“Financial and Psychological Determinants of Donors' Capacity to Give”

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UNDERSTANDING THE NEEDS OF DONORS
THE SUPPLY SIDE OF CHARITABLE GIVING

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3

Financial and psychological determinants of donors’ capacity to give

Thomas B. Murphy

This chapter explores the criteria that prospective donors use to determine how to allocate their income among investment, consumption, and philanthropy. The benefit for donors is that the criteria can enable them to determine the resources that they can comfortably allocate for philanthropic purposes. The benefit for fundraisers is that to the extent that they can know the donor’s giving capacity, they can more accurately tailor solicitations to individual donor requirements.

The first part of this chapter describes how two wealthy individuals interact with the political, cultural, and economic landscape in determining financial decisions, including their philanthropic dispositions. The two individuals are real people whose financial circumstances are widely different. While they do not represent in any way a statistical sample, their situations are illustrative of the difficulty of determining outcomes from initial decisions that must pass through the labyrinth we call the tax code.
The second section of the chapter illustrates how changes in the tax environment can induce behavioral changes among all taxpayers. This section illustrates how (1) early 1990 changes in the tax laws influenced charitable giving, and (2) the estate tax laws affect giving.

The focus here is implicitly on the top 10 percent of donors; those whose wealth, income, and philanthropy represent an inordinately large percentage of the aggregates. Table 3.1 sets out these percentages. This focus is not to minimize the importance of giving among the nonwealthy but to call attention to the fact that their giving capacity is limited by lesser amounts of discretionary income.

The asset environment of wealth transfer decisions

The primary financial decision-making criterion for determining one’s capacity to engage in philanthropic activities is neither wealth nor income but the expected current and future relationship between income and expense.

Given the generally accepted assumption that one provides first for oneself and one’s family and does so at some level of lifestyle, philanthropy enters into the decision-making process when the difference between the expected level of income, current and future, and expected level of expense, current and future, to maintain one’s desired standard of living is substantial and relatively permanent, as measured by the subjectively determined criteria of the decision maker. It is from this difference that the financial wherewithal for discretionary activities emerges.

The primary criterion is neither wealth nor income, because neither alone recognizes the prior needs of the resource owner that must be satisfied. That wealth and income are different faces of the same underlying reality becomes apparent on reflection. Certain assets such as stocks, real estate, bonds, and other debt instruments produce for their owner an income stream, and the value of this income stream tends to be equal in monetary terms to the market value of the underlying asset. Other assets, such as debt-free ownership of a house, reduce the level of expense that needs to be incurred to sustain one’s standard of living. Still other assets, such as collectibles, produce for their owner some level of continuing pleasure that enhances the quality of life.

Once individuals have established the income stream emanating from a given mixture of income and assets, the next step is to determine the amount of this income stream required to maintain their standard of living and pay requisite taxes. That which remains is the discretionary income, which is allocated in the following ways:

- Accumulating for future contingencies (for example, through investing)
- Increasing consumption levels (that is, standard of living)
- Allocating for philanthropic initiatives

The extent to which this difference (discretionary income) between income and expense is positive quantifies the financial resources available for philanthropic activities. The extent to which this difference is perceived as permanent strengthens the case for allocating some of the resources for philanthropy. The extent to which the difference is positive, permanent, and growing in magnitude enhances the philanthropic allocation. This relatively simple criterion that establishes the amount of resources available for philanthropic purposes is within a country that encourages charitable giving but prescribes the conditions under
which the gifts can be made and whose wealth holders differ widely in circumstances.

The context within which such decisions are made is illustrated by describing the situations of two individuals whose circumstances differ widely. (I use pseudonyms here.) Each of the wealth holders brings to the discretionary spending decision a unique combination of income, assets, and tax constraints that evokes a different response. Examining their decision making provides insights into the complexities that wealth holders face as they grapple with their own allocation problems. For one of the wealth holders, the decision-making process is straightforward; the decisions are readily compatible with public policy, and the ramifications for the larger community are easily discerned. The second case is substantially more complex and more important, for this second person is representative of that already large and growing class of individuals who own family businesses whose continued success and viability are important to both the individuals involved and the larger national economy.

