

## COMPENSATION

# What Drives Nonprofit Executive Compensation?

by Peter Frumkin, PhD, and Elizabeth K. Keating, CPA, PhD

Ever since the professionalization of the nonprofit sector that took place thirty years ago, nonprofit executive salary has been influenced by business compensation concepts—but for-profit pay practices cannot be indiscriminately applied to nonprofits. So what really powers executive pay in the sector? As it turns out, size *does* matter.

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**W**HEN IT COMES TO ATTRACTING AND retaining talented leaders, the setting of executive compensation packages has posed continuing challenges to nonprofits since the 1980s. These challenges relate to the professionalization of the sector, the increasing desire to measure and reward success, and the need to retain and promote the most talented managers.

Due to commercialization and increased competition from for-profit and other nonprofit providers, the thinking around executive compensation practices has changed significantly over this period. Some nonprofits have shifted from fixed salaries to ones containing a variable cash-compensation component based on fundraising, cost reductions, or specific programmatic outcomes.<sup>1</sup> However, these plans have met with resistance because they tend to focus heavily on financial measures of nonprofit performance rather than on the social dimensions—namely, mission

fulfillment. Nonprofit managers have also sought "comparable pay" with business managers.<sup>2</sup>

Also influential is the fact that the benchmarking of salaries of nonprofit and business executives has become more prevalent—encouraged in the United States by a new set of IRS regulations allowing sanctions and fines to be levied on nonprofit organizations that pay their executives excessive compensation relative to similar nonprofit and for-profit firms.<sup>3</sup> Fully implemented in 2002, these new regulations allowed for cross-sector comparisons, and set standards and procedures for justifying compensation levels in nonprofit organizations. For many nonprofits, however, increasing executive compensation remains prohibitive due to budgetary and moral constraints.

So what *really* affects salary levels for nonprofit executives?

The short answer seems to be organizational size. According to our research findings, in most parts of the nonprofit world you will find a base rate of pay that increases in direct proportion (in most cases) to every \$1000 of operating expenses. To better understand nonprofit compensation practices, we tested three main competing explanations. First, we considered whether executive compensation in nonprofits is a function of the

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**PETER FRUMKIN**, PhD, is professor of public affairs and director of the RGK Center for Philanthropy and Community Service at the Lyndon B. Johnson School of Public Affairs, University of Texas at Austin; **ELIZABETH K. KEATING**, CPA, PhD, is a lecturer at Boston College and Boston University.



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size of the organization. Second, we examined the prevalence of pay-for-financial-performance in this sector. Third, we looked at the role of liquidity, or “free cash flow,” and examined its effect on compensation. The second and third tests are particularly important in the nonprofit context: if a strong association exists between compensation and financial performance or liquidity, it would challenge the effectiveness of the nondistribution constraint, a standard that prohibits the paying out of excess earnings and requires instead their application to advancing the mission of the organization.

### For-Profit CEO Compensation

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The extensive body of research in this area reveals three general themes. First, compensation studies consistently find a link between the size of the company and executive compensation.<sup>4</sup> Faced with considerable uncertainty, companies pay CEOs based on the scope of their responsibilities and the amount of resources they are charged with managing. Herbert A. Simon’s early explanation of this phenomenon was that firms use compensation to distinguish between different managerial levels, and since large firms have more levels, they tend to pay their leaders more than smaller and less hierarchical companies.<sup>5</sup> Subsequently, extensive empirical work has demonstrated that managers earn more when they have been entrusted with leading large companies.<sup>6</sup>

Second, many studies have examined the link between a company’s financial performance and executive pay. Some have found a connection to profitability, although many other studies have concluded that firm performance is not a key driver of CEO compensation.<sup>7</sup> Researchers also focused on relative performance evaluation, and tested whether CEO pay decisions were driven by the performance of a manager compared to his or her peers in a given field.<sup>8</sup> One reason why boards might take into consideration the compensation decisions of other companies stems

from the possible increased efficiency that such information might make possible.<sup>9</sup>

The third theme relates to the independence and relative power of the board.<sup>10</sup> In situations where the board is not independent or is weak, CEOs may be highly compensated due to poor oversight or collusion. In either case, the control systems designed to protect the interests of shareholders fail. Some research has also considered the relative power and influence of shareholders in an attempt to understand board decision making.<sup>11</sup> Recent compensation studies have been primarily practitioner focused, with salary ranges and averages reported, making it difficult to attribute reasons for differences.<sup>12</sup>

The conceptual framework for business remuneration, however, cannot be directly applied to nonprofits, since they must, by law, observe a nondistribution constraint. And, if they adhere to this constraint, neither liquidity nor financial performance should—in principle at least—result in higher pay.

