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Commissioning public services – grants versus contracts

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The aim of this report is to consider economic arguments around alternative commissioning arrangements through which the Department for Education (hereafter 'the Department) might fund services for children, young people and families. In particular, the report considers whether there are particular reasons for favouring either the current grant-based system or an alternative contract-based system. The current grant-based system allocates funding solely to not-for-profit organisations.[1] One potential reason to move to a contracting-based system might be to open up the commissioning process to for-profits. There is therefore some potential overlap between the choice of commissioning arrangements and the choice of provider-type and we consider both issues here.

There is almost no direct, robust evidence that we are aware of on whether a grants-based system or a contracts-based system is likely to deliver better outcomes. A number of arguments have been presented that emphasize the potential benefits and costs associated with both funding systems (see for example, Children England, 2010, NAVCA, 2007). In some cases, these refer to evidence from individual case studies. However, what is lacking is any systematic analysis that directly compares the impact of the two types of funding arrangement on organisations and outcomes, and particularly any quantitative analysis that could be used as a firm basis for policy-making. Part of the reason for this is that grants and

[1] This includes for-profit organisations bidding on a not-for-profit basis.

contracts are often used for different purposes, so direct evidence comparing the two ways of sourcing providers is very hard to come by. There is also little common understanding of the scope of the two different arrangements (NAO, 2005). In many cases, arguments about the impact of grants versus contracts may in fact relate to issues around the administration of the two types of funding arrangement. For example, a big change in the conditions of a contracting scheme (which may affect organisational autonomy) may have a larger effect on community and voluntary organisations than moving from grants to contracts.

In the absence of any robust, causal evidence on the effect of grants versus contracts, this report considers some of the underlying economic principles and arguments with a view to providing insights into the relative strengths and potential weaknesses of the two forms of funding arrangement. We also review the available evidence that is relevant to the issues that have been raised on both sides. This is not a substitute for more direct analysis of the impact the two types of funding and, going forward, this kind of evidence may become available as more organisations move from grant- to contract-funding.

The plan of the report is as follows:

Section 1 contains a basic discussion of commissioning arrangements, some of the economic problems it raises and the implications for provision by for-profit (FP) and not-for-profit (NFP) organisations.

Section 2 summarizes the key features of the alternative funding arrangements (grants and contracts)

Section 3 considers in more detail some of the main arguments around alternative funding arrangements – drawing together available evidence on both sides.

Section 4 concludes.

Section 1: The commissioning process

In this report the term "commissioning arrangements" is used to describe the general process through which the Department chooses how to allocate a pot of spending to meet its needs. This process, set out by the Commissioning Support Programme (2009) and cited by the Department, embodies a number of steps in a cyclical process:

- Stage 1: Understand: Recognising the outcomes you want to achieve from the service, including understanding local needs (the views of children, young people and families should be included).
- Stage 2: Plan: Considering different ways of delivering activities to meet the outcomes outlined in the first stage (providers should be involved).
- Stage 3: Do: allocation of funding across spending priorities and across delivery organisations. These delivery organisations could be for-profit, not-for-profit (voluntary and community sector) or the Department itself.
- Stage 4: Review: monitoring of delivery

The commissioning process should be designed to meet the Department's needs. The main objective is likely to be that the process should deliver the highest possible quality services that meet the Department's service priorities (for a given level of Departmental funding). Considering the impact of the commissioning process on cost and quality of service provision is therefore crucial.

Additionally, the Department may consider it a separate objective to ensure that there are a number of diverse delivery organisations. This could be important for ensuring that service priorities are met in the long-term as well as the short-term. This could imply some consideration to how the commissioning process can sustain a healthy voluntary and community sector as a further objective, although it may be that the for-profit sector can also meet the need for diversity in the long-run.

The allocation of funding could be done either through a grants-based system, or through a contracting based system. These are decisions made in the later stages of the commissioning cycle (predominately stage 3). Whilst the scope of this report is to focus on the differences between grants and contracts, the process by which priorities for the services are set and information from stakeholders gathered will also influence the success of any procurement exercise. Ultimately, it is not just the funding arrangement that is important for ensuring that departmental objectives are met, but the whole of the commissioning process.

Some economics of commissioning

The commissioning process is designed to enable one organisation – referred to as the principal – to have some of the activities necessary to meet its objectives carried out by another organisation (or other organisations) – referred to as the agent. There are a number of well-known – and related – economic problems that may arise in a commissioning process. These are worth reviewing before considering alternative funding arrangements in more detail.

First – there is a fundamental principal-agent problem in that the objectives of the Department (the principal in the relationship) may not exactly match those of the delivery organisation (the agent). One reason for having contracts may be to try to tie the organisation more closely into delivering what the Department wants.

Second – there is typically an asymmetry of information. The Department can not perfectly monitor the activities of the organisation. Nor can it perfectly infer the activities of the organisation from the outcomes because "bad" outcomes may be due to factors beyond the organisation's control and/or may reflect something to do with the types of people that the organisation is working with.

Third – there may be a problem of incomplete contracts in that it may not be possible for the principal to specify all desired outcomes exactly. Even though the parties involved (the

Department and the delivery organisations) may be able to identify accurately what is happening (eg what level of quality of care is being provided), it may not be possible for a third party (e.g., a judge) to accurately observe or to define in a watertight legal way. The issue of incomplete contracts is likely to be very relevant to services for children, young people and families. For example, it is difficult to define the quality of care that should be administered in particular situations in more than a very basic way and hard to prove legally that someone is not doing enough in different situations. NB the problem of incomplete contracts may affect both grants and commissioning contracts.

