ncvo
Sustainable Funding Project

Scanning the environment: what are the key funding and financing issues on the horizon and what impact will they have on the sector?

This article explores the future funding environment for the voluntary and community sector (VCS). The fiscal environment is challenging, and set to get tougher because of various factors, including a decline in grants and cuts to government spending through the 2007 Comprehensive Spending Review. Organisations will need to embrace a new way of thinking to survive in this funding environment. However there are opportunities for forward-thinking voluntary and community organisations (VCOs) to benefit from the new direction of funding.

This article summarises the themes discussed in a seminar of the same title, the plenary session at the Sustainable Funding Project's Annual Gathering, held at NCVO on 7 June 2007. Speaking were Karl Wilding, NCVO's Head of Research, Craig Dearden Phillips, Chief Executive of Speaking Up!, and Carl Emmerson, a Deputy Director of the Institute of Fiscal Studies, and Programme Director of their work on pensions, saving and public finances.

The funding environment

There are tough times ahead for the VCS, and VCOs have already seen the impact of a more difficult funding environment. The so-called 'Tescoisation' of the sector has had a real impact at the grassroots. Smaller organisations are facing the prospect of being squeezed out of the market. Organisations with less than £1million income are facing income shrinkage, almost across the board. Of those with larger income, of between £1million and £10million, only half are growing. Only the really big charities, the 'Tescos' of the sector, have been very successful, financially speaking.

However, there are many positives. The increase in social enterprise activities has already enabled many VCOs to create a more sustainable funding mix through unrestricted income from trading. There is a favourable political environment, and the growth in contracts means that money from government is there for the taking, albeit in a different form. Smaller VCOs are proving that they have the flexibility to adapt and change to the new funding environment.

According to the Charity Commission for England and Wales, there are approximately 168,000 charities, and between them they share a total £42 billion of income every year. However, only 2.5 per cent of charities have an income of more than £1 million, and 57 per cent of charities have an income of less than £10,000. While 80 per cent of charities have an income of less than £100,000, half of all income goes to charities with more than £10 million. The smallest charities, with up to £10,000, get a fraction of the income total.

Supported by
BIG LOTTERY FUND

As the big charities thrive, the VCS is undergoing a step change in terms of funding. We are seeing a distinct move from a funding to a financing environment. Grants are no longer the norm. The 2007 Comprehensive Spending Review makes it likely that there will be even less funding available through government.

In addition, the traditional problems around funding still exist. Some funding relationships are simply not working. It has been said that funders get the sector they deserve: in this case a sector where organisations face a highly uncertain future. There is high level of volatility in charity income. NCVO's *UK Voluntary Sector Almanac 2007* showed that 10 per cent of the charities sampled had moved up or down an income band between one financial year and the last. This means that organisations can see their incomes halve or double year on year.

This precarious situation heightens the need for a sustainable funding mix. VCOs that rely on fewer sources of funding can be hit hard when the contract finishes. The need for full-cost recovery also becomes more pressing in this environment.

The Comprehensive Spending Review

The details of the government's Comprehensive Spending Review (CSR) will be announced in the latter part of 2007. The review will set out spending priorities up to 2011/12. Analysis suggests the CSR will be a challenging one for the government, with knock-on effects to sector funding. The fiscal policies set out by Gordon Brown, and continued by Alastair Darling, will underpin the funding environment for the VCS.

It is useful to look back at Labour's record so far, and compare it to future plans, so we can get a sense of what to expect. In Labour's first two years in office, public spending fell sharply as a share of national income, but it then rose. For the public sector, it was a case of famine, then feast. Looking ahead, it won't exactly be a 'famine', but it will certainly be a diet compared to what we've become used to in recent years. Public spending is set to grow this year, but will then decline slightly over the next four years as a share of GDP.

We can see a similar trend in current expenditure. This is the total amount spent, excluding public sector net investment (such as buildings, which last longer than a year). The government is spending more on investment now than when in came into office. Looking ahead, the investments are unlikely to decline, but the current expenditure, such as wage bills and benefits, will be under pressure.

The reason for this squeeze is the tax burden. There was a sharp increase to the tax burden during Labour's first term in office. This is due both to Gordon Brown's policies as chancellor, but also those he had inherited. There was a decline then a recovery in the second term. This was because the financial sector performed poorly, so tax paid on its profits fell. The situation only improved towards the end of Labour's second term.

What does this mean for public spending? In short, the chancellor will be looking for an increase in the tax burden and a cut in current spending as a share of GDP over the next four years. It's likely that half the money will be raised from taxes, and half from savings.

For the VCS, this will create two new funding challenges. Organisations that fundraise from the public will be asking for money from individuals who are paying more tax. These increases might not be immediately obvious: for example, individuals will move up to pay a higher tax rate, or will have to pay a higher stamp duty. However the result will be less disposable income available for good causes.

