



Community Development INVESTMENT REVIEW

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Pay for Success Financing

Background and Context

- The Real Revolution: Ending 40 Years of Stagnant Results for Communities
- Pay for Success is Not a Panacea
- The Promise of Pay for Success
- Social Impact Bonds (SIBs): Lessons Learned So Far
- Pay for Success: Understanding the Risk Trade-offs
- The Ethics of Pay for Success
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- Tax Increment Finance: A Success-Driven Tool
- Paying for Success to House the Homeless in Massachusetts
- Using Performance-Based Contracting for Kids and Families



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Community Development INVESTMENT REVIEW

The Community Development Department of the Federal Reserve Bank of San Francisco created the Center for Community Development Investments to research and disseminate best practices in providing capital to low- and moderate-income communities. Part of this mission is accomplished by publishing the *Community Development Investment Review*. The *Review* brings together experts to write about various community development investment topics including:

Finance—new tools, techniques, or approaches that increase the volume, lower the cost, lower the risk, or in any way make investments in low-income communities more attractive;

Collaborations—ways in which different groups can pool resources and expertise to address the capital needs of low-income communities;

Public Policy—analysis of how government and public policy influence community development finance options;

Best Practices—showcase innovative projects, people, or institutions that are improving the investment opportunities in low-income areas.

The goal of the *Review* is to bridge the gap between theory and practice and to enlist as many viewpoints as possible—government, nonprofits, financial institutions, and beneficiaries. As a leading economist in the community development field describes it, the *Review* provides “ideas for people who get things done.” For submission guidelines and themes of upcoming issues contact David Erickson, Federal Reserve Bank of San Francisco, 101 Market Street, Mailstop 215, San Francisco, California, 94105-1530, David.Erickson@sf.frb.org. The material herein may not represent the views of the Federal Reserve Bank of San Francisco or the Federal Reserve System.

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Foreword

Ian Galloway*

Federal Reserve Bank of San Francisco

April 2013

I first read about the social impact bond in Emily Bolton and Louise Savelle's excellent 2010 report, *Towards a New Social Economy: Blended Value Creation through Social Impact Bonds*.¹ In it, Bolton and Savelle predicted that the bond could someday be "a significant source of finance for effective services addressing a range of social issues, delivering attractive returns to a wide range of investors and improving people's lives." Their prediction proved prescient. Social impact bonds have become a global phenomenon—now being tested in the United Kingdom, Australia, Canada, and more recently in New York, Massachusetts, and Ohio.² As they increase in popularity, however, it's useful to position the bond in a larger context. The "big idea" behind the social impact bond isn't actually the bond itself; it's that the social sector should be held accountable through *ex post* payments for evidence-based results rather than *ex ante* payments for promising programs. This idea, encapsulated in the phrase "Pay for Success," promises to transform the social sector into a competitive marketplace that efficiently *produces* poverty reduction.

This issue of the *Community Development Investment Review* attempts to do two things. The first is to serve as a comprehensive resource for the most current thinking on the origins, models, and potential implications of Pay for Success. The second is to encourage readers to weigh its exciting potential against its possible pitfalls. Pay for Success is a tantalizing idea but it raises important questions. Are we privatizing important government services that should remain under public control? How can we accurately measure and enforce "success"? Can we guard against fraud? Can we effectively balance our often-conflicting goals of equity, efficiency, and efficacy? Understanding and answering these, and other, questions is a crucial first step before widespread adoption of Pay for Success tools.

Thirty-nine authors contributed to this issue of the *Review*. This diversity of opinion allowed us to present Pay for Success as a constellation of important concepts—not just as a monolithic idea rooted in the social impact bond. Our hope is that this diversity will help policymakers, investors, service providers, and foundations better understand their roles in

* It takes a village to publish a journal. In particular, I would like to thank Caroline Whistler and Steven Godeke for their counsel from the outset and for introducing me to the rich community of practice that supports Pay for Success efforts around the world. I would also like to thank David Erickson, Scott Turner, Ellen Seidman, and Theresa Stark for their invaluable feedback and edits. This journal would not have been possible without their support.

1 Emily Bolton and Louise Savelle, "Towards a New Social Economy: Blended Value Creation through Social Impact Bonds." Social Finance UK, March 2010, available at http://www.socialfinance.org.uk/sites/default/files/Towards_A_New_Social_Economy_web.pdf.

2 Robert Hahn and Peter Passell, "Bonds, Social Impact Bonds." *US News and World Report* Economic Intelligence Blog, November 15, 2012, available at <http://www.usnews.com/opinion/blogs/economic-intelligence/2012/11/15/international-aid-could-find-more-success-with-incentives>.

future Pay for Success transactions. The volume is loosely organized into three sections: 1) Background and Context, which highlights potential benefits and hazards, including ethical implications; 2) Roles and Responsibilities, which explores the participants involved in Pay for Success contracts and their respective responsibilities; and 3) Applications and Models, which profiles existing service interventions ranging from homelessness to foster care, and the various Pay for Success financing structures that support them.

As Daniel Stid points out in this issue, Pay for Success is not a panacea. Nevertheless, it offers an attractive alternative to the status quo of paying for programs instead of results. Despite our best efforts, the poverty rate today is roughly what it was when the War on Poverty began in 1964.³ We are winning important battles but losing the war. A new social policy paradigm is needed. Pay for Success financing has the potential to improve the social sector's effectiveness by rewarding programs that work, encouraging innovation, validating progress, and attracting private capital to the anti-poverty cause. As George Overholser and Caroline Whistler write in this issue, it would "redirect and refocus our abundant resources, relentlessly, toward the innovations that demonstrate an ever-improving ability to deliver the results our communities need." Certainly, important questions remain about Pay for Success. Equally important, however, is can we afford to pay for anything less?

A handwritten signature in black ink, appearing to be 'A. J.' or similar, with a stylized flourish at the end.

³ The official national poverty rate dropped from 17.3 percent in 1964 to 15 percent in 2011. US Census Bureau, Annual Social and Economic Supplement (ASEC) to the Current Population Survey (CPS), available at <http://www.census.gov/hhes/www/poverty/index.html>.

The Real Revolution of Pay for Success: Ending 40 years of Stagnant Results for Communities

George Overholser and Caroline Whistler

Third Sector Capital Partners

Pay for Success (PFS) contracting, social impact bond financing, collective action, impact investing, human capital performance bonds—these are all fascinating and powerful ideas. But the big idea that unites them is progress.

Over the years, most sectors of the U.S economy have displayed a long and steady march of progress, where innovation builds on innovation, relentlessly driving efficiencies and effectiveness to ever-higher levels. A particularly striking example is Moore's Law, which has for 40 years correctly predicted a re-doubling of computer processing speeds and memory size every 24 months.¹ The gains we have seen in medicine, leading to a 50 percent reduction in the US death rates from coronary heart disease and childhood cancers in the last half-century,² are no less impressive. Even from the broadest perspective, where America's real GDP per capita has more than doubled since 1970,³ the steady march of economic progress seems almost inexorable.

And yet, as Jon Baron, president of the Coalition For Evidence-Based Policy, pointed out in a November 29, 2012, *New York Times* op-ed, much of our social sector seems frozen in time.⁴ Forty years after Lyndon Johnson declared a War on Poverty, real median incomes among the poorest 20 percent of Americans have not budged. Nor have our national test scores on math and reading.

Why has the War on Poverty gone so poorly, while Richard Nixon's War on Cancer has made steady progress? Baron's response is to point out the powerful role that rigorous evidence has played in determining which medical innovations are adopted and which are not.

This, indeed, is the *really big idea* behind PFS. Done properly, PFS will create the rigorous feedback loop we need to correctly allocate government's abundant social sector resources. We say "abundant" because government already dedicates tremendous amounts of money and talent towards addressing our most intractable social problems; vastly more money, for

1 For more information see www.moorelaw.org.

2 Jon Baron. "Applying Evidence to Social Programs". *New York Times* "Economix" blog. November 29, 2012, available at <http://economix.blogs.nytimes.com/2012/11/29/applying-evidence-to-social-programs/>.

3 Catherine Mulbrandon. "Long Term Real Growth in US GDP Per Capita 1871-2009". Visualizing Economics. March 8 2011, available at <http://visualizingeconomics.com/blog/2011/03/08/long-term-real-growth-in-us-gdp-per-capita-1871-2009>.

4 Baron. "Applying Evidence". *New York Times* "Economix" blog.

example than all of philanthropy combined.⁵ But we too often fail to direct these resources towards the innovations that work best or to redirect resources when new and better innovations come along. This is the real promise of PFS contracting: redirecting and refocusing our abundant resources, relentlessly, toward the innovations that demonstrate an ever-improving ability to deliver the results our communities need.

