

Accumulations of Wealth by Nonprofits

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Between 1988 and 1998, nonprofit organizations other than churches saw the value of their financial holdings grow in real terms at an annual rate of 7.8 percent per year, from \$777 billion to \$1.77 trillion. In contrast, holdings of financial assets by households grew at a rate of 4.8 percent and holdings by nonfarm businesses at 3.5 percent. The more rapid accumulation of financial assets in the nonprofit sector shifted the share of national wealth held by nonprofit organizations. Estimates for the years between 1998 and 2001 indicated that the rate of growth had held steady; and according to estimates in the AAFRC Trust for Philanthropy's annual publication, *Giving USA*, contributions to charitable organizations between 1999 and 2001 increased by \$50 billion (AAFRC 2003). Although the recession that began in 2001 broke these growth cycles, the decline in nonprofit sector wealth was not greater proportionately than the decline in private-sector wealth, despite predictions.

Contrary to some public perceptions, most of the wealth in the nonprofit sector is not in the hands of private foundations. It is instead held by service-providing organizations, notably hospitals and related health care organizations, together with colleges and universities. However, wealth of individual organizations varies greatly. Some colleges and universities have endowments in the billions while others have little or no permanent funds.

Can there be too much wealth in the nonprofit sector? If so, how much is too much? Should society care about wealth accumulation and, if so, what should we do about it? These questions were the subject of the sixth Seminar on Emerging Issues in Philanthropy held in November 2001 in Cambridge, Massachusetts, sponsored by The Urban Institute's Center on Nonprofits

and Philanthropy and the Hauser Center for Nonprofit Organizations at Harvard University. Nonprofit executives and their advisers joined scholars with expertise in economics, sociology, law, business, and public administration to review then-current trends and consider mechanisms to control wealth, should regulation be considered desirable.

Where Are We Now?

Setting the stage for the discussion, participants were reminded that anxieties about the size and perpetuity of charitable funds were at least as old as those that led Henry VIII to dissolve the English monasteries. In the wealth-related concerns of policymakers and commentators, however, size and longevity have often been merged with a third factor: control. For example, longevity and control were linked in the 1965 *Treasury Department Report on Private Foundations*, which recommended limiting donor control of foundations to 25 years after formation.

That foundations are closely controlled, whether by the donor's family or by others, helps to explain why they attract much more regulatory zeal in response to their wealth and longevity than "public charities" that are just as big and perpetual. Thus, the Senate Finance Committee's 1969 effort to terminate all foundations after 40 years of life and proposals to break up very large foundations have not translated into similar regulatory thrusts aimed at public charities. Perceived differences in the tightness of control largely inspire the disparate treatment of foundations and public charities. However, these differences are not as dramatic as may be supposed. Trustee hegemony is found throughout the charitable sector, and public charities can be subject to dynastic control almost as fully as foundations.

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These observations trigger two further inquiries. First, why should we care about the trinity of size, longevity, and control? Although some objections to these phenomena have been ideological (such as complaints from the right or the left about foundation biases), the quintessential lament is about power: “a concentration of economic power” (Rep. Wright Patman), power over government (in the “shadow government” literature), and power over the world of grantees—indeed, in the words of Senator Albert Gore, Sr., “unaccountable” power. If, as a result of the power problem or some other difficulty, we conclude that we do care about size-longevity-control issues, then a second inquiry is presented: Is there an appropriate regulatory remedy?

Mechanisms for Controlling Wealth

Although essentially extinct, the mortmain statutes suggest one approach to controlling wealth: direct legislation limiting size, longevity, or close control. The 1969 Tax Reform Act strictures (limits on foundation lobbying and business control, an annual payout mandate, and a tax on investment income, as well as the failed legislative proposals mentioned earlier), suggest a tax code avenue to regulation—one that some observers would like to extend to *all* charities. Still another strategy would be to respond to power with countervailing power. This pluralist approach would call for tax changes and contracting-out policies that encourage robust entry into the philanthropic marketplace—an enlarged birthrate of large-scale charitable competitors.

