SUMMARY
Public service delivery has often been seen as a choice between direct state provision and the use of the private sector. In many instances, though, the “third sector” (often referred to as the voluntary and community sector) provides an alternative. This report examines how government departments and other funders can best work with the third sector to achieve value for money in public services.

In recent years the government has recognised that third sector organisations (TSOs) have an important role to play in the drive to improve public service delivery. In some cases TSOs may be best placed to deliver a service, especially where a service needs to connect with clients who are difficult to reach or distrustful of state agencies. TSOs can also have great expertise in their specialist areas, and help develop and pilot innovative solutions to difficult issues. In the right circumstances, TSOs can help deliver a more effective service and provide the taxpayer with better value for money.

TSOs already carry out a wide variety of public services funded or part-funded by the taxpayer, such as hospice care for terminally ill patients, childcare services in disadvantaged areas, and advice and guidance for young people. Figure 1 overleaf gives some examples of the various ways in which TSOs provide public services.

Although the sector is a prominent provider in some areas of public services, it nonetheless accounts for only around 0.5 per cent of central government expenditure. The government has a declared commitment to increasing the role of the third sector in public services. However, both TSOs and government have noted that their relationship is not as effective as it might be. In 1998, a Compact on relations between the government and the voluntary and community sector set out how they should work together. Many local authorities subsequently developed Local Compacts with the third sector in their area, modelled on the national Compact. Problems continued, however, and proposals for an additional Compact Plus scheme were published for consultation in March 2005.

The third sector
The “third sector” describes the range of institutions which occupy the space between the State and the private sector. These include small local community and voluntary groups, registered charities both large and small, foundations, trusts and the growing number of social enterprises and co-operatives. Third sector organisations share common characteristics in the social, environmental or cultural objectives they pursue; their independence from government; and in the reinvestment of surpluses for those same objectives.

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1 For a discussion of Third Sector characteristics, see ‘Exploring the role of the third sector in public service delivery and reform: a discussion document’ published by HM Treasury, February 2005.
2 A glossary of terms used is provided in Appendix 2 of this report.
3 Estimates of the amount of government funding to the third sector are discussed in Part 1 of this report. These estimates exclude work done by unpaid volunteers, which some estimates value at around £40 billion per year, some 20 times the amount of public funding.
5 Funding processes have been a particular stumbling-block, despite the existence of a Compact code of practice on funding. In 2002, a Treasury Review of the involvement of the sector in public services identified several important and commonplace weaknesses in funding processes and made recommendations for improvement. This report examines the progress made by departments and other government funders, led by the Home Office, on improving the way they fund the sector to deliver public services.

6 The Treasury 2002 review provided a good framework for better use of TSOs in the delivery of public services. Successful implementation is, however, dependent on departments’ willingness to embrace new ways of working and to embed new practices across their funding streams. Our work takes those efforts further forward, by encouraging greater co-ordination amongst civil servants responsible for such activities, dissemination of good practice, and training and support for those involved, including encouraging a degree of specialisation in procuring and funding services from TSOs. We also identified a need for greater clarity and guidance on some of the principles promulgated by the 2002 review, for example on full cost recovery, through mechanisms such as worked case examples. Where departments are in effect procuring a service from TSOs, it may be more appropriate to engage with TSOs on the same basis as when services are procured from the private sector.

7 Recent work to examine the efficiency of the public sector as a whole has re-emphasised the importance of effective working with the third sector. Sir Peter Gershon’s 2004 Efficiency Review recommended that government should adopt four key principles for third sector funding – longer-term funding, appropriate balance of risk between the funder and the TSO, full cost recovery and streamlined monitoring and reporting – reflecting the key concerns of the Compact and the Treasury Review. These principles promote efficiency in public funding – for example, longer-term contracts mean TSOs can retain staff and make investments to improve services – and apply equally to public procurement from small and medium-sized private companies.

8 Our work is based principally on a review of the practices, policies and progress made by central government departments. We also held a number of group discussions, workshops and individual interviews, both with funders and TSOs, to explore specific issues and case examples. We worked in partnership with the National Council for Voluntary Organisations (NCVO). NCVO’s research team carried out the bulk of the research to examine the sector’s perspective on progress on funding issues. We are grateful to NCVO for their assistance.

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5 Originally published in 2000, the Compact funding code was revised in March 2005. The new Compact Code of Good Practice on Funding and Procurement is available to download from www.thecompact.org.uk.