Davis Donald is one of three children of an immigrant father who made his fortune in the real estate and construction business. All of Donald's wealth has been inherited from his now-deceased father. Except for some real estate holdings, the greater portion of his wealth is in professionally managed trusts, which produce income for Donald and his family. A significant part of the holdings is in generation-skipping trusts, which provide income to children of the donor but allow the corpus of the trust to pass tax free to the donor's grandchildren at the death of the children. The Tax Reform Act of 1986 sharply curtailed the use of this type of trust by limiting the amount of the generation-skipping tax exemption to $1 million. Fortunately for Donald, the change was not retroactive.

With no financial worries and a substantially redundant income stream relative to his lifestyle, Donald is perfectly positioned to engage in philanthropic activities. Not an activist in philanthropy, his contributions of both time and money are in response to initiatives by the beneficiaries.

Under the guidance and influence of a battery of lawyers, accountants, and trust officers, Donald is pursuing a course of decision making, the primary goal of which is to minimize the government's share of gift and estate taxes. The active part of this decision making involves a combination of lifetime gifts and bequests at death. For instance, he recently established a charitable trust partly as a way to grapple with the problems of estate taxes. The divestiture of assets will continue until it reaches the point beyond which further reductions could affect his standard of living. The bequests at death are an important part of this strategy. Donald may not be familiar with Andrew Carnegie's famous quotation, "To die rich is to die in disgrace," but he will very likely be less rich at the time of his death than he is today, and by a considerable margin.

Alan Able presents a more complex situation. He is a naturalized citizen who arrived in the United States as a young man with little more than pocket change and the clothes on his back. The rise, fall, and recovery of his fortunes are illustrative. By 1989, he had built a prosperous real estate empire. However, his assets dramatically fell in value during the recession and real estate devaluation of the early 1990s. Recently, his holdings have begun to recoup their value. Table 3.2 indicates the value of Able's wealth holdings at three points in time.

In 1989, Able's most reasonable allocation choices were to continue his investment portfolio as is or sell property, pay capital gains taxes, reduce mortgages to zero, and invest the proceeds of the sales (between approximately $200 million and $335 million) in a diversified portfolio of low-risk investments that would produce a secure income of $15 million to $20 million annually.

If Able had died in 1989, his estate taxes on $500 million net worth would have been $275 million, which would have left his heirs $225 million. If it had taken two years to settle the estate and if (in

<table>
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<th>Table 3.2. Financial status of Alan Able, 1989–1994</th>
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<td>1989</td>
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*Note: It is assumed that the tax basis of assets equals the mortgage balance.*
order to come up with cash to pay the estate taxes) property had had to be sold in the depressed market of 1991, the estate would have become bankrupt. A 40 percent reduction in market values of real estate between 1989 and 1991 would have produced an 80 percent reduction in net worth. The heirs, who would then have possessed real estate holdings worth $600 million, would be faced with $500 million in mortgage debt and $275 million in estate taxes, and so would have been left with a net worth of minus $175 million.

If he had remained alive in 1991, Able’s prospects would have been far more advantageous, even if he had chosen to sell his holdings in the midst of the depressed real estate market. Let us say that he did sell his property to reduce debt. After capital gains taxes, he would receive approximately $70 million in net proceeds. If invested in a diversified portfolio, this sum would produce an annual income of between $5 million and $7 million. If Able died in 1991 with a net worth of $100 million, his estate taxes would have been $55 million, leaving his heirs $45 million.

It turns out that Able did not die, nor did he sell any of his properties to reduce the amount of indebtedness and the level of his risk. Like many other business owners, his life is inextricably tied to his business, making voluntary separation extremely difficult. As long as he desires to remain active in running his business, his enormous wealth will remain foundational to the business and cannot be easily diverted for philanthropic or any other purposes without weakening the underpinnings of the business. Consequently, although Able does engage in philanthropic activities in the areas of education and religion, he does so at a much lower level of activity than he might otherwise be capable of and prefer.

Although the dollar amounts are quite large and the real estate market values are subjected to an inordinately high degree of volatility during the period observed, Able’s situation differs from most other privately held businesses only in degree. The problems and decisions he faces are qualitatively the same as those faced by small business owners, who now comprise 42 percent of the top 1 percent of wealth holders (over $200,000 of income and $3 million of net worth) (Stanley and Danko, 1996).