Voluntary and community organisations that are dependent on the public sector for funding will also face new challenges. The size of the state grew from 2000 to 2006; looking ahead it is expected to scale back slightly. This will provide a different backdrop for those seeking government funding, and it is unlikely to be a favourable change.

The growth in public spending is set to decline, as we can see if we look at the year on year increase after economy-wide inflation. From 2000/01 to 06/07 spending grew. Over the next four years, it will still grow, but at a much lower level.

One way to look at Brown's past and future actions is to compare these with the Conservatives. As the economy grows, and generates more income, how much is Brown choosing to spend on public services, and how much is he choosing to leave in people's pockets?

Under Margaret Thatcher and John Major, for every additional pound, approximately 30 pence went to public spending, and 70p remained private. To date, Labour has used about half of every additional pound on public spending. Going forward, Brown's plans imply that the split will be 35p for public spending, versus 65p left in the private sector.

In other words, Gordon Brown's spending plans are much more similar to the Conservative approach, than to what Labour has delivered up to now.

Another way to approach the changes in public spending is to look at the average increase by year. In total, public spending is expected to grow by two per cent a year after inflation. This is half the rate of recent years – since April 1999, Labour has delivered a four per cent increase.

Current spending is expected to grow 1.9 per cent a year over the next four-year period. Again, this is not much higher than growth under the Conservatives, where the average was 1.7 per cent. The difference is that Labour is planning to continue increasing the capital budget, which was squeezed under the Conservatives.

When Gordon Brown was chancellor, finances were strengthened, and borrowing was reduced. However a further reduction in borrowing is required. The tax burden is set to continue rising, and spending will be cut as a share of national income.

There are tough choices ahead for the chancellor. Of course, spending plans can always be revised, and the distribution of money may change from the original allocation. However, this would require additional finance. Increasing tax would be a difficult move in the run up to an election. It therefore seems wise not to assume that new pots of money will appear from the horizon, and belts will need to be tightened.

2007 Comprehensive Spending Review: How will the money be divided between government departments?

Brown has announced the total available to spend during the period covered by the CSR. He has already announced the allocations for some departments, and we can make assumptions about others to see how much will be left for the chancellor to play with. This is what we know, and can surmise:

- Public spending is to grow at 2 per cent a year after inflation. The chancellor keeps a small contingency fund. This means that the rest of public spending can grow at 1.9 per cent.

- The combined budget of the Ministry of Justice and the Home Office will be cut by 0.7% a year after inflation.

- Nine smaller departments, including the treasury and cabinet office, will see year on year cuts of 5 per cent.

- The education budget will grow by 2.4 per cent, roughly in line with what we expect the economy to grow by over the same period. This compares to 5 per cent in recent years, showing a significant slowdown in growth.

- Labour has pledged to increase overseas development assistance to reduce poverty and reach UN targets by 2013. If we assume that spending will be increased quickly to reach that target, that will see a growth of 11.2 per cent per year.

- Costs including social security and tax credits are expected to grow by about 2 per cent between this year and next.
- If the NHS is allowed to grow by 4.4 per cent, this will leave 0.4 per cent for the rest of government. The Treasury commissioned a report in 2002 to assess how much it needed to spend on the NHS to 2020 in order to progress to a world-class system. The figure of 4.4 % was the lowest the report envisaged. This is still lower than 7% the NHS is used to. This scenario doesn't leave much for other government spending priorities, including transport, housing and defence.
- If the NHS grows by 3.4 per cent this leaves 1 per cent for the rest of government spending. The figure of 3.4 per cent is the average rate of growth from the birth of the NHS, up to Labour coming into power. The 1 per cent for other departments is still small, but is comparable to what they will get this year and next.

Looking ahead: the challenges

VCOs have seen the end of string-free grants, which are being replaced by service level agreements or contracts. This is a challenge for the VCS. For VCOs with an income of less than £1m, the move away from grants is likely to be especially painful. Where organisations have to compete, it can be hard because there hasn't been investment to improve the capacity to do so.

Larger organisations, those earning more than £1 million, will also face problems. There will be less funding for innovation as the grant economy declines. Costs are growing faster than income. We have reached the end of quite a long era of expansion. The VCS has forgotten what's it's like to be in a dip, as growth comes to an end. It will come as a shock to many.

As public service delivery opens up, there's likely to be more competition, and not just from within the VCS. Increasingly, VCOs are facing direct competition with statutory organisations or the private sector, and it can be difficult to compete. Attitudes to risk and lack of capital are potential barriers. The sector should also bear in mind that the call for a level playing field in public service delivery is also potentially risky. The levelling out could work both ways, with businesses demanding more.

Public service delivery is especially hard for small organisations. There's an awkward clash. The rhetoric from the government is about the empowerment of communities, initiatives at local level. But findings from the 2007 NCVO almanac showed that these organisations are getting squeezed quite hard. The trend is for larger organisations to mop up contracts, threatening diversity. Competing for contracts well and winning is hard for the sector.

