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PAY IT FORWARD? LAW AND THE PROBLEM OF RESTRICTED-SPENDING PHILANTHROPY

BRIAN GALLE[*]

ABSTRACT

American foundations and other philanthropic giving entities hold about $1 trillion in investment assets, and that figure continues to grow every year. Even as urgent contemporary needs go unmet, philanthropic organizations spend only a tiny fraction of their wealth each year, mostly due to restrictive terms in contracts between donors and firms limiting the rate at which donations can be distributed. Law has played a critical role in underwriting and encouraging this buildup of philanthropic wealth. For instance, contributors can typically take a full tax deduction for the value of their contributions today, no matter when the foundation spends their money, and pay no tax on the investment earnings the organization reaps in the meantime.

What, if anything, justifies public support for "restricted spending" charity? This Article offers the first comprehensive assessment of that question and supplies original empirical evidence on several key aspects of it. I argue that restricted spending sacrifices crucial information, leaves superior opportunities on the table, and on average transfers funds to times when they are less useful. While there is a place for large and long-

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lived philanthropic organizations in American society, that role does not require public support for restricted spending. As long as foundations can demonstrate their value to new donors, they will continue to thrive. I set out a series of policy recommendations aimed at better reconciling nonprofit law and the principles that justify it.

I support my claims with new evidence drawn from a data set of over 200,000 firm-year observations of private foundations. For example, I find that foundations earn about twice as much money per year as in earlier studies funded by foundation-industry lobbyists and that they are growing three times faster than those earlier studies suggested. This finding implies that the law could require a much higher annual "payout" from foundations. I also find that new laws introduced in about a dozen states since 2006 have significantly slowed foundation spending in the enacting states. Last, I offer simulations of several policy proposals for making foundations more effective at fighting recessions.

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INTRODUCTION

If the US philanthropic sector were the output of a nation, it would rank as the product of the world's sixteenth-largest economy, just behind Mexico, and ahead of Turkey, Saudi Arabia, and Sweden.[1] Philanthropic institutions on this scale are uniquely American.[2] Other wealthy nations, such as Great Britain and Germany, have recently begun to develop modest philanthropic sectors, but nothing to rival ours.[3] Some of this phenomenon is cultural, an outgrowth of the ideals of the decentralized American state.[4] Much of it, though, likely owes its success to legal rules that have encouraged the accumulation of philanthropic wealth, including a set of generous federal and state tax subsidies.[5] In a modern era where wealth and power are growing ever more concentrated, what justifies this use of public funds to underwrite private, if charitable, wealth?

The growth of philanthropic wealth depends on law's willingness to embrace what I will call a policy of restricted spending. At many charitable organizations, managers are free to spend most or all of the firm's revenues on current needs, whether they be housing the indigent or curing deadly diseases. Foundations, in contrast, almost uniformly are governed by agreements that prohibit managers from spending more than

1. *See GDP Ranking*, THE WORLD BANK, http://data.worldbank.org/data-catalog/GDP-ranking-table (last updated Apr. 11, 2016), *archived at* https://perma.cc/78YB-ZSZ4. If we only compared *changes* in US philanthropic wealth to world GDPs, US philanthropy would rank around sixtieth, behind New Zealand but ahead of Hungary. *Id.*

2. Helmut K. Anheier & Stefan Toepler, *Philanthropic Foundations: An International Perspective*, *in* PRIVATE FUNDS, PUBLIC PURPOSE: PHILANTHROPIC FOUNDATIONS IN INTERNATIONAL PERSPECTIVE 3, 8 (Helmut K. Anheier & Stefan Toepler eds., 1999).

3. *Id.* at 3–5.

4. DAVID C. HAMMACK & HELMUT K. ANHEIER, A VERSATILE AMERICAN INSTITUTION: THE CHANGING IDEALS AND REALITIES OF PHILANTHROPIC FOUNDATIONS 19–42 (2013).

5. *See* OLIVIER ZUNZ, PHILANTHROPY IN AMERICA: A HISTORY 11–17 (2012).

a small portion of the value of a given donor's gift in any given year.[6] By holding spending down below the annual investment earnings and other income of the foundation, the restricted-spending rules permit the organization to grow ever larger.

Law assists the project of restricted spending in a variety of ways.[7] The federal government, and most states, award generous tax incentives for making donations to charity. Those incentives do not depend at all on when the charity spends the donated funds; the government offers the same reward at the time of donation whether the charitable acts actually occur the same year or centuries in the future. Because donors can usually invest their tax savings for a profit over time, this structure provides a powerful incentive to donate first and spend later. In some ways, as I'll detail, the tax rewards for giving are even higher for gifts to organizations that restrict their spending. Further, state organizational law imposes a duty on managers to safeguard the wishes of donors who want to see their money last in "perpetuity"; and, in more than a dozen states, the law actually presumes that managers have failed that duty simply by spending more than seven percent or so of their organization's assets in any year.

The result is that nearly a trillion dollars of philanthropic wealth now sits on the sidelines, held in abeyance not just for tomorrow, but for the indefinite future.[8] Taxes paid by current taxpayers have bolstered these funds in considerable measure.[9] Yet the benefits, if they ever arrive, will be enjoyed mostly by future generations.

Surprisingly, there has been little serious scholarly attention to law's role in restricted spending and the buildup of the philanthropic sector. A handful of think-tank white papers and public policy journal articles have batted around some basic ideas, such as whether we should care about whether public funds pay for charity now or later.[10] The closest to a

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6. *See* LOREN RENZ & DAVID WOLCHECK, FOUND. CTR., PERPETUITY *OR* LIMITED LIFESPAN: HOW DO FAMILY FOUNDATIONS DECIDE? 4 (2009), *available at* http://foundationcenter.org/gainknowledge/research/pdf/perpetuity2009.pdf.

7. For detail on the points in this paragraph, see *infra* Part I.

8. *See Aggregate Fiscal Data of Foundations in the U.S., 2012*, FOUND. CTR., http://data.foundationcenter.org/#/foundations/all/nationwide/total/list/2012 (last visited Apr. 19, 2016), *archived at* https://perma.cc/AP7R-DHPE.

9. *See* Michelle H. Yetman & Robert J. Yetman, *How Does the Incentive Effect of the Charitable Deduction Vary Across Charities?*, 88 ACCT. REV. 1069, 1071 (2012) (reporting that private foundation donors are highly sensitive to tax incentives).

10. Bill Bradley et al., *The Nonprofit Sector's $100 Billion Opportunity*, HARV. BUS. REV., May 2003, at 3, 3–11; Renée A. Irvin, *Endowments: Stable Largesse or Distortion of the Polity?*, 67 PUB. ADMIN. REV. 445, 445 (2007); Akash Deep & Peter Frumkin, *The Foundation Payout Puzzle* 1–31 (Hauser Ctr. for Nonprofit Orgs., Working Paper No. 9, 2001), *available at* https://www.hks.harvard.edu/content/download/68878/1248322/version/1/file/workingpaper_9.pdf. Some foundation leaders

complete exploration is an eight-page monograph from Stanford Professor Michael Klausner.[11] There has been no systematic examination of the arguments for and against government support for restricted-spending foundations and little effort to link the policy arguments to concrete legal rules. This gap in theorizing has also produced a gap in empirical data: because few people have been formulating the questions, we have not had much research to tell us the answers.

This Article attempts to begin all these tasks. I critically examine prior justifications for restricted spending and offer some new possibilities for consideration. I show that in some cases theory doesn't take us all the way to a conclusion and that we need more facts about how donors and foundation managers actually behave. I attempt to fill in some of those facts with original empirical data. And I then connect these tentative findings with some basic principles for reforming the current underpinnings of the law of restricted spending.

To preview the analysis in a bit more detail, I first examine the social costs of restricted-spending rules. As others have acknowledged, setting aside funds for the future reduces the efficacy of the resulting spending by worsening the fit between society's needs and the donor's goals, and heightens the cost of separating the uses of the money from the owner's control.[12] I add that waiting imposes other kinds of costs on governments, beneficiaries, and the foundations themselves. Waiting sacrifices the opportunity to learn from and build on charitable successes and failures, and to invest in social programs with long-term rewards. It also shifts money from a time when resources are relatively scarce (now) to a period

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have weighed in, usually on the side of perpetual foundations. *E.g.*, PAUL BREST & HAL HARVEY, MONEY WELL SPENT: A STRATEGIC PLAN FOR SMART PHILANTHROPY 259–66 (2008); JOEL L. FLEISHMAN, THE FOUNDATION: A GREAT AMERICAN SECRET 236–48 (2007); Carl J. Schramm, *Law Outside the Market: The Social Utility of the Private Foundation*, 30 HARV. J.L. & PUB. POL'Y 355, 398–407 (2006). Evelyn Brody also has provided a fine overview of the history of the endowment debate. Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873, 899–944 (1997).

There have been notable articles analyzing the related question of wealth accumulation by operating charities, such as universities and hospitals. *See, e.g.*, Daniel Halperin, *Tax Policy and Endowments: Is Excessive Accumulation Subsidized?*, 67 EXEMPT ORG. TAX REV. 17 (2011); Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUD. 3, 14–39 (1990); Sarah E. Waldeck, *The Coming Showdown over University Endowments: Enlisting the Donors*, 77 FORDHAM L. REV. 1795 (2009). As we will see, that question has some overlap with foundation spending, but also many points of departure. *See* Waldeck, *supra*, at 1814 ("[Private-foundation] rule[s] . . . reflect[] policy concerns that are largely absent in the university context.").

11. Michael Klausner, *When Time Isn't Money: Foundation Payouts and the Time Value of Money*, 1 STAN. SOC. INNOVATION REV. 51, 51–59 (2003).

12. *See* Jesse Dukeminier & James E. Krier, *The Rise of the Perpetual Trust*, 50 UCLA L. REV. 1303, 1327–39 (2003).

(the future) when, as I demonstrate with some new evidence, foundations will be flush with cash.

On the other side, I argue that while there are strong arguments for encouraging savings by charities, these arguments mostly don't support current restricted-spending rules. For example, it is true that foundations can develop expertise in their chosen policy areas and can serve as laboratories and incubators for new ideas.[13] But preserving these incubators doesn't demand restricted spending, as long as managers are willing to seek out new funding—as indeed most commentators believe they should. I also suggest that charity can usefully save to prepare for times of future great need—but this implies that the organization should also be free to spend profligately when the need arrives.

These analyses supply some basic principles for reforming current law. While I leave development of exact details to await later work and better data, I argue that at a minimum federal law should require many foundations to pay out a considerably larger share of their assets each year than it now does. Congress also should close the loopholes presented by lightly regulated alternatives to the foundation form, especially those offered by the so-called donor-advised funds. At the same time, good policy might additionally include rewards or other positive incentives, especially incentives for foundations to spend or loan out money during recessions. State tax law could mirror these changes, and states should likely abandon the current movement to impose a legal cap on annual foundation spending.

At each stage of the analysis I supplement my argument with original empirical data. Drawing on a database spanning twenty-five years and thousands of foundations, I am able to offer at least preliminary evidence on several key questions underlying the restricted-spending debate. I find, for example, that foundation investments grow at about double the rate claimed in earlier work funded by the foundation industry. I also find that, including new contributions, foundation wealth is growing at more than triple the rate advocates of restricted spending have suggested. The data suggest that state laws setting a defeasible cap on spending in fact have diminished spending. And I am able to run simulations to compare several different policies for curing the problem of pro-cyclical foundation spending. While these findings are hardly the last word on foundation spending, they helpfully fill in holes in our current understanding.

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13. *See* discussion *infra* Part IV.B.

Part I of the Article lays out more detailed background on philanthropy and the laws that subsidize it. In Part II, I consider Professor Klausner's arguments that the concept of the time value of money should not apply to foundations and show several significant gaps in his claims. Part III delves into the social costs of restricted spending, while Part IV reviews old and new arguments in its favor. Part V synthesizes the two into a set of policy implications. The Appendix sets out technical details of the empirical analysis appearing throughout.

I. BACKGROUND

Let's begin by clearing up some terminology. A foundation, in the ordinary use of that word, is a charitable institution that exists to give away money, usually to other charities. The tax code's definition doesn't quite line up with general English usage. In tax lingo, a "private foundation" is an organization that draws revenue from just a few sources.[14] In contrast, a "public charity" is generally one that derives support from a relatively broad cross-section of the public.[15] Private foundations are subject to rules and regulations, and even a small tax, from which public charities are exempted.[16]

Thus, some entities that the general public would think of as "foundations" are not foundations for tax purposes. A common example are the so-called "community foundations," which collect small donations from the public and spend them in a concentrated geographic area.[17] Other entities that the tax code treats as "private foundations" may distribute few funds, and instead focus on direct charitable service; the code calls these private "operating foundation[s]."[18] For simplicity, in this Article I use the term "foundation" to refer generically to grant-making institutions, whether they are treated as private foundations by the tax code or not.

A major recent alternative to the foundation form is the donor-advised fund, or "DAF." A DAF is just an account, managed by a "sponsoring"

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14. *See* ROBERT J. DESIDERIO, PLANNING TAX-EXEMPT ORGANIZATIONS § 16.03 (LexisNexis Matthew Bender 2016).

15. *See id.* § 17.08.

16. George Johnson & David Jones, *K. Community Foundations*, *in* INTERNAL REVENUE SERV., EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION (CPE) TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1994 (1994), *available at* http://www.irs.gov/pub/irs-tege/eotopick94.pdf.

17. For a helpful overview, see Tanya D. Marsh, *A Dubious Distinction: Rethinking Tax Treatment of Private Foundations and Public Charities*, 22 VA. TAX REV. 137, 141–42 (2002).

18. I.R.C. § 4942(j)(3) (2014).

nonprofit, holding assets contributed by a donor.[19] The donor retains the right to "advise" the nonprofit on how to spend the money. Once placed in the account, the donated funds can be used only to support the sponsor or other charities.[20] Since sponsors know they won't receive new contributions if they ignore their donors' "advice," as a practical matter, the donor remains in control of the funds.[21] Nonetheless, the donor can claim a full deduction at the time the money is placed in the account.[22] Often, the sponsor will qualify as a "public charity," since by sponsoring many accounts it can claim that its revenues derive from a broad cross-section of the community.[23] From the donor's perspective, though, the DAF works much like a mini foundation, albeit not subject to the extra rules that usually go with the foundation form.

The vast majority of foundations follow a policy of what I will call "restricted spending."[24] Through the firm's organizational documents and governing state law, the foundation's managers are constrained to spend only a small fraction of the available assets each year. Sometimes this constraint will be phrased as a percentage of the value of the firm's assets, while in other instances it will be a more general instruction to pursue a strategy that will preserve the organization's assets "in perpetuity."[25]

As other scholars have demonstrated, the law is not simply neutral towards restricted spending and the goal of perpetuity, but rather actively supports them.[26] The charitable contribution deduction is the first, and probably largest, support. The federal government and most states allow taxpayers to reduce their taxable income by the amount of any donation to an eligible charity.[27] Similarly, decedents' estates can deduct the amount of any money left to charity from the amount subject to federal tax.[28] In effect, the deduction is a matching grant for the production of charitable goods.[29]

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19. *Id.* § 170(f)(18).

20. HOWARD HUSOCK, MANHATTAN INST., GROWING GIVING: AMERICAN PHILANTHROPY AND THE POTENTIAL OF DONOR-ADVISED FUNDS 2 (2015), *available at* https://www.manhattan-institute.org/sites/default/files/cr_97.pdf.

21. *See* Marsh, *supra* note 17, at 170–71.

22. HUSOCK, *supra* note 20, at 2.

23. *See* Marsh, *supra* note 17, at 147.

24. *See supra* note 6 and accompanying text.

25. Susan N. Gary, *Charities, Endowments, and Donor Intent: The Uniform Prudent Management of Institutional Funds Act*, 41 GA. L. REV. 1277, 1282–83, 1305–06 (2007).

26. *See, e.g.*, Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 TAX L. REV. 283, 306–07 (2011); Hansmann, *supra* note 10, at 20; Irvin, *supra* note 10, at 454.

27. I.R.C. § 170(a)(1) (2014).

28. *Id.* § 2055.

29. Brian Galle, *Charities in Politics: A Reappraisal*, 54 WM. & MARY L. REV. 1561, 1568

Allowing foundation donors to claim their deduction at the time of contribution creates powerful incentives to give far in advance of when the donor wants the money spent.[30] By accelerating her donation, the donor can get the benefit of the government's subsidy sooner and invest that money in the interim. This allows her to spend more in the future, or, alternatively, to obtain the same future spending amount with a smaller out-of-pocket outlay.

Commentators disagree about whether these incentives are costly to the government. Michael Klausner argues that in many circumstances delayed spending does not cost the government anything.[31] Assuming that the foundation's assets are invested as profitably as the government's money would have been, the delay does not reduce the present value of the government's subsidy.[32]

An immediate deduction also makes restricted spending appealing if the donor can make partial use of her money in the interim. For example, commentators note that control of a foundation and its resources gives the donor prestige, power, and influence.[33] In the case of entrepreneurs who donate corporate stock, the private foundation's founders and their heirs can sit on its board and direct how the shares it holds are voted, maintaining *de facto* control of the firm whose ownership they have in form surrendered.[34] To the extent that donating money directly to an operating charity would not bring these same rewards, establishing a foundation looks relatively more attractive.

(2013); Saul Levmore, *Taxes as Ballots*, 65 U. CHI. L. REV. 387, 405 (1998).

30. Daniel Halperin, *Tax Policy and Endowments: Is Excessive Accumulation Subsidized? (Part II)*, 67 EXEMPT ORG. TAX REV. 125 (2011); Hansmann, *supra* note 10, at 20; Irvin, *supra* note 10, at 447; Ray D. Madoff, *What Leona Helmsley Can Teach Us About the Charitable Deduction*, 85 CHI.-KENT L. REV. 957, 968 (2010). For a formal mathematical analysis, see Carolyn B. Levine & Richard C. Sansing, *The Private Foundation Minimum Distribution Requirement and Public Policy*, 36 J. AM. TAX'N ASS'N 165, 167, 169–70 (2014).

31. Klausner, *supra* note 11, at 54. *But see* Michael E. Porter & Mark R. Kramer, *Philanthropy's New Agenda: Creating Value*, HARV. BUS. REV., Nov.–Dec. 1999, at 121, 121–22.

