

# THE FUNDING RELATIONSHIP

## INTRODUCTION

1. Funding of the VCS is complex. There are around 140,000 General Charities with a total income of £15.6 billion in 2001. A third of this income is concentrated in the top 200 largest organisations. The smallest organisations - which represent 90% of the total - account for a mere 10% of total current income.

2. Table 1 below summarises these facts.

**Table 1 : Estimated numbers of Voluntary and Community Organisations in 2001**

<i>Annual Income</i>	<i>General Charities (a)</i>	<i>Community Level Organisations (b)</i>	<i>Total</i>
<i>Under £100,000</i>	126,219	180,000 to 360,000	306,000 to 485,000
<i>£100,000 to £1million</i>	12,838		12,838
<i>£1 million to £10 million</i>	1,701		1,701
<i>Over £10 million</i>	206		206
<b>TOTAL</b>	140,964	180,000 to 360,000	300,000 to 500,000

Sources:

- (a) NCVO 2002 Almanac
- (b) Social Exclusion Unit PAT 9 report.

3. These figures highlight the difficulty of making any generalisations about the VCS. Not only is the income base of the largest and the smallest groups incomparable, but they are often engaged in different types of activity. The inclusion of social enterprise adds further diversity to the sector.

4. Table 2 gives more detail about the different sources of funding for the VCS as a whole. This is interesting because it highlights the complexity of the income base – notably that 40% of total income comes from ‘independent’ sources and relates to donations from the general public and returns on organisations’ investments.

5. The aggregate income matrix hides significant disparities in sources of funding between the largest and the smallest groups. The key points are:

- larger groups generate significantly more of their income from sales of goods and services – in particular to government. For example, for the smallest charities (income under £100,000) just under 7% of total income comes from selling services to government whereas for the largest groups this rises to 20%;
- larger groups typically derive less income from donations (12.7% of total income) than smaller groups (20.7%);
- larger groups are also typically much less dependent on grants than smaller groups;
- less than 5% of total income comes from business and larger groups are the major beneficiaries here.

**Table 2: General Charities Income Matrix**

<b>Sources of income (%)</b>	<b>Transaction type (%)</b>			<b>Total</b>
	Earned income / sales of goods and services	Voluntary income / grants and donations	Returns on investments	
<b>General public</b>	15.0	19.7	0	34.7
<b>Government</b>	16.1	12.9	0	29.0
<b>Voluntary organisations</b>	1.2	7.6	0	8.8
<b>Business</b>	2.8	2.1	0	4.9
<b>Internally generated</b>	0	1.3	21.3	22.6
<b>Total</b>	35.1	43.6	21.3	100

Source: NCVO 2002 almanac.

6. Further detailed analysis of government earned income in the mid 1990s revealed that almost two-thirds came from Local Authorities (41%) and Health Authorities (22%). In contrast, central government provided about 25%, Quangos a further 10% and only about 2% of funding came from the European Union. More funding may now come from central government reflecting the partnership agenda and initiatives such as SureStart. But the continued importance of local funding is underlined by the 2001 NCVO Almanac which notes that 70% of the sector operates at a local level.

7. This paper focuses on the funding relationship associated with service delivery. This spans small and large organisations, though the very smallest

groups are less likely to directly engage in service provision on behalf of central or local government.

#### **TRENDS IN FUNDING FOR VOLUNTARY ORGANISATIONS**

8. The key patterns in funding to emerge over the last five to ten years are:

- **a decline in the early 1990s in the level of public charitable giving.** In aggregate, public giving fell by 31% in real terms between 1993 and 1996. By the late 1990s it had stabilised at around £5 billion per annum – still significantly below the £5.3 billion raised in 1993. More recent data suggests that giving is again rising – to £6.58 billion in 2000. Recent initiatives such as the Giving Campaign are key to ensuring this trend continues.
- **increased funding from the sale of goods and services to government – especially around contracts for services.** There was rapid growth in contract income in the early 1990s largely reflecting the impact of the care in the community reforms and subsequent contracting out of statutory LA services for older people. More recently, the partnership agenda, and initiatives such as SureStart, the Children's Fund, the various New Deals for employment have resulted in increased earned income from government.
- **a shift towards increased reliance on earned as opposed to grant income,** partially reflecting the increasing use of so-called 'grant funds' for service delivery i.e., increasing use of 'grant' type monies to commission services.
- **the decline in income for endowed trusts and foundations** reflecting the removal of tax relief on dividend income as the period of transition comes to an end.

