
11 Direct government funding

Key points

- Governments fund not-for-profit organisations (NFPs) to deliver services that they view as citizen entitlements or part of the social safety net. They also contribute financially to NFP activities that have significant community benefit:
 - direct government funding of NFPs is substantial (currently \$25.5 billion), widespread and growing but has changed in character over recent decades from relatively simple grants to more complex purchasing arrangements
 - clarity and transparency about the contribution of government funding to the costs of NFP services and activities is important for the efficiency and effectiveness of funded activities, and for the achievement of funding outcomes.
- Governments should determine and clearly articulate whether they are fully funding particular services or activities undertaken by NFPs, or only contributing to the costs and, if so, the extent of that contribution:
 - Cost estimates should cover all relevant and reasonable costs required for the service or activity, including evaluation and other appropriate overheads; and contract prices should allow for cost variations related to industry-specific cost factors and the impact of policy changes.
 - Grants are increasingly made under competitive arrangements, and require disproportionate accountability, imposing undue compliance burdens. While recent reforms have moved to reduce this burden, governments could go further in reducing the cost of applying for and acquitting grants, consolidating reporting requirements and removing unnecessary ‘standard contract’ conditions.
- Some conditions on funding are seen as extending beyond what is required:
 - governments should respect the independence of funded organisations, and not impose conditions beyond those essential to achieve agreed outcomes.

Direct funding of the NFP sector is substantial and growing. It is also taking new forms, as governments seek to strengthen accountability and encourage greater funding independence for NFPs. Governments fund NFPs for a range of reasons, which shape the conditionality of the funding, but they also require accountability for the use of taxpayer dollars. However, excessive conditions and compliance requirements impose unnecessary burdens.

The clarity and transparency of funding of NFPs, the level of funding, and its terms and conditions, are all relevant to the efficiency and effectiveness of funded NFPs.

11.1 What should government fund?

In general, government funds the services and activities that the community expects it to fund. This varies across countries and across regions within countries. It also changes over time, as countries become wealthier or changes occur in the demographic profile or household structure. NFPs often seek to influence the expectations of what government will fund through advocacy and empowering citizen rights. Government must find a balance between satisfying demand and the willingness of the community to fund services and activities through taxation.

What does government fund?

In Australia, government funding for NFP activities fall into three broad categories:

- citizen entitlements — for example, primary and secondary health care; and primary and secondary education
- social safety net — unemployment, disability and age pensions are examples of government committing to provide for minimum basic needs. While this is often done through income support, it can also be through targeted provision of a specific good or service, such as housing and some disability services
- activities which government assesses as having significant community benefit — in relation to NFPs, these cover the activities of a myriad of organisations such as sporting clubs, environmental organisations, national cultural institutions, and universities. Government funding is often provided to complement NFP self-funding and co-contributions from participants, and to attract additional resources into NFP activities (chapter 2). Government may also fund peak bodies as a mechanism for engaging with the sector on policy and other issues, such as the development of standards.

An important distinction exists between the first two categories and the third. The first two categories are activities that government sees as essential and feels obliged to ensure are provided, although what belongs in these categories can change over time and with governments. The third category covers activities that are desirable, at least to some in the population.

The services in the ‘essential’ category are generally ‘revealed’ by policy decisions rather than explicitly stated. A recent example was the Australian Government’s

financial support — totalling \$56 million (SEEWRRRC 2009b) — to ensure the continued operation of hundreds of child care centres following the collapse of ABC Learning in 2008. However, as this example suggests, a government commitment to ensure that a service is available does not necessarily involve meeting the full cost of the service — with child care, user co-payments are typical, even for those on low incomes.

The scope and scale of funding in each of these categories depends on community expectations and the government's response. Once government commits to funding, the funded organisation could be a for-profit entity, an NFP or a government agency.

Deciding what to fund — adopting a net benefit test

What government should fund, and to what extent, is ideally based on an assessment of the net benefit. The greatest community wellbeing is achieved when all government funding is allocated efficiently (chapter 2).

In practice, expenditure is lumpy — there is often a minimum level of funding required to get an activity established, and a natural maximum efficient scale. In addition, historical funding relationships can dominate decision making, making reallocation of public resources difficult. For these reasons, and also because of the influence of strategic industry behaviour, it can be difficult to reallocate funding to where it does the greatest good. Greater use of impact assessment, or some form of net benefit test, would assist in directing government funding in ways that would improve efficiency and increase community wellbeing. Maximising net benefits over all funding options provides a broad guiding principle for government funding decisions, and net benefit has been adopted as a key decision criterion for assessing regulatory proposals (Australian Government 2007a).

Use of net benefit to guide funding decisions can be applied at two levels — in deciding where public money is best spent and, within a particular program, in deciding which supplier or applicant would deliver the best 'value for money' in line with the procurement frameworks of Australian governments (chapter 12).