Contracts can also be incomplete because the desired outcomes may be too numerous to categorise. There may be clusters of outcomes making it difficult to pick one outcome for a contract that does not skew the performance of others. In public services a job often requires workers to perform several tasks – perverse effects can arise when only some of these are rewarded (Burgess and Metcalfe, 1999). MacDonald and Marx (2001) build a model where there are a range of outcomes that the principal sees as complements (they want them all to be achieved) whereas the agent sees them as substitutes (they will prioritise one at the expense of others). In this case rewarding some activities causes what they call 'adverse specialisation'.

<u>For-profit versus not-for-provision of public services</u>

A number of arguments have been made in the economics literature around the implications of these related issues with commissioning for whether public services should be provided by for-profits (FP) or not-for-profit (NFP) organisations (see Grout, 2010, for a discussion). These are worth considering before moving on to focus specifically on grants and contracts.

The main advantage typically associated with FP firms is that they are likely to have greater incentives for cost-cutting because of the profit motive (Hart, Schleifer and Vishny (1997) and Glaeser and Schleifer (2001)). However, when there are incomplete contracts, this cost-cutting pressure could potentially have an adverse impact on non-contractible quality. There is therefore likely to be a tension between achieving cost and quality. The main conclusion from the analysis is that where the social cost of non-contractible quality reduction is large relative to potential cost savings then the case for FP providers is weakened (relative to provision by the public sector or NFPs). In practice, this means that there may be a strong case for FP firms to deliver services such as refuse collection, but there may be a potential concern for non-contractible quality in areas of social care, for example. This is almost certainly the case for many services for children, young people and families – particularly those where there is a strong “care” element where non-contractible quality is likely to be important.

Cost-cutting pressures are likely to be lower in the NFP sector and, as a consequence of this, quality is likely to be higher. Glaeser and Schleifer (2001) show that the higher quality is independent of the NFP having any particular mission or motivation and is driven simply by the absence of a profit motive. Put simply, NFPs are more likely to be trusted not to compromise on the quality of care in pursuit of profit.

Missions are a typical feature of NFP organisations. If the organisation’s mission aligns with that of the Department (i.e. the organisation cares directly about outcomes in the same way as the Department) this can help to alleviate the principal-agent problem – and indeed may remove it altogether. However, there may be a tension if the organisation’s particular mission does not align exactly with the Department’s objectives (one example might be if not-for-profit organisations have particularly narrow ideological missions). For a further discussion of the principal-agent problem and how it might apply in the public sector see Chowdry, 2011.

The organisation’s mission can also help it to attract additional donations – whether of money or time – that can help to lower the cost of provision (Francois and Vlassopoulos, 2007). There is some evidence to support this – Gregg et al (2011) show that donations of unpaid overtime are greater in the case of non-profit organisations (defined to include both not-for-profit organisations and the public sector) than they are for comparable people working in for-profit organisations. The difference is sizeable: Looking at workers in health, education and social care, in the not-for-profit sector, nearly half do some unpaid overtime, while in the for-profit sector, the figure is 30 per cent. The analysis also shows that the mechanism appears to be one of selection – i.e. that motivated agents are attracted to mission-oriented sectors. The fact that workers do not change their behaviour when they switch sectors also rules out that the difference is attributable to different sector-wide practices.

Donations of either time or money can allow NFPs to provide services more cost-effectively (compared to FPs). There is a further implication for how organisations – and individuals within those organisations – can be incentivised. Besley and Ghatak (2005) show that motivated agents require less explicit (financial) incentivisation to provide effort. Benabou and Tirole (2006) go even further and suggest that explicit incentives may crowd out mission. A contract system that links payments to results may create explicit financial incentives that could be cascaded through the organisation. This may be effective within a FP organisations, but less so within a NFP organisation. Recent UK evidence presented by Delfgaauw et al (2011) supports this idea, showing that management tools such as targets and individual rewards and incentives are less strongly related to quality of outcomes in NFP organisations than in comparable FP organisations operating in the same sector.

Section 2: Grants versus contracts – essential features

2.1 Key features of a grants-based system

In a grants-based system, organisations compete with each other by proposing a set of activities that they will deliver in return for a specified amount of money

The range of the proposed activities is likely to be defined by a specific call, which could be broad or narrow. Typically, however, there is likely to be some flexibility for organisations to contribute to the definition of activities to be funded (eg compared to contracts-based system) and to shape spending priorities – which could lead to improved outcomes if delivery organisations have better information (eg about client needs). The flip-side is that there is no guarantee that the proposed activities will fully meet the Department's spending objectives. Also, it is important to emphasize that the funding arrangement itself is not the only opportunity for organisations to feed into priorities – there are other opportunities within the commissioning process.

The current grants-based system run by the Department tightly defines a set of activities that it wants to fund. There is relatively little opportunity for organisations to shape priorities at the bidding stage. This may not maximise the potential to benefit from a grants-based system compared to contracting.

A grant is a lump sum of money that is essentially a gift without any legally binding status. It is usually subject to terms and conditions set by the funder such as to provide a service or complete an activity in a certain way. The money received can only be used to fund the proposed activities and anything not used for that purpose should in principle be returned to the funder. In principle, this may weaken any incentive to cut costs because there is no possibility of generating any surplus. The fact that there is no surplus also means that grants are only likely to be suitable for not-for-profit (NFP) organisations, or private for-profit (FP) organisations who are bidding on a 'not for profit' basis).

A grant is typically linked to a set of activities – with some reporting requirements to check that those activities have been delivered, but monitoring is unlikely to be perfect. Failure to deliver the services described in the grant proposal may result in the organisation having to pay back the value of the grants (but no more) – this reduces financial liability compared to contracts where organisations may be liable to pay additional compensation. In principle, this may make grants more attractive to NFPs (compared to FPs).