Several seminar participants noted that skewed outcomes can result from captive boards of trustees that are not accountable to the general public, donors who are given deference in admissions policies, or the ideological bias of the institution, whether about the curriculum, its investments, or its anti-discrimination policies.

Donor Control

Interestingly, participants discounted as relatively mild the specter of donors exercising permanent power over

expenditures. Rather, the larger problem was what dependency on a large universe of donors does to the entity. The costs in terms of time and attention are not measurable but are very real, and the need to devote time to fundraising tends to keep university presidents from moving into positions of leadership in the general society. The nonprofit thus is shaped by a fear of offending donors. Participants gave examples of the adverse effect of charities’ dependence on major donors, particularly those who wish to manipulate policy. At the same time, participants recognized that in many instances, if a donor provides support for one purpose, the charity might well be able to shift funds for support of other purposes. Further, reliance on the “market” for donations skews the areas of support—it is relatively easy to get funds for a business school, but harder to get them for an education or divinity school.

On the other hand, some participants suggested that wealth allocation should be based on some market test. At least the charity would be responding to someone’s current assessment of the best use of the money. But, incorporating market concerns into wealth allocation is difficult when a growing number of donors want to place restrictions on their gifts—regarding purposes, or investment policies, or both. Donor demands represent a difficult challenge for institutions, which are reluctant to turn away any gifts.

Mandatory Payout Requirements

Participants noted the tension between deploying funds to relieve current needs and accumulating some portion of current funds to meet future needs—both foreseen and unforeseeable. Trustees and directors are constantly balancing what they know about society’s current needs and how to ameliorate those needs, against what they do not know, but presumably will learn, about future needs and new means of amelioration.

These questions affect the proper payout rate for endowment funds—that is, funds (however labeled) held to provide ongoing support rather than being available for immediate dis-

bursement. For a private foundation, the Internal Revenue Code mandates an annual payout rate of 5 percent of the fair market value of assets held for investment—a rate meant to approximate the real rate of return on a typical investment portfolio. Universities and other charitable organizations not classified as private foundations are not subject to a mandatory current payout, although seminar participants affirmed that most of them have adopted a fixed spending rate. That rate is usually applied on a three- to five-year rolling average to the value of the endowment fund. Participants generally agreed that the major problem of colleges and universities was assuring that there was no bias against current use. This problem was viewed as a concern of the entire academic community: trustees, faculty, and investment advisers, as well as students.

The most telling criticism of a fixed minimum spending rate was the lack of flexibility it affords, given the variability of inflation and investment returns and the substantial volatility of returns over short periods (such as three years or less). This rigidity makes it particularly difficult to meet the current needs of society during an economic downturn. Many participants favored adopting a flexible approach, reducing the payout rate in good times, and increasing it during periods of recession when needs are greater. One participant suggested that as long as an organization reached a mean payout equal to the existing minimum of 5 percent over 20 years, the public purpose of requiring distribution of a fixed amount would be met.

Why society or nonprofit institutions themselves should care about the rate of current spending depends on one’s vantage point. If one considers the tax benefits arising from exemptions and charitable deductions as current subsidies, it is a short step to conclude that taxpayers have an immediate right to a real return on that subsidy. In this light, some commentators look on spending to provide a quasi-market measure of the “efficiency” of the nonprofit endeavor. For those who do not accept the subsidy concept or do not agree that it mandates some immediate current spending, the question revolves more around respecting

donors' wishes to have their gifts spent over time, for example by making gifts to organizations with perpetual life.

Regulation of Investments

Substantive state laws that govern how nonprofit organizations invest their funds also control charities' programs. These laws may limit a charity's ability to accumulate income. However, by granting perpetual life to charitable trusts and endowment funds, such laws foster at least some retention or accumulation of principal, leaving trustees and directors the task of striking a fair balance between the needs of present and future generations.