Responses to the draft report expressed varying views on the proposed wider application of net benefit to guide public funding decisions. This is not surprising, given uncertainty over measurement methods, particularly what is included in the scope and the cost of demonstrating outcomes. Yet the alternative is to continue to rely on opaque 'values' or threshold criteria that may exclude innovative suppliers which offer greater, but different, benefits. Greater use of net benefit to make

funding decisions will be assisted by the development of measurement tools and information (chapter 5).

Whose costs and benefits?

A challenge in applying a net benefit test arises where the cost and benefits fall into different areas of government or across jurisdictions. A more integrated service approach such as multi-agency funding (Queensland Government, sub. 156) is likely to drive a broader consideration of costs and benefits across different areas of government. Nevertheless, working across the different ‘silos’ in human services can be difficult to achieve, and requires an effective driver (box 11.1).

Box 11.1 South Australia’s Social Inclusion Initiative

The Initiative aims to use innovative ways to address some of the state’s priority social issues, including homelessness, drug abuse, Aboriginal health and wellbeing, school retention, youth offending, mental health and disability services, and identify novel funding approaches:

- by seeking to facilitate a more appropriate whole-of-government or ‘joined up’ approach, involving government agencies working together and in partnership with the community sector to deliver these joined up services
- by funding to implement specific Action Plans for these priority areas which is independent of portfolio allocations, including \$28.4 million over four years for school retention and \$130 million to better address the needs of people with complex mental health issues
- where possible, by redirecting existing portfolio funding following rigorous evaluation of what is working and what is not.

The 2007 rapid appraisal of the initiative found that the traditional silo approach of individual agencies was the major barrier to more joined up ways of working. It also identified that an issue for the sustainability of the initiative is that agencies often have difficulty in taking over responsibility for social inclusion initiatives if they see them as unfunded ‘non-core’ business.

Sources: South Australian Government (2007, 2009).

Long-term funding decisions

Some government funded services and activities involving NFPs require substantial long-term investment, and will require a ‘... heightened need for cost-effective spending by all governments in the years ahead’ (Rudd 2009). The Commission’s case study on current developments in social housing (presented in appendix I)

illustrates such challenges for government policy and draws out the related implications for the role of the sector as service provider.

Social housing is comprised of public housing and community housing delivered by NFPs. Under Australian governments' current policy for affordable housing, the role of NFP providers is widening significantly, from small organisations catering to a niche market and managing a small proportion of the overall social housing stock to include 'growth providers' with substantial functions in property procurement and disposal, and in housing development.

The case study suggests that, where NFPs are involved in new ways in long-term investments, there is value in: clear policy objectives about the role and value of NFP provision; careful assessment of risk and the risk management options; transparency about all sources of funding; and robust evaluation.

11.2 How does government fund the sector?

Direct funding by government of NFPs is substantial and widespread, and currently exceeds \$25 billion (chapter 4). It is also growing, particularly in relation to the delivery of government funded services (appendix D).

Types of funding

Direct government funding of NFPs is of three types¹:

- *Giving* (or donating) to worthy causes such as scientific and charitable foundations, where the funder wishes to provide general support or a contribution but does not define the expected outputs and allows the recipient to decide on the best use of funds. Core accountability mechanisms are the grant application and subsequent acquittals.
- *Shopping* for (or purchasing) specialised social services, such as disability, counselling and health services for individuals or families in need, where government's focus is on cost and the quality of service delivered. In this model government typically defines the expected outputs and specifies this in a contractual form. Core accountability mechanisms are set out in the funding agreement or contract and subsequent detailed performance reporting.

¹ This typology is based on work originally published in *The Grantmaking Tango* (Unwin 2004). It has been used by the UK National Audit Office (2007a), the UK Treasury (HM Treasury 2006), and the Queensland Auditor-General (2007b), and has found expression in the Queensland Government's *Framework for Investment in Human Services* (2007b).

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- *Investing* seeks a longer-term outcome, such as developing an organisation's or sector capacity and the direction and nature of activities. As with *giving*, accountability is mainly through grant application and acquittals.

Government funding of entitlements or social safety net services typically involve 'shopping'. Support for community benefit activities generally involve 'giving'. Governments do make investments associated with government funded services to ensure adequate supply of providers that can meet quality standards. They may also 'invest' in community endowments that support community benefit activities.² And, more generally, they invest in the sector to promote its sustainability. From an NFP's viewpoint, funding is usually for the purchase of services, or support to NFPs for their activities, although they may also be able to access support services that would not be possible without government investment in this area.

Does government funding cover costs?

While government funding of NFPs covers a broad range of activities, the study has heard most extensively from NFPs involved in the delivery of government funded services. Underfunding by government of NFPs for service delivery has been a repeated theme.³ Some perceptions of underfunding may be due to NFPs feeling that government should provide greater support for NFP activities. But, more generally, there are widespread indications that many government funded services provided by NFPs are not sufficiently funded to cover the cost of service provision — around 85 per cent of providers disagree with the statement 'Government funding covers the true cost of delivering contracted services' (ACOSS 2009).

