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Each year, American foundations spend tens of billions of dollars supporting the public through grants to charitable organizations. The total awarded may be moderate compared to aggregate funding of charitable organizations from all sources, including fees, government grants and contracts, and individual donations. Yet foundations are a significant source of capital reserves for the sector and are particularly helpful to many individual charities as well as charitable subsectors that, unlike the hospital and higher-education sectors, have few reserves of their own. A question then arises as to whether foundations could serve their social role better if grantmaking increased at crucial times, especially when the national or local economy is underperforming and support from other sources has diminished. Correspondingly, if grantmaking goes up in bad times, it would necessarily go down or grow more slowly in good times. Yet good times and above-average returns on assets tend to correlate, which then can raise political objections to why foundations are not more quickly sharing their newfound wealth.

As a condition of incorporation as 501(c)(3) entities, American grantmaking foundations must distribute a minimum of 5 percent of their investment assets annually for charitable purposes. Most of these distributions take the form of grants to other charitable organizations. The total amount distributed is often referred to as the “distribution amount” or “payout.” A simple adherence to a “5 percent of assets per year” rule would, by its very nature, make a foundation’s payout procyclical: as the economy—particularly the stock market in which substantial foundation assets are invested—rises and falls, foundation payouts would rise and fall with it. Thus, when economic downturns leave the larger nonprofit sector most in need of funding, foundations are required to pay out the least. Whether they do is one of the issues examined in this brief.

To discuss the effect of the procyclical nature of foundation payouts, as well as to examine ways to make payouts themselves more efficient, the Tax Policy and Charities project of the Urban Institute (a project of the Urban Institute’s Center on Nonprofits and Philanthropy and the Urban-Brookings Tax Policy and Charities Brief)
Policy Center) and the Indiana University Lilly Family School of Philanthropy convened the "Foundation Grantmaking over the Economic Cycle" conference on March 13, 2014, in Washington, DC. Over 25 experts with legal, economic, research, and financial backgrounds in the foundation sector attended the meeting. Presenters included Ben W. Blanton (Faegre Baker Daniels), Joseph Cordes (Trachtenberg School of Public Policy and Public Administration), Nathan Dietz (Urban Institute), Steven Lawrence (Foundation Center), Patrick Rooney (Lilly Family School of Philanthropy), Kenneth Jones (The Annie E. Casey Foundation), Janne Gallagher (formerly with the Council on Foundations), Eugene R. Tempel (Lilly Family School of Philanthropy), and John Craig (Commonwealth Fund).

Early on, the discussion made clear that foundations have a limited capacity to combat the effects of economic downturns. Total foundation spending amounted to $51.8 billion in 2012, or just 0.3 percent of gross domestic product (GDP; Foundation Center 2014b). Bumping that number up, say, 10 percent rather than down 10 percent might entail a difference of roughly $10 billion. But an economic decline of even a few percentage points of GDP entails a loss for the economy as a whole of hundreds of billions of dollars. Foundation grants, therefore, are modest in scope and effect compared to government transfers or individual giving: they cannot counter broader negative effects on the economy or on the charitable sector.

But they can make a difference. Foundations still account for an estimated 15 percent of total private giving in the United States (Giving USA Foundation 2014) and they play a big role with particular charities. Thus, during downturns they are one potential source of support and stabilization for nonprofits that typically face declining individual donor support or increased demands from a public in greater need.

**Procyclical Payouts**

The procyclical nature of foundation payouts is partially attributable to certain legal restrictions on how foundations are required to disperse their funds. Foundations must distribute, at minimum, 5 percent of their net worth (after adjusting for taxes paid and other distributions and deductions; Foundation Center 2012). This amount is based solely on current-year value rather than a longer period. Some limited flexibility is allowed: foundations can make up shortfalls in their next fiscal year or apply surpluses to deficits for up to five years.

In addition, foundations must pay an excise tax on foundation net investment income. This tax has been set at 1 or 2 percent based on previous performance: if a foundation dropped below its five-year average, it had to pay the higher rate. This dual rate structure may be overturned: on February 12, 2015 the House of Representatives sent a bill to the Senate, the America Gives More Act of 2015, in which the rate would be set at a constant 1 percent. Under the dual rate, foundations are penalized for operating in a procyclical way: a higher payout rate today means a higher tax later if the foundation returns to its previous average rate of payout (Steuerle and Sullivan 1995). This penalty applies even when a foundation merely maintains a previous year’s level of giving while its net worth fluctuates in value, thus leading to a fluctuating rate. Though the Council on Foundations and other associations
protest the inefficiency of the tax (legislative history shows that it was meant to fund IRS monitoring of the charitable sector, and that purpose has never been met), members of the panel noted that some foundations pay only limited attention to the “1 percent versus 2 percent” issue. Though any additional tax paid at the higher rate diverts more funds from grantmaking, it may be more efficient for some foundations to simply pay the additional tax instead of doing the necessary machinations to avoid it. Some foundation leaders may accept the tax as only a moderate cost relative to all of their operations; others may decide that their commitments to their grantees leave limited room to maneuver quickly. Nonetheless, most foundations do avoid the 2 percent fee, indicating that they either pay attention to the tax or for some other reason stick close to a flat payout rate.

