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Charities Shouldn't Follow Lead of Businesses in Setting Compensation for CEO's

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By Pablo Eisenberg

As the economy improves, the salaries of nonprofit chief executives will probably continue to soar.

A growing number of people argue that the skyrocketing compensation is a good trend, a sign that salaries are now being set by the marketplace, just as they are in corporate America.

One of the most vocal proponents today of this belief is Dan Pallotta, whose book, *Uncharitable,* calls for the loosening of financial restraints on nonprofit compensation.

But that path is a questionable one, and following it could undermine the ability of the nonprofit world to play its special role in serving the public's interest.

Mr. Pallotta, who ran a company that helped many charities raise money through three-day bike rides, has drawn attention to compensation issues in his book and his blog on the Harvard Business Review site. He believes charities need more room to innovate, take risks, raise capital, and produce more effective long-term results—and that won't happen, he says, unless charities can offer financial incentives to entrepreneurial leaders.

Without higher compensation, not only will charities fail to become more effective, he believes, but also the best nonprofit leaders will flee for jobs in business or government. The best young people won't flock to jobs in the nonprofit world, in his view, because most of them want to earn money and do good simultaneously.

Mr. Pallotta and his like-minded colleagues essentially argue that there should be no hard lines separating nonprofit and for-profit organizations; both should be driven by self-interest, not self-deprivation, which they claim is the current ideology of charities.

Both types of organizations should compete in the market for the best executive talent, and both should be run according to sound business practices. They assume, contrary to existing evidence, that business executives are smarter and better managers than nonprofit leaders.

Here's what's wrong with those assertions, and why more nonprofit leaders need to take a different route than the one Mr. Pallotta suggests.

Charities are not businesses. There has always been and always should be a huge difference in the mission, spirit, ethos, and work of charities and businesses.

Nonprofit organizations exist to serve what we call the public interest—the welfare, health, education, and quality of life of our citizenry, including services and functions that neither government nor business can provide. It is the social capital that glues our factions and communities together. It is based on the notion of public service, ethical behavior, and work for the common good. It calls for personnel who are not primarily interested in making big money.

Businesses exist to meet a more narrow goal, namely to make a profit.

Whenever the profit motive diverges from the concerns of the public, the bottom line trumps other considerations. Rarely do corporations initiate efforts to protect workers or consumers or to promote measures that protect the environment unless they are forced to do so by government regulations and oversight, watchdog reporting, and public pressure.

In short, they operate to maximize their financial returns with limited regard for ethical behavior beyond what the market dictates.

That key difference is why the line dividing business and charity must remain clear and intact.

Government subsidies change the rules of the game. Nonprofit groups are supported by a substantial system of tax benefits, including large deductions for donors and exemptions from taxes on sales, real estate, and investment returns for charities. Federal and state governments, in the interest of taxpayers, have the right and obligation to make certain nonprofit organizations spend their money wisely and not waste it on foolish expenditures, including huge salaries. Government has a fiduciary responsibility not to permit nonprofit salaries to be dictated by market forces.

Federal law specifically prohibits excessive compensation. But the Internal Revenue Service's standards and guidelines are so fuzzy that it has continually failed to prevent excessive compensation.

In particular, rules allowing charities to compare their salaries with those offered corporate executives with similar levels of responsibility make a mockery of the idea that nonprofit groups need a different standard. The IRS needs to tighten its regulations and enforce them.

High compensation won't increase the nonprofit talent pool. Some people believe good nonprofit managers and CEO's are so hard to find that they need to be paid excessively or that they should be recruited from the ranks of high-paying corporate personnel. That's not true.

Part of the problem is the myth, perpetuated especially by charity board members who come from the corporate world, that the quality and importance of top nonprofit positions are determined by their compensation levels, not by the attributes and competence in those filling the jobs.

Why are so many nonprofit directors' compensation packages doubled or tripled from their previous salaries when they take on a new job?

Mainly they were paid that much because their new salaries were perceived by their boards to reflect the stature of their positions.

Many fine nonprofit executives are available, and they would be satisfied with reasonably good salaries.

Search firms and nonprofit boards just don't know how and where to look for them, nor are they motivated to do so. Too many are looking for "stars" they believe must be paid outrageous salaries.

A huge amount of money is being wasted on highly compensated executives, funds that should be used to carry out charitable programs and advocacy work.

Since large organizations often set the trends for all nonprofit groups, many midsize and small organizations are now trying to keep up by providing overly generous compensation packages. Many small organizations now offer their CEO's packages that can run from 15 percent to 25 percent of their budgets.

Because the IRS has been so lax about setting tough standards concerning excessive compensation and has been reluctant to enforce their regulations, a large number of nonprofit groups and their boards are not getting the message to keep compensation packages within reason.

The public hates the idea of high pay at charitable organizations.

As Paul Light, a professor of public policy at New York University, has pointed out, increasing public awareness of compensation is likely to further erode public confidence and trust in nonprofit organizations. The result could easily lead to a reduction in charitable contributions.

Mr. Light has recommended setting a ceiling of $223,500 on nonprofit compensation, the sum the chief justice of the Supreme Court receives. I believe that is too low—$400,000 seems more like a reasonable limit to me.

To give charities time to adjust to this idea, they should be allowed to pay more than the limit but be required to pay a tax of 100 percent to 200 percent on the amount of compensation that exceeds $400,000. Such a requirement would force boards to think hard before setting high salaries.

Mr. Pallotta and his colleagues arguing in favor of high pay are dead wrong.

We don't need salary inflation to strengthen nonprofit organizations. Rather, we need to cool the inflationary spiral to bring salaries to a reasonable level, thereby ensuring the integrity of nonprofit organizations and continued support from the public for charitable institutions.

Let those who aren't satisfied with reasonable nonprofit pay take a corporate job.

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