Perhaps more tellingly, a number of government agencies admitted to making a contribution to contracted service delivery, rather than providing full funding. Almost three-quarters of departments and agencies responding to the Commission's survey also indicated that they fund at least some of their major programs on a contribution basis (appendix D). While there are no comprehensive data on the proportion of costs met by government, available evidence suggests an average of

² While the concepts of *shopping* align with procurement, and *giving* or *investing* align with grants, the term 'grant' is often used to describe what is effectively procurement, in part because of the history in Australia of funding NFPs to deliver services using submission-based grants rather than competitive tendering processes.

³ Underfunding is separate to the matter of fees and charges or consumer co-payments, which provide for a degree of self-funding for the service. Underfunding of services is used here to refer to situations where the level of funding provided by government, even allowing for co-payments, is not sufficient to cover the direct and indirect costs of service provision.

around 70 per cent, with fees and charges making up some of the difference (box 11.2).

Box 11.2 Contribution of government funding to NFP service costs

Available data indicate that the overall proportion of costs met by government funding for contracted services is around 70 per cent, while the level of fees and charges varies.

- In a Queensland study of the cost of providing disability and community services, on average governments grants comprised 74 per cent of total revenue of the NFP service.
- For NSW alcohol and drug residential rehabilitation services, predominantly provided by NFPs, a survey using 2003-04 data found that, on average, services received 71.3 per cent of revenue from government and 17.5 per cent from client fees, leaving a gap of 11.2 per cent. Excluding services with significant revenue from donations and fund raising, these figures are 77.7 per cent, 18.1 per cent and 4.2 per cent respectively.
- The ACOSS Community Sector Survey (2009) found 69.6 per cent of funding was from government, 8.5 per cent from client fees and the remaining 21.9 per cent from own source income (including donations, sponsorships and sales to the public).

Sources: SPRC (2009); Network of Alcohol & Drug Agencies (sub. 66, attach B); ACOSS (2009).

What are the total costs?

At an organisational level there is evidence of a lack of understanding about total activity costs, in particular indirect costs. A Queensland study of disability and community services noted ‘... organisations’ inability to distinguish organisational from service delivery expenditure leading to double counting’ (SPRC 2009). A NSW study of alcohol and drug residential rehabilitation services also found that for estimating costs, the data sources for some services were problematic (Network of Alcohol and Drug Agencies sub. 66). And the National Roundtable of Nonprofit Organisations submitted that:

Other important issues ... [include] ... the extent to which the sector is able to fully cost its services ... (sub. 105, attach B, p. 10)

Some of these difficulties may resolve over time. For example, while the cost of new services may be difficult to estimate, improvements over time in evaluation and in record keeping in relation to established services should assist in estimating the cost of new services, for both governments and NFPs (chapter 5 and chapter 6).

Other difficulties may not be easy to resolve, including the attitude that NFP expenditure on administration is a ‘bad’. This attitude — found amongst donors and some NFPs, though not all (Mission Australia, sub. 56) — not only affects the funding of ‘good’ overheads such as evaluation but also the level of understanding of overhead costs and how they are accounted for in the funding relationship.

11.3 Improving the funding relationship between government and not-for-profit organisations

The government’s funding relationship with the sector is both significant and complex. For all types of funding, a good relationship requires a clear understanding of the costs of the funded service or activity — so that government can undertake due diligence and NFPs can manage well and sustainably. It also informs dialogue between the two.

While recognising government initiatives underway, the Commission recommends broader use of robust costing of funded activities

Cost estimates should be consistent, appropriate and comprehensive over all direct and indirect costs of the funded service or activity. They should also allow for the likelihood of cost variations over the period of the funded activity and causes of systemic variation in costs between NFPs.

Taking account of all relevant direct and indirect costs

The Industry Commission in its 1995 inquiry into charitable organisations (IC 1995) recommended that where governments set the price at which they purchase a service, they should take into account all cost components required to deliver the service, including for evaluation and other such ‘good’ overheads.

A number of Australian governments are undertaking work to better understand costs, including the development of costing methodologies and tools and the examination of costs in particular service areas (box 11.3). While these developments are welcome, there is value in consistency as many NFPs delivering services work across jurisdictions, or across agencies within a jurisdiction.

Box 11.3 Service costing by Australian governments

State governments provided information on their costing exercises for funded services delivered by NFPs:

New South Wales Government (sub. DR315):

The Department of Human Services has developed a costing manual to help NFPs determine the indicative unit cost for a range of child and family services.

Victorian Government (sub. DR305):

Departments have undertaken price reviews that take into account the full costs of delivering services, and include the consideration of other contributions to costs such as fees and co-payments where appropriate.

South Australian Government (sub. 175, p. 32):

The Government has addressed the unit cost of mental health services, noting:

For mental health, SA Health has adopted a strategy of seeking cost/resource inputs from NFPs in the delivery of services to ensure that services are properly costed and funded adequately. *It is a high risk strategy to underfund a service provider, especially when dealing with high risk clients.* [italics added]

Tasmanian Government (Department of Health and Human Services 2009):

As part of its community sector reform agenda, the Department is developing unit costing principles for the funding of community based services with the aim of promoting equity between the regions and defining how much service providers will be paid for the delivery of services.