Many foundations are set up to operate in perpetuity, which can affect how they approach whether to vary payout rates, regardless of any excise tax incentive. For instance, when any institution—household, business, or foundation—finds its net worth declining significantly, it tends to retrench on spending, trying to ensure that it has adequate reserves to carry on into the future. However, this common tendency exacerbates economic cycles across the economy, so that what might be seen as reasonable risk aversion by the institution adds to risk for the broader public. By paying out more than is required, a foundation might fear that it will jeopardize its ability to operate for the public good well into the future.

For growing foundations or those with spend-down policies, the matter is more complex. For instance, for those still receiving substantial contributions from their major donors (e.g., the Bill & Melinda Gates Foundation in the beginning of the twenty-first century), a higher current level of spending out of existing assets may not reflect the foundation’s eventual rate of payout after most or all contributions to it have been made.

Benefits of Countercyclical Grantmaking

In light of the recent recession, this event discussed what might be done to encourage more countercyclical behavior among foundations. The roundtable was not asked to assess what the longer-term rate of payout should be, either from a foundation or government perspective. That is, whatever one’s views on what the average payout rate should be, the question on the table was whether there are better ways to allocate payout to periods of greater need.

Individual giving tends to fall as individual incomes fall during recessions. During the Great Recession, the estimated decline in individual giving ranged from $20 billion to $23 billion (Rooney et al. 2014).

As a major endowment backbone for the charitable sector, more flexible rules or practices could help foundations better serve charities affected by this decline in individual giving, including many social service providers without a large asset base. Some panel participants worried that foundations may be more likely to cut smaller organizations and grants out of their budgets when trimming distributions during recessions (Brown et al. 2013). Rural areas can also be hit harder because they tend to have less funding to begin with, and larger national foundations located in urban areas may divert a
larger share of a reduced grant base to their own communities and a smaller share to further-away recipients.

Payouts in the Great Recession

What did happen to foundation grants during recent recessions? Answering this question requires looking both at the absolute level of grantmaking and the rate of giving out of declining portfolio values. For this purpose, we define total payout as real (inflation-adjusted) dollars spent and payout rate as:

\[
\frac{\text{Total Expenses for Charitable Purposes}}{\text{Net Value of Noncharitable Use Assets}}
\]

This is essentially a simplified version of the IRS formula for payout rates,\textsuperscript{1} or “distribution rate,”\textsuperscript{2} which for this purpose we will consider the same. Drawing on National Center for Charitable Statistics data on all private foundations,\textsuperscript{3} an Urban Institute team found that absolute dollars of grantmaking did fall at many foundations during the recession years of 2001, 2008, and 2009.\textsuperscript{4} These reductions often occurred after a modest time lag, though in many cases the declines were smaller than would have occurred had the average rate stayed constant.

The majority of foundations with total assets over $1 million experienced minor or no change in their payout rate on a year-to-year basis. Note that a 10 percent gain in the payout rate would correspond to a foundation changing from a 5 percent payout to a 5.5 percent payout in the next year, so even those groups in the “gain” or “loss” category are not necessarily changing their payouts dramatically. In any year, less than 7.3 percent of foundations experienced declines greater than 50 percent in their payout rate and 10.5 to 16 percent experienced gains of more than 50 percent. During the Great Recession, more foundations shifted to a higher payout rate relative to the percentage shifting in that direction in the previous year; the share of foundations experiencing gains of more than 10 percent in 2008 increased to 50.5 percent from 30.4 percent in 2007, but the share of foundations experiencing reductions fell from 28.1 percent to 21.9 percent. In 2010, the share of foundations experiencing gains in payout rates returned to 24.5 percent. The year 2010 also had a large gain in the share of foundations experiencing reductions, which rose from 25.5 percent in 2009 to 47.3 percent. No significant changes in payout rate appeared during the 2001 recession.
The relative constancy in payout rates, even during recessions, foretells what will happen to the real value of payouts when portfolios decline. The share of foundations with assets over $1 million experiencing reductions or declines in the real value of expenses paid for charitable purposes spiked during both recessions. The share of foundations experiencing a 10 percent or greater reduction in their payout increased from 22.4 percent in 2000 to 29.6 percent in 2001. There appears to be a lag effect because the rate climbed to 40.9 percent in 2003 before payouts began to recover. The Great Recession again saw an increase in the share of foundations experiencing reductions in their total real expenses for charitable purposes: it climbed to 45.2 percent of foundations in 2009.
As shown in figure 3, in aggregate, overall grantmaking fell 14.7 percent in 2001, though that followed a period of significant increases. Overall grantmaking fell again during the Great Recession by 2.2 percent in 2008 and 2.3 percent in 2009. Some of this more modest aggregate effect reflected newer, growing foundations, such as the Bill & Melinda Gates Foundation, which were still in a contribution stage and making grants both higher than in previous years and much higher than 5 percent of their net worth.
Looking at distribution rates rather than total distributions, the median distribution rate rose slightly at the beginning of both the 2001 recession and the Great Recession. Figure 4 shows this distribution rate by year. As shown, the highest distribution rate actually occurred during the Great Recession, though it dropped off again in 2010 (the last year for which data is available). The aggregate payout rate is compared to the performance index of The Investment Fund for Foundations’ Multi-Asset Fund, a mixed portfolio of stocks, bonds, and other assets. As of January 2014, the fund held $5.7 billion in assets for endowments, foundations, and nonprofits that have over $5 million in assets.⁵
FIGURE 4
Aggregate Total Expenses for Charitable Purposes over Aggregate Net Noncharitable Use Assets by Year, Graphed alongside the Investment Fund for Foundations’ Multi-Asset Fund Performance Index, 1997–2010

