty positions, innovative academic programs, medical research, and libraries.

An endowment usually is given by donors with a number of restrictions placed on it. For example, the donor may choose to allow the university access to the principal if necessary or the donor may dictate how the income or principal is spent.[15] Donors can give funds to a true endowment or a term endowment. True endowments may contain funds that the donors have to dedicated scholarships or faculty support.[16] On the other hand, term endowments can be restricted by the donor for some period of time. After the set period has passed, unused funds or principal become unrestricted.[17] Institutions may also put other unrestricted funds, such as general gifts or bequests, in the endowment. These funds are referred to as quasi-endowments. When calculating the total value of an institutions endowments, true endowments, term endowments, and quasi-endowments are included.[18]

In the early days of endowments, real estate was the primary investment vehicle for educational institutions. As a result of past financial crises, universities have emphasized diversity in their endowment investments and have moved heavily into commodities, natural resources, private equity, and other illiquid assets.[19] The complicated nature of these investment

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[14] *Understanding College and University Endowments,* American Council on Education, (2014) https://www.acenet.edu/news-room/Documents/Understanding-Endowments-White-Paper.pdf.
[15] *Id.*
[16] Molly F. Sherlock, Jane G. Gravelle, Margot L. Crandall-Hollick and Jeffrey M. Stupak, *College and University Endowments: Overview and Tax Policy Options,* Congressional Research Service, (December 2, 2015) https://www.fas.org/sgp/crs/misc/R44293.pdf.
[17] *Id.*
[18] *Id.*
[19] *Understanding College and University Endowments,* American Council on Education, (2014) https://www.acenet.edu/news-room/Documents/Understanding-Endowments-White-Paper.pdf.

funds has encouraged more and more universities to outsource their fund guidance to professional fund management companies. By diversifying their assets and hiring outside help, Universities have been able to achieve increased rates of return on their endowment investments. In 2014, endowment assets earned a rate of 15.5% on average.[20] Furthermore, larger institutions tended to garner higher returns because of their use of alternative strategies including hedge funds and private equity.

Although some public universities' endowments rank among the largest in the country, most public colleges have little to no endowment and rely on state subsidies that are not usually available to private colleges.[21] The median endowment at private colleges is roughly 7.9 million dollars, which at a normal spending rate of 5% would support an annual expenditure of $340,000.[22] Of the nation's 4,000 public and private non-profit colleges, only 657 have an endowment over $50 million. As of 2012, 62 institutions had endowments exceeding $1 billion. Even more alarming is the fact that 11% of institutions hold 74% of all endowment assets.[23]

Current tax law benefits endowments and the accumulation of endowment assets. Specifically, endowment fund earnings are exempt from federal income tax. Additionally, taxpayers making contributions to university endowment funds may be able to deduct their contribution from income subject to tax.[24] Endowments are exempt from taxes for one of two reasons. Either they are part of a university which is tax-exempt as a 501(c)(3) organization or

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[20] Molly F. Sherlock, Jane G. Gravelle, Margot L. Crandall-Hollick and Jeffrey M. Stupak, *College and University Endowments: Overview and Tax Policy Options*, Congressional Research Service, (December 2, 2015) https://www.fas.org/sgp/crs/misc/R44293.pdf.
[21] *Understanding College and University Endowments*, American Council on Education, (2014) https://www.acenet.edu/news-room/Documents/Understanding-Endowments-White-Paper.pdf.
[22] *Id.*
[23] Molly F. Sherlock, Jane G. Gravelle, Margot L. Crandall-Hollick and Jeffrey M. Stupak, *College and University Endowments: Overview and Tax Policy Options*, Congressional Research Service, (December 2, 2015) https://www.fas.org/sgp/crs/misc/R44293.pdf.
[24] *Id.*

government entity, or the endowment itself has 501(c)(3) status.[25] Additionally, the investment earnings of the endowment are tax free. Contributions to 501(c)(3) institutions are generally tax deductible to the donator under Internal Revenue Code (IRC) section 107.[26] Comparisons are often drawn between private foundations and college endowments. Unlike private foundations, college endowments are not subject to a payout requirement. In order to limit accumulation of tax-exempt funds by foundations, Congress requires private foundations to pay out at least 5% of their fund ever year under IRC section 4942. Private foundations are also subject to an excise tax on net investment income of 2%.[27]

The concentration of large endowment funds among the most prestigious schools in the country and the special treatment of these funds are two of the main reasons why people have begun to call for endowment reform policies.

