

A Surer Funding Framework for Improved Public Services

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Introduction

Voluntary sector organisations are increasingly delivering public services on behalf of government. Often funding arrangements – grants and contracts – are unstable, short-term and wasteful. There is a compelling case for action to address inefficiencies within these funding relationships.

The purpose of *Surer Funding* is to examine the problems associated with current funding regimes and to provide practical solutions. This document begins by outlining the problems in voluntary sector service delivery. Analysis centres on the notion of efficiency, a concept at the heart of the public service reforms recently set out by Sir Peter Gershon.² It then presents a solution to these problems in terms of a new '*Surer Funding Framework*'. This document is a shortened version of the arguments and proposals that are contained in *Surer Funding: acevo Commission of Inquiry report*.³ Implementing the recommendations of this report would result in better value for money and improved outcomes for users in public services.

Who is *Surer Funding* for?

The purpose of *Surer Funding* is to improve public services provided by voluntary organisations. The conclusions are of interest to the following audiences:

- charities delivering public services, or those contemplating delivering services
- public funders, including local authorities, primary care trusts, government departments and non-department public bodies
- those interested in the role of the voluntary sector or in public service reform

¹ New Philanthropy Capital (NPC) is a charity that conducts research for the benefit of voluntary sector organisations and the people they help. More information is available at www.philanthropycapital.org

² The Gershon Review – *Releasing Resources for the Frontline: Independent Review of Public Sector Efficiency* – has identified and agreed £20 billion of auditable and transparent efficiency gains in 2007-8 across the public sector. This includes significant gains in improving procurement and contracting practices.

³ *Surer Funding: the acevo Commission of Inquiry report* (with research by NPC) can be purchased from acevo at www.acevo.org.uk or 0845 345 8481

The problem

HM Treasury's *The Role of the Voluntary Sector in Public Service Delivery: a Cross Cutting Review* recognises that improvement in the funding relationship with government is necessary. *Surer Funding* examines two sources of waste and inefficiency that hinder charities and other non-profit organisations from delivering their services most effectively. These result from:

- inappropriate allocation of risk between purchaser and provider
- excessive demands of application and reporting processes

It is the responsibility of funders and voluntary sector providers to recognise these problems and to seek a solution. Government has already recognised these concerns and is committed to better working.⁴ *Surer Funding* calls for the application of these commitments and for a renewed effort to bridge the gap between rhetoric and practice. It supports this with a more detailed analysis of the problems than has hitherto been undertaken.

Problem: the inappropriate allocation of risk between funder and provider

Risk is an everyday part of providing public services – the possibility of financial loss due to the uncertainties of delivering a service. Uncertainty results from factors such as fluctuation in demand for a service, changing priorities within government policy or in delivering the service to a specified standard. For funders, risk describes the responsibility for accounting for the use of public funds. For voluntary organisations, risk describes the chance that costs incurred in delivering a service to the terms of the contract exceed the revenues from the funder. It is the role of the funding agreement to distribute risks between funder and provider.

NPC's research shows that funding agreements tend to load a disproportionate amount of risk onto voluntary sector providers. The norm is for government funders to act in a 'risk averse' manner and push as much risk as possible onto providers.

Mechanisms for distributing risk

There are two main mechanisms that funders use to load risk onto the provider. The first is the use of **short-term funding agreements**. Funders prefer short-term arrangements because they satisfy a desire for flexibility, allowing them to withdraw at short notice without incurring any costs. This is particularly common in contracts for services from local authorities, as illustrated by the two examples below.

⁴ See the *Compact on Relations between Government and the Voluntary and Community Sector* and HM Treasury's *The Role of the Voluntary and Community Sector in Service Delivery: A Cross Cutting Review*

- A charity provides a day centre and transport facilities for older people to enable them to continue to live independently. It is contracted to do this by a local authority.

Funding is only provided for one year at a time, with no assurance that the contract will be renewed. This uncertainty means that the charity is not able to provide job security, and so many skilled individuals have been lost. The charity is also unable to invest in new mobility equipment that would improve the service.

A longer-term contract would result in a better service for the older people.

- John Grooms provides residential care to disabled people. Its main funding is from local authorities and health trusts under annual contracts.

John Grooms has identified an unmet need, and wants to expand its services by building new care centres. To do this, it needs to take on a bank loan. The uncertainty of contract renewal causes problems for John Grooms in borrowing. If they took on loans, and contracts were not renewed, they would be unable to meet loan repayments, and would face financial loss and potentially have to cut services for disabled people.

Greater funding security would put John Grooms in a better position to borrow and invest in new facilities and improved care for disabled people.

