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# Health Policy Matters

HELPING DECISION MAKERS PUT HEALTH POLICY INTO PRACTICE

This issue

## Foundation Trusts in the NHS: does more freedom make a difference?

## Introduction

**In 2003 the UK Parliament passed the Health and Social Care Act to create a new type of organisation transforming English NHS Trusts into Foundation Trusts (FTs).[1] FTs are independent not-for-profit public benefit corporations. They are required to meet national targets, like any other Trust, but have more freedom to decide how they achieve these standards.[2]**
**Details of all the additional freedoms are provided in Box 1.[3]**

**Box 1. New freedoms for FTs**

- greater financial flexibility: do not have to break even; allowed to retain surpluses
- can invest in buildings and new services
- manage their own assets
- borrow both from the public and the private sector
- recruit and reward staff with more competitive salaries

**FTs have been introduced in a phased manner since 2004. Applying for Foundation Trust status is voluntary but conditional on achieving high performance. Only Trusts achieving three stars are allowed to apply for Foundation status.**

**The numbers of Trusts in England acquiring Foundation status are provided in Box 2.**

**The Department of Health predicts that around 170 acute and specialist trusts will achieve foundation status by the end of 2008,[4] so it is timely to consider progress. We briefly summarise some of the evidence available on FTs and describe our own research findings on how they are performing to date.**

**Box 2. Number of new FTs in England**

| | Acute Trusts | Specialist Trusts | Mental Health Trusts | Total |
|---|---|---|---|---|
| 2004/05 | 21 | 4 | - | 25 |
| 2005/06 | 5 | 2 | - | 7 |
| 2006/07 | 18 | 4 | 5 | 27 |
| 2007/08 (to April 2007) | 1 | 1 | 1 | 3 |
| Total | 45/153 | 11/20 | 6/74 | 62/247 |
| **Percentage of total type of Trust** | **29%** | **55%** | **8%** | **25%** |

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## Potential benefits of FT status

FT status is expected to bring a range of benefits for citizens and patients.

First, the governance structure of FTs involves a bigger role for local communities, a form of "social ownership" in which local people and FT staff have the right to become members and vote for a board of governors. Responsiveness to local communities in terms of service provision and overall strategy may therefore be enhanced. The morale of staff may improve if they are closely involved in the governance of their organisation, with knock-on effects for users.

Second, whilst local accountability may be enhanced through the changes in governance structure, accountability upwards to the "centre" is reduced. FTs are not directly accountable to the Secretary of State for Health and are not performance managed by strategic health authorities. Monitor is the independent regulator responsible for granting licenses for FTs and monitoring their financial affairs.

Third, the range of additional financial freedoms experienced by FTs is expected to enable them to improve their financial management, efficiency and performance. Being FTs, they should be able to improve their ability to plan and develop services, invest in infrastructure, improve waiting times, maintain standards of care and invest in education and training.[3]

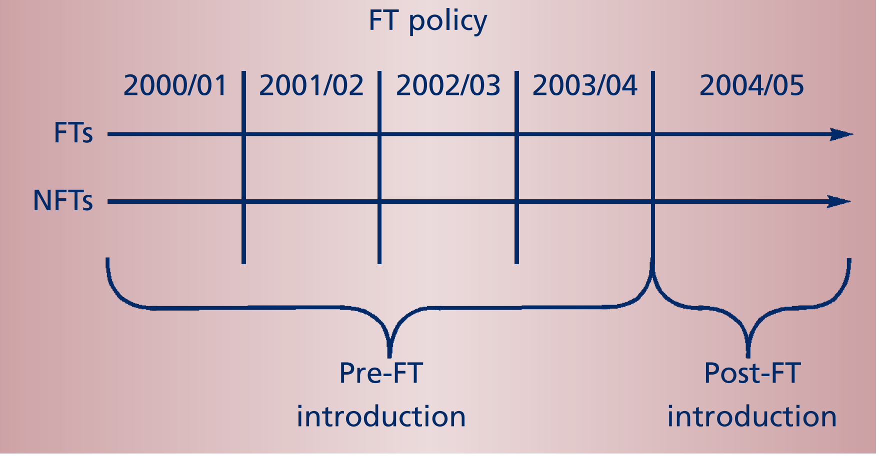
## The realisation of potential benefits

What do we know about whether these benefits have been achieved in practice?