Grant-funding can be conditional on match-funding from the organisation. This may rule out some organisations from applying (those who feel unable to raise the additional money). In principle however, match funding could be used as a way of assessing the organisation's degree of commitment to the project and/or wider public support. It can also be used to leverage other funding sources.

Grants can only be used when certain conditions are met. In brief these are that the commissioning body has the legal power to make a grant, that the grant will not contravene EU rules on state aid (generally not the case for TSO's) and the block of money you intend to use for the grant is able to be used for this purpose (for a fuller discussion see NAO 2010a).

2.2 Key features of a contract-based system

In a contracts-based system, organisations compete on the basis of price and/or quality to deliver a specified service.

One implication is that there is a specification – a description of the service to be delivered. This will generally be narrowly defined (eg compared to a grants-based system) giving less opportunity to organisations to shape spending priorities but ensuring a greater chance that the Department gets services that meet specific spending priorities. If the Department has a clearly defined set of priorities, as seems to be indicated by some of the specific activities listed to be delivered under the current grants-based system, then contracting may be appropriate.

Another feature is that failure to deliver the specification has legal implications. This could mean the organisation paying compensation, which in principle could be more that the value of the contract. Compared to a grants-based system, therefore, contracts imply a higher level of financial risk for the delivery organisation. This may make them less attractive compared to grants for not-for-profit organisations who may have less access to credit.

A contract can tie payment to results but this puts some risk onto the delivery organisation which may be penalised for bad outcomes it is not responsible for; it may also create incentives for gaming (for example, selecting client groups in order to achieve good outcomes more easily).

The party paying the money has a right to determine the specification of the completed service and agree a price. There is no right to know how money is spent and if a contractor can meet the specification cheaper they can keep the excess. The opportunity to generate surplus provides an incentive to cut costs and will make them suitable for both not-for-profit and for-profit organisations.

Finally, all public procurement in the UK is governed by the European Union (EU) Treaty and the EU Procurement Directives and UK Procurement Regulations that implement the Directives (NAO, 2010a). These procurement rules exist to try and ensure all providers can compete for contracts on an equal basis and mean that procurement practices should not involve preferential treatment for third sector organisations (NAO, 2010a). However, there are some exceptions to the stringent procurement rules of the EU directives, particularly with ‘Part B’ services which would include the types of services that the department is commissioning. Detailed analysis of procurement law is beyond the scope of this paper.

Contracts imply a legally-binding promise, defined by contract law. A payment under a contract is a fee not a grant, and is subject to VAT (NAO, 2010a).

Section 3: Implications of alternative funding arrangements

Over the last 10 years there has been a big change in the way that funding from statutory sources has been distributed, with funding increasingly coming in the form of contracts compared to grants. Over the period 2000 to 2008 data from NCVO shows that voluntary sector organisations have seen the amount of funding they receive from statutory services grow overall up to 2008, although this is increasingly distributed in the form of contracts. The amount of statutory income given in the form of grants decreased from £4.1 billion to £3.7 billion, whilst the value of contracts increased from £4 billion to £9.1 billion (with the total amount of statutory funding increasing overall). The picture is likely to change following the latest austerity measures.

A number of arguments have been made for the implications of this shift for voluntary and community sector organisations. In this section, we look at these arguments, together with any available evidence, focusing on:

- Effects on organisation size
- Effects on cost of delivery
- Risk transfer
- Effects on quality

3.1 Size of organisations

There has been some concern that the growth of contracting out may have favoured large organisations who are better able to bid for contracts. For example, application and administration costs may act as a barrier for small NFP organisations, while contracts may also carry greater risk that smaller NFP organisations are unable to bear (eg the Department for Work and Pensions set a minimum cash flow requirement for potential prime providers in their recent commissioning process for the Work Programme).

Recent work by the Third Sector Research Centre has attempted to address this by looking at the distribution of incomes in the charitable sector from both a cross-section and longitudinal perspective. (see Backus and Clifford 2010a and 2010b). Looking over the period 1998 – 2008 when there was a growth in contracting out, they find little evidence to suggest that big charities grew disproportionately over the period.

The cross-sectional evidence shows that the share of total income accounted for by the top 10 charities and the top 100 charities (measures of the dominance of biggest charities) fell slightly over the period. Between 1998 and 2008 the share of total income accounted for by the largest 10 charities fell from 11 per cent to 10 per cent. Looking only at social service charities, the share of total income accounted for by the largest 10 charities also fell from 29 per cent to 27 per cent. A similar pattern arises looking at the incomes of the largest 100 charities. Among all charities, their income share remained broadly constant at 62 per cent over the period 1998 – 2008. Among social service charities, the income share of the biggest 100 charities fell from 65 per cent to 63 per cent over the same period.

The longitudinal evidence looks directly at organisations' income growth over the same period. This shows that average (mean) growth among smaller charities was greater than average (mean) growth among larger charities. This pattern is consistent with the cross-sectional evidence showing a slight reduction in the concentration of incomes within the sector. However, mean growth rates, particularly for small charities, can be very much affected by a few very high growth rates – eg some small charities that increased their size many times over. Looking at median growth rates provides more information on the typical growth experience among charities of different sizes. This evidence showed that median growth was slightly lower among smaller charities (those with incomes of £50,000) than among larger (those with incomes greater than £500,000).

Taken together, this evidence suggests that bigger charities have tended to grow more than smaller, but that some small charities have grown very fast (more so than bigger) and that this has stopped incomes across the sector as a whole from becoming more concentrated.

The evidence does not, however, lend much support to the hypothesis that the growth in contracting out has squeezed out smaller charities and heavily favoured big charities.