9. These changes in funding streams help to explain some of the concerns raised by the VCS in the course of this review. In particular, the increasing use of grant mechanisms to fund specific projects or service delivery, and the sector's more widespread engagement in contracts for service delivery has causing increasing concern about their ability to finance so-called 'core' or overhead costs.

#### **THE DIFFERENT TYPES FINANCE USED TO FUND SERVICE DELIVERY**

10. Service delivery would normally be funded through service contracts and agreements. However, the use of grant mechanisms is also on the increase. Building on work published by ACEVO in 1999, the Home Office Compact on Funding identifies three distinct ways in which grant finance may be used:

- **project funding** where grants are used to finance a specific project or outcome;
- **development funding** where organisations are effectively awarded seed corn money to support their start-up costs, or to enable them to expand;

- **strategic funding** – or grant-in-aid – that is given to established organisations recognised to be of strategic importance and whose continued existence and activities are considered to be beneficial. The single largest source of strategic funding within Government is the ACU’s strategic grant programme totalling some £12 million per annum.

11. Clearly it is critical to get the right approach and balance between all three types of financing. Development and strategic funding play a key role in supporting and promoting the service delivery agenda. Development funding enables organisations to grow and innovate and strategic funding helps to ensure that the infrastructure supporting the thousands of voluntary organisations remains healthy and effective. However, the focus of this paper is the funding relationship specifically associated with service delivery i.e. service contracts and agreements as well as project funding through grants.

12. The 1998 Compact, and the related code on funding, focuses on grant finance only. Service contracts and agreements lie outside the scope of the Compact. This paper is therefore largely about some of the difficulties that can be caused by the existing contracting regime. Getting this right is increasingly important to ensure that those organisations involved in service delivery retain a sound financial base.

#### **CAPITAL FUNDING**

13. VCS representatives and groups have also stressed the importance of capital funding to support the sector’s ability to deliver services and to enable them to develop a sound asset base that helps them to generate sustainable income streams.

#### **WHAT ARE THE KEY CONCERNS SURROUNDING SERVICE DELIVERY?**

14. The five major concerns identified in the review around service agreements and contracts are:

- raising awareness of, and adherence to, the Compact guidance on ensuring grant project funding is based on full cost recovery i.e. includes the appropriate element of the ‘core’ (or overhead) cost associated with providing a given service and extending this approach to service contracts and agreements;
- streamlining access and performance management requirements for multiple – often small – funding streams;
- end loading of payments – with the VCS sector bearing upfront costs/risks;

- moving to a more stable funding relationship – i.e. moving from 1 year contracts to 2-3 year contracts;
- creating a level playing field – in particular around VAT.

15. These concerns apply as much to social enterprises as to more traditional voluntary sector organisations.

16. Other common points raised include:

- the need for a culture shift within central and local government in the way they approach dealing with the VCS, as well as social enterprises;
- better ‘supply chain’ management – the VCS needs to be much more actively engaged in the contracting process from the outset including policy design and the alignment of policy goals and aims with actual targets for delivery.

17. As these issues are discussed in other papers this paper focuses on the five issues in paragraph 14 above.

#### **MOVING TO FULL COST RECOVERY**

18. Numerous studies, including the recent, ‘Next Steps in Voluntary Action’,<sup>1</sup> have raised the so-called ‘core costs’ problem as have many submissions to this review. The existing Home Office Compact on funding notes that project funding should be allocated on a full cost recovery basis, i.e., that it should include the relevant element of overhead cost. However, the current Compact only applies to grant finance and so there is no presumption that this approach should be adopted where service agreements or contracts are being used. Equally the Compact principles are not applied consistently across central government, let alone at local government level.

19. The VCS is concerned that unless the principle of full cost recovery is adopted for service contracts and agreements then they will face increasing difficulty in financing so called ‘core costs’. In keeping with this, the Compact Working Group and the ACU have been developing guidance for public/ VCS partnerships as a supplement to the Funding Code<sup>2</sup>.

20. Broadly speaking, core costs relate to fixed or overhead costs – for example, management and staff development, premises, administration and sometimes research and development. There is a strong view within the VCS that funders are often unwilling to finance these costs because of a common

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<sup>1</sup> ‘An analysis of five years of developments in the voluntary sector’, NCVO and the Centre for Civil Society, LSE, 2001.