IV. Why are Endowment Funds Controversial and How they can be Used More Effectively?

This article has discussed why individuals choose to allocate their endowments to higher education in a particular way, what endowment funds are, and how they work. Now, this article will address why endowment funds have become such a hot button issue and what policy options are available to address some of the common complaints associated with endowment funds. The common complaints levied against the endowment fund system are that it helps concentrate funds among the most prestigious schools in the country who need the money the least, and that universities abuse the special privileges endowment funds are afforded without reinvesting

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[25] Bruce R. Hopkins, "Chapter 11: Other Charitable Organizations," in The Law of Tax Exempt Organizations, 10th ed. (John Wiley & Sons, Inc., 2011).
[26] College and University Endowments: Overview and Tax Policy Options
[27] *IRC Section 4942*

sufficiently in their students. The policy options this section of the article will discuss to combat these complaints are: (1) a payout requirement similar to that imposed on private foundations, which would require a certain percentage of funds be paid out annually; (2) a tax on endowment investment earnings; (3) a limitation on charitable deductions for certain gifts to endowments.[28]

The first complaint lobbied against the current endowment fund system is that it perpetuates a setup in which the rich schools keep getting richer. The universities with the five largest endowment funds in the United States are Harvard, the University of Texas system, Yale, Stanford, and Princeton with funds ranging in size from $20.7 billion to $36.4 billion.[29] These schools all enjoy fantastic reputations and breed zealous, active alumni. There is not much that can be done or should be done about the fact that these schools attract wealthy donors, who want to contribute to higher education. However, many people believe that these massive donations could be put to better use if they weren't concentrated among prestigious, highly selective institutions. A common joke on the subject states that Harvard is a hedge fund with a university attached to it. The not so funny part of the joke, at least to most traditional hedge funds, is that they are taxed while Harvard's endowment fund is not. Many point to the lack of taxation on university endowments as a symbol of how prestigious private schools continue to get richer, while low ranking publicly funded schools struggle to provide students with adequate educational resources. For example, Jorge Klor de Alva, a former president of the University of Phoenix, released a report that compared the approximate amount of money private colleges saved from not having to pay tax on their endowments with the funding state schools received

[28] Molly F. Sherlock, Jane G. Gravelle, Margot L. Crandall-Hollick and Jeffrey M. Stupak, *College and University Endowments: Overview and Tax Policy Options,* Congressional Research Service, (December 2, 2015) https://www.fas.org/sgp/crs/misc/R44293.pdf.

[29] The 100 Richest Universities: Their Generosity and Commitment to Research.

from appropriations.[30] Among the sixty schools Klor de Alva analyzed, private universities with large endowments averaged $41,000 per student in tax subsidies compared to $15,300 in direct funding for public flagships.[31] A solution to this problem, which will be discussed later in this section, would be to implement a tax on university endowments. The aim of this policy change would be to redistribute some of the endowment earnings to publicly funded schools. Although there are attractive elements of this potential policy, it still does not address another complaint against endowment funds that they are not focused enough on helping students.

The second major complaint brought against the current endowment fund system is that not enough funds are reinvested in students. Harvard's endowment is spread across a huge spectrum of investments ranging from stocks to California wine vineyards and reached a level of $36.4 billion in 2014.[32] The public consensus seems to be that too much of these endowments are being tied up in illiquid assets and management fees instead of being used for the betterment of students. For example, in 2014, Yale paid about $480 million to private equity manages to manage one-third of its endowment. In contrast to the $1 billion the endowment contributed to the University's operating budget, only $170 million was earmarked for tuition assistance, fellowships, and prizes.[33] Private equity fund managers also received more than students at Harvard, Texas, Stanford, and Princeton.[34] These private equity managers are compensated through an arrangement known as "2 and 20" which refers to a two percent annual management fee and a tweney percent share of the investment profits, or carried interest.[35] The arrangement

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[30] Jordan Weisman, *Is it time to Tax Harvard's Endowment?,* Slate, (September 7, 2015) http://www.slate.com/articles/business/moneybox/2015/09/harvard_yale_stanford_endowments_is_it_time_to_tax_them.html.
[31] *Id.*
[32] *Id.*
[33] Victor Fleischer, *Stop Universities from Hoarding Money*, The New York Times, (August 19, 2015) http://www.nytimes.com/2015/08/19/opinion/stop-universities-from-hoarding-money.html?_r=0
[34] *Id.*
[35] *Id.*

is even more advantageous from a tax perspective, as the fund manager's carried interest is taxed at lower capital gains rates instead of ordinary income tax rates.[36] Opponents to the current endowment fund system have suggested a number of policy approaches with the goal of spreading funds to as money students as possible and making sure that a greater portion of endowment resources are used on students.

