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The Quick (Spending) and the Dead: The Agency Costs of Forever Philanthropy

Brian Galle

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ESSAY

The Quick (Spending) and the Dead: The Agency Costs of Forever Philanthropy

*Brian Galle**

American philanthropic institutions control upwards of a trillion dollars of wealth. Because contributions to these entities are deductible from both income and estate taxes, and the entities' earnings are tax-free, that trillion dollars is heavily underwritten by contemporary taxpayers. Law offers little assurance that those who pay will be those who benefit. To the contrary, since these subsidies become more valuable the longer charitable assets are left unspent, the law strongly encourages philanthropies to save rather than spend, even in situations of great current need. Other legal rules further encourage grantmaking institutions to strive to exist "in perpetuity."

This Essay offers new empirical evidence of the social cost of forever philanthropy, that is, of institutions that long outlive their founders. Drawing on a relatively unique dataset of foundation donors, and combining it with a large archive of tax returns filed by private foundations, I search for evidence that managers of long-lasting organizations depart significantly from the preferences of the organization's supporters. I find that a firm's overhead, or the ratio of administrative expenses to grants made, jumps by about 12% as soon as the organization's last living donor dies. Payout rates, or the share of assets spent each year, move sharply in the opposite direction, falling about 7% at that time.

* Professor of Law, Georgetown University Law Center. I'm grateful for advice, assistance, and commentary from Dan Halperin, Henry Hansmann, Daniel Hemel, Shelly Layser, Ray Madoff, Ben Marx, David Schizer, Ben Soskis, Rich Steinberg, and Eric Talley, as well as attendees of the Giving in Time Conference organized by the Urban Institute and the Boston College Forum on Philanthropy and the Public Good.

I interpret these findings as evidence of substantial agency costs. Since the timing of the donor's death is relatively random, these outcomes offer convincing causal evidence that the ability of a donor to monitor her foundation's managers importantly affects whether those managers follow her wishes. I argue that overhead and payout changes in the directions I observe strongly suggest that managers, once free from direct oversight, are operating the firm for their own comfort and security. Thus, by unnaturally extending the lifespan of foundations, law is encouraging wasteful allocation of taxpayer supported charitable resources.

Therefore, I suggest several policy options that would reduce the agency-cost problem. Among others, I support maintaining or increasing legal requirements for mandatory distributions by private foundations and closing legal loopholes offered by a relatively new charitable phenomenon, the donor-advised fund.

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INTRODUCTION

Forever, the pop icon Prince told us, is a mighty long time.¹ Despite our ambitions, human projects rarely last a generation, let alone for eternity.² Yet the law of philanthropy—the collection of state and federal rules shaping charitable giving by large philanthropic organizations—stubbornly insists on building and preserving institutions to carry out the wishes of their founders not just for a few

1. PRINCE & THE REVOLUTION, *Let's Go Crazy*, on PURPLE RAIN (Warner Bros. Records 1984).

2. See, e.g., Percy Bysshe Shelley, *Ozymandias*, in THE ART OF THE SONNET 125, 125–29 (Stephen Burt & David Mikics eds., 2010).

years, but “in perpetuity.”³ Federal tax law offers charitable donors powerful incentives to donate to a grantmaking organization they control now, but to forestall actually distributing the money to support active charities for as long as possible.⁴ State law protects donor prerogatives to delay grantmaking, and about fifteen states actually penalize grantmakers who spend too fast.⁵

Philanthropy and its timing have become major hot-button issues in recent years, in part due to the rise in global wealth inequality.⁶ Mass-market authors, such as Anand Giridharadas, criticize the ways in which global elites stash vast sums in grantmaking organizations and use them as tools for amassing social influence, all while not doing much in the way of actually funding real charity.⁷ Academics, including me, my erstwhile colleague Ray Madoff, and the Stanford political scientist Rob Reich, have all suggested that there is a fundamental mismatch between the resources society devotes to supporting philanthropy and the ways in which “perpetual” grantmakers actually deploy those resources.⁸ For instance, it is quite possible for a foundation donor to claim a charitable contribution deduction of billions of dollars while never allocating a single dollar of those funds for grants.⁹

3. Brian Galle, *Pay It Forward? Law and the Problem of Restricted-Spending Philanthropy*, 93 WASH. U. L. REV. 1143, 1153 (2016).

4. David M. Schizer, *Charitable Subsidies and Nonprofit Governance: Comparing the Charitable Deduction with the Exemption for Endowment Income*, 71 TAX L. REV. 665, 689–94 (2018).

5. Susan N. Gary, *Restricted Charitable Gifts: Public Benefit, Public Voice*, 81 ALB. L. REV. 565, 607 (2018); Galle, *supra* note 3, at 1200 n.281; Daniel Halperin, *Tax Policy and Endowments—Is Excessive Accumulation Subsidized?*, 67 EXEMPT ORG. TAX REV. 17, 22 (2011).

6. See NAT’L COMM. FOR RESPONSIVE PHILANTHROPY, CRITERIA FOR PHILANTHROPY AT ITS BEST 84 (2009) (“Payout has been a frequent subject of debate and continuing dialogue within the philanthropic field.”). Debate about philanthropic wealth and its uses is of course not a new phenomenon. See Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873, 899–944 (1997) (discussing how the debate evolved through the twentieth century).

7. ANAND GIRIDHARADAS, WINNERS TAKE ALL: THE ELITE CHARADE OF CHANGING THE WORLD 53, 164–65, 182 (2018); see DAVID CALLAHAN, THE GIVERS: WEALTH, POWER, AND PHILANTHROPY IN A NEW GILDED AGE 235–60 (2017) (describing modern philanthropists as “the new Medicis”).

8. RICHARD POSNER, ECONOMIC ANALYSIS OF LAW § 19.4, at 713–14 (9th ed. 2014); Galle, *supra* note 3, at 1159–81; ROB REICH, JUST GIVING 90–93, 144–49 (2018); Ray Madoff & Rob Reich, *Now or Forever: Rethinking Foundation Life Spans*, CHRON. PHILANTHROPY (Mar. 30, 2016), <https://www.philanthropy.com/article/Opinion-Now-or-Forever-/235896> [<https://perma.cc/RB36-WFGK>].

9. See John E. Core & Thomas Donaldson, *An Economic and Ethical Approach to Charity and Charity Endowments*, 68 REV. SOC. ECON. 261, 265 (2010) (explaining that when charitable distributions are smaller than real growth of charitable assets, organization never need to spend the principal).

The recent COVID-19 crisis has drawn even greater attention to the tightfistedness of many philanthropic organizations. Pointing to the urgent need for fiscal and public-health interventions, many commentators have urged philanthropists to open their wallets.¹⁰ Recent estimates suggest traditional philanthropies hold upwards of \$1 trillion in assets.¹¹ Yet it made major news when five—not five hundred, five—of the thousands of American foundations announced plans to increase their annual planned spending.¹²

Although state and federal taxpayers massively underwrite philanthropic giving, the laws authorizing that support have surprisingly little to say about how quickly the money is spent. As readers likely know, individuals who give to charitable organizations get an income-tax deduction, and donated funds are also exempt from estate and gift taxes.¹³ Investments held by charities are exempt from any further tax as well, and because of this rule the government's contribution to a gift grows larger the longer an organization holds it.¹⁴ Taken together, as Ray Madoff and I have described elsewhere, these benefits can represent an effective matching grant of 70% or more of the value of a gift.¹⁵

In exchange, some but not all organizations pledge to spend a certain minimum fraction of their resources each year. Traditional grantmakers are mostly categorized by the tax code as “private foundations.”¹⁶ That status requires them to pay out roughly 5% of their

10. Benjamin Soskis, *Amid the Covid-19 Crisis, Foundations Should Stop Treating the 5% Payout as Holy Writ*, CHRON. PHILANTHROPY (Mar. 30, 2020), <https://www.philanthropy.com/article/Amid-the-Covid-19-Crisis/248374> [<https://perma.cc/P4H7-9AB5>]; Paul Sullivan, *How Philanthropists Are Helping During the Crisis*, N.Y. TIMES (Mar. 27, 2020), <https://www.nytimes.com/2020/03/27/your-money/philanthropy-coronavirus.html> [<https://perma.cc/8EFW-Z7M6>]; *COVID-19 Exposes American Philanthropy's Strengths and Weaknesses*, ECONOMIST (Apr. 27, 2020), <https://www.economist.com/united-states/2020/04/27/covid-19-exposes-american-philanthropys-strengths-and-weaknesses> [<https://perma.cc/U6DU-9BRF>].

11. Maria Di Mento, *Foundation Assets Top \$1 Trillion, but Signs Point to Slump*, CHRON. PHILANTHROPY (Aug. 19, 2019), <https://www.philanthropy.com/article/Foundation-Assets-Top-1/246975> [<https://perma.cc/5FTY-9468>]; see *Aggregate Fiscal Data of Foundations in the U.S., 2015*, FOUND. CTR., <http://data.foundationcenter.org> (last visited Jan. 25, 2020) [<https://perma.cc/XC2K-NG6L>] (showing that assets held by foundations in the U.S. was near \$1 trillion in 2015).

12. James B. Stewart & Nicholas Kulish, *Leading Foundations Pledge to Give More, Hoping to Upend Philanthropy*, N.Y. TIMES, <https://www.nytimes.com/2020/06/10/business/ford-foundation-bonds-coronavirus.html> (last updated June 16, 2020) [<https://perma.cc/CU8H-XC39>].

13. I.R.C. §§ 170, 2055.

14. *Id.* § 501(c)(3); see Halperin, *supra* note 5, at 18 (explaining how tax exemptions impact the growth of endowments).

15. Brian Galle & Ray Madoff, *The Myth of Payout Rules: Where Do We Go from Here?*, in *GIVING IN TIME* (Benjamin Soskis ed., forthcoming) (manuscript at 3–4) (on file with author).

16. See Roger Colinvaux, *Defending Place-Based Philanthropy by Defining the Community Foundation*, 2018 BYU L. REV. 1, 8–16 (describing legal categories for grantmaking organizations).

investment assets annually in grants and other charitable activity.¹⁷ Even this low number has some important loopholes.¹⁸ Active charities, such as universities, usually face no requirement at all.¹⁹

Because of a quirk in how “private foundation” is defined, some grantmakers also escape from that definition, and so are free from any payout requirement.²⁰ Beginning in the early 1990s, the Internal Revenue Service (“IRS”) gave its approval to so-called “commercial donor-advised fund sponsoring organizations,” or what I’ll call DSOs (often known by the shorthand term “donor-advised fund” or “DAF”).²¹ A DSO is a kind of condominium of private foundations, with one organization managing investments and administration for many individual donor accounts.²² Commercial DSOs took a while to catch on, but have shown massive growth since 2010, exceeding \$120 billion in assets on hand as of 2018.²³ IRS data suggest that roughly one-fifth of DSOs averaged a payout rate of zero—as in no dollars spent at all—during the period for which the IRS had information available.²⁴ DSOs also create several key loopholes in the regulatory regime for private foundations.²⁵ For instance, a foundation can potentially satisfy its minimum distribution requirement by moving money to an account at a DSO, then transferring those funds back again.

Though modest and loophole riddled, the minimum payout rule for private foundations has become intensely controversial. A group of self-described “patriotic billionaires” is pressing Congress to double the minimum amount, even as many pillars of the nonprofit world press in the opposite direction.²⁶

Some have framed this debate as a question of intergenerational justice. Payout rules offer a counterbalance to legal and other forces

17. I.R.C. § 4942(e).

18. Galle & Madoff, *supra* note 15 (manuscript at 6–10).

19. I.R.C. § 509(a).

20. Colinvaux, *supra* note 16, at 52–53.

21. See U.S. DEP’T OF THE TREASURY, REPORT TO CONGRESS ON SUPPORTING ORGANIZATIONS AND DONOR ADVISED FUNDS 21–22 (2011) (providing an overview on DSOs).

22. *Id.*

23. NAT’L PHILANTHROPIC TRUST, 2019 DONOR-ADVISED FUND REPORT 10 (2019).

24. Paul Arnsberger, *Donor-Advised Funds: An Overview Using IRS Data*, in THE RISE OF DONOR-ADVISED FUNDS: SHOULD CONGRESS RESPOND? 61, 67 fig.D (2015).

25. 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, 521–38 (2010); Colinvaux, *supra* note 16, at 52–53; Galle, *supra* note 3, at 1198–1200.