Key findings and conclusions

Our work has focused on the action taken by government departments to improve their funding relationships with TSOs; however, the third sector itself also has a responsibility to take an active part. The National Council for Voluntary Organisations, our partner in this research, has published its own report which complements this report and a summary of its recommendations is given at the end of this Summary. The Association of Chief Executives of Voluntary Organisations is also active in promoting a better relationship between government and the sector, principally through its ‘Surer Funding’ report.

At a strategic level

Data on the sector and its part in delivering public services needs to be improved. The Home Office has a target to increase the sector’s involvement in public services by 5 per cent, by 2006. There appears to be an upward trend in the amount of government funding provided to the sector, but the Home Office’s estimates of the funding distributed by government differ from estimates made by the voluntary sector of funding which it receives from government sources. This discrepancy appears to have several causes, including the different ways in which the sector and ‘public services’ can be defined, limitations of departments’ information systems and the complexity of central and local government’s funding relationships with the sector. More reliable and timely data are needed, to gauge the sector’s contribution to public services and to understand whether it is growing as government intends. The Home Office is currently working to develop a standard information requirement for government bodies, which it expects will improve the quality of the information provided.

Despite the lead provided by the Home Office and the Treasury, departments need to develop their capacity to work better with the sector. All major funding departments have both senior “champions” and middle-ranking liaison officers with specific responsibility for encouraging implementation of the Treasury Review.

During 2004 and early 2005 most departments produced a strategy outlining their future plans to further involve the sector in their areas of responsibility. The development of these strategies often involved contributions from departments’ finance and procurement specialists, who advise staff who are responsible for awarding funds to TSOs. However, in most cases these strategies are at an early stage of implementation. In the absence of such a strategy, departments have to date relied mostly on individual initiative to improve funding practices, rather than developing expertise across their organisations. In addition, apart from a few high-profile initiatives there is little evidence of effective joint working across Whitehall.

The recommendations of the Cross-Cutting Review have been addressed, but further steps are needed to improve funding in practice. More needs to be done to translate high-level commitments into practical results wherever government interacts with TSOs, and to introduce additional mechanisms for improving funding practice. Our research shows that most TSOs have not seen any general improvement in funding practices since 2002, and in some cases funding practices are perceived to have worsened.

Spreading good funding practice throughout government and at local level is a particular challenge. Much of the funding for TSOs passes through executive agencies and Non-Departmental Public Bodies (NDPBs), regional bodies and local authorities; for these bodies, as for departments, good funding practices are not yet the norm. Indeed, the National Audit Office believes that the complexities and transaction costs of filtering money through a variety of organisations until it reaches the front line should be simplified and reduced wherever possible. Some intermediary bodies appreciate and have adopted the Treasury’s recommendations, but others, particularly those where an effective relationship with the sector is not perceived as central to their work, have not yet taken these recommendations on board. Our research suggests that funding problems are particularly acute at local level, despite the adoption of Local Compacts by many local authorities.

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9 At the time of writing this report, 278 of the 388 local authorities in England (71 per cent) had published a Local Compact and a further 100 were planning to do so (source: Compact Working Group).
At an operational level

14 Funds need to be clearer about the purpose of funding, and decide for each funding programme whether they are engaged in supporting a worthy cause (‘giving’), procuring services (‘shopping’) or in building capacity in the sector (‘investing’). Each purpose requires a different approach, with ‘shopping’ being the most appropriate model for the delivery of public services. The ‘shopping’ approach to funding implies a need for a tightly-specified contract and procurement processes, while ‘investing’ and ‘giving’ approaches are closer to conventional grant-making. Currently there is little settled practice on whether to use grants or contracts, and both funding models are often inappropriately used. Potential conflicts with European Union rules on state aid must also be considered.

15 There has been little progress on reimbursing the full costs of service delivery or the associated question of whether funding should be given as a grant or a contract after procurement. The two issues are closely connected, since ‘grant’ funding often requires TSOs to detail precisely what costs the grant will cover. Most contracts for service delivery, at least when agreed with private sector suppliers, focus on the price bid by the supplier and on the desired outcome, not on details of the supplier’s costs. Many TSOs complain that government funders are inconsistent in their treatment of TSO suppliers, too often relying on a grant culture and thus requiring a much greater level of cost disclosure than they would expect of private sector firms. Existing guidance to funders has touched on these issues but has tended to focus on principles rather than practice, leaving practitioners unclear as to how to take this forward. There is much that could be learned and applied from good procurement practice, especially the work done by the Office of Government Commerce in relation to procurement involving the small and medium-size enterprises with whom many TSOs share many characteristics. Meanwhile, TSOs and their representative organisations have a parallel responsibility to develop their understanding of their cost structures and to use the information to inform their applications for funding.