Note: TIFF = The Investment Fund for Foundations. Recession years are shaded.

Figures 3 and 4 only present aggregates for the foundation sector taken as a whole; Figure 5 breaks out foundations with greater than $10 million in assets. As seen in figure 5, the median distribution rate hovered around 5 percent in all years, but skirted close to 6 percent in the years directly following both the recession of the early 2000’s and the Great Recession. By 2004 and then again by 2010, it fell back to the 5 percent level.
Stephen Lawrence (Foundation Center) supports the claim that payout rates rose during the recession. The study he cites shows that the mean and median foundation payout rate increased between 2004 and 2006 and between 2007 and 2009 (Foundation Center 2012). He notes that although his data focused on larger foundations, smaller foundations tend to have even higher payout rates because they are often less locked-in to plans to exist in perpetuity than are larger organizations; smaller foundations are thus more likely to be willing to disperse more funds quickly. In particular, “pass-through” foundations, which often hold very little in stable assets, tend to be small.

As noted, however, an increased rate of grantmaking does not mean an increase in the amount of money a foundation distributes to grantees. Payout rates represent distributions relative to total assets; if an organization continues paying out the same dollar amount during times of recession (perhaps because they are locked in to multiyear grants), its payout rate will increase solely because its assets have diminished, not because it is actually paying out more real dollars.

Patrick Rooney and colleagues (2014) find that the Great Recession’s effect on total giving was more significant than on foundation giving. They find that the Great Recession was associated with large losses in household giving even after controlling for permanent income, wealth, earlier recessions,
and changes in tax rates. In other words, household giving was more sensitive to the general turbulence of the Great Recession, holding other economic factors constant, than foundation giving.

Another question is whether foundations change their funding priorities during recessions. Hypothetically, foundations might redirect their funding toward human service organizations during recessions to combat economic instability and high unemployment. But surveys find that foundations are not necessarily changing their grantmaking priorities during recessions (Foundation Center 2012). According to the Foundation Center’s data on grants from the top 1,000 foundations, in 2012 foundations gave the largest number of grants to human service organizations but continued to give the largest amount to education and health organizations (Foundation Center 2014a).

One topic of speculation during the meeting was whether foundation grantmaking should take into account those organizations hardest hit by the recession and those most dependent on their grants. As one example, consider arts organizations and human service organizations. When all sources of giving are considered, arts organizations appear to be among those harder hit by reduced donations during a recession. A recent series of studies by the Urban Institute’s National Center for Charitable Statistics suggests that arts, culture, and humanities organizations were more negatively affected by the Great Recession than most other subsectors, in terms of both revenue (Dietz et al. 2014) and closure rates (McKeever et al., forthcoming). Arts, culture, and humanities organizations already receive a much lower proportion of total charitable dollars than human service organizations (Giving USA Foundation 2014). According to the Foundation Center (2014b), in 2012 arts, culture, and humanities organizations received 13 percent of grants and 10 percent of total dollars granted by the top 1,000 foundations, compared to 27 percent of grants and 16 percent of the total dollars granted for human service organizations. Thus, one rich topic of conversation during the conference was whether foundation grantmaking should be adjusted to help boost organizations that are more affected by recessions than others, such as arts, culture, and humanities organizations, though no one suggested that this was an issue for legislation.

Solutions

The afternoon session focused on possible methods to promote countercyclicality without any long-term effect on foundation size. Discussions first centered on legal incentives and policy remedies. Attendees showed support for simplification of both the excise tax and carry-forward rules.