<sup>2</sup> NCVO 2001: Consultation Document – a proposed supplement to the Funding Code. Guidance for Public/ Voluntary Sector Partnerships.

perception that either strategic grants or public donations may already be being used for the same purpose – so called ‘double funding’.

21. There is no reason why potential service providers should not include overhead costs within their bids for service contracts. To do this, the VCS needs the expertise to apportion overhead costs effectively but there is no principled reason why service funders should be opposed to the inclusion of relevant overhead costs in bids. Different providers will, however, want the autonomy to decide how to structure individual bids and funders will want to award service contracts on a best value basis.

### **MAKING THIS HAPPEN**

22. Nonetheless, the complexity of funding streams to voluntary organisations can leave funders uncertain about whether overhead costs are covered by other non-service sources of finance (see [Table 3](#) below taken from the NCVO almanac). ACEVO have proposed that the development and widespread use of common accounting guidelines identifying how different funding flows were being used would help to address this perceived concern.<sup>3</sup>

23. Of course, many of the larger organisations involved in service delivery are already able to do this (eg. NACRO, Leonard Cheshire) and there should be scope for building on their experience and expertise to help spread best practice. Their experience could also be used to help develop unit cost indicators for client and sector specific service areas.

**Table 6: The Complexity of Voluntary Organisations funding base**

	<i>Transaction type</i>		
<i>Sources of income</i>	Earned income/sales of goods and services	Voluntary income/grants and donations	Return on investments
<b>General public</b>	<ul style="list-style-type: none"> <li>Fees for goods and services (e.g. book sales, residential home fees, concert tickets).</li> <li>Membership subscriptions (with significant benefits).</li> </ul>	<ul style="list-style-type: none"> <li>Street and door-to-door collections.</li> <li>Covenants and Gift Aid payments.</li> <li>Legacies.</li> <li>Membership Subscriptions (no significant benefits).</li> </ul>	-
<b>Government</b>	<ul style="list-style-type: none"> <li>Local authority community care contracts</li> </ul>	<ul style="list-style-type: none"> <li>Grants for core funding and project activities from central</li> </ul>	-

<sup>3</sup> See, Funding our Future : Core Costs Revisited, ACEVO, 2001

<b>Voluntary organisations</b>	<ul style="list-style-type: none"> <li>• Services provided under contract.</li> </ul>	<ul style="list-style-type: none"> <li>• Grants from charitable trusts.</li> </ul>	-
<b>Business</b>	<ul style="list-style-type: none"> <li>• Sponsorship</li> <li>• Research services</li> <li>• Patent royalties</li> </ul>	<ul style="list-style-type: none"> <li>• Grants from businesses' community affairs departments.</li> </ul>	
<b>Internally generated</b>	-	<ul style="list-style-type: none"> <li>• Covenanted profits from trading subsidiaries.</li> </ul>	<ul style="list-style-type: none"> <li>• Equities</li> <li>• British Government securities.</li> <li>• Common investment Funds. Realised gains.</li> </ul>
<b>The National Lottery Fund</b>		<ul style="list-style-type: none"> <li>• Grants for strategic and development funding</li> </ul>	
<b>NOF / CF</b>		<ul style="list-style-type: none"> <li>• Project funding</li> </ul>	

24. Equally, at central government level, there are examples of service agreements which explicitly recognise the overhead cost associated with service provision - the Rough Sleepers Unit is an example. In addition, many of the New Deal for Employment contracts are based on the unit cost of providing training and employment services and, as such, are intended to include relevant overhead costs. DfES are currently reviewing the impact of formula funding<sup>4</sup>, as part of their "Getting the Best from each Other" initiative. Although there have been some difficulties in the pricing of contracts to date, the formula funding approach is a potential way of recognising overhead costs in the contracting process.

25. The ACEVO submission to this review<sup>5</sup> suggests that the sector should develop clear accounting guidelines for the allocation of overhead costs – in particular to enable the sector allocate the relevant element of overhead costs to specific service agreements and contracts. ACEVO are helping to take this work forward in collaboration with New Philanthropy Capital, and based on 13 detailed case studies. The aim is to publish a report in November 2002 – this has the potential to form an important building block in helping to develop clear accounting guidelines for the sector.