Evidence is quite limited because of the relatively short time in which FTs have operated. Allen[5] summarises research evidence relating to governance and concludes that greater local accountability has not, as yet, been adequately demonstrated. Public and patient membership of boards is low and even where it exists, does not seem to be "active" in terms of producing high turn-outs for board elections. However, there are signs of improvement in terms of the numbers of people becoming members of FTs,[4] although the degree to which they are representative of the community is not known. The Healthcare Commission's review of FTs[3] reported little change in local relationships between FTs and other organisations, with those that had always been good, remaining so; whilst those that were poor, not showing signs of improvement. In terms of staff morale, evidence is sparse. A study undertaken in the early days of the FT process, reported that when asked about autonomy, managers were highly motivated by the thought of having increased discretion in order to provide high quality and responsive services.[6] However, staff generally do not appear to be particularly engaged with the FT process, although contrary to some predictions, there have been no reports of widespread poaching of staff by FTs from other Trusts.[3]

Although central regulation of FTs has been loosened in some areas, they are still subject to a great deal of central control in a rather crowded regulatory environment, covering economic regulation, quality and public safety. Allen[5] describes the autonomy of the FT as being "residual" because the licensing conditions for FTs circumscribe a large part of their activity, although Monitor has said they will pursue a lighter touch with those performing well.[7] Research on the "earned autonomy" package in the NHS (which goes beyond FT status) suggests that Trust managers perceive that in practice autonomy is often granted less in line with their actual objective performance, and more according to their past reputation, quality of informal relationships with the centre and other "softer" factors.[8]

**Box 3: A graphical representation of our analysis**




It is very common to read that FTs are "out-performing" non Foundation Trusts (NFTs) financially.[9] However, this is usually based on very superficial comparisons. There is very little empirical evidence relating to the financial management and performance of FTs. Our own research is the first to shed light on the comparative performance of FTs and NFTs using robust methods. We therefore describe the study and our findings in the next sections.

## Financial management of Foundation Trusts

We explore whether the new financial freedoms enjoyed by FTs have produced any difference in financial management compared to NFTs.

We focus on two measures:

- Retained surplus (measured as a proportion of total expenditure). Despite the fact that FTs are free to not make surpluses, it is clear that Monitor views surplus as a sign of strong financial performance[10] making this a good proxy measure for financial management. Under the increased freedoms, we would anticipate FTs to attain a higher retained surplus when they become an FT.

- Reference Cost Index (RCI). The RCI is an activity weighted average of a Trust's casemix costs relative to the national average. Foundation Trusts are the first Trusts to experience Payment by Results (PbR) under which Trusts are paid a national tariff based on casemix. With the introduction of casemix funding under PbR, Reference Costs are used to set the national tariff on which Trusts are reimbursed.[11] FTs with lower casemix costs may be able to exploit benefits from economies of scope (focusing on the mix of services with costs below national tariff) and economies of scale (expanding the volume of activity for services with costs below the tariff). Trusts have strong incentives to increase activity since this will increase income by much more than it increases costs in the short-term and so can help achieve annual balance.[12] The RCI is also viewed by the Department of Health as a measure of Trusts' relative efficiency – low cost Trusts will have an RCI below 100, although of course the RCI excludes any notion of service quality.[13] Nevertheless, given the new PbR regime, RCI is another good proxy measure for financial management and we would anticipate Trusts to have a lower RCI when they became FTs.

## What we did

We evaluated the financial management of FTs by comparing financial management of FTs and NFTs before and after the policy implementation as shown in Box 3.