In any case it is not clear that grants always favour smaller organisations. As with contracts, there may be fixed costs (eg associated with the application process) that make them unattractive. As shown in Table 1, current Department grants funding under this programme is heavily skewed towards large and major charities. This is even compared to all statutory funding from grants and contracts. Major and Large organisations (which together make up all charities with incomes > £1m) account for 89 per cent of current Department funding, compared to 78 per cent of all statutory funding.

Table 1: Distribution of the Departments Voluntary and Community Sector (VCS) grant funding by size of organisation, and compare to other income sources.

	Micro	Small	Medium	Large	Major	Total
VCS grant offered 2011-12 (£) by size of organisation*	200,397	240,000	4,961,411	22,050,949	19,515,814	
VCS grant offered 2012-13 (£) by size of organisation	168,752	180,000	4,712,658	19,417,134	19,147,574	
Total VCS grant offered 2011-13	369,149	420,000	9,674,069	41,468,083	38,663,388	90,225,540
Current DfE VCS grants (shows grants awarded to each size of organisation divided by the total of VCS grant available)	0%	0%	11%	46%	43%	
Total statutory funding (statutory funding by size of organisation as a percentage of all funding received by size of organisation) 2007/08**	0%	3%	18%	33%	45%	
All funding (total amount of funding per size of organisation as a percentage of all funding to the voluntary sector) 2007/08**	1%	5%	18%	32%	44%	
Micro = total income < £10,000 Small = total income £10,000 - £100,000 Medium = total income £100,000 - £1m Large = £1m - £10m Major = total income > £10m * data from Charities Commission Website, not compiled for all DfE grants, only those readily accessible on charity commission website (14 grant holders missing). ** calculated from NCVO Civil Society Almanac 2010						

More detailed information on the organisations that obtained funding under the VCS scheme is summarized in Appendix 1. This information is provided by the Charities Commission and it is important to note that disaggregated information on income and spending is only reported for larger organisations, while information on staff and volunteers is reported inconsistently for all charities. We look at the amount that organisations spend on income generation and fundraising where available. Whilst overall one might expect that larger organisations would be able to exploit economies of scale in applying for funds, this doesn't seem to be the case with major organisations spending more on income generation and governance than large ones. Major organisations do gain more revenue from trading than large organisation, (7% compared to 3%).

3.2 Effects on costs

In principle, the choice of commissioning arrangement may impact on costs in the following ways:

- Administration costs – the costs of administering grants/ contracts may differ
- Delivery costs – the two systems may result in different delivery costs
- Leverage of other funding – grants potentially provide a mechanism for increasing overall levels of funding

3.2.1. Administrative burden

Directly relevant to choice of funding arrangement is which is more expensive and burdensome in terms of time and money and infrastructure. In principle, it should be relatively straightforward to collect information on the magnitude of the costs associated with the two funding arrangements, but there has been no previous analysis that did this and it was outside the scope of this report. We therefore briefly consider costs to the commissioner and to the provider at each of the stages of the commissioning cycle outlined in section 1.

Stage 1 and 2 of the commissioning process: Understand and Plan

In theory, both of these stages of the commissioning cycle are done in collaboration with providers, service users and other stakeholders. This should be the same for both types of commissioning process, grants and contracts.

It may be the case that, if organisations are funded primarily through contracts they will have less scope for staff to be involved in strategic decisions with commissioners, as these are unlikely to be activities funded through contracts. Infrastructure organisations (more so at a local level) have traditionally been more involved in these discussions but this may change as they experience funding pressures.

Stage 3: Do

This is the stage where decisions are made about how to deliver the desired objectives and whether to use either grants or contracts.

To the commissioning body, contracts are presumably more time consuming to devise, because more work needs to be done to tightly specify the service to be delivered. Again, it depends how both grants and contracts are implemented. We would presume more outcomes focused contracting leaves more scope for the providers to devise the activities to be delivered.

The view from within the sector is that grant funding is less burdensome than contract with grant applications typically being less onerous than contracts. Interviews with a sample of voluntary sector organisations conducted by Children England (2010) suggested that tendering for contracts takes longer than grants, with interviewees stating the proportion of time spent on fundraising compared to actual delivery has increased due to the widespread introduction of contracts. There is also a concern from within the sector that some contract funding is for short time periods which can be disruptive for service provision.

The LGA (2011) commissioned some case studies to look at the administrative costs in terms of staff time spent on certain procurement procedures. They used a case study approach because the size and composition of procurement teams, budgets and projects are very variable. Whilst these aren't representative of all authorities (as only 4 case studies were completed) open procedures each cost over £10,000 for two of the local authorities, with one single competitive dialogue procedure (carried out in two of the local authorites) costing over £30,000 for one shire district. Procurement exercises which didn't use any EU procurement procedure cost less, between £1400 and £2000 (but a direct comparison isn't possible as there are likely to have been differences in the type of services being commissioned).

Stage 3 Reporting

Both grants and contracts are likely to have reporting requirements. In the case of grants, conditions can be very detailed and include the process by which money is paid, what the money will be spent on, and even who will spend the money. Also if the activity is not delivered the funder can stop paying further sums. Kennedy (2009) reviewed the terms and conditions of grant funding for different types of funders (central government, trusts and foundations and private companies). Their research indicated that central government were more resistant to renegotiating terms and conditions than other funders. Kennedy (2009) suggest that terms and conditions issued by entire government departments may not be sufficiently tailored to meet needs of particular programmes, and they are often poorly placed to respond to requests to renegotiate terms. The NAO (2009) guide on monitoring cites evidence that public funders' monitoring of third sector providers is more likely to be excessive; and that, on average, public funders impose a heavier monitoring burden on TSOs than do other funders (Heady and Keen, 2009).