In 2014, David Camp, then chair of the House Committee on Ways and Means, proposed a flat 1 percent excise tax rate in his proposals, and in early 2015 the House of Representatives passed a bill doing just that. Earlier, President Obama had suggested a flat 1.35 percent rate. As noted, both would remove the procyclical bias of the current excise tax (currently when a foundation increases grants in a recession, it is likely in later years to get hit by a higher rate of tax; Steuerle and Sullivan 1995).

But a reformed excise tax is only a part of the story. Some discussion centered on whether there might be some extralegal adjustment for foundations that bump up their grantmaking in recessionary times. Attendees didn’t pursue this option very far, noting the difficulty of creating meaningful reform
because of the heterogeneity of foundations. "Rough justice is the best you're ever going to get," said one participant.

More interest was shown in adjustments to carry-forward rules. One attendee noted that the carry-forward rule seems to work "one year back but five years forward." Attendees suggested drafting a simpler carry-forward rule, perhaps allowing foundations to carry forward a required payment for more than one year. With any reform of the excise tax, this would seem a logical next step to consider. Others noted the political difficulty of gathering support for any reform when foundations have different interests. Some participants feared that reform would work against the interests of the foundation donors, reenergize a conflict about perpetuity, and do little to remove the criticism that in good economic times they should do more and pay out (pro- rather than countercyclically) an even higher percentage of net worth.

But much adjustment can be achieved only by foundations, independently of any legal requirements. Individual foundations maintain significant ability to boost their payouts during recessions or other periods of special need among the public or among their grantees. Some participants noted that institutions with more liquid assets and less fixed commitments could use financial planning and portfolio management to adjust more easily and successfully to a recession. In fact, as Gene Tempel of the Lilly Family School of Philanthropy illustrated, university foundations, as public charities, are not subject to the payout requirements and excise tax penalties by which private foundations must abide. Consequently, university foundations in theory are able to "smooth out" their payout amounts to account for changes in inflation and other economic conditions. Professor Joseph Cordes of the George Washington University, however, noted that many universities do not seem to make such adjustments, implying that a simple payout rule may be as much a standard operating procedure for endowed institutions, independent of any formal legal requirement.

Participants called for further study, using techniques such as Monte Carlo analysis, to explore methods of increasing payouts during bad years while preserving the same level of corpus in the long term. Other participants pointed out that mission-related investments and program-related investments, relatively new tools that are not yet widely used by foundations, may also be used effectively to combat procyclicality.

For that matter, a foundation could also simply make up-front but longer-term grants that avoid the threat of a cutback for the grantee organization in a few succeeding years. Even further, the contractual terms of grants could help the charity build up some reserves for bad times. In effect, removal of the excise tax penalty for extra grantmaking at any point in time, and a simplified payout rule that allowed more carry-forwards and carry-backs, make countercyclical planning easier. But, in the end, each individual foundation must decide what type of timing serves the public interest best.

Conclusion

The legal landscape for foundations encourages procyclical and discourages countercyclical grantmaking. The data indicate that in aggregate the problem is not as bad as a pure flat rate of payout
would imply, but many foundations do come close effectively to paying out a flat percentage of net worth every year. They thereby cut back on grants during or just after a recession, causing adverse effects on charities relying on those foundations for support. Legal changes, including to the excise tax and carry-back and carry-forward rules, could encourage more foundations to increase or at least not decrease the dollar value of their grantmaking during economic downturns. Portfolio management techniques and longer-term grantmaking formulas could also help, and research could show ways of minimizing risk to both grantors and grantees. New wealth creators and new donors display more diversity in the use of their philanthropic dollars; certainly their growth during recent recessions offset some of the declines in giving by foundations that stuck pretty close to the same payout rate year after year, though with different winners and losers within the grant-receiving charities. Whatever techniques are used or reforms adopted, a more countercyclical approach to grantmaking would likely serve the public and charities better in times of greater need, a goal consistent with one of the purposes of having and maintaining charitable endowments.

Notes

1. See Foundation Center (2012) for a useful guide to the payout rate.

2. The NCCS core files do not contain all financial data for all foundations as reported on the 990PF and used to calculate the distribution rate. Therefore, “total expenses for charitable purposes” (form 990-PF, Part I, Line 26[d]) were divided by the “net value of noncharitable-use assets” (Part X, Line 6) as a proxy for the calculated payout rate.

3. Data was taken from the National Center for Charitable Statistics core files for private foundations. These files, which represent individual 990-PF filings from private foundations by fiscal year, were used to construct a representation of all private foundations through the recession period. Private operating foundations were excluded from analysis. Thus, the analysis contains cross-sectional data for all foundations filing between 1997 and 2010 (the first and last years for which complete data were available), which totaled 1,195,121 entries for 137,312 private foundations.


References


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