

How Much Is Enough? Assessing Leadership Pay in Nonprofits

By Pete Smith

Smith Compensation Consulting

High compensation for nonprofit leaders, such as the recently reported \$1 million pay for Michael Govan, Executive Director of the Los Angeles County Art Museum, often creates a outcry for federal limits on nonprofit executive compensation. The concern is understandable, but much that's been written about this is off the mark.

Critics objecting to high levels of nonprofit compensation often hold one or more of the following views:

1. Pay for leaders in nonprofits should be reasonable in terms of competitive levels for similar nonprofit executives, and the expectations of donors and funders of charitable organizations. As such, they should almost always be below those paid in the private sector.
2. Pay for nonprofit leaders should be less than some arbitrary standard, such as the salary of the President of the United States.
3. Nonprofit leaders should work primarily for the psychic income of fulfilling important missions; compensation should not be an important factor in recruiting or retaining leaders.
4. The world is full of competent leaders who would work in nonprofit positions for compensation that critics deem reasonable.

The article's main theses are:

1. Except for the first point above, with which I fully agree, most critics of high nonprofit compensation don't have a good understanding of the dynamics of nonprofit leadership or of the pay required to attract and retain top talent.
2. Setting an arbitrary standard to limit nonprofit executive compensation would be a mistake, with damaging unintended consequences.
3. Existing controls – board oversight, the threat of fines and sanctions, and public review provide sufficient control of nonprofit compensation, even at the top. But these controls could be strengthened.

Managing Nonprofits Can Be Highly Complex

Imagine you are the CEO of a YMCA in a major metropolitan area. You are responsible every day for hundreds of children in dozens of locations; you need to structure operations and supervision so that none of them are lost or injured or abducted or drowned. This is in addition the normal responsibilities of ensuring financial health, raising funds, coordinating with city and state authorities, developing and motivating staff, etc. Few for-profit positions have a similar level of complexity and risk.

The same can be said of presidents of universities, who must combine significant fund-raising expertise with sufficient diplomacy to influence diverse constituencies (faculty, students, alumnae, trustees) to uphold and improve educational excellence. Ditto for hospital CEO's, with their financial and regulatory imperatives and diverse constituencies.

Leaders of these organizations and many other types of nonprofits are responsible for much more than revenues and profits – they nurture individual growth and development, heal and comfort the sick, shelter the homeless, protect the battered, and in hundreds of other ways improve our communities. Yes, almost all of them are willing to do this for less pay than their jobs would be worth in the private sector. But that does not mean that their pay should be limited to some arbitrary number.

Good Leadership Makes a Difference

One thing I have noticed in my nonprofit work is that there are usually four to five organizations that are considered the leaders in each city's nonprofit sector and that these leaders vary considerably by type of service provided. In city A the top charities might include a foundation or museum, in city B it may include the Girl Scouts or an animal welfare charity, in city C it may include a hospital or a homeless shelter or a zoo.

Whether a cause or result of their success, these top charities almost always attract a high level of contributions. Community leaders want to serve on their boards, where doing so is a badge of honor and acceptance. These charities usually do a good job of measuring outcomes clearly; they have a strong track record of success; they are financially stable.

These charities are not the community leaders just because of what they do – there are always equally worthy charities not in the leadership group. Sometimes their leadership results from a significant economic windfall – the Marin Community Foundation comes to mind. But almost always, somewhere during the organization's growth, an inspirational, highly effective leader brought its performance to a level where it's achievement and value became clearly apparent to the most important and influential individuals in the community. And their involvement – encouraged by this leader – contributed exponentially to its success.

Now let's assume you are a trustee of a nonprofit looking for a new leader and you want someone with the potential to build the organization to one of the premier nonprofits in your community. Or to turn around an organization in trouble. Or to greatly enhance the organization's ability to achieve its mission. The pool of potential candidates includes existing executive directors, nonprofit managers just below the ED level, and for-profit executives, either active or recently retired. Any of these candidates could be independently wealthy, willing to work for little or even no compensation.