In response to this the NAO have produced guidance on 'intelligent monitoring'. This guidance suggests three 'rules of thumb' for monitoring contracts. In their good commissioning guidance the NAO (2010a) also note that there may be terms and conditions that, although minor, may inadvertently discriminate against NFPs (such as payment terms).

As a way to guard against this they suggest holding decision back on some terms and conditions until post-tender negotiations. There are two important caveats to this: the issues must be relatively minor (i.e. not include price or other substantive issues) and all potential bidders must be told about which issues are being held back for post-tender negotiations.

One consequence of reporting arrangements may be to change the way the organisation manages itself. For example, it may need to introduce additional financial procedures and systems. It should not be assumed that all of this is a burden. Some of the changes may have a positive effect to the extent that management practices are strengthened and improved. A growing economics literature has found a positive relationship between management practices (monitoring, targets and incentives) and performance (see Bloom and Van Reenen 2010). This finding is true for manufacturing firms where more rigorous management is associated with higher profitability (Bloom and Van Reenen, 2007), as well as hospitals (Bloom et al, 2010). This might suggest that commissioning arrangements that impose tighter management practices on organisations might have some positive benefits (as well as imposing some extra cost).

Interestingly, however, there is some evidence that this relationship between the quality of management practices and organisational outcomes does not hold for not-for-profit firms. A study of care homes and fostering/adoption agencies which compared similar FP and NFP organisations found that, while better management was associated with better regulatory assessments for FP firms, the same was not true for NFP organisations (Delfgaauw et al, 2011). This would be consistent with the idea discussed in Section 2 that motivated workers need less explicit incentivisation. While this is only one study, it may suggest that the additional management that comes with commissioning arrangements may not translate into improved organisational performance among NFPs. And indeed, such reporting requirements may be seen as intrusive and by NFPs and may erode intrinsic motivation.

3.2.2. Delivery costs

In general, as outlined in section 2, for-profit firms have a greater incentive to cut costs than non-profit firms because – in the case of a contract – they can make a surplus. The downside is this can reduce (non-contractible) quality of the service below the level of optimal social benefit. Grout (2010) describes this as a trade-off between price and quality. In contrast the NFP sector has less incentive to cut quality and may additionally care directly about quality. Whether the non-profit sector is better hinges on whether the social costs of reductions in non-contractible quality are large relative to potential cost savings, and also the contractibility of the output.

With grant arrangements, there is no ability to make profit, as the grant that is made must be spent entirely on the services that has been commissioned. This has the benefit of reducing the possibility of cutting costs on the part of delivery organisations, but it also may encourage the organisations to be inefficient.

With contracting, the potential for organisations to make a surplus means that cost-cutting could be an issue. This will apply predominately to for profit organisations. In reality there is an interplay between the type of commissioning arrangement and the type of organisation (generally it is only NPs that are eligible for grant funding). This means it is difficult to isolate the effect of the commissioning arrangement from the organisational form. An example using Legal Aid funding is given in focus box 1.

With contracting, the commissioner cannot control how organisations (both NFP and FP) spend any surplus they make (if they are able to make a surplus). Whilst clearly non-profit firms will not be able to take this surplus as profit, they may use it to cross subsidise other charitable objectives. Weisbrod (2004) argues that all non-profit firms produce what he calls a ‘mission good’. Maximising the production of this good forms the objective function of non-profit firms but won’t be produced at all by for-profit organisations. For example, the Red Cross supplies blood to rural hospitals, even though this is a loss-making activity. Politically the Red Cross cannot abandon this activity, although arguably they would if they were profit maximizing. Typical behaviour of non-profit firms such as prioritising clients with more access needs could be meeting their mission. Whether this is desirable or not depends on the whether the Department supports the charitable mission of provider and/or is interested in the delivery of wider social outcomes.

Focus box 1 – Different contractual relationships in Legal Aid funding.
Moorhead et al (2003) look at the differences between two types of provider (lawyer verses non-lawyer) in legal aid. In practice this has some parallels between non-profit and for-profit firms, as non-lawyer firms are often (but not always) non-profit. Their study is useful for our purposes because in the data set that they use non-profit firms were contracted using the times spent on cases (inputs, rather than outputs) and the lawyer firms were funded on contracts based around outputs.

Comparing cost and quality across the groups they found that non-profit organizations were cheaper in terms of an hourly rate (because wages were lower and they were able to leverage volunteer time). However the non-profit organisations spent more time on each case that led to a cost per case in non-profits that was almost double that of private solicitor practices. Despite costing more, non-profits did perform better on quality measures including both subjective reports from postal responses of clients and on quantifiable outcome measures. Non-lawyer firms were also more likely to see groups with access problems (minors, elderly, ethnic minorities, disabled).

It is hard to determine whether the differences identified in the providers are due to the type of provider or the type of contract (or some combination of both). It may be that the contract design led to the differences in cost and quality. These differences may persist even without the different contractual relationship, as non-profits may have a different approach to work, and be less willing to cut quality as outlined in some of the economic theory.

3.2.3. Leverage

One way to achieve greater value for money is if government funding leverages further donations. This may be one reason for favouring NFPs (and a grants-based system).

However, from a theoretical perspective, the effect of grants on donations is unclear. Classic public goods models of individual donor behaviour predict that donations will be perfectly crowded out by government funding (see Warr, 1982). Alternatively, government funding might leverage donations if it provides a quality signal and/or if it allows charities to engage in further fundraising activities (eg the grant can be seed money leading to increased donations).