One of the most common suggestions used to address the concerns associated with endowment funds is to require a minimum payout every year. An avenue to accomplish this policy would be a percentage requirement much like the 5% payout requirement mandated for private foundations. The payout requirement could be restricted to certain endowments, such as those that exceed a certain level, either in absolute terms or on a per-student basis. Payout requirements could be tied to investment earnings or capped to not exceed investment earnings in bad years.[37] One of the issues raised in opposition of this approach is the restrictions on endowments imposed by donors. Usually donor restrictions require that principal not be spent or that funds only be spent for a specific purpose.[38] Because donations are often inhibited by these restrictions, universities may not be able to guarantee the ability to hit an imposed payout requirement. The other concern with payout requirements is that they may be difficult to hit in years when the economy experiences a downturn. This concern can be mitigated by requiring minimum payout to be averaged over several years.[39]

Another way to address the concerns connected to endowment funds would be to tax the endowment earnings or the endowments themselves. This policy could be undertaken in a

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[36] *Id.*
[37] Molly F. Sherlock, Jane G. Gravelle, Margot L. Crandall-Hollick and Jeffrey M. Stupak, *College and University Endowments: Overview and Tax Policy Options*, Congressional Research Service, (December 2, 2015) https://www.fas.org/sgp/crs/misc/R44293.pdf.
[38] *Id.*
[39] *Id.*

number of different ways. For example, the tax could only be applied to endowments of a certain size or to universities that have increased tuition at a certain rate such as more than the rate of inflation.[40] For the earnings of endowment funds, the government could impose a tax at the 35% level used for normal investment earnings or it could be implemented similar to the 2% excise tax private foundations are required to pay on investment income.[41]

Yet another route available for tackling problems associated with endowments is to limit the charitable deductions for gifts to endowments. Currently, donors can claim the charitable deduction of a gift at the time it is made, even if the gift is not immediately used for charitable purposes.[42] Limiting the deduction for restricted gifts to endowments or term endowments would reduce the tax incentive for making these kinds of contributions. Taxpayers might decide instead to make non-restricted donations, substituting one form of giving for another. The downside for this type of policy is the possibility of charitable donations falling. To address this concern, the policy could include adjustments based on the declining value of dollar. For example, if a donation is expected to support educational activity for 10 years, then the charitable deduction could be adjusted based on the fact that a dollar spent in the future is worth less than a dollar spent today.

There is no clear answer to the questions presented by those opposed to how endowments are typically managed. Each policy recommendation made above would present new challenges and drawbacks if implemented. In practice, it is probably best to begin with a more conservative and flexible plan because of the restrictions that most donors put on their endowments.

[40] *Id.*
[41] Molly F. Sherlock, Jane G. Gravelle, Margot L. Crandall-Hollick and Jeffrey M. Stupak, *College and University Endowments: Overview and Tax Policy Options,* Congressional Research Service, (December 2, 2015) https://www.fas.org/sgp/crs/misc/R44293.pdf.
[42] *Id.*

However, based on the disparity of assets afforded to certain prestigious institutions compared to less respected universities, it appears necessary that some sort of change should be made. It seems obvious, but whatever policy change is implemented should have the sole aim of helping as many students as possible. In my mind that means that we should not be focused on implementing a policy that punishes a school like Harvard just because it produces wealthy donors that enjoy giving back to their alma matter. We should implement a policy that reduces the restrictions that can be put on endowments, so they have the greatest chance of helping the most students.

V. CONCLUSION

The purpose of this article was to provide an in-depth analysis of how endowment funds are handled at higher learning institutions. The article first looked at the donations themselves and why wealthy individuals choose to give generous gifts to particular colleges over others. Next, the article discussed what endowment funds are and how they are operated. Finally, the article examined the common complaints against the current endowment fund system and how these complaints may be addressed.

Towards the end of the *My Little Hundred Million*, John Hennessey, the President of Stanford, is posed with the question of whether he would consider giving some of his enormous endowment to the University of California System. The University of California system educates more than 220,000 students, while Stanford has an enrollment of 16,000.[43] The University of California system is also ranked among the nation's best for educating students who came from low-income and diverse backgrounds. Hennessy's answer to the question implied that he could

[43] Malcolm Gladwell, My Little Hundred Million, Revisionist History (2016) http://revisionisthistory.com/episodes/06-my-little-hundred-million.

not envision a scenario in which he would share any of his endowment with the University of California system.[44] Hennessy's attitude is symbolic of the overarching problem the system faces the endowment fund system and why simple policy changes may not fix it. Schools need to start collaborating more in the best interests of students. Forcing Harvard to pay out a set portion of its endowment annually may help some of its own students, but incentivizing Harvard to help other universities will help the greatest number of students.

[44] Malcolm Gladwell, My Little Hundred Million, Revisionist History (2016) http://revisionisthistory.com/episodes/06-my-little-hundred-million.