26. Stewart & Kulish, *supra* note 12; Michael Kavate, *Inside the Foundation Payout Debate: How Crisis and Opportunity Are Forcing Change*, INSIDE PHILANTHROPY (June 19, 2020), <https://www.insidephilanthropy.com/home/2020/6/19/for-decades-foundations-have-given-the-minimum-required-that-may-be-changing> [https://perma.cc/8VNM-BCFP].

that favor low spending.²⁷ By spending little, an organization stands a better chance of stretching those dollars forever. It could be argued, then, that one's views on payout should depend at least in part on whether one believes philanthropy should exist for today or instead for tomorrow, and whether current taxpayers should underwrite benefits for humans who have yet to be born.²⁸

In my view, though, the core of the debate is an empirical one. Payout defenders can grant that it might be wise to transfer wealth from today to tomorrow, but still question whether subsidizing philanthropic organizations with no payout requirement is the best or the wisest way to undertake that transfer.²⁹

One key open empirical question is the extent to which organizations' managers abide by the wishes of their supporters. Payout defenders argue that payout rules help to mitigate what they call the "dead hand" problem.³⁰ This is the idea that, once an initial funder is no longer around to control her organization, the new managers will no longer serve the mission she had in mind and may instead spend scarce charitable dollars on their goals or even their own comfort. An economist might say that "agency costs," or the gaps between what a principal desires and what her agents accomplish, are vastly larger in long-lived organizations.³¹

That makes some theoretical sense, but how big is this problem, really? Is it actually the case, for instance, that managers will feather their own nests instead of making grants? After all, the managers who run charities are . . . charitable. Don't they want to do the most good for the most people? Some of the most renowned scholars in the fields of managerial studies and nonprofit theory argue on these and related grounds that agency costs at charitable organizations are low.³²

27. Galle, *supra* note 3, at 1185–92.

28. Compare Michael Klausner, *When Time Isn't Money: Foundation Payouts and the Time Value of Money*, 1 STAN. SOC. INNOVATION REV. 51, 52–59 (2003) (arguing that the policy should not prefer spending today over tomorrow, at least if on the basis of "pure time preferences"), with Core & Donaldson, *supra* note 9, at 281 & n.18 (arguing that intergenerational equity argument is internally inconsistent and neglects importance of community connections), and Henry Hansmann, *Why Do Universities Have Endowments?*, 19 J. LEGAL STUD. 3, 14–16 (1990) (arguing that future generations will be wealthier than present and do not deserve additional transfers).

29. Galle, *supra* note 3, at 1156–59; see also Hansmann, *supra* note 28, at 18 (questioning whether university endowment would be the appropriate method for transferring resources to the future).

30. Galle, *supra* note 3, at 1162; Lester M. Salamon, *Foundations as Investment Managers Part 1: The Process*, 3 NONPROFIT MGMT. & LEADERSHIP 117, 118 (1992) (providing a historical background for the payout requirement); Schizer, *supra* note 4, at 695–98.

31. Hansmann, *supra* note 28, at 33.

32. See, e.g., Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327, 344–45 (1983) (finding low agency costs for nonprofits); Myron J. Roomkin & Burton A. Weisbrod, *Managerial Compensation and Incentives in For-Profit and Nonprofit*

In this Essay, I present new evidence on agency costs in philanthropic organizations. Drawing on two large databases of private foundation fiscal and other information, I show marked differences in the behaviors of foundations with living donors and those whose donors are all deceased. Overhead ratios, or the share of firm expenditures devoted to salaries and administration, increase slightly as the number of living donors diminishes and then jump by 10% as soon as the last living donor dies. Similarly, payout rates drop in the first couple of years after the last living donor passes, then fall quickly to the 5% minimum for the remaining observable years of the foundation. Other writers have found a correlation between the age of a charity and its spending rate.³³ My unique contribution is that, given the relatively random timing of the donor's death, I am able to argue that these changes are caused directly by the death of the donor and not some other factor that happens to correlate with the age of the charity.

Both these results, I argue, are evidence of important agency costs. Each shows that, as soon as there are no donors around to influence an organization's behavior, the firm's managers behave quite differently. I confirm prior findings that donors dislike overhead costs, including some of my own work reporting that overhead is lower when donors have the power to sue a charity's managers.³⁴ As far as I know, this is the first published work to report important differences in spending patterns between firms with living donors and firms without.

These results thus supply some new reasons to be supportive of payout rules and skeptical of efforts to slow spending, such as through loose federal regulation of DSOs. All else equal, a donated dollar spent today rather than after the donor's death will have a higher social

Hospitals, 15 J.L. ECON. & ORG. 750, 751–52 (1999) (suggesting that nonprofit firms use compensation structures to select managers who are not motivated by money and do not need close monitoring to prevent diversion of funds); Susan Rose-Ackerman, *Altruism, Nonprofits, and Economic Theory*, 34 J. ECON. LITERATURE 701, 716 (1996) [hereinafter Rose-Ackerman, *Altruism*] (suggesting that ideological commitment helps to overcome agency problems in some nonprofits); Susan Rose-Ackerman, *Ideals Versus Dollars: Donors, Charity Managers, and Government Grants*, 95 J. POL. ECON. 810, 812 (1987) (hypothesizing that people without financial incentives are more likely to pursue positions as nonprofit managers).

33. Richard Sansing & Robert Yetman, *Governing Private Foundations Using the Tax Law*, 41 J. ACCT. & ECON. 363, 376–77 (2006). Others similarly find that foundations that have not received recent gifts spend at close to the minimum statutory level. Timothy R. Yoder & Brian P. McAllister, *Do Private Foundations Increase Current Distributions to Qualify for a 50 Percent Tax Rate Reduction?*, 34 J. AM. TAX'N ASS'N 45, 47 (2012); Lester M. Salamon, *Foundations as Investment Managers Part II: The Performance*, 3 NONPROFIT MGMT. & LEADERSHIP 239, 248–50 (1993).

34. Brian Galle, *Valuing the Right to Sue: An Empirical Examination of Nonprofit Agency Costs*, 60 J.L. & ECON. 413, 428–30 (2017); Uri Gneezy, Elizabeth A. Keenan & Ayelet Gneezy, *Avoiding Overhead Aversion in Charity*, 346 SCIENCE 632, 633 (2014); Daniel Tinkelman & Kamini Mankaney, *When Is Administrative Efficiency Associated with Charitable Donations?*, 36 NONPROFIT & VOLUNTARY SECTOR Q. 41, 56–57 (2007).

return, because it will better satisfy the donor's preferences. To be clear, though my evidence is only on how managers and donors differ with respect to overhead and payout, my claim is broader: these divergences are only symptoms of a larger underlying problem. Donors cannot control their foundation effectively after they are dead, and this will be evidenced not only in the easily measured outcomes I report but also in others that might be even more important to donors—such as choices about which causes to support.

The results have implications for state laws, as well. As I mentioned already, more than a dozen states presume charity managers act unlawfully when they spend the organization's money too quickly. Nearly every state presumes that, unless a donor expressly says otherwise, she intends for any donation subject to conditions or restrictions to also be subject to the implied limitation that the gift be used "in perpetuity."³⁵ And important accounting rules force nonprofit managers to act as though foundation money has to be preserved forever.³⁶ All these rules appear contrary to the observed preferences of donors and instead reflect the desires of professional nonprofit managers. That is understandable as a political economy matter, but it probably does not reflect ideal policy.

Finally, my findings could justify new thinking about the ways in which governments incentivize giving. Tax and other policies should favor "giving while living" over perpetually endowed philanthropic organizations. I will argue that this justifies higher payout requirements as well as a larger estate tax that applies to more estates. To the extent that individuals accidentally leave behind charitable estates, rules that encourage faster spending during the donor's life would also help to improve the return on our investments in the charitable sector.

In Part I of this Essay, I will set out some additional theoretical background for readers new to this topic and review prior empirical findings that touch on aspects of my work here. Part II explains my data sources and the construction of key variables. In Part III, I examine the impact of donor death on payout and overhead ratios, using both graphical and regression analyses. Part IV considers what we can infer

35. Susan N. Gary, *Charities, Endowments, and Donor Intent: The Uniform Prudent Management of Institutional Funds Act*, 41 GA. L. REV. 1277, 1305–07, 1311 (2007).

36. FIN. ACCT. STANDARDS BD., FASB STAFF POSITION NO. 117-1, ENDOWMENTS OF NOT-FOR-PROFIT ORGANIZATIONS, at app. ¶¶ A12–13 (Aug. 6, 2008), https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220134971&acceptedDisclaimer=true [https://perma.cc/8MNQ-QV2R]. For evidence that accounting constraints are important drivers of foundation behavior, see Brian Galle, *Why Do Foundations Follow the Law? Evidence from Adoption of the Uniform Prudent Management of Institutional Funds Act*, 36 J. POL'Y ANALYSIS & MGMT. 532, 551–52 (2017).

from my findings and discusses policy implications for the law of philanthropy as well as the estate and gift tax regime. I then conclude.

I. BACKGROUND AND PRIOR LITERATURE

A. *Tax Incentives for Charitable Giving: Details and Rationales*

Federal tax law provides several distinct benefits for charitable contributors.³⁷ Among these are charitable contribution deductions from income and estate taxes, exclusions from the gift tax and income tax on gifts of appreciated assets, and the ability to deduct the full fair market value of noncash property.³⁸ A back-of-the-envelope calculation suggests that for high net-worth individuals, these rules in combination can produce in excess of \$7 million worth of return value on a \$10 million gift.³⁹

Why does Congress provide such generous tax benefits for charitable giving? The prevailing view is that subsidies make up for two

37. This Part I.A draws extensively on Galle & Madoff, *supra* note 15.

38. Evelyn Brody, *Reforming Tax Policy with Respect to Charitable Organizations*, in RESEARCH HANDBOOK ON NOT-FOR-PROFIT LAW 484, 484–86 (Matthew Harding ed., 2018).

39. A useful overview of these benefits and how the wealthy maximize them is MYRON S. SCHOLES, MARK A. WOLFSON, MERLE M. ERICKSON, EDWARD L. MAYDEW & TERRENCE J. SHEVLIN, TAXES AND BUSINESS STRATEGY: A PLANNING APPROACH 485–502 (5th ed. 2016). The first benefit is an income tax deduction. Setting aside some technical detail, a charitable contribution reduces the donor's taxable income, which in turn saves her an actual number of dollars equal to the donation amount times her "marginal" tax rate, which is the rate she pays on the last dollar of income. For instance, since the current top tax rate is 37%, a \$10 million donation reduces a donor's tax paid by \$3.7 million.

In addition, two separate rules combine to provide extremely favorable treatment for donations of property that have appreciated in value since acquired. First, although taxpayers usually must include such gains in income when property is "sold or otherwise disposed of," donations to charity do not trigger this rule—in technical lingo, a donation is not a "realization event." Second, and subject to some important exceptions, donations of property provide a charitable contribution deduction in the amount of the full fair market value of the property.

Finally, charitable contributions are not subject to the gift tax and also reduce the estate tax. At current estate and gift tax rates of 40%, this produces \$4 million of savings on a \$10 million gift.

Taken together, then, a donor who establishes a private foundation with a new \$10 million contribution of appreciated, publicly traded stock can save up to \$7.7 million in current and expected taxes. The initial donation creates \$3.7 million in income tax savings. Assuming that none of the value of the stock has yet been taxed, its transfer saves the donor another 23.8% x \$10 million = roughly \$2.4 million in potential capital gains taxes. And that \$10 million will neither be taxed at the time of donor's death nor subject to the gift tax. Assuming estate taxes are only being saved on the value of the contributed assets net of taxes that would have been paid (which would be \$3.9 million assuming the donor had paid the additional \$3.7 million and \$2.4 million in taxes), this would still save an additional \$1.6 million (40% of 3.9 million). Adding these up, the creation of a \$10 million private foundation could save the donor (and effectively cost the government) up to \$7.7 million. *Cf. id.* at 499 (modeling effective tax rate on charitable gifts and estimating subsidy rates in the 70% range, depending on statutory rates).

market failures, one economic, one political.⁴⁰ Despite our best intentions, most humans remain at least somewhat self-interested. We therefore are usually unwilling to pay fully for benefits that accrue to other people—what an economist would call “positive externalities.” Many goods, once purchased by one person, provide additional spillover benefits to others, so that no one individual has an incentive to provide as much as would be ideal from a social perspective. Examples here include public parks, museums, and medical research. By offering tax benefits, Congress hopes that we can be motivated through selfish considerations to purchase more of the positive-externality goods, moving society closer to the level it would choose if not for the market’s failure.⁴¹

Of course, taxing and spending is another way to cure market failures, and so the second failure that rationalizes charity is government failure.⁴² A single national government could meet the demands of the majority voter, but would sometimes leave unsatisfied those who wanted more or different goods than the majority prefer. Subsidies for charity are, in essence, a version of private federalism, dividing the atom of sovereignty by handing over some of the federal budget for allocation by donors and the managers they hire. In an ideal world, this has the potential to promote diverse and pluralistic responses to the world’s ills.⁴³

Congress has established a fairly dense set of rules governing which entities are eligible to receive subsidized gifts. These limits are aimed at ensuring that money goes to its intended purposes—generally, providing goods that the private market alone would struggle to deliver.⁴⁴ For example, an eligible organization must be organized and operated for one or more exempt purposes.⁴⁵

Congress also distinguishes among eligible organizations, most notably in the division between “public charities” and “private

40. Burton A. Weisbrod, *Toward a Theory of the Voluntary Non-Profit Sector in a Three-Sector Economy*, in ALTRUISM, MORALITY, AND ECONOMIC THEORY 171, 175–77 (Edmund S. Phelps ed., 1975). On the prevalence of this “dual failure” theory, see, for example, JOHN D. COLOMBO & MARK A. HALL, THE CHARITABLE TAX EXEMPTION 100–08 (1995); and Miranda Perry Fleischer, *Theorizing the Charitable Tax Subsidies: The Role of Distributive Justice*, 87 WASH. U. L. REV. 505, 520 (2010).