However, recent evidence from Andreoni and Payne (2009) has found that individual charities tend to reduce their fundraising in response to receiving a grant (since they prefer to focus on their core services which are now grant funded) and that this reduction in fundraising has an adverse effect on donations. Using US data they find fairly high levels of crowd out. Every $1 grant leads to a $0.72 reduction in private donations – primarily driven by a reduction in fundraising.

There is relatively little UK evidence on the effect of grants on individuals' donations. Some preliminary work at the University of Bristol looks at what happens to organisations who receive grants from the Big Lottery Fund, compared to those that apply and are unsuccessful. Looking at successful and unsuccessful applicants is one way of trying to compare similar types of organisations and thus identify the effect of receiving a grant. The results give very little indication that grants result in a substantial leveraging in of other income. Successful organisations see their incomes rise in the years following a successful application compared to unsuccessful organisations but net income (i.e. total income minus the value of the grant) does not increase.

However, very few of these organisations engage in fundraising in any meaningful way. In this case, they are less likely to respond to a successful (unsuccessful) grant application by reducing (increasing) their fundraising. This points to the fact that grants may provide an important funding source for some organisations that do not find it cost-effective to fundraise more widely.

Of course, money donations may not be the only resource that NFPs can draw on. As research outlined in section 2 shows NFPs are more likely to have staff who work unpaid overtime. They may also be able to get volunteers involved in their service. They may also have different relationships with users and be better placed to coproduce services with users. Here, the impact of the funding arrangements on the organisation's mission is important since this attracts motivated individuals.

3.3 Risk

Closely linked to the cost arguments is the issue of risk transfer. In general terms a contracting arrangement will transfer financial risk to the provider. This may be one reason why contracs help to lower costs for the principal. However, it may also affect the suitability of contracts for NFP organisations who may be less able to take on financial risk (eg because of reduced access to capital markets). However, there are a range of different types of risk (to both provider and commissioner) that should be taken into account. The NAO (2009) identifies four:

- Financial risk: the budget may be exceeded or there is poor value for money.
- Performance risk: the agreed objectives are not met
- Reputational risk: unwanted actions of the provider brings the programe or funder into disrepute.
- Opportunity Risk: the funder or provider is too risk averse and fails to take actions that could lead to better outcomes.

Technically speaking, contracts transfer both financial risk and performance risk onto providers. In practice, however, contracts have been subject to re-negotiation in the event of factors that have affected the performance of providers. For example, the DWP 'Pathways to Work' Programme aimed to get those on incapacity benefit back to work. It was first piloted in seven districts before being rolled out nationally. In responding to the tender documentation, many contractors overbid, and promised more than they were able to deliver. In response to contractor underperformance and cash-flow difficulties, the DWP invited contractors to submit individual applications for a proportion of the contract service fee to be paid early. During 2008-09 some £24 million of service fees were paid in this way. Payment of these fees was based largely on contractors providing evidence that they had already made service improvements with no commitment to further enhancements required (NAO, 2010b).

Even where contracts have been issued that do transfer performance and financial risk onto the provider, if things do go wrong, the provider will still need to know about serious incidents/ cases. Whilst financial costs from any legal dispute would be covered by the provider, there may still be significant reputational risk to the commissioner. In addition open procurement can be subject to legal challenge. In the four case studies surveyed by the LGA (2011) one of the districts had two legal challenges with an average cost per challenge of £3,400. Two of the other case studies didn't actually face a legal challenge but reported spending staff time dealing with challenge issues, and negating and reducing the risk of challenge.

3.4 Quality

While FP firms may have better incentives than NFP to attain lower costs in delivery, this is not the same as value for money, which is instead is about the optimum combination of whole-of-life costs and quality (NAO, 2010; Neitzert and Ryan-Collins, 2009). However one the main problems is that value for money can be hard to measure and to embed in a contracting relationship. As discussed in section 2 there is a risk that competitive contracts can produce downward pressure on quality when delivered by FP firms seeking to make a surplus. This is particularly for aspects of quality that are harder to measure or contract over (referred to as non-contractible quality). This section briefly explores evidence on quality in relation to gaming, and comparison of quality between for profits and non profits.

3.4.1 Gaming

Most contracts (and in some cases grants) have a number of potential gaming strategies. One common strategy is to focus on 'easier to help' clients who may be less effort to get to a particular output or outcome than others. There is some evidence that non-profit organisations are less likely to game standards in this way as the mission of the organisation can provide a counterbalance to the desire to game. Focus Box 2 gives an example of this as applied to a job training programme.

Focus Box 2 - JTPA

A government programme that is worth mentioning for the amount of scrutiny it has received in the economics literature (although it is based in the US and took place some time ago) is the Job Training Programme (JTPA). This was a national service to help support people back into work in the US and was one of the first major programmes to incentivise providers based on outcomes.

The contract payment structure meant there was a strong incentive for providers to 'game' the standards. Despite this, Heckman, Heinrech and Smith (1997) found that in practice this did not happen as much as anticipated. Front-line staff were motivated to help the harder to reach clients, and as they had considerable discretion over who to accept onto the program they prioritised the disadvantaged (despite this needing higher effort from staff). This shows that staff don't always respond in predictable ways to a performance standard. The presence of motivated staff can change the dynamics of the principal-agent problem.

The program was implemented in different ways across states in the US so the results from Heckman et al may not apply across the board. Other studies did find evidence of gaming responses to the performance standards. County and Marscke (2004) show how agencies manipulated the timing that they graduated candidates from the programme.