#### **STREAMLINING ACCESS, AND PERFORMANCE MANAGEMENT REQUIREMENTS FOR MULTIPLE – OFTEN SMALL – FUNDING STREAMS**

26. In June 2001, the Regional Co-ordination Unit (RCU) was asked to consider how to make **regeneration** funding more accessible to VCOs. This work

<sup>4</sup> 'Formula funding' describes a national price per unit of provision, which includes an element of running, or overhead, cost and which is agreed (in the case of DfES/ LSC), by a National Rates Advisory Group that includes provider representatives.

<sup>5</sup> "The Third Sector Delivers: ACEVO's Submission to the Government Reviews". autumn 2001.

included streamlining the application and monitoring process. In November 2001, the RCU produced a short interim report. The key proposals were:

- using a 'lead funder' wherever possible i.e. agreeing that one funder will arrange monitoring and inspection and will 'passport' information onto to others;
- developing an electronic registry of providers involved in regeneration containing 'common' information relevant to all potential funders;
- ensuring officials dealing with regeneration funding contracts and performance management fully understand the implications of Government Accounting requirements and principles;
- guidance to regeneration funders to ensure maximum commonality in application forms and performance monitoring requirements. This will include specific Treasury guidance to funders to help clarify certain aspects of the guidance in Government Accounting;.
- establishment of an 'Implementation Unit' within a central Whitehall department to ensure recommendations are fully implemented.

27. The cross cutting review has broadly endorsed these proposals. Within the wider VCS, there is particularly strong support for the proposals on lead funders and Treasury guidance. On streamlining the application process, external members felt there was much to be learnt from the Community Fund.

28. A particular concern to emerge from the RCU work is that earlier studies reaching similar conclusions have not been implemented – hence the proposal for a dedicated implementation unit. The cross-cutting review agrees that implementation is critical but believes the best way forward is to build on existing structures to ensure implementation is mainstreamed from the outset.

29. Finally, on the proposed electronic registry, it is critical that this is fully joined up with initiatives in other departments to streamline VCS access to funding. The RCU needs to work with the ACU, CMPS and other relevant departments to ensure this happens.

### **ISSUE 3: END LOADING OF PAYMENTS – WITH THE SECTOR BEARING UPFRONT COST/ RISK**

30. For those VCOs involved in service delivery this is widely perceived to be a major problem and, in some instances, a significant deterrent to participating in service delivery. It is also a source of concern to social enterprises as they seek to manage cash flow and risk. The two examples discussed below – both taken from different New Deal for Employment programmes - help to highlight two aspects of risk:

- the risk associated with the contracting body making assumptions about likely demand/ level of use for services which transpire to be unrealistic;

- the risk associated with agreeing output goals that the provider is then responsible for delivering, and given maximum freedom to design the actual delivery mechanism.

31. In broad terms, it seems unrealistic to expect the provider to bear all the risk associated with the first kind of risk. However, the second is slightly different. Incentivising good outputs through the contracting process is clearly a sensible way forward. It has the potential to meet organisations' concern that contracts should be output (not process) focussed and that there should be maximum flexibility in the way services are delivered. Provided the output goals are discussed and agreed, it seems sensible for the provider to bear the risk of non-delivery in return for a degree of flexibility in how services are delivered.

32. Members of the funding working group also flagged the need to ensure that programme design and output targets reflect the realities of the client group being targeted. For example, the DfES "Entry to Employment" scheme sets out the basic skill level that individuals need to participate effectively in the programme. For those unable to reach the entry point clear links to other services are signposted.

#### **EXAMPLE 1: NEW DEAL FOR YOUNG PEOPLE**

33. The post-16/ New Deal for 25+ has experienced difficulties as the expected client flow has proved lower than initially projected and payments linked to throughput have therefore failed to cover fully running costs. In recognition of the inappropriate balance of risk between funder and service provider, the DfES/DWP underpinned a significant proportion of the running costs associated with delivering the initial client throughput targets.

34. This example highlights the first kind of risk above and underlines the importance of setting appropriate interim targets at the outset and keeping developments under review.

#### **EXAMPLE 2: NEW DEAL FOR DISABLED PEOPLE**

35. The early structure of payments for the New Deal for Disabled People caused particular concern for some voluntary groups. The heavy end loading of payments dependent on the successful placement of clients in jobs and their continued employment for at least six months generated significant concern about cash flow and the degree of output risk being carried by voluntary sector providers if policies failed to deliver appropriate outcomes.