32. Klausner, *supra* note 11, at 54.

33. Levine & Sansing, *supra* note 30, at 169. This can be true of the estate tax deduction, as well. For instance, suppose that Leona calculates that her heirs will want to give some money to charity during their lifetimes. If she sets aside some money from her estate into a family foundation, she can give her heirs three benefits: money to spend on charity, the power and prestige of the foundation, and relief from the estate tax. If she simply left them the money, they would get only the cash left after the estate tax's bite.

34. *See* I.R.C. § 4943(c)(2) (2014). Private foundations can't hold more than twenty percent of a business, *id.*, but this is a large enough block of a publicly traded firm to give effective control in many instances. And firms can exceed the cap for as long as ten years after the gift. *Id.* § 4943(c)(6)–(7). Even more flexibility is possible by using contingent voting rights or by setting voting thresholds for certain key corporate actions in a way that gives the foundation an effective veto. Treas. Reg. § 53.4943-3 (2015).

A less-familiar aspect of the rule allowing full deductibility for restricted-spending gifts is that it facilitates tax planning. Donors can contribute at the moment that the deduction will generate maximum value—usually when their tax rate is highest or the value of the assets they are contributing is at its peak—again without having to trade off that goal against their preference for when to fund charitable projects.[35]

Thus, a common piece of tax advice given to entrepreneurs whose firms are about to go public is that they should contribute a portion of their stock to a new foundation or DAF.[36] Assuming that the entrepreneur was planning to donate *someday*, donating at the moment of the IPO accelerates the deduction during a year when the entrepreneur's tax rate is as high as it will ever be. It also allows the entrepreneur to claim the value of the donated stock as a deduction at a time when that value, too, may be at its peak.[37] Government loses not only because of the timing and the rate shift, but also because the value of the stock at the time it's ultimately sold for charitable purposes may be less than the value of the deduction the donor claimed.

As Dan Halperin has shown, another major tax subsidy for restricted spending is the exclusion of foundation investment earnings from the corporate income tax.[38] By contributing their investment assets to a foundation earlier than they want the funds spent, donors can allow those investments to grow tax-free. In contrast, if they held the investments themselves, they would often have to pay tax on any appreciation.

Professor Halperin acknowledges the counterargument that other tax rules might allow for effectively the same treatment,[39] but this may be an unnecessary concession. Donors who contribute publicly traded stock to a foundation can deduct the full value of the gift without paying tax on their built-in gains, seemingly achieving the same end result as early contribution.[40] To avoid all tax on her donated assets, though, the donor must never exchange them, from the day she acquires them until the day they are donated. This lock-in is itself economically costly, since it

35. *See* Marsh, *supra* note 17, at 171 (noting that DAFs allow donors to claim deductions in high-income years).

36. *E.g.*, Ryan Boland, *The First (and Often Forgotten) Rule of Impactful Giving: Give the Right Asset*, PRAC. TAX STRATEGIES, Oct. 2014, at 148, 152–53. DAFs have the advantage that they allow a full market value deduction for the founder's stock, even if not publicly traded. *See id.* at 152.

37. *See* David Yermack, *Deductio' ad absurdum: CEOs Donating Their Own Stock to Their Own Family Foundations*, 94 J. FIN. ECON. 107, 110–11 (2009) (reporting that stock donated to foundations tends to decline in value after donation).

38. Halperin, *supra* note 26, at 288, 302, 305.

39. *See id.* at 308.

40. *See* Brody, *supra* note 10, at 944.

prevents the donor from switching away from underperforming investments.[41] At the margin, we would expect donors to accept a lock-in cost of just a hair short of the full amount of the tax saved.[42] So the ability to contribute built-in-gain securities with no tax is less valuable than it appears at first glance.

Finally, in addition to tax law, other legal rules help to underwrite restricted spending. The state law of nonprofit organizations obliges managers to obey the wishes of a donor who chooses to limit the uses of her money.[43] Charitable trusts are exempt from the rule against perpetuities.[44] Other rules set a default that managers must operate a foundation with the goal of preserving its resources in perpetuity.[45] As with the laws of contract and business corporations, the existence of a judicial apparatus for enforcing these guidelines is itself a modest subsidy.[46] More significantly, and unlike an ordinary business corporation, state attorneys general are charged with enforcing managers' adherence to nonprofit law.[47] Few do so with much vigor,[48] but donors can and often do choose to incorporate in states, such as New York and California, with the most active attorney general offices.[49]

In sum, the law not only tolerates restricted spending, but also actively encourages donations to restricted-spending organizations. My goal for the remainder of this Article will be to try to understand what, if anything, can justify that choice.

II. THE TIME VALUE OF CHARITY: A FRAMEWORK FOR ANALYSIS

Restricted-spending policies defer charitable good deeds into the future. How should policy makers compare charity now against the benefit of charity later? One standard tool in most policy contexts is present-value

41. *See generally* James M. Poterba, *Taxation, Risk-Taking, and Household Portfolio Behavior*, *in* 3 HANDBOOK OF PUBLIC ECONOMICS 1109–71 (Alan J. Auerbach & Martin Feldstein eds., 2002) (describing effects of taxation on portfolio allocation).

42. *Id.*

43. Brody, *supra* note 10, at 877–80.

44. *Id.* at 877.

45. UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT § 4(a), (d) (2006).

46. Brian Galle, *Keep Charity Charitable*, 88 TEX. L. REV. 1213, 1219 (2010).

47. MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS: FEDERAL AND STATE LAW AND REGULATION 305–06 (2004).

48. *See* Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 250–52.

49. *See* Garry W. Jenkins, *Incorporation Choice, Uniformity, and the Reform of Nonprofit State Law*, 41 GA. L. REV. 1113, 1128–29 (2007) (reporting number of each state's attorney general employees assigned to charitable oversight).

analysis, also called time discounting.[50] Over the rest of this Article, I will employ time-discounting analysis to evaluate restricted-spending policies. The basic process is intuitive: I will ask whether the social welfare produced by subsidizing restricted-spending policies is greater or less than other possible uses of the government's money. Before I do that, though, I must deal with a major critique of time discounting raised by Professor Klausner, who claims that time discounting is "irrelevant" to the merits of restricted spending.[51] In this Part, I will show that Klausner's description of the significance of time discounting is no longer the most persuasive and that, in the end, present value is and must be a key part of serious policy analysis. That will set the stage for the two Parts to follow, each of which is in a sense aimed at identifying what components should go into our present-value analysis.

A. Time Discounting: A Review

It may be useful for some readers to begin with a review of the idea of the time value of money. Most readers know that, all else equal, the average investor would rather have money now than later.[52] Suppose Kent loans money to Lois. While Lois has the funds, Kent cannot invest them. Therefore, Kent will want Lois to compensate him for the alternative investments he could have made in the meantime. To simplify a bit, these alternative investments are the time value of Kent's money.[53] We might then describe the value of some future promise to pay in terms of its "discounted present value."[54] By this we just mean: how much money would Kent have to invest today in order to have that much money at the time of Lois's promised payment? The "discount rate" is the rate of return that Kent would have earned on his money.[55]

We can extend this same concept to governments. When a policy maker is considering "investing" in some policy that will pay off in the future, she should want to think about her opportunity cost. Which will have a better payoff: building this bridge or instead investing the same

50. RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 16 (6th ed. 2000).

51. Klausner, *supra* note 11, at 53.

52. BREALEY & MYERS, *supra* note 50, at 16.

53. *Id.* at 22. A more complete version of the tale would also account for the risk Kent takes that Lois might not repay the debt. We might then separate the time value of money into purely riskless waiting, "the risk-free rate of return," and a component that reflects the risky aspects. But that nuance is not particularly important for our analysis here.

54. *Id.* at 18–19.

55. *Id.* at 17.

money, collecting the proceeds, and spending the money later (on a bridge or something else)? Using present-value analysis to appraise the future value of projects implicitly builds in this opportunity-cost calculation: the policy maker is deciding how many *future* dollars she is giving up, assuming she could invest at the chosen discount rate.[56]

It isn't always easy to decide the correct discount rate. Sometimes, the government is comparing two different cash payoffs—that is the easy case. But many times, the government is comparing the non-cash payoff from a policy "investment" against the cash payoff from investing the policy's cost instead, or even against the non-cash payoffs from implementing a different policy.[57] While commentators mostly agree that the discount rate is important to any inter-temporal policy choice, these non-cash situations can raise special considerations that go into choosing the correct rate.[58] Comparing cash to non-cash payoffs requires that both payoffs be converted into some common denominator, such as "utility" or well-being. Government shouldn't give up $500,000 worth of present consumption unless the utility of the future payoff is greater than the utility earned by investing the money.[59]

Another complication is that investments may have different payoffs at different points in time. Humans experience diminishing marginal utility from wealth; each dollar is more important to us when we have only a handful of them than when we have vaults stuffed with them.[60] If future beneficiaries of government spending will be richer than we are in the present—as everyone expects they will be, on average—then the future utility payoff from government spending is correspondingly lower.[61]

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56. *Id.* at 16.

57. KENNETH J. ARROW & MORDECAI KURZ, PUBLIC INVESTMENT, THE RATE OF RETURN, AND OPTIMAL FISCAL POLICY xxv (1971).

58. Richard L. Revesz & Matthew R. Shahabian, *Climate Change and Future Generations*, 84 S. CAL. L. REV. 1097, 1101–20 (2011), and David Weisbach & Cass R. Sunstein, *Climate Change and Discounting the Future: A Guide for the Perplexed*, 27 YALE L. & POL'Y REV. 433, 438–49 (2009), summarize the debate. *See also* Revesz & Shahabian, *supra*, at 1145 (conceding the importance of discounting but raising special considerations in the context of climate change).

59. *See* Bradley et al., *supra* note 10, at 7.

60. JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 322 (3d ed. 2011).

61. *See* Kenneth J. Arrow et al., *Intertemporal Equity, Discounting, and Economic Efficiency*, *in* CLIMATE CHANGE 1995: ECONOMIC AND SOCIAL DIMENSIONS OF CLIMATE CHANGE 130, 131 (James P. Bruce, Hoesung Lee & Erik F. Haites eds., 1996); Partha Dasgupta, *Discounting Climate Change*, 37 J. RISK & UNCERTAINTY 141, 150–64 (2008).

B. Is Time Money for Foundations?

Let's turn now to Klausner's critique. Although Professor Klausner makes much of his rejection of time discounting,[62] at the end of the day he accepts most of this framework. He agrees that the relative wealth of current and future generations is an important factor in the spend/save decision.[63] And, consistent with the discounting literature, he concludes that charities should consider "how cost-effective a grant to current charity would be, compared to future charity"—that is, that foundations should consider opportunity costs.[64] He maintains, though, that foundation savings shouldn't be compared against the government's potential investment return or against the payoffs from short-run charitable projects the foundation could have chosen to fund.[65] Both these claims rest on unlikely assumptions.[66]

First, Klausner's description of the reason planners discount future payoffs by the government's investment rate is less convincing than other accounts. Klausner claims that "by discounting future grants to present value, we would be saying that" future people's lives are less important "simply because [they] live at different times."[67] As David Weisbach and Cass Sunstein have explained, however, we could value future and present lives equally and still want to consider the government's opportunity costs.[68] Indeed, to do otherwise would be unethical: it would be throwing money away, money that could benefit the present and future both. Again,

62. Klausner, *supra* note 11, at 52–55.

63. *Id*. at 57; *see also* Hansmann, *supra* note 10, at 14.

64. Klausner, *supra* note 11, at 57; *see also* Schramm, *supra* note 10, at 400.

65. Klausner, *supra* note 11, at 58.

66. In conversations after he generously agreed to read this draft, Professor Klausner suggests that his article is not best read to make the argument I attribute to him here. Instead, he makes two distinct points. First, that there should be no "pure time preference," that is, no discounting of the returns to projects that benefit future generations solely because they are in the future. And, while he agrees that saving should be compared with the opportunity cost of spending, he believes that using the time value of money is an inapt way of accounting for opportunity cost.

Framed in this way, it may be that my differences with Professor Klausner are semantic. We both would compare the total returns available throughout time from a spending project against those available from investing funds instead. My view is that we can use the language and methodology of time discounting to engage in that comparison, albeit using a "social" discount rate that reflects the returns to spending projects, as well as a potentially negative adjustment to the rate of return earned by investments to account for the costs of deferred spending I describe in the next Part. Klausner would avoid using discount rates altogether, as he seems to believe they are too easily confused with pure time preferences. He would instead simply add the value of each alternative over its expected life. And he appears to conclude that there are a relatively narrow, albeit potentially important, set of spending projects with the potential for long-term payoffs.

67. *Id.* at 53–54.

68. Weisbach & Sunstein, *supra* note 58, at 450–51.

by applying a market discount rate, in effect we are asking, "Which would produce more wealth for the future: funding this project or investing the money?" If the project would pay less than an investment would, how does it serve the future to fund the project?

Klausner also is unpersuasive when he suggests that foundations (and, presumably, the society that subsidizes them) need not weigh the benefit of restricted spending against the lost opportunity to fund short-term projects.[69] That is, his view seems to be that foundations don't have to show that their investment returns exceed the "return" that spending could produce. There are many ways charitable spending today could benefit the future. Economic development might create a path of economic growth that enriches later generations.[70] Future research could build on present-day discoveries.[71] But Klausner seemingly would consider these alternatives only if the social return "continues *in perpetuity*" and "produces benefits that compound . . . at a higher rate than assets in the foundation's portfolio."[72]

It looks, therefore, as though Klausner's objection to considering opportunity costs is about math. The idea seems to be that, over an infinite amount of time, a foundation's investment returns will outstrip the value of any finite spending project. Only spending projects whose benefits continue indefinitely are a better choice than investing, and even then only if their "rates of return" are consistently higher. This fits with standard models of capital budgeting—that is, plans for how to allocate firm resources over time—which suggest that firms spend so as to obtain an equal marginal return on their expenditures in each time period.[73] If the firm plans to exist for an indefinite period, and if we assume that on average the returns on expenditures are similar each year, it should spend roughly its net-of-inflation investment returns each year.[74] Spending out of principal would reduce the marginal payoff in future periods, unless that extra spending could itself provide value in future years in excess of the investment return.

While the math here is right, the assumption that foundations will exist literally forever is very implausible. Realistically, no foundation will live

69. Klausner, *supra* note 11, at 55.

70. *See* BREST & HARVEY, *supra* note 10, at 261; Deep & Frumkin, *supra* note 10, at 4–5.

71. *See* Irvin, *supra* note 10, at 448.

72. Klausner, *supra* note 11, at 55, 57.

73. *See* ARROW & KURZ, *supra* note 57, at xx–xxi.

74. Perry Mehrling, *Endowment Spending Policy: An Economist's Perspective*, *in* FUTURES FORUM 2004 53, 53–55 (2004); John E. Core & Thomas Donaldson, *An Economic and Ethical Approach to Charity and to Charity Endowments*, 68 REV. SOC. ECON. 261, 269 (2010).

on in perpetuity, even if we can't now predict its exact end date. So it is inaccurate to compute the value of investing by assuming an infinite life. But how long should we assume? Often, the answer doesn't matter. Imagine that we are comparing the value of investing against a spending project, using the standard compound-returns formula to compute each one:

$$(U_i = P_0(1 + r_i)^n) \; > < \; (U_s = P_0(1 + r_s)^m) \qquad (1)$$

where U_i and U_s are the utility payoffs from investing and spending, r is the annual rate of return on each option, and n and m are the expected life spans of the foundation and the spending project, respectively. If n and m are equal, then we can cancel them from each side of the inequality, with the result that we would choose whichever option has a higher rate of return.

The expected life of the foundation will often drop out of our calculations in this way because many projects a foundation takes on will have an *expected* life as long as the foundation itself. Perhaps investing in advances in chemotherapy will not have an infinite payout, assuming that someday gene therapy will supersede chemo as a leading cancer treatment. Will that day come before or after foundations are no longer a sensible social arrangement, laws change, or future managers of the foundation find a way to bring its operations to a halt?[75] We don't know, and that makes the expected life of the investment effectively the same as that of the foundation.

Where then does this analysis leave us? As Klausner concedes, foundations' decisions to restrict their spending should be measured against the lost opportunities this decision presents.[76] Doing otherwise would cheat future generations as much as it would cheat present-day taxpayers. In addition, I've argued here that to justify *government support* for restricted spending, foundation savings should have to beat two benchmarks. First, the utility payoff to future spending—net of all the costs and benefits that delay might bring—should exceed the government's investment opportunity: when the government gives foundations a dollar, the utility of future spending should equal or exceed the utility we could get from a dollar of present spending. Second, the net payoff should exceed any returns that the foundation could achieve by

75. *Cf.* Weisbach & Sunstein, *supra* note 58, at 454–55 (noting that the duration of any inter-generational transfer is uncertain because of the possibility of acts by intervening generations).

76. Klausner, *supra* note 11, at 55–58; Hansmann, *supra* note 10, at 18.

spending now on projects whose useful life is expected to be just as "perpetual" as the foundation itself.

III. THE COSTS OF WAITING

My argument so far is that it is important to consider whether the future payoffs that a restricted-spending foundation can deliver are better than the alternatives of unrestricted spending, or of eliminating the government's subsidy and investing that money for some other kind of future spending instead. In this Part, therefore, I examine some factors that might potentially diminish the value of charitable spending deferred by foundations into the future. I show that short-term spending can have long-lasting impact, that future charitable spending is likely to be less valuable because the growing philanthropic sector will have to turn to lower-priority projects, and that spreading spending out over time introduces several different forms of agency and information costs. In the last Subpart, I'll discuss a counterargument that might apply to all these points: that the charitable contribution deduction, by its very nature, commits the decision to accept these costs to charities, not the government.

A. Opportunity Costs

First, as we saw in Part II.B, even proponents of restricted spending agree that foundations could increase returns to society by investing in projects that last in perpetuity. Realistically speaking, those projects don't have to last forever to, in expectation, beat foundation savings; they just have to have an expected life that approximates the foundation's own. Every one of these projects that goes unfunded due to government policies favoring foundation savings is a waste of resources. If projects with this kind of indefinitely lived value are rare, though, perhaps this is a minor concern.

In fact, though, because foundations are engines for innovation, it very well could be that almost every project in which a foundation engages potentially has value that could continue growing as long as or longer than the foundation itself. It might be the case that grants to provide hospice care for the terminally ill won't benefit the future much directly, but discovering new methods for delivering that care likely will. Every project the foundation engages in can potentially be a source of information for

the next grant, for other operating charities, and for other foundations.[77] Foundation advocates claim repeatedly that foundations are almost unique in society in their power to use their grant-making ability to experiment, measure outcomes, and derive lessons for the future.[78] If so, though, delays in grant-making also deny the world the opportunity to benefit from those lessons.