Big Data Is Revolutionizing the Science of Impact Evaluation

Historically, randomized control trials, virtually the only reliable and accurate way to truly measure social impact, have been multi-million dollar affairs, involving expensive survey-based ways of collecting data and disruptions to social service operations. Now, in the age of *Freakonomics* and “big data,” we are able to harvest huge quantities of information from administrative databases that are a natural byproduct of running government programs and that passively “observe” social programs in action without disrupting or denying services. The presence of big data is by no means a panacea as local variation in database quality is significant and databases may not capture all types of outcomes or relevant information. Additionally, while big data can “observe” social programs in action, it has a limited ability to evaluate details of the implementation process that are also critical monitoring tools for social programs. Yet despite these limitations, quality government administrative databases are nevertheless an important enabler of significant progress in social service evaluation.

A compelling example comes from the John D. and Catherine T. MacArthur “Genius Award” winner in 2012, Raj Chetty, who was able to compile a database of teacher and classroom assignments from the 1990s for 2.5 million grade school students and to relate them to 18 million test scores.⁶ Then, incredibly, for 90 percent of the students, he was able to match these data up with current tax returns. The results show compelling and rigorous evidence that superior teachers raise students’ future earning power by an average of \$50,000 per student. One might expect that a study like this would cost many millions to conduct. In fact, the data compilation and analysis cost less than \$100,000.

Professor Jeffrey Liebman of Harvard’s Kennedy School of Government has used a similar approach to arrive at comprehensive and ongoing measures of incarceration for the current Massachusetts PFS project. For decades, Massachusetts has used a state wide system called CORI, which provides law enforcement with criminal records of people whom they encounter. The great benefit of CORI is that it captures the incarceration data needed to undergird a randomized control trial. This data can be used to determine a program’s impact, and therefore success payments in a PFS contract. Not only does the CORI database capture data in the same way for all people (whether in a test group or a control group), it is

5 Giving USA: The Annual Report on Philanthropy for the year 2011 (2012). Chicago: Giving USA Foundation, available at www.givingUSAreports.org.

6 Chetty, Friedman, & Rockoff. “The Long-Term Impacts of Teachers: Teacher Value-Added and Students’ Outcomes in Adulthood.” Cambridge: Harvard University December 2011, available at http://obs.rc.fas.harvard.edu/chetty/value_added_slides.pdf.

also ongoing. Most evaluations produce a snapshot of impact; CORI shows us a movie.

These are not isolated examples. The Coalition for Evidence Based Policy recently listed five examples of “gold standard” randomized control trials in which “study costs range from \$50,000 to \$300,000, with random assignment itself comprising only a small portion of this cost (between \$0 and \$20,000).”⁷

As the cost of conducting randomized control trials plummets, and as evaluation methods move from taking snapshots to making movies, the evidence-driven march of social sector progress becomes possible. This tremendous (actuarial) breakthrough is strengthening social science techniques to a point where they are becoming inexpensive enough and reliable enough to (literally) be bankable.

The Danger of Conflating Financing with Contracting in Social Innovation Financing

Social innovation financing is another important breakthrough. But it is wrong to conflate financing with contracting. The distinction is this: PFS contracting means providers cannot be paid until after their level of impact has been assessed. This inherently introduces significant delays in payment. If providers’ balance sheets are very strong, they can self-finance the delays, essentially borrowing money from themselves. But more typically, they will need to borrow from other parties. This bridge financing is precisely what social innovation financing provides, through mechanisms such as the social impact bond (SIB). Technically, the SIB is not actually a bond, but rather a loan to finance the multi-year delays that happen between when service provision expenses are incurred and when government success payments are finally made. SIBs also take on the risk that government payments never materialize.

Outcomes-Based Contracting and Financing Are Not New Ideas

Outcomes-based contracting with government, and the financing it necessitates, have been around for a long time, just not in the social sector. A typical outcomes-based contract might involve the building of a highway. If and when the goal of building the highway is met, the government rewards the builder by sharing toll receipts, which might be high or low depending on the highway’s popularity. But in the interim, the cost of building the highway is financed by investors, who earn market-rate returns on the capital they put at risk. Over time, this form of financing has developed into a multi-billion dollar project finance industry. While social outcomes are potentially more nebulous and difficult to measure than highway construction, PFS deals are not that different.

7 Coalition for Evidence-Based Policy. “Rigorous Program Evaluations on a Budget”. Washington, DC: Coalition for Evidence-Based Policy March 2012, available at <http://coalition4evidence.org/wp-content/uploads/2012/03/Rigorous-Program-Evaluations-on-a-Budget-March-2012.pdf>.

Financing From Mainstream Investors? Yes, But Not Yet.

Just as with highways and power plants, we believe that mainstream investors will one day routinely finance PFS deals. Some particularly profitable nonprofit providers may even self-finance using their own balance sheets. But not yet. Currently, most interventions are not yet cost-effective enough to support the economics of mainstream capital markets. Nor are they proven enough for potential investors to understand the nature of the risks they present. That is why, for a period of time, the PFS industry will need to tap into below-market sources of risk capital: philanthropic donors and impact investors.

Consider the field of micro-finance. It took more than 20 years and \$20 billion of combined philanthropic support and below-market impact investments to fully mature.⁸ Today, the micro-finance industry is large (\$39 billion in loan volume)⁹ and commercially viable (one-half of the industry functions well in a for-profit mode.) Is PFS contracting on a similar path? Only time will tell, but it is worth noting how close we already may be, at least in certain subsectors.

Incarceration avoidance provides a tantalizing example. Soon, we expect to see a PFS arrangement in which: (1) a state saves money as levels of incarceration are reduced, (2) the state shares a portion of the savings in the form of PFS payments, and (3) those payments are more than enough to cover for the expense of the social intervention. In other words, projects like these already show signs of being mildly profitable.

Although these mild profits are not yet sufficient to pay a commercial market rate of return for both the equity and debt capital required to finance the project, they are large enough to provide a modest rate of interest on the debt portion of the financing. In the scenario illustrated in Table 1, we estimate a need to borrow money for three years, with an average loan balance of \$4 million. Based on projected levels of social impact, the project might generate \$11 million in PFS payments against a \$10 million cost structure, generating a surplus of \$1 million. This puts the project in a position to pay a 7 percent annual rate of interest on the debt, and to provide a return of capital, but only minimal surplus, to philanthropists who provide additional equity-like financing. This is well below market for such an unproven and risky proposition. On the other hand, for the philanthropists, the retained surplus represents gains over and above a replenishment of their original grant – a vastly better financial outcome than the 100 percent loss they generally experience when they make a donation. Still, it is not enough to attract for-profit equity investments.

But consider the “march of progress.” Suppose the program becomes more efficient over time or is replaced by a succession of superior innovations. Two things happen. First, a

8 Monitor Group. “From Blueprint to Scale: The Case for Philanthropy in Impact Investing”. Mumbai, India: Acumen Fund. April 2012, available at http://www.monitor.com/Portals/0/MonitorContent/imported/MonitorUnitedStates/Articles/PDFs/Monitor_From_Blueprint_to_Scale_April_2012.pdf.

9 Microfinance Information Exchange. “The MicroBanking Bulletin No. 19.” Washington, DC: Microfinance Information Exchange. December 2009, available at http://www.themix.org/sites/default/files/MBB%2019%20-%20December%202009_0.pdf.

track record is established that reduces the project's perceived risk. In this case, the 7 percent interest rate no longer looks so far below market. Second, the project becomes more profitable. For example, suppose there is a 30 percent improvement in efficiency over a relatively short time period. This translates into a 30 percent increase of PFS payments (to \$14.3 million) without changing the project's costs. That would generate a surplus of \$4.3 million, enough to pay 10 percent interest to the lenders and still have \$2.7 million of surplus left to reward the investors of equity risk capital. At this point, no one can say how many of America's social interventions are within shooting distance of becoming profitable in a PFS format.

Table 1. PFS Financing Example

| | Current Economics | 30% Progress on Impact |
|-----------------------------|----------------------|---------------------------|
| PFS Rewards | \$ 11.0 | \$ 14.3 |
| Project Expense | \$ (10.0) | \$ (10.0) |
| Surplus Before Cost of Debt | \$ 1.0 | \$ 4.3 |
| Interest Paid @ 7% | \$ (0.9) | |
| Interest Paid @ 10% | | \$ (1.3) |
| Retained Surplus | \$ 0.1 | \$ 3.0 |

Philanthropy's Role as an Interim Catalyst

PFS contracting and social innovation financing offer a particularly attractive opportunity to philanthropists, whether they are outright grant makers or impact investors who accept below-market rates of return on their loans. Either way, they have a rare opportunity to invest for a period of time and then enjoy permanent systemic change that no longer needs philanthropic support. In other words, philanthropists have a chance to truly act as catalysts.

Each issue area, whether it be recidivism, homelessness, child welfare, or another, needs its own march of progress. Some will prove to be already profitable; others will have a long distance to go. But one by one, specific interventions serving specific populations will eventually crack the impact and cost-benefit code and enter into a self-reinforcing mode of profitability and growth.