16 There is still plenty of scope for moving to longer-term funding and away from annual awards. The 2002 Treasury Review identified that TSOs were too often reliant on annual funding which made it difficult to provide continuity of service and certainty of funding, causing avoidable costs for the TSOs (and funders) concerned, especially when award decisions were delayed. And this uncertainty can cut into the quality of work that the TSO does by diverting staff away from front-line duties. There have been some encouraging developments since 2002, but annual funding remains the norm, especially at local level, although future changes to local authority funding are expected to facilitate longer-term funding arrangements with TSOs. The National Audit Office believes that this in part reflects a general suspicion and lack of trust together with a tendency to underrate the sector’s professionalism and ability to deliver public services. Without trust, partnerships cannot work. Government funders have much more to do therefore to ‘mainstream’ the sector into public service delivery and thereby secure the full contribution which the third sector can provide.

17 Funders have made better progress in streamlining application processes and moving to funding in advance of expenditure. Most departments have been able to make helpful changes to application processes for at least some of their funding, through means such as two-stage application processes, use of online application forms and funding portals on the internet. Departments have shown a greater willingness to make payments in advance of expenditure, for example through profile (or instalment) funding, following the issue of new Treasury guidance, to ease the financing burden on TSOs.

18 There has been less success in reducing the burden of monitoring. A pilot to examine the scope for sharing information between funders had some success in reducing the burden of administration involved in making funding awards. But the pilot was much less successful in reducing the burden of monitoring which TSOs face. Although funders have made various efforts to improve monitoring systems, the impact of these changes has not been widely felt and there is still a need for monitoring systems which are proportionate to the risks, the amounts of funding and the nature of the service involved.

11 The Office of Government Commerce points out that government provision of equipment or space for a TSO might qualify as inappropriate state aid if this support provides the TSO with a financial cushion allowing it to bid for a public contract.
The specific recommendations of the 2002 Treasury Review have in the main been implemented (as shown in Appendix 1 of this report), but this has not yet been enough to bring about a widespread and substantive change in departments’ funding practices. Whilst the Home Office and the Treasury have sought to move matters forward, a significant gap remains between the principles set out in the Treasury Review and subsequent practice. Our recommendations focus on how best to fill that gap.

The Home Office, as the government department with lead responsibility for these issues, the Treasury and other government departments should work together to:

1. Improve information about the sector’s involvement in public services, by collaborating with other expert organisations to strengthen national and local data on the amounts of public sector funding going to the sector. Funders should introduce systems to clearly distinguish payments to TSOs from other spending, enabling data on their TSO funding to be collated quickly;

2. Introduce new measures to improve funding practices, including:
   a. issuing a checklist of good funding practice, as a simple reference point for both funders and providers – as the Home Office now proposes;¹²
   b. identifying and promoting ‘beacon’ funders at all levels of government, to act as centres of expertise and help spread good practice;
   c. establishing an annual awards scheme to recognise and celebrate good practice and innovation in the way funders and third sector providers work together for successful service delivery;
   d. making all relevant guidance to government funders, whether produced by government or outside experts, available from a single source to provide a web-based ‘virtual university’ for funders;
   e. considering the potential benefits of an accreditation process to ‘kitemark’ funders complying with the principles of the Treasury Review, and bring forward recommendations on this; and
   f. supporting other government departments in implementing the measures recommended below.

¹² The Home Office’s proposals for ‘Compact Plus’ outlined in paragraph 21 of this report, include a checklist of good funding practice. ‘Effective Local Partnerships’, a checklist for local funders and third sector organisations, was published by the Treasury in February 2005, as part of the results of the Treasury’s Voluntary and Community Sector Review 2004. Meanwhile, the ACEVO report ‘Surer Funding’ published in November 2004, proposes a checklist of good funding practice.

¹³ This recommendation is inspired by the Beacon Councils scheme operated by IDeA, the improvement and development agency for local government. The scheme identifies local authorities with expertise in specific policy areas and helps them to share good practice with other local authorities.
3 Develop targeted guidance on those funding issues which cause most difficulty, working in collaboration with the Office of Government Commerce (OGC). There is already a variety of funding guidance in existence covering general funding principles; new material should focus on adding value for funders in their everyday work. It might cover, for example, guidelines on whether and when to use grants, contracts and procurement processes; grant terms and conditions which run counter to good value for money; contractual elements which are unhelpful; and how and when to apply the principle of full cost recovery. The latter would complement the guidance produced for the sector by the Association of Chief Executives of Voluntary Organisations (ACEVO). The NAO would be pleased to work with the Home Office and other key stakeholders on developing new guidance;