Simple comparisons of FTs before and after policy implementation or between FTs and NFTs, will not produce robust results because they will only take into account either cross sectional differences (FTs versus NFTs) or temporal differences (FTs before the policy versus FTs after the policy). A major challenge in policy evaluation of this type is to combine and evaluate the temporal and cross sectional differences jointly. Compared to simple comparisons, this joint comparison has the advantage of dealing with self-selection (since FTs self-select into the policy) and also with changes affecting all Trusts (not just FTs) over the period the policy was introduced.

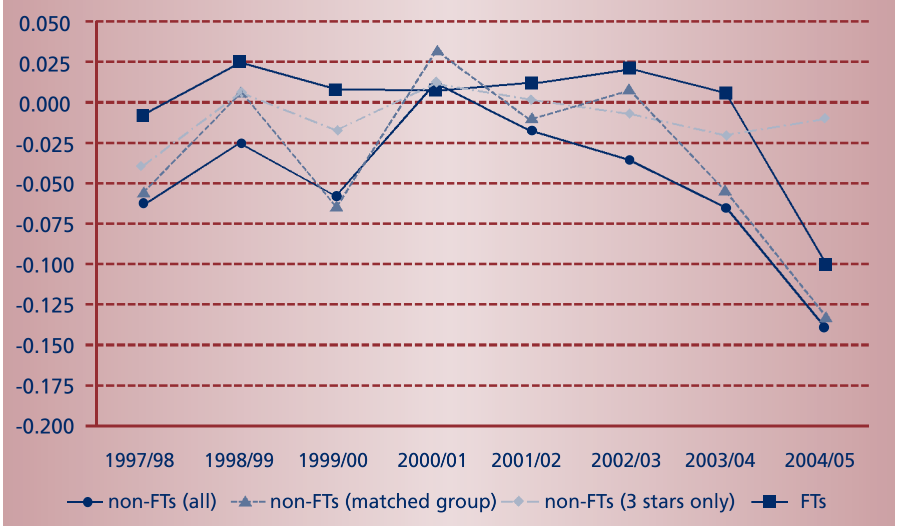
We compared the change in financial management for FTs before and after the policy intervention with the change in financial management for Trusts in a comparator group that is not undergoing the intervention, over the same period. Our methodology considered the introduction of FTs as an experiment and it used a control group (NFTs) with which to compare the FTs.

We compared FTs to three groups of NFTs:

- all NFTs (148 Trusts);
- 3-star NFTs which were eligible to apply for FT status but yet did not (53 Trusts);
- a group of NFTs which were statistically matched to have the same characteristics as FTs (70 Trusts).

We also tested whether there was strategic behaviour in the adoption of FT status by examining the introduction of FT status in waves:

**Figure 1 Retained surplus, FTs and 3 groups of NFTs**




- a group of 10 Trusts which became FTs in April 2004 (wave 1 FTs);
- a group of 10 Trusts which became FTs in June 2004 (wave 2 FTs);
- a group of 5 Trusts which became FTs in January 2005 (wave 3 FTs).

## How we did it

We used data from 2000/01 to 2004/05. We controlled for a large number of observable differences between FTs and NFTs in our models, for example, using data on activity, expenditure, resource use, performance and staffing.

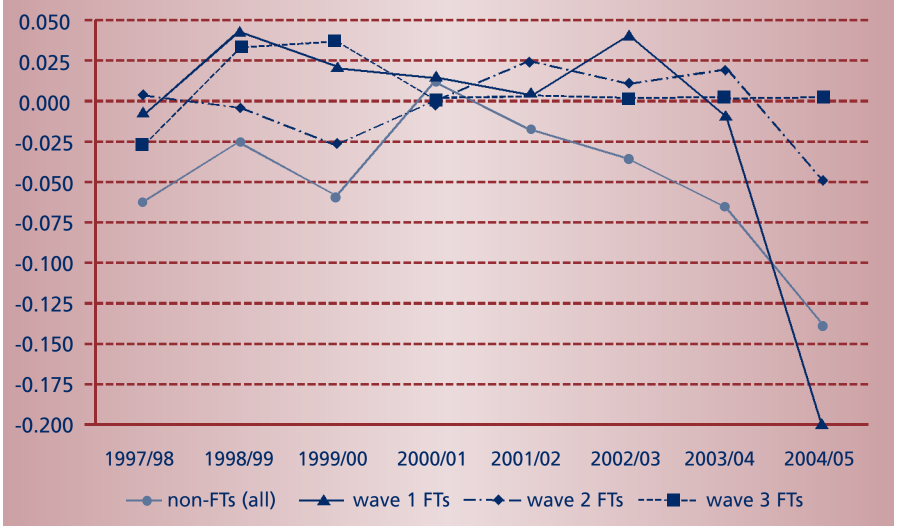
There are some differences in the accounting practices of FTs and NFTs which can affect the measure of retained surplus but we took steps to adjust for this.