3.4.2 Price and Quality Trade-off's

In general, it is hard to find evidence of non-contractible quality of services reducing after the introduction of contracting (not least since this is hard to measure), nor for quality attained by different provider types. Much of the evidence comes from the US and from the hospital sector where both for-profit and not-for-profit firms are present. Sloan (2000) conducts a review, finding that for-profit hospitals tend to have lower staffing levels, especially lower nurse staffing (although there is no clear link to poorer outcomes). For many of the studies reviewed there are few differences in quality between private non-profit and for-profit organisations. His conclusion is that increased competition narrows any initial differences between non-profits and for-profits. This is also the finding in Schleisinger et al (1997) where

NFPs provide greater access (in terms of offering uncompensated care) compared to FPs. However, with increased competition these differences narrowed.

In the NHS Propper et al (2004) found that when competition allowed both price and quality to vary, hospitals located in more competitive markets had poorer quality outcomes following heart attack treatment. However a later study by Gaynor et al (2010) which looked at competition in the NHS where prices were regulated found hospitals engaged in (positive) quality competition. This resulted in significant improvements in mortality and reductions in length-of-stay without changes in total expenditure or increases in expenditure per patient. The conclusion here is that focus on price as the dimension of competition can be potentially harmful and that competition (contracting) should focus on quality.

If there is little clear evidence on quality between FP and NFP providers, there is even less evidence on differences in quality between commissioning using grants and contracts. This is largely because grants and contracts are often used for different purposes so there is no clear comparison group. The focus box below uses the example of children's residential care services. Whilst this is not a recent example, it was written at the time when many local authorities were shifting from a grants system to competitive tendering, so addresses some of the issues around tendering as it was being done at the time.

The mission of a NFP organisation may play some role in driving quality within NFP organisations. There is a perception – particularly within many NFP organisations – that contracting may adversely impact on the mission of an organisation (and linked to this, the motivations of people who work in a paid or unpaid capacity there). In practice, this is likely to depend on how much the activities or outcomes specified in the terms match those that the organisation would like to be doing anyway. As outlined by Chowdry (2011) the impact of incentives relies on understanding an agent's motivations to begin with.

There is some literature from the third sector that suggests regulations that come with statutory funding may limit organisations ability to pursue a mission. Staff or volunteers who thought they were involved in mission focused independent organisations may find their commitment and motivation declining if they encounter regulatory control (Alcock, 2010). At a local level NAVCA (2007) suggest that volunteers may not want to deliver services defined by the local authority as part of a contract. Whilst this does match with some of the theory around motivated agents, it is important to emphasize that there is very little hard evidence of the extent to which mission and volunteerism declines in voluntary organisations moving from grants to contracts.

There may be ways to protect quality in a system of contracts. NAO (2010a) guidance states that NFPs should not be given preferential treatment in procurement, but that steps should be taken to level the playing field). To achieve this, it suggests several principles (which we expand on and add to below) that can help to maximise pubic benefit. In fact, these would seem relevant if the department decided to maintain their current competitive grants programme or move towards full open competitive tendering.

- Make the best use of all resources available: This means ensuring resources including finance, workforce, providers and the market place, buildings, community assets and co-production (Commissioning support programme, 2011). This also means building on the motivation and mission of non-profit organisations who have been working in this field for some time.
- Include social and environmental benefits in the contract terms. As noted by the NAO (2010a) NFPs may have additional benefits that they can add to work they carry out on behalf of public bodies. These may be social, environmental and wider economic benefits, for example, they may provide a sustainable catering service which employs people with mental health issues who might otherwise be claiming benefits or in care. If these kind of benefits are shared by the commissioning body they should be written into the contract terms.
- Ensuring NFP's are involved in the earlier stages of commissioning. It is recommended that you raise awareness about potential procurement with the non-profit sector and involve them in the design of the process (NAO, 2010a). This can also help to align mission of principle and agent.

- Specify outcomes, not activities on the tender: This can enable organisations to be more innovative in the way they deliver a service. It's also important to consider how to value prevention, or preventing negative outcomes occurring in the future.
- Do not inadvertently discriminate against non-profits. This includes insuring contract terms enable non-profits, with small surpluses (NAO, 2010a) to take part. For example, a commitment to pay the provider quarterly in arrears may be acceptable to a large company with cash at its disposal. But it may cause a small TSO, with small surpluses, not to take part in the procurement process. Also ensuring proportionality, so that the scale and complexity of the procurement process is in proportion to the amount of money it involves.

Focus Box 3: Children’s Residential Care: Case Study

In 2008 the new economics foundation produced a report which looked at two case studies as examples of good child-centered practice within specialist therapeutic provision. Whilst the report only used data from two organisations the report is relevant because it was written at a time when contracting was being introduced. Specialist therapeutic provision is an expensive option, and it can be hard to show the benefits of such intervention when looking at ‘hard outcomes’ because change takes a long time, and the young people involved come from severely disadvantaged backgrounds, not only in relation to their families of origin but in terms of their care pathways (Lawlor, E, 2008).

One of the providers in the case studies, Shaftesbury Young People, had recently lost out on contracts to larger providers because it could not compete on price, and was committed to providing higher quality services. The report found that providers were being forced to view essential psychotherapeutic and advocacy services as ‘nice to have’, and staff are being pressurised to slim down their offering to compete on price.

The report argues that if short-term savings compromise care quality, then society and the state will be paying more in the long term to cover the costs associated with poor outcomes among care leavers. Establishing value for money, in other words, means measuring the long-term costs and benefits of intervening over the long-term, and in a more holistic way than commissioners were taking into account at the time. 3

The report also suggested that large voluntary providers might have more in common with large private providers than they do with small voluntary providers. It recommended further research on the relationship between scale and outcomes to better understand this.

