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Donor Support of Nonprofit Overhead

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Abstract

Many nonprofits suffer the ill effects of the starvation cycle, when charities perceive and feel pressure by donor expectations to minimize overhead costs. Donor expectations are derived, in part, from the labor donation theory and castigated by Dan Pallotta in his fundraising model made popular by a hopeful nonprofit manager audience. Although a broad literature exists on the starvation cycle’s ill effects, not much research has been done on whether the perception of an organization’s governance affects donor support of overhead, including compensation. This study reviews and discusses the labor donation theory and Pallotta’s fundraising model and concludes that board governance makes a positive difference in donor support of overhead. Recommendations are provided for how donors can be informed of an organization’s good governance. This is an important study because it could provide an alternative to the starvation cycle and its ill effects.

Keywords: nonprofit overhead support, starvation cycle, labor donation theory, Pallotta

When I was in high school, I asked my father if he would sponsor me for a walk to raise money to fight hunger. He was skeptical about the cause and said before he would give any money, he would need to know how much the executive director’s salary was. Naively I called the salary was and promptly ended the conversation. Many donors, like my father, want their money to go toward a nonprofit organization’s cause, not to what they perceive as overhead cost, and certainly not toward someone’s compensation.

Dan Pallotta, head of the Charity Defense Council and inventor of the multi-day charitable event industry, has made his living expounding the unfairness of the lack of support for nonprofit overhead, including executive compensation. As Pallotta says in his popular 2013 TED Talk,
“[w]e have a visceral reaction to the idea that anyone would make very much money helping other people” (3:20). Unfortunately, this common mindset has created a “starvation cycle” that Gregory and Howard (2009) find begins with unrealistic expectations funders have about what it costs to run a nonprofit organization, which results in organizations misrepresenting their overhead costs and, meanwhile, cutting back on important infrastructure and resources. A 25-year study of nonprofit data by Lecy and Searing (2015) shows that reporting of overhead cost, especially administrative expenses, has declined over that period and that most of the cuts have fallen on wages of nonexecutive staff and professional fees.

Charity watchdog groups BBB Wise Giving Alliance, GuideStar, and Charity Navigator (2013) provide an open letter to donors printed by Crain’s Detroit Business that stated “overhead at a charity is not a bad thing” (p. S007). This is supported by Stahl, in The Foundation Review (2013), a peer-reviewed journal whose readers are foundation staffs and boards, who made a much stronger statement advocating for funders to invest in talent and staff support systems because it will not only increase the performance of their grantee organizations, but also make funders themselves more effective. These statements are undergirded by Harris, Petrovits, and Yetman’s (2015), who found evidence that, although efficiency is a consideration for funders, governance attributes are important in their decision-making so nonprofit managers and boards should not focus so much on expenditure ratios.

Many studies have been done on how overhead costs affect giving. Portillo and Stinn (2018) provide an extensive review of those studies conducted thus far in the twenty-first century, while their own study finds that if donors are not provided an overhead-free option, they would prefer to give toward fundraising costs rather than salary. Very few studies, however, address donors’ willingness to give toward overhead, including compensation, if it is made clear that the organization is governed well. This, then, is an important study because it could provide an alternative to the starvation cycle and its ill effects.

I hypothesize that donors will give toward a nonprofit organization’s overhead cost, including the compensation of staff, if it is made clear that the organization is governed well. To find if this hypothesis is true, this paper reviews and discusses the available research on the labor donation theory, on Dan Pallotta’s fundraising model, and on the giving practices of donors based on the charity’s governance. The following section defines key
concepts. The section after that describes the labor donation theory, which is followed by a section on Dan Pallotta’s fundraising model. The penultimate section provides studies showing evidence of good governance breeding donor support of overhead, and the final section offers conclusions and recommendations.

Defining Key Concepts

In order to discuss the hypothesis that donors will give toward compensation if the organization is well-governed, it is necessary to define what is meant by overhead, what it means for an organization to be governed well, and how one finds out about the governance of an organization.

Overhead Cost

Overhead consists of administrative costs and fundraising expenses. These encompass anything, including staff time (and compensation of that time), that is not devoted to program activities (BBB Wise Giving, GuideStar, & Charity Navigator, n.d.). This article will focus on the compensation aspect of overhead, especially executive compensation, as that seems to be the most abhorrent to donors.

