



## Over Two Decades of Philanthropic Reform

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January 24, 2003

*Waldemar A. Nielsen Issues in Philanthropy Seminar Series*  
Georgetown University

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It is a pleasure to be with you today. Many thanks to Virginia Hodgkinson for having invited me. Without her pioneering efforts the field of nonprofit research would not be where it is today.

Let me begin with a caveat. While I do work for the Wyss Foundation, and my direct experience with that family foundation, along with other types of grantmakers, informs the following remarks, I am not representing the Foundation today. The ideas, opinions, and research I'm about to impart are my own, or those of my colleagues and critics.

I am honored to have been invited to be a part of the Waldemar A. Nielsen Seminar Series. Thank you. His work has informed us all, although I think he has been one of my critics.

My employment and research over the last two decades (maybe longer) has centered on the philanthropy of wealthy Americans as well as the nonprofit (or nongovernmental) institutions which distribute funds to a wide range of causes. I'm aware that these days the term philanthropy is used quite broadly, but in this presentation, I will be referring to the reform of foundations or similar tax vehicles for major giving by individuals and families. My premise, based on earlier research, continues to be that the giving of the wealthy and foundations primarily perpetuates the status quo and does not bring about substantive change.

I'm going to pause for a moment to nod to Pablo Eisenberg, who has been a mentor, friend, and real leader in the nonprofit community. I'm afraid I have very little to say here that he hasn't already exhorted us about.

I will focus on four major issues affecting a lack of philanthropic reform: 1) Accountability, which we might also call Ethics, (accountability actually subsumes all the following categories) 2) Diversity and the Culture of Philanthropy,

3) Foundation Payout and Portfolio Management, and 4) finally a few odds and ends that affect the Partnership between grantmakers and grantees that most of us say we want.

Foundations exist to serve the public interest. Tax exemptions for charitable giving are based on the expectation that public – not private – interests are being served by their activities. Of course, foundations are “both private and public institutions,” but while the source of their money is private donors, the application of these resources to public purposes should make foundations accountable to the public. The public has a right to detailed information about foundations’ operations, as well as access to the grantmaking process. Along with others, I have argued that the expenditure of income that would otherwise have become taxable makes these charitable gifts in some sense public money.

At its best, philanthropy provides a check against corporate or government domination or indifference. It is also inextricably linked with business and political affairs. Individual nonprofit groups, including foundations, can be important players in a kind of balance of power as independent centers of thought, action, involvement and pressure.

As most of you know, in the US we have a mixed political economy of giving – what has been termed a partnership between government and voluntary organizations. Nonprofit organizations provide more than half of the nation's social services, with funding from both government and private sources. Although I seem to be in the minority these days, I still think the government should have the major responsibility for insuring good public education, sound health care, adequate housing and food for citizens. We used to call this a “federal safety net.” It had been carefully woven together since the 1930s, but has been nearly demolished with devolution and privatization since the 1980s.

Also, when the nonprofit sector is doing what government should be, I'm not sure that as much creative, cutting edge, critical work takes place. Advocacy and promoting public policies that might be counter

to the present government are bound to diminish. And in the current political climate, dissent seems nearly impossible. I think foundations should be funding dissent, especially now.

As a related aside, I understand that Lester Salamon has a new report out indicating that the nonprofit sector is saturated, that there is not enough funding available to sustain the million plus nonprofits currently in operation. And, I believe he predicted that nonprofits were likely to lose about \$100 billion in federal funds over the last few years. My worry here is that this gives even more power to foundations and wealthy donors. I fear that funding will be increasingly directed to the bigger, more established nonprofit institutions.

A quotation from my book, *Charity Begins at Home*, illustrates this point. It was made by a prominent attorney who advises wealthy individuals and foundations:

*The first and easiest course is to find some established charity that is already doing what you want to do... You can avoid all the difficulties and expense and time... Option number 2 is to see if an organization that is already in being can be moved in the direction that you want to go... I guess only after you explore those areas do you get around to saying, "Well, let's think about something new."*

If the "easiest" option is to give money to an established" charity, then new ideas and grassroots or small organizations that don't have access – especially advocacy groups -- are less likely to receive grants. Many of these groups are doing the most important work, but they will be the ones that do not make it through this downturn.