Even if not every project has this informational value, the claim that time-limited projects inevitably pale in comparison to an opportunity to invest forever is overstated. Again, it is unrealistic to believe foundations really are timeless. Few foundations in the world today are more than one hundred years old.[79] Compound interest for one or two hundred years is powerful, but many time-limited projects could well rival that return, especially if we expect that the product could outlive the foundations themselves.

B. Diminishing Marginal Returns: Redistribution and the Growth of the Foundation Sector

Next, future spending might deliver a smaller payoff than spending today because of diminishing marginal returns. We have already seen one aspect of that argument: future generations could be wealthier than ours, on average. That implies that, if anything, we should borrow money from the future and spend it today.[80]

Another possibility, with similar implications, is that the foundation sector itself could be growing. Let's assume that foundations tend to fund their highest-value projects first, however subjectively "value" is defined.[81] As the foundation sector expands, it will have to choose projects lower and lower down on its list. The same is true of each individual foundation, assuming that foundation managers have somewhat idiosyncratic tastes relative to other managers: as the foundation gets richer, its marginal project has a lower payoff. Standard capital budgeting theory, we've seen, prescribes that a firm in that situation should shift the money to a time period when its marginal returns will be higher.[82]

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77. FLEISHMAN, *supra* note 10, at 3–9; Porter & Kramer, *supra* note 31, at 123–25.

78. BREST & HARVEY, *supra* note 10, at 262–63; Schramm, *supra* note 10, at 398–400, 404.

79. ZUNZ, *supra* note 5, at 37–68.

80. Hansmann, *supra* note 10, at 14.

81. *See* BREALEY & MYERS, *supra* note 50, at 257–82 (describing methods of prioritizing projects for firms).

82. *Cf.* Timothy R. Yoder & Brian P. McAllister, *Do Private Foundations Increase Current Distributions to Qualify for a 50 Percent Tax Rate Reduction?*, 34 J. AM. ACCT. ASS'N 45, 51 (2012)

What's happening to the size of foundations and to the foundation sector overall? In Part V.C.2, I report new empirical findings on the rate of growth of foundation assets. To preview briefly, I find steady growth in the real (i.e., net of inflation) value of private foundations' assets, including investment income and new donations but omitting expenditures—in other words, in the amount of money that would be available for spending. Together, new contributions and investment earnings offer a mean growth rate of about eighteen percent, after inflation. The foundation sector, in other words, is growing rapidly, and those figures do not include the even faster expansion of donor-advised funds.

Unless Congress has some reason to believe that the marginal value of future charitable spending will be higher than present charitable spending, this trend seems to fly in the face of the capital budgeting principles I've just outlined. Today's foundations should to some extent borrow against the value of future foundation growth by spending down their assets and letting new money replace those funds.[83] To equalize marginal returns in each period, assuming that on average projects of equal value are available each year, foundations could spend up to their growth rate each year—here, on the order of eighteen percent of their assets annually.

Current spending levels are considerably lower. Drawing on the sample of tax returns described in the Appendix, I computed average payout rates for organizations categorized as private foundations for tax purposes over several recent decades.[84] I separated spending rates according to whether organizations have received any recent donations.[85] This division is intended to reflect the possibility that firms with active donors may behave differently from those whose donors are deceased or otherwise no longer actively involved with the firm. Figure 1 below summarizes the result.

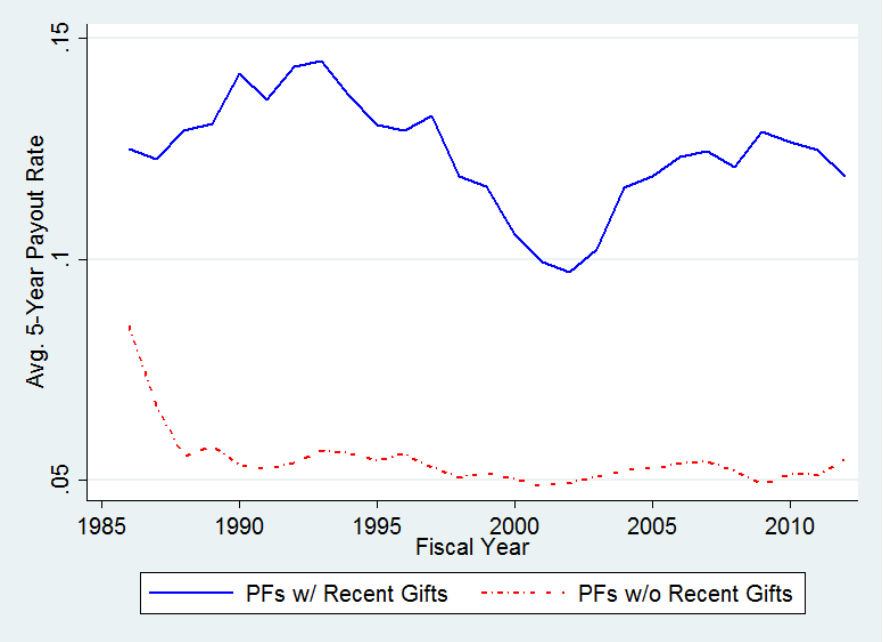
("By distributing assets contemporaneously, foundations reduce their ability to distribute assets in the future when a higher philanthropic return may be available."); Halperin, *supra* note 10 (suggesting that endowment spending rules should account for future contributions).

83. *Cf.* Deep & Frumkin, *supra* note 10, at 8 ("The availability of . . . new funds for giving in the future should make higher levels of giving today more appealing."). Admittedly, it is possible that the marginal returns curve on foundation spending is very flat—that is, that marginal returns diminish very slowly. This might be the case if foundations are now reaching only a small fraction of the neediest charities.

84. My computation is simply an averaging across firms of the mean payout rate each firm reported on its tax return for the five-year period ending in the return year. New firms, of course, may report a period of fewer than five years, but for simplicity I include these together with other firms. I winsorize the sample and weight firm observations by assets, as described in the Appendix.

85. I define "recent" as the tax return year and the four preceding years.

FIGURE 1: SELF-REPORTED PAYOUT RATES AT PRIVATE FOUNDATIONS, BY RECENT GIVING STATUS



Notes: Self-reported 5-year payout ratios. Winsorized and asset weighted. "Recent" gifts are gifts within 5 years of current period. Source: PF-SOI 2011 Cumulative File.

As Figure 1 demonstrates, average payout rates reported by private foundations are well below sustainable levels. Indeed, among foundations without recent gifts, payouts hover close to the statutory minimum of five percent annually.

C. Project Selection, Agency Costs, and Information

As many prior commentators have observed, stretching foundation spending over time tends to reduce the value of that spending through two additional mechanisms. One is agency costs: over time, it becomes harder for donors to constrain the impulses of managers who may prefer to hold down spending in order to shield themselves from risk and reduce effort or to spend in ways that contravene the donors' preferences.[86] Another is

86. *See* Lester M. Salamon, *Foundations as Investment Managers Part I: The Process*, 3 NONPROFIT MANAGEMENT & LEADERSHIP 117, 118 (1992) [hereinafter Salamon, *The Process*]; Deep

information: even if donors could perfectly control their agents, the donor's ability to best target her spending will get ever more stale over time.[87] In this Subpart, I want to add some less-familiar aspects of these problems.

First, and most simply, a relatively unfamiliar argument about restricted spending is that it presents an informational dilemma for the government as well as for donors. In theory, government subsidies or other incentives should be attuned so that the marginal social benefit generated by another dollar of charitable activity is equal to the incentive's marginal cost.[88] Restricted spending forces the government to forecast both,[89] and the more restricted the spending is, the longer the range of the forecast. As the forecast gets fuzzier, the likelihood increases that the government will do something socially wasteful: either overpay to encourage behavior that is not cost-effective or underpay and leave some beneficial behavior still on the table.[90] Some scholars have argued that when the government faces this level of uncertainty about the payoff from its policies, it should not award up-front subsidies at all, but should instead wait until after the behavior it wants to encourage occurs.[91]

Second, recent work on the psychology of foundation managers suggests yet another possible wedge that time might drive between the manager and donor. Studies report that foundation managers are often motivated in significant part by the amount of the assets under their control, rather than by what those assets can accomplish—a classic example of "empire building."[92] Managers also tend to favor accumulation

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& Frumkin, *supra* note 10, at 7–8, 10–11 (noting, *inter alia*, that managers prefer restricted spending because it protects their jobs, but describing this as an argument in favor of the practice). For evidence, see John E. Core, Wayne R. Guay & Rodrigo S. Verdi, *Agency Problems of Excess Endowment Holdings in Not-for-Profit Firms*, 41 J. ACCT. & ECON. 307, 309 (2006), and Mihir A. Desai & Robert J. Yetman, *Constraining Managers Without Owners: Governance of the Not-for-Profit Enterprise*, 4 J. GOVERNMENTAL & NONPROFIT ACCT. 53, 70 (2015).

87. Hansmann, *supra* note 10, at 33–34; Irvin, *supra* note 10, at 449; *see also* Brody, *supra* note 10, at 919, 922, 942. *But see* FLEISHMAN, *supra* note 10, at 246–47 (arguing that foundations are valuable because they "allow the values of past generations to provide a counterweight to . . . the present").

88. *See* GRUBER, *supra* note 60, at 135.

89. Recall that under current law, restricted spending is subsidized both through an up-front tax deduction and also by an ongoing exemption for the investment returns of the charity.

90. *See* Steven Shavell, *Corrective Taxation Versus Liability as a Solution to the Problem of Harmful Externalities*, 54 J.L. & ECON. S249, S256 (2011).

91. *See* Donald Wittman, *Prior Regulation Versus Post Liability: The Choice Between Input and Output Monitoring*, 6 J. LEGAL STUD. 193, 200 (1977).

92. Gian Paolo Barbetta et al., *The Impact of Fiscal Rules on the Grant-Making Behavior of American Foundations* 16 (Universitá Cattolica del Sacro Cuore, Working Paper No. 9, 2012); Deep & Frumkin, *supra* note 10, at 16–18.

over program activities because of measurability bias: it is easier to evaluate the performance of the firm's investments than of its programs, and hence managers favor investing over spending.[93]

A last point also deals with information, but it will take a bit of unpacking. Let's begin by returning to the idea that firms optimally allocate their resources when they equalize the marginal returns to spending in each time period. This is as true of donee firms, the operating charities, as it is for foundations. Restricted spending can interfere with operating charities' ability to allocate their money. In essence, restricted spending forces some operating charities to wait to obtain resources that in some cases could have been spent more efficiently in earlier periods. For instance, it is unlikely that the best use of a soup kitchen's money is to have zero dollars for four years and then a million dollars in the fifth, rather than $200,000 each year. Of course, if the operating foundation could borrow, this wouldn't be a problem, but most charities are severely credit-constrained,[94] and many nonprofit managers are averse to taking on debt that could increase the risk of bankruptcy.[95]

Foundations could overcome this problem if they had perfect information about the plans and operations of the donee firms. A perfectly informed foundation would parcel out more or less money to each donee each year, depending on the payoff. In other words, the foundation would make grants that match the spending pattern the operating foundation would choose. The problem, of course, is that the foundation managers don't have that information, and they usually can't rely on the donee firm to provide it. This information asymmetry problem comes up in many other contexts, such as government grants and insurer-insured relationships.[96] In the literatures studying those fields, scholars report that information transfers are imperfect because one party may have incentives to only convey information favorable to its interests, because information gathering is costly, and because some crucial information may be hard to reduce to writing.[97]

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93. Deep & Frumkin, *supra* note 10, at 16.

94. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 877 (1980); *see also* Brody, *supra* note 10, at 889.

95. *See* Hansmann, *supra* note 10, at 36.

96. *See, e.g.*, Paul M. Healy & Krishna G. Palepu, *Information Asymmetry, Corporate Disclosure, and the Capital Markets: A Review of the Empirical Disclosure Literature*, 31 J. ACCT. & ECON. 405, 420–26 (2001); Jonas Prager, *Contracting Out Government Services: Lessons from the Private Sector*, 54 PUB. ADMIN. REV. 176, 179 (1994).

97. *See* KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY 60 (1986).

An alternative strategy for the foundation would be simply to award all the money it plans to give to an operating charity up front and let the donee firm allocate those funds over time, but that plan also has problems. Once the donee firm has the funds, its managers may slack or diverge from the plans they promised. Those managers also are unlikely to surrender the funds in the event some other, more productive project appears at another firm. Therefore, a donor might be willing to incur the information costs of holding back funds in order to obtain greater accountability and flexibility.[98]

While at first glance this theory seems to support restricted spending by foundations, in fact it undermines it. Individual donors could obtain the benefits of accountability and flexibility by holding donated funds in their own name and then contributing directly to operating charities when the time seems right.[99] Adding a foundation in between, and directing it to restrict its spending, introduces exactly the two problems that waiting supposedly solves: it allows the foundation managers to diverge from the donor's preferences, and it reduces flexibility. Once funds are contributed to the foundation, they cannot lawfully be returned to the donor.[100] This means that if the donor comes upon a highly productive investment opportunity, she can't shift money from the foundation to that use (and then potentially back again).[101]

In short, restricted-spending foundations are likely to be less efficient than foundations that award their funds quickly, because donee firms have better information about when that money should be spent. Although donors may be willing to pay that information cost in order to gain

98. *See* Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323–24 (1986) (arguing that the need to return to funders for additional capital can reduce agency costs); Edward L. Glaeser, *The Governance of Not-for-Profit Firms* 37–44 (Harvard Inst. of Econ. Research, Discussion Paper No. 1954, 2002) (same). David Walker and I report evidence that this theory also has some traction in the nonprofit setting, finding that dependence on outside donors can affect the managerial decisions of university presidents. Brian Galle & David I. Walker, *Nonprofit Executive Pay as an Agency Problem: Evidence from U.S. Colleges and Universities*, 94 B.U. L. REV. 1881, 1917–18 (2014).

99. *See* FLEISHMAN, *supra* note 10, at 240–41 (2007) (noting that the two options are often equivalent).

100. *See* I.R.C. §§ 170(f)(3), 2055(e)(2) (2014).

101. Of course, the foundation could also pursue the investment opportunity available to the donor. We know from recent work in international taxation, however, that the "lock up" of assets inside a firm can create severe economic distortions. The identity of the owner of an investment can matter a lot to how well that investment pays off. *See* Mihir A. Desai & James R. Hines Jr., *Old Rules and New Realities: Corporate Tax Policy in a Global Setting*, 57 NAT'L TAX J. 937, 956–57 (2004). Professors Klick and Sitkoff have shown evidence that the ownership of assets affects value in the foundation context. Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey's Kiss-Off*, 108 COLUM. L. REV. 749, 814–16 (2008).

accountability and flexibility, foundations reduce those two very things. The accountability and flexibility factors could net out to either social gains or losses from foundation restricted spending, but we presently have no evidence on how they play out. For now, if we assume that they roughly balance out on average, the net result is that restricted-spending foundations create imperfect information without any offsetting benefit.

Having said all of that, there may be some situations in which it would be beneficial for society to encourage donors to "lock up" their assets in a foundation, even if that strategy reduces the value of the assets. For instance, lockups may be a way of transferring resources from a time when they have a low marginal utility (say, a booming economy) to a time when they will have a higher marginal utility (say, a recession). We'll return to that thought in Part IV.

D. Let Charity Decide?

Before moving on, though, I want to consider a counterargument that could be raised to most or all the arguments I've addressed in this Part. A standard view among most scholars of the nonprofit sector is that the foibles of managers and errors of donors are the price society must pay for the private production of public goods.[102] That is, since one of the central goals of charity is to challenge or provide an alternative to majoritarian government, the assumption is that it would be counterproductive to have government bureaucrats or elected officials second-guessing or influencing charities' choices.[103] Putting this point another way, we might say that the majority's dislike for a charity's choices shouldn't count as an additional cost, since that very dislike is a reason *for* the subsidy. For instance, I suggested that restricted spending could cause undesirable redistribution, but some commentators believe that charities should be free to be as redistributive (or not) as they choose.[104]

Whatever its general merits, this argument is not very persuasive as a justification for policies that actually encourage restricted spending. It is one thing to accept what to government eyes is wasteful charity when that is the price of vibrant and diverse uses of the charitable contribution

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102. FLEISHMAN, *supra* note 10, at 22–24; Kenneth L. Karst, *The Efficiency of the Charitable Dollar: An Unfulfilled State Responsibility*, 73 HARV. L. REV. 433, 462 (1960); *see also* Rob Atkinson, *Reforming Cy Pres Reform*, 44 HASTINGS L.J. 1111, 1137–38 (1993).

103. FLEISHMAN, *supra* note 10, at 23–24.

104. Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U. L. REV. 505, 530–31 (2010) (identifying and critiquing theories that implicitly adopt this view).

deduction. It is another for government deliberately to set in place additional policies that encourage waste. That is, if the only question were whether restricted-spending charities should be eligible for the same subsidies all other charities can claim, the answer might well be yes. But the question instead is whether government's *extra* subsidies for restricted spending—full deductions at the time of contribution, exemption of investment earnings, and so on—can be justified. Denying those subsidies does not sacrifice charitable autonomy, since the restricted-spending funds could be given over to present-day charity instead.

Putting this point another way, we might say that our fundamental policy question is whether foundation managers are likely to spend faster or slower than the socially optimal level. As we have already seen, managers have incentives and ways of thinking about restricted spending that may cause them to tend to spend slower than an outside observer would. Unless there is some story about why these incentives and frames of reference reflect genuine charitable interests, and not externalities, agency costs, and cognitive bias, the managerial preference for delay would not seem to command the same kind of deference as other charitable choices.

Limits on charitable choice are often defensible, in any event. For example, when charities produce significant negative externalities, the diversity rationale is harder to invoke: the charity is not only going its own way, but is also dragging others along. As I've argued elsewhere, the assumption that government cannot limit some charitable decisions without threatening charitable independence underestimates tools of the modern administrative state.[105] For instance, clear and simple rules can limit the discretion of government actors who might disfavor unpopular charities. Judicial review, and the threat of it and other kinds of outside evaluation, also constrain administrative biases.

Limiting restricted spending fits this model of where government can regulate charitable choice effectively. Restricted spending deprives the future of information, renders operating charities less efficient, imposes added enforcement costs on state attorneys general and the IRS, and creates unwanted redistribution. With a few mechanical rules, such as guidelines on how rapidly a firm should spend its assets, many of these problems could be curtailed. Part V addresses some of these rules in more detail.