### Findings

We did not examine the question of board oversight in our study, focusing instead on size, performance, and liquidity. We went into the project with some conjectures, namely that (1) CEOs managing large nonprofits will earn more than CEOs at smaller organizations, (2) nonprofit CEO pay will not be based on the financial performance of the organization, and (3) nonprofit CEO compensation will not be determined by liquidity or free cash flows.

The sample data used in our analysis originate from the annual IRS Form 990 nonprofit tax filings for the period of 1998 through 2000. At the outset of our analysis, we ran pooled sector-wide regressions to understand the overall relation between compensation and the explanatory variables. The sector-wide regressions were then compared to determine if one hypothesis accounted for significantly more of the variance in compensation. To control for firm dependence, we assessed the statistical significance of individual variables using a t-test, which assesses whether the means of two groups are statistically different from each other. To assess the relative explanatory power of

groups of variables, we used the Vuong test, which evaluates whether the difference in the explanatory power of two regression models is statistically significant.<sup>13</sup> For our dependent variables, we used three different measures of compensation: CEO salary, CEO benefits, and total CEO compensation (which simply combines executive salary and benefits).<sup>14</sup>

To test our first hypothesis, we relied on two variables: lagged total fixed assets and lagged total program expenses. We chose total fixed assets as a proxy for scale of operations and total program expenses as a measure of the annual budget.<sup>15</sup> To test our second hypothesis, we developed two variables associated with pay-for-performance compensation: administrative efficiency and dollar growth in contributed revenue.<sup>16</sup> To test our third hypothesis, we selected three variables that determine whether an organization is cash constrained or has free cash flows: lagged commercial revenue, liquid assets to expenses measure, and investment portfolio to total assets measure.<sup>17</sup>

Since the nonprofit industry is quite heterogeneous, we explored the compensation question in the major subsectors: arts, education, health, human services, “other,” and religion.<sup>18</sup>

### Arts

The compensation of arts CEOs increases more rapidly relative to program expenses than in the other subsectors, and the remuneration of arts CEOs is negatively associated with commercial revenue share. This stands in contrast to the positive relation of this factor in the remaining subsectors.

Greater administrative efficiency, higher liquidity, and a more extensive endowment are associated with higher compensation, but generating additional contributions is not. Overall, the organizational-size variables explain a substantially greater proportion of the variation in compensation for arts CEOs than the other two factors combined.

### Education

While arts executive pay is closely related to program expenses, CEOs at educational institutions receive compensation that is significantly

associated with fixed assets. These organizations include primary and secondary schools, as well as colleges and universities. Unlike the arts CEOs, educational leaders are better compensated when their organizations have growth in contributions but not when they are more administratively efficient.

### Health

Due to the competition in the health subsector between for-profit and nonprofit firms, one might expect that compensation would be more heavily weighted toward the pay-for-performance variables. Instead, we found that CEO compensation in this subsector is strongly related to organizational size. It is weakly tied to administrative efficiency, and is not significantly related to growth in contributions. From these results, we concluded that compensation in the health subsector is not closely tied to classic pay-for-performance measures.

With regard to free cash flows, we found that the sensitivity of CEO remuneration to increases in the commercial revenue share is highest in the health subsector. Health CEO remuneration is also quite sensitive to the relative size of the endowment. We found no significant relation between health CEO compensation and liquidity. Overall, the organization-size variables explain a greater portion of the variation in pay in the health subsector than the pay-for-performance and free cash flow variables combined.