But why limit your search to those willing to accept below fair pay? The candidate pool undoubtedly includes qualified people with children in college or other financial needs, without independent financial resources, for whom a decent salary is very important. The best leaders may come from this pool.

Why capping pay is wrong

For most nonprofits, the type of caps being paid is immaterial – few pay their top people close to \$400,000 or \$500,000. But for the small percentage of nonprofits who do pay this level of compensation, caps would create serious problems.

First, any pay limit set by the IRS or Congress or other governing body would be arbitrary. The most common suggestions are limiting nonprofit executive pay to the salary of the President of the U.S. (currently \$400,000) or the \$500,000 base salary limit being applied by the Treasury Department to organizations receiving government funding under the TARP program. But neither of these numbers reflect the value of the work being performed – they are just politically expedient numbers the public can more readily accept.

Second, any cap would undoubtedly be unfair to nonprofit executives whose scope of responsibilities genuinely reflect greater value than the cap itself. Limiting pay for university investment professionals or basketball coaches or heads of cardiology in medical schools to \$400,000 or \$500,000 would result in a unsustainable gap between what they can make in the private sector and what nonprofits could pay.

Third, it is likely that a pay cap would lead larger nonprofits to look for other ways to compensate their top people, through expanded benefits, or added time off, or job sharing, or special fees, in order to keep their best talent. The government might try to preclude this through legislation beyond the pay cap, but such legislation would be very complex and costly to administer.

Fourth, the pay cap could actually result in higher compensation for leaders of smaller nonprofits – those below the pay cap. Even \$150,000 or \$200,000 is higher compensation than the vast majority of nonprofits should be paying their executive directors today – most charities are very small. Providing an official ceiling of \$400,000 or \$500,000 could put pressure on trustees to raise executive compensation more quickly than they would do absent the cap.

Finally, in the largest nonprofits, a pay cap could cause salary compression, with many executives earning close to the cap even though their responsibilities are substantially less than those of the CEO, creating serious inequities in the compensation structure.

There is a Solution

You won't get rid of excessive pay entirely in nonprofits, no more than in any other sector. But there are good steps that can be taken to lessen the incidence of egregious pay.

First, the IRS should use existing sanctions more forcefully. These sanctions (commonly called the “intermediate sanctions”) enable the IRS to fine trustees and tax executives in cases of egregious excess compensation. But these sanctions are rarely used. According to the IRS, sanctions were applied to only xx organizations in 2008, less than x% of the charities who have reported full compensation information on their 990 forms. The IRS should be much more proactive going after cases of apparently excessive compensation.

Further support should come from publications such as the Chronicle of Philanthropy or the Chronicle of Higher Education, and organizations such as the Independent Sector or Charity Navigator. Some of these organizations may be reluctant to bite the hands that feed them, but as the Chronicle of Philanthropy has shown, pointing out specific cases of potential abuse can create change.

Most important, the Boards of Trustees should do their homework with a thorough periodic review of top officer compensation. This review should address these questions:

- Does the organization have a compensation policy, and if so what is the intended position of the organization’s compensation against the peer groups to which it will be compared. If the intended position is above average (e.g., 75th percentile), is this strategy supported by the organization’s size and complexity and/or the background, experience, and performance of the executives being reviewed?
- Is the peer group against which the organization being compared truly representative, in terms of size, mission, scope, and geography?
- How does the top executive’s market position compare to that of other executives and employees in the organization? If the CEO is the only executive at the 75th percentile while everyone else is at or below average, is there a clear justification for the difference?
- How transparent is the entire compensation package? Are there special benefits or perquisites that apply only to the top officer, and if so is there a justification for this? Will this justification stand up to public scrutiny?

With strong board oversight, a stronger and more active IRS, and aggressive publicity about questionable compensation, we can strengthen nonprofit compensation generally and reduce the incidents of abuse.

Pete Smith is the President of Smith Compensation Consulting. The former CEO of Watson Wyatt Worldwide, he now provides executive compensation consulting services to the nonprofit community.

He can be reached at pete@smithcompensationconsulting.com.

Revised March, 2011