Other governments have considered the potential impact of specific cost drivers on NFP service delivery.

Queensland Government (sub. DR301):

Queensland government agencies negotiate variations to service agreements where changes in government policy affect the delivery of contracted services: variations require the mutual agreement of both parties.

Western Australian Government (sub. 157):

Funding for human services is indexed on the basis of Wage Price Index and Consumer Price index growth rates.

ACT Government (sub. DR273):

The Government's Service Funding template allows for the joint review of funding and/or outputs where costs increase due to circumstances beyond the NFP's control, including as a result of government policy, and all payments to community sector organisations are based on a combination of Consumer Price Index and Wage Cost Index.

As a guide, in addition to direct costs (such as employees and direct operational expenses), costs should include:

- relevant share of overheads. This includes the fixed costs of running the organisations that can be apportioned to the funded activity, and would include:
 - staff training and other mechanisms to support governance, unless funded by government
 - the annualised cost of capital used in the service, allowing for depreciation
- the cost of taking on and managing risk, including the relevant share of insurance and legal costs
- costs associated with activity related monitoring, reporting and evaluation. As well as ensuring that funded organisations can afford to undertake monitoring and reporting activity, and evaluation where required, this would provide incentives for agencies to only ask for data that are necessary and valued (Ryan, Newton and McGregor-Lowndes 2008, p. 22, also chapter 5)
- costs of reaching required standards, including the cost of related training
- an appropriate share of the costs of meeting other regulatory requirements (including reporting), such as for public liability insurance or related to privacy legislation.

Addressing variations in costs

Costs may vary between service types and delivery in different settings, or over the time period of the funding agreement or contract. Cost estimation should include:

- appropriate indexation factors, taking account of industry-specific wage price movements in highly labour-intensive areas of service delivery and a reasonable allowance for productivity improvement
- other factors which have a systematic impact on cost, such as location, specific client group characteristics, or the requirement that services be available on weekends as well as weekdays
- an assessment of changes in cost that would arise with possible policy change.

This last issue has been raised by a number of submissions, as while policy changes that directly affect service costs or client numbers and service revenue streams can only be managed by governments, some departments have sought to shift this cost onto the providers. The Public Interest Advocacy Centre and the Whitlam Institute (sub. 159, attach A) in particular noted the scope for unilateral variation clauses to impose operational difficulties and uncertainty on contracted service providers.

Improving capacity for costing

It is one thing to identify what is needed for comprehensively estimating reasonable and relevant costs, another to implement such costings. There is often a presumption that with competitive tendering, the tenderer will make a full assessment of costs in developing their bid. Yet government agencies are exposed if they do not know if these costings are adequate to ensure services are delivered as envisaged, so both NFPs and agencies have an incentive to undertake comprehensive costings. For new or expanded services this can be difficult. While the draft report proposed that the costing of NFPs' services and activities be an independent exercise, submissions noted that the experience and understanding of the nature and extent of these costs lies with government and the sector. This knowledge is valuable, and is being employed in current costing exercises (box 11.3).

The question arises as to whether sector providers and funding agencies are likely to need assistance in undertaking costings. Overseas experience is relevant. In the United Kingdom, despite strong endorsement for a policy of full cost recovery (FCR), implementation initially stumbled on several factors including the difficulties that both NFPs and funding departments had in knowing and appropriately attributing the actual costs of service delivery (UK NAO, 2005, 2007a). This was seen as a result of a 'cultural hangover' from the grants funding era, when a common practice of NFPs was to simply add on to a cost estimate a fixed percentage for management costs, with no regard as to whether this was relevant to actual overhead costs.⁴

To address this factor, both government and the sector subsequently provided extensive practical support for implementation of FCR, including the training of sector providers and officials and the development of a costing tool that provided a transparent model to use by NFPs in approaching funding departments (box 11.4). The New Zealand Government, in support of its policy of full funding of essential services, also provided service costing tools (box 11.4).

It is expected that Australian NFPs and government officials may similarly need support to undertake robust costing exercises. This could utilise methodologies and tools for best practice already developed here and overseas.

⁴ Similar issues related to funding from private donors and the National Lottery, but it was thought by the sector that funding by government was the place to address this first (ACEVO, pers. comm., 7 December 2009).

Box 11.4 Costing NFP service delivery in the United Kingdom and New Zealand

United Kingdom (UK) — In 2003, the Government endorsed a policy of ‘full cost recovery’ or FCR, for implementation by 2006, by which ‘funding bodies should recognise that it is legitimate for third sector organisations to recover the appropriate level of overhead costs associated with the provision of a particular service’. As part of implementing the policy, there has been widespread and sustained training of NFP service providers in estimating the full cost of running their organisation, with around 15 000 organisations now trained.