A second mechanism is to use **variable payment funding agreements**, where providers receive payment related to a variable that they have very little or no control over, such as the demand for the service. This insulates funders from the possibility of financial loss due to these uncertainties by shifting responsibility to the provider. This is common under a number of government funding programmes including the New Deal and Supporting People. An example is given below.

- Marie Curie Cancer Care provides an in-home nursing service to people suffering from terminal illness. They are partially funded by local primary care trusts based on the number of patient calls they make. These contracting arrangements between Marie Curie and the health service have evolved over many years..

It is not possible to forecast how many patients will need help at any point in time. As a result, Marie Curie has to employ a core set of nursing staff, and use a pool of part-time nurses to help cover peak periods. These nurses are not always available, so not all requests for a night's care for a patient can be met at peak periods, and this may end up with the patient being admitted to hospital.

With greater funding security, Marie Curie would be able to employ additional core staff to care for more patients at peak periods. It would also allow more patients to stay at home, reducing the level of hospital admissions.

These examples illustrate problems that abound across the sector, and result in services that are below the high standards required.

Risk has a cost

These examples show a few of the detrimental effects of risk on existing arrangements and demonstrate the adverse impact on the potential for increased provision. This situation is in part precipitated by a lack of understanding among funders and providers about what is the best balance of risk. Many funders believe that loading as much risk as possible onto voluntary sector providers, through short-term contracts or variable payment contracts, is the way to achieve value for money, despite government guidance to the contrary. This approach to service delivery fails to produce value for money because managing risk can have a significant cost. This cost is associated with:

- a difficulty in recruitment and retention of staff
- a need to keep high reserves to insure against loss
- a difficulty in accessing finance
- an inability to adequately plan and invest for the future

The more risk that a provider has to bear, the higher the costs are, and the more difficult it becomes to provide a consistent high quality service. Changing the allocation of risk would result in a better arrangement for everyone: better value for money for the funder, greater stability for voluntary organisations to better carry out their services, and improved services for users.

Problem: the excessive demands of application processes and reporting requirements

Just as inefficiency can result from the inappropriate allocation of risk in contracts, additional inefficiencies can occur in fulfilling the bureaucratic requirements of funders. Entering into a funding agreement typically has a significant cost in terms of the process of application and reporting on progress. Often this cost is excessive.

High costs are the result of a number of factors including:

- the large number of funding bodies each provider often has to deal with
- a lack of consistency and uniformity between funders
- a lack of flexibility in the procurement process, particularly in the application of government accounting and EC procurement rules
- overly stringent regulatory regimes
- demand for information and reporting requirements disproportionate to the size of the contract

The consequence of high transaction and reporting costs is a diversion of resources away from frontline service provision. Correspondingly, this increases the overall cost of a service. The example below provides an example of onerous reporting requirements.

- 'Tackling drugs' is the cross-department national drug strategy for drug prevention and treatment. Since December 2003, treatment agencies have had to return three sets of data to three different bodies on three different time scales. The following data is required:
 - on the 10th of each month: demographic and drug data for the Drug Treatment Monitoring Unit
 - on the 14th of each month: demographic and drug data for the Strategic Health Authority
 - on the 14th to 16th of the month every quarter: waiting time and workforce development data for the Drug and Alcohol Action Team
 - all the agencies were expected to deliver more comprehensive demographic, drug and treatment information to the National Drug Treatment Monitoring System

Within these requirements there is substantial duplication but no standardisation of the form and formats.

The demand for transaction and reporting is related to the funders' attitude to risk. Excessive costs can be seen as a result of unwillingness to trust providers to deliver services. A less risk averse approach by the funder may lead to a material decline in the red tape which threatens to overwhelm many organisations.

Efficiency in service delivery

The two problems discussed above exert a significant impact on service provision. In general, they result in services that are more expensive or lower quality than they could be under more appropriate contracting arrangements. In strict terms, efficiency describes a situation where one party cannot be made better off without a corresponding loss by another party. Inefficiency is a situation where changes can be made to a contract in which at least one party is made better off without a loss to the other party. In the allocation of risk, efficiency gains can be made by shifting risk to the party best able to manage it. In practice, this will often mean encouraging funders to take on more risk. In the case of high application and reporting costs, this will require reducing the burden through streamlining and standardising. By definition, these efficiency gains are in the interests of both the funder and provider.