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105. Brian Galle, *The Role of Charity in a Federal System*, 53 WM. & MARY L. REV. 777, 848–50 (2012).

IV. THE VALUE OF FUTURE SPENDING

So far, I've argued that restricted spending is socially costly in several important respects. I now turn to considering the other side: what are the benefits of paying out slowly over time? Earlier commentators have identified five main arguments in favor of restricted spending. One, the idea of intergenerational equity, we've already seen. That claim ultimately depends on whether future spending might be more valuable than spending today. While the other four arguments bear on that point, none is persuasive. At best, they weigh in favor of long-lived *entities*, but not necessarily long-term restrictions on *spending* by those entities. But there are some other possibilities that have not been seriously developed elsewhere that merit more thoughtful consideration. In particular, the latent power of foundations to buoy the economy during recessions and to rival the national government both could justify relatively long-term spending projects.[106] I argue, though, that neither of these goals merits a permanent endowment; both counsel that at some point spending limits should be lifted.

A. Prior Justifications for Restricted Spending

Prior authors set out four basic claims about why restricted spending might be more valuable than other forms of charity. Most simply, they claim that donors value perpetual life.[107] This claim underwrites two separate rationales for subsidizing perpetuities: first, that perpetual life increases the "warm glow" donors experience;[108] and second, that in doing so it also triggers increased total giving.[109] Third, commentators argue that foundations have institutional expertise or economies of scope that make their spending more efficient, so that it would be wasteful for them to close their doors after spending down their endowment.[110] Lastly, foundation advocates claim that a foundation's best project might not arise for many years. None of these claims survives careful scrutiny.

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106. Prior commentators have suggested that foundations could help to fight recessions, see NONPROFITS AND GOVERNMENTS: COLLABORATION AND CONFLICT 3 (Elizabeth T. Boris & C. Eugene Steuerle eds., 2006); Desai & Yetman, *supra* note 86, at 58, but have not explained why this should be a task for the nonprofit sector in particular.

107. Irvin, *supra* note 10, at 449.

108. *E.g.*, Adam J. Hirsch, *Bequests for Purposes: A Unified Theory*, 56 WASH. & LEE L. REV. 33, 52, 53 & nn.74, 84 (1999).

109. Karst, *supra* note 102, at 475.

110. *See infra* Part IV.A.2.

1. Donor Preferences for Restricted Spending

No doubt, donors value long-lasting recognition for their generosity. A visit to the entry hall of any museum or opera house can tell us that.[111] Some commentators suggest that the opportunity to satisfy these preferences is itself a reason to favor perpetual gifts.[112] Alternatively, and I think more plausibly, others claim that allowing long-term restrictions on gifts, especially restrictions on spending, encourages donors to give.[113]

I should first note that, as several eminent commentators have observed, there is no empirical support for the proposition that restricted spending encourages donations.[114] Donors may like perpetuities, but it could be that those who value perpetuities the most are those who were already the most inclined to donate. While prior studies find that donors actively shop for states that will allow perpetual trusts,[115] that jurisdictional competition seems entirely driven by federal tax benefits that accompany trusts with unlimited lives.[116]

In any event, the possibility that donors have preferences for limited spending argues for lesser, not greater, government cash subsidies for limited-spending gifts. In essence, we could think of the two approaches, tax subsidies and government support for restricted spending, as substitutes. I agree on this front with John Colombo, who points out that government is justified in offering subsidies when markets fail, but that

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111. William A. Drennan, *Surnamed Charitable Trusts: Immortality at Taxpayer Expense*, 61 ALA. L. REV. 225, 239–40 (2010).

112. *See* MARION R. FREMONT-SMITH, THE URBAN INST. & THE HAUSER CTR. FOR NONPROFIT ORGS., ACCUMULATIONS OF WEALTH BY NONPROFITS 2–3 (2004); Hirsch, *supra* note 108, at 84; *see also* Deep & Frumkin, *supra* note 10, at 11 (suggesting that preference of managers for conservative spending is a reason to limit payout); *cf.* Daniel B. Kelly, *Restricting Testamentary Freedom: Ex Ante Versus Ex Post Justifications*, 82 FORDHAM L. REV. 1125, 1147–49 (2013) (making this argument in support of donor conditions generally).

113. Charles H. Hamilton, *Payout Redux*, *in* VIII CONVERSATIONS ON PHILANTHROPY: PHILANTHROPIC REFLECTIONS 28, 33 (2011); LEWIS M. SIMES, PUBLIC POLICY AND THE DEAD HAND 117 (1955); Brody, *supra* note 10, at 942; *see also* Drennan, *supra* note 111, at 253 (noting this argument).

114. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 19.3 (9th ed. 2014); 4A AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 399.4 (1989); Alex M. Johnson, Jr., *Limiting Dead Hand Control of Charitable Trusts: Expanding the Use of the* Cy Pres *Doctrine*, 21 U. HAW. L. REV. 353, 357 (1999). Scott and others argue that history, in fact, teaches the opposite, but historical anecdote admittedly cannot rule out possible confounding factors. Atkinson, *supra* note 102, at 1133 n.79.

115. Robert H. Sitkoff & Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L.J. 356, 410 (2005).

116. Max M. Schanzenbach & Robert H. Sitkoff, *Perpetuities or Taxes? Explaining the Rise of the Perpetual Trust*, 27 CARDOZO L. REV. 2465, 2495–97 (2006).

markets for naming rights seem to function just fine.[117] The more donors want to give, the less the government needs to support their giving. If donors want to give more when their gifts can be subject to restricted-spending rules, government's support in dollars can be lower.

In more technical terms, the greater self-satisfaction that comes with permanent recognition implies that those donors are likely to be infra-marginal: the government's cash, while costly to the public, does not increase the donor's contribution.[118] A third, closely-related point is that the donors' utility is private consumption, while optimal subsidies for the production of positive externalities should depend only on the spillover benefits to others.[119]

Perhaps what prior commentators have meant to say is that rules encouraging the use of perpetuities are a less socially costly way of encouraging giving than tax subsidies.[120] If so, this claim would be dubious. One reason to doubt it is that the social costs of perpetuities are not measured in any government budget. Since perpetuities are "off budget," the political discipline that at least gently constrains most tax incentives has not weighed on them.[121] In other words, it is unlikely that society's choice to encourage perpetual gifts reflects a considered judgment about their efficiency.

The best argument for the efficiency of perpetuities would likely be the case in which there are some donors with strong preferences for future spending, but only weak sensitivity to cash incentives. A pair of economists recently predicted that perpetuities could increase giving under

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117. John D. Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction: Integrating Theories for the Deduction and Tax Exemption*, 36 WAKE FOREST L. REV. 657, 695, 699–700 (2001); *see also* William A. Drennan, *Where Generosity and Pride Abide: Charitable Naming Rights*, 80 U. CIN. L. REV. 45, 48, 69 (2011).

118. *See* MOLLY F. SHERLOCK & JANE G. GRAVELLE, CONG. RESEARCH SERV., R40919, AN OVERVIEW OF THE NONPROFIT AND CHARITABLE SECTOR 49 (2009) (explaining that government should not subsidize contributions from infra-marginal donors).

119. LOUIS KAPLOW, THE THEORY OF TAXATION AND PUBLIC ECONOMICS 28–29 (2008). In any event, the donor's utility properly measured, is likely to be tiny relative to the costs of the government's subsidies. Once the donor is dead, she no longer can care about her reputation. *But see* THE SIXTH SENSE (Buena Vista Pictures 1999). She might take some bit of added satisfaction during life at the thought of her name being carved in stone. Kelly, *supra* note 112, at 1147–49. But that feeling is fleeting, while the government's subsidies will, by definition, last in perpetuity.

120. Or, as Peter Diamond suggests, of reducing the deadweight loss of progressive taxation. Peter Diamond, *Optimal Tax Treatment of Private Contributions for Public Goods with and Without Warm Glow Preferences*, 90 J. PUB. ECON. 897, 898–99 (2006).

121. *See* Steven A. Dean, *The Tax Expenditure Budget Is a Zombie Accountant*, 46 U.C. DAVIS L. REV. 265, 286–88 (2012) (summarizing ways in which budgeting imposes political constraints on spending).

that assumption.[122] The existing evidence, though, largely suggests the opposite: wealthy donors are both the most sensitive to tax incentives and also the most likely to give to restricted-spending vehicles.[123]

Whatever the relative efficiency of taxes and perpetuities as stimulants to giving, there still is no argument for granting more generous tax subsidies when a gift carries spending restrictions. The whole premise of the efficiency argument would be that restricted spending is useful because it permits *lesser* tax subsidies. And it is similarly incoherent to offer tax subsidies for perpetuities in order to appeal to donors who are indifferent to tax subsidies.

I should emphasize that I am not proposing to outlaw perpetual gifts. I agree with scholars who maintain that, all else equal, individuals have some right to dispose of their property as they choose.[124] The question for this Part is whether there are reasons to *encourage* restricted spending.

2. Firm-Specific Value

Another argument sometimes advanced for restricted-spending policies is that grant-making institutions add value.[125] For example, Paul Brest, erstwhile Dean of Stanford Law School and former President of the Hewlett Foundation, argues that major grant-making organizations have developed expertise in their project areas, and have ties to networks of experts who can support, guide, and evaluate the work of the grantees.[126] These kinds of expertise are closely tied up in human capital: the staff's knowledge, their sense of how to work collaboratively with one another and outside experts, and their ability to trust the judgment of their working partners. While that capital could be replicated or reassembled, Brest

122. Levine & Sansing, *supra* note 30, at 167.

123. *See* IRS STATISTICS OF INCOME, CHARITABLE GIVING AND THE NONPROFIT SECTOR: WHAT TAX DATA CAN TELL US (2014) (reporting that giving to private foundations is predominantly from the top one percent of households by income); LILY FAMILY SCHOOL OF PHILANTHROPY AT INDIANA UNIVERSITY, GIVING USA 2014, at 140 (2014); Jon Bakija, *Tax Policy and Philanthropy: A Primer on the Empirical Evidence for the United States and Its Implications*, 80 SOC. RES. 557, 571 (2013) (finding evidence that price-elasticity of giving is higher among higher-income donors). It is true that some of the reason for the prevalence of wealthy donors in restricted-spending vehicles is the relatively higher transaction costs of that form of giving, so that the pattern of observed giving may not reflect solely the underlying preferences of donors. But the possibility that restricted gifts carry higher transaction costs only serves to make our point about the lower efficiency of that form.

124. Hansmann, *supra* note 10, at 33.

125. BREST & HARVEY, *supra* note 10, at 264.

126. *See id.*

suggests, doing so would be very costly.[127] Why, then, would we want to force such an organization to spend all its money and dissolve?

Another way this point is sometimes put is that foundations generate large economies of scope.[128] Society might get a much bigger bang for its subsidy dollar by underwriting foundations, because the foundation is overseeing many projects at once. That puts the foundation's staff in a position to be able to compare the projects to each other, see potential synergies, and apply lessons learned in one project to others. Joel Fleishman, a Duke professor who once was a senior official at The Atlantic Philanthropies, makes a version of this claim when he suggests that foundations are a key source of policy experimentation: the foundation can support several alternative ways of achieving the same policy goal, then put its money behind the one that proves to work best and advocate for it over time.[129]

These are powerful arguments, but they make a case only for long-lived institutions, not restricted spending. It is true that some organizations, including Fleishman's own The Atlantic Philanthropies, have decided intentionally to spend all of the foundation's available funds.[130] The Gates Foundation's organizational documents also reportedly require it to expend all available resources within fifty years of the death of its founders.[131] Spending the *founder's* money, though, need not mean the end of the organization. Most charities raise new money from donors and other sources. The Gates Foundation, for instance, received a massive pledge from Warren Buffett, and Buffett demanded that Gates spend some of the Foundation's preexisting money each year as a condition of receiving his donation.[132]

Admittedly, Buffett's decision is unusual in that it appears that it is rare for the very largest foundations to receive new contributions other than from the founder and his or her family.[133] Individuals who plan on making

127. *Id.*

128. *See* George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102, 1150 (2004).

129. FLEISHMAN, *supra* note 10, at 245–46.

130. HEIDI WALESON, BEYOND FIVE PERCENT: THE NEW FOUNDATION PAYOUT MENU 12–24 (2007), *available at* http://community-wealth.org/content/beyond-five-percent-new-foundation-payout-menu.

131. BREST & HARVEY, *supra* note 10, at 260.

132. FLEISHMAN, *supra* note 10, at 237.

133. The Foundation Center reports that the fifty largest foundations in America received about $9.5 billion in new gifts in 2012, against $10.7 billion in grants awarded and $209 billion in total assets. *Fiscal Totals of the 50 Largest Foundations in the U.S. by Total Assets, 2012*, FOUND. CTR.,

very large charitable contributions often prefer to establish their own foundations, even when there may already be other successful grant-making institutions pursuing the same goals.[134]

Yet even now, when policy gives them little reason to do so, many foundations readily attract new gifts. In the dataset I constructed, one-third of private foundations receive donations in a year other than their first year in the dataset. Fourteen percent of firm-years see the firm take in more in contributions than it spends. On average, foundations replace about sixty-two percent of all their expenses with new contributions. I find, as prior researchers also found, that it is mostly the largest and oldest foundations that tend not to receive new gifts.[135]

To the extent that foundations don't bring in new revenues, the reasons for that failure are not reasons the government should embrace. Donors usually explain their preference for setting up their own foundations as based on their desire to retain maximum control over their gifts.[136] Part of it, no doubt, is also ego.[137] Alfred Nobel established his prize to change the legacy attached to his name, not because he loved mankind.[138] Contributing money to a foundation named for someone else wouldn't likely deliver the same reward. And, although donors rarely say so out loud, controlled private foundations offer greater tax-planning opportunities than contributing to someone else's charity.[139] In addition, managers of an existing foundation may prefer not to seek new revenues because, as I have mentioned, it would tend to make them more accountable to others.[140] Prior studies also find evidence consistent with the idea that nonprofit managers find fundraising personally unpleasant.[141]

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http://data.foundationcenter.org/#/foundations/all/nationwide/top:assets/list/2012 (last visited Apr. 19, 2016), *archived at* https://perma.cc/L7B4-5JJ9.

134. *See id.*

135. *See* Yoder & McAllister, *supra* note 82, at 65. In regression analysis, I find large and statistically significant negative correlations between foundation age and new giving, and between foundation size and new giving. Details of these regressions are available upon request.

136. Victoria B. Bjorklund, *Giving to the Private Foundation, Donor-Advised Fund and Supporting Organization*, CS045 A.L.I.-A.B.A. COURSE OF STUDY 431, 456, 460 (2011).

137. FLEISHMAN, *supra* note 10, at 45 (describing this as "the primary driver of the creation of perpetual foundations").

138. RAY D. MADOFF, IMMORTALITY AND THE LAW: THE RISING POWER OF THE AMERICAN DEAD 87 (2010).

139. Wendy C. Gerzog, *From the Greedy to the Needy*, 87 OR. L. REV. 1133, 1169–70 (2008). For example, a controlled private foundation can be granted stock without concern that it will exercise its voting rights contrary to the interests of the controlling donor. *See id.*

140. FLEISHMAN, *supra* note 10, at 82–83; *cf.* Drennan, *supra* note 111, at 229 (noting that families may resist giving up control of foundations bearing their names).

141. James Andreoni & A. Abigail Payne, *Is Crowding Out Due Entirely to Fundraising? Evidence from a Panel of Charities*, 95 J. PUB. ECON. 334, 335 (2011); Cagla Okten & Burton A.

Still, an advocate for limited spending might say that, given these natural human tendencies, limited spending is the price we must pay in order to get the largest, very long-lived institutions. Yet none of these behaviors is inevitable: for instance, donors also make very large unrestricted gifts to universities—often with some naming rights attached, but not necessarily the power to rename the whole institution.[142] Managers of operating charities do fundraise, even though they dislike it.[143] Both parties can be incentivized to do the things that are needed to preserve long-lasting institutions. The question again would be whether limited spending is the least socially costly way of achieving the goal of institutional expertise. If donors are reluctant to give to someone else's foundation, why not change tax rules to encourage additional giving? Or, if the problem is managers, perhaps imposing a higher mandatory payout rate would motivate managers who want to retain their jobs to work harder to bring in new money.

I also agree with Mark Hall and John Colombo's argument that the ability to attract new donations is an important signal of an organization's quality.[144] If individual donors no longer want to support the mission of a foundation, what does that say about how well-spent the government's subsidy dollars are? Hall and Colombo's critique is especially trenchant for large foundations, which long have been criticized for being insular vehicles by which the super-rich can shape society.[145]

Scholarly work in the cognitive psychology of group decision making also suggests that policy often is best made in settings where decision makers know that there will be opportunities for those with differing points of view to probe and challenge.[146] In other words, I question

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Weisbrod, *Determinants of Donations in Private Nonprofit Markets*, 75 J. PUB. ECON. 255, 267 (2000).

142. *See* Brody, *supra* note 10, at 884; Hansmann, *supra* note 10, at 8.

143. *See* Andreoni & Payne, *supra* note 141, at 335.

144. Mark A. Hall & John D. Colombo, *The Donative Theory of the Charitable Tax Exemption*, 52 OHIO ST. L.J. 1379, 1450–51 (1991); *see also* Tax Reform Act of 1969, 1969-3 C.B. 464 (justifying statutory limits on nonprofit borrowing on the ground that nonprofits could otherwise expand without the need for additional donations); Irvin, *supra* note 10, at 449; *see also generally* S. REP. NO. 91–552 (1969).

145. Lester M. Salamon, *Partners in Public Service: The Scope and Theory of Government-Nonprofit Relations*, *in* THE NONPROFIT SECTOR: A RESEARCH HANDBOOK 99, 112 (Walter W. Powell ed., 1987).

146. CARLOS SANTIAGO NINO, THE CONSTITUTION OF DELIBERATIVE DEMOCRACY 117–28 (1996); Cass R. Sunstein, *Deliberative Trouble? Why Groups Go to Extremes*, 110 YALE L.J. 71, 105–08 (2000). This could also be spun as a negative feature of new donations, however. By introducing new points of view, the charity may cause donors to worry that other donors will act at cross-purposes to their own, introducing cross-monitoring costs. *See* Triantis, *supra* note 128, at 1147–48.

whether an organization that need never raise new money really can achieve the kind of institutional expertise and openness to new ideas championed by Professors Brest and Fleishman. In contrast, rules that incentivize the organization to demonstrate the worth of its mission to outsiders help to open doors, or at least windows, into the closed interiors of philanthropic power.