Well-Governed

For an organization to be well-governed, the board must perform its core functions. Relevant to the governance of an organization’s overhead are the board’s ability to establish policy; ensure and enable accountability; secure essential resources (including staff) to accomplish the organization’s mission; lead and manage CEO performance, including recruiting, hiring and setting compensation; and ensure effective use of resources (including staff) to accomplish the organization’s mission (Renz, 2010). If a board performs all of its core functions thoroughly and reviews its processes regularly, the organization will be well-governed. Although enacted in response to a series of corporate financial scandals, the Sarbanes-Oxley Act of 2002 provides nonprofits with good governance practice that should also be followed. The act underscores some of the core functions listed above,
but provides more detail in terms of accountability and compensation. Relevant provisions, as quoted by the American Bar Association, hereafter ABA (2012), include:

- Audit committee review[s]… accounting policies and decisions and the adequacy of its internal control systems, and oversee[s] the accuracy of its financial statements and reports; [c]ompensation committee determines the compensation of the chief executive officer and determines or reviews the compensation of the other executive officers and assures that the compensation decisions are tied to the executives’ actual performance in meeting predetermined goals; [e]xecutives… should be compensated fairly and in a manner that reflects their contribution to the organization. (pp. 27-28)

The need for transparency is also accounted for in the act, so, by following the act’s guidance, the board would be expected to assure that “[d]isclosure and integrity of institutional information” exists and “[c]hics and business conduct codes” are in place and being followed (ABA, 2012, pp. 27-28).

In order for an organization to be well governed by its board, the above core functions must be performed and overlaid with the good governance practices from the Sarbanes-Oxley Act. Making sure these functions and principles are attended to, the board will be performing its duty of care, requiring that directors “be reasonably informed about the organization’s activities, participate in decision-making, and act in good faith”, as well as their duty of obedience, requiring that directors “comply with applicable federal, state, and local laws, adhere to the organization’s governing documents, and remain guardians of the organization’s mission” (Hopkins & Gross, 2010, p. 59).

Information Gathering on Governance

To make decisions about whether or not to support an organization, donors must be able to find information about how well the organization is governed. This information is much more readily available since 2008 when a list of questions about governance was added to the Internal Revenue Service (IRS) Tax Form 990, which is publicly available (Harris, Petrovits, & Yetman, 2015). Not only is Form 990 a ready source for donors to review now, but they can also be assured the board has approved its contents because that is a legal requirement before it is filed.
Giving Toward Overhead – What the Research Says

Reviewed and discussed here are labor donation theory, Pallotta’s fundraising model, and whether board governance makes a difference in donor support of overhead. It is important to address the labor donation theory because it belies some of our most prevalent thoughts as donors about nonprofit fiscal management and is the basis for the starvation cycle. In contrast, Pallotta’s model is extremely popular among nonprofit managers because of the hope it breeds that managers won’t have to be tied to the real or perceived restrictions that produce the starvation cycle.

Labor Donation Theory

The labor donation theory contends employees of nonprofits work for less than their counterparts in the for-profit workforce because they are donating their time to some extent to the organization’s cause, and donors reward this. Hansmann (1980), who seems to be the father of this theory, posits that nonprofits screen “selectively for a class of entrepreneurs, managers, and employees who are more interested in providing high-quality service and less interested in financial rewards than are most individuals” (p. 876).

Becchetti, Castriota, and Tortia (2013) take the definition a bit further to include the mission of the organization as a motivation and summarize the theory this way:

The common rationale… is that wage-earners will accept lower pay if they find intrinsic (non-monetary) value in their jobs. This implies that intrinsically motivated workers who find that their motivations are satisfied in their occupations and in the missions of their productive organisations, are willing to donate labour to them. (pp. 379-380)

According to Bishow and Monaco at the U.S. Bureau of Labor Statistics (2016), nonprofit management and professional wages are, in fact, lower compared with wages of their for-profit employee counterparts. But there are two assumptions in the labor donation theory. One is from the employees’ point of view that they believe so much in the cause, that is, they are so intrinsically motivated, that they donate their labor, to a certain extent, by accepting a lower salary. Becchetti, Castriota and Tortia (2013), however, find evidence that suggests the donative labor theory is weak.
Chen’s (2014) research concurs, finding that nonprofit managers’ desire for pay and security is not less important to them than their intrinsic motivation. In fact, Gneezy and Rustichini (2000) and Becchetti, Castriota, and Tortia (2013) find that receiving an increase in pay can even enhance staff performance and productivity if the pay is high enough. This is underscored by Berlin, Masaoka, and Schumann (2017), who found that when organizations strove to keep down overhead costs, programming and services were diminished in quantity and quality. So, if an organization’s employees are putting forth more effort, improving their performance, and providing more quality programs, that would infer goals set through the board’s strategic planning are being met or exceeded, and would signal that an organization is being governed and run well. The positive effect is cyclical: In addition to employees performing better, the organization would be able to attract good talent if its positions are being compensated at fair market value. Better talent means better performance and better progress toward the organization’s goals toward accomplishing its mission.