Our collective agenda should focus on harnessing the march of progress for PFS, using philanthropy to drive towards a sustainable market. Philanthropy's role is not only to support these journeys, but also to foster behaviors and interactions that will be needed to sustain PFS once philanthropy is no longer required. For example, even if a philanthropist has enough money to provide 100 percent of the financing needed for a proposed PFS

contract, it is good strategy to nevertheless recruit banks (at near market rates) into covering some portion of the financing. In this way, philanthropy can create the pathway that makes it possible to wean the system off philanthropic support. Philanthropy can also support a sustainable transformation in government transparency and data-driven decision-making by insisting on strict evidence standards and contracting disciplines as conditions to their PFS grant-making. Eventually, philanthropy may pave a march of progress all the way to self-sustaining economics and more efficient government contracting.

Changes Needed to Grow the Field

Several changes are needed to grow the field and build a mature financing market around PFS contracts:

Develop government capacity to measure outcomes through administrative databases and capture fiscal savings on an on-going (not pilot) basis. Sophisticated government databases across all issue areas will drive the ability to contract for outcomes.

Commit to impact that builds PFS contracts around meaningful outcome targets and validates them through transparent, rigorous, and independent evaluations that are cost-effective and feasible for government decision cycles. If absolute rigor is not the top priority, the march of progress will lose its way.

Avoid new recipe laws that take successful one-off pilots and, through political means, roll out the interventions based on programmatic design without keeping the outcomes evidence feedback loop intact. This would tend to refreeze the system into a “fund what once worked” mode.

Invest in scalable and spreadable innovations that have the potential to succeed not just once, but over and over again with PFS contracts.

Create openings for commercial capital to gain exposure and experience with the nascent PFS and social innovation finance field, so that over time it may become the primary financier of contracts. Of course, as government is the ultimate payer of PFS contracts, incentives for commercial capital must align with government expectations and commitments to pay.

Experiment with multiple structures to determine which intervention approaches and financing constructs enable PFS to become most effective in the long term. This includes experimentation with sole-provider versus collective action models and with varied levels of autonomous decision-making power for the intermediary.

Adhering to these principles will be difficult, and the evolution from an innovative idea to a robust market solution will take time. But the long march of progress certainly seems well worth the effort. We have a chance to break away from decades of relative stagnancy, and to transform the way government funds many of the most vital social services in this country. Not only will our taxpayers feel less burdened, but our most vulnerable communities may at long last begin to rise on the same tide that has lifted so many others to such great heights.

George Overholser is CEO and co-founder of Third Sector Capital Partners. Previously, he was a member of Capital One's founding management team and co-founder of North Hill Ventures, a Boston-based venture capital firm, before transitioning full-time to the social sector 12 years ago. An expert in finance, evaluation, and social entrepreneurship, he is a recognized leader in the emerging PFS and social innovation financing fields.

Caroline Whistler is a partner and co-founder of Third Sector Capital Partners. Previously, she worked at Nonprofit Finance Fund Capital Partners, where she developed growth capital campaigns for high-performing nonprofits and supported over \$300 million in nonprofit financing.

Pay For Success Is Not a Panacea

Daniel Stid

The Bridgespan Group

Our society needs Pay for Success (PFS) schemes to work. We are spending too much on social programs that do not generate results, too much on high-cost treatments, and not enough on lower cost and more humane prevention. Amid our deteriorating fiscal state, we must figure out how to do more with less. No wonder a growing array of academics, financial intermediaries, consultants, government officials, and *New York Times* commentators are extolling "The Promise of Social Impact Bonds," an intriguing new variant of the PFS approach.¹

Yet I'm hesitant to jump on the bandwagon, in part because to date there are only a few social impact bonds (SIB) up and running, and we don't know yet if they are working. The most established initiative, to combat recidivism among inmates released from the Peterborough Prison in the United Kingdom, has yet to produce any definitive results. In 2012, the first SIBs were launched in the United States in New York City and Massachusetts, among other early adopters. But it will be years before we know whether these experiments have paid off. If the "invest in what works" movement is about scaling proven solutions, there is considerable irony in so many of its participants calling for widespread adoption of a financial mechanism for doing so that remains essentially untested.

Ultimately, my skepticism is grounded in the challenges that federal, state, and local government agencies have faced in trying to use performance-based contracts during the past two decades—and how SIBs may in fact make several of these challenges worse. In what follows I map out these challenges, then suggest some ways in which advocates and practitioners of this latest approach might seek to overcome them.

Some background will be helpful at the outset. PFS schemes are not new. Performance-based contracting, in which government pays not for activities (inputs and outputs) but rather for results (outcomes), was a central thrust of the "reinventing government" movement that began in the 1980s and was championed by Al Gore during the Clinton administration. For all of the initial promise, performance-based contracting has not become pervasive and has taken hold in only a few places with strong management capacity (e.g., New York City) or where legal challenges and scandals have cleared the way for it (e.g., child

¹ See, for example, Jeffrey B. Liebman, "Social Impact Bonds: A Promising New Financing Model to Accelerate Social Innovation and Improve Government Performance" (Washington, DC: Center for American Progress, February 2011); Social Finance, "A New Tool for Scaling Impact: How Social Impact Bonds Can Mobilize Private Capital to Advance Social Good" (Social Finance, February 2012); McKinsey & Company, "From Potential to Action: Bringing Social Impact Bonds to the US" (McKinsey & Co., May 2012); Jonathan Greenblatt, "Social Impact Bonds Bring Social Innovation to the Bay State," *Huffington Post*, May 9, 2012, and Tina Rosenberg, "The Promise of Social Impact Bonds," *New York Times*, June 20, 2012.

welfare in Illinois and Tennessee).²

Social impact bonds solve one problem that has constrained PFS: the lag in time between when costs are incurred to deliver services, such as supporting and finding a home for a foster child, and when outcomes materialize, when the foster child is stably and safely housed over a given period. Government agencies seeking to pay only for results have had to fudge things by reimbursing nonprofits for select inputs and outputs along the way, enabling them to cover at least some of their costs, and then paying out the remaining portion of the contract after the outcomes have been realized. With SIBs, a third-party intermediary lines up the resources to pay nonprofits as they do the work and takes on the financial risk of delivering results. The government later reimburses the intermediary at levels that provide it and its investors a sufficient rate of return—but only if and when the outcomes are realized. So what's not to like?

Why Government Agencies Will Face Challenges in Making SIBs Work

To start, all of this assumes that procurement functions in federal, state, and local government agencies will be ready, willing, and able to use SIBs. I doubt they will any time soon. Another reason government contracting officials—typically not the most visionary and experimental of bureaucrats—remain wedded to using inputs and outputs as the basis for their contracts is that these things are much easier to confirm and count than outcomes. A 2009 survey of more than 600 government procurement officers working at all levels of government found that only 40 percent of them were using performance-based contracting for services. The most frequently cited barriers to increased use were "lack of trained procurement staff" (39 percent) and "lack of understanding on the part of top administrators" (28 percent).³ If these officials are challenged to implement basic performance-based, two-party contracts, how will they fare with SIBs given the third parties, extended time horizons, independent impact evaluations, and all-or-nothing payments involved?

Moreover, SIBs will exacerbate the government's principal-agent problem. This problem exists even in traditional performance-based contracts, where the principal, that is, the government agency issuing and managing the contract, must rely from a distance on its agent, the nonprofit using taxpayer dollars appropriately (or not) to deliver services effectively (or not). Hence, government's temptation to micro-manage nonprofits, insisting that their work reflects certain inputs and outputs, even though the ostensible goal is to pay for results.

2 See, for example, David Osborne and Ted Gaebler, *Reinventing Government* (New York: Penguin Books, 1993); Lawrence L. Martin, "Performance-Based Contracting for Human Services: Does it Work?" *Administration in Social Work* 29(1), 2005: 63-77; Dennis Smith and William Grinker, "The Promise and Pitfalls of Performance-Based Contracting." Paper prepared for the annual research conference of the Association for Public Policy Analysis and Management, Washington, DC, November 2003; and Quality Improvement Center on the Privatization of Child Welfare Services, "Examples of Performance Based Contracting in Child Welfare Services," July 2005.

3 Lawrence J. Martin, "Performance Based Contracting For Services: A Survey of NIGP Members." Presentation for GSA Training Conference and Expo, 2010, available at www.fai.gov/.../Larry_Martin_PBC_for_NGIP_Members.ppt.

Social impact bonds will aggravate this problem in part because of the high stakes involved. As a recent study by McKinsey points out, for SIBs to pay off, they must offer enough savings from effectively delivering prevention to provide ample margins for all the intermediaries and investors involved—and so that government will find the more complicated arrangements worth the effort. This calls for engaging with high-cost users of government services such as the chronically homeless or ex-offenders.⁴ But these populations also present higher risks of harm, to themselves or others, and thus of headlines that can lead to one's boss getting fired and one's boss's boss losing the next election.