36. The structure of payments has subsequently been adjusted to ease cash flow difficulties following consultation with the VCS. Nonetheless, payments remain quite heavily end loaded reflecting the continued emphasis on delivering outputs, and provider flexibility in determining how best to deliver these results.

## TACKLING CASH FLOW PROBLEMS

37. Work by the RCU on their study looking at how to make regeneration funding more accessible to VCOs has also indicated that the structure of payments and the subsequent impact cash flow is a general concern among many organisations. The RCU work suggests that part of the perceived problem is a lack of clarity about what is allowed under Government Accounting rules, particularly as they apply to making payments ahead of incurred expenditure.

38. The widespread perception that there is no flexibility is incorrect. There are two types of advance payment:

- payment in advance in need;
- payment in advance of expenditure.

39. The guidance in *Government Accounting* steers departments towards assessing need on the basis of actual expenditure. The clearest demonstration of the need is that the expenditure has occurred. Government Accounting says:

*“Cash should not be issued to the recipient body in advance of need; and often payments will not be made until the body itself has incurred the expenditure and claims reimbursement.”*

40. Some funders have taken this to mean that they could **only** make payments on the basis of actual expenditure. But the guidance on assessment of need is advisory, not mandatory – what is mandatory is that payment must not be made in advance of **need**. (The reason being that there is an opportunity cost to the Exchequer if it advances sums before it has to.) But pre-funding recipients' expenditure would be consistent with *Government Accounting* if the funder can adequately and properly assess anticipated expenditure on the project and receive proof that the grant achieved its agreed purpose and outcome.

41. So in value for money, regularity and propriety terms, there is no reason why the VCS should be left carrying the financial burden of meeting the upfront costs associated with starting up a new programme, or running an overdraft to finance running costs. The 'Guidance to Funders' would apply to all service providers – private as well as those in the VCS.

42. In more practical terms, profile funding (see para 44) offers a potential way of developing output focused contracts without leaving the sector financing all interim running costs.

## LINKING PAYMENTS TO OUTPUTS

43. There are clearly robust management and value for money reasons for wanting to end load at least a certain percentage of contract payments to incentivise good outputs. One of the points made strongly by the VCS during this

review has been the need to focus on outputs and outcomes rather than processes. In contractual terms, this obviously means that it will be important to link a certain percentage of payments to achieving agreed results. The example below gives an example taken from the New Deal where a balance appears to have been struck between rewarding good outputs without jeopardising the financial viability of organisation.

#### **Case Study – Prince's Trust**

*Prince's Trust is a charitable social enterprise with a mission of supporting disadvantaged young people through self-employment. The Trust, with a strong reputation and its influential networks, has been a pioneer in testing a stable social performance contract approach.*

*The Prince's Trust operates a social performance contract with the DWP to support young people find employment. Targets of the numbers of young people to be helped into employment are set annually based on agreement between DWP and Prince's Trust. Prince's Trust provides business support, mentoring and start-up financial awards – primarily business loans – to eligible youth as part of their normal programme activities. Lump sum 'outcome' payments are made by DWP to Prince's Trust on a quarterly basis for each young person provided with an award. The DWP's aim is to assist people find long-term unemployment. Hence, an additional 'survival' payment is made to Prince's Trust for every individual that is still employed or trading after 12 months. This provides an added incentive for the Prince's Trust to provide high quality support.*

*For the Prince's Trust, funding from the performance contract with DWP represents a secure and stable source of revenue. The social performance contract represents 40% of business programme revenue and 12% of overall Prince's Trust revenue. It is also a flexible source of financing, much welcomed in an arena where funding can be highly restricted. For DWP, the social performance contract provides an effective means for them to deliver services to young unemployed people. It delivers both results and ultimately the best use of scarce public funds.*

*Source: New Economics Foundation, 2001*

#### **WHAT CAN WE LEARN FROM THE NEW DEAL FOR EMPLOYMENT.**

44. DfES/DWP have consulted extensively around the contracting process used for the post 16/ New Deal for 25+ programmes. The consultation has revealed widespread concern about the cash flow and risk issues discussed above. In April 2001 profile funding was introduced across the majority of LSC and ES contracts in attempt to ensure that providers were not left covering upfront costs themselves. The DFES consultation document "Getting the Best from Each Other" explains profile funding as:

“Providers’ expected costs or anticipated outputs are agreed at the time of signing the contract/ service agreement, and regular payments are made up to the agreed date for returns. Future payments are then adjusted after receipt and approval of output returns, to take account of the difference between planned and actual outturns.”