The UK’s Association of the Chief Executives of Voluntary Organisations has also been active in supporting implementation of FCR through developing a range of support measures including website resources, one-to-one support, an organisation-wide budgeting tool (the Full Cost Recovery toolkit) and related publications. The budgeting tool is valued as a transparent model to go to funders with, and its wider value is seen in its endorsement by the Big Lottery Fund.

In 2008, the Government reported that its National Program for Third Sector Commissioning is providing training for up to 3000 public sector commissioning and procurement officers, to improve their practice in working with the sector, including in relation to the implementation of FCR.

New Zealand — In 2008, the then Government committed to move towards fully funding organisations that provide ‘essential services’ — that is, ‘those services which are best provided by community organisations and that government would have to provide directly if the community couldn’t’. In implementing this policy, the Department of Social Development, as an initial step, engaged with providers to understand the full cost of their essential services. A service costing analysis tool was developed, taking into account both direct costs and indirect overhead and operational costs.

Sources: UK NAO (2007a,b); HM Treasury (2006); UK House of Commons (2008b); UK NAO (pers. comm., 7 December 2009); ACEVO (2008; pers. comm., 7 December 2009, 2010); New Zealand MSD (2008a,b).

Given the activity in this area in Australia (box 11.3), no specific recommendation is made in regard to support of costings. However, as with reporting requirements and in other areas, development of a commonly agreed method has the potential to substantially reduce costs over time.

11.4 Funding not-for-profit organisations for service delivery: is change required?

As well as clarity and transparency about the cost of funded services or activities, the level of funding for service delivery remains an issue for the sector. Underfunding is seen as affecting the quality and viability of services (box 11.5).

Where underfunding has occurred, it may relate to one of many cost factors. As such, the current funding crisis for some services may represent the compounding of a relatively minor level of underfunding that has persisted over years. Inadequate indexation, a minor expansion of requirements, or continuous improvement in service standards, that impose only small costs that can be absorbed in one year, add up over time. In imposing and accepting such small cost imposts, adequate regard must be given to long-term cost implications. These issues point to the need to fully understand cost drivers.

Sources of underfunding and its impact

Several elements appear to have contributed to the current levels of funding. One is an apparent confusion about the role of NFPs' own income — the view that many NFPs have access to in-kind resources (donations and volunteers), as well as tax concessions (chapter 7, chapter 10).

In addition, there appears to be inadequate recognition of variable costs — including those incurred in meeting mandated minimum quality standards — and of fixed costs such as those related to overheads. Consultations revealed a reluctance among some government agencies to fund any overheads.

There also appears to be no consistent approach to indexation. In some service areas, lack of full indexation over many years has been related to expectations of offsetting increases in productivity (National Disability Services, sub. 85; PC 2008). However, in services, productivity improvements often provide improvements in quality rather than reductions in unit cost.

Underfunding is seen as having a range of effects on the efficiency and effectiveness of the sector — on the reach of services and their quality, on access to services in rural and remote areas, and on the scope for services to innovate (box 11.5). Other suggested effects include inadequate provision of resources for design, evaluation and organisational management (SPRC 2009); reduced quantity of service provided, and restricted ability for providers to respond to the changed support needs of clients and communities (SPRC 2009); reduced ability to raise capital (chapter 7); reduced ability to recruit and retain staff with the required skills (chapter 10); the exit of some providers from the service market; and a negative impact on the relationship between funding agencies and the sector.

Box 11.5 Views on the adequacy of government funding

Current funding levels are seen as inadequate and having both short and long-term impacts, as noted by the National Roundtable of Nonprofit Organisations:

Frequently inadequate government funding for nonprofit delivery of government services shifts significant financial risk to nonprofit organisations, doesn't pay sufficient regard to their costs of financial capital and results in organisations being required to meet shortfalls in funding from their own resources — thereby diminishing their ability to offer services or innovations which governments are not prepared to fund. (sub. 105, p. 14)

A Queensland study (SPRC 2009) of specialist disability services and community services also found a widespread gap between costs and funding levels.

The National Disability Services noted the impacts and urgency of underfunding:

A history of low funding has undermined the ability of non-government organizations to maintain and update infrastructure or sustain services. ... The situation for many providers is now critical. (sub. 85, pp. 7–8)

Similarly, BoysTown observed:

The true costs of service delivery are not recognised or met in most funding contracts. In negotiating funding contracts the usual procedure is to estimate the direct delivery costs and then add-on a percentage figure for a management fee. This percentage can range across the sector from 5–20% of the service cost. This management fee is intended to cover a proportion of the Manager's time in coordinating the program as well as some administrative costs. There is usually no consideration given to the funding of other required factors needed for the delivery of the program such as regulatory compliance, infrastructure, IT and human resources. Indeed most Governments tend to be very reluctant to fund any capital cost involved in program delivery. (sub. 77, p. 9)

It was also suggested by the Australian General Practice Network (sub. 151) that inflexible service contracts and program guidelines mean NFPs operating in rural and remote locations are at times particularly disadvantaged by higher operating costs.