The government's principal-agent problem will be further compounded because SIBs create an additional layer of agents. The intermediary orchestrating the initial financing and delivery of services as described in multiple white papers by advocates will now stand between government and the work it might ultimately be on the hook to pay for, not to mention the populations it has a particular interest in monitoring. The frictionless world imagined by SIB proponents, one in which government agencies defer to the decisions of intermediaries as they enlist and manage service providers and to the judgments of yet another third party on whether results have been realized and tax-payer dollars should be handed over will, I'd wager, prove to be just that—imaginary.

Moreover, there will in almost all cases be not one but multiple government principals involved and wanting their policies and priorities reflected in a given SIB. High-cost populations that offer the financial upside needed to make SIBs feasible are typically the focus of several agencies and programs across the federal, state, and local levels of government. Most advocates of SIBs gloss over this complication.

To its credit, the McKinsey report acknowledges that a social impact bond "will likely touch multiple programs and agencies, and require coordination on terms and structure; agencies may resist giving up their power and autonomy," and that "repaying investors from realized cash savings may require aggregating SIB benefits across multiple agencies and programs as well as different levels of government. This could prove challenging." Indeed it could! McKinsey's proposed solutions include a mayor or governor creating a "dedicated 'super team' with central decision-making authority" as well as "ensuring that government data systems are capable of tracking costs and service utilization at the client level."⁵ These recommendations fail to come to grips with the messy realities of American politics and government in most states and localities.

Potential Ways of Overcoming These Challenges

How can advocates in government, the social sector, and finance calling for expanded use of SIBs overcome the challenges outlined above? The first and most practical way will be to simplify, to the greatest extent possible, the government's principal-agent problem. All else

4 McKinsey & Company, "From Potential to Action," pp. 22-34.

5 Ibid, pp. 36-37.

being equal, this problem will be simplified when:

- The population(s) being served present less risk of harming others, themselves, or being harmed by others;
- There are fewer levels—federal, state, or local—of government involved (if not just one);
- There are fewer agencies involved within a particular level of government (if not just one);
- The interval between the service provision and the demonstration of impact that triggers payment is shorter;
- The data demonstrating impact are already available and being tracked within existing government systems;
- The government agency or agencies overseeing the bond are able to select and guide the work of the service provider(s) directly.

Now obviously optimizing for all of these simplifying conditions at once will greatly reduce if not eliminate the feasible scope of SIBs; if there is no risk there will be no upside for the parties involved. But in developing variants of SIBs, the government leaders, intermediaries, philanthropists, investors, and nonprofits involved will need to keep things as simple as they can. Taking on more complexity on two or three of these dimensions will be much more feasible than taking on more complex solutions for all of them at once, especially in the initial wave of experiments.

Indeed we are already seeing more practical workarounds developing. In both New York City and Massachusetts, for example, government officials engaged directly with the program intermediaries and service providers that they wanted to work with instead of leaving that choice up to the third party that was bringing the financing to the table. Government leaders may be prepared to go out on a limb and experiment with SIBs, but they want to do so with organizations whose programmatic capacity to deliver they know and trust.

Another simplification would have well-capitalized and philanthropically-backed service providers already working closely with government agencies offering to take on the financial risk of successful delivery directly, provided that they would enjoy the same degrees of freedom and marginal upside that, in the more institutionally elaborate models of SIBs, are given to the intermediaries and funders engaged.

As the leaders of one high-performing provider that is contemplating this approach pointed out to me, the delayed timing of many government payments at present means they already have to finance much of the cost of service provision well in advance of reimbursement. This self-financed SIB model would also offer the advantage to society of concentrating the financial benefits of delivering results fully in the organizations that are providing them, thereby improving their ability to sustain and expand their superior outcomes over time.

Beyond simplifying government's principal-agent problem, those seeking to expand PFS also need to bolster the capacity of government to make PFS a reality. We need someone to do for PFS what Eli Broad has done for school district reform: notably, to recruit, train, and

support a cadre of government leaders with the drive and public sector management chops needed to transform how human services are funded and delivered in this country.

When Eli Broad launched his philanthropic effort to transform the performance of the nation's urban school districts, he began with a basic premise from his experience in business: effective organizations require leadership of the highest caliber. He observed, however, that many executives in urban school districts lacked the wherewithal needed to drive change. "We saw most of the superintendents or chancellors start as a coach or a teacher without any training in management, labor relations, systems, communications, logistics, etc."⁶

The Broad Superintendents Academy and the Broad Residency in Urban Education aimed to change that by recruiting and preparing exceptional leaders from diverse backgrounds—including business, the military, nonprofits, and within education—to become catalysts for change in urban school districts. To date, Broad participants and alumni have filled more than 400 district leadership positions. They stay actively connected in a peer network, sharing best practices and helping one another fill leadership posts as they tackle similar challenges in other school districts across the United States.

The results have been impressive. *Education Week* recently reported that the nation's three biggest districts (New York, Los Angeles, and Chicago) had Broad-trained executives in top leadership positions, and that "21 of the nation's 75 largest districts now have superintendents or other highly placed central-office executives who have undergone Broad training."⁷ In addition, four Broad alums now serve as state school chiefs in leading reform states. The Broad Foundation reports that 75 percent of currently serving academy graduates who have led districts as superintendents for at least three years are outperforming comparison groups based on a variety of student achievement data.⁸ This impact in turn greatly strengthens the talent pool of leaders coming into the programs.

Now imagine that in ten years a similarly high-powered and well-connected network of several hundred leaders are serving in the largest state health and human service departments and major city halls across the country, focused to a person on driving social impact by directing the government funds at their disposal to programs and providers delivering superior results. If a philanthropist were to provide the same kind of vision and commitment toward this end that Broad has provided to urban school districts—including sustaining it for a decade or more, not the two or three years typical of philanthropic initiatives—that picture could in fact be realized.

It may seem counterintuitive to call for philanthropy to invest in building the capacity of government in light of the relative resources of the two sectors. However, government at all levels struggles to invest in recruiting and developing leaders, a problem that will persist given our current fiscal challenges. Moreover, elected officials and political appointees are

6 Eli Broad interview with Kai Ryssdal of National Public Radio's "Marketplace," December 2011, available at www.marketplace.org/topics/life/education/running-education-more-business.

7 Christina Samuels, "Critics Target Growing Army of Broad Leaders," *Education Week*, June 7, 2011.

8 Data from <http://www.broadcenter.org/about/impact-of-broad-graduates>.

typically focused much more on policymaking than on organizational execution, and they cycle rapidly through political leadership roles. Thus, they rarely have the time or the inclination to develop leaders among the civil servants who stay with government for the long haul and manage front-line contracting processes.

Given our system for funding and delivering human services, every social entrepreneur doing great work must have an equally entrepreneurial public sector counterpart to have impact. Focusing investments to make this happen could provide highly leveraged returns for a visionary philanthropist's dollar.

Conclusion

The preceding discussion has underscored the challenges government faces in making PFS work, as well as the need for ongoing experimentation with different approaches and innovations in philanthropy to overcome them. Fortunately, the recent and widespread interest in reinvigorating PFS approaches has marshaled a growing array of people, ideas, organizations, and money focused on overcoming the barriers identified. Promising experiments are now underway, led by blue-chip organizations partnering creatively across the public, private, and social sectors. Some of these experiments will prove successful; others will not. Both outcomes will yield important lessons, provided we invest the time and engage in assessment and reflection to learn from them. We won't end up with a panacea, but we may well identify better ways of funding and delivering human services.

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The Promise of Pay for Success

Jonathan Greenblatt

White House Office of Social Innovation and Civic Participation

Annie Donovan

White House Council on Environmental Quality

The president's fiscal year 2014 budget demonstrates that we can make critical investments to strengthen the middle class, create jobs, and grow the economy while continuing to reduce the deficit in a balanced way. Pay for Success (PFS) fits squarely in this strategy.

The Obama administration is fostering a PFS market using all the tools at our disposal: policy development, budget proposals, pilot programs, and open dialogue with innovators from across government and the private sector to share knowledge and best practices. These strategically designed programs are meant to encourage both smarter government and the development of a robust capital market for PFS.

In the fiscal year 2014 budget, President Obama is accelerating his commitment to PFS by nearly doubling the fiscal year 2013 commitment with more pilots across the federal government. But more importantly, he is proposing the creation of a new, \$300 million PFS Incentive Fund, a breakthrough initiative that is designed to spark systemic change across government at all levels. The program will empower cities and states by helping to spread evidence-based innovation throughout the country. It will facilitate new resources to nonprofits that need support to scale up interventions that work. Finally, it will incentivize private investment in PFS financings by creating a mechanism to reward federal savings, unlocking new capital for communities. In addition to the Incentive Fund, another \$185 million is proposed to support nine new PFS pilots in four agencies.