### Human Services and “Other”

CEO compensation in the human-services and “other” subsectors exhibit considerable similarities in the magnitude of the coefficients. Total program expenses are significantly related to compensation, with a \$10–\$11 gain in compensation for each \$1,000 increase in program expenses. In neither case are total fixed assets significantly associated with remuneration. CEOs in both subsectors can expect to be financially rewarded for greater administrative efficiency and when the share of commercial revenue is higher and the relative size of the investment portfolio is larger. One striking difference is that CEOs in the other subsectors receive substantially higher compensation

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when contributions are increased, while CEOs of human-service providers oddly receive significantly lower compensation when liquidity is higher. In both subsectors, the organizational-size variables had more power to explain compensation than the other two variable groups combined.

### Religion

Compensation for religious leaders differs substantially from the other sectors. First, “base” pay and both organizational-size variables are insignificant. In the area of pay-for-performance, the regression results indicate that compensation is not directly associated with growth in contributions. More unusually, it is negatively related to administrative efficiency. In one regard, the CEOs of religious organizations are similar to their counterparts: their compensation is significantly associated with the commercial-revenue share and the relative size of the investment portfolio. For CEOs of this subsector, the size hypothesis was most strongly supported, but it did not dominate the other two hypotheses combined.

### Conclusions

We found that nonprofit CEOs are paid a base salary, and many CEOs also receive additional pay associated with larger organizational size. Our results indicate that while pay-for-performance is a factor in determining compensation, it is not prominent. In fact, in all the subsectors we studied, CEO compensation is more sensitive to organizational size and free cash flows than to performance. While our analysis suggests that nonprofits may not literally be violating the nondistribution constraint, we did find evidence that CEO compensation is significantly higher in the presence of free cash flows. In only one subsector (education), however, did we find evidence that free cash flow is a central factor.

The IRS intermediate sanction regulations have been used to penalize nonprofits that excessively compensate executives.<sup>19</sup> These regulations determine the reasonableness of executive compensation based on benchmarking against comparable organizations. Our analysis suggests that strong industry-specific similarities in pay are related to free cash flows and, to a lesser extent,

organizational size, rather than to performance. Hence, the existing regulations may not be particularly effective in identifying either absolute levels of compensation that are too high or organizations that are violating the spirit of the nondistribution constraint.

One final implication of our analysis bears on the enduring performance-measurement quandary that confronts so many nonprofit organizations. We believe that nonprofits may rely on organizational size to make compensation decisions, drawing on free cash flows when available, rather than addressing the challenge of defining, quantifying, and measuring the social benefits that they produce. Nonprofits typically produce services that are complex and that generate not only direct outputs but also indirect, long-term, and societal benefits. These types of services often make it difficult to both develop good outcome measures and establish causality between program activity and impact. In the absence of effective metrics of social performance and mission accomplishment, many organizations rely on other factors in setting compensation. Perhaps, once better measures of mission fulfillment are developed and actively implemented, nonprofits will be able to structure CEO compensation in ways that provide appropriate incentives to managers who successfully advance the missions of nonprofit organizations, while respecting the full legal and ethical implications of the nondistribution constraint.

### NOTES

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13. The Vuong test indicates that compensation is most strongly related to the first hypothesis. Not only do the size variables provide more explanatory power than either the pay-for-performance or free-cash-flow variables, they explain more variation in compensation than the other two hypotheses combined. When compared to the pay-for-performance variables, the free-cash-flow metrics have higher explanatory power, meaning that compensation is more closely related to free cash flows than to incentive performance.

14. Prior studies have generally used total assets or log of total assets as a proxy for size. Our field experience with nonprofits leads us to believe that boards set CEO compensation based on annual budgets and scale of operations in comparison to industry peers.

15. In nonprofits, total program expenses include cost of program services but exclude administrative and fundraising expenses. We expected CEO compensation to be positively associated with both fixed assets and program expenses.

16. To measure *administrative efficiency*, we took one minus the administrative expenses to total expenses. *Dollar growth* in contributed revenue is a particularly observable measure that boards may correlate with CEO effort.

17. Commercial revenues are composed of proceeds from sales of goods as well as program service fees and charges generally paid by clients, insurance companies, or some government agencies. Often, these funds are relatively free of donor oversight or externally imposed restrictions.

18. Developed by the IRS, National Center for Charitable Statistics, and the Foundation Center ([nccs.urban.org/classification/NTEE.cfm](http://nccs.urban.org/classification/NTEE.cfm)).

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