The possibility of a gain without any corresponding loss is enticing. In an economists' jargon, this is known as a "Pareto" gain and it is the foundation of arguments about efficiency. The leading British economist John Kay wrote recently:

“It is hard not to be in favour of Pareto efficiency. A Pareto improvement is a politician’s dream – a policy from which there are only winners. If you could make someone better off without making anyone worse off, wouldn’t we do it?”

To illustrate the potential for Pareto gains, the examples above can be considered in more detail. Marie Curie Cancer Care and John Grooms illustrate the costs of an uneven balance of risk, transferred to the providers through different mechanisms in the contract. The Tackling Drugs Initiative illustrates the waste caused by replicated transaction and reporting. In each case we can make a case for the existence of a Pareto gain.

Marie Curie Cancer Care

As described above, Marie Curie Cancer Care is paid to provide in-home services by primary care trusts based on the number of patients it treats. The problem for Marie Curie is that the demand for this service, and therefore its income, is unpredictable. As a result of the contracting arrangement, Marie Curie accepts all the uncertainty.

Marie Curie provides nursing care for the primary care trusts at short notice from a pool of nurses. To manage the uncertainty in demand, Marie Curie employs a high proportion of nurses from a bank of part-time flexible workers to avoid taking on the fixed costs of permanent contracts. Bank nurses are less reliable than contract nurses as they may be unavailable to work when requested. Uncertainty in the contract thereby results in uncertainty of service. Although Marie Curie strives to provide for patients in need and frequently uses voluntary income to supplement the service, the high volatility of demand means that in up to 30% of cases nurses are unavailable.

This uncertainty is the reason for the inefficiency in the contract. If primary care trusts shared risk with Marie Curie, the latter would feel confident enough to employ additional contract nurses and provide a more reliable service. More efficient risk sharing would involve funding guarantees from the primary care trusts. But wouldn’t the primary care trusts lose out from this because it would have to pay more for the service? Superficially, yes. The primary care trust would be exchanging flexibility of financing for greater security of service delivery, and incur greater costs as a result of employing nurses in times of low demand. However, such a trade-off represents good value for money. If Marie Curie was given funding guarantees, the problems created by the present uncertainties would disappear. Reliability, a key element in the quality of a service, would improve as a result.

Beyond this simple improvement in reliability, there are additional gains that amplify the case for change. Where Marie Curie is unable to provide nursing care, hospital admission frequently ensues. Research by Marie Curie shows that this doubles the price of care for the tax payer.⁵ Moreover, not only is Marie Curie’s nursing care less expensive, it also contributes to a better quality of life for terminally ill patients by

⁵ Research by Marie Curie shows hospital admission to be approximately twice the price of nursing at home services. See <http://www.mariecurie.org.uk/campaign/economic/>

allowing them to die at home. Marie Curie estimates that where they are able to provide a nurse, more than 90% of patients achieve a home death.

Marie Curie illustrates the potential for efficiency savings within existing contracting arrangements. Our second example, John Grooms, illustrates the opportunities for increased activity by the voluntary sector in service provision.

John Grooms

John Grooms provides specialist residential homes designed to accommodate adults with severe disabilities, funded through annually renewable contracts from local authorities and primary care trusts. John Grooms encounter particular difficulties with this regime of funding where they want to develop new services.

To build a specialist care centre for twenty-four people costs around £5.2 million. This requires John Grooms to take out a commercial loan over a twenty-five year period. Commercial banks are willing to lend the capital in full, but require collateral to secure the loan.

The specialist features of each care centre mean that they cost significantly more to build than they are worth if subsequently sold on the property market. As a result, lenders will seek to secure the loan against the charity's other assets to ensure that they can recover the value of the loan if for some reason John Grooms is unable to maintain repayments. Such practice is standard among commercial banks. However, it creates a major barrier for the trustees of John Grooms seeking to establish a basis for commercial borrowings.

In order to undertake new developments, John Grooms must effectively put its established work at risk. In the event that the annual contracts are not renewed, John Grooms will be faced with dipping into its reserves, selling one or more of its other assets or closing down parts of its established work. Like many providers of public services, John Grooms is caught between a rock and hard place. It is keen to respond to an identified unmet need but faces excessive uncertainty in the form of annually renewable contracts.

A better balance of risk would be achieved through longer term contracts. Given that the length of an average residential placement in a care centre is likely to be approximately 5-10 years, short term contracts are not only inefficient but unnecessary. By providing only one year funding, purchasers are shifting their own uncertainties about funding onto John Grooms, and by extension the residents of John Grooms' homes. A common sense assessment of John Grooms' contracts question whether this is sensible. If people end up losing their accommodation, their welfare will suffer and the funders will need to find alternative suitable accommodation often at greater cost. It is because John Grooms does not want to expose its residents to these risks that services fall short of what could be provided.