Many participants were concerned by the lack of a consistent approach to indexation:

Adequate price indexation for funding provided by the Federal Government for the delivery of community services is essential to ensure that the value of the funding keeps pace with costs. The Federal Government does not have a consistent or adequate approach to indexation of funding to community organisations. (ACOSS, sub. 118, p. 33)

There was also a strong view among participants that current indexation methodologies do not adequately reflect the underlying costs of service provision. As submitted by Family Relationship Services Australia:

Over time the accumulated impact of inadequate indexation applied to federally funded services has undermined the viability of community service providers. ... 2007-08 ... was the third consecutive year that wage costs in the health and community services sector increased by around 4% while indexation rates were around 2%. (sub. 132, p. 25)

There is also concern that alternative sources of funding may be limited, such as fund-raising and access to in-kind pro-bono resources (Gilbert + Tobin, sub. DR288), and that increased fees and charges to address funding shortfalls may limit service access (Australian Red Cross, sub. DR296).

Is there a need for action?

The Commission considers that improvements in clarity and transparency about governments' role in funding NFPs is required to improve the efficiency and effectiveness of government funding of the sector and assist in aligning expectations with commitments. It is proposed that Australian governments should determine and clearly articulate whether they are fully funding particular services or activities undertaken by NFPs or only making a contribution towards the associated costs, and the extent of that contribution. This proposed approach, outlined in the draft report, has been welcomed by both governments and the sector, with the Queensland Government suggesting that its move to output-based funding will provide such clarity.

The draft report also recommended that Australian governments should fully fund those services and activities that they would otherwise provide directly, having regard to whether the funded activity is considered essential, as part of the social safety net or an entitlement for eligible Australians. This was seen as providing a more consistent basis on which to decide which services or activities should be fully funded. In proposing this criterion, the Commission was not making an assessment about whether the overall quantum of funding of purchased services and activities delivered by external organisations (including NFPs) is optimal, nor whether the funding allocation is appropriate.

Many respondents to the draft report considered that the proposed criterion was valuable, while some saw it as difficult to implement — how would government determine which of the funded services or activities provided by NFPs it would otherwise provide? Governments also raised concern about the potential fiscal impact.

NFP service providers may agree to make a contribution from their own funding source. This should not be taken for granted. It should be part of the negotiations with the sector on the design of the program for providing the services.

The line between what is fully funded and what receives only a contribution towards costs is ultimately one for governments to draw. However, the Commission considers that it could be made more consistently with regard to the broad range of factors relevant to community wellbeing. It suggests that, in deciding on the level of government contribution to particular services and activities, the following should be taken into consideration:

- whether services or activities are considered citizen or social safety net entitlements (whether means-tested or not) or are otherwise considered essential

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- whether government is clearly purchasing the service or activity on behalf of the community
 - the required reach of these services or activities
 - the impacts of current government funding levels for service quality
 - the long-term implications of the level of funding on the sustainability of service capacity
 - capacity for client contributions
 - whether the NFP service providers have agreed to make a contribution
 - the value to the community of alternative uses of additional government funding, taking account of the efficiency costs of raising taxation revenue.

Adoption of these considerations may see some funded organisations receive increased direct funding from government. While this may appear to be a fiscal impost, these are the services that are likely to require additional funding over time to prevent a collapse in service provision. The net fiscal impact is, however, uncertain, as in such circumstances government could either expand funding or change the level or reach of services provided.

Given the fiscal constraints facing all governments, the main result for many services will be greater clarity and transparency about the extent of funding. This should bring a reconsideration of what is the appropriate balance of requirements that government can impose on NFPs under service provision arrangements, considered further in section 11.5.

RECOMMENDATION 11.1

Australian governments should, in the contracting of services or other funding of external organisations, determine and transparently articulate whether they are fully funding particular services or activities undertaken by not-for-profit organisations, or only making a contribution towards the associated costs and the extent of that contribution.

Australian governments should fully fund those services that they would otherwise provide directly (allowing for co-contributions from clients and any agreed contributions by service providers). In applying this criterion, governments should have regard to whether the funded activity is considered essential, as part of the social safety net or an entitlement for eligible Australians.

Australian governments should ensure that service agreements and contracts include provision for reasonable compensation for providers for the costs imposed by changes in government policy that affect the delivery of the contracted service, for example, changes to eligibility rules, the scope of the service being provided, or reporting requirements.

11.5 Minimising the costs of funding processes

Costs of funding processes, and the obligations imposed on funded NFPs, affect the efficiency and effectiveness of funded organisations. While chapter 12 addresses concerns about processes in contracting for government funded services, this section considers funding more broadly.

Grant funding is a substantial source of NFPs' income. Individual grants vary in value and can be substantial — from less than \$1000 to millions of dollars. For some NFPs, grants are a significant proportion of income. As an illustration, a recent audit by the New South Wales Government (NSW Auditor-General 2009, p. 5) identified expenditure of over \$5 billion in grants each year to a wide variety of individuals and organisations, ranging from 'very small community grants to large grants for health and disability [service] providers'. Over the five years covered by the audit, an average of five grants per included NFP organisation was provided, to a total value, on average, of \$724 000.