In sum, to the extent that the institutional expertise arguments have any power, it is only with respect to a small subset of restricted-spending organizations. Only those large, old, and vibrant enough to have developed significant irreplaceable human capital, or capable of carrying out extensive policy experimentation, can claim the benefit at all. And only those organizations seem to need restricted spending to protect their extended lives; other philanthropies have little trouble raising new money.

3. Real Option Value of Waiting

A last argument one sometimes reads from restricted-spending advocates is that a foundation's best project is not always available immediately.[147] For instance, the Gates Foundation wants to combat malaria. Should it put all its billions into the first malaria vaccine that comes along? Or should it try to develop several potential solutions, saving its biggest expenditures for the one that proves most promising? This second route has an intuitive appeal, and the underlying insight is sometimes called "real option value."[148] By waiting, we get more information about the world, and that can allow us to make better choices.[149]

Economic models of real options suggest that waiting isn't an unmitigated good.[150] Instead, there is an optimal balance between waiting and acting.[151] Even for actors with theoretically infinite lives, waiting can mean missing out on opportunities that might have turned out to be the best choice.[152] At some point, Gates has to get behind one of its vaccine manufacturers, before they all go out of business. Real option theory may

147. Irvin, *supra* note 10, at 449–50; Deep & Frumkin, *supra* note 10, at 12–13.

148. BREALEY & MYERS, *supra* note 50, at 619; Alexander J. Triantis & James E. Hodder, *Valuing Flexibility as a Complex Option*, 45 J. FIN. 549, 549–50 (1990).

149. BREALEY & MYERS, *supra* note 50, at 625. Relatedly, foundations may serve as intermediaries whose greater capacity to investigate and verify service organizations makes them valuable sources of seed capital. Triantis, *supra* note 128, at 1160. But this, too, is a story in which, while saving is useful, the foundation must constantly spend to make the savings worthwhile.

150. BREALEY & MYERS, *supra* note 50, at 625–28.

151. *Id.*

152. *Id.*

justify some degree of savings, but in the end it's a theory of action, not inaction.

Real options also don't offer much support for awarding subsidies to donors at the time of their gift, rather than the time the foundation spends the contribution. What value is created for society by the Gates Foundation's holding Bill Gates's money as it searches for the best ways to spend it? What difference would it make if Gates himself held the bulk of the funds, then contributed the rest when the Foundation informed him it had found the right target? If anything, placing the money in the Foundation's hands shifts the administrative costs of investing the funds to the Foundation, and introduces the kind of agency costs I discussed in Part III.[153]

B. New Arguments for Restricted Spending

In addition to the possibilities other commentators have raised, I want to raise some additional potential benefits from the accumulation of wealth by philanthropic organizations. In earlier theoretical work, I argued that the best justification for subsidies for the charitable sector may be the sector's potential to achieve what local governments cannot: spend during times of acute need, compete effectively with the federal government, and conduct guided policy experiments, among other goals.[154] Each of these three achievements likely requires some buildup of charitable assets over time. I'll now claim, however, that rather than prescribing accumulation of unlimited wealth over endless periods of time by private foundations, these policies generally weigh in favor of limited savings, call for occasional aggressive spending, and may make more sense for operating charities than private foundations.

As a prelude to this analysis, I should mention that the traditional rationale for government support of charities is that charity is basically a delivery vehicle for positive externality goods that neither government nor market would otherwise provide.[155] So, for example, charity can pursue goals that could not command a majority of voters. In this Subpart, I will

153. Perhaps the firm can do slightly better long-range planning when it has actual title to the donation, rather than just a pledge by Gates to commit the money in the future. But that seems a fairly slender benefit.

154. Galle, *supra* note 105, at 835–40.

155. Burton A. Weisbrod, *Toward a Theory of the Voluntary Non-Profit Sector in a Three-Sector Economy*, *in* ALTRUISM, MORALITY, AND ECONOMIC THEORY 171, 175–83 (Edmund S. Phelps ed., 1975); Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1399 (1988).

build on some additional examples of instances in which charities can succeed while governments fail.

1. Crisis Spending

One key example where governments predictably fail is crisis spending.[156] Private citizens should want to buy insurance or build up a buffer stock of savings against the possibility of bad times, such as natural disasters or recessions.[157] But because of asymmetric information between individuals and insurers, markets for these kinds of insurance are overpriced, unavailable, or otherwise "incomplete," which is a nice way of saying that they fail.[158] Governments can and often should step in to provide fallback social insurance, whether in the form of disaster insurance, unemployment insurance, or fiscal stimulus (that is, extra spending or tax cuts) during recessions.[159] However, for a variety of reasons I have sketched in earlier work, government—especially state and local government—also performs poorly during recessions.[160] Historically, US states have tended to cut spending and raise taxes during recessions, which is the exact opposite of what they should be doing.[161] Federal relief arrives more consistently, but often at the wrong times and aimed at the wrong people.[162]

Nonprofits can and should step in to fill this gap, but they face some practical obstacles in doing so. Donations to charity fall during recessions.[163] Logically, donors are more likely to give when they have more available, and recessions can squeeze even the most generous. Wealthy individuals with no credit constraints, however, should be indifferent to current market fluctuations: they should anticipate that

156. Galle, *supra* note 105, at 823–24.

157. *See* Martin Feldstein, *Rethinking Social Insurance*, 95 AM. ECON. REV. 1, 2–3 (2005).

158. *Id.* at 4.

159. As with any insurance, government social insurance can give rise to bad incentives on the part of those who are insured, often called "moral hazard." Good social insurance programs will include design features that balance the cost of moral hazard against the benefits of helping citizens deal with risk.

160. Brian Galle & Jonathan Klick, *Recessions and the Social Safety Net: The Alternative Minimum Tax as a Countercyclical Fiscal Stabilizer*, 63 STAN. L. REV. 187, 195–210 (2010).

161. Jonathan Rodden & Erik Wibbels, *Fiscal Decentralization and the Business Cycle: An Empirical Study of Seven Federations*, 22 ECON. & POL. 37, 37 (2010); David A. Super, *Rethinking Fiscal Federalism*, 118 HARV. L. REV. 2544, 2609–10 (2005).

162. Super, *supra* note 161, at 2608. Danshera Cords provides a similar account of charitable efforts in relief of natural disasters. Danshera Cords, *Charity Begins at Home? An Exploration of the Systemic Distortions Resulting from Post-Disaster Giving Incentives*, 44 RUTGERS L.J. 213, 234–36 (2014).

163. Irvin, *supra* note 10, at 450.

markets will rebound, and donate out of future wealth.[164] That they seem not to fully do so tells us that the dip in giving may also be attributable to some other factor, such as tax policy.

Tax incentives for giving are also weaker during recessions. As current incomes fall, so do marginal tax rates, reducing the size of the government's matching grant.[165] Further, recall that a major tax advantage for donations of securities is that they allow the donor to deduct the full value of the security, without paying tax on the gains. During recessions, when the stock market is weaker, the securities held by potential donors are usually worth less, making both of these tax incentives less valuable.[166]

Foundations might therefore serve as private piggy banks for the charity world. Governments would like to save for future crises, but struggle to do so in the face of political preferences for the present. Tax subsidies for foundations would be the equivalent of a government contract with private parties to save in government's stead.

Even so, private foundation savings may not contribute much to the problem of crisis spending. Instead of paying for foundation savings, government could find ways of encouraging greater donations during times of need, as it did following Hurricane Katrina and other recent disasters.[167] That would tend to reduce the need for charities to build up funds in anticipation of crises. On the other hand, it might be difficult for operating charities to absorb huge influxes of new funds over short periods.[168] But that still doesn't necessarily support foundation savings since new funds would be hard to absorb, whatever their source. It might be better for the operating charities to decide for themselves when to save and when to spend; for then such charities might use excess funds during non-crisis times to build infrastructure and response capabilities.

Another difficulty with offering more generous subsidies for new donations in times of need is that donor responses to crises can also be somewhat inefficient, with gifts flowing to areas that get more press coverage, rather than those that may offer the greatest social benefit.[169] On

164. *See* Jon Bakija & Bradley T. Heim, *How Does Charitable Giving Respond to Incentives and Income? New Estimates from Panel Data*, 64 NAT'L TAX J. 615, 620 (2011).

165. Triantis, *supra* note 128, at 1146.

166. *See* Bakija & Heim, *supra* note 164, at 619.

167. *See* Ellen P. Aprill & Richard Schmalbeck, *Post-Disaster Tax Legislation: A Series of Unfortunate Events*, 56 DUKE L.J. 51, 53–56 (2006).

168. Deep & Frumkin, *supra* note 10, at 13.

169. Cords, *supra* note 162, at 249.

that front, at least, foundations can help by using more rigorous methods for directing funds.[170]

Whatever the theoretical case for private foundation savings as a cure for crisis, in the real world, private foundations don't seem to pursue that goal. Foundation spending is flat or lower during recessions.[171] As a result, it is difficult to justify current foundation limited-spending policies on the basis that these policies allow for greater spending when economic need is greatest. In Part V, I discuss some possible ways in which a limited-spending rule could be reshaped to better fit with this goal.

2. A Federal Alternative

A second instance where federated government often fails to produce a diverse array of policy choices for citizens is in the delivery of public goods whose benefits are spread relatively thinly across many different states.[172] When benefits spill over in this way, it is rational for each state and local government to aim to free ride on the efforts of others, and assembling an inter-jurisdictional special government entity to deal with the problem is costly and politically fraught.[173] As a result, the national government rarely has direct state competitors in important policy areas such as international aid, wildlife and natural resource conservation, basic science funding, and the like.[174] Charities offer the public an alternative to exclusive reliance on their national elected officials, and by providing competition or a yardstick for comparison can help to force those officials to perform better.[175]

We live in a big country, though, with big problems. The federal alternative story may require similarly large stores of charitable resources. Perhaps to be effective at the regional or national level, the charitable sector must build a deep pool of funds.[176]

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170. Foundations might also be able to respond more quickly than individual donors. *See* Triantis, *supra* note 128, at 1147.

171. Irvin, *supra* note 10, at 450–51. I also perform regression analysis, using the data set described in the Appendix, to determine whether foundations increase spending when their home states are suffering through recessionary periods. I find a slight but statistically significant negative effect of recessions on foundation spending. Full regression results are available on request.

172. Galle, *supra* note 105, at 822–25.

173. *Id.* at 823.

174. *Id.* at 810.

175. *Id.* at 822–23.

176. *Cf.* FLEISHMAN, *supra* note 10, at 247 (arguing that perpetual foundations are better able to "stand up" to government because they can use "slow, steady pressure"); Marsh, *supra* note 17, at 169 (suggesting that foundations can "tackle large community projects" because they are able to "concentrate capital").

As with crisis spending, it isn't clear that foundation savings are the best source of savings for this kind of future need. As national aggregator organizations such as the United Way show, the resources to achieve national influence need not come from one donor, whose seed money must then snowball over time. Put another way, the national influence story doesn't clearly establish whether any particular donation should be used for one large project or instead for a steady stream of small ones.

Further, operating charities, too, can build their resources to the point where they can be effective across a wide geographic area. Operating charities might also be perfectly effective if there are many small organizations that in the aggregate are able to get things done. That is largely the model of US international aid organizations; basic science, similarly, can be funded a handful of labs at a time.[177] Or national influence service organizations could be funded with an ongoing, rolling stream of contributions from individual donors and moderate-sized foundations. On the other hand, having centralized funding to guide and evaluate new projects is likely important to their ultimate success.

Nor does the need for large organizations justify government support for gifts with indefinite or inflexible restricted-spending provisions. It may take time to build a firm to the point where it can meaningfully pursue nationwide projects. But at some point the firm reaches that scale. Under a restricted-spending rule, the time it takes the firm to achieve the appropriate scale for a national-level project is far longer: because the firm is bound to spending only a small fraction of its assets each year, it must wait until its assets grow to something like twenty times the annual spending it will need.[178] In contrast, a firm that was free to spend, say, twenty percent of its assets in a year could launch its project far sooner.[179]

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177. *See* Jon Bennett, *Introduction: Recent Trends in Relief Aid: Structural Crisis and the Quest for a New Consensus*, *in* MEETING NEEDS: NGO COORDINATION IN PRACTICE xi–xxi (Jon Bennett ed., 2013) (summarizing studies of how NGOs deliver international aid).

178. *Cf.* FLEISHMAN, *supra* note 10, at 243 (explaining how spending limits postpone effective spending).

179. For example, suppose the foundation begins with a $10 million bequest and wants to be able to fund a $20 million project. Under a 5% payout limit, the foundation must have a $400 million endowment before it can spend that much. A firm that can spend up to 20% of its assets need only accumulate $100 million. How long will it take, assuming a 10% rate of return, to reach those numbers? The standard formula is $n = \frac{\log(FV) - \log(PV)}{\log(1+i)}$. Plugging our made-up values into this formula, it would take about 38.7 years to reach $400 million, but only 24.2 years to reach $100 million. The example simplifies the real world a bit, because foundations with limited payouts may be able to skip payout years and build up to a larger one-year expenditure. This would complicate our math, but the upshot—that the less restricted firm could hit its target much sooner—would remain the same.

In short, a firm with national ambitions must be free to spend in large chunks at times when an opportunity to effect broad change arises. While foundations are a vital alternative to government, there is little reason to believe that ever greater wealth accumulation is necessary for, or even consistent with, that goal.

C. A Review

Let's step back for a moment to assess where the argument so far has taken us. As I've framed it, the basic question is whether subsidizing restricted-spending charity is a better use of the government's resources than other alternatives. One alternative would be for the government to invest its money, and then later devote the resulting payoff to charity or some other worthwhile project. Another would be to fund charities that will spend the subsidy relatively quickly.

While I cannot put precise numbers on any of the three options, the analysis so far suggests that restricted spending, except within certain limits, usually will have less value than either of the other choices. For instance, compare restricted spending with government savings. Both government and foundations will likely earn similar investment returns. The problem is that the utility payoff from foundation spending diminishes over time, as the usefulness of each dollar declines with the expanding foundation sector, and agency and information costs eat away at the sector's advantages. Or compare restricted-spending charity with funding operating charities that will quickly spend the funds. Here, the unrestricted alternative's advantages are that current programs generate learning externalities for present and future charity and that a dollar spent now, when the world is needier, pays more than a dollar spent in the future.

As Part IV has shown, there are counterarguments for restricted-spending policies, but those arguments seem limited in scope. Foundations with a pool of assets can serve important roles, but those roles often demand flexibility to spend in times of great need or great opportunity. And, by fundraising, foundations can serve that role without the need for preserving the perpetual existence of any particular donor's contribution. At best, the argument for restricted-spending subsidies would be an argument that foundations should not have to attract new donors, but if anything the opposite would seem to be true.

What, then, is to be done?

V. POLICY IMPLICATIONS: PAYOUT RULES AND BEYOND

Let's now turn from theory to policy. So far, my argument is that long-term restricted spending is socially costly and, at a minimum, should probably not be subsidized. However, as I will explain in Subpart V.A, simply eliminating existing federal subsidies for restricted-spending foundations is problematic. I'll therefore consider a series of possible alternative approaches to at least mitigate the worst aspects of restricted spending in private foundations and to shape restricted-spending policies to more closely resemble their theoretical justifications. In other words, in Parts V.B through V.E, I work through ways to encourage foundations to spend money faster and also to spend more intensively during times of great need. Part V.F will then move on to focus on restricted spending in a popular new substitute for private foundations, the so-called donor-advised fund. Finally, Part V.G looks at recently adopted state laws that encourage restricted spending. I report, for the first time, evidence of the impact these laws have had on foundation policy—to preview, they have indeed reduced spending by some measures—and then make a case for their outright repeal.

A. Existing Subsidies Are Hard to Repeal

Part I sketched the two main ways in which federal tax policy is currently underwriting restricted spending. First, donors receive a deduction at the time of their contribution to a foundation, irrespective of when the foundation spends that money. Second, the investment returns the foundation earns on that money are tax-free, so that it is tax-advantaged to have the foundation hold profitable assets over time.

While one approach to fixing the restricted-spending problem would be to just repeal or greatly limit these tax advantages,[180] full repeal seems impractical, at least for the immediate deduction. For example, suppose that Congress were to defer a donor's deduction or a portion of it until the donated funds were actually expended by the foundation.[181] Because money is fungible, such a rule would not necessarily increase the amount of money actually appropriated each year by foundations, at least at organizations that borrow, have received multiple gifts, or have other

180. *See* Brody, *supra* note 10, at 945 (noting this possibility).
181. *See* Gerzog, *supra* note 139, at 1180; Halperin, *supra* note 30; Madoff, *supra* note 30, at 974.

sources of revenue.[182] The Foundation might spend more of Bill Gates's money now, but reduce the money it was spending out of its small donor fund or its special event revenues. Non-donative, non-investment revenues are empirically significant. For instance, in my sample, "other" income accounts for about 4% of total foundation inflows.[183]

Death, too, complicates any repeal plan. Repeal would put pressure on foundations to spend earlier so that donors could claim their deductions sooner. But once a taxpayer no longer has a stream of income against which to claim her deductions—for instance, because she's deceased—the foundation no longer would have any incentive to accelerate payouts. Delaying the deduction would also be complex to implement for bequests. Presumably, large estates would be denied a full deduction against the estate tax in the year of death,[184] but then entitled to partial refunds over time as the bequest is spent down by the donee organization. This could entail burdensome record-keeping over many years, as well as potential legal uncertainty about how to divide the refunds among various heirs.

Rules applicable to new donations also would not affect any restricted-spending rules that now bind the nearly one trillion dollars in existing private foundation wealth.[185] Deductions to organizations that do not pay out old wealth could be curtailed, but that would just encourage donors to form new foundations, leaving old money still subject to old rules.

While the administrative obstacles to taxing foundation investment earnings are not as substantial, there may be economic side-effects that make that option undesirable. Current law already imposes a small tax of 1% to 2%, as I will detail a bit more in Part IV.C, so there would be little direct administrative burden from simply increasing the rate.[186] But it is far from clear that it would be optimal to impose the same tax on charitable investments as other businesses or individual investors face. A tax on foundation investment assets could encourage spending, but in some situations could also discourage it, and would introduce other changes in managers' behavior as well. The optimal tax rate would represent a balance between these factors. In order to explain the tradeoffs fully, I will first have to explore some other legal rules that currently govern

182. *See* Halperin, *supra* note 30 (noting this problem with a rule requiring spending out of endowment).