Several general observations summarize what at this point needs to be emphasized about Donald and Able. First, both wealth holders are in their sixties; death is now less remote, and it would advantage for them to consider decisions about managing their resources in view of their death. Indeed, one of the two wealth holders has suffered from serious heart complications in the past five years.

Second, the opportunity for philanthropy is greatest among those wealthy individuals whose holdings are concentrated in minimum-risk assets and whose income stream is stable, predictable, and secure. Third, the opportunity to engage in philanthropy is least among those wealthy individuals (such as Alan Able) whose holdings are concentrated in inherently volatile assets and whose income stream is relatively unstable and unpredictable. These situations demand the full attention and focus of the wealth holder. In effect, the wealth holders are captives of their wealth in a negative sense. As already noted, 42 percent of the top 1 percent of wealth holders are in this class. Their incomes are greater than $200,000 per year and their net worth is greater than $3 million and they started their own businesses more than twenty-two years ago (Stanley and Danko, 1996). Few of them have college degrees. Many of these individuals have the choice of selling their business, paying their capital gains taxes, and living the good life. Why do they not sell can be captured by the lament of one who did. At closing, a meeting that took two days and required the presence of twelve lawyers, one of the lawyers said to the seller, “You do seem too happy, Bill. You are getting a very good price for the company. Why do you seem unhappy?” Bill responded, “Are you married?” To which she replied, “Yes.” Bill’s next question: “Do you have any children?” The reply again was, “Yes.” Bill’s next and last question was, “Would you sell one of them?” She knew with having to reply why Bill was so sad despite being so rich. In regard to philanthropy, it is difficult to get the attention of those who remain substantially devoted to raising their commercial offspring and if you get their attention, it is difficult to get them to respond financially.
Fourth, in addition to the volatility of the income stream, the small business owner's capacity for philanthropy is further limited by the contingent liability of estate taxes. Although such tax liabilities are substantial, they do not appear on the balance sheet of an estate until death intervenes. If a business owner does not actively attend to such potential tax liabilities before death, they will, at the time of death, become potent, if not intractable, determinants in the ultimate disposition of an estate.

Able's case dramatically exemplifies the stark effects of uncontrollable contingencies (such as the tax code, death, and shifts in market value of assets) on the magnitude of one's estate and the ability of apparently wealthy individuals and their estates to make philanthropic contributions. At the same time, Able's case shows how important it is for wealth holders to face actively, rather than passively acquiesce to, such consequential environmental contingencies. For example, were he to have died in 1989, estate taxes would have extracted equity from the business, thereby reducing the enterprise's capacity to withstand adversity at the very time when its management capability had been weakened by the death of its founder. These factors, when combined with the uncertainty surrounding the market value of a privately held company, lessen to a considerable degree the capacity for philanthropy by Able and his counterparts. (In late 1999 and early 2000, Able sold a major part of his real estate holdings for cash, paid his capital gains taxes, and has substantially increased his philanthropic activities in the areas of education and religion while continuing an active engagement in his business.)

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**Tax laws, behavioral effects, and philanthropy**

Now consider how the interaction between the tax and wealth environments affects the level of philanthropic giving. That is, to understand the effect of tax provisions on philanthropic giving, it is necessary to explore how tax laws first change people's financial decision making and how such changes influence philanthropic giving. I propose a three-variable model as a starting point:

\[
\begin{align*}
T \rightarrow P \\
B \rightarrow T \\
\end{align*}
\]

where \( T \) is a tax provision, \( B \) is a set of behavioral effects produced by the tax provision, and \( P \) is philanthropic contributions in dollars.

This model postulates that tax provisions have a direct effect on philanthropic contributions, independent of any additional behavioral changes the tax provision may induce. That is, even those who ignore or avoid the potential behavioral effects of changes in tax provisions are required to act within the constraints of tax provisions in deducting philanthropic contributions.