41. Mark P. Gergen, *The Case for a Charitable Contributions Deduction*, 74 VA. L. REV. 1393, 1396–1407 (1988).

42. Weisbrod, *supra* note 40, at 175–77.

43. A problem with this account is that federalism itself also has these features, raising the question what additional role charity might play. I consider this question in (much) more detail elsewhere. Brian Galle, *The Role of Charity in a Federal System*, 53 WM. & MARY L. REV. 777, 790–835 (2012).

44. *Id.* at 788.

45. I.R.C. § 501(c)(3).

foundations.”⁴⁶ To simplify a bit, tax law defines a public charity as an organization that derives most of its revenues from a wide base of donors or charitable-service revenues, while a private foundation gets its money from just a few individuals. Schools, hospitals, and churches are always public charities no matter their financing.⁴⁷ Gifts to public charities are treated a little more favorably than are gifts to private foundations.⁴⁸ Private foundations must also comply with a slightly more onerous set of governance rules, and they pay a modest tax, a bit more than 1%, on their net investment earnings.⁴⁹

More relevantly for our purposes, among the special rules applicable to private foundations is the requirement that they make regular distributions, or “payouts.” Each year, a private foundation computes 5% of the net value of its investment assets.⁵⁰ It then has until the end of the following year to spend that amount on “qualifying distributions,” which can include grants to other charities.⁵¹ Failure to meet the deadline triggers a hefty penalty.⁵² Notably, administrative expenses count against this minimum, and they can include reasonable compensation to, and travel costs for the benefit of, family members of the donor.⁵³ Several other major avenues for philanthropic giving, such as donor-advised funds and so-called “supporting organizations,” do not face any similar payout obligation.⁵⁴

B. The Payout Debate

If the charitable sector is intended to hand the keys of public-goods production over to private operators, what explains rules, like the payout requirement, that tell nonprofits how to do their job? While this debate has become quite intricate, and its particulars vary depending

46. Buckles, *supra* note 25, at 497–98; see I.R.C. § 509(a) (laying out generally the definition of a private foundation).

47. I.R.C. § 509(a)(1).

48. *Id.* §§ 170(b)(1)(D), (e)(1)(B)(ii), (e)(5).

49. Dana Brakman Reiser, *Disruptive Philanthropy: Chan-Zuckerberg, the Limited Liability Company, and the Millionaire Next Door*, 70 FLA. L. REV. 921, 932–47 (2018); see I.R.C. §§ 4940–4945 (setting out special excise taxes for private foundations).

50. The exact calculation is somewhat more intricate than the description in the main text—this is tax law, after all. For details, see Buckles, *supra* note 25, at 503–05. For added detail on the history of the payout requirement, see NAT’L COMM. FOR RESPONSIVE PHILANTHROPY, *supra* note 6, at 84–87; and Daniel Halperin, *Tax Policy and Endowments—Is Excessive Accumulation Subsidized? (Part II)*, 67 EXEMPT ORG. TAX REV. 125, 126–28 (2011).

51. Foundations can also, with IRS permission, save up over multiple years for a single large grant. I.R.C. § 4942.

52. *Id.* § 4942(a).

53. *Id.* § 4942(g)(1)(A).

54. Colinvaux, *supra* note 16, at 52–53. Certain supporting organizations do have a payout requirement, but it is generally smaller. Buckles, *supra* note 25, at 507–08.

on whether we are discussing grantmaking organizations or active endowed institutions such as universities, I will try to sketch the general contours of the argument. My focus in the discussion, as in my data, will be on grantmaking organizations.

Payout rules, or something else like them, are arguably necessary in order to achieve neutrality because our tax system strongly encourages early gifts and delayed spending. As Dan Halperin has shown, because charities are exempt from taxes on investment income, donors have strong incentives to contribute money to charities earlier than they otherwise would prefer.⁵⁵ In effect, the donor makes use of the charity's exemption to make a larger (after-tax) gift.⁵⁶ This multiplier effect grows larger the longer the donor's gift is able to compound tax free.⁵⁷ Similarly, donors strongly prefer giving money to charity at the time of their death, rather than leaving cash to their heirs for later donation.⁵⁸ The former allows donors to both enjoy the charity's tax exemption for longer and escape the estate tax.⁵⁹ These two benefits compound each other since the extra donated funds that escape the estate tax also get to grow tax free.

The result is that donors have powerful incentives to turn money over to nonprofit managers for long stretches of time, which in turn likely reduces the degree to which donors can influence the firm. A standard way in which funders control their agents is through "staged financing."⁶⁰ Staged financing allows the funder to demand satisfactory performance in period one before the agent can receive another round of funding in period two.⁶¹ Without this source of leverage, the agent might opportunistically use the funder's money for her own purposes, such as taking a payment to sit on a beach sipping mai tais.⁶² Research

55. Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 TAX L. REV. 283, 287–88, 306–08 (2011).

56. *Id.* at 288, 307; see Hansmann, *supra* note 28, at 20 (making this point informally).

57. Halperin, *supra* note 55, at 305, 308.

58. See Michael J. Brunetti, *The Estate Tax and Charitable Bequests: Elasticity Estimates Using Probate Records*, 58 NAT'L TAX J. 165, 168–69, 176–78 (2005) (summarizing prior studies and reporting new evidence that price-elasticity of charitable giving out of estates is about -1.3). *But see* Steven A. Hanke, Ted D. Englebrecht, Hui Di & Timothy Bisping, *A Two-State Analysis of Estate Taxes and Charitable Bequests from the Most Generous Decedents*, 28 ADVANCES ACCT. 38, 46–48 (2012) (not finding tax rate to have statistically significant effects on charitable bequests).

59. I.R.C. § 2055.

60. Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461, 1464 (1995). For a cogent explanation in the nonprofit context, see Schizer, *supra* note 4, at 695–98.

61. Gompers, *supra* note 60, at 1461–62.

62. Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 323 (1986); for evidence that leisure is an important goal for managers, see Marianne Bertrand & Sendhil Mullainathan, *Enjoying the Quiet Life? Corporate Governance*

in the for-profit setting finds that an agent who has access to “free cash flows,” or money that is not conditioned on her satisfactory performance, exhibits considerably more opportunistic behavior and rather less effective performance.⁶³

In short, the tax treatment of charity creates agency costs. When there is a separation of ownership and control—when agents have unconstrained use of their principals’ money—agents will often serve their own interests, not those of the principal.⁶⁴ It is of course possible to reduce an agent’s chances for opportunistic behavior through means other than staged financing, and indeed this is largely the function of the law of organizations.⁶⁵ But drafting organizational documents, and especially monitoring and enforcing compliance with them, is itself a costly endeavor.⁶⁶ Nonprofit law compounds this problem by barring most donors from suing to challenge managerial decisions, leaving it to state attorneys general to act on behalf of an organization’s supporters and beneficiaries.⁶⁷

Where do payout rules figure in this story? A payout requirement accelerates the flow of dollars out of the hands of managers, reducing the amount and duration of free cash under their control. It thus works to offset some of the incentives for delayed spending that tax rules create.⁶⁸ Of course, we could just undo those tax rules, as Congress recently did in imposing a small, new tax on the investment earnings of colleges and universities.⁶⁹ But while raising

and *Managerial Preferences*, 111 J. POL. ECON. 1043, 1044, 1058 (2003). For evidence that mai tais are delicious, see your nearest bartender.

63. E.g., Olivier Jean Blanchard, Florencio Lopez-de-Silanes & Andrei Shleifer, *What Do Firms Do with Cash Windfalls?*, 36 J. FIN. ECON. 337, 352, 355, 358 (1994); Jensen, *supra* note 62, at 323, 325–29; see also Edward L. Glaeser, *Introduction*, in *THE GOVERNANCE OF NOT-FOR-PROFIT ORGANIZATIONS* 1, 12–17, 20–23 (Edward L. Glaeser ed., 2003) (explaining that free cash flows reduce responsiveness of university employees to outside influences).

64. Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 302–24 (1983). For application to charities, see Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey’s Kiss-Off*, 108 COLUM. L. REV. 749, 779 (2008). The argument traces back to ADAM SMITH, 2 *THE WEALTH OF NATIONS* 282–302 (E. Cannan ed. 1976) (1776).

65. See generally Oliver E. Williamson, *Transaction Cost Economics*, in *HANDBOOK OF NEW INSTITUTIONAL ECONOMICS* 41 (Claude Ménard & Mary M. Shirley eds., 2008).

66. Gompers, *supra* note 60, at 1464.

67. Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1429 (1998); Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 601 (1981).

68. Galle, *supra* note 3, at 1153, 1185.

69. I.R.C. § 4968. For a detailed explanation of the rationales for taxing university endowments, see Halperin, *supra* note 5, at 17–25; Sarah E. Waldeck, *The Coming Showdown over University Endowments: Enlisting the Donors*, 77 FORDHAM L. REV. 1795, 1817–22 (2009); Edward A. Zelinsky, *Section 4968 and Taxing All Charitable Endowments: A Critique and a Proposal*, 38 VA. TAX REV. 141, 166–74 (2018). As Halperin observes, one could offset any reduction in giving that results from a tax by providing offsetting benefits to charity of other kinds. Halperin, *supra* note 50, at 131.

taxes on charities might help to reduce timing distortions, it also might have the unwanted side effect of reducing the net dollars available for the charities' missions.⁷⁰ Payout rules potentially offer a route to mitigating timing distortions without reducing charity resources.⁷¹

The urgency of payout requirements thus relates directly to the importance of agency costs. Suppose that the agency costs of some set of charities were very modest: despite the opportunity for self-dealing, managers rarely ignored donor preferences. This might be the case if managers and donors are unusually aligned in their preferences, or if there exists some very effective "technology" (a really easily enforced contract, say) for monitoring managers. If that were true, the agency-cost case for payout rules would be much weaker.

Another common argument against payout rules is that slower spending is actually good.⁷² In this account, society has an obligation to share its current resources equally with future generations.⁷³ Allowing investment returns to accumulate inside a grantmaking organization is said to satisfy this obligation better than actually making grants, since financial returns are generally higher than the overall rate of economic growth in the economy.⁷⁴

I have argued that there are many, many problems with this story.⁷⁵ Among others, it neglects the likelihood that immediate spending itself has compounding returns and that these returns are likely to exceed the average financial return a philanthropy could earn.⁷⁶ Another gap in this anti-payout account is that it ignores agency

70. NAT'L COMM. FOR RESPONSIVE PHILANTHROPY, *supra* note 6, at 85 (noting that this argument is the reason Congress initially enacted a minimum payout requirement instead of a tax on endowments). It is possible that taxes do not reduce charity resources, though. For example, donors could respond to a tax on charities by giving more.

71. *See* Galle, *supra* note 3, at 1192–95 (considering the choice between minimum payout rules and investment taxes).

72. PAUL BREST & HAL HARVEY, MONEY WELL SPENT: A STRATEGIC PLAN FOR SMART PHILANTHROPY 262–66 (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).

73. Klausner, *supra* note 28, at 52, 58; *see* James Tobin, *What Is Permanent Endowment Income?*, 64 AM. ECON. REV. 427, 427 (1974) (describing this possible view without clearly endorsing it).