183. *See infra* tbl.A.1.

184. *See* I.R.C. § 2055 (2014).

185. *See Aggregate Fiscal Data of Foundations in the U.S., 2012*, *supra* note 8.

186. I.R.C. § 4940(a) (2014). A potential complication, as Dan Halperin notes, is that if the tax were large enough Congress would likely have to also change some of the rules for taxes on unrelated business income. Halperin, *supra* note 26, at 306.

foundation payout, and so I will defer a complete discussion until Part V.C. For now, it is enough to say that it is unlikely government would want to fully repeal foundations' exemption for investment income.

B. Time-Neutral Contribution Deductions

If outright repeal of foundations' tax advantages is not an attractive policy option, what other choices are there? One option would be to target donor incentives. We have seen that a key flaw in the current system is that it incentivizes donors to prefer restricted spending, because restricted spending increases the total subsidy available from the government.[187] In general, in a well-functioning market we should expect private actors to make decisions that maximize their own welfare.[188] Government should not distort private choices unless the market "fails" or otherwise goes wrong.[189] Since there is no reason to believe that firms would otherwise spend *faster* than society would prefer, the tax system should strive to be neutral about the timing of expenditures. If we cannot readily remove the tax subsidy for restricted spending available to firms, we should alter donor incentives to leave the system neutral overall.[190]

Prior commentators have proposed fully disallowing any deduction for permanently restricted gifts (albeit in the university, not private foundation, context), but Congress likely need not go that far.[191] An alternative approach would be to reduce the value of a charitable

187. It might be argued that when foundations are considered in the larger context of the income tax as a whole, the exemption of their investment income in fact is "neutral." The argument would be that an income tax creates a substitution effect in favor of faster consumption, because it reduces the returns to savings. *See* GRUBER, *supra* note 60, at 650 (modeling effect of an income tax on savings). The tax exemption for restricted spending firms then restores donors to indifference between spending money on charity now or spending it later. But this argument goes astray because most other savings options in our tax system remain subject to tax. Therefore, the exemption still distorts the donor's choice about whether to place money in a restricted-spending vehicle or to keep or spend it elsewhere.

188. *See id*. at 3.

189. *Id.*

190. I should note that existing law already mildly penalizes donations to private foundations, such as through a modestly lower cap on annual giving and reduced benefits for in-kind gifts other than publicly traded stock. I.R.C. § 170(b)(1)(D), (e)(1)(B) (2014). But these rules apply regardless of how fast or slow the organization spends.

191. Herwig Schlunk, *An Argument for the Repeal of Tax Preferences for Educational Endowments* 22 (Vanderbilt Univ. Law Sch. Law & Econ., Working Paper No. 09-37, 2009); Waldeck, *supra* note 10, at 1818; *see also* MOLLY F. SHERLOCK ET AL., CONG. RESEARCH SERV., R44293, COLLEGE AND UNIVERSITY ENDOWMENTS: OVERVIEW AND TAX POLICY OPTIONS 19 (2015) (citing *Examining the Rising Costs of Higher Education: Hearing Before the H. Comm. on Ways and Means Subcomm. on Oversight*, 114th Cong. (2015) (testimony of Brian Galle, Professor of Law, Georgetown University Law Center), *available at* http://waysandmeans.house.gov/event/39840295/) (examining the possibility of reducing the value of the deduction for restricted gifts).

contribution deduction by the amount of any tax benefits that derive from restricted spending. This calculation would not be an exact science. The general idea, though, would be to make some reasonable estimates about the value of the perpetual exemption from tax on investment earnings, discount that total to present value, and subtract the result from the donor's initial deduction. As Herwig Schlunk has shown, the exact value depends on what we expect the foundation's average rate of pre-tax returns will be.[192] Congress or Treasury would have to make an educated guess about that number and could adjust it periodically.

To illustrate, suppose that in year one donor A makes a restricted gift of $1 million to Foundation Z. The gift is subject to a restriction that Foundation Z maintain the real value of the gift in perpetuity. Let us assume that the discounted present value of the tax benefits from exempting an infinite series of Foundation Z's resulting investment returns converges to $100,000. Donor A would reduce her charitable contribution deduction in year one from $1 million to $900,000.

Admittedly, this proposal has some important limitations. Like outright repeal of existing time preferences, it would not affect any assets already under management by philanthropic organizations. Further, some donors may be relatively indifferent to the charitable contribution deduction. The tax rules facing many entrepreneurs are already so favorable that they have relatively little need for yet another means of reducing their income.[193] Other donors, such as the Gateses, may have such massive deductions relative to income that they already will be unable to use more than a fraction of their income tax deduction.[194]

C. Section 4942: Federally Required Payouts

In light of these obstacles, and the likely political difficulty in changing the rules for charitable contributions, it is worth examining other options as well. Another obvious possibility, which Congress already is employing to a limited extent, is to require that foundations loosen the knots of

192. Schlunk, *supra* note 191, at 8–9.

193. David J. Herzig, *Why We Should Stop Slamming Mark Zuckerberg and Priscilla Chan's Philanthropic Plans*, WASH. POST (Dec. 9, 2015), https://www.washingtonpost.com/news/acts-of-faith/wp/2015/12/09/why-we-should-stop-slamming-mark-zuckerberg-and-priscilla-chans-phil anthropic-plans/.

194. Estate-planning techniques could potentially substitute for the lost value of the charitable contribution deduction from the estate tax, although these techniques may be less effective than is commonly assumed. Paul L. Caron & James R. Repetti, *The Estate Tax Non-Gap: Why Repeal a "Voluntary" Tax?*, 20 STAN. L. & POL'Y REV. 153, 158–68 (2009).

restricted-spending rules. That is, Congress can set a payout rate—a minimum amount of annual spending for foundations each year. Under current law, organizations that are categorized as private foundations for tax law purposes must annually spend at least 5% of the net investment assets they held at the end of the previous year.[195] Qualifying expenditures include grant distributions to operating charities, as well as salary and other administrative costs.[196] Private foundations that can show they are saving up for a large future expenditure can get a temporary waiver of the spending requirement.[197]

The payout rate should be much higher. When Congress adopted the current rule in 1981, its explanation was that 5% is the maximum sustainable payout.[198] Foundation advocates presented Congress with the results of studies suggesting that the real rate of return on foundation assets averages about 5%.[199] Any higher and foundation assets would tend to diminish over time, assuming no new contributions. I will now argue, though, that both these assumptions are flawed: real rates of return are much higher than 5%, and new contributions largely offset expenditures.

1. New Data on Real Rates of Return

Even accepting the premise that foundations should be able to sustain themselves indefinitely without attracting new donors, the best evidence actually demonstrates that average sustainable payout rates are considerably higher than 5%. Since in my view prior studies all have significant flaws, I present new data drawn from a large sample of foundations.

First, though, I should describe the prior studies and their problems. One early set of studies was built around simulations.[200] The authors looked at some basic surveys of how foundations allocate their assets between stocks and bonds.[201] Using average market performance for those two categories, they computed the expected returns for typical foundation

195. I.R.C. § 4942(a), (e) (2014).
196. *Id.* § 4942(g)(1)(A).
197. *Id.* § 4942(g)(2).
198. C. Eugene Steuerle, *Distribution Requirements for Foundations*, 70 PROC. ANN. CONF. ON TAX'N 423, 424 (1977).
199. *Id.*
200. DEMARCHE ASSOCS., INC., PAYOUT POLICIES AND INVESTMENT PLANNING FOR FOUNDATIONS: A STRUCTURE FOR DETERMINING A FOUNDATION'S ASSET MIX (1990). Salamon, *The Process*, *supra* note 86, at 119, summarizes several other early simulation results.
201. DEMARCHE ASSOCS., INC., *supra* note 200.

asset allocations.[202] Most of these studies estimated real rates of return—that is, profits net of inflation—of between 5% and 6%.[203]

Simulated data based on market averages don't provide a good picture of real foundation returns. Other studies have found that some nonprofits can "dramatically outperform market indices,"[204] and this result should not be surprising. Foundations have a number of tax and other advantages over other investors[205] and may have investment opportunities and revenue sources other than stocks and bonds.[206]

The more convincing studies look to the actual investment earnings reported by real foundations on their tax returns. In 1981, the Michigan Council on Foundations, a trade group that represents foundation interests, hired the University of Michigan School of Business to examine the historic investment returns at a handful of Michigan foundations.[207] Since then, the study was turned over to Cambridge Associates LLC ("CAI"), a financial consultant, which produced updates in 2000, 2004, and 2013.[208] Each time, CAI has concluded that "data from . . . [t]he actual . . . experience of a sample of Michigan foundations [with diversified portfolios] do[] not support a [payout] rate higher than 5%."[209]

One issue with the CAI study is that it examines not a random sample of foundations, but instead a group of foundations that apparently voluntarily agreed to participate.[210] Most of the participating entities,

202. *Id.*

203. *E.g.*, *id.* However, an IRS simulation for the years 1979 to 1982 projected a rate of 8.5%, and that number did not even include unrealized appreciation. MARGARET RILEY, INTERNAL REVENUE SERV., PRIVATE FOUNDATION INFORMATION RETURNS, 1982, at 7 (1985), *available at* http://www.irs.gov/pub/irs-soi/82pfinforeturns.pdf.

204. Garth Heutel & Richard Zeckhauser, *The Investment Returns of Nonprofit Organizations, Part I: Tales from 990 Forms*, 25 NONPROFIT MGMT. & LEADERSHIP 41, 45 (2014).

205. Taxable investors are more reluctant to shift investments because selling most assets triggers a tax on any investment gains in that asset. Therefore, we should expect nonprofits to be able to more actively churn their portfolios. Halperin, *supra* note 26, at 309. At the same time, because of its long time horizon, the foundation typically has the luxury of holding relatively illiquid assets, which can provide for a greater return. *See* Lester M. Salamon, *Foundations as Investment Managers Part II: The Performance*, 3 NONPROFIT MGMT. & LEADERSHIP 239, 244 (1993) [hereinafter Salamon, *The Performance*] (reporting that "[f]oundations with longer time horizons tended to perform better"). Foundations have opportunities for tax arbitrage; to take the simplest example, a foundation can hold taxable bonds, rather than tax-exempt bonds, and earn the higher rate of return that taxable bonds carry. *See* John M. R. Chalmers, *Default Risk Cannot Explain the Muni Puzzle: Evidence from Municipal Bonds That Are Secured by U.S. Treasury Obligations*, 11 REV. FIN. STUD. 281, 284–88 (1998) (summarizing evidence on the premium for taxable bonds).

206. *See infra* tbl.A.1.

207. CAMBRIDGE ASSOCS., INC., SUSTAINABLE PAYOUT FOR FOUNDATIONS, at iii (2000).

208. CAMBRIDGE ASSOCS. LLC, SUSTAINABLE PAYOUT FOR FOUNDATIONS: 2013 UPDATE STUDY 1–2 (2013) [hereinafter CAMBRIDGE ASSOCS. LLC, UPDATE].

209. *Id.* at 1.

210. *See* CAMBRIDGE ASSOCS., INC., *supra* note 207, at 1–2.

furthermore, were in Michigan.[211] We might expect that a foundation that agrees to open its books to close scrutiny by outsiders would be atypical in some ways. For example, if foundations with good or bad results were more likely to be included in the sample group, that could produce results that are not representative of the foundation population as a whole. In any event, given the small size of the study—fewer than 50 firms—its results may be unrepresentative simply by random chance.

The nonprofit scholar Lester Salamon took a more convincing approach.[212] Salamon drew a random sample of more than 1000 foundation tax returns, sent them a mail survey, and then examined more closely the 350 or so that responded.[213] Once more, we don't know whether the firms that responded were representative of the sector as a whole, but at least Salamon was looking at about seven times as many firms. On the other hand, he was only able to study seven years of data, from 1979 to 1986.[214] Over that stretch, Salamon reports that "[a]fter adjusting for inflation, the rate of return on foundation assets was close to [eleven] percent a year."[215]

In an attempt to get a truly representative picture of foundation performance, I replicate the CAI methodology in a large, randomized sample of private foundations with 25 years of data. Again, I detail the construction of the sample and my calculations in the Appendix.

I find an average compound return a bit higher than the CAI results. The mean nominal rate of return is 12.69%. The weighted median is 8.52%.[216] These returns are good but not extraordinary; many simple investment portfolios could have achieved returns in excess of 11% over the same period.[217]

Obviously, this number is much higher than the 5% figure estimated by CAI. In fact, though, the nominal rates of return I find—that is, the returns

211. *See id.* at 23. CAI's 2013 update reportedly adds "data from a national aggregate of private foundations obtained from the IRS," without detailing the methodology for that analysis. CAMBRIDGE ASSOCS. LLC, UPDATE, *supra* note 208, at 4. A footnote to the update appears to imply that the report relied on IRS aggregate data, *id.* at 4 n.3, suggesting that the report does not winsorize to exclude extreme outliers.

212. Salamon, *The Performance*, *supra* note 205, at 241–42.

213. *Id.*

214. *Id.*

215. *Id.* at 243. An IRS study of 1 year of data also found returns of 12.4%. Margaret Riley, *Private Foundation Returns, 1985*, *in* INTERNAL REVENUE SERV., SOI BULLETIN: SUMMER 1989, at 27, 31 (1989). In a summary table, Yoder and McAllister report mean net investment income, exclusive of asset appreciation, of 9.9% for the period 1995 through 2007. Yoder & McAllister, *supra* note 82, at 53, 58.

216. The unweighted but winsorized mean is 8.11%, with a median of 6.87%.

217. CAMBRIDGE ASSOCS., INC., *supra* note 207, at 7.

before inflation—are quite close to the CAI figures. For example, CAI's 2000 report finds *nominal* rates of between 11.04% and 12.48%.[218] CAI apparently reaches its much lower figure by discounting nominal returns by a rate of inflation of between 5% and 6%.[219]

To provide a full apples-to-apples comparison, I also attempt to estimate a real (i.e., net of inflation) rate of return. I cannot be certain that I am fully replicating CAI's method, however, because CAI does not disclose how they calculated their inflation rate, except to state that their figure relies on the "CPI deflator."[220]

I emphasize the choice of inflation methods because the average inflation rates in my data are much lower than the 5% to 6% range CAI assumes in its 2000 report.[221] Depending on which measure of inflation I employ, I get an average inflation rate of between 2.5% and 3.3%. Readers interested in inflation measures can find more detail in the Appendix.

After accounting for inflation, firms still achieve an average rate of return of between 9.34% and 10.11%. The median real compound return is 4.84% to 5.65%. Table 1 summarizes the results.

TABLE 1: REAL RATES OF RETURN AT A SAMPLE OF PRIVATE FOUNDATIONS USING THREE DIFFERENT MEASURES OF INFLATION, 1985 TO 2011

	CPI-U	PCE	GDP Deflator
Mean	9.34%	10.05%	10.11%
Median	4.84%	5.59%	5.65%

Notes: Source: IRS PF-SOI 2011 Cumulative File. Number of firms: 21,486. Data are winsorized and weighted by average firm assets.

In short, I find that even when accounting for inflation, we should expect that the average dollar invested in a private foundation will earn a return of at least 9%. That number, of course, is considerably higher than the current 5% minimum payout required under federal law. The 5% figure was defended, historically, as the maximum that foundations could

218. *Id.* at 7, 25. The 2013 update claims that both Michigan and "national" nominal returns are lower, at about 9.5%. CAMBRIDGE ASSOCS. LLC, UPDATE, *supra* note 208, at 4. Notably, the data for the update end in 2009, *id.*, which of course was a historically poor year for investment assets.

219. CAMBRIDGE ASSOCS., INC., *supra* note 207, at 7.

220. *Id.* at 25. I submitted a working draft of this paper to CAI for their comment, but they did not respond, despite initially indicating that they would do so.

221. The 2013 Update appears to apply an inflation discount of about 3%. CAMBRIDGE ASSOCS. LLC, UPDATE, *supra* note 208, at 4.

spend and still be able to sustain their endowment.[222] My results suggest that sustainable spending could exceed 5% by a considerable margin.

It might be argued that, while the mean rates of return are substantial, median rates fall around the traditional 5% figure. About half of foundations, mostly quite small ones, cannot sustainably spend 5%.

I would argue in response that the mean returns are much more important for policy purposes. For one, we've seen that most of the arguments for restricted spending apply to the foundation sector as a whole, not any given firm. The mean rate of return is the number that would preserve the total amount of funds available across all firms and time periods. Secondly, even if a minimum payout set at the mean rate would eventually cause underperforming firms to spend down their assets (assuming no new contributions), that is the right result. If Congress can invest public money in two alternate savings vehicles, one paying 5% and the other 10%, why would it want to leave its funds in the firm that can only manage a 5% return? To the extent that there is value in perpetual life for a particular firm, we've seen that this value likely only holds for large and venerable organizations, not the small and perhaps neglected foundations that largely comprise the group earning sub-median returns.[223]

In any event, even if there were good policy reasons to protect the perpetuity of small underperforming foundations, that would not be a reason to set the same minimum payout rate for larger and more successful ones. There is no obvious reason Congress must set the same minimum payout rate for all foundations. Minimum payout rates could be determined by the amount of foundation assets—for instance, by having the minimum rate scale up as assets increase—or set individually for each firm by using a rolling average of past investment performance.[224]

2. New Data on Growth in Overall Foundation Assets

As I argued in Part III, standard finance theory suggests that foundations should be willing to spend out of future expected contributions as well as present wealth. Therefore, I also examine the combined effect of investment returns and new contributions on foundation assets. I follow the same methodology as in Part V.C.1, except

222. *See supra* note 198 and accompanying text.

223. *See* Richard Sansing & Robert Yetman, *Governing Private Foundations Using the Tax Law*, 41 J. ACCT. & ECON. 363, 376 (2006) (describing the positive relationship between firm size and investment returns); Salamon, *The Performance*, *supra* note 205, at 247 (same).

224. On the latter point, see Deep & Frumkin, *supra* note 10, at 20.

that the formula for change in assets does not subtract out new contributions. Table 2 summarizes the results.