Figure 1 plots retained surplus from 1997/98 onwards, for FTs and the three NFT comparator groups. It is clear that FTs have the highest retained surplus over almost the entire period. However like most other Trust groups, except 3-star NFTs, they experienced a large decline in financial balance with the implementation of the reform in 2004/05.

Figure 2 shows that wave 1 FTs seemed to perform well over the entire period, but then saw a massive decline in their surplus in the intervention year (to a worse position than all NFTs). Wave 2 and wave 3 FTs performed reasonably consistently over the period, but while wave 3 FTs maintained financial balance in 2004/05, wave 2 FTs also saw a decline in surplus.

For the RCI we found very similar results. FTs had the lowest RCI over the whole period compared to NFTs. Wave 1 FTs were the best performers in terms of RCI.

Figure 2 Retained surplus, FTs by wave and all NFTs




## Summary of the Findings

Our results from evaluating the difference in financial management between FTs and NFTs are summarised in Box 4. For the FT policy to have had an effect in changing behaviour with respect to financial management, we would expect the difference in surplus to be positive and significant in 2004/05, and the difference in RCI to be negative and significant in 2004/05. Instead we see significant differences between FTs and NFTs over a sustained period of time, and not just in 2004/05. Results are similar when using the other comparator groups.

Both wave 2 and wave 3 FTs had a higher retained surplus in 2004/05, but wave 3 FTs significantly improved their financial position relative to all NFTs over time. We see that these differences have been long-standing and are not brought about specifically by the policy change in 2004/05.

Looking at the RCI, we see that FTs have always tended to outperform NFTs by achieving a lower RCI. In particular wave 1 FTs have a lower RCI of around 8 percentage points over the entire period. We do not observe a change in RCI brought about by the policy.

## What does this mean?

The financial freedoms of FTs should enable them to take a longer planning horizon when it comes to borrowing and investment

**Box 4: Summary of results, difference between FTs and all NFTs in each year**

| **Retained Surplus** | All FTs | Wave 1 | Wave 2 | Wave 3 |
|---|---|---|---|---|
| Difference in 2000/01 | -0.027 | -0.019 | -0.023 | -0.051* |
| Difference in 2001/02 | 0.007 | 0.001 | 0.021 | -0.013 |
| Difference in 2002/03 | 0.050 | 0.063 | 0.039 | 0.041* |
| Difference in 2003/04 | 0.063* | 0.035 | 0.087* | 0.066* |
| Difference in 2004/05 | 0.047 | -0.061 | 0.105* | 0.145* |
| **RCI** | | | | |
| Difference in 2000/01 | -6.180* | -8.778* | -3.246 | -7.001 |
| Difference in 2001/02 | -4.428* | -9.351* | 1.005 | -5.281 |
| Difference in 2002/03 | -3.100 | -8.792* | 0.177 | 1.447 |
| Difference in 2003/04 | -3.964* | -10.152* | 0.524 | -0.876 |
| Difference in 2004/05 | -3.871* | -7.994* | -0.129 | -3.434* |

** Indicates statistically significant result* decisions and may give them long run financial advantages. While they may have greater freedoms to borrow and invest, capital investment under the PbR regime may make it more likely that they can incur deficits. This is because the prospective payment system (PbR) is based on the average of both recurrent and capital costs, which tends to systematically under-fund new capital stock.[12] New hospitals are likely to have higher-than-average capital costs compared to older hospitals whose historic capital costs may be largely written down. This means that FTs with investments in new hospitals or services will tend to be under-funded and more likely to incur deficits in future.