The model also indicates that the effect of tax provisions on philanthropic giving is mediated by specific behavioral effects. That is, the tax provision provides an array of incentives and disincentives that changes the behavior of individuals and, hence, the economic capacity to give to charity. There are four effects that we will consider here:

- \( B_a \), an income effect
- \( B_p \), a price effect, or cost-of-giving effect
- \( B_c \), a composition effect
- \( B_w \), a wealth effect

The effect on capacity to give depends on the characteristics of the tax (tax rates and the types of assets affected) and the tax-induced behavioral changes, especially those made by the wealth holders who actively, rather than passively, respond to the tax changes. This is illustrated by two changes that were incorporated in the tax code passed by the Congress and signed by the president in 1993: an increase in the top marginal income tax rate and the charitable deduction for appreciated property.
**Income and price effects**

Theoretically, one's capacity to engage in philanthropic activity can be captured by the following index: capacity to give is equal to income, less taxes and less expenses, to maintain standard of living divided by expenses to maintain standard of living. Expressed symbolically,

\[ Cg = \frac{Y - T - SLe}{SLe} \]

where \( Cg \) is the capacity to give, \( Y \) is income, \( T \) is taxes, and \( SLe \) is expenses to maintain one's standard of living.

The 1991 and 1993 tax law changes increased the marginal income tax rate on individual incomes greater than $250,000 from 31.0 percent to 39.6 percent, an increase of 27.7 percent. For both Donald and Able, the increases in marginal income tax rates decrease the potential capacity to give by an amount precisely equal to the amount transferred by way of the tax increase from the individuals to the government. This is an expression of the negative income effect. Therefore, before the 27.7 percent increase in marginal income tax rates, the capacity to give was greater because any wealthy individual paying taxes at the tax rate would have been left with 8.6 percent more of the discretionary income taxed at the maximum rate. Expressed symbolically,

\[ Cg \text{ (at time 1)} = \frac{Y - .31(Y) - SLe}{SLe} \]

while \[ Cg \text{ (at time 2)} = \frac{Y - .396(Y) - SLe}{SLe} \]

At the same time, every change in marginal income tax rates also changes the cost of giving, or what amounts to the psychological capacity to give. That is, every increase in marginal income tax rates that produces a negative income effect also produces a countervailing positive price effect, reducing the cost of giving. As marginal income tax rates increase, the additional amount of discretionary income that a donor must contribute to determine the social use of a dollar decreases. For example, a marginal income tax rate of 31 percent means that for every philanthropic dollar that donors choose to direct, it costs the donors 69.0 cents and the government 31.0 cents. However, with a marginal income tax rate of 39.6 percent, every dollar of philanthropy costs the donor 60.4 cents and the government 39.6 cents.

Because the price and income effects interact with each other in opposite directions and with the other effects I will discuss, and because of potential additional changes in the cultural environment and motivational situation of donors, it is difficult to predict the long-term effects on charitable giving. For instance, while the changes in marginal income tax rates encourage giving by reducing the cost (or price) of making a gift from 69.0 percent to 60.4 percent, the same changes discourage giving by reducing the amount of donors' discretionary income. Fortunately, the third variable in the preceding formula provides a hint about how to determine the relative impact of the income and price effects. By taking into account the degree to which a new income tax schedule impinges on a wealth holder's customary standard of living, we can begin to estimate how consequential the negative income effect may be. For instance, a high capacity-to-give index, say at 5, indicates a high degree of redundancy in the donor's capacity to give; therefore, the donor is less likely to alter his giving pattern. If the capacity-to-give index is at or below 1, then the income effect is more likely to reduce his giving. Intuitively, this means that wealthy individuals who lose a greater amount of their discretionary income because of an increase in marginal income tax rates will reduce their giving more than will the superwealthy, whose income stream is relatively less affected. For instance, we would expect small business owners who have a greater proportion of their assets as foundational to their business to be especially sensitive to such negative income effects. In contrast, for wealth holders whose cash flow is derived from tax-free bonds or generated from real estate depreciation, the income effect on capacity to give is less significant and could be negligible.
The second 1993 tax change permitted a charitable deduction equal to the fair market value for gifts of appreciated property made to qualified charitable organizations. The difficulty in obtaining valid evaluations for appreciated property, particularly with respect to works of art, led lawmakers in 1986 to rescind the provision that allowed deductions to be determined by current market value of the appreciated assets. The 1993 change allows the donor to receive not only a deduction for the original cost of the gift but for whatever appreciation may have occurred since the donor acquired the asset.

