Foundation Giving: Will it Follow the Bubble Economy?

C. Eugene Steuerle

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One of the first studies I ever published was about a quarter century ago; it was on payout rates by foundations for the Filer Commission. The research was done largely with a prod from Gabriel Rudney, then a Treasury Department economist who also served as the Research Director of the Filer Commission. Gabe is remembered fondly as one of the "fathers" of charitable sector research as an identifiable field of inquiry. The concern he raised with me was whether the payout requirement made sense or not, and he wanted someone without any stake in the outcome to analyze the issue thoroughly.

Among my conclusions at the time was that Congress should amend the requirement that foundations sometimes make payouts on the basis of their recognized income, rather than simply on the basis of a fraction of their net worth. Since recognized income depended mainly on rates of realization of capital gains, that part of the formula arbitrarily penalized foundations with income-earning stock, bonds, or who simply recognized gains to diversify their portfolios. The formula also tended to encourage higher payouts when interest rates were high merely because of inflation.

While that wart was removed in later legislation, the recent stock market boom has revealed another one to which little attention has been paid so far. At first it may appear that we are surrounded by good news about giving by grantmaking foundations. Giving has climbed from about $13.8 billion in 1996 to $19.5 billion in 1998, according to the Foundation Center's 1999 edition of Foundation Giving—that is an increase of 41 percent in merely two years. Yet, I believe that the current formula for payouts—and the way it is applied by foundations—faces a new danger not entirely unrelated to the old one. That is, in following a stock market cycle, giving can easily run counter to social needs and opportunities.

One reason this issue is hard to address is that most attention on the payout rate is devoted to the level of giving, not its variance over time. With high returns from the stock market over the past 15 years or so, some would argue that a 5 percent payout rate is not sufficient and does not adequately reflect the real returns received by stockholders over time. Opponents to changing the formula argue that the future remains uncertain, and a 5 percent rate is still more than adequate to balance current with future needs of society.

A similar debate raged in the late 1960s over the size of the payout rate. In both cases—then and now—the appropriate average level of payout over time is a separate issue from whether the design of the payout requirement and its application by foundations can lead to inappropriate cycles of giving.

The new bubble economy in the United States is reflected mainly in stock values. Until about three years ago, the increases in stock values were offset by relative declines in the value of real estate—so that household wealth relative to national income stayed within its normal bounds. (See economic perspective, "The New Bubble Economy," Tax Notes, Sept. 14, 1998, p. 1359.) Today that ratio is at an all-time high, as are such ratios as stock price-to-earnings and price-to-dividend ratios. The repercussions of a reversal, should any occur, are yet to be felt. One place they could be felt severely is in the foundation community and by those who receive grants from foundations.

Suppose, for example, that price-to-earnings ratios fall suddenly by about half back to their historic averages. Over a long period of time, such a reversion would not necessarily affect total returns available to stock market investment or the payouts that would be made by foundations. In fact, one of the little secrets of finance is that savers should actually prefer a stock market decline, as that means that they can buy existing assets for less and increase their long-term return.

If the market should drop suddenly, however, then the payments made by foundations not soon thereafter could decline at an equal rate. Thus, it is not so much that the decline could drastically reduce long-term grants that is at stake; it is the unnecessary cycle of ups and downs in grantmaking that would be costly.

What might be a theory by which to assess the relative value of payouts over time? And how might it prove that cycles of giving could be costly? Presumably we want grants to be made when and where they could achieve the greatest good. Although such a standard is quite broad, economic theory generally holds that there are declining returns to different efforts over time. The first dollar of food or clothing or whatever is generally more valuable than the last. If that theory can be extended to grantmaking by foundations, it would imply that more level giving—rather than sudden bursts up and down—would be most advantageous for society. Alternatively, it might be posited that foundation grantmaking is most useful if done in a counter-cyclical manner. That is, when the economy is in a downturn of some type, then society should be able to turn to some of its stored up wealth to dampen the effect of the downturn. Hence there may be higher social returns if foundations gave more when there were shortfalls elsewhere. A related theory applies to counter- rather than pro-cyclical efforts by government.

There is no theory, however, that foundation giving should rise the most when the economy is doing well, only to fall when the economy is doing poorly. But in many cases growth in the economy takes place simultaneously with foundation payouts based on their net worth. As a result, the current payout requirements and patterns tend to be pro-cyclical in their application. This pro-cyclical tendency has been hidden, however, by the relative steadiness in stock market growth in recent years.

There are several related reasons why giving tracks net worth so closely year-to-year. The current foundation payout rate discourages giving more than 5 percent of net worth away in any year. The excise tax on income is increased if payout in any one year falls below the average for previous years. Therefore, extra giving in one year merely raises the base on which the adequacy of future payouts will be assessed. (See C. Eugene Steuerle and Martin A. Sullivan, "Toward More Simple and Effective Giving: Reforming the Tax Rules for Charitable Contributions and Charitable Organizations," American Journal of Tax Policy 12(2): 399-447, Fall 1995, republished in The Exempt Organization Tax Review 13(5): 769-787, May 1996.)

The foundation community itself is not without some blame. There is a tendency, especially among the wealthiest of foundations, not to give much more than they have to give. Their fear, in part, is that if they do give more, and other foundations do not, then they lose their relative standing in the pecking order, as defined by net worth.

Whatever the reason, there is a grave danger today that foundation giving could follow the cycle of the bubble economy. Coming up with a method of avoiding that potential problem should be a priority of both Congress and the foundation community. For example, the excise tax could be fixed so that it does not penalize extra giving. Carryover and carryback provisions could be liberalized, and the payout requirement could be set on the basis of net worth for a longer number of years without necessarily affecting expected average giving over time. Whatever the various patches to this roof, they should be made while the sun is still shining, rather than waiting for the rain to start.

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- C. Eugene Steuerle

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