Various funding forces are at work. There has only been a modest growth in the amount of money available as grant income, and the investments that produce grants are growing slowly. Meanwhile, lottery money has become part of the VCS's lifeblood. This year alone, the Big Lottery Fund is in the process of handing out £630 million to community organisations and to projects for health, education and the environment. However, many lottery funding streams are already oversubscribed. Many funds, such as 'Reaching Communities', are very difficult to gain access to, even with an excellent application.

The organisations set to lose the most are those who aren't thinking hard enough about their financial management. They won't seek to upscale, or use their assets to maximum potential, for example keeping on expensive offices in London instead of relocating staff and making money from their property. Above all, organisations who still believe the world owes them a living because they are in the voluntary sector will be in for a rude awakening.

Looking ahead: the opportunities

At first glance, the future funding environment might look bleak. But there are opportunities for organisations that are prepared to be forward thinking. The key is to embrace change, and look for the opportunities.

There are positive moves afoot. With the move from funding to financing, we've seen the growth of new financial schemes for the sector, with more loans for example. Futurebuilders, for example, will be expanding its remit from 2008, moving from working in a limited number of areas, to be able to give loan finance to any organisation that delivers public services.

VCS organisations could also benefit from quasi equity investment. This means that if work grows and is successful, the funder gets a proportion of the earned income back. However if a project doesn't work, the organisation doesn't have to repay the investment. Finance providers such as Venturesome are using this type of investment for higher-risk projects which also offer the prospect of a high return.

There are also new capital initiatives to explore, most notably the transfer of community assets. The action plan from the Department for Communities and Local Government earlier this year promoted the transfer of disused buildings from local authorities to community groups. A £400,000 pilot scheme will see some 40 assets transferred for community use. In addition, Gordon Brown established a £30m fund to help these transfers take place. If adequate funding is available, this could provide an excellent opportunity for some groups to expand.

Social enterprise is the buzzword of the moment, and there are currently 55,000 social enterprises in the UK, of which 62 per cent are charities. Social enterprise is set to become even bigger in the future, and some projects will benefit more from business plans than from grants. Let's be clear - social enterprise is not the future for everyone, but there is certainly potential. To encourage the entrepreneurial side of the sector there should be more training for anxious trustees to help them consider loans and other forms of finance. There's a myth of liability, but with a limited company, the worst-case scenario is that the assets of the charity change.

It is also important to bear in mind the increasing convergence of sectors. It's now much harder to define what is public sector, charity, business… The rise in ethical business and social enterprise is helping to blur the boundaries. While this doesn't have to be entirely negative, there may be some work required to ensure the public understand the difference between an ethical business and a charity that trades.

The winners in this new environment will be those who understand their costs and get better at controlling them. Too few organisations have really good financial control. We have to be faster in exploiting the commercial potential of our work. Lots of charities have potential to sell their services, but it's a sleeping potential. Organisations need to build assets, not liabilities.

The winners in this environment are those who build deep relationships across sectors, those who are able to find complementary partners. Successful organisations will also be those who use a broad range of financial instruments.

In conclusion, the key to success for VCOs is to be prepared for a different funding environment in the future. Not everyone will find this easy, but there will be lots of opportunities. Collaboration will be crucial. Voluntary sector culture has been entrenched for a long time, but it will need to change. It's a 'change or die' scenario - VCOs that aren't willing to change have probably got about 10 years left. We're entering a new age and we need to change with it.

Further information and support

If you are interested in following up on any of the issues raised in this article, the following provide a starting point for action.

For an overview of income diversification and tools and resources to support sustainable funding, visit NCVO's Sustainable Funding Project. See www.ncvo-vol.org.uk/sfp

The Public Service Delivery Network is for those working in, and with, the voluntary and community sector, with a responsibility for negotiating and managing public services contracts. It was established by the Sustainable Funding Project in partnership with Futurebuilders England. See www.ncvo-vol.org.uk/psdnetwork

NCVO's Third Sector Foresight project aims to help voluntary organisations plan effectively for the future, with a particular emphasis on providing information about trends affecting the voluntary and community sector. See www.ncvo-vol.org.uk/3sf/

The Charity Commission has published guidance for charities that wish to trade. The guidance, CC35 – *Trustees, trading and tax: How charities may lawfully trade*, is available at www.charity-commission.gov.uk.

The Sustainable Funding Project is an NCVO initiative working in partnership with the Big Lottery Fund and Charity Bank.

The Sustainable Funding Project encourages and enables voluntary and community organisations to explore and exploit a full range of funding and financing options to develop a sustainable funding mix.

The Sustainable Funding Project
funding in the round
Website: www.ncvo-vol.org.uk/sfp
Tel: 0800 2 798 798
Email: sfp@ncvo-vol.org.uk