74. Klausner, *supra* note 28, at 52.

75. Galle, *supra* note 3, at 1159–81.

76. *Id.* at 1159–60; *see* Core & Donaldson, *supra* note 9, at 269 n.11 (observing that spending may also generate compound returns); *see also* Schizer, *supra* note 4, at 702 (making this point about operating charities); Hansmann, *supra* note 28, at 18 (making this point about university endowment). *But see* Halperin, *supra* note 5, at 20 (agreeing with Klausner that some charitable acts, such as feeding the hungry, may be equally valuable no matter when performed). I agree that there may be some expenditures that do not have compounding returns, or returns that compound only very slowly. What is unclear is why Congress would want to subsidize the inefficient hoarding of wealth when higher-return options are available. *Cf.* Klick & Sitkoff, *supra* note 64, at 755 ("It

costs. Turning money over to foundation managers to hold for generations adds an extra and potentially costly layer of agency costs. If we are comparing the relative social return to immediate versus delayed spending, these costs have to be subtracted from the net payoff of long-lived philanthropy.⁷⁷

Thus, there are several reasons that it is important for us to understand the magnitude and nature of agency costs at philanthropic institutions. The larger these costs, the stronger the argument for a payout rule or other policies to encourage immediate expenditures.

C. Agency Costs in Philanthropic Firms

What, then, do we know about agency costs in grantmaking organizations? An optimistic take might draw on “stewardship theory” or related ideas to suggest that costs are low.⁷⁸ In this view, nonprofit managers are not particularly opportunistic because they share a lot of their donors’ goals and values.⁷⁹ The nonprofit manager chose to work in philanthropy because that is what she is passionate about, and she is not going to waste resources on other goals.⁸⁰ Firms can write contracts that help them screen for individuals who are committed to mission, not pay or perquisites.⁸¹

That is surely true of many foundation managers, but managers are also human. Humans may prefer the easy and the measurable over the difficult and the abstract.⁸² For instance, one survey reported that managers favor accumulation because they can see it.⁸³ While many

is hardly obvious that a trust with so large a corpus and so small a mission warrants the tax subsidy.”). An appropriately modest planner would also discount future payoffs from acts like feeding the poor by the possibility that these acts may not be as valuable in the future, or that the organization holding assets may not exist or no longer be the most effective way of delivering the service. Core & Donaldson, *supra* note 9, at 273; Hansmann, *supra* note 28, at 16. If, however, there is a possibility that future beneficiaries will be even worse off than we now expect, that might be an argument for greater savings. Core & Donaldson, *supra* note 9, at 273.

77. Cf. Evelyn Brody, *Charitable Endowments and the Democratization of Dynasty*, 39 ARIZ. L. REV. 873, 930–35 (1997) (explaining that spend vs. save decisions should depend on comparison of financial returns to net social payoff from spending); Klausner, *supra* note 28, at 55–57 (same).

78. See sources cited *supra* note 32. The label “stewardship theory” appears to originate in Stijn Van Puyvelde, Ralf Caers, Cind Du Bois & Marc Jegers, *The Governance of Nonprofit Organizations: Integrating Agency Theory with Stakeholder and Stewardship Theories*, 41 NONPROFIT & VOLUNTARY SECTOR Q. 431, 435–36 (2012).

79. E.g., Rose-Ackerman, *Altruism*, *supra* note 32, at 719–20.

80. *Id.*

81. Fama & Jensen, *supra* note 32, at 344–45.

82. See Daniel Tversky & Amos Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, in JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 163, 164–65 (Daniel Kahneman, Paul Slovic & Amos Tversky eds., 1982) (summarizing results of ten studies).

83. Akash Deep & Peter Frumkin, *The Foundation Payout Puzzle*, in TAKING PHILANTHROPY SERIOUSLY 189, 199 (William Damon & Susan Verducci eds., 2006). Reportedly, the study was

managers are undoubtedly motivated by a desire to do good, outside their preferred sphere they may not fully take into account the consequences their decisions might have for others.⁸⁴ For example, not all managers will strive to fail spectacularly in ways that will provide useful lessons for others, even though this is actually an important benefit that risky grantmaking provides to the world at large.⁸⁵

Managers also are unlikely to be totally ignorant of their own self-interest.⁸⁶ Foundation employment is good, steady work. The manager's reputation is a personal asset that she cannot easily diversify.⁸⁷ Thus, it is in managers' self-interest to take few risks with the finances or reputation of their organization.⁸⁸ This is even more evident for managers with close ties to for-profit operations that can profit from holding assets under management, such as in the commercial DSO industry. Reputation and personal reward can also be tied to asset accumulation.⁸⁹

We have little direct evidence to settle these potential disagreements,⁹⁰ but what we do have is suggestive that agency costs

inspired by speculation in Hansmann, *supra* note 28, at 37, that nonprofit board members might focus on financial returns because they are more measurable.

84. Sung Min Park & Jessica Word, *Serving the Mission: Organizational Antecedents and Social Consequences of Job Choice Motivation in the Nonprofit Sector*, 17 INT'L REV. PUB. ADMIN. 169, 187–90 (2012) (finding that charitable sector workers are motivated by a mix of altruistic and self-benefitting motives, but that women are more motivated by mission than men); see also 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, 1895–97 (2014) (arguing that even altruistic managers optimize tradeoffs between mission and purely self-serving decisions, that marginal contribution of a decision to the latter is often much larger than to the former, and showing evidence of this phenomenon in higher education).

85. Galle, *supra* note 3, at 1159–60.

86. Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 844, 875, 878 (1980); see James Andreoni, *Impure Altruism and Donations to Public Goods: A Theory of Warm-Glow Giving*, 100 ECON. J. 464, 464–65 (1990) (arguing that even pure altruists free ride on others' efforts); Raymond Fisman & R. Glenn Hubbard, *The Role of Nonprofit Endowments*, in THE GOVERNANCE OF NOT-FOR-PROFIT ORGANIZATIONS, *supra* note 63, at 217, 218–23 (arguing that endowments allow for managerial opportunism).

87. See John E. Core, Wayne R. Guay & David F. Larcker, *Executive Equity Compensation and Incentives: A Survey*, ECON. POL'Y REV., Apr. 2003, at 27, 33 (making this point about executives generally).

88. Core & Donaldson, *supra* note 9, at 280; see also Hansmann, *supra* note 28, at 36 (noting this incentive in a variety of charitable organizations).

89. Howard P. Tuckman & Cyril F. Chang, *Nonprofit Equity: A Behavioral Model and Its Policy Implications*, 11 J. POL'Y ANALYSIS & MGMT. 76, 78–79, 85–86 (1992) (reporting evidence that managers accumulate endowment for their own personal reward); Halperin, *supra* note 5, at 19 (discussing how endowment size can benefit universities); Hansmann, *supra* note 28, at 38.

90. See Ralf Caers, Cindy Du Bois, Marc Jegers, Sara De Gieter, Catherine Schepers & Roland Pepermans, *Principal-Agent Relationships on the Stewardship-Agency Axis*, 17 NONPROFIT MGMT. & LEADERSHIP 25, 30–32 (2006) (explaining that evidence does not conclusively resolve the debate between “stewardship” and agency cost models of nonprofit management); Klick & Sitkoff, *supra* note 64, at 756 n.36, 783 (observing that at the time there were no quantitative studies of agency costs in charitable trusts).

still matter. Several papers find that even for operating charities, where managers are involved in on-the-ground service to beneficiaries, statistical measures of agency cost are rather higher in settings where monitoring is incrementally more difficult.⁹¹ For instance, David Walker and I find that when university presidents show up on a list of the “Top 10 Most Highly Compensated,” donations to their university—and the growth rate of the president’s pay—drop afterwards.⁹² This implies that donors dislike excessive pay, but have a hard time monitoring for it unless some publication produces an easy-to-read comparative list.⁹³ And, absent that ready monitoring, executive compensation grows very quickly. As in some for-profits, nonprofit compensation is strongly correlated with free cash flows.⁹⁴

Similarly, in prior work I find evidence that changes in monitoring processes result in changes in measurable agency costs. In particular, when state legislatures give donors the right to sue a donee private foundation, overhead (defined as the share of an organization’s budget that is not spent directly on its charitable mission) and executive compensation at the foundation fall on average between 5% and 10%.⁹⁵ A trio of accounting professors find that large endowments among operating charities (i.e., not the foundations I study) are correlated with high overhead ratios.⁹⁶

We should not place too much weight on one or two papers. Among other potential issues, my finding on the right to sue could not wholly rule out the possibility that the results were caused not by the right to sue itself, but instead by other components of the legislation that states usually enacted together with that change.⁹⁷ There are a number of potentially innocuous explanations for why overhead would

91. Mihir A. Desai & Robert J. Yetman, *Constraining Managers Without Owners: Governance of the Not-for-Profit Enterprise*, 4 J. GOVERNMENTAL & NONPROFIT ACCT. 53, 67–69 (2015); Raymond Fisman & R. Glenn Hubbard, *Precautionary Savings and the Governance of Nonprofit Organizations*, 89 J. PUB. ECON. 2231, 2240–41 (2005); see also Klick & Sitkoff, *supra* note 64, at 757 (reporting evidence of large waste of value by managers of the Milton Hershey Charitable Trust, which operates the Milton Hershey School and owns a controlling share of the eponymous chocolate company).

92. Brian Galle & David I. Walker, *Donor Reaction to Salient Disclosures of Nonprofit Executive Pay: A Regression-Discontinuity Approach*, 45 NONPROFIT & VOLUNTARY SECTOR Q. 787, 794–97 (2016).

93. *Id.* at 797.

94. 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, 325–29 (2006); Galle & Walker, *supra* note 84, at 1914–15, 1917; see also Glaeser, *supra* note 63, at 23, 26 (offering anecdotal evidence of this effect).

95. Galle, *supra* note 34, at 428–30.

96. Core et al., *supra* note 94, at 323–25.

97. Galle, *supra* note 34, at 437–38.

correlate with endowment savings, including that managing money is expensive.

Another notable mechanism that principals have used to control their agents is a pretty basic one: being alive.⁹⁸ Even in the absence of an express right to enforce contractual terms, we might think that the mere presence of a donor's watchful eyes would be a meaningful constraint on how agents behave. In line with this account, a recent paper finds that entrepreneurial firms often crater shortly after the death of their founder.⁹⁹ Whatever insights or strategies the founder brought to the table apparently cannot easily be committed to paper, or if so, subsequent agents cannot be effectively compelled to follow their inherited wisdom.

This raises an interesting question about philanthropy: What happens to measurable agency costs when a foundation's guiding voice dies? Let's turn to some data to find the answer. The only previous findings that I am aware of are correlational studies reporting that firms without recent donations—and thus, we might think, firms where the donors may well be dead—tend to spend less money.¹⁰⁰ I will argue later that this correlation could be an indicator of agency costs. But many other factors could probably explain the correlation. It makes sense, then, to dig deeper and look for some evidence of causal connections.

II. DATA

My analysis relies mostly on two large databases of private foundations. The more familiar, for experienced readers, is the IRS Core-PF file. Tax returns filed by charities are public documents.¹⁰¹ The Core-PF is an electronic compilation of selected information from the Form 990 tax returns of every filing private foundation, stretching from 1987 to 2012 and representing a total of about 1.3 million firm-years.¹⁰² The advantages of the Core-PF data are their universal coverage and long time span. A downside, however, is that they collect only a very small fraction of the total information on an organization's return, which itself is not a complete picture of the firm. For example, since

98. See Hansmann, *supra* note 28, at 33–34, 34 n.51 (noting that standard bargaining mechanisms needed for efficiency no longer function when the donor is dead).

99. Matthew Smith, Danny Yagan, Owen Zidar & Eric Zwick, *Capitalists in the Twenty-First Century*, 134 Q.J. ECON. 1675, 1675 (2019).

100. See sources cited *supra* note 33.

101. I.R.C. § 6104.

102. BRICE MCKEEVER, URB. INST., BEGINNER'S GUIDE TO USING NCCS DATA 2–3 (2018), <https://nccs.urban.org/sites/default/files/2018-12/Guide%20to%20Using%20NCCS%20Data.pdf> [<https://perma.cc/EX55-2T8A>].

donor information is anonymized in public filings, the Core data do not tell us anything about whether an organization still has any living donors.

Another notable gap is that the Core data do not include the foundation's payout rate. For years after 1992, however, they do report most of the necessary components needed to calculate payout, including the organization's investment assets and charitable-related expenditures. These fields do not map perfectly onto the statutory definition, but are fairly close.¹⁰³ Another uncertainty is that the statute provides foundations with two full fiscal years to make qualifying distributions.¹⁰⁴ It is not apparent from the Core data whether an organization's charitable expenditures in 2005, say, were applied to its 2004 minimum distribution amount, or instead to 2005. My calculations of payout rates are therefore only approximate.