TABLE 2: AVERAGE PRIVATE FOUNDATION INVESTMENT RETURNS PLUS NEW CONTRIBUTIONS

	Growth Rate Per Firm, Real Dollars	Nominal Growth Rate Per Firm Over Nominal US GDP
Mean	18.17%	2.72
Median	8.13%	1.61

Notes: Reflects period 1985 to 2011. Inflation calculated using historical PCE deflator data from the US Bureau of Economic Analysis. Individual firm data are winsorized and weighted by firm mean assets. Source: IRS PF-SOI cumulative file.

As Table 2 shows, the combination of investments and donations would allow foundations to grow at more than 18% a year on average. I also find that foundation assets grow considerably faster than the economy: The median firm grew more than 60% faster than the US economy.[225]

Because I measure only within-foundation changes, these data might either over- or understate assets available to the foundation sector as a whole, as foundations may close or new foundations may open. Survey data from the Foundation Center report that the number of foundations grew from 64,000 to 86,000 between 2002 and 2012, and that new gifts to foundations have been roughly equal to total foundation grants paid in about half the years over that period.[226] That is, in half of the years in the last decade the foundation sector has, on net, not spent *any* of the investment return on its assets.[227] Foundation Center data show that foundations have usually grown by more than 5% annually, net of expenditures, implying that there is room for considerably greater spending.[228]

225. I include share of GDP because, as Gene Steuerle argues, "[t]he absolute size of the foundation sector may not be so important as its size relative to national wealth." Steuerle, *supra* note 198, at 428. I compare each firm's growth rate to the growth in GDP over the period we have data for that firm. This explains why the ratio for mean GDP ratio is not more than double the ratio for median GDP ratio: the GDP growth rate is different for the mean and median firm.

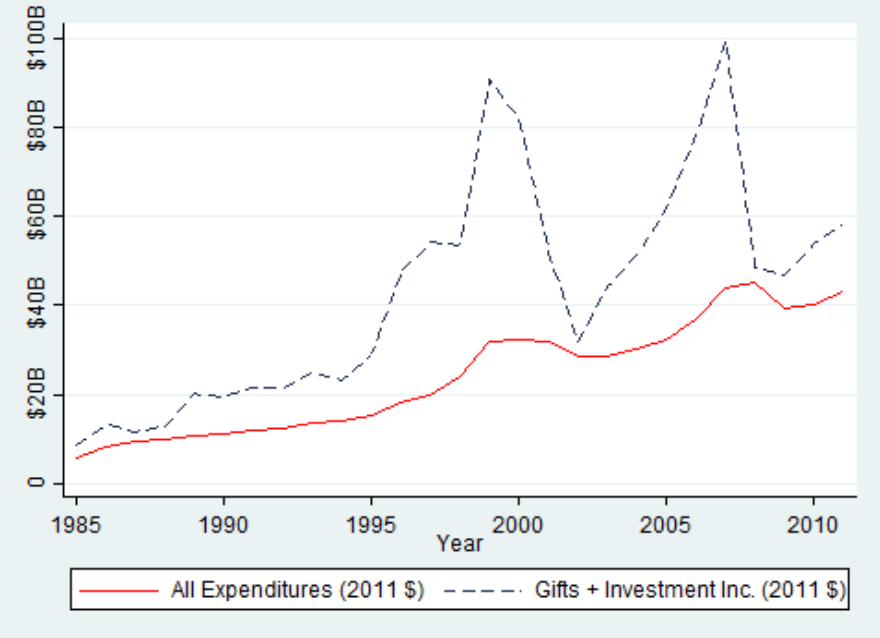
226. *Foundation Stats*, FOUND. CTR., http://data.foundationcenter.org/about.html#quick-start (last visited Apr. 19, 2016), *archived at* https://perma.cc/43C8-867G.

227. *See id.*

228. *Id.*; *see also* PERRY MEHRLING, NAT'L NETWORK OF GRANTMAKERS, SPENDING POLICIES FOR FOUNDATIONS: THE CASE FOR INCREASED GRANTS PAYOUT 7 (1999), *available at* https://economics.barnard.edu/sites/default/files/inline/spending_policies.pdf (examining Foundation Center data for 1980s and 1990s).

Figure 2 illustrates foundation inflows and outflows between 1985 and 2011. Notably, there was not a single year during this period when real total foundation savings declined.

FIGURE 2: AGGREGATE FOUNDATION REVENUES AND EXPENDITURES, 1985–2011



Notes: Values summed across all sampled foundations. Dollar values deflated to 2011 dollars using the PCE deflator. Source: IRS PF-SOI 2011 Cumulative File. Number of firm-years: 228,407.

3. Summary and Caveats

I believe these data make a strong case that, even assuming foundations should do nothing but spend an equal amount of money every year in perpetuity, the amount the law could demand they spend should be much higher than the present 5%. Admittedly, however, there might be some offsetting costs to higher spending rates. We do not presently know how donors would respond to an increased payout requirement. If donors view payout rates as burdensome, they might shift to giving directly to operating charities, and it is also possible that overall contributions to charity could fall. This effect could be offset if managers are concerned about falling asset balances and work harder to bring in new donations. If

managers dislike high payout rates or fundraising, however, they might demand greater compensation. There is some existing evidence that managers at faster-paying firms earn a bit more,[229] and I find a similar trend in my data, as detailed in the Appendix. This latter cost is a modest portion of foundation resources, however.

More problematically, if managers view payouts as in effect a tax, they might be less willing to exert effort at earning a high return on foundation assets. There is some evidence that pre-1981 law, which imposed in effect a 100% payout requirement on foundation earnings above 5%, somewhat depressed foundation investment performance.[230] But reforms to increase payouts to something like 10% or 15% would be a much less draconian burden than 100%, so it is hard to know whether the pre-1981 scenario would return under my proposals. More empirical work on these questions would be useful going forward.

D. Section 4940: Federal Tax on Net Investment Earnings

In addition to requiring a minimum payout of foundation net assets, Congress also imposes a small tax on net foundation investment earnings ("NIE").[231] Ordinarily, the tax rate is 2%, but an organization can cut that to 1% if its annual payout share exceeds its average over the previous five-year period.[232] Given this low rate, and the fact that net earnings are only a fraction of the value of the foundation's total investments, the total amount of tax is tiny compared to the payout requirement. In my data, the mean tax payment is just $35,000, or about one-tenth of 1% of the average firm's investment assets.[233]

In theory, a tax on foundation investment income could spur increased grant making. Like a carbon tax, the foundation tax would be a "Pigouvian" tax, or a penalty on a behavior that has undesirable effects for others.[234] By reducing the payoff to investing, the tax would make investing less attractive for managers, relative to other options—in

229. Sansing & Yetman, *supra* note 223, at 365, also find a significant correlation between payout rates and compensation.

230. Salamon, *The Performance*, *supra* note 205, at 243–44. Salamon notes that overall market conditions were also changing during this period, making causation difficult to pin down. *Id*.

231. I.R.C. § 4940 (2014).

232. For a cogent summary of the intricacies of the tax, see Yoder & McAllister, *supra* note 82, at 49.

233. *See infra* tbl.A.1.

234. *See* GRUBER, *supra* note 60, at 141–42 (describing Pigouvian taxes).

economics lingo, this is the "substitution effect" of the tax.[235] So managers would be more inclined to spend, although potentially some of that spending might be on their own salary and perks rather than grant awards.[236]

But taxes also could affect foundations in other ways. Right now, foundations can aggressively switch between investments without worrying that sale of the underperforming asset will trigger a tax on the appreciated gains.[237] Making them taxable would undermine this advantage. Lower returns on investment could also reduce managers' incentives to put time and resources into asset management, although it also could spur fundraising to make up for the lost dollars. And donors, knowing that their contributions will earn lower returns overall, might give less.[238] So even if the foundations actually pay little in tax, the behavioral side effects of its imposition could reduce the resources available for charity. Professor Halperin proposes a tax on total assets, rather than earnings, which could eliminate the first problem but likely not the others.[239]

More problematic still, an NIE tax could actually diminish managers' desire to spend. An economist would say that there is an undesirable "income effect" that contends with the substitution effect we want to produce.[240] For example, suppose that in order to maintain the foundation in perpetuity and protect their jobs, managers prefer to spend only investment earnings, and will not spend any money directly out of endowment.[241] By reducing the net earnings of the foundation, the tax would reduce the amount these managers would be willing to spend.

On the other hand, a minimum payout rule, in combination with a higher tax, might soften the blow of the income effect. Perhaps the relative influence of the income and substitution effects varies across firms. The worry would be that the drop in spending due to the income effect at some firms would outweigh the substitution-driven increase at others. A minimum payout would help to tip the balance towards greater spending,

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235. *See id.* at 36; *see* Halperin, *supra* note 30 (proposing this rationale for a tax on investment income).

236. *See* Halperin, *supra* note 26, at 305–06.

237. *Id.* at 309.

238. *See id.* at 301. For evidence, see Heutel & Zeckhauser, *supra* note 204, at 43.

239. Halperin, *supra* note 30.

240. GRUBER, *supra* note 60, at 36; *see also* Halperin, *supra* note 26, at 305.

241. One suggestive piece of evidence on this front is that foundations' shift to higher-return investment strategies closely followed the 1981 reduction of mandatory payout rates. Salamon, *The Process*, *supra* note 86, at 128.

by constraining firms that would otherwise be inclined to cut their expenditures. But this would certainly not be a perfect solution.

This might be a situation where carrots, not sticks, offer a better solution.[242] If Congress could offer higher after-tax investment returns to foundations that pay out more generously, that would flip some of the unwanted side effects of an investment tax. An investment *bonus* for payouts would still create substitution effects in favor of spending, but would also realign income effects to point in the right direction.[243] Since it would be, in effect, a matching grant for foundation investments, it might also encourage donors to give more, and managers to work harder.

Current law somewhat approximates this goal, but clumsily. Again, by exceeding their 5-year historical average payout, foundations can trim their tax from 2% to 1%.[244] One problem with this approach is that, as others note, it sometimes gives firms the wrong incentive, since increased payouts in any year will require even higher payouts in the future in order to secure the 1% rate.[245] My colleague Ray Madoff has recently proposed a simplified version that eliminates this problem.[246] More generally, though, it is unclear that a 1% carrot is enough of an incentive: the right bonus could be 5% or 10%.[247]

All of this is to say that the optimal rate of tax on foundation investments depends on a set of tradeoffs. Since we don't yet have good data on how firms would respond to a significant tax, the correct rate is unclear, and might well be negative—that is, the best policy might be a subsidy, not a tax at all.

What we do know is that foundations with living donors behave quite differently than firms whose founders are long gone: foundations with deceased donors are much more likely to distribute only the statutory minimum.[248] Potentially, the ideal policy would impose different rates of tax, or offer different rates of subsidy, depending on these kinds of basic firm demographics. For instance, for "old and cold" foundations that are

242. For a more complete discussion of the carrot/stick tradeoff, see Brian Galle, *The Tragedy of the Carrots: Economics and Politics in the Choice of Price Instruments*, 64 STAN. L. REV. 797, 831–40 (2012).

243. *Id.* at 832.

244. *See supra* note 232 and accompanying text.

245. Sansing & Yetman, *supra* note 223, at 367; Yoder & McAllister, *supra* note 82, at 46–47.

246. Ray D. Madoff, *A Better Way to Encourage Charity*, N.Y. TIMES (Oct. 5, 2014), http://www.nytimes.com/2014/10/06/opinion/a-better-way-to-encourage-charity.html?_r=0.

247. The 1% cut is a carrot because it enriches firms relative to the existing 2% baseline. Galle, *supra* note 242, at 803–04.

248. Salamon, *The Performance*, *supra* note 205, at 248–50; Sansing & Yetman, *supra* note 223, at 365; Yoder & McAllister, *supra* note 82, at 47; *see also supra* fig.1.

unable to attract new donations, and whose spending has been persistently bumping along at the statutory minimum, a tax might make more sense than a subsidy. The minimum distribution rule already is preventing untoward income effects, and bonuses may be unlikely to spur new giving.

E. Countercyclical Payouts

In Part IV.B, I argued that restricted spending can be justified to the extent that foundations play a role in fighting recessions and disasters. We saw empirically that does not actually happen. One likely reason, as others have observed, is that current tax law actually discourages recession-fighting, or "countercyclical," foundation spending.[249] Because the minimum payout rule depends on the value of the foundation's assets in the prior tax year, and assets tend to decline in value during economic slowdowns, existing law weakens any incentive for firms to spend during hard times. Managers' job security concerns may be especially acute during recessions, compounding the problem. As we saw earlier, a similar tax flaw is that the incentives for new contributions to philanthropic organizations also decline during recessions, due to the diminishing worth of the charitable contribution deduction during those periods.[250]

Prior proposals to fix these problems are too milquetoast. The main suggestion, which is sensible, is to calculate the minimum payout floor based on a multi-year, rolling average of the firm's assets, instead of just one year at a time.[251] That way, at the beginning of recessions, the average will include some good years as well as the more recent bad ones.[252] But this idea just doesn't go far enough. Using my sample of foundations, I ran simulations in which I calculated how much a 3-year inflation-adjusted rolling average would boost spending during recession years.[253] The 3-year average raised recession spending by about 11.3%, from a mean of $7.6 million to a mean of $8.5 million. Inflation adjustment is important; without it, spending increases only 5.5%.

In any event, rolling averages would also have the unwanted side effect of depressing spending in the period just after recessions, since the post-recession average would be weighed down by the recessionary asset

249. FREMONT-SMITH, *supra* note 112, at 2.
250. Steuerle, *supra* note 198, at 425.
251. Salamon, *The Performance*, *supra* note 205, at 251; Steuerle, *supra* note 198, at 426.
252. Salamon, *The Performance*, *supra* note 205, at 251; Steuerle, *supra* note 198, at 426.
253. For simplicity, I assume that all firms actually meet or exceed their minimum-spending threshold.

values. State and local budgets usually lag recessions somewhat.[254] The period of greatest fiscal stress for those governments—and therefore the time of greatest need for charitable supplements—would be just when rolling averages would be pushing down foundation spending.

It would be more effective, and more consistent with the best rationales for restricted spending, to raise the minimum spending floor during recessions. For example, a simulation of a temporary 2% increase in the payout floor, to 7% during recessions, predicts a 26% increase in recession spending.[255]

To be sure, we should consider carrots for countercyclical spending alongside, or instead of, the minimum payout stick. For instance, to make up for shortfalls in donations, Congress and state governments could offer more generous tax subsidies during times of need, as Congress has occasionally done before.[256]

A more dramatic approach would be to add a bonus deduction, perhaps even refundable, for donations that are earmarked for immediate spending during recessions. That would accomplish several recession-fighting goals at once: it would lower taxes, put more people to work, and provide more safety-net spending. It is possible that the bonus would only change the timing of some planned gifts, rather than increasing donations overall.[257] That, though, would also be socially useful, since the payoff to the government's subsidy dollar is higher during recessions.

A parallel policy aimed at foundation managers could be to offer bonus credit against future § 4942 requirements or § 4940 liability. That is, if a foundation spends a dollar above the 5% floor during a recession, it would be able to reduce the amount it must distribute after the recession ends by, say, $1.20 or $1.50. Again, the effect of this incentive would mostly be to shift the timing of foundation spending,[258] but that is exactly what governments should do: they should move public money from flush times to hard times. My own view is that this option is hard to defend, since it would tend to reduce foundation spending rates overall. I offer it for those who disagree with me about the value of restricted spending, but would nonetheless like to see foundations act more countercyclically.

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254. Rodden & Wibbels, *supra* note 161, at 57.

255. To simplify, I assume the simulated policy would not affect the foundation's assets except through the spending rule.

256. *See supra* note 167 and accompanying text.

257. *See* Bakija, *supra* note 123, at 573 (suggesting that some donor response to variations in tax incentives may be pure re-timing).

258. If donors view spending floors as a tax, there might also be increased donations via the income effect.

Finally, foundations could be encouraged to issue more loans or loan guarantees. Service organizations report that donations and local government contracts dry up during recessions.[259] As we saw earlier, a firm without credit constraints would borrow to smooth revenues over these tougher periods, especially given the higher marginal returns to its output—that is, the greater social need—during those times. Foundations could step in to help service organizations fill this borrowing need.

Current law already offers very mild incentives in this direction, allowing foundations to count below-market loans to service providers against their § 4942 limit.[260] In my sample, though, foundations hardly use this option at all; barely one-tenth of 1% of foundation assets is given over to these "program-related investments."[261]

More generous treatment—such as offering bonuses against later § 4942 obligations, allowing foundations to earn higher rates of return, or booking loan guarantees as current expenditures—might help to stimulate more loans. Even a simple informational campaign could help foundations to recognize the important role that more aggressive use of loans and guarantees could serve.

All of these policies would work better if they were automatically triggered. Timing is crucial for recession-fighting policy.[262] Waiting for Congress to get around to enacting a temporary fix rarely works out well,[263] as our experiences with the 2009 stimulus bill illustrated. A well-designed statute would trigger whenever economic conditions hit certain thresholds, such as employment rates that dipped a substantial amount below historical trends.[264]

F. Closing Donor-Advised-Fund Loopholes

I mentioned earlier that the last decade has seen a dramatic rise of donor-advised funds, an alternative to private foundations. Because of their novelty, DAFs remain exempt from many of the rules that govern

259. *See generally*, *e.g.*, Noah D. Drezner, *Recessions and Tax Cuts: Economic Cycles' Impact on Individual Giving, Philanthropy, and Higher Education*, 6 INT'L J. EDUC. ADVANCEMENT 289 (2006).

260. I.R.C. § 4944(c) (2014); *see also* David A. Levitt & Robert A. Wexler, *Proposed Regulations Would Bring Program-Related Investments into the 21st Century*, J. TAX'N, Aug. 2012, at 100, 102–03.

261. *See infra* tbl.A.1.

262. *See* Jeff Strnad, *Some Macroeconomic Interactions with Tax Base Choice*, 56 SMU L. REV. 171, 179–81 (2003).

263. Christina D. Romer, *Changes in Business Cycles: Evidence and Explanations*, 13 J. ECON. PERSP. 23, 37 (1999).

264. *See* Strnad, *supra* note 262, at 179–81.

private foundations—and indeed, DAF organizers attribute much of the institution's popularity to this freedom.[265] In the long run, it will do little good to reform the rules of private foundation spending if new donors can use DAFs to avoid the new rules.