Pay for Success is Good Policy

Pay for Success is a mechanism whereby private investors fund social or environmental interventions upfront that save the government money, either because they prevent more expensive future problems, such as early childhood programs that reduce instances of learning disabilities, or they use a more cost-effective approach, such as energy efficient housing retrofits. Some of the savings generated by a better program are used to repay investors at the end of the established program period. But investors only are repaid by government if the program intervention is successful – thus the name, “Pay for Success.” Theoretically, if the program does not achieve its stated outcomes, the government does not repay the investor. From the viewpoint of government, this is a really efficient way to do business.

Efficiency is not the only benefit of PFS. For the federal government, it is much more than a simple financing tool. For example, instead of reimbursing nonprofits serving incar-

cerated juveniles for the delivery of services based on the number of people reached, PFS requires government to pay only if the population served stays out of prison at a higher rate than otherwise would occur. Not only does lowering recidivism save taxpayer dollars, it also improves the prospects for a healthy, productive future for the young people participating in the program.

PFS also brings together government, philanthropy, service providers, and investors in a strategic partnership of shared interests. We know from experience that government acting alone is not enough to solve persistent problems. PFS uniquely can drive such cross-sector collaboration.

Pay for Success as a Federal Tool

Consistent with President Obama's commitment to using rigorous evaluation and evidence in budget and policy decisions, the Office of Management and Budget (OMB) kicked off the fiscal year 2014 budgeting process with a memo to all agencies urging greater use of evidence and evaluation in budget decisions and the design of grant programs. PFS was called out as a viable strategy for improving government performance because of its emphasis on funding only those programs that can prove they work.

But the federal government's promotion of PFS actually began with the president's fiscal year 2012 budget, when he proposed \$100 million to fund seven pilot programs in five federal agencies. These encompassed workforce development, education, juvenile justice, and care for children with disabilities. Meanwhile, several agencies proceeded to launch pilots under their existing budgetary authority.

In 2012, the US Department of Justice (DOJ) gave preference to applicants incorporating PFS into programs under the Second Chance Act grant competition. Last fall, DOJ awarded nearly \$750,000 to Cuyahoga County in Ohio and \$50,000 to the City of Lowell, Massachusetts. The agency also supported a contract with the Urban Institute to develop a blueprint for municipal, state, and federal governments to use social impact bonds to pay for evidence-based anti-crime programs. This blueprint will build the capacity of government at all levels to implement Pay for Success.

The Department of Labor set aside up to \$20 million in its Workforce Innovation Fund in FY12 for a new competition for state, local and tribal governments wishing to create PFS programs for workforce development. Instead of predetermining how funds may be spent, this competition provides grantees with more flexibility to implement programs based on their view of the community interests – as long as they deliver results. This PFS pilot radically shifts the role of the federal government from top-down, process driven, to bottom-up, results oriented. The grant solicitation closed in January, and awards will be announced later this year.

The White House Office of Social Innovation and Civic Participation (SICP) has been seeking to advance PFS on numerous fronts. Along with supporting and encouraging agency

efforts, SICP has convened a series of sessions with diverse groups of stakeholders to share knowledge and develop best practices. A session held in November 2011 included New York City Deputy Mayor Linda Gibbs who subsequently launched the first PFS initiative in the US. In August 2012, she announced that the City would undertake a \$9.6 million social impact bond with Goldman Sachs and supported by Bloomberg Philanthropies. This partnership was focused on reducing recidivism among a target population of young male offenders on Rikers Island.

Demand for PFS is growing at a rapid pace, particularly among cities and states across the country as policy makers explore new models to fund important programs. Philanthropies and private investors are expressing interest as they seek to partner with government and experiment with PFS. At this important stage in the growth of this new field, the president has laid out an ambitious plan in the FY14 Budget to accelerate its adoption.

Scaling Pay for Success

The nearly \$500 million proposed in the Budget aims to build greater scale in the PFS market through new federal pilots and an important new initiative designed to spur greater experimentation and investment at state and local levels: the Pay for Success Incentive Fund.

Housed within the US Department of the Treasury, the Incentive Fund will encourage new investment in PFS in two important ways. First, it will facilitate funding for state and local projects that result in federal savings. Successful PFS efforts in policy areas such as housing and health care regularly produce savings across multiple programs and levels of government, but the logistics of accounting for savings across multiple programs is complex and daunting. The Incentive Fund intends to address these concerns by providing a mechanism to pay for outcomes in proportion to the federal share of savings from the Fund.

Second, the Incentive Fund will catalyze PFS approaches with “credit enhancements” that reduce the risk to government and nonprofit investors, making it more likely that they will invest in the models. This is important because PFS projects to date have required credit enhancements to reduce downside liabilities to investors as demonstrated in the NYC-Goldman-Bloomberg example. In the absence of such backup, investors in relatively new PFS instruments might demand a rate of return that state and local governments cannot afford, killing the market before it emerges. Safeguarding taxpayers’ investments is an enduring concern for this administration so, while the Incentive Fund will partially offset any losses, it will only do so for public and nonprofit investors.

The Incentive Fund will operate alongside other successful community development finance and credit programs within the Treasury Department such as the Community Development Financial Institutions Fund, the Small Business Lending Fund and the State Small Business Credit Initiative. This will encourage shared learning and facilitate best practices. The Fund only will focus on projects under conditions set by the Treasury Secretary in consultation with relevant federal agencies.

Conclusion

President Obama is committed to building on the progress of the past four years. Consistent with this focus, the newly proposed PFS Incentive Fund represents an important step forward. The Fund will empower local and state governments, investing taxpayer dollars wisely while building strong public-private partnerships. PFS can strengthen our communities and engage our capital markets to work together for the common good.

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Social Impact Bonds: Lessons Learned So Far

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Although Pay for Success (PFS) contracts have received widespread attention in the United States and abroad, there is nothing fundamentally new about governments paying for outcomes. Performance clauses in construction contracts are common, and the Department of Defense has procured services using performance-based contracting for years. Many state and local governments now use performance clauses in their procurement of human services, for example by providing bonuses to contractors administering job training programs based upon the number of clients who obtain and/or retain jobs.

What makes recent PFS initiatives distinctive is that they are focused not simply on creating additional financial incentives for contractors to produce better outcomes, but more broadly on overcoming the wide set of barriers that are hindering the pace of social innovation. For sure, these barriers include a lack of performance focus and outcome measurement, but they also include political constraints that prevent government from investing in prevention, the inability of nonprofits to access the capital needed to expand operations, and insufficient capacity to develop rapid and rigorous evidence about what works. In some of these new models, the amount of performance risk shifted from taxpayers to those on the hook for producing the outcomes is much greater than under traditional performance contracts, requiring the participation of socially-minded investors to make the projects feasible.

The social impact bond (SIB) is one of the new approaches to financing social innovation. Under the most common SIB model, the government contracts with a private-sector intermediary to obtain social services. The government pays the intermediary entirely or almost entirely based upon achievement of performance targets. Performance is rigorously measured by comparing the outcomes of individuals referred to the service provider relative to the outcomes of a comparison or control group. If the intermediary fails to achieve the minimum performance target, the government does not pay. Payments typically rise for performance that exceeds the minimum target, up to an agreed-upon maximum payment level. Payments are funded at least partially by the cost savings to government achieved through the improvement in outcomes.

The intermediary obtains operating funds by raising capital from independent commercial or philanthropic investors who provide up-front capital in exchange for a share of the government payments that become available if the performance targets are met. The intermediary uses these operating funds to contract with service providers to deliver the interventions necessary to meet the performance targets.

For the past two years, the Harvard Kennedy School's Social Impact Bond Technical Assistance Lab (SIB Lab)¹ has provided pro bono technical assistance to several state and local governments as they have developed SIB initiatives. This hands-on involvement informs our research on how governments can foster social innovation and improve the results they obtain with their social spending.

This article describes some of the lessons we have learned about SIBs from our work, focusing in particular on topics where our thinking has changed since our initial analysis of the model.² It also describes what we see as the key unanswered questions about the future of the SIB model.