The Core data are also only as accurate as the reporting organization makes them. Before implementing any analysis of these data, I follow a "cleaning" protocol in which I omit or correct obviously wrong (e.g., negative numbers for values that can logically only be positive) or missing (e.g., no fiscal year listed) information. This protocol is described in more detail elsewhere.¹⁰⁵ I hand calculate firm age based on the older of the reported firm founding date or the first year the firm appears in the data; where a founding date is unavailable I simply use the latter. To ensure that all firms are subject to the same legal rules, I omit "private operating foundations" and "flow-through foundations," both of which are governed by somewhat different rules (and make up a small slice of the data).

To make up for gaps in both the informational and temporal coverage of the Core data, I turn to a fairly unique source: the Foundation Directory ("FD" or "the Directory").¹⁰⁶ The Directory is a publication of the Foundation Center, which now is part of the Candid organization. It is compiled through a combination of surveys sent to larger private foundations and other publicly available information, such as their tax returns and requests for grant proposals. The

103. Among other issues, the statute has an assortment of technical exceptions. Some unexpended money can count as expended (such as in the case of "program-related investment" or money set aside for certain future projects), while some expended money can count as unexpended (such as distributions to a controlled entity). See DARRYLL K. JONES, DAVID BRENNEN, STEVEN WILLIS & BEVERLY MORAN, *THE TAX LAW OF CHARITIES AND OTHER EXEMPT ORGANIZATIONS* 486–87 (3d ed. 2014).

104. I.R.C. § 4942(c). In addition, firms that exceed their minimum payout in one year can apply the excess to later years two through six. *Id.* § 4942(i).

105. Galle, *supra* note 36, at 540–52.

106. *Foundation Directory Online*, CANDID, <https://fconline.foundationcenter.org/> (last visited Jan. 25, 2020) [<https://perma.cc/WZ35-N8FH>].

Foundation Center has published the Directory on average once every three years since the early 1960s. The economist Ben Marx has scanned, cleaned, and used text-analysis software tools to create a database of information reported in these periodic FD volumes,¹⁰⁷ and he generously shared these data with me for the years up to and including 1992. In joint work with Marx and our coauthor Cesare Buiatti, I extended this work to the 1998 edition as well.¹⁰⁸

FD data do not cover the universe of private foundations but instead are limited to those that hit either a given asset cutoff or expenditure cutoff, each of which varies from edition to edition. In general, the Foundation Center estimates that their reports cover foundations in the aggregate holding more than 80% of the total assets held by the private foundation sector. This form of sampling can lead to selection effects if the researcher's outcome variable of interest is correlated with inclusion in the database, as may plausibly be the case for payout ratios and the expenditure cutoff. My results could therefore conceivably be driven in part by selection, although I believe the most likely selection effect would tend to cut against the results I observe.¹⁰⁹ To ensure apples-to-apples comparisons, I omit "community" foundations with a broad base of public support and foundations supported by corporations.¹¹⁰

Like the Core file, the FD does not directly report overhead or payout rates. When using only FD data, I calculate overhead as the ratio of FD's "inside," or non-grant-related, costs to total expenditures. I compute payout as grants over assets, which is again not a perfect match for the statutory definition but a decent approximation of it.

107. Benjamin M. Marx, *Has Regulation of Charitable Foundations Thrown the Baby Out with the Bath Water?*, 129 J. PUB. ECON. 63, 66 (2015).

108. Cesare Buiatti, Brian Galle & Benjamin M. Marx, Risk, Return, and the Law of Trusts in Private Foundations (June 2017) (unpublished manuscript) (on file with author).

109. The impact of selection would likely be to overstate the proportion of higher-payout firms, since low expenditure firms that miss the asset cutoff would drop out of the data. Thus, selection effects caused by sampling should tend to overinflate payout ratios. As described below, I find that the death of a donor sharply reduces payout, so the hypothesized selection effect is working against my results.

110. See PERRY MEHRLING, NAT'L NETWORK OF GRANTMAKERS, SPENDING POLICIES FOR FOUNDATIONS: THE CASE FOR INCREASED GRANTS PAYOUT 6 (1999), <https://efc.issuelab.org/resources/16160/16160.pdf> [<https://perma.cc/G5TM-S643>] (noting payout policies of community and corporate foundations are quite different from the majority of foundations). These organizations are also governed by somewhat different legal rules than other private foundations, particularly in the case of community foundations. Tanya D. Marsh, *A Dubious Distinction: Rethinking Tax Treatment of Private Foundations and Public Charities*, 22 VA. TAX REV. 137, 141–42 (2002). For more discussion of the differences among the groups, see ELIZABETH T. BORIS, LOREN RENZ, ASMITA BARVE, MARK A. HAGER & GEORGE HOBOR, FOUNDATION EXPENSES & COMPENSATION: HOW OPERATING CHARACTERISTICS INFLUENCE SPENDING 3–4 (2006), <https://www.issuelab.org/resources/16024/16024.pdf> [<https://perma.cc/4TSW-3VXS>]. Community and corporate foundations represent about 11% of foundations on average. *Id.* at 6.

Crucially, the FD does report a complete list of each private foundation's supporters, as well as whether those donors were still living at the time of the published edition. From these lists, I calculate a number of key variables, including the number of living donors, the last year in which a firm had any living donors, and whether the organization is a so-called "corporate" foundation—that is, one that is supported by a business entity rather than by individuals.¹¹¹

FD data have very limited firm financial information. I therefore match the FD data to the Core data using taxpayer ID numbers where available from the FD and by using text-based matching on names and addresses otherwise. This allows me to repeat my analysis for the subset of firm-years in which I have both FD and Core-PF information.

For analysis of Core data after the temporal coverage of the FD has ended, it is still useful to be able to distinguish between firms with any living donors and those without. I therefore construct a predictive model of whether a firm has any living donors, using the known outcomes for firms with matching FD data. In essence, I look at how each Core variable is correlated with the presence of known living donors and then use those observed relationships to predict whether there are any living donors for unmatched firm years.

More technically, I implement a simple probit regression in which the outcome variable is whether the FD reports living donors in a given firm-year, and the predictive variables are most of the other observables available in the Core data. I then drop variables with insignificant coefficients and repeat the analysis. Using the resulting coefficients, I make an out-of-sample prediction of the likelihood of living donors for each Core firm-year without matching FD data. In the main reported results, I code firms as having predicted living donors if they register a predicted likelihood of 80% or more.

All of these data are reported on a fiscal year basis. Firm fiscal years only sometimes align with a calendar year. For purposes of imposing a fixed control for time, I assign firms to a calendar year according to a simple rubric in which firms whose fiscal years end after June are assigned the same calendar year, while firms whose years end in June or before are assigned the prior year. Thus, a firm-year whose 2007 fiscal year ends in July is coded as having a 2007 calendar year, while one whose 2007 fiscal year ends in May is coded as 2006.

Table 1 presents some summary statistics. Panel A, at the top of the table, summarizes data derived from the FD, while Panel B summarizes Core-PF data.

111. Again, once I determine that an organization is a corporate foundation, I omit it from subsequent analysis.

TABLE 1: SUMMARY STATISTICS

	<i>Mean</i>	<i>Std. Dev.</i>
Panel A: Core-PF Data		
Firm Age	15.817	14.894
Assets	6.1*	146*
Dividend Inc	173	3.26*
Total Expenses	575	14.2*
Interest Inc	33.23	2.69*
Total Liabilities	259	18.4*
Officer Compensation	12.74	553
Overhead Ratio	.198	.278
Payout (SOI Reported)	.544	53.415
Payout (Author Calculated)	.114	.158
Panel B: Foundation Directory Data		
Firm Age	24.398	17.686
Assets	24.2*	194*
Has Living Donor	.496	.5
Number of Living Donors	.695	.907
Overhead Ratio	.165	.198
Payout (Author Calculated)	.091	.201

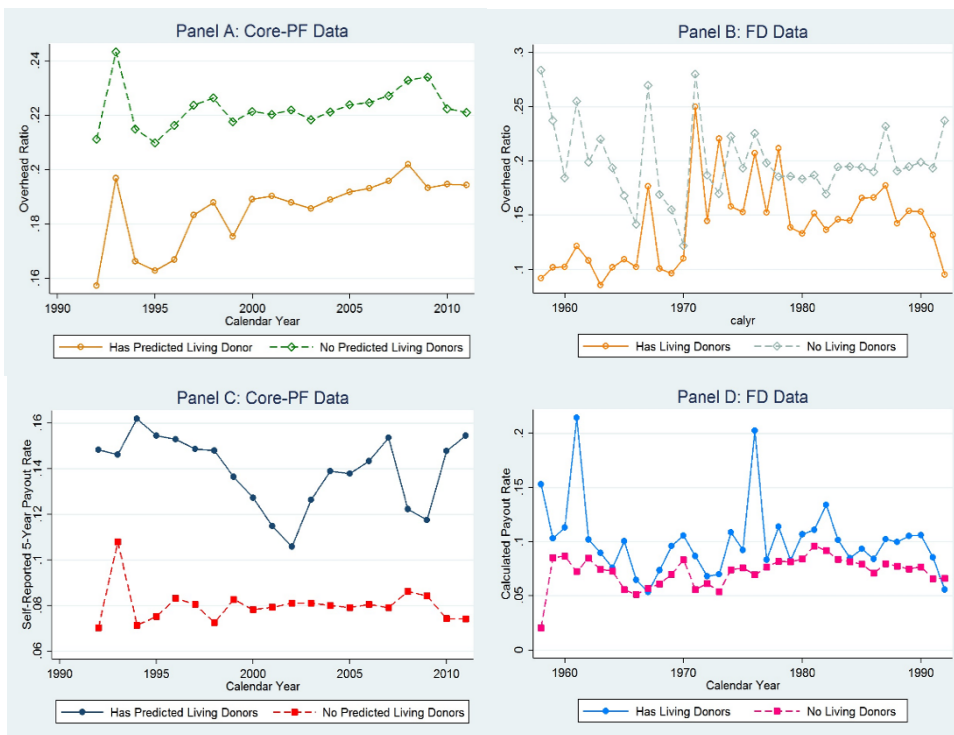
Notes: Core-PF values in thousands of 2011 dollars. Foundation Directory data in thousands of 1992 dollars. *: millions.

III. THE EXPERIMENT: AGENCY COSTS AND LIVING DONORS

I will now investigate the hypothesis that agency costs are higher among firms without living donors. With the limited data available in the FD dataset, I focus in on two key measurables: overhead ratios and payout rates. As I mentioned, there is an extensive literature documenting that donors dislike overhead, while theory predicts that opportunistic managers might increase overhead (either through salary or other perks, such as office space or administrative support).¹¹² Similarly, my theory predicts that managers will have self-serving preferences for low payout rates, making payout policy a potentially important marker of differences in preferences between donors and managers.

112. Desai & Yetman, *supra* note 91, at 62–63; *see also* sources cited *supra* note 34.

FIGURE 1: OVERHEAD AND PAYOUT BY WHETHER FIRM HAS LIVING (OR PREDICTED LIVING) DONORS



Just from simple line plots we can observe a strong positive correlation between payout and the presence of living donors, as well as a strong negative correlation between living donors and firm overhead ratios. These correlations are evident both in the FD data, where we have direct information on living-donor status, and also in the Core data, where I predict the presence of living donors (as detailed in Part II, *supra*).¹¹³ I plot these in Figure 1 Panels A through D.

These relationships are not necessarily causal. Other factors—some measurable, some not—such as the age and size of the organization, its degree of professionalization, and the nature of its mission, might be correlated both with the presence of living donors and

113. Because the Core includes many extreme and relatively unverified observations, for Core values I omit the highest and lowest 1% of observations before graphing. FD data are relatively volatile when plotted on a yearly basis because the Directory is not published annually, so that for years in between editions the number of observations is relatively small, reflecting only firms whose data were not fully up to date at the time of publication.

with overhead and payout.¹¹⁴ If that is so, it might offer an alternative reason we see these patterns, unrelated to the presence of agency costs.