The second assumption in donative labor theory is from the donors’ point of view. Donors expect that nonprofit employees should donate some of their labor and work for a lower salary. Balsam and Harris (2014) find that donors reduce their support of nonprofits after disclosure of high executive pay. The effect “is most negative for nonprofits that are more charitable in their focus, as opposed to nonprofits that provide services to their donors” (Balsam & Harris, 2014, p. 446).

Although Balsam and Harris (2014) show that contributions from “sophisticated donors” decline with higher compensation levels, a more recent study by Harris, Petrovits, and Yetman (2015), finds “compensation policies [emphasis added]... can help to assure donors that their gifts are not being used to fund excessive salaries...” (p. 589). Good policy is developed through good board governance and assures donors that their money is being used well. If board policies dictate that employees are paid, not excessive salaries, but fair market value, employees will perform well.

Balsam and Harris (2014) find that sophisticated donors seem to look for and use Form 990 compensation information when making donation decisions, but donors may not always be able to tease out whether the compensation of staff is being well governed. According to the Overhead Myth website (n.d):

The applicable portion of employee and executive salary expenses are recognized or “allocated” to three functional expense categories based
on the estimated time staff members devote to carrying out each of these functions: program service activities, administration, and fundraising. The vast majority of salary expenses are counted as programmatic rather than as administrative or fundraising. (FAQs, paras. 6-7)

As long as reporting salary expenses as mostly programmatic is truthful, this is a perfect example of what should be clearly communicated to donors so that they understand exactly how money is being spent. If the compensation in question is allocated as administrative, such as human resources or accounting, that too must be communicated by making a case that these are necessary functions to make the organization run. By dedicating professionals to these roles, the organization’s board, performing its core functions, is securing essential resources and ensuring effective use of those resources for the organization to accomplish its mission. After synthesizing existing research on overhead costs and conducting interviews with nonprofit managers, Bedsworth, Gregory, and Howard (2008) recommend that organizations frame the discussion with donors around organizational goals, communicate the logic for increased overhead to all levels of the organization, and provide donors with other ways to measure performance. This communication can be done in a variety of ways, including publications, a website, traditional and social media, events, and meetings with donors, to name a few. Given that donors are more likely to support organizations that are governed well, the organization should find creative ways to educate supporters about what the core functions and duties of the board and executives of the organization are and how they go about their work ensuring the organization is as effective in accomplishing its mission that it can be. This way, donors will feel confident they are giving to a well-governed organization. Sophisticated managers may be the ones to do this communication as they seem to feel less pressure to manage ratios to appear more program-oriented than they actually are, according to Parsons, Pryor, and Roberts (2017).

Portillo and Stinn (2018) studied whether supporters have an aversion to certain types of overhead and found that the average donor prefers to direct donations toward a charity that has an overhead-free option readily available. However, if donations are not overhead-free, most prefer the donation go toward fundraising efforts instead of salary-related costs. This builds on Gneezy, Keenan, and Gneezy (2014), who, based on their study, advocate for using donations from a major donor to cover overhead
expenses so that the nonprofit can offer other potential donors an overhead-free donation option, which increases the donation rate by eighty percent. This increase in donations seems positive. The problem is that this idea undermines the real education that needs to happen. Doing what these researchers suggest perpetuates the idea that overhead is not worthy of being supported. The bottom line is that it costs money for nonprofits to offer services not covered by the government or by the private sector and it is in everyone’s best interest if we all contribute to that public good.