As with Marie Curie, it is difficult to understand the reluctance of funders to enter into longer term contracts on the basis of government guidance. If contracts with purchasers were longer term, uncertainty over funding to meet loan repayments would be reduced. Consequently, the risk from taking out a bank loan to build a new home would also be reduced. John Grooms trustees could then feel assured that funding was sufficiently secure to take out the loan, and that their existing services would not be put at undue risk. Without such comfort, John Grooms is severely inhibited in its ability to expand services.

The Tackling Drugs Initiative

The Tackling Drugs Initiative imposes repetitive and unnecessary levels of reporting on voluntary sector organisations delivering services to drug users. This represents a significant waste of resources, especially in diverting the time and skills of high level management away from frontline service provision. A reduction in the quantity of the information required and a better co-ordination of data between the three different regulatory and funding bodies – through streamlining and standardisations – would both lower the cost of service for the funder and reduce the onerous requirements for the provider. This is true as long as providing service delivery remains within the limits of full accountability.

At present large quantities of resources, both financial and human, are invested in fulfilling similar requirements all across the public services. Reducing these costs would result in better value for money for the tax payer and improved services by increasing the resources available to frontline providers.

The solution: the Surer Funding Framework

If the voluntary sector is to become a significant part of public service reform and tax payers are to get value for money, the inefficiencies in the funding relationship need to be addressed urgently. The *Surer Funding Framework* presented here provides a structure to improve services based on a series of seven principles: three relating to the allocation of risk and four relating the costs of transaction and reporting. The principles are accompanied by a corresponding process for implementation, based on establishing a better dialogue between the funder and provider through a 'risk meeting'. These principles are consistent with existing government guidance. If funders fail to implement these principles and persist with an inappropriate allocation of risk, the *Surer Funding Framework* proposes a system of incentives to encourage change.

Surer Funding Principles

There are seven *Surer Funding Principles* that funders should follow to achieve the most efficient funding practice.

There are three that relate to the allocation of risk. These are:

Principle I The risks to service delivery, and the mechanisms used to distribute those risks, need to be recognised and understood.

Principle II Risks should be discussed when negotiating funding agreements, recognising that risk has a cost.

Principle III Risks should be placed with the party best able to manage them, at the lowest cost.

An increasing awareness of the issue of risk and the mechanisms used to distribute risk is a precursor for establishing better practice. Both parties should draw up a register of risks that need to be distributed in the funding agreement and be able to identify and justify which party is in the best position to manage each risk.

In addition to those that concern the allocation of risk, there are four principles that relate to how funders should ensure that the costs of transaction and reporting are appropriate for the circumstance. These are:

Principle IV Reducing the number of funding bodies the provider has to interact with;

Principle V Increasing efforts to ensure consistency between funders;

Principle VI Increasing flexibility in the procurement process to avoid unnecessary procedure;

Principle VII Ensuring that regulatory procedures are fit for purpose and proportionate

The *Surer Funding Framework* suggests a process for the implementation of these seven principles. This centres around the concept of a ‘risk meeting’, where the provider and funder come together to agree on the most efficient allocation of risk and examine how reporting mechanisms can best suit the needs of both.

Sir Peter Gershon’s review of public sector efficiency published in summer 2004 recommended that government improve its funding relationship with the sector by “considering carefully the appropriate assignment of risk between the statutory body and the voluntary and community organisation” and “streamlining and rationalising monitoring, regulatory and reporting requirements”.⁶ Despite this, good practice remains the exception rather than the rule. Far more common are funding arrangements such as those faced by Marie Curie and John Grooms.

To achieve better practice, the prevalent culture and habits in contracting with voluntary sector organisations must be tackled. Too often, contracts are presented without any possibility of discussion. Funders appear for the most part not to recognise or to appreciate the gains in efficiency which can be achieved through a better balance of

⁶ Gershon (2004) *Releasing Resources for the Frontline: Independent Review of Public Sector Efficiency*

risk, a better co-ordination, or reduction in reporting requirements. This highlights the urgency of recent Home Office guidance for providers of public services to engage in discussion with statutory funders.⁷ For their part, voluntary organisations need to accept a more systematic approach to risk and be more aware of the risks to which they may be exposed in funding agreements.

Acknowledging and acting on these principles will ensure improved value for money for funders, better and more reliable services for users and set the scene to facilitate increased voluntary sector service delivery in the future. Funders who successfully practice these principles as well as full cost recovery – the other key component of good funding practice – could be rewarded with a kitemark.⁸

In the event that these principles fail to change attitudes and practice, the *Surer Funding Framework* proposes a secondary solution based on a system of incentives to encourage change.