This provision also affects charitable giving by a price and an income effect. But in this case, not only is the price effect extremely positive, but the effect on the donor's cash flow is positive as well. The behavioral effect should be a short-term increase in gifts of appreciated property and a sustained higher level over the long term. For example, let us consider a gift of a work of art or restricted stock with a current market or appraised value of $100,000 and a cost basis of $10,000. Subject to annual limitations, this gift now provides the donor a $100,000 deduction, or a reduction in taxes of $39,600 (at 1993 top bracket of 39.6 percent), versus the situation prior to the change, which provided a deduction of $10,000 and a reduction in taxes of $3,100 (at the pre-1993 top bracket of 31 percent). In addition, when capital gains tax savings are taken into account, the cost is reduced even further, to just $35,200 ($100,000 less 28 percent capital gains tax on $90,000, which equals $74,800 less the income tax deduction of $39,600, or $35,200). Prior to the change, the net cost to the donor would have been $71,700 ($74,800 minus $3,100). Thus, the tax change produced a reduction in the cost of giving this type of asset by 49 percent, increasing the donor's cash flow by $49,000. For those with such assets, this change provides the opportunity not only to make a significant contribution of a non-income-producing asset at a relatively low cost but also to convert the reduction in taxes into a positive cash flow. Given these calculations, we can confidently predict that an increase in donations of this type of asset will occur.

The liquidating effect

People's capacity for philanthropy cannot be defined without reference to the liquidity of their assets (that is, the relative amount of wealth invested in various types of assets, such as real estate, stocks, bonds, cash, collectibles, and privately held small businesses) and the flexibility to shift or redistribute wealth among the various asset holdings as their needs change or in response to changes in the tax code.

The composition of a particular individual's assets reflect his or her preferences based on the characteristics of assets with respect to safety, liquidity, and yield. With the exception of privately held small businesses, individuals allocate their wealth in pursuit of some or all of the following objectives:

- Preservation of capital or safety
- Payments from assets
- Growth of capital to increase wealth
- Deployment for philanthropic purposes

Both income and estate tax provisions influence these allocations. For example, an allocation that pursues growth may limit one's capacity for philanthropy in the short run while enhancing it in the long run. As I already noted, the cost of allocating assets for philanthropy depends not only on the asset but on whether and how one owns it—for example, as appreciated stock, collectibles, or retirement accounts.

With respect to wealth stored within the structure of a small business, little, if any, flexibility may be present because the wealth is foundational to the business and may not be able to be withdrawn without jeopardizing the health of the business. Frequently capitalized at levels that constrain growth, these entities provide the job-creating growth that fuels the larger economy. The capital requirements of these businesses, when combined with their relative inflexibility to reallocate assets in response to changes in the tax code, might sharply curtail the philanthropic activities of their owners.
Although small businesses are limited in their ability to respond to changes in the tax code, they do respond when they can and pay additional taxes when they cannot, as the following two instances illustrate. When the tax law made it more advantageous to pay taxes at individual rates rather than at the higher corporate rates, the number of businesses that switched their tax-paying status to “Subchapter S” increased from 257,475 in 1970, to 545,389 in 1980, and 1,575,092 in 1990. Conversely, changes increased marginal income tax rates for individual taxpayers and Subchapter S corporations from 28 percent to 31 percent in 1991 and to 39.6 percent in 1993. These increases had the effect of channeling what would be additional capital available for investment from small businesses to the government.

Fundraisers need to be aware that the substantial repositories of wealth stored within small businesses may be limited in their availability for philanthropic purposes.

The wealth effect
The fourth behavioral effect of tax laws concerns implications of estate tax laws for wealth transfer. The wealth effect is the behavioral response induced by tax provisions that affect both the short- and long-term capacity to give by encouraging or discouraging growth in individual wealth levels. How an individual wealth holder responds to tax provisions depends on his or her income and wealth levels relative to his or her economic needs. For the overwhelming majority of Americans, their level of wealth accumulation is somewhat below that which they desire, and so they are motivated to increase their wealth through the investment of savings. For this large segment of the population, the motivation to increase their wealth holdings will most likely be more powerful and controlling than their efforts to minimize the adverse effects of tax changes. Large in numbers but with limited wealth, this group will pursue economic goals that are compatible with what has been the expressed national economic goal—increasing gross domestic product (GDP)—ever since John Maynard Keynes first theorized, during the depths of the Great Depression, that increasing GDP was the most important factor in producing job growth.