There is evidence of concerns about the efficiency of grant-making. For example, the NSW Auditor-General (2009, p. 6) found that 'fewer than one in four [respondents] agree that decisions to approve grants are timely and only one in ten say there is coordination between grant-making agencies (including the Commonwealth)'.

Similar issues apply to funding of NFPs more generally — the Victorian Government's 2007 *Review of Not-for-Profit Regulation* (SSA 2007) estimated savings of \$12 million could be made from the streamlining of service agreements and a further \$0.8 million from the streamlining of grants.

Applying for funding is resource-intensive

A common refrain from NFPs is the high costs of grant application processes, coupled with the uncertainty of success. In small organisations such applications are

commonly prepared by the chief executive officer or manager, or volunteers, while larger NFPs may have more specialised staff (McGregor-Lowndes and Ryan 2009). There is evidence that some organisations are spending almost as much in resources in applying for grants as they ultimately receive. Information provided by government agencies on application success rates and average grant values should assist NFPs in making cost-effective decisions about applying for funding. Such information is being provided by some, for example, the New South Wales Government (NSW Auditor-General 2009) and the Department of Families, Housing, Community Services and Indigenous Affairs (FaHCSIA 2009e).

Costs to government are another consideration in the submission stage of funding. A two-stage tender with initial calls for expression of interest, and pre-tender vetting, are two methods for reducing cost to both parties (McGregor-Lowndes and Ryan, 2009; Ryan, Newton and McGregor-Lowndes 2008). Good information about the government's purpose in funding and its assessment criteria is also clearly important for the efficiency of the application process.

Acquittal and performance reporting can be costly

Funded organisations are typically required to undertake acquittal and performance reporting. Both involve costs which may affect efficiency and effectiveness.

For acquittal, there is a view that the compliance burden related to acquittal is unnecessarily high as '... an increasing portion of the grant is spent on the acquittal process and not for the purpose of the grant' (CPA Australia, sub. 152, p. 3). In particular, non-standard acquittal makes the collection and reporting of such information time consuming and difficult and thus costly. Non-standard acquittal also reduces the usefulness of such information in comparative analysis (chapter 5), though national adoption of a standard chart of accounts (chapter 6) will assist.

The costs of performance reporting have been a repeated theme of submissions, with many indicating that they see little value in it, in part because of both duplication and non-comparability arising from non-standardised data variables. Questions have also been raised about whether governments value reporting by service providers — this was crystallised in a statement by a community resource officer who, when asked by the auditor what they did with an NFP's annual report, responded 'I just file it' (Queensland Auditor-General 2007b, p. 8).

Considering the above sources of administrative and compliance costs, there is limited scope to pass such costs on. While service providers could increase fees and charges, there are concerns that such increases may limit service access (box 11.5).

Most governments are taking action to address the regulatory burden associated with funding NFP activity (box 11.6). Efforts to join up funding streams will drive this further, as will improvements in the understanding of overhead costs. Further reform could consider the apparent value of:

- clear guidelines on how applications will be assessed, including assessment of wider or indirect benefits that are expected to arise from the activity
- processes that are mindful of the application costs and devise proportionate grant assessment processes
- the value in government indicating past success rate for funding applications, and information on the typical number of applicants and range of funds provided
- required reporting on acquittal and agreed performance measures that are consistent with the measurement framework and its underlying principles.

Where government funds NFPs, what is it buying?

As discussed, many NFPs perform multiple roles and access a number of government funding sources, often with disparate reporting requirements. A related concern raised by study participants is that government at times exerts undue influence on funded organisations (box 11.7) — including undue government control over funded activities, such as: highly prescriptive contract conditions that are disproportionate to risk; undue overall control and influence where government is only part-funding an activity; and government control over activities unrelated to the purpose of the funded activity, such as advocacy.

Where government exercises control that is disproportionately high compared to the level of funding, this may have second-round effects. As an example, the Queensland study (SPRC 2009) of specialist disability services and community services found that where government insisted on branding the activity as ‘government funded’ when it was only part-funded by government, NFPs had difficulty in raising funds to cover the remaining costs.

One view is that where government only provides part of the funding, its control should be proportionate to the share of activity funded. From this, it follows that government should exercise more control where it is a major funder, a view recognised by the South Australian Government (sub. 175) and supported by the New South Wales Government (sub. DR315).

Box 11.6 Measures to reduce the regulatory burden in funding

Australia governments have sought to address the red tape burden of funding of NFPs:

Australian Government — New guidelines for grants administration (DFD 2009b) apply the principle of proportionality to reporting and other processes. FaHCSIA has developed master agreements for long form and short form funding agreements.