Social Impact Bonds Are Spreading Faster Than Expected, Both in the United States and Abroad

Following the announcement of the world's first SIB in the United Kingdom in 2010,³ countries as varied as Australia,⁴ Canada,⁵ Columbia,⁶ India,⁷ Ireland,⁸ and Israel⁹ have started exploring SIBs. Proposed projects target social problems ranging from recidivism to homelessness,¹⁰ unemployment,¹¹ youth outcomes,¹² and early childhood education.¹³

In the United States, interest in SIBs continues to spread rapidly. Funding for PFS contracts was proposed in President Obama's February 2011¹⁴ and 2012 budgets,¹⁵ and a

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- 1 The authors are grateful to the Rockefeller Foundation for financial support. For more information about the Harvard Kennedy SIB Lab, see www.hks-siblab.org.
 - 2 Liebman, Jeffrey B. "Social Impact Bonds: A Promising New Financing Model to Accelerate Social Innovation and Improve Government Performance." Center for American Progress, February 2011.
 - 3 Ministry of Justice/Social Finance, "Minister Launches Social Bond Pilot," September 2010, available at www.socialfinance.org.uk/sites/default/files/SIB_Launch_PR.pdf.
 - 4 Centre for Social Impact, Australian School of Business, "Report on the New South Wales Social Impact Bond Pilot," February 2011, available at www.csi.edu.au/assets/assetdoc/0b6ef737d2bd75b9/Report_on_the_NSW_Social_Impact_Bond_Pilot.pdf.
 - 5 Human Resources and Skills Development Canada, "Government of Canada Involvement in Social Finance," November 2012, available at www.hrsdc.gc.ca/eng/consultations/socialfinance/goc_involvement.shtml.
 - 6 Instiglio, "Adolescent Pregnancy in Colombia," available at www.instiglio.org/the-innovation/projects/.
 - 7 Instiglio, "Gender Gap in Education in India," available at www.instiglio.org/the-innovation/projects/.
 - 8 Clann Credo—the Social Investment Fund, "Research to Identify High-Potential Social Impact Bond Areas in Ireland," April 2011, available at www.clanncredo.ie/default.aspx?m=30&mi=217.
 - 9 The Portland Trust, "Innovative Financing to Deliver Sustainable Funding for Israel's Social Sector," 2012, available at www.portlandtrust.org/projects/financial-infrastructure/social-investment-and-social-finance.
 - 10 Commonwealth of Massachusetts, "Massachusetts First State in the Nation to Announce Initial Successful Bidders for 'Pay for Success' Contracts," August 2012, available at www.mass.gov/anf/press-releases/fy2013/massachusetts-first-state-in-the-nation-to-announce-ini.html.
 - 11 San Diego Workforce Partnership, "Board of Directors Agenda Item 10: Pay for Success Grant Procurements," October 2012, available at http://workforce.org/sites/default/files/pdfs/agendas/10-03-12_bod_agenda.pdf.
 - 12 Ready by 21, "Using Social Impact Bonds to Support a Bundle of Youth Interventions," May 2012, available at www.readyby21.org/resources/webinar/using-social-impact-bonds-support-bundle-youth-interventions.
 - 13 David W. Chen, "Manhattan Borough President Seeks Bonds to Expand Early Education," *New York Times*, October 15, 2012, available at <http://www.nytimes.com/2012/10/16/nyregion/manhattan-borough-president-seeks-bonds-to-expand-head-start.html>.
 - 14 Office of Management and Budget, "Fiscal Year 2012 Budget of the US Government," available at www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/budget.pdf.
 - 15 Office of Management and Budget, "Fiscal Year 2013 Budget of the US Government," available at www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/budget.pdf.

grant solicitation is currently in progress from the US Department of Labor that would fund up to \$20 million of PFS contracts to improve employment and training outcomes.¹⁶

New York City established the first SIB in the United States.¹⁷ The initiative provides services to 16- to 18-year-olds who are jailed at Rikers Island and aims to reduce recidivism and its related budgetary and social costs. Services are being delivered to approximately 3,000 adolescent men per year from September 2012 to August 2015. MDRC, a prominent nonprofit research organization, serves as the intermediary, overseeing day-to-day implementation of the project and managing the two nonprofit service providers who are delivering the intervention. Goldman Sachs is funding the project's operations through a \$9.6 million loan to MDRC. The city will make payments that range from \$4.8 million if recidivism is reduced by 8.5 percent to \$11.7 million if recidivism is reduced by 20 percent. Bloomberg Philanthropies is guaranteeing the first \$7.2 million of loan repayment.

Meanwhile, Massachusetts and New York State are working to become the first state governments to enter into PFS contracts using SIBs. In January 2012, Massachusetts launched procurement processes to obtain intermediaries and providers for two SIB projects, and it announced the selection of those partners in August 2012. The first project will serve 900 youth over three years who are aging out of the juvenile justice system and expects to produce budget savings from reduced incarceration costs. The second project aims to house 400 chronically homeless individuals over a three-year period and expects to produce budget savings from reduced Medicaid spending. In July 2012, New York State began the procurement process to seek an intermediary to help set up a PFS project that would offer transitional employment services to adults released from state prisons.

Recently, the Harvard Kennedy School SIB Lab requested applications for additional US jurisdictions to assist. Twenty-eight state and local governments applied.

Why are so many governments interested in SIBs? SIBs offer an answer to a question all policy makers are facing in these difficult fiscal times: How do we keep innovating and investing in promising new solutions when we can't even afford to pay for everything we are currently doing? SIBs also align well with the spread of data-driven leadership practices focused on improving government performance and with government efforts to collaborate with nonprofit and for-profit partners in solving community-based problems.

Several Different Model Variations Are Starting to Emerge

The SIB model requires specific tasks to be completed by the government's private-sector partners. These include raising capital to fund operating costs and absorb risk, assembling a team of service providers, and managing the team to achieve performance objec-

16 US Department of Labor, "ETA Solicitation for Grant Applications: SGA/DFA PY 11-13," May 2012, available at www.doleta.gov/grants/pdf/pfs_sga_dfa_py_11_13.pdf.

17 Mike Bloomberg, "NYC Announces Nation's First Social Impact Bond Program," August 2, 2012, available at www.mikebloomberg.com/index.cfm?objectid=E791E137-C29C-7CA2-F5C2142354A09332.

tives. In the original Peterborough SIB project in the United Kingdom,¹⁸ the intermediary, Social Finance, is at the center of the transaction, performing all three roles and holding the contract from the government. However, other structures are also possible. For example, the government could contract directly with a lead provider, and that provider could raise funds from philanthropists and subcontract with additional providers. In that case, intermediaries might serve as consultants to the lead provider, helping the provider build its capacity to raise funds and meet performance targets. It is also possible that a foundation with an interest in testing solutions for a particular social problem might assume the lead role in negotiations with the government and then hire staff to manage the project and recruit providers.

For a UK job creation initiative, the ethical investment group Triodos Bank took the role of lead advisor and made all the arrangements for a foundation, a private investor, and a social enterprise to enter into a PFS contract.¹⁹ In Minnesota, legislative authority has been obtained for a human capital bond approach under which the state will issue new debt in order to finance preventive investments.

Given that SIBs remain experimental, the emergence of multiple models is promising since we do not yet know which models will work best, and it is likely that different structures will be most effective in different circumstances.

The Most Important Criterion for Deciding Whether to Establish a Social Impact Bond: Impact

When we wrote our initial paper on SIBs in 2011,²⁰ we identified five key criteria that a project must satisfy to be appropriate for a SIB: sufficiently high net benefits to allow both taxpayers and investors to come out ahead; measurable outcomes; well-defined treatment populations; credible impact assessments; and safeguards against harming the treatment population. After experiencing the complexity involved in developing SIB projects, we now believe the most important criterion for deciding whether to do a SIB is its potential for a large impact.

Establishing a SIB takes sustained attention over the course of a year or more from top officials in the state, county, or city implementing them. Given the other demands on these officials' time, an initiative is only worth undertaking, and only likely to succeed, if it is directly aligned with one of the governor's, county executive's, or mayor's top priorities. To be worth the effort, SIBs require either a large initial scale or a realistic vision for scaling up an initial successful SIB into a larger (e.g., statewide) initiative. Or they need to be aligned with a broader performance or reform agenda in such a way that a successful SIB has spillover benefits into an important area of existing spending.

18 Social Finance, "Peterborough Social Impact Bond," 2011, available at http://socialfinanceus.org/sites/socialfinanceus.org/files/SF_Peterborough_SIB_0.pdf.

19 Andrew Holt, "Triodos Raises Social Impact Bond for New Social Enterprise," *Charity Times*, November 2011, available at www.charitytimes.com/ct/Triodos_raises_Social_Impact_Bond.php.

20 Liebman, *Social Impact Bonds*, February 2011.

Initial Projects Contain More Innovation and Learning and Less Replication Than Anticipated

Initially, we expected the first applications of the SIB model to involve replication and scaling of proven interventions. However, experience has shown that rigorously proven models do not exist for most of the preventive investments that are the highest priorities for state and local governments. Thus, the interventions being tested in most of the initial SIB projects are riskier, more innovative, and offer more potential learning benefits than we had anticipated.

While the accumulation of additional knowledge about what works is clearly a benefit of these more innovative interventions, their greater risk does raise questions, particularly for investors. So far, philanthropic capital has been the major source of financing for these projects and has been used as a backstop for private capital. It is unclear how quickly private capital might be able to take over for philanthropic capital in absorbing failure risk in future SIBs. A recent report found that many investors are uncomfortable with the prospect of being locked into a SIB contract with a long duration and concluded that future SIBs may need to involve more risk sharing from government.²¹

It Is Difficult to Find Interventions That Truly Pay for Themselves

Initial discussions have focused on initiatives that could yield budgetary savings that fully cover program costs, but most socially beneficial interventions are unable to meet this standard. It is an open question how often governments will be interested in signing on to projects that, for example, produce budget savings equal to 70 percent of their costs along with significant nonmonetizable social benefits (e.g., reduced crime, higher earnings, better health).