During the past two decades, almost every state has changed its laws governing the investment of assets, recognizing the limitations of fixed-income securities and the potential for equities to offer higher total returns, albeit at the expense of lower current "income" yields. To accommodate this shift, it is now legal to expend the principal of permanent funds to make up for the lower current yield—an unprecedented concept as recently as 30 years ago.

Several participants with expertise in trust investment law were adamant that controlling investment is the worst way to control wealth. Such a method contradicts the modern principle that the "prudence" of a fiduciary's investment and management decisions should be judged "not in isolation but in the context of the [fund] portfolio as a whole and as a part of an overall investment strategy, having risk and return objectives reasonably suited to the fund's purpose and circumstances" (Uniform Principal and Income Act secs 2(a) and (b)).

In the absence of arbitrary prohibitions on investment types or courses of action, individual decisions, even viewed in the overall context, might still be imprudent in relation to "market" risk, diversification, or justifiable costs. They also might result from breaches of loyalty or impartiality. Impartiality is the source of the trust law's duty to achieve "reasonable productivity of income"—balancing the interests of the present against those of the future in light of the particular organization's charitable purposes.

The disparate needs, purposes, and circumstances of different nonprofits make it generally unwise to restrict investment in order to resolve under-productivity, patronage and power, or other abuses (even land use concerns). Certainly, borrowing may lead to excess risk or inadequate payout. Specific types of investment activities may present temptations, obvious or subtle, involving patronage or conflict of interest. Excesses of size and duration offer similar temptations, as well as the risk of mindless growth and inefficient commitment of resources for the long term. However, restrictions on investment or fund management are not an appropriate tool for responding efficiently or fairly.

Several other responses were suggested, such as enforcing the traditional fiduciary standards of loyalty and prudence more effectively. The legal doctrines of *cy pres* and deviation—which permit a court to modify a charitable purpose or donor-directed method of administration that has become obsolete, impossible, or impracticable—afford means for assuring continuing social utility. Another approach would be flexible monitoring of nonprofits' expenditure/growth policies, recognizing that optimal investment programs are already being facilitated by combining modern fiduciary investment principles with the flexible expenditure policies that can be adopted under the Uniform Management of Institutional Funds Act, which applies to managing and investing endowment funds.

Another participant strongly supported the view that there should be few, if any, limits on the nature of nonprofit investments or on the amount of debt a nonprofit can take on to pursue program or investment goals. He favored both hyperdiversification in investment and appropriate access to ultramodern investment and management techniques, but was extremely wary of legal limits. In his view, few, if any, legitimate investment or management techniques are so dangerous, or so tainted, that they should be forbidden. Most are neutral tools. The truly competent trustee should be free to take rational risks in investing and bor-

rowing without inviting fools to participate in their own destruction.

Another seminar member noted that new investment techniques involve leverage and commit endowed funds to exotic instruments such as hedge funds, private equity, LBO funds, commodities, distressed debt, and sophisticated forms of arbitrage for which many members of investment committees have not been trained. Risk, its analysis, and its understanding, have been almost totally transformed since the days of investing only in publicly traded securities and avoiding any hint of leverage. He cautioned that just as the classic cases of investment committee imprudence have involved lack of diversification, in the future there might be examples of too much diversification into asset classes for which the concept of risk was inadequately analyzed. He suggested the need for a program to train investment committees on how to exercise their responsibility properly in the new investment environment of arbitrage, leverage, and exotic investment classes.

At the conclusion of the seminar, the participants agreed on the need to pay continued attention to the problems of wealth in the charitable sector, and particularly to understand and articulate the purposes for maintaining and expending wealth and the costs associated with excessive accumulation. Writing in 1990, Professor Henry Hansmann called on universities and other endowed institutions to satisfy themselves and others that their policies toward accumulation were reasonable in light of the ends to which their institutions are dedicated. It was evident from the day's discussion that this need is no less important a decade later.

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