Getting back to accountability, the record of foundations around public accountability has been extremely poor. A study by Dennis McIlroy traces the accountability of foundations over a 25 year period. McIlroy demonstrates that legislated accountability has not improved noticeably since the implementation of the Tax Reform Act of 1969, and that voluntary accountability has improved only slightly.

Accountability encompasses three distinct elements: minimum or absolute legal requirements (filing the tax forms and making them available to the public); voluntary actions that are not required but are designed to meet a broad social consensus about acceptable standards of behavior; and the adoption of principles that each organization employs to construct its own way of being accountable.

In the mid-1990s, the National Network of Grantmakers (NNG) conducted a study of "exemplary foundations" that determined the most important aspects of good funding involve: access to information (for the grantees), open grantmaking processes, diverse and informed decision-makers, good relations with grantees, and organizational effectiveness.

I have been giving speeches on these themes for over a decade, have convinced a few funders to be more accessible, accountable and transparent, but on the whole find very little change to have occurred. Also, in spite of having made the incorrect predictions some fifteen years ago that foundations were on the decline, their numbers seem to be booming.

Every foundation is idiosyncratic. It's a characteristic of the field. But the cloak of privacy seems envelop most of them. In preparing for this talk, I reviewed my old files. I've modified my timeframe for considering philanthropic reform from 20 (that of my own tenure) to 30 years – primarily because it neatly fits with the anniversary of the Filer Commission.

In 1973, John D. Rockefeller III initiated the Commission on Private Philanthropy and Public Needs, which was named after its Chairman, John H. Filer. Some of you got a copy of the Donee Group Report, which you might have thought an odd – or old -- choice for me to distribute. The Donee Group – a wide-ranging coalition of nonprofit groups and free thinking individuals was organized by Pablo [Eisenberg] in 1975 and began meeting in tandem with the Filer Commission. Wally – to whom this lecture series is dedicated -- was

also a member of the The Donee Group, which ultimately issued its report as a kind of dissenting opinion to the Commission's findings.

The recommendations that the Donee Group proposed sound very familiar to those that NNG was still calling for 20 years later, and that I advocate in 2003. Access to the philanthropic process must be widened and made more readily available to many organizations shut out of the system. Similarly, greater accountability and changes in governance are necessary to strengthen as well as to provide greater access to the system.

I've been asking myself what has changed over the course of my career in philanthropy, and while I don't come up with meaningful internal change, I do see substantial differences in the world outside: greater concentration of wealth/ disparity of income/ inequality; corporate ascendancy; global economy/globalization; exporting philanthropy; greater worldwide poverty; outright war against the environment (my latest career endeavor so I need to mention it – but the list goes on); as Pablo has been writing about lately, we have a paucity and shallowness of leadership; and huge demographic changes. Which leads me to a not altogether new call – and my second point -- for greater diversity of decision makers in the foundation field. It follows directly from the tenants and successes of the Civil Rights Movement, but while the face of philanthropy has changed, the culture has not.

Last year, research on which I collaborated with Lynn Burbridge, the late Bill Diaz and Aileen Shaw, was published by the Joint Affinity Groups (JAG). This study had a rather amazing history. It was over a decade in the making, largely because we couldn't get it funded for years. Then, speaking of philanthropic reform, when we did get our first grant for the work from the Ford Foundation, Ford severely constrained the parameters of the study. (Foundations seem to have a penchant for dictating to grantees.)

Anyway, one of our major findings was that the institutional or internal culture of philanthropy is elite, rather than diverse. (This was not a surprise, as I'd found the same to be true in interviews with donors and

their advisors ten years earlier—but the donor culture seems to extend to the organizations they create.) Wally himself had noted that within foundations, manners and politeness are highly valued. (I'm afraid I've been accused of being impolite in the past. What I may have been was impolitic.)

Several years ago, an outside consultant was brought into the Hyams Foundation expressly to evaluate the foundation's institutional culture. This person identified a culture of “niceness” that was felt to be oppressive by some of the diverse staff, who could not express themselves candidly using direct language, because they worried they might be perceived as “not nice.”

While the foundations featured in the JAG research have generally done quite well in recruiting diverse staff and trustees—this is why they were chosen for the study -- in our interviews we frequently heard from the diverse employees at the program level how unwelcoming or difficult their institutional cultures were to adapt to. A gay man of color on the staff of an independent foundation put it most bluntly, “You primarily have white men in power, giving directions to all the people of color.”