Pallotta’s Fundraising Model

Dan Pallotta, a fundraising consultant, reacts against the labor donation theory, arguing that donors shouldn’t worry about how much overhead it takes to raise funds, as long as a lot of money is being raised toward the cause. He begins his very popular 2013 TED Talk arguing that “the things we’ve been taught to think about giving and about charity and about the nonprofit sector are actually undermining the causes we love…” (0:50). He lists five areas in which our “belief system… discriminates against the [nonprofit] sector…, the first being compensation” (3:00). “We have a visceral reaction to the idea that anyone would make very much money helping other people” (3:15). This way of thinking, he says, “gives a really stark, mutually exclusive choice between doing very well for yourself and your family or doing good for the world to the brightest minds coming out of our best universities,” (3:50). This, he says, “sends tens of thousands of people who could make a huge difference in the nonprofit sector marching every year directly into the for-profit sector because they’re not willing to make that kind of lifelong economic sacrifice” (3:60).

Pallotta cringes at the question: “What percentage of my donation goes to the cause versus overhead?” (11:45), saying we ask this question because we are under the mistaken perception that “the less money you spend on fundraising, the more money there is available for the cause” (12:35). But, he argues, “investment in fundraising actually raises more funds” (12:45) and ends his argument with “Who cares what the overhead is if these problems [the cause has been established to address] are actually getting solved?” (17:30).

Pallotta’s argument essentially breaks down to these components:

1. People should be allowed to make a lot of money even if they are working for a charity because then charities could attract the
best talent to work for them and they could solve big problems.

2. These large salaries would be paid for by big fundraising
efforts, the cost of which funders shouldn’t worry about, but
rather they should focus on how much is netted for the cause
to be effective.

To Pallotta’s first point about attracting talent, he is correct that
nonprofits are competing with for-profit companies. Lisa Brown Morton,
Nonprofit HR’s former chief executive officer, referring to the improving
economy, predicted in 2015 that nonprofits would “find it harder to retain
staff as lucrative jobs at for-profit companies open up…. Organizations that
continue to pay below the market will find themselves lagging further and
further behind” (Daniels, March 4, 2015, para. 5, 7).

No doubt good talent is important at all levels. Meer (2017) underscores
the tenuous connection between overhead cost ratios and an organization’s
effectiveness and notes that a fixation on overhead costs leads organizations
to divert investment from important functions, especially expert workers.
It is especially important to have good, expert talent at the executive level
because the executive director, along with the board, must integrate resource
acquisition, strategy, and mission, according to Herman (2010). This,
however, does not require an excessive salary such as the chief executive
officer of a publicly traded company receives. In fact, Chikoto and Neely’s
(2014) findings show that large expenditures in executive salaries negatively
affect the potential for nonprofits to grow financially.

Although large salaries negatively affect potential financial growth, a fair
market wage is appropriate. The doctrine of private inurement holds that
compensating employees of nonprofits is legal, provided the compensation
is reasonable, which translates to fair market value paid for like services by
like organizations (Hopkins & Gross, 2010). Fair market value means not
only how the compensation compares to like positions elsewhere, but it
also reflects what the market will bear. In the case of nonprofits, they are
offering a service to the public that the government is not providing or
cannot provide and is not lucrative enough for a private entity to provide.
A value is placed on that service, tied to which is the value of the integrity
of the organization that offers it. Nonprofits have to build that value in
stakeholders’ minds, so they can see the importance of the service and of
the staff that provides the service. Donors also need to understand the
value of the integrity of the organization, which translates to how well the
organization is governed.
Pallotta’s second point is that big salaries for good talent, along with the rest of overhead costs, can be covered by big fundraisers, without regard for how much overhead the fundraisers themselves produce. A master with language, Pallotta nearly creates a cult of personality, which accounts for the 4.5 million views his TED Talk has had on YouTube. Part of his approach plays on people’s wariness of others’ selfish motivations and then he flips the argument.

Quoted in an article in *Stanford Social Innovation Review*, Deborah Small, professor of psychology and marketing at the University of Pennsylvania, observes about Pallotta’s arguments that “if you change the counterfactual so that people are thinking not about how much more the organization could have done [with more money going to the cause rather than to overhead], but about how much less they could have done, the organization appears [more favorable]” (Day, 2014, 65). Ken Berger, former president of Charity Navigator, paints a more nefarious picture of Pallotta, that his model lacks accountability. Quoted in the *Chronicle of Philanthropy*, he says “there are ‘kernels of truth’ in Mr. Pallotta’s messages. ‘But when you look under the surface,’ he adds, ‘he becomes an apologist for anybody doing anything without accountability’” (Perry, 2013, p. 7).