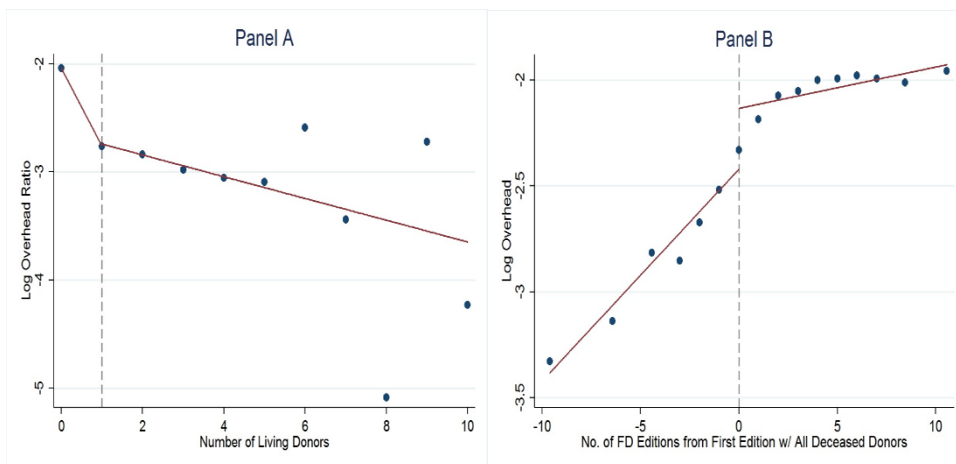
Thus, to establish a clearer causal connection, I consider the natural experiment of the death of the last living donor. The timing of a donor's death is relatively random. We should not expect dramatic shifts in factors such as the skill and experience of managers, firm size, or organizational mission to happen to occur immediately after the lone remaining supporter passes. These are organization-wide factors that likely take a good deal of time to evolve into new patterns. If we indeed see sharp changes in overhead and payout closely following the date of death, that would accordingly be powerful evidence that these changes are related to the inability of the donor to continue to influence them, rather than broad organizational factors such as size or mission.

A. Graphical Results

Let's first consider some graphical evidence. Figure 2 plots (in Panel A, on the left) the relationship between the number of living donors at a firm and the average overhead ratios for firms with a given number of donors. We see a dramatic jump in overhead as we read from right to left, from the bin with one living donor to the bin with zero living donors. Interestingly, overhead is also gently decreasing as the number of living donors increases. That could be consistent with a story in which the more donor eyes there are available to monitor the firm, the more successful donors are at moderating overhead costs.

114. See BORIS ET AL., *supra* note 110, at vii (reporting correlation between administrative expenses and certain foundation missions, such as international aid).

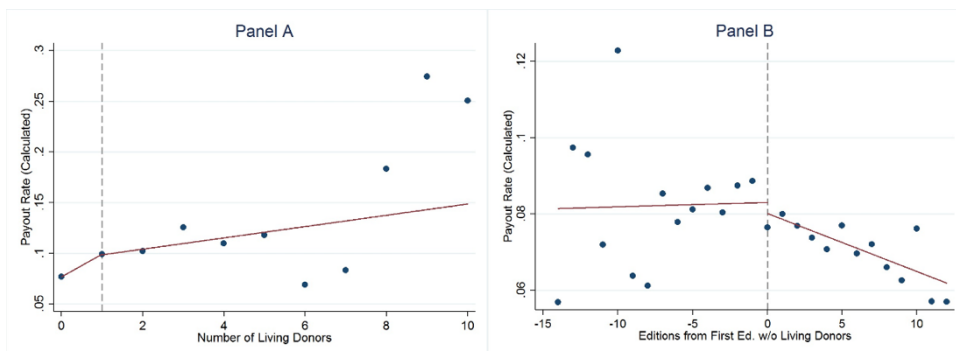
FIGURE 2: OVERHEAD RATIOS IN FOUNDATION DIRECTORY FIRMS



Panel B, on the right side of Figure 2, tells a similar story. Here, I plot overhead against the number of FD editions a firm observation is from the last edition in which it reports any living donors (recall that the FD is published about every three years, on average). Again, we see a sharp rise in overhead the first reporting period after the last donor has died. Overhead is rising as we approach that date from the left. This might represent a diminishing number of donors, diminished capacity of the remaining donor to monitor, or some combination.

I next repeat this graphing exercise for my approximation of payout rate, as depicted in Figure 3. Here, we see that payout drops immediately after the death of the last donor, whether measured in number of living donors (Panel A on the left) or in time to the last reported edition with living donors (Panel B on the right). It also appears that payout is highest in the edition or two before the last donor's passing. This might be explained as the donor having some sense of failing health and wanting to see more projects come to fruition during her life, as an aversion to handing assets over to managers, or perhaps some combination.

FIGURE 3: PAYOUT RATES IN FOUNDATION DIRECTORY FIRMS



Payout is fairly irregular once we are ten editions or more prior to the donor's death. While there are many factors that could explain this result, the simplest and most likely is that I just have a relatively small number of observations for those periods, since there are not many organizations in the early years of the data. Alternately, it may be that firms at this stage of their life cycle are not yet fully funded. If donors periodically contribute large cash infusions, even a relatively stable spending pattern would produce a fluctuating payout rate, depending on when a donor's most recent contribution occurred.

B. Regression Results

Regression analyses confirm with math what our eyes tell us. Using the FD dataset, I employ a slightly modified “regression-discontinuity” or “RD” estimation in which the outcome variable is either overhead (Table 2, Columns 1 and 2) or payout rate (Table 2, Columns 3 and 4). The RD design assumes that it is random whether, in a given reporting period, an organization has one donor or zero donors and measures the incremental impact of randomly being assigned zero donors.¹¹⁵ Thus, holding constant the identity of each

115. I describe my RD design as “slightly modified” because the unique nature of my data makes a standard RD impractical. In the typical RD, the researcher includes both an indicator variable for whether an observation is “treated” by the discontinuity and also a set of interaction terms for the “running” variable on either side of the discontinuity. *See generally* David S. Lee & Thomas Lemieux, *Regression Discontinuity Designs in Economics*, 48 J. ECON. LITERATURE 281 (2010) (describing the RD approach). This latter is just a measure of how far away a given observation is from the discontinuity, as measured by whatever units the discontinuity occurs in. Here, the discontinuity is measured in number of living donors, but on one side of the discontinuity there is only one number: zero. In other words, I cannot include a control for the number of the living donors at firms with zero living donors. In the RD equation below, this would have been included as an additional term $\beta(z - c)$, but here $(z - c)$ is always one.

foundation and any unobserved aspects of it that do not change over my sample period, I examine how going from one donor to zero affects overhead and payout. For firms with living donors, I also estimate how each incremental live donor affects these outcomes.

I control for some basic firm demographics, such as age and assets, as well as for the calendar year and state-by-year trends.¹¹⁶ To reduce the influence of outliers, I use the natural logarithm of the value of all the variables, except for year and “indicator” variables taking only zero-or-one values. For readers interested in equations, I summarize the regression approach in the following equation:

$$Y_{it} = \alpha + \rho D_{it} + \beta_1(z - c)^n D_{it} + \beta_2 X_{it} + \lambda_t + \varphi_s \lambda_t + \varepsilon_{it}$$

where Y_{it} is the outcome variable (overhead or payout) for a given firm i in year t , D_{it} is the discontinuity (an indicator variable for the presence of any living donor), X_{it} is the vector of control variables, and $(z - c)$ is the distance from the discontinuity for the running variable, here the number of living donors in excess of zero. The coefficient on D , ρ (rho), represents the impact of losing the firm’s last living donor. I initially included higher-order polynomials of the $(z - c)$ term, but since these were insignificant, I drop them in the reported results. λ_t and $\varphi_s \lambda_t$ represent controls for the calendar year of the observation and a set of state by year trends, respectively. ε_{it} is the error term.

116. For regressions with payout ratio as the outcome variable, I omit a control for assets. Since I calculate payout as spending divided by assets, if I include assets on the right-hand side I am effectively controlling for the outcome variable with itself.

TABLE 2: EFFECTS OF LIVING DONORS ON PF OVERHEAD AND PAYOUT, FROM FOUNDATION DIRECTORY DATA

VARIABLES	(1) Overhead Treatment	(2) Overhead Placebo	(3) Payout Treatment	(4) Payout Placebo
Has Living Donor	-0.123*** (0.0434)		0.0690*** (0.0264)	
Fewer Than Two Donors		-0.0714 (0.0787)		0.0149 (0.0478)
Log Firm Assets	0.134*** (0.0234)	0.134*** (0.0235)		
Log Firm Age	0.0312 (0.0414)	0.0322 (0.0415)	0.248*** (0.0330)	0.247*** (0.0330)
Living Donor x Distance from One Donor	-0.0414 (0.0358)		0.0511** (0.0220)	
Fewer Than Two Donors x Distance from Two Donors		-0.0349 (0.0487)		0.0502 (0.0332)
More Than Two Donors x Distance from Two Donors		-0.120*** (0.0433)		0.0673** (0.0264)
Observations	29,086	29,086	29,852	29,852
R-squared	0.144	0.144	0.090	0.090
Number of Firms	6,194	6,194	6,351	6,351

Notes: Fixed-effect panel regressions with (standard errors) clustered by firm. Includes controls for calendar year and state-by-year effects. Years cover the range 1960 to 1992, and 1998. "Placebo" treatment is effect of fewer than two donors. ***: statistically significant at the 1% level. **: statistically significant at the 5% level.

Table 2 summarizes the results. Columns 1 and 3 are the main treatments of interest: the results of moving from one living donor to zero. Columns 2 and 4 are essentially placebo tests, examining the impact of a comparable-sized move from two living donors to one.¹¹⁷ As Column 1 reports, going from zero to one living donor reduces overhead by about 12%, and this result is highly statistically significant.¹¹⁸ The mean overhead ratio in the firms included in the regression is 16.5%. Thus, my result implies that the death of the last donor on average increases a firm's overhead ratio by 12% x 16.5%, or 2 percentage

117. For placebo tests, I am able to include a control for the running variable on both sides of the discontinuity. I run alternate regressions in which I omit this control in order to ensure that including it does not drive the difference between the placebo and treatment regressions. Placebo results when omitting the full running-variable control are essentially unchanged.

118. The 95% confidence interval is 3.8% to 20.8%.

points. In contrast, in Column 2 I report that the impact of going from two donors to one donor has no statistically measurable effects on overhead, with confidence intervals that could include both substantial increases or decreases.

Columns 3 and 4 report a similar pattern for payout ratios. As Column 3 summarizes, a firm with one living donor has a payout that is on average 6.9% higher than a firm with none.¹¹⁹ The mean payout ratio in these firms is 9.1%. So the estimate implies that with the death of the last donor, average payout falls by 6.9% x 9.1%, or 0.6 percentage points.¹²⁰ Again, the placebo treatment has no statistically significant impact, with relatively wide confidence intervals.

In theory, an RD design should not need to include controls, on the assumption that the location of a firm-year on either side of the discontinuity (here, the date of death) is essentially as good as random assignment.¹²¹ It is reassuring, however, to also be able to include control variables. For instance, payout policies might be sensitive to a firm's investment performance. It is useful to double-check that the donor's presence is affecting payout directly, rather than, say, changes in investment policies that in turn affect payout. To expand the set of controls available, I repeat my analysis using the matched set of FD and Core-PF data. This allows me to control for investment returns, dividend income, and firm liabilities. As I noted, I have considerably fewer observations in the matched set, as the FD extends back to 1960, but the Core-PF only has reliable information back to 1988. We should expect this smaller number of observations to cause less precisely estimated regressions.

119. The 95% confidence interval for this result is 1.7% to 12.1%.

120. Some commentators on earlier drafts inquired whether my overhead results are actually driven by payout. If grantmaking falls but there is no actual change in overhead expenditures, the overhead ratio will rise mechanically. To test this theory, I repeat the overhead analysis, but using (log) nongrant expenditures as the outcome variable instead of overhead ratio. My results are quite similar to those reported in Table 2, Columns 1 and 2. A living donor reduces "internal" costs by about 14%, with a 95% confidence interval ranging from 5% to 23%. The move from one donor to two has no statistically measurable effect. Thus, living donors actually reduce administrative expenditures, not just the ratio of administration to grants.