And, while diversity had been directly addressed by all the foundations we investigated, a gap still remained/s between those in executive management positions and those who serve below them. While diversity at the program level may provide a greater responsiveness to the needs of representative communities, multiculturalism in executive management is needed to create an atmosphere of better understanding and responsiveness within foundation culture and toward the grantees we serve.

One program officer may have put her finger on the problem when she observed how much her foundation operated on an academic model. This is a historical trend that has not fostered philanthropic reform.

When Andrew Carnegie and John D. Rockefeller invented the modern independent foundation -- or Olivia Sage formed hers a bit later -- they

were interested in applying the best available knowledge to the underlying causes of social problems. Consequently, they turned to academic experts as staff to guide their foundations. This tradition continues. For example, of the foundations in the JAG study, the president and CEO of the Kellogg Foundation, was formerly the president of Johns Hopkins University. The president of the Rockefeller Foundation, was previously vice chancellor at the University of Sussex, England. (In my book with AKD and EB, *Working in Foundations*, we had documented this trend of hiring from academia some 20 years earlier.)

The academic culture instilled by this tradition encourages rather direct, but polite, criticism from one's colleague of one's work product – similar to a dissertation defense or peer review of a journal article. This kind of direct criticism, so normal in the academic tradition, may be foreign to people who have been denied access to the academy. Due to societal barriers, people of color are disproportionately represented in this latter group; however it is important to note that white people without access to higher education also experience this disconnect. As a result, direct criticism of a work product like a grant recommendation (or on the other side of the table, the proposal) can be perceived as hostile and personal. This is one of the problems with the nature of grantmaking. Who is the expert, the program officer or the nonprofit leader seeking funding.

Philanthropic reform will only occur if implemented from the top. Executives, senior management and trustee support are central to any commitment to diversity or full reform. Endorsement from the CEO and board authorizes action as well as financial support and leads by example. I believe leadership is essential to philanthropic reform, but largely lacking in our community. Our greatest need is for creative, smart people with diverse experiences, backgrounds, and personal identities, who are willing to take risks.

By hiring or recruiting more than one token board or staff member, foundations achieve critical mass. A cascade effect follows as diverse hires make subsequent recruitment easier through their access to

networks and talent pools. This also affects institutional culture, makes retention easier, and can change relations with grantees. Yet, diversity is at the top is the most important.

We found that staff and board diversity usually follows programming, although the converse is not necessarily the case. For example, the presence of more women in the field has not led to more funding for women. However, women tend to be hired where programs for women are initiated. Foundations often seek out those with knowledge of the issues funded and are hiring program officers from grantee communities. The overwhelming rationale for diversity is to reflect the constituencies served. Diversity is increasingly viewed as part of foundations' accountability mechanisms to populations they fund.

Multiculturalism advances programmatic goals in a nonprofit climate that serves an increasingly diverse grantee base. It helps in gaining access to and conferring legitimacy with constituent groups.

Let me turn to the third topic, foundation payout and portfolio management. Payout is the amount of money distributed annually by private foundations and other grantmakers. It is the engine that drives grantmaking and a crucial source of capital for nonprofit organizations. Under IRS rules, the minimum payout required of a private foundation is 5 percent of net investment assets. Thus, a foundation with \$100 million in assets is required to pay out only \$5 million a year. Please don't doze off here. This math is easy. (I am proud to say that the foundation I work for, which has only about a \$40 million endowment, paid out over \$5 million in grants last year, well over the legal requirement, or floor.)

Since most Americans have never heard of payout, they would likely be surprised to learn that it does not refer solely to foundation grants to nonprofit organizations. The 5 percent rule actually governs what is called "qualifying distributions," which comprise grants as well as other expenditures: administrative expenses (salaries and travel costs), program related investments, amounts set aside for future charitable projects, capital expenses (such as new buildings), and even trustee fees.

There are few legal restrictions concerning these expenditures. So while a foundation may be paying out 5 percent each year, its overhead expenses might easily constitute 2 percent or more of that total, leaving less than 3 percent for grants.

The 1969 Tax Reform Act, which Congress passed to curb abuses of public trust among nonprofits and foundations, established the first payout requirement. It stipulated that private foundations distribute the entire amount of their net investment income or 6 percent of their non-charitable assets, whichever was greater. Congress lowered the payout requirement to 5 percent in 1981 under heavy lobbying from the foundation community. Battered by stagflation, foundation endowments had eroded sharply throughout the 1970s, and the lower payout rate was intended to help foundations rebuild their assets – which they did amply. But is building endowments what we want for philanthropy. (I fear that foundations will use this excuse again because of their declining portfolios and possibly ask for an even lower payout.)