Finding Large Enough Sample Sizes Can Sometimes Be Difficult

To determine whether an outcome was produced by the intervention rather than by chance, a sufficiently large number of people must be served—generally at least 200 per year. This rules out some preventive investments that are targeted at high-cost populations that are very small.

Adequate sample sizes are also often critical to program economics. For example, in a small recidivism project, only “marginal cost” savings from reducing the number of prisoners will be attainable—those associated with items purchased on a per-prisoner basis, such as clothing, food, and, in some cases, medical care. Larger-scale projects have the potential to achieve far greater “average cost” savings, from reducing staffing or closing a correctional facility. In addition, the overhead costs of the SIB financing mechanism, including fees for legal counsel, intermediary costs, evaluation expenses, and costs associated with investor due diligence, are primarily fixed costs and will constitute a smaller proportion of the total project as the size of the intervention grows. In most cases, these costs are only worth incurring for a SIB contract worth at least \$20 million.

21 Steven Godeke and Lyel Resner, “Building a Healthy and Sustainable Social Impact Bond Market: The Investor Landscape,” Godeke Consulting and The Rockefeller Foundation, November 2012, available at www.rockefellerfoundation.org/news/publications/building-healthy-sustainable-social.

Building Government Capacity Requires Dedicated Staffing and Expertise

SIBs are complex, novel arrangements and require a great deal of work to get off the ground. Governments face two main challenges in using this model. The first is sustaining focus over the year or more it can take to get a project up and running. Given all of the competing responsibilities of government officials, it can be hard to keep a SIB initiative on track without dedicated staffing. The second is technical expertise. Establishing a SIB requires expertise in areas such as incentive contracting, cost-benefit analysis, and evaluation design that may or may not already exist in house.

The Harvard Kennedy School's SIB Lab's assistance model attempts to address these challenges. We place a full-time "government innovation fellow" in the state or local government agency that is spearheading the state's PFS initiative. The fellow helps the agency both in coordinating its policy process and in performing technical analysis. The fellow reports to the state PFS policy lead and also receives supervision from SIB Lab Director Jeffrey Liebman, who provides direct technical assistance to the state as well. The SIB Lab also helps the state match and analyze administrative data sets to establish historical baselines, determine potential cost savings, and identify populations to serve. To date, this assistance model has been tested in Massachusetts and New York State.

Governments Are Taking Several Different Approaches to Identifying an Intervention

As already discussed, one of the key challenges in establishing a SIB is finding an intervention with a sufficiently high probability of success. We have observed governments using three complementary approaches to identify promising projects.

One approach relies on a policy process within government agencies. Officials often possess a wealth of knowledge about gaps in service provision and areas that offer the potential for budgetary savings if investments in prevention are made. It generally takes two or three meetings spaced over a couple of weeks to develop a good list of ten to twenty candidate projects using this method. At the first meeting, the SIB concept is explained, and questions about it are answered. At subsequent meetings, individuals brainstorm about ideas and then narrow down the list to the most promising options.

Under another approach, the government solicits suggestions from the public through a request for information (RFI). Both Massachusetts and New York State issued RFIs in an effort to collect suggestions for PFS projects from the public. The RFI process offers the potential to learn about promising projects and programs that government officials may not be aware of, as well as an opportunity to begin to engage with organizations that may ultimately become provider and intermediary partners. An open process for gathering ideas about projects also provides greater transparency, which can be important for experimental projects such as these.

The third approach, also widely used by governments, is to review evidence from sources such as the Coalition for Evidence-Based Policy’s “Social Programs That Work” list, the Washington State Institute for Public Policy’s cost-effectiveness studies, and recent research results from professional evaluation firms to find proven programs in priority policy areas that could be replicated locally. The benefit of selecting an option from one of these lists is that they provide evidence collected from rigorous evaluations, thereby providing far greater levels of confidence in the intervention’s efficacy. But the policy areas where proven interventions exist do not always overlap with a chief executive’s top policy priorities or with local provider capacity.

Through these processes, several types of interventions appear to be getting the most attention across multiple jurisdictions:

- Projects that aim to reduce recidivism among those released from prison or jail.
- Services for at-risk youth such as those aging out of the foster care and juvenile justice systems.
- Homelessness prevention services.
- Prenatal, early childhood, and preschool services.
- Preventive health care interventions such as those for asthma or diabetes.
- Home-based services designed to keep elders out of nursing homes.
- Employment/workforce development services.

Provider Capacity Is a Significant Challenge

In the states initially establishing SIBs, at most a handful of high-performing organizations in each policy area are capable of delivering services, and they tend to operate in limited geographic regions of the state. The current initiatives involve relatively modest expansions of provider operations. Finding a way to scale a successful SIB statewide or to transplant a successful one into a new state will be much harder and will present execution risk above and beyond the risk present in the initial projects.

Governments Have Several Options for Selecting Intermediaries and Service Providers

Some governments have undergone competitive procurement processes to select counterparties for the contract, while others have worked closely with a particular intermediary or a consultant from the beginning, relying on the intermediary’s or consultant’s expertise to identify a service provider and choose a program model. The competitive procurement process offers benefits from a transparency and legitimacy perspective and may allow the state to identify high-quality providers that it would otherwise not have been aware of. While competitive procurements are often slower than noncompetitive processes, establishing a SIB requires months of data analysis and other preparation within the government, as well as a process to

obtain legislative authority, work that can occur at the same time as the procurement process. Thus, the amount of delay caused by procurement processes is minimal.

New Structures Are Necessary to Enable Government to Commit to Future Payments

Investors have expressed concern about whether governments can commit to making future, success-based payments. In particular, given the annual appropriations process, questions have been raised about whether future legislatures might renege on commitments made today. The authorizing language enacted in Massachusetts addresses this issue, giving full faith and credit authority to success payments and setting up a sinking fund to steadily fund the payments over the life of the contract, rather than requiring a future legislature to appropriate payments on the back end.

Questions for the Future

Over the past year we have learned a great deal about the hurdles that must be overcome to get a SIB project off the ground. However, several questions remain unanswered about the future, not just of the projects currently under development, but also of PFS contracts more widely.

How Will This Model Become Sustainable and Scalable?

So far, it is not obvious that it will be substantially easier to create subsequent PFS projects after completing the first several. Those involved still need to establish relationships within government, build trust in the provider community, and create project-specific data systems and evaluation frameworks. In addition, it is unclear where sustainable funding streams for intermediaries and government capacity-building will come from. Because projects are relatively small and do not appear to yield supernormal returns, continued philanthropic support of both intermediaries and government capacity may be needed for quite some time.

What Aspects of the Pay for Success Structure Will Drive Better Outcomes?

PFS contracts introduce several potentially valuable components: performance measurement, performance-based pay, an intermediary with management talent, financial resources for successful nonprofits to expand, and new program models. A subset of these components may be sufficient for, or may explain a large portion of, an intervention's successful outcome. If the model is successful, we may not be able to tell the relative contributions of each. From the government operations perspective, a key benefit of the PFS approach is that it forces a sustained, multiyear focus on achieving improved performance in a particular policy domain. This type of focus can be very difficult to achieve with conventional public-sector funding and management approaches. In particular, leaders often create interagency task forces to tackle policy objectives, but then allow the enthusiasm and commitment to disappear shortly after the initial announcement of the task force.

How Can We Manage the Tension Between Targeting Innovative and Evidence-Based Programs for Social Impact Bonds?

For many social problems, we lack proven, scalable solutions, so what we need is innovation. But innovation is inherently risky, and investors in a SIB project, even those who are socially minded, may not be willing to take on that risk. On the other hand, with proven interventions, governments may simply want to fund the preventive services directly, without introducing the complexity and extra costs of a SIB structure. The challenge is to find the sweet spot of projects that are sufficiently innovative that they are hard to fund through the conventional budgeting process, but likely enough to succeed that investors are willing to back the projects.

How Should Risk Be Spread Among Project Partners?

In the initial SIB projects, philanthropic investors have assumed most of the risk of the projects. Little or no government payment has been required unless the projects meet their performance targets. This “money-back guarantee” structure has been very attractive to governments considering the SIB approach and is a big part of the reason that the model has spread so rapidly. But in the longer run, it may be necessary for governments to share more of the failure risk if SIBs are to reach their full potential. The pool of capital available and the number of policy areas where it will be possible to convince investors to take on all of the risk are likely to be limited. As the model evolves, it will also be interesting to see how large a portion of intermediary and provider fees will be linked to performance.

Will SIBs Be Used for Interventions Whose Benefits Accrue over Long Time Horizons?