Section 4 – summary

Table 2 below brings together the discussion by summarizing the key features of grants and contracts by scoring them "high" or "low" against a set of possible criteria. This is designed to (over)emphasize the main differences between the alternative funding arrangements. In practice, the detail of the design of the commissioning process (whether grants-based or contracts-based) will also have an important effect on each dimension. A narrowly defined call for grants, for example, could restrict organisations' ability to shape services – possibly even more so than a broadly-defined competitive tender.

There is a strong link between the arguments around contracts versus grants and the arguments around for-profits and not-for-profits. This is because opening up services to for-profit firms is likely to involve a shift to contract funding. It is hard to consider the case for alternative funding arrangements without considering the arguments around different types of provider. However, sometimes arguments around grants versus contracts become reduced to a debate about provider type. It is important to recognise the difference between the two. It then might be possible, for example, to think about a making a system of contracting more favourable to NFPs by opening up earlier stages of the commissioning process to a wide range of stakeholders and recognising the range of outcomes that might be important in the service specification (to include more than cost efficiency).

It seems likely that contracting will be more costly in terms of resources in monitoring and compliance (and associated costs if providers game these measures), although this will vary depending on the contract design. The economic arguments suggest that contracting – by opening up service delivery to FP firms – is likely to lower costs of delivery.

However, there may be an important cost-quality trade-off. The type of services that the Department commission are ones where asymmetric information and incomplete contracts are likely to be important in practice. Whilst FPs might deliver cost advantages this could come at the expense of (non-contractible) quality. Thus, one of the main arguments for keeping a grants-based system may be to favour NFPs rather than FPs. However, there may however be other ways of achieving a similar goal, eg finding ways to value the outcomes of NFP firms in a contracting process, such that the decision is not based simply on narrow cost efficiency but on the basis of a proper social cost benefit analysis (or social return on investment analysis).

Whilst grants are often thought of as enabling providers to contribute to the definition of priorities and take advantage of specialised knowledge, the Department's current system seems to specify a narrow set of activities to be delivered. It also allocates funding to large organisations. This may not maximise the potential to benefit from a grants-based system and suggest small costs from moving to a contracts-based system. It is also important to re-emphasize that the funding arrangement is only one part of a wider commissioning process – if the Department wanted to open up priory-setting to a wider group of stakeholders it could do that at an earlier stage in the process. An alternative way to encourage NFPs within a contracts-based system might be through involvement in planning stages, and designing the evaluation criteria to ensure that social value (including desired outcomes such as community engagement and active citizenship) are adequately reflected in the evaluation criteria.

More important than a simple choice between grants versus contracts is to establish good principles that govern the commissioning process. These are likely to apply irrespective of the exact funding arrangement.

Table 2: Summary comparison of key features – grants versus contracts

Characteristics	Grants	Contracts	Comment
Suitability for for-profits (and NFPs)	Low	High	Grants are only really suitable for NFPs. Contracts may be used with both types of organisation. Opening up provision to FPs is likely to involve a move to contracting and many of the arguments around contracting are really about NFP v FP provision
Opportunities for organisations to feed into Departmental spending priorities at funding stage	High	Low	Grants are typically more flexible, allowing organisations to shape priorities. However, it is possible that grants can be tightly specified. Also, there may be other opportunities for priority-shaping within the commissioning process
Certainty over meeting Departmental spending priorities	Low	High	Contracts may be a more effective way for the Department to meet tightly defined spending priorities since the service can be specified exactly (although grants can also be relatively tightly focused).
Administration costs	Low	High	There is some evidence of lower costs for grants, but this is limited. In principle, this seems to be one area where it should be relatively straightforward to do some analysis
Incentives to cut costs in delivery	Low	High	The opportunity to make a surplus under a contract is likely to provide a stronger incentive to cut costs for FP firms. The funding arrangement may make little difference to NFP firms
Opportunity to draw in funding from other sources	High	Low	In principle, organisations can use grants to leverage other funding, but there is little evidence on this.
Financial risk for delivery organisations	Low	High	Contracting passes financial and performance risk to the organisation which may make it less attractive to NFPs. In principle, this may help to reduce costs for the commissioning body. In practice, however, many contracts have been re-negotiated in the face of factors that have impacted on performance.
Quality of service provision	High	Low	The opportunity to make a surplus under a contract may lead to a reduction in non-contractible quality for FP firms. The funding arrangement may make little difference to NFP firms, although grants may allow for more flexiliblity in service provision
Mission	High	Low	The argument has been made that contracting may erode NFP missions, threatening quality, but there is little evidence on this.

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Appendix 1: **Information on organisations that the DfE currently fund (in £'s) from Charity Commission Website**

Size of organisation*	Micro	Small	Medium	Large	Major
Income ***					
Voluntary Income (includes gifts, donations, legacies, grants which provide core funding).				34,596,425	291,625,136
Trading to raise funds (income from trading where the main motivation is raising funds, rather than meeting needs of beneficiaries)				4,980,199	87,639,732
Investment (includes dividends, interest and rents).				426,159	10,101,550
Charitable activities (income received as fees or grants which meet the needs of beneficiaries)				112,731,955	912,365,287
Other				1,385,502	9,065,525
Total Income	21	90,208	16,218,352	160,919,529	1,310,797,230
% Voluntary Income				21%	22%
% Trading				3%	7%
% Charitable activities				70%	70%
Spending					
Spending on income generation & governance				12,719,440	342,225,097
Proportion of income used for income generation & governance				8%	26%

*Micro = total income < £10,000; Small = total income £10,000 - £100,000; Medium = total income £100,000 - £1m; Large = £1m - £10m; Major = total income > £10m
** While DfE made 118 grants, 13 of these were different grants to the same organisations, and 14 were to organisations who were not charities or information was not found on the charities commission website
*** Disaggregated information is only reported consistently for large and major organisations.