45. Profile funding therefore offers a potential mechanism for ensuring that:

- providers are not left carrying the upfront costs associated with setting up and running a programme ahead of any programme targets being achieved; and
- there is flexibility to adjust final payments to reflect the achievement of agreed goals and outputs.

46. Profile funding therefore provides a potential way of structuring contracts so that they remain output focused without effectively requiring the provider to finance interim running costs. Of itself, profile funding may not be sufficient to address the balance of risk between the funder and the provider if the interim or output targets on which final payments are based are unrealistic. DfES/ DWP are also conscious that profile funding does not – in its present form – reward service providers who deliver more than the specified minimum. They are keen to explore the option of building in ‘bonus’ payments to those organisations that ‘overachieve’.

47. DfES/DWP are currently in the process of evaluating the impact of profile funding. Preliminary indications are that although this move has been broadly welcomed, the processes involved in applying the principle (by Government Offices, Employment Service Districts and Local learning and Skills Councils) has been inconsistent. Guidance on the application of profile funding is an anticipated output of the DfES “Getting the Best from Each Other” initiative, and may form a useful platform for all government funders to ensure that the VCS are not left carrying interim running costs.

#### **ISSUE 4: MOVING TO A MORE STABLE FUNDING RELATIONSHIP**

48. Lack of long term funding arrangements is a major source of concern and potential financial instability within the VCS. This issue has been raised repeatedly in the course of this review.

49. In general terms there are different aspects to this problem reflecting the different types of funding relationship that the sector may have with either central or local government. Although this review focuses on the funding relationship around service delivery it recognises the importance of ensuring an effective strategic and development funding relationship is in place.

50. The move to three year spending settlements for individual departments, combined with end year flexibility, gives departments much greater financial certainty than they have had in the past and so helps them to enter into longer term service agreements and/ or contracts.

51. At a central government level there are examples of departments entering into longer term service agreements and contracts subject to performance targets being met. Equally, where departments are able, and it is sensible, longer indicative funding relationships should be considered – subject, of course, to satisfactory performance.

52. Members of the funding working group also flagged the importance of ensuring that:

- review and notice periods are adequate to enable providers to plan future cash flow and, if necessary, develop exit strategies as some programmes unwind;
- decisions involving different government departments are better co-ordinated and made in much more timely way.

53. In practical terms, it appears that the funding relationship at the local level is causing the most concern. The biggest gains may therefore flow from changing practice at the local level. The example below shows how more stable contracting relations at the local level, subject to performance, can be achieved.

**Medway Council (Unitary Authority)**

*Medway Council has developed 3 year “Agency Agreements” for the majority of social care services provided by voluntary sector agencies in Medway.*

*An Agency Agreement provides the voluntary sector agency with stability of funding, enabling them to plan effectively. This document is as rigorous as a contract used with the private sector with the exception that the Agency Agreements are not intended to be enforced in law: agency Agreements are made with voluntary organisations with a constrained resource base against whom the local authority would not generally wish to pursue a legal case.*

*3 years is the norm for Agency Agreements; 1 year agreements are used in circumstances where particular services are being piloted or where a client officer wishes to migrate to an alternative supplier but needs lead time cover. Agency Agreements are fixed term not rolling.*

*Performance management*

*Each service Agency Agreement is subject to annual review and includes monitoring & review procedures that include:*

- *Service monitoring output data*
- *Regular review meetings with the provider organisation (involving service commissioners & procurement staff)*
- *Annual agreement review meetings*
- *The service provider actively seeking feedback from service users to inform future service provision*

*Performance criteria vary considerably depending on service.*

## **CREATING A LEVEL PLAYING FIELD – IN PARTICULAR AROUND IRRECOVERABLE VAT**

54. This has been a source of ongoing concern for many years. The 1999 Review of Charity Taxation set out the problem around irrecoverable VAT. In brief, whereas Local Government-type bodies are covered by a special VAT refund scheme, Section 33, all other bodies which provide services free of charge or exempt services are unable to recover the VAT they incur on the things they buy. This potentially impacts on charities providing services in key areas such as education, health and social care. The Charity Taxation Reform Group estimated that charities have an irrecoverable VAT bill of around £ 0.5 billion per annum.