New South Wales — Reforms in grants administration include streamlining contract administration arrangements through, for example, three-year funding cycles, simplified reporting requirements and new IT interfaces between agencies and NFPs, and release of a *Good Practice Guide for Grants Administration* (2006).

Victoria — Under the *Action Plan for Strengthening Community Organisations*, development of more consistent service agreements and reform of grant-making, is part of broader action to reduce the red tape burden by 25 per cent by July 2011.

Queensland — General reduction in administrative and compliance costs and unnecessarily prescriptive funding agreements: for human services, that financial and performance reporting requirements be commensurate with risk; for disability services, development of new guidelines and procedures to streamline administrative processes and reduce the level of administrative demand/cost for non-government service providers, including in relation to providers retaining savings or seeking a change of purpose for funding; and in the Department of Communities, introduction of an Online Acquittal Support Information System to make it easier, simpler and faster for funded organisations to electronically update records, submit financial acquittals and performance information and access reports relating to this information. Programs co-funded by the Commonwealth Department of Health and Ageing and Queensland Health have also reviewed and aligned their reporting requirements.

South Australia — Actions under the *Red Tape Reduction Program* include: provision of Child safe policy and model Code of Conduct templates for use in preparing risk and safety assessments and developing related policies; simplification of small grants procedures including for acquittal; standardising and simplifying of contract documentation by the Department for Families and Communities through development of a Master Agreement and Service Agreement, in conjunction with the Department of Health; reduced reporting requirements through mutual recognition of quality and accreditation mechanisms against the Service Excellence Program Standards.

Western Australia — Reporting requirements have been reduced and rationalised across certain program areas: one example is for NFPs with multiple contracts with the Drug and Alcohol Office and the Office of Aboriginal and Torres Strait Islander Health.

Tasmania — Steps are being taken to reduce the auditing burden on funded NFPs.

Northern Territory — the Department of Health and Families has streamlined reporting and is using request for proposals instead of tenders.

Sources: NSW Government (sub. 166); Victorian Government (2008); Queensland Government (2009a, sub. DR301); South Australian Government (sub. 175); Western Australian Government (sub. 157); Lenders (2007); Tasmanian Government (pers. comm., 28 October 2009); appendix D.

Box 11.7 Views on undue influence by government as funder

A number of participants expressed concern about what they saw as the level of control by government associated with receipt of government funding.

The Public Interest Advocacy Centre and the Whitlam Institute addressed specific contract conditions:

Of particular note in the review of [government-funded service] contracts was the fact that many of the contracts reviewed included provisions that give the government party the right to:

- remove and replace employees of the not-for-profit party with employees satisfactory to the government party ...
- impose detailed recruitment requirements in respect of staff employed using the government funds under the contract ... [and] ...
- have direct and controlling input to the nature of the governance arrangements for the NFPO or consortium ... (sub. 159, attach A, pp. 44–5)

The Australian Meals on Wheels Association expressed its concerns as follows:

... Government partners with not for profit organisations and seeks significant control over them, often asks more of them or makes them comply as part of the partnership but is not always receptive to changing itself or fully recognising the needs and issues of the not for profit organisation as its true partner. (sub. 28, p. 2)

The Brotherhood of St Laurence spoke about control over advocacy and policy advisory roles, which it identified with broader changes in the relationship between government and the sector dating back to the 1990s:

... the new approach ... had adverse effects ... [including] ... the use of funding contracts 'to curb and control criticism of government policy or even participation in its formation'. (sub. 172, pp. 2–3)

The significant buying power of government funders will inevitably create tensions for NFPs and others in bidding for that funding, and place a focus on the terms on which funding is made available. While NFPs have a choice in engaging with government funders on the proposed terms, the public policy purpose of the funding remains the central consideration. What level of control is appropriate and how it is exercised requires careful judgment about risks to government, NFPs and service clients. Taken simply, partial funding could result in government imposing too few controls for a risky venture, and conversely full funding could result in too much control by government 'just because it can'. Neither would be efficient for either party. Where funded projects are risky, an approach based on relational governance rather than the exercise of control is the more appropriate course (chapter 12).

In relation to the concern about control or influence over NFP activities that are beyond those required to achieve the funding outcome, the ACOSS Community Sector Survey (2009) found that 8 per cent of respondents disagreed with the statement '... our organisation is able to speak publicly about issues affecting our

clients'. While this is less than the 13 per cent figure for the previous year, it suggests that tensions remain. Where influence or control is exerted by government over funded organisations in order to limit advocacy and other activities of NFPs, it is likely to be wasteful of public funds, and may also distort the best endeavours of community organisations.

The above suggests that some conditions on funded organisation and some types of interactions between government and funded organisations may be affecting NFPs' efficiency and effectiveness. Both government and the sector have supported the proposed broad principle for government funding to respect the independence of NFPs.

RECOMMENDATION 11.3

Australian governments funding service provision or making grants should respect the independence of funded organisations and not impose conditions associated with the general operations of the funded organisation, beyond those essential to ensure the delivery of agreed funding outcomes.