Monitor has already warned that FTs need to make bigger surpluses if they wish to invest in new services and renew their assets.[7] Indeed there are already several examples of FTs that have invested to expand their capacity and develop new services.

According to the Department of Health in a report explaining the NHS deficits from 2003/04 to 2005/06, the deficits are due to a slow adjustment to the change in accounting rules, which from 2004/05 onwards disallowed virement flexibility between capital and revenue accounts. This amounted to between £200 and £300 million of the aggregate deficit.[14] This exogenous shock would have affected all Trusts, but those with better financial management expertise may have been better placed to weather this shock. Wave 3 FTs may therefore have been more proficient at making the most of accounting and financial management skills, relative to other Trusts. Monitor's desire to build a critical mass of FTs with the first wave of implementation, may also have meant that their entry criteria were initially less stringent, suggesting a possible explanation for why wave 1 FTs did worse than wave 3 FTs on retained surplus.

The financial performance of FTs in the future will be affected by the regulatory environment in which they operate. The principles underlying the freedoms granted to FTs allow them greater flexibility to decide on the appropriate level of retained surplus. Thus they are not subject to the same level of central pressure to tackle deficits or to meet ambitious targets for surpluses, that other hospitals have experienced recently.[15] However, FTs are not exempt from these financial pressures. Out of 59 FTs, Monitor has recently rated one of them as risk rating 2 for financial matters (signifying "risk of significant breach in Terms of Authorisation in the medium term, e.g. 9 to 18 months in the absence of remedial action") and a further 12 FTs as risk rating 3 (signifying "regulatory concerns in one or more components. Significant breach of Terms of Authorisation is unlikely").[16] Results for 2005/06 showed that whilst overall the financial position of FTs was relatively healthy, there were 11 FTs with deficits, with one FT running a deficit of almost £40 million.[7]

Monitor has emphasised that the generation of greater surpluses is key to the FT regime and is a signal of efficiency. FTs have been encouraged to move away from the notion that it is somehow inappropriate to make surpluses when other Trusts are in difficulty or to worry that commissioners will use the existence of healthy surpluses as a reason for adopting a hard negotiating position.[8] Monitor also suggests that previous experience shows that FTs are able to "turn-around", responding quickly and effectively to financial challenges and they are therefore optimistic that the financial difficulties faced by a few FTs will be temporary. If they prove to be more entrenched, it is not clear what the mechanism will be for tackling these issues – revoking the licence to operate as an FT will work as an interim measure but will be weaker once the FT process rolls out to all Trusts.

## Conclusions

The evidence on the extent to which the potential benefits of FTs have been achieved in practice is not, so far, particularly promising. Although of course, it is early days for FTs and we might expect such changes to take time to appear. Local responsiveness and accountability has room for improvement; there is limited evidence of enhanced staff morale; and the regulatory regime may not be allowing for as much autonomy for FTs as initially predicted. Evidence on the comparative financial management and efficiency of FTs has not previously been produced aside from superficial comparisons which lack robustness. Our research presented here suggests that, rather than the FT policy suddenly having brought about a change in behaviour, there seem to be longstanding differential trends between these different groups of Trusts. The FT policy per se has not made a significant difference to their financial management. Whether these long-standing trends are sustained as the policy is rolled out to additional hospitals, or whether improved financial performance is gained at the expense of quality, is a matter for future study.

One of the ironies of granting FTs greater freedom is that they are no longer required to provide financial data returns to the "centre". This will severely hamper evaluation of the future performance of FTs due to the lack of comparable financial data available in the public domain. Ideally, we could extend and update our analysis but in the attempt to make FTs more akin to "private" sector organisations, it seems that Monitor may treat such data as commercially sensitive and not available for comparative analysis. This prohibits the analysis of performance and the determination of value for money for tax payers – a troubling trend indeed, given that FTs are indeed still very much part of the public sector.

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