Foundation assets actually doubled over the second half of the 1990s, from \$227 to \$449 billion. Average payout remained at 5 percent. Most foundations treated what was meant to be the minimum floor of giving as a ceiling.

With certain notable exceptions, the foundation community focuses on investment returns, market fluctuations, and maximizing wealth. Foundations seem to have lost sight of why they and payout exists—the grantees. We need to move the focus of the payout debate from investment banking to how foundations can increase grants. Grants fund the people and organizations that do the daily work of building community, alleviating poverty, and creating change.

These are difficult times. The economy is on a downswing. Foundation, in spite of portfolio problems, should be stepping forward, not backwards.

Although foundations account for roughly ten percent of all charitable giving, they do so at a relatively high public cost. Michael Porter and

Mark Kramer outlined this cost in a 1999 *Harvard Business Review* article. If an individual contributes \$100 to charity, the nation loses about \$40 in tax revenue, but the charity gets \$100, which it uses to provide services to society. The immediate social benefit, then, is 250 percent of the lost tax revenue. When \$100 is contributed to a foundation, the nation loses the same \$40. But the immediate social benefit is only \$5.50 per year that the foundation gives away – that is, less than 14 percent of the forgone tax revenue.

Of course, the foundation will continue to pay out 5.5 percent of the principal for many years to come. Even so, there is substantial cost in holding so much money aside. At a 10 percent discount rate, for example, the present value of the foundation's cumulative contributions after five years is only \$21. After 100 years, it is still on \$55. Compare that with the \$100 contributed directly to the provider of the social services in year one.

Put another way, when Bill Gates donated \$17 billion into the Gates Foundation in 1999, his gift cost taxpayers roughly \$3.4 billion in lost capital gains taxes. The foundation was only required to pay out 5 percent of its net investment assets, or \$8.5 million that same year (I actually think there might have been a grace period) -- but keep following the math here. These costs are multiplied across the foundation community. In the past decade the C.S. Mott Foundation's assets grew 176 percent—from \$838 million to \$2.3 billion—while the Ford Foundation has seen its portfolio grow 65 percent from 1998 to 2000 with net assets increasing from \$9.4 to \$14.4 billion. Yet both Ford and Mott have kept their payout at the bare minimum of 5 percent.

While those opposing increased payout have built a case that to payout out less today will allow them to better assist society tomorrow, they have done so with asset growth, not social return in mind. Along with the National Committee for Responsive Philanthropy, I am calling for a 6 percent payout rate in grants only. Increasing the payout rate to 6 percent in grants would contribute at least \$7 billion more annually to nonprofit organizations, which need these funds now.

It doesn't look like I'll have the time to elaborate, but there are also many ways in which foundations could redirect their investment portfolios for socially responsible purposes. These range from program related investments to exercising proxy votes to actually building portfolios around socially responsible principles, using screens for positive and negative attributes of the companies in which they are investing.

Given the time left, I'll move to my final series of points and quickly run through them. I cannot overemphasize the importance of general operating support to the health of nonprofit organizations. Giving general support grants is actually a sign of good relations with grantees and trust in their decision-making. Foundations that do this are less directive and the power relations are more equal.

I do think philanthropy is more responsible when nonprofit organizations and programs are investigated, held to certain standards, and carefully evaluated. The standards, though must not be simply the standards of the elite and must not be applied only to certain organizations. By bringing grantseekers, grantmakers, various intermediaries, and the affected constituencies together more often, a consensus might be reached, or at a minimum, compromises could be made and understanding increased.

Finally, whether or not philanthropy is to be viewed as an alternative form of taxation, when people are given choice about where "their" money goes, more democratic safeguards need to be instituted. The income tax system should be more equitable across all income groups, and here would be a charitable deduction for all citizens or for none. The present system is untenable. A fair income tax system would also be effectively progressive, and corporations would pay their share. Unfortunately, we are facing a "reform" in this area, which serves the opposite purpose. (The idea that a tax on dividends is about to be rescinded amazes me.) And, I can't even really talk to you about the repeal of the estate tax. Our inheritance system perpetuates inequality and the concentration of wealth, as does traditional foundation giving.