121. See Lee & Lemieux, *supra* note 115, at 296–301 (discussing the need for a control in RD design).

TABLE 3: EFFECTS OF LIVING DONORS ON OVERHEAD AND PAYOUT,
FROM CORE-PF AND FOUNDATION DIRECTORY DATA

VARIABLES	(1) Overhead Treatment	(2) Overhead Placebo	(3) Payout Treatment	(4) Payout Placebo	(5) Payout Predicted
Has Living Donor	-0.229*** (0.0516)		0.0856 (0.146)		
Fewer Than Two Donors		0.0981 (0.0739)		0.303 (0.289)	
Has Predicted Living Donor					0.165*** (0.00415)
Log Investment Return	0.0545** (0.0256)	0.0540** (0.0256)	-0.0234 (0.0318)	-0.0306 (0.0308)	0.0385*** (0.00124)
Log Interest & Dividend Income	0.0970*** (0.0319)	0.0984*** (0.0319)	0.131** (0.0584)	0.137** (0.0586)	0.0895*** (0.00263)
	0.0167*** (0.00537)	0.0168*** (0.00537)	0.000221 (0.00461)	0.000205 (0.00459)	0.0171*** (0.00122)
Log Liabilities	0.112* (0.0644)	0.113* (0.0645)	0.0717 (0.167)	0.0575 (0.163)	-0.418*** (0.00673)
Log Firm Age	0.0337 (0.0410)	0.0331 (0.0409)			
Log Firm Assets					
Living Donor x Distance From One Donor	-0.0332 (0.0290)		0.163 (0.174)		
Fewer Than Two Donors x Distance fr. Two		0.00693 (0.0400)		0.499** (0.194)	
More Than Two Donors x Distance fr. Two		-0.0745** (0.0366)		0.0951 (0.146)	
Observations	12,931	12,931	4,977	4,977	884,793
R-squared	0.052	0.052	0.049	0.054	0.036
Number of Firms	6,884	6,884	3,366	3,366	98,655

Notes: Fixed-effect panel regressions with (standard errors) clustered by firm. Includes controls for calendar year and state-by-year effects. Columns 1 through 4: years cover the range 1988 to 1992, and 1998. Column 5: years cover range 1988 to 2012. "Placebo" treatment is effect of fewer than two donors. ***: statistically significant at the 1% level. **: statistically significant at the 5% level. "Predicted living" = 80%+ predicted likelihood of having living donors, based on probit regressions of known living status on observables.

The regressions in Table 3 suggest that including additional firm controls yields roughly similar results. Columns 1 and 2 reconsider the effect of living donors on overhead. In the subset of 12,931 firm-years

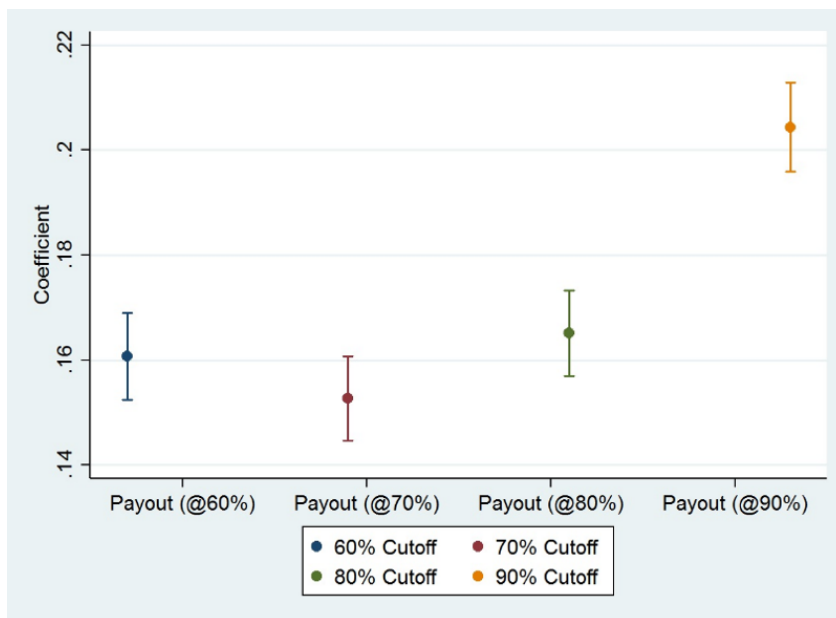
with matched data (as opposed to about 29,000 in the full FD sample), the impact on overhead is almost twice as large, with a highly statistically significant point estimate of about a 23% increase. The difference in estimates between here and in the FD data is driven by the difference in which firms and years I observe, not by the controls; when I repeat the Column 1 regression without the added firm controls, I obtain basically the same 23% coefficient. The placebo treatment, reported in Table 3, Column 2, remains statistically insignificant.

The payout story is a bit more complicated. In Table 3, Column 3, the point estimate for the impact of living donors on payout is similar to the estimate from Table 2 but is not close to statistically significant. I only have, however, about 5,000 firm-year observations in the matched dataset with the information needed to compute a reliable payout ratio (early years of the Core-PF only report “book” value of assets, or their worth at the date of contribution), and this likely explains the reduced precision of my outcome.

For an alternative approach, I use the predicted presence of living donors, as described in Part II, above. I then examine the simple correlation between this predicted marker and payout in the nearly 900,000 firm-years of the Core-PF sample for which I can compute payout.¹²² As Table 3, Column 5 reports, payout is on average 16.5% higher among firms predicted to have living donors, and (as expected, given the enormous sample size) this result is very precisely estimated. For the result reported in the table, I use a cutoff of 80% predicted likelihood for whether a firm-year is coded as having living donors. This estimate is not especially sensitive to varying the probability cutoff, as summarized in Figure 4. The measured effect is somewhat larger when I require a 90% likelihood that the firm has living donors, implying that at lower certainties, the impact of “treatment” may be diluted by including some untreated firms.

122. Because the Core-PF files often include unverified data, and result in some measurements that are eye-opening extreme (e.g., payout ratios in the millions), I omit the top and bottom 1% of firms by payout.

FIGURE 4: EFFECTS OF PREDICTED LIVING DONORS AT VARYING “PREDICTED” CUTOFFS



IV. INTERPRETATION AND IMPLICATIONS

A. What Do the Results Tell Us?

Overall, I interpret both the overhead and payout effects as evidence of agency costs. Whether declines in payout rates are evidence of agency costs is open to debate, but I tend to believe that they are. Such dramatic differences during life and afterwards strongly suggest that donors and managers have different preferences about how quickly to spend the organization’s money and that managers’ views prevail as soon as the donor’s direct influence is removed. As I mentioned earlier, managers have several potential reasons for preferring slower spending that are not generally shared by donors, such as the desire to protect a safe and comfortable job.¹²³ It also appears from Figure 3, Panel B that managers steadily lower payout rates after the donor has died, until the average eventually reaches the statutory minimum. While the trend is highly suggestive, I cannot clearly establish a causal link between that decline and agency costs.

123. See *supra* text accompanying notes 86–89. This is not to say some donors may not also enjoy the thought of a perpetual legacy. Halperin, *supra* note 50, at 125.

One potential counterargument to an agency-cost interpretation of the payout results could be that living donors in fact have similar payout rates to managers, but donors have a larger denominator: they are spending out of both funds already in the firm and also future planned gifts.¹²⁴ Or, put another way, living donors can direct the organization to spend more because they know they can restock the firm's cupboards, but, after the donor's death, managers know that they have a fixed pool of principal to manage.

This alternative hypothesis struggles to explain the observed data. On this theory, we should expect that donor-controlled spending rates will diminish close to the end of the donor's life. At that point, the donor likely understands that she will not have much time for earning more money and that the portion of her estate set aside for charity likely represents all the available resources. Effectively, her "denominator," or pool of capital, is about the same size as the pool available to managers shortly after her death. We should thus expect to see similar payout rates both shortly before and shortly after the donor's demise. Instead, in Figure 2 we see a rise in spending by donors who are close to death and then a sharp decline in spending by managers thereafter. Again, the peak in spending just before death is consistent with an agency-cost story in which donors would prefer to allocate money themselves than to leave that task to heirs and managers.

Admittedly, there are two potential explanations for my overhead finding that may not necessarily involve agency costs. Indeed, in one of these rival theories, donors *want* their private foundation to spend money on overhead, because that money is primarily paid to or enjoyed by the donor's heirs. Tax planners regularly advise wealthy clients that this ability to use tax-deductible dollars to pay out reasonable expenses, even to heirs, is an attractive feature of the private foundation rules.¹²⁵ While I cannot rule out this story, as I noted earlier, in prior work I found that overhead is on average lower when donors have more control over an organization.¹²⁶ It is still possible that some donors desire high overhead, but the overall preference seems to be in the opposite direction.

Another possible theory that could explain my overhead result is that donors provide valuable free services to their foundations.¹²⁷

124. I am grateful to Eric Talley for making this point.

125. Victoria B. Bjorklund, *Giving to the Private Foundation, Donor-Advised Fund and Supporting Organization*, SS045 ALI-ABA 431, 462–63 (2011) (noting private foundation is preferable choice when donor wants organization to "pay for his involvement").

126. Galle, *supra* note 34, at 428–30.

127. See BORIS ET AL., *supra* note 110, at 15 (hypothesizing that their finding that family foundations have lower overhead could be explained by family provision of free services).

Once the donor has died, the organization can no longer rely on those services and must pay to replace them. My placebo results help to rule out this alternative, however. As Columns 2 and 4 of Table 2 show, there is no comparable impact of moving from two donors to one, even though this is a loss of the same amount of donor labor as the move from one to zero.

As an additional check on the lost-labor story, I use the combined FD-Core data to confirm that my overhead result persists even if I limit the sample to firm-years in which the foundation reports paying its officers.¹²⁸ In other words, in firms where officers are paid when the donor is alive, overhead costs still go up after her death. Neither of these results is totally inconsistent with the lost-labor theory, but they do make it less likely.

In any event, to the extent that these alternatives might challenge my overhead account, neither makes an especially appealing case for perpetual philanthropy. Both suggest that taxpayer dollars are being misspent by long-lived organizations: either donor heirs claim resources that were supposed to be subject to the estate tax or dedicated to charitable purposes, or organizations that persist long past the donor's life incur large expenditures that more limited-term entities would not.

B. Policy Implications of the Results

Gaps of this magnitude between donor preferences and managerial behavior suggest that perpetual philanthropy is not the best use of social resources. Again, we give up tax dollars to support philanthropy because we think charitable giving creates a double benefit: it makes donors satisfied with their good works, and it allows for the production of goods with positive externalities that the private market would struggle to provide.¹²⁹ Agency slack suggests our returns on both sides of this equation are lower. Obviously, donors do not get as much of what they want. But also, some portion of the resources that are supposed to go to beneficiaries are instead used to satisfy the private desires of managers for stable and comfortable careers.

To be sure, overhead and other administrative expenses are not always wasteful, but instead can represent payment for important sources of added value, such as project management expertise.¹³⁰ It is

128. The 95% confidence interval for the effects of a living donor in this specification ranges from -8.5% to -28%.

129. See *supra* Part I.A.

130. Peter Frumkin & Mark T. Kim, *Strategic Positioning and the Financing of Nonprofit Organizations: Is Efficiency Rewarded in the Contributions Marketplace?*, 61 PUB. ADMIN. REV.

conceivable that donors are overly reluctant to incur these kinds of costs.¹³¹ If that were true systematically, then it could be the case that agency costs are actually good, to the extent that they allow these value-adding expenditures to rise closer to socially optimal levels. My data do not offer a clear picture of what higher overhead is buying.

Rising overhead is most concerning, then, because overhead and payout are likely to be only the tip of the agency iceberg. These two variables are probably the easiest of all charitable outputs to measure, as they can be computed readily from basic financial information. Managers influence many other crucial decisions that are much more difficult to observe, such as what kinds of missions to support and how risky the organization's choices about grantees and investments should be.¹³² If agency costs are high for the outcomes that are easy to measure (and, hence, for donors to supervise), they are likely even higher for these others.

Here again, we have losses for both donors and society at large. Anecdotal evidence that donors care a lot about their organization's grantees and choice of mission can be found nearly everywhere in philanthropic literature, including in the promotional materials of at least one prominent DSO, which offers to help donors limit their heirs' choices.¹³³ On the beneficiary side, a long-standing critique of big philanthropy is its isolation from outside influence.¹³⁴ Social science tells us that organizations that are not answerable to anyone rarely perform as well as those that are more accountable.¹³⁵

266, 272 (2001). *But see* Core et al., *supra* note 94, at 321 (“[T]his ratio is widely used as a measure of efficiency and performance . . .”).

131. *Cf.* Benjamin Moses Leff, *The Case Against For-Profit Charity*, 42 SETON HALL L. REV. 819, 864–65 (2012) (offering reasons donors might fail to understand how to effectively monitor for agency costs).

132. The challenge of measuring nonprofit outputs is almost axiomatic, given that this difficulty is one of the factors that motivates adoption of the nonprofit form. Hansmann, *supra* note 67, at 623. For an interesting description of how nonprofit service organizations try (but largely fail) to articulate meaningful outcome measures, see John C. Sawhill & David Williamson, *Mission Impossible? Measuring Success in Nonprofit Organizations*, 11 NONPROFIT MGMT. & LEADERSHIP 371, 377–86 (2001).