Surer Funding Incentives

Recommendation 35 of the Cross Cutting Review talks about ‘incentivising’ best practice in risk management. NPC’s research found no instances where this is occurring. *Surer Funding Incentives* have been designed to fill this gap and help funders realise the merits of a better balance of risk, fulfilling Principles I, II and III above. Here we briefly outline how such a scheme might operate. More detail of the framework and the questions it raises can be found in the *Surer Funding* report.

Surer Funding Incentives offer funders a choice between managing uncertainties more effectively and paying a ‘risk premium’. Funders can either accept the risks they are best placed to manage according to the outcome of the risk meeting, or pay an additional premium to shift them onto providers. In the case of Marie Curie or John Grooms, this means funders would either opt to provide a funding guarantee or longer term contract, or pay a risk premium. The extra cost that comes with poor contracts will incentivise funders to share risks more efficiently, benefiting taxpayers and service users.

The premiums paid by funders contribute to a risk pool, which would compensate organisations for any losses caused by the risks passed to them. Such an arrangement should obviously include appropriate exclusion clauses based on performance criteria. The availability of a payout would enable the organisation to plan better than in the current short-term environment. It would create certainty where endemic insecurity currently exists. All the positive benefits mentioned above regarding planning, human resources, reserves and access to external finance would follow. Risk would not be removed as the organisation would still face uncertainty as to its costs and its

⁷ Home Office (2004) *think smart...think voluntary sector! Good practice guidance on the procurement of services from the voluntary and community sector*

⁸ For more information on full cost recovery see www.philanthropycapital.org/fcr.php

performance but the risks due to demand for the service and non-renewal of funding would be reduced.

Surer Funding Incentives could operate equally for risks passed to providers through short term funding and through variable payments. However, such a mechanism is not readily applicable to the principles that address application and reporting costs. Of course, this does not preclude government from using some sort of an incentive mechanism to reduce costs but this may be more appropriate in the form of a conventional system of financial reward linked to the savings funders make.

Operation of Surer Funding Incentives

The practical application of such a scheme raises a number of interesting questions. Firstly, it would be desirable for *Surer Funding Incentives* to be financially self-sufficient. This means linking the level of payouts and the premiums paid into the fund. Determining the appropriate level of payouts, and therefore the protection and increased certainty afforded by the framework, is the first step towards setting the premiums. Payouts would need to be sufficient to provide a financial incentive to funders to move to more secure funding whilst also offering enough comfort to providers to realise the full benefits detailed above.

A second question concerns who should implement the scheme? There are three basic possibilities. The private sector could operate the scheme, the voluntary sector could implement the scheme itself, or government could step in. Which of these possibilities is most viable is unclear. Currently the private sector does not provide the insurance protection required by voluntary sector organisations and it is uncertain whether it would have the appetite to cover these risks in the future. Whilst the voluntary sector would not appear to have the skills at present to implement the framework, it is possible that with external expertise and support this might be achievable. Finally, government intervention is only justified in the event that these two options are exhausted and there is a market failure. Such failures are not unusual and there are many precedents for government to step in where the market does not offer a solution. The Export Credit Guarantee Department, bank deposit insurance, the National Insurance system and Pool Re for terrorism insurance are all examples.

Whoever is in position to supply such a scheme, government should be involved at some level, at least to endorse the scheme. Government support would be vital to ensure the insurance costs are paid by funders and embedded into standard procurement practice. In the event *Surer Funding Principles* do not achieve their aim, the opportunity offered by this incentive framework is open for further exploration.

Conclusion

The *Surer Funding Framework* provides a solution to the problems caused by inappropriate allocation of risk and excessive costs of bureaucracy in public service funding agreements. Existing government guidance recognises these problems but insufficient progress is being made to implement a solution.

There is a compelling argument to take action. Far from a case of ‘special pleading’, a call for surer funding is in the mutual interest of all stakeholders – the funder, the provider and, ultimately, the service users. The recommendations of the report are wholly consistent with present public service reforms, supporting a purchasing structure based on contestability and choice. The *Surer Funding Framework* can help government fulfil the commitments made in the Cross Cutting Review and achieve the savings agreed in the Gershon review.

The *Surer Funding* report outlines these problems and solutions in more detail. It is a call to government to take action. Change must proceed in the name of efficiency; to remain with existing arrangements is doing a disservice to taxpayers and service users. Better contracting makes sense for everyone.

Surer Funding was supported by:

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