For a small but rapidly growing number of the wealthy who control in the aggregate an inordinately large percentage of the nation’s wealth, their existing levels of wealth are equal to or in excess of their current and future economic needs. While in 1997 only 2.2 percent of families had sufficient wealth to be subject to the estate tax provisions of the tax code, projections by Havens and Schervish (1999) show that in the twenty-year period ending in 2017, 6.5 percent of the 25.8 million final estates will owe an estate tax, even taking into account the rise in the asset requirement. According to calculations by the Boston College Social Welfare Research Institute, the top one-half of 1 percent of the population owns 25.7 percent of total wealth (Survey Research Center, University of Michigan, 1998). Currently, most estimates place total wealth in excess of $30 trillion. It is in this area that income and estate tax laws interact with the personal motivations of the wealthy to encourage the allocation of assets in ways that are inimical to a national objective of providing job-creating economic growth. When the rewards associated with successful risk-taking entrepreneurial activities are taxed at such high levels (income at a marginal rate of 39.6 percent, capital gains at 20 percent, and gift and estates at 55 percent) and the losses associated with unsuccessful ventures are borne 100 percent by the investor, some owners of excess capital may be dissuaded from pursuing such ventures. The result is that such capital flows into safe wealth-preserving assets rather than job-producing growth ventures.

These effects enter into the decision making of both those whose wealth is deployed in instruments easily transferable and those whose wealth is encased in small family businesses. These effects become clearer in contemplating the explicit conflict that is present when one considers the purpose of government economic policy (to increase GDP) juxtaposed against the purposes of both groups of wealthy. The purpose of those whose wealth is readily transferred among alternative investment vehicles is all too often preservation of capital and transfer to the next generation, as opposed to growth of capital, for the obvious reason that they have enough capital for their needs. The responses among
this group to the estate tax laws are, to an increasing degree, taking several forms:

- Increasing inter vivos (while living) transfers
- Removing assets to offshore tax havens outside the jurisdiction of the taxing authorities
- Changing the status of one's citizenship to that of a country with lower estate taxes
- Allocating funds for philanthropic purposes

There has been an increase in the number and amounts of very large donations, as well as a persistent increase in overall levels of giving.

Among those whose wealth is encased in family businesses, the area in which greater job growth takes place, the responses take the following forms:

- Eschewing the risk of taking the enterprise to the next level—for example, expanding from a city operation to a statewide operation, from a statewide operation to a regional or national operation, or from a national to an international or global operation.
- Focusing the attention of the business on presenting to the government a set of financial numbers that minimizes the valuation of the businesses for estate tax purposes. Extracting 55 percent of the equity of many capital-short small businesses for estate taxes, for example, creates inordinately leveraged companies.3

I can only hint at the complexities that confront individual wealth holders as they attempt to achieve their objectives by allocating their “free” resources among investments, additional consumption, and philanthropy. For both individual wealth holders and those fundraisers who assist them as they pursue their goals in the ever changing environment, a clear understanding of the landscape in which they dwell will help them to reach their objectives.

Conclusion

Long-term trends in the United States have been evidenced by a persistent rise in national income as measured by GDP and a concomitant increase in accumulated wealth. The growth in GDP has produced for the most part an increase in discretionary income at all levels. At the lower- and middle-income levels, the increases in disposable income have been properly used to increase the living standards of those who received them. At the upper-income levels, the limitations for consumption create an unusually fertile area for the allocation of amounts of discretionary income for philanthropic purposes. This phenomenon, combined with the burgeoning number of people entering the wealthy class, defines a growing potential for philanthropy that could justify Schervish’s prediction that we are entering a golden age of philanthropy.

Notes

1. Marginal tax rates as opposed to average tax rates are used to simplify the illustration. In addition, wealth holders tend to make decisions based on marginal tax rates.
2. The capital gains tax rate currently is 20 percent.
3. The effects cited in the preceding sections reflect what an unscientific sample of residents of a small but wealthy community have done over the most recent fourteen-year period. These effects cannot be projected to the entire population of the wealthy.

References


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