4 Establish a champion or panel of experts to advise on funding practice, when approached following discussions between TSOs and their funders. In procurement situations, competition and procurement laws should apply;

5 Expand the scope of the government funding web-based portal within an agreed timescale, to include details of all government grant funding which is available to the sector;

6 Designate and train individuals and groups of staff to specialise in working with the sector, including working with procurement methods and experts where this is appropriate, focusing training on the funding issues which cause most difficulty and providing opportunities for staff to undertake secondments to TSOs;

7 Expand the role of departmental champions and liaison officers – in addition to their intra-departmental role – to include regular contact with third sector providers and groups of providers, where this does not already occur;

8 Develop Gershon-style joint or shared teams for dealing with funding third sector service providers, especially where individual funders are not large enough to provide a critical mass to maintain such expertise alone;

9 Develop a template contract for procurement from the third sector, suitable for adapting to special requirements;
10 Fully integrate, where appropriate, their associated executive agencies and Non-Departmental Public Bodies into departmental strategies for working with TSOs;

11 Commission further research into local funding practices, leading to recommendations for improvement at a local level. Key stakeholders such as the Office of the Deputy Prime Minister (ODPM), the local government improvement agency IDeA, the Audit Commission and the Local Government Association should be involved in this research. The research could also extend to other local funders including regional bodies and local health organisations;

12 Above all, seek through training and co-operation, greater trust between the governmental authorities and the third sector so that real partnership can be created and inform the relationships between funding and service suppliers.

21 In March 2005 the Home Office published proposals for a new Compact Plus scheme, which public sector bodies and TSOs will be able to opt into if they wish. The proposals, which are undergoing consultation until 12 July 2005, are in part informed by our review and our discussions with the Home Office. The proposals directly address some of our recommendations, for example by putting forward a list of good funding practices and a ‘kitemark’ for members of the scheme. The Home Office proposals also suggest that a ‘Compact Champion’ should be established who would be independent of both the sector and government. This proposal is in line with our recommendation above. Further details of the Home Office proposals are given in the main text of this report.

22 Internal and external auditors should work with funders and sector representatives to produce guidance on the monitoring and audit processes best suited to different types and values of funding. Monitoring processes should be proportionate – tailored to the amount of funding, good financial management and risk to value for money in specific cases. This work should build on the ‘lead funder’ and ‘Combined Audit National Pilot’ projects described later in this report, and address funders’ reluctance to share information and assurance about TSOs they fund jointly. The National Audit Office would be happy to contribute to this work.
Improvements to funding practice require the active involvement of TSOs as well as funders. For example, an effective approach to full cost recovery requires that TSOs have a good understanding of their cost structure, which they use to inform their bids for public service contracts. The third sector will also need to make changes to the way it works. The National Council for Voluntary Organisations published its own report \(^\text{14}\) on the funding relationship with government, in June 2005. Its key recommendations include:

- **Full cost recovery** – TSOs must own the principle of full cost recovery, ensure that they cost contract bids appropriately and consider refusing to accept under-funded contracts;

- **Sustainable funding environment** – TSOs should seek clarity about the length of funding they are bidding for, improve their skills and knowledge about different funding mechanisms, and take on responsibility for their own sustainability in the long term;

- **Application processes** – TSOs need to improve their skills base in making applications, help to reduce the administrative burden and always request feedback from funders;

- **Relationships with funders** – TSOs should work with funders to design targets, outcomes and mechanisms for monitoring and evaluation;

- **Delivery through tiers of government** – local funders and local TSOs should explore ways that they can work together to ensure that public services are adequately resourced.

Meanwhile, the Association of Chief Executives of Voluntary Organisations feels that many TSOs need to develop their skills in analysing their costs and negotiating contracts with public funders. Its report *Surer Funding*, showed that current contracts between government and the sector are failing to deliver value for money. The Association is working to encourage TSOs to adopt its template for analysing and allocating overhead costs \(^\text{15}\) and to encourage the adoption of its Surer Funding framework across government.

Third sector representative bodies, including the National Council for Voluntary Organisations and the Association of Chief Executives of Voluntary Organisations, are working to improve the sector’s skills in negotiating contracts, through the ‘finance hub’ being set up as part of the Home Office’s ChangeUp initiative (see paragraph 2.2 of this report). The finance hub is led by the Charities Aid Foundation.

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14 ‘Shared aspirations: the role of the voluntary and community sector in improving the funding relationships with government’, NCVO June 2005.