55. In representations to the Review of Charity Taxation, charities argued that this problem should be resolved by:

- allowing them to recover VAT under the Section 33 VAT refund scheme;
- establishing a grant scheme to compensate them for their irrecoverable VAT;
- allowing them to reclaim all the VAT they incur on purchases relating to their charitable objectives.

56. In the final report of the Review of Charity Taxation, the Government responded to these ideas as follows:

*“[Section 33] was originally enacted so that VAT did not fall as a burden on local taxpayers. The only bodies added to Section 33 since 1972 have been those undertaking what are, or were formerly, local authority functions, and who have the power in law to precept on local taxes. Charities have no such power and so it is inappropriate in our view to consider extending Section 33 to include them.*

*We have looked closely at the case for a UK grant scheme from public expenditure to compensate charities for the VAT they incur on goods and services used in their exempt and non-business activities. Having given this very careful consideration we have concluded, for reasons of principle and cost, that this is not an idea we wish to pursue.*

*A fundamental principle of VAT is that organisations and individuals can only recover VAT to the extent to which they make taxable supplies. If individuals or organisations are not making taxable supplies, they cannot recover VAT on the things that they buy. This includes charities providing services for no charge and those making exempt supplies. To give charities this tax back would be contrary to this fundamental principle.*

*Moreover, any such scheme would mean a large rise in public spending on charities. Charities have estimated that their VAT bill relating to their non-business activities and exempt activities is in the region of £460*

*million per year. The figure would continue to rise in proportion to the size of the sector and its range of activities. We would therefore be faced with a permanent, high and rising demand on annual public expenditure, which would need to be found from elsewhere in the Government's budget, and would inevitably compete with other public spending priorities. A grant scheme would also increase administrative costs for charities and Government. It would add further complexities to the system, and run counter to our objectives of simplifying the tax system for charities and helping to minimise their compliance costs."*

57. Participants in the current review have stressed the critical importance to the sector of finding a way forward on this issue. They are particularly concerned by the 'unlevel' playing field faced by some Charities providing services as compared with Local Authorities. Two examples from the NCVO submission to this review are below.

Leonard Cheshire

*Leonard Cheshire, a major provider of residential care, training and employment and day care services for disabled people estimates that irrecoverable VAT costs the charity around £800,000 a year. For example, the charity is unable to reclaim VAT on the cost of extending, altering and repairing residential homes whilst public and private sector organisations operating within the same market can reclaim VAT.*

NCH

*NCH is a major provider of social care services for children both under contract and in partnership with central and local government. The organisation similarly feels that the burden of irrecoverable VAT means there is no level playing field when bidding for contracts for children's services against statutory agencies, and that is unfair.*

58. Participants suggested that the problem might best be tackled by adopting a targeted approach to the issue – for example, by targeting refunds or VAT-equalising grants on charities involved in delivering specific services. They note that a precedent for this has already been established in two areas of VAT: in relation to museums and galleries and also for repairs to listed buildings used as a place of worship. These issues are not, therefore, insuperable.

59. However, other groups within the VCS including the Charity Taxation Reform Group do not support a targeted approach. They continue to press for all irrecoverable VAT to be refunded.

60. Participants have also highlighted the way in which the VAT system might inhibit Charities from sharing buildings and backroom costs and asked that the Government also look at ways of addressing this.

## **UNDERSTANDING THE VAT POSITION**

61. A more general concern raised in the course of this review is that the VAT legislation is extremely complex and widely misunderstood. Projects and programmes – including some established and funded by central government - are sometimes set up with little understanding of how the structure of the organisation – or partnership - will affect the VAT liability.

62. There was agreement within the working group that it would be useful to establish an advice point to explain what VAT issues should be taken into consideration when designing and delivering charitable services.

### **THE LOCAL DIMENSION**

63. Much of the above discussion relates to central government programmes and initiatives. Securing effective relations at this level is clearly important. However, in practice, many VCOs still engage most heavily at the local level – particularly in areas such as social care.

64. So developing effective working and funding relationships at a local level are equally important. In practical terms this means ensuring the general principles discussed above – notably around full cost recovery, sensible structuring of payments and moving to longer term funding arrangements – are also applied at the local level.