133. *Bequest Accounts and Planned Giving*, DONORSTRUST, <https://www.donorstrust.org/what-we-offer/bequest-accounts-planned-giving/> (last visited Jan. 26, 2020) [<https://perma.cc/MYN5-GGA4>] (“You will also leave with us a donor intent statement, amendable by you at any time during your lifetime, so there is no question as to how you want your charitable legacy to be spent.”).

134. Eric Franklin Amarante, *The Perils of Philanthrocapitalism*, 78 MD. L. REV. 1, 17–18 (2018); Brody, *supra* note 6, at 920–28.

135. Elisabeth S. Clemens, *The Constitution of Citizens: Political Theories of Nonprofit Organizations*, in *THE NONPROFIT SECTOR: A RESEARCH HANDBOOK* 207, 208, 211–12 (Walter W. Powell & Richard Steinberg eds., 2006); Marc Hooghe, *Voluntary Associations and Democratic Attitudes: Value Congruence as a Causal Mechanism*, in *GENERATING SOCIAL CAPITAL: CIVIL SOCIETY AND INSTITUTIONS IN COMPARATIVE PERSPECTIVE* 89, 106 (Marc Hooghe & Dietlind Stolle

To be sure, this last point might be made into something of an argument in favor of agency costs, but I think that claim would go too far. The point would be that mega-rich donors are *even more* isolated and elitist in their attitudes than nonprofit managers. As between forever foundations controlled by their original donors and those controlled by professional managers, we might actually prefer the latter.¹³⁶ That may be so, but it neglects a third potential option: organizations that are subject to payout requirements high enough that, in order to survive, they must raise new money. If manager insulation from donors creates agency costs, or manager isolation from society otherwise reduces the quality of their work, we should ensure that organizations have continuing incentives to be open and accountable to potential supporters. That is what a payout rule can do.¹³⁷

This is not to say that the case in favor of payout rules necessarily supports the exact current design of U.S. law. Many of the goals of a payout policy can be met if distribution amounts are based on a rolling average over several years, as some have proposed.¹³⁸ Payout rates could also vary with market conditions or the economy, as in some prior suggestions to encourage foundation distributions during economic downturns.¹³⁹ In any event, the exact level of payout should probably be sufficient to put some modest pressure on organizations to seek out new funding, and whether a steady 5% obligation achieves that is an empirical question for later work.¹⁴⁰

eds., 2003); Cass R. Sunstein, *Deliberative Trouble? Why Groups Go to Extremes*, 110 YALE L.J. 71, 85–96 (2000).

136. See Iris J. Goodwin, *Ask Not What Your Charity Can Do for You: Robertson v. Princeton Provides Liberal-Democratic Insights into the Dilemma of Cy Pres Reform*, 51 ARIZ. L. REV. 75, 123 (2009); Melanie B. Leslie, *Time to Sever the Dead Hand: Fisk University and the Cost of the Cy Pres Doctrine*, 31 CARDOZO ARTS & ENT. L.J. 1, 16–17 (2012); Ray D. Madoff, *What Leona Helmsley Can Teach Us About the Charitable Deduction*, 85 CHI.-KENT L. REV. 957, 974 (2010); Allison Anna Tait, *The Secret Economy of Charitable Giving*, 95 B.U. L. REV. 1663, 1715 (2015). For an argument about why leaving donors out of nonprofit governance is undesirable, see Dana Brakman Reiser, *Dismembering Civil Society: The Social Cost of Internally Undemocratic Nonprofits*, 82 OR. L. REV. 829, 865–86 (2003).

137. See MEHRLING, *supra* note 110, at 10 (“[P]ayout rates should be high enough that foundations are required to attract new funds in order to pursue their missions.”).

138. See Halperin, *supra* note 50, at 127 (offering this suggestion with respect to university endowments).

139. YAIR LISTOKIN, LAW AND MACROECONOMICS: LEGAL REMEDIES TO RECESSIONS 45–46 (2019); Salamon, *supra* note 33, at 251; Eugene Steuerle, *Distribution Requirements for Foundations*, 70 PROC. ANN. CONF. ON TAX’N 423, 426 (1977); see Galle, *supra* note 3, at 1196–98 (showing through data simulations that other proposals would not result in meaningful countercyclical spending and recommending more robust adjustments to payout rules).

140. Cf. MARION R. FREMONT-SMITH, GOVERNING NONPROFIT ORGANIZATIONS 276 (2004) (noting that appropriate payout rate likely varies with economic variables and mission of organization).

The results also speak to the debate about DSOs. Admittedly, agency costs are likely somewhat different at DSOs than at private foundations, but they share some broad features. Both foundation managers and DSO operators benefit from slow spending. The DSO is paid based on a share of assets under management, giving it little incentive to encourage donors to recommend quicker giving.¹⁴¹ Each of the nation's large "commercial" DSOs contracts with a for-profit partner, with fees that reportedly vary quite substantially.¹⁴² It is unclear if DSO managers have any real incentive to negotiate these fees. By a remarkable coincidence, no major commercial DSO seems to have ever contracted with any partner except the for-profit investment firm that founded the DSO, suggesting that there is little genuine competition for management fees.¹⁴³

In any event, at a minimum my results suggest that DSOs should not provide easy loopholes for escaping payout rules. As Roger Colinviaux and Ray Madoff have argued, a DSO should not be available as an easy way to satisfy a private foundation's 5% payout requirement, nor should contributions from a single DSO account allow the donee organization to escape private foundation status.¹⁴⁴

High agency costs also offer reasons to reconsider the set of state laws that tend to encourage perpetual spending. In fifteen states, organizational managers are presumed to act "imprudently," and thus contrary to law, if they spend more than 7% of a firm's assets in a year.¹⁴⁵ As I have reported before, these laws indeed seem to reduce spending, and if anything may tend to reduce giving.¹⁴⁶ Forty-nine states and D.C. also presume that if a donor places any restrictions on assets she leaves to a charity that she also intends that those assets be preserved in perpetuity.¹⁴⁷ Although in theory that presumption can be

141. MOLLY F. SHERLOCK & JANE G. GRAVELLE, CONG. RSCH. SERV., R42595, AN ANALYSIS OF CHARITABLE GIVING AND DONOR ADVISED FUNDS 7 (2012), <https://fas.org/sgp/crs/misc/R42595.pdf> [<https://perma.cc/G3TQ-4CL8>].

142. U.S. DEPT OF THE TREASURY, *supra* note 21, at 63; Colinviaux, *supra* note 16, at 22–23. As Jake Brooks notes, fees at some organizations seem to approximate the value of the tax savings offered by the DSO. John R. Brooks, *The Missing Tax Benefit of Donor-Advised Funds*, 150 TAX NOTES 1013, 1016 (2016).

143. See Alan M. Cantor, *Wall Street's Charitable Gold Rush*, INSIDE PHILANTHROPY (Feb. 25, 2015), <https://www.insidephilanthropy.com/home/2015/2/25/wall-streets-charitable-gold-rush.html> [<https://perma.cc/H9RT-D42D>] (noting that each investment firm has its own "in-house" DSO).

144. Roger Colinviaux & Ray D. Madoff, *Charitable Tax Reform for the 21st Century*, 164 TAX NOTES 1867, 1871–74 (2019).

145. Galle, *supra* note 3, at 1200 & n.281. For discussion of the presumption and its operation, see Gary, *supra* note 35, at 1314–16.

146. Galle, *supra* note 3, at 1201.

147. Gary, *supra* note 35, at 1305–07, 1311.

drafted around by counsel, as I and others have found, these kinds of default provisions seem to have real impact on nonprofit (and noncharitable trust) behavior.¹⁴⁸ Lastly, important accounting rules require charitable managers to act as though endowment funds are intended to last forever, and these rules purport to implement state law.¹⁴⁹

Even if we weren't going to reform the law of perpetual giving, my findings suggest there could be some benefit in encouraging donors to give money to charity while they are alive, instead of at the time of their death. Money that is donated before death is more likely to be spent according to the preferences of the living donor. Prior commentators have not considered the possibility that these kinds of rules might be desirable, but the sharp divide I find between firms with living donors and firms without suggests there could be a lot of social value in them. Let me offer a few initial suggestions.

The estate tax (or potentially some substitutes for it, such as a tax on the inheritances received by noncharitable heirs) could offer powerful incentives to give during life. That might seem counterintuitive. If my estate is not subject to tax, then a charitable contribution deduction against the estate tax does not have any value to me, so that it might appear that lower estate taxes reduce incentives to give at death. Crucially, however, giving to charity during life is usually an *even better* way to reduce the estate tax than giving at death, so that the bigger and more generally applicable the estate tax, the more *inter vivos* gifts we should expect.¹⁵⁰ A gift during life reduces the donor's income taxes as well as her estate taxes.¹⁵¹ For high net-worth individuals, the charitable contribution deduction must often be spread out over several years in order to maximize its income-tax value.¹⁵² So this is not an option donors can use effectively in their last year of life.

Once money is transferred to charity during the donor's life, it is also important to ensure the money is spent during her life, not afterwards. As we saw, most organizations with living donors do spend quite vigorously. But to the extent that some might not, a payout rule helps to ensure that money is spent at a time when agency costs are low. In my data, we do not observe many organizations with very low

148. Galle, *supra* note 36, at 543–46; Max M. Schanzenbach & Robert H. Sitkoff, *Did Reform of Prudent Trust Investment Laws Change Trust Portfolio Investment Allocation?*, 50 J.L. & ECON. 681, 687–88, 696–707 (2007).

149. FIN. ACCT. STANDARDS BD., *supra* note 36, app. ¶¶ A12–13.

150. For theoretical discussion and review of the available evidence, see Wojciech Kopczuk, *Taxation of Intergenerational Transfers and Wealth*, in 5 HANDBOOK OF PUBLIC ECONOMICS 329, 361–63 (Alan J. Auerbach, Raj Chetty, Martin Feldstein & Emmanuel Saez eds., 2013).

151. Kopczuk, *supra* note 150, at 361.

152. Brakman Reiser, *supra* note 49, at 955.

payouts, because of course current law requires distributions of at least 5%. But there is reason to believe rates could be quite a bit lower in the absence of this rule. For instance, IRS data suggest that among DSOs, which have no payout requirement, about one-fifth of organizations have average annual payout rates of less than 1%.¹⁵³

Another possibility my findings suggest is to reconsider the rules applicable to private foundation payments to family members of the main supporter. Again, one alternate interpretation of my overhead finding is that some organizations actually prefer high overhead once the donor has passed on, because this is a way to exploit a loophole in the combined estate tax-private foundation regime. The estate tax system effectively relies on the rules governing charitable organizations to ensure that money exempted from the estate tax as a charitable donation is in fact used for charitable purposes, not for the benefit of the decedent's friends and family. But private foundation rules in turn allow heirs to be paid substantial salaries and benefit from "reasonable" administrative costs, such as for semiannual board meetings in Key West.¹⁵⁴

This is an estate tax problem, and it should have an estate tax solution.¹⁵⁵ Private foundations of course should be entitled to pay reasonable employee compensation and other expenses. If, however, those payments benefit a relative of the organization's substantial contributors, or other individuals bequeathed a substantial sum in the contributors' wills, those payments should be included as part of the taxable estate. The rule would ensure that applicable estate-tax rates are imposed on these payments, which after all are basically an effort to escape from those taxes. In many cases, the correct tax rate is zero: if the foundation makes a payment to an heir whose benefactor's estate would not have been taxable, there is no tax avoidance and there should not be any penalty. Current nonprofit law fails to achieve either of these results, imposing too much tax on some payments and not enough on others. I would extend the penalty not just to heirs but also to others named in the will as a way of reaching lovers, close friends, and others whose bequests would usually be taxable; nonprofit law currently reaches only excess payments to the donor's relatives.¹⁵⁶

153. Arnsberger, *supra* note 24, at 67.

154. Galle & Madoff, *supra* note 15, at 6.

155. *Cf.* Halperin, *supra* note 55, at 303 (noting that tax subsidies for charitable accumulation are more palatable if donors retain little control over the charitable organization).

156. Treas. Reg. § 53.4946-1 (1972). Of course, this rule could be planned around by leaving the beneficiary nothing directly, except the right to be paid by the private foundation, but this result would probably be very undesirable for individuals with millions of dollars to donate to favored beneficiaries.

CONCLUSION

I have offered new causal evidence of significant agency costs at philanthropic organizations. When donors are available to monitor foundation managers, and can threaten to withhold future donations, it appears that managers likely spend faster and are more careful to hold down administrative expenses. Tax and nonprofit law each encourage organizations to incur these costs. While debate should and will continue about how to remedy that problem, at a minimum, my findings suggest that more conversation is appropriate.