Most critically, DAFs are not subject to any minimum payout requirement.[266] Contributors to a qualified DAF can claim a full charitable contribution deduction at the date of transfer, even if the fund itself *never* distributes any money.[267] Furthermore, because the organizations that sponsor DAFs are usually treated as public charities for tax purposes, donors get an even more generous tax subsidy than is usually available to private foundation contributors.[268]

DAF defenders suggest that no minimum payout rule is needed, because they claim that as a descriptive matter, payouts from DAFs have been relatively rapid.[269] This is not necessarily true, and also proves less than the defenders think. The IRS does not currently require DAF sponsors to report DAF payouts on a fund-by-fund basis.[270] Therefore, sponsors such as Fidelity are able to report aggregate statistics. Judging by these aggregates, DAF payout rates are respectable, averaging about 16% of the funds under management annually.[271] But we have no way of knowing whether this could represent a few funds that pay out all their money, together with many funds that pay little or nothing.[272] Recent IRS data suggest that roughly a quarter of DAF sponsor organizations average close to a 0% payout.[273] Further, because DAFs are so new, we don't know what DAF payout rates will look like when the funds are mature, especially after the death of the donor. In the private foundation data, old firms, especially those whose original donors have passed on, spend much lower shares of their assets than others.[274]

It might also be argued that DAFs raise fewer concerns about agency costs than foundations. In theory, all the spending decisions of the DAF

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265. *See* Marsh, *supra* note 17, at 147.

266. Johnny Rex Buckles, *Should the Private Foundation Excise Tax on Failure to Distribute Income Generally Apply to "Private Foundation Substitutes"? Evaluating the Taxation of Various Models of Charitable Entities*, 44 NEW ENG. L. REV. 493, 509 (2010).

267. *See id.*

268. Marsh, *supra* note 17, at 147.

269. U.S. DEP'T OF THE TREASURY, REPORT TO CONGRESS ON SUPPORTING ORGANIZATIONS AND DONOR ADVISED FUNDS 73–74 (2011) (summarizing advocate comments).

270. *Id.* at 5, 50.

271. NAT'L PHILANTHROPIC TRUST, 2013 DONOR-ADVISED FUND REPORT 7 (2013).

272. U.S. DEP'T OF THE TREASURY, *supra* note 269, at 59.

273. Paul Arnsberger, *Donor-Advised Funds: An Overview Using IRS Data*, 1 B.C. L. SCH. F. ON PHILANTHROPY & THE PUB. GOOD 61, 67 (2015).

274. Sansing & Yetman, *supra* note 223, at 378–79; *see also supra* fig.1.

are made by the contributors, mitigating the problem that managers will make decisions the donors wouldn't. The DAF agency problem is subtler, though. DAF sponsors make money by claiming a yearly management fee, usually a percentage point or two of the assets in the fund.[275] The sponsors therefore have an incentive to discourage distributions. DAF sponsors have been wonderfully innovative in crafting ways to make it easy to get money into a DAF, but we haven't seen similar innovations in tools for spending the money.[276] Neither of these facts is surprising, given the way that DAF sponsors are compensated.

G. State Law

Finally, the federal government is not the only charity regulator. State organizational law provides default rules for the rights and obligations that nonprofit stakeholders share. Notably, state law provides background principles for how nonprofit managers invest and spend the organization's funds.[277] In 2006 and the years following, many states undertook dramatic revision to their investment rules, as they adopted a model act known as the Uniform Prudent Management of Institutional Funds Act, or "UPMIFA."[278]

A little-noticed provision of UPMIFA could have considerable impact on foundation spending. UPMIFA's drafters included an optional provision (modeled on a longstanding Massachusetts rule) allowing adopting states to create a soft cap on endowment spending for corporate charities (but not, for the most part, charitable trusts).[279] The cap states that annual spending in excess of 7% of a firm's investment assets would be presumptively a violation of the manager's duty to the organization, although the presumption is rebuttable.[280] Fifteen states have adopted some version of the cap, although Ohio's differs from all the others.[281]

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275. Marsh, *supra* note 17, at 147, 178.

276. *See id.* at 175–76 (describing bare-bones donation forms employed by DAFs); U.S. DEP'T OF THE TREASURY, *supra* note 269, at 50 (noting evidence of low advisory effort by national DAF sponsors).

277. FREMONT-SMITH, *supra* note 47, at 304–06.

278. Gary, *supra* note 25, at 1288–89.

279. *See* UNIF. PRUDENT MGMT. OF INSTITUTIONAL FUNDS ACT § 4(d) (2006).

280. *Id.*

281. CAL. PROB. CODE § 18504(d) (West 2015); ME. REV. STAT. tit. 13, § 5104(7) (2015); MD. CODE ANN., EST. & TRUSTS § 15-403(d) (West 2015); MASS. GEN. LAWS ch. 180A, § 2 (2015); MONT. CODE ANN. § 72-30-209(4) (2015); NEV. REV. STAT. § 164.667(4) (2015); N.H. REV. STAT. ANN. § 292–B:4(VI) (2015); N.Y. NOT-FOR-PROFIT CORP. LAW § 553(d) (McKinney 2015); N.D. CENT. CODE § 59-21-03(4) (2015); OHIO REV. CODE ANN. § 1715.53(D) (West 2015); OR. REV. STAT.

My empirical analysis shows that the cap has had an impact on foundation spending. Table 3 reports the results of a regression analysis comparing firms in UPMIFA-adopting states before and after the adoption of the spending cap. I first examine the effect of changes in law within firms over time, comparing firms where the cap took effect against other firms in the same state that are not governed by UPMIFA—a so-called "difference in differences" analysis. The imposition of a cap seems to reduce average spending in newly capped firms by about 8% and reduces the likelihood that the firm will exceed the federal floor by 7%. In another analysis, detailed in the Appendix, I also find that, comparing firms subject to a cap to similar firms in uncapped states, capped firms are 30% less likely to exceed the 5% federal spending floor.

TABLE 3: EFFECT OF DEFAULT SPENDING CAP ON FOUNDATION EXPENDITURES

VARIABLES	(1) Does Firm Pay Over Five Percent Floor?	(2) Log of Grants Awarded
Year subject to cap	-0.0710***	-0.0836***
	(-4.971)	(-5.938)
Log officer comp.	0.0611***	0.0949***
	(3.348)	(3.356)
R-squared	0.096	0.037

Notes: Coefficients reported with (z-score). Regressions include controls for foundation net assets, donations received, officer compensation, income, and negative income; state expenditures, population, and share of population under 26 and over 64; and state, firm, and calendar-year fixed effects. Number of firms: 7,477. ***: statistically significant at the 1% level.

There is no obvious policy justification for the spending cap, and it is reducing the money available for current charitable needs.[282] The policy recommendation here is simple. States should repeal their caps. Further, some states have adopted tax incentives to lure restricted-spending

§ 128.322(4) (2015); TENN. CODE ANN. § 35-10-204(d) (2015); TEX. PROP. CODE ANN. § 163.005(d) (West 2015); UTAH CODE ANN. § 51-8-304 (West 2015); WYO. STAT. ANN. § 17-7-304(d) (2015).

Ohio sets the cap at 5% and flips the presumption, stating that spending under 5% is presumptively prudent. OHIO REV. CODE ANN. § 1715.53(D).

282. UPMIFA's drafters included the cap provision out of "[c]oncern that charities would be tempted to spend endowment assets too rapidly." Gary, *supra* note 25, at 1314.

vehicles away from other states.[283] Others should resist this kind of destructive race to the bottom, and federal rules disfavoring restricted spending might help in that direction.

CONCLUSION

Choosing exactly the right regulations for restricted-spending charities won't necessarily be easy or obvious, but we probably know enough today to take some first steps. The arguments in favor of subsidizing charitable gifts subject to restricted spending are surprisingly thin. Future philanthropy is often predictably of lower value than charity today. To the extent that waiting has value, that goal can be met through policies other than perpetually restricted spending: Organizations can raise new money, and government policy can encourage organizations to set aside money temporarily to distribute in a later crisis.

The real question, then, is how best to reconcile the unappealing nature of restricted spending with the welter of current laws that support and encourage it. To be sure, any policy change could have unwanted side effects. If we demand that donors allow their gifts to be spent more quickly, there is some potential that donors or managers could change their behaviors in response. But there is no evidence right now to suggest that this effect would be a major factor. There is, on the other hand, considerable evidence—including new data I have reported here—that foundations could continue indefinitely even under much higher rates of spending than the law now requires. Further, there seem to be no worries about side effects from revoking several of the more egregious, and unjustified, rules propping up restricted spending, such as the non-regulation of donor-advised funds and state laws that seem to have no purpose other than a race to the bottom to entice foundation-lawyering business from state to state.

In sum, while caution is appropriate, this is an area where some of the fruit are hanging low indeed. Policy makers should consider some first steps now, and researchers can study whether these steps give any indication that more dramatic action to curb restricted spending would have unwanted impacts.

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283. Irvin, *supra* note 10, at 454.

APPENDIX

The foundation data used throughout this Article are derived from the 2011 Cumulative PF-SOI data file compiled by the National Center on Charitable Statistics ("NCCS"). NCCS collates data from individual Form 990 tax returns filed by each foundation and then machine-scanned by the IRS. The Cumulative file includes tax returns for fiscal years spanning 1985 through 2011. Not all organizations are included in the PF-SOI data; instead, the data are a stratified sample, with overweighting of the largest firms. Unless otherwise noted, I use sample weighting to recover the population distribution.

Except where noted, I deflate nominal values to real dollar amounts using the PCE index calculated by the Bureau of Economic Analysis. Table A.1 provides a statistical overview of the data; data reported in this table are not winsorized but are sample weighted.

TABLE A.1: SUMMARY STATISTICS

Variable	Mean	SD	Min	Max
Donations	386773	1.66E+07	0	1.40E+10
Fundraising	498220.9	9426910	0	3.77E+09
Assets	6170387	1.31E+08	0	3.91E+10
Taxable Trust?	0.000345	0.018572	0	1
Operating Foundation?	0.080528	0.27211	0	1
§ 4942 Expends	477772.4	9200223	0	3.77E+09
Other Income	33831.49	1271622	-3.54E+08	4.14E+08
Total Income	848706.7	2.10E+07	-4.63E+08	1.39E+10
Officer Comp.	10850.59	81551.72	0	9371595
Grants Paid	415127.2	1.05E+07	0	4.16E+09
All Expends	534889.7	1.17E+07	0	4.72E+09
Liabilities	233251.6	1.49E+07	0	1.29E+10
Payout / Inv. Assets	1.575511	69.13112	0	18773.4
Net Investment Assets	5532168	1.22E+08	0	3.55E+10
UPMIFA in Effect	0.169227	0.374953	0	1
Prog. Related Inv. ($)	34342	821275	0	1.68E+08

Notes: Number of Observations: 228,407. All dollar figures deflated to 2009 dollars using the PCE deflator.

Foundation Returns on Investment

Part V.C.1 describes the historical rate of return on foundation investments. For the most part, I replicate the methodology of Cambridge Associates, Inc. ("CAI"), which has prepared a series of prior reports, but I use my full sample of thousands of foundations, rather than CAI's four dozen. I omit private operating foundations and nonexempt charitable trusts.

To calculate the average compounded rate of return, I follow the method for imputing investment returns provided in the 2000 CAI report Appendix D. That is, the imputed annual rate of return, before inflation, is:

$$(\text{net investment assets}_{t} - \text{net investment assets}_{t-1} + \text{expenditures}_{t} + \text{taxes paid}_{t} - \text{new contributions}_{t}) / \text{net investment assets}_{t-1}$$

where the subscripts *t* and *t-1* indicate that values are for the current fiscal year and the antecedent year, respectively.[284] In order to translate these figures into a compounded rate of return, I link the individual annual observations in a geometric sequence and compute an annual rate of return using the standard compound growth rate formula.

As typically occurs with large financial databases, the resulting values include some extreme outliers. A standard research practice in this context is to "winsorize" the data, which is to drop observations falling in the highest and lowest percentile of results.[285] Hand examination of samples of the dropped observations suggests that many seem to have been carelessly reported or inaccurately scanned, with implausible values for key inputs into the formula.[286] Again, following the methodology of the CAI report, I also weight the results by firm assets.

I calculate real rates of return using three measures of inflation. The US government uses different measures of inflation for different purposes.

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284. The CAI study is unclear on whether it uses current- or antecedent-year-values for expenditures, taxes, and new contributions. Logically, since the value we are reconstructing is the change in asset values between the end of year 0 and the end of year 1, these should be year 1 values.

Both expenditures and taxes paid are included in the equation because the instructions for the "total expenditures" field on the Form 990 direct the firm to exclude the amount of taxes paid when calculating the "total."

285. Dhiren Ghosh & Andrew Vogt, *Outliers: An Evaluation of Methodologies*, 1 AM. STATISTICAL ASS'N SECTION ON SURVEY METHODS—JOINT STATISTICAL MEETING 2012, at 3455, 3456 (2012).

286. For example, NCCS attempts to flag and correct returns for which some values are reported in dollars and others in thousands of dollars, but they do not claim, and likely could not realistically achieve, complete success in that effort.

Three of the major measures are CPI, PCE, and the GDP deflator.[287] Each measure varies somewhat from the others in which goods are included in the "basket" whose price is observed, the method of estimating consumer responses, and similar technical details.[288] CPI itself has two variants, standard and "chained" CPI.[289] Chained CPI and PCE each assume that, as prices rise, consumers will switch to cheaper alternatives, while standard CPI assumes (probably unrealistically) a fixed basket of goods.[290] PCE is probably the best measure of the inflation rate facing foundations, since it is chained and its basket explicitly is modeled to include items commonly purchased by service-providing nonprofits, while CPI tracks only goods bought by consumers.[291]

In any event, I calculate real rates of return separately for CPI, PCE, and GDP deflator. I allow each firm to face an individualized inflation rate by comparing monthly inflation rates for the last month of the firm's fiscal year in the first year the firm appears in the SOI file against the monthly CPI-U for the last month the firm appears.[292]

Recessionary Spending Simulation

Part V.D reports the simulated effect on recessionary spending of a policy in which firms use an inflation-adjusted 3-year average of their minimum payout floor. Recession dates are derived from NBER determinations.[293] I code a year as recessionary if the economy was contracting for more than one month of that year.[294] To run the simulation, I assume that any firm that met its minimum payout rate in reality would also meet any increased payout triggered by the use of a 3-year average;

287. Clinton P. McCully et al., *Comparing the Consumer Price Index and the Personal Consumption Expenditures Price Index*, SURVEY OF CURRENT BUS., Nov. 2007, at 26, 26; *What Is an Implicit Price Deflator and Where Can I Find the GNP IPD?*, U.S. BUREAU OF ECON. ANALYSIS, http://www.bea.gov/faq/index.cfm?faq_id=513 (last updated Mar. 19, 2009), *archived at* https://perma.cc/3CWH-JNFC.

288. *See* McCully et al., *supra* note 287, at 28–30.

289. Sean Sullivan, *The Ins and Outs of 'Chained CPI' Explained*, WASH. POST (Apr. 10, 2013), https://www.washingtonpost.com/news/the-fix/wp/2013/04/10/the-ins-and-outs-of-chained-cpi-explained/.

290. *See* McCully et al., *supra* note 287, at 28.

291. *See id.* at 29.

292. Because historical GDP deflator data are only available quarterly, I use the quarter closest to the close of the firm's fiscal year in place of the actual month.

293. *US Business Cycle Expansions and Contractions*, NAT'L BUREAU OF ECON. RES., http://www.nber.org/cycles.html (last visited Apr. 19, 2016), *archived at* https://perma.cc/85F2-M7MB.

294. I therefore code 2007 as non-recessionary, since the economy was contracting only in December of that year.

this assumption may slightly overstate the real impact of a higher floor. For simplicity, I assume that changing the floor does not affect firms whose spending exceeded the simulated floor amount or those that missed their real minimum.

After winsorizing and weighting by firm mean assets, I find that mean spending during recessions was $7.63 million, while simulated spending using the 3-year average would rise to $8.49 million, an increase of 11.3%. If averaging is done with nominal rather than inflation-adjusted floor amounts, spending would increase only 5.5%. In contrast, a simulation of a 7% floor increases mean recession spending to $9.62 million, a 26.1% increase.

Effect of Default Spending Caps

Part V.G describes the results of regression analyses in which I examine the impact of a state law default presumption of imprudence for firms spending in excess of 7% of their net investment assets. To control for the effects of other reforms that might affect spending, I limit the analysis to states that enact UPMIFA, a 2006 model act adopted by forty-six states between 2006 and 2011. UPMIFA includes an optional provision imposing the 7% cap, and thirteen states either adopt the model provision or already had one in place as of the date UPMIFA went into effect. Data on UPMIFA adoption date and cap adoption were hand collected and coded. Because Ohio's cap rule is dissimilar from all other states, I omit Ohio from the analysis. My results aren't meaningfully affected by dropping Ohio.

I estimate the impact of the cap three different ways. The first two employ fixed-effects panel regressions, with the dependent variable either logged grants awarded or the share of firms distributing qualifying funds in excess of their federal 5% floor. In both cases, I use a difference-in-differences identification strategy. UPMIFA governs the behavior of nonprofits organized as corporations, but not those organized as trusts. The reported coefficient measures the interaction effect of dummy variables for corporate status and post-cap-enactment time period, as in equation 2, below:

$$S_{it} = \alpha + \beta_1 Cap_{jt} + \beta_2 Corp_i + \delta Cap_{jt} * Corp_i + \beta_3 X_{it} + \lambda t + \gamma i + \varphi j + \varepsilon it \quad (2)$$

where *delta* is the coefficient of interest, the interaction term between cap enactment and the "treated" population; *j* and *i* index states and firms, respectively; and *X* is a vector of firm-level controls. To account for endogenous choice of form, the *Corp* variable is defined as the firm's

organizational form in the year prior to treatment. Since by construction *Corp* does not vary within firm, it is dropped in the actual regression. Because the treatment effect varies only at the state level, I cluster standard errors by state.

To capture some sense of the cross-sectional variation, the third approach uses a pooled probit model, again identifying off the difference in differences. I then estimate the marginal effect of the cap provision at sample means using the margins command in Stata 13. As reported in the main text, using this approach suggests that the existence of a cap reduces by about 28% the likelihood that the mean firm will exceed the federal spending floor, with 95% confidence interval, from 24.18% to 32.34%. I note, though, that pooled regressions of this kind can sometimes be biased upwards.

Complete regression results are available from the author on request. I also find the expected coefficients on the control variables, as well as that increased spending is correlated with greater executive compensation. One dollar in additional grants is correlated with about ten cents in added executive salary.