A well-governed nonprofit would not allow even the appearance of a lack of accountability. As mentioned above, the Sarbanes-Oxley good practices require accountability, as well as transparency, which Pallotta seeks to avoid. “In the absence of fraud, [Pallotta and his supporters] argue, regulators have no business telling charities how much to spend on fundraising or make them volunteer that percentage to potential contributors.” This is a slippery slope as “Pallotta’s anti-overhead stance can give cover to charities that mislead donors about where donations go” (Perry, 2013, p. 7). Pallotta’s suggestion of opacity may benefit nonprofits in the short run, as Wong and Ortmann (2016) find that donors care about the “charity price” or overhead ratio because they want their donations to do the most good they can, but they dislike searching for the overhead ratio because it costs them in time and effort. Their literature review finds that if donors are not able to easily find information on a nonprofit, they may give to it anyway. Nevertheless, this lack of transparency makes donors wary of the nonprofit sector as a whole and thus counteracts the very thing Pallotta claims he wants for nonprofits, which is to get on with solving big problems. Exposed unethical behavior in one organization diminishes the
reputation of other organizations, so instead of working on solving big problems, they are spending time, money, and energy doing damage control with their stakeholders.

**Giving Practices of Donors Based on Organization’s Governance**

Chikoto and Neely’s (2014) findings suggest that an organization may not be able to grow financial capacity without investing in administration and executive compensation. This is underscored in Mitchell’s (2017) study, which finds that “fiscal leanness appears to inhibit fiscal responsiveness” (p. 1272). If good governance of an organization includes ensuring effective resources and effective use of those resources, as shown above, it follows that compensating staff appropriately to help respond to the economic environment and growing the organization’s financial capacity is important.

Yan and Sloan (2014) studied the impact that above-the-median employee compensation has on nonprofit donations and whether the impact depends on the financial performance of the organization. Their findings show that, although higher than median employee compensation is unfavorable for donations overall, “the negative effect is mitigated by sound financial performance” (p. 1). Again, sound financial performance signals good board governance, and therefore even the perceived problem of an organization’s above-the-median compensation is mitigated.

Harris, Petrovits, and Yetman (2015) make an even more direct connection between donations and good governance. They “find consistent evidence that donations and government grants are positively associated with… factors that capture good governance, including… review and approval of executive compensation” (p. 579). In fact, their “evidence indicates that improved governance over executive compensation results in the largest increase in donations for [their] sample” (2015, p. 607). It should be noted they do not find that the compensation must be kept low. They find that donations increase when it is made clear compensation is being governed well.

Evidence from the literature thus shows that it is much more effective and constructive for the cause and is a much more sustainable solution for the organization to govern with transparency and accountability so that no one suspects any unethical behavior and the organization maintains the public trust. By seeing that the board is performing its duties, functions,
and good governance practices set out by Sarbanes-Oxley, donors are more likely to give to the organization.

Conclusion and Recommendations

As can be seen through the discussions of labor donation theory and Pallotta’s fundraising model, neither are helpful in accomplishing charities’ missions. In fact, they can reduce efficiency and damage organizational reputation, both of which cause donors to shy away from donating to charities. BBB Wise Giving Alliance, GuideStar, and Charity Navigator (n.d.) wrote an open letter to nonprofits in 2014 urging them to “demonstrate ethical practice and share data about [their] performance,” “manage towards results and understand [their] true costs,” and “help educate funders (individuals, foundations, corporations, and government) on the real cost of results” (homepage, paras. 3-5).

As demonstrated above, good governance results in these very things: ethical practice, transparency, and securing and using resources efficiently. Therefore, the hypothesis that donors will give toward a nonprofit organization’s overhead, including the compensation of staff, if it is made clear that the organization is governed well, is true.

When this is communicated well, donations will follow good governance. Certainly, researching nonprofits by examining their Form 990 is a good start, but all donors may not know to look at Form 990 for how well an organization is governed. It would be important for the organization to tell their story of good governance in terms of accountability, transparency, and fair compensation policy. The story should include showing how fair market wages attract experts who are accomplishing the organization’s board-approved mission and goals by increasing the quality and quantity of programs. This story should be made well known throughout the organization so there are positive ambassadors at every level, and can also be told in annual reports, newsletters, traditional media, and social media to create value in the minds of supporters.

If the executive director of the hunger charity had reframed my conversation with him regarding his salary and explained how well the organization used its resources of staff and donations, that the organization was financially sound, and told me about all the good the organization was doing, it would have saved us both embarrassment and maybe my father would have sponsored me for the charity walk.
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