Consider investments in prenatal health care. Such investments may produce short-term benefits such as improved infant and maternal health and lower health care costs, but they may also produce longer-term benefits such as reduced special education spending, reduced crime during teenage years, and increased adult earnings. While it would not make sense for a SIB contract to pay out over two decades as results become apparent—the feedback loop between management practices and results would be too long to be useful—it might be possible to design a SIB that paid out based upon short-term results that are predictive of longer-term benefits. It will be interesting to see whether any governments are willing to make payments based on these potential longer-term benefits.

How Will Governments Manage Pay for Success Contracts Across Political Administrations?

New administrations often replace and/or rebrand initiatives associated with prior administrations. It will be important to ensure that PFS initiatives have sufficiently broad support to persist. Building legislative support may be instrumental in making sure these initiatives become permanent features of the policy environment.

Can the Pay for Success Contract Align Incentives Across Different Levels of Government?

So far, we have seen initiatives that involve collaboration between agencies within one

level of government. We have yet to see state-local or federal-state partnerships, though the US Department of Labor grant proposal is a first step toward federal-state collaboration. In theory, the PFS mechanism should help build alignment between levels of government as it has between agencies within a single level of government. Until more collaboration starts occurring between levels, it may be particularly difficult for cities to use PFS contracting because the cost savings produced by a local initiative are likely to accrue in large part to county or state budgets.

How Will Governments Scale Pay for Success Contracts That Work?

In designing initial PFS contracts, it is important to have a vision for what will happen at the end of the contract if the project is successful. Clearly, it would be a bad idea to have the contract conclude, have services shut down, and then start the process of figuring out what comes next. But it is also not remotely possible to specify a plan for scaling up a successful intervention several years ahead of time since what is learned along the way will be critical to designing any follow-on plan. In practice, a sensible approach may be to write explicit decision dates about contract extensions and scaling into the original contract with sufficient lead time to allow for effective expansion. For example, if the initial contract is for six years, then by the end of the fourth year a decision would be made about years seven and eight. Another question is whether follow-on contracts should assume the same PFS model or whether the government could simply contract directly for the now-proven program model. Ideally, the government will maintain capacity to measure impacts rigorously during successor contracts regardless of their setup.

Conclusion

After two years of working on PFS contracts, we remain optimistic about their potential to overcome barriers to social innovation and speed up progress in addressing social ills. But there is still much to be learned about how best to structure these contracts and whether they can indeed produce better results for government social spending.

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Alina Sellman is responsible for communications, recruitment, and coordination of projects of the Harvard Kennedy School's Social Impact Bond Technical Assistance Lab, including its expansion to serve four additional states. Ms. Sellman spent three years working for the Ministry of Justice as a participant in the UK Civil Service's leadership development program, where she gained experience in a variety of government roles, including operational delivery, change management, and policy development. She has also completed internships with the Commonwealth of Massachusetts Performance, Accountability, and Transparency team and the civic engagement nonprofit organization MassVOTE. Ms. Sellman graduated from the University of Warwick in 2008 with a BA (with honors) in German and English literature.

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Pay for Success: Understanding the Risk Trade-Offs

Kristin Giantris and Bill Pinakiewicz

Nonprofit Finance Fund

Pay for Success (PFS) financing is a relatively new concept in the United States, with great potential for improving the social sector and government efficiency. As with anything new and disruptive, there are numerous unknowns for the pioneers forging the early path. Early excitement about the first social impact bond in the United Kingdom (Peterborough prison pilot) was quickly followed by the question, How will this work in the United States, and what are the risks? When new financial markets emerge, it is common to see wide variation in the proposed mechanisms for addressing risk, reflecting the different perspectives and risk tolerances of the participants involved. Only by understanding, quantifying, and managing this risk will investors become comfortable enough to invest in PFS financing structures.

Over the past two years, Nonprofit Finance Fund has served as an independent voice in the emerging PFS financing market.¹ As we have engaged stakeholders on the value of the model, we have been persistently asked about risk trade-offs. How can we consider risk sharing to enhance market participation? How can structures be adapted to respond to local market context? What might the PFS financing market look like in the future? And what risk preferences would have to be considered and balanced in order get there? Answering these questions will be crucial to the development of a mature and robust PFS financing market in the United States.

Risk Considerations for Partners Involved

The first step to creating a PFS financing structure is to understand the risk trade-offs that underpin it. In particular:

- The potential for measurable social impact
- The ease of identifying and capturing the economic value of social impact
- Financial risk and return to each stakeholder
- Reputational risk for each stakeholder
- Transaction execution and due diligence costs
- Cost of capital to the government funder and service provider(s)
- Transaction management and governance structures
- Legislative requirements and appropriations risk

¹ Our work includes curating www.payforsuccess.org, a neutral platform that provides education and disseminates information on the potential benefits and challenges of PFS financing. This perspective has given us the privilege (and obligation) of both heralding the development of the PFS model and calling out the gaps in its development.

- Changes in procurement and contracting systems
- The potential for replication and scaling

PFS financing projects require significant collaboration on all of these issues from three key stakeholders—government, investors, and service providers.

Government

In a time of shrinking budgets and a simultaneous call for both cost reduction and innovation, the PFS model provides governments that have the political will the opportunity to test a hypothesis that requires a “new way of doing business” in the provision of services.

Governments taking the lead on PFS financing face reputational risk tied to both providing services and testing a new approach. There are also risks associated with introducing new policies and practices to accommodate PFS financing. Balancing these risks is the prospect of accessing private capital at no cost to the government until outcomes are achieved.

Given the decentralized governmental structure in the United States and the continued pressure at the state and local levels to manage shrinking revenues while maintaining services, it is most likely that cities, counties, and states, rather than the federal government, will launch proof-of-concept pilots of PFS financing in the United States. The federal government has advocated this bottom-up approach and now provides a variety of resources to facilitate the development and launch of proof-of-concept pilots by cities, counties, and states. The Department of Labor has committed \$20 million through the Workforce Innovation Fund to PFS financing projects that help Americans find work, and the Department of Justice, under the Second Chance Act, made grants that gave preference to applicants who incorporated a PFS financing element into recidivism reduction/job creation programs. These two solicitations will likely incentivize greater piloting of PFS financing models and may pave the way for increased activity at the federal level.

Investors

Much of the appeal of PFS is the prospect of attracting new money to social problem solving. There is a healthy appetite for investment opportunities that deliver social as well as financial value, though the recent recession has made some investors less likely to experiment with new vehicles. The cliff-like risk structure piloted in the Peterborough social impact bond, where investors provide all the needed capital upfront and risk losing 100 percent of their investment capital if the outcomes are not met, offers one alternative for risk allocation in PFS financing. Openness to and support of hybrid and alternative transaction execution structures will provide more diverse ways of allocating and apportioning risks, returns, and other material trade-offs to private investors. The structure recently unveiled by New York City and Goldman Sachs, with commercial investors benefiting from a partial (75 percent) guarantee from a philanthropic investor, exemplifies a shared-risk structure. Having this structure in the market is expected to accelerate the development of other structures

that appeal to a broader pool of potential investors and increase the magnitude and pace of private, commercial, and impact investing capital flows into the US social sector. For example, serious consideration is already being given to lower guarantee levels and the use of subordinated debt.

Service Providers

At the core of the PFS financing structure is the delivery and measurement of positive outcomes for individuals, families, and communities of need and delivering these outcomes at scale. Thus, the success of PFS financing is ultimately dependent on the performance of service providers. However, the number of PFS financing-ready providers in the United States is limited, in part due to the scale and size of many nonprofit providers and the long-standing revenue model that rewards simple outputs and is driven by cost reimbursement—a business model that is not well suited for participation in outcome-driven PFS financing. As a result, providers entering into PFS projects who are not prepared to operate programs under an outcomes-based contract are at risk of underperforming, failing to meet contract terms, and not completing the contract work. Thus there is real risk of an unprepared provider compromising the organization’s reputation for providing good results to people in need. Additionally, depending on whether the working capital delivered to providers in PFS financing is available up front or upon meeting contract terms, the provider may bear significant operating and financial risk while undergoing significant change and building its capacity. Incubation and acceleration of provider PFS financing readiness is needed to build a pipeline sufficient for the replication and growth to the scale necessary to build a sustainable PFS financing market in the United States. Provider readiness is one of the best and most sustainable risk-mitigation vehicles because it goes beyond an individual transaction to build the capacity of the field.

Among the small number of PFS financing-ready providers in the United States are established, high-performing local and multistate service providers that can act as program intermediaries in their social issue areas. By sharing their own experiences and providing template materials such as term sheets, these intermediaries can reduce the risk for other providers and help accelerate the development of a pipeline of providers ready for PFS financing. These organizations have the current capacity to act as first-mover providers and program intermediaries in proof-of-concept pilots of PFS financing. Tellingly, a program intermediary is present in the first two PFS projects in Massachusetts, as well as in the New York City social impact bond transaction.

PFS Financing: Transaction Characteristics and Types

In mapping the PFS financing market, we considered four probable structures:

Social impact bonds (SIBs): PFS financing is executed through the private equity structure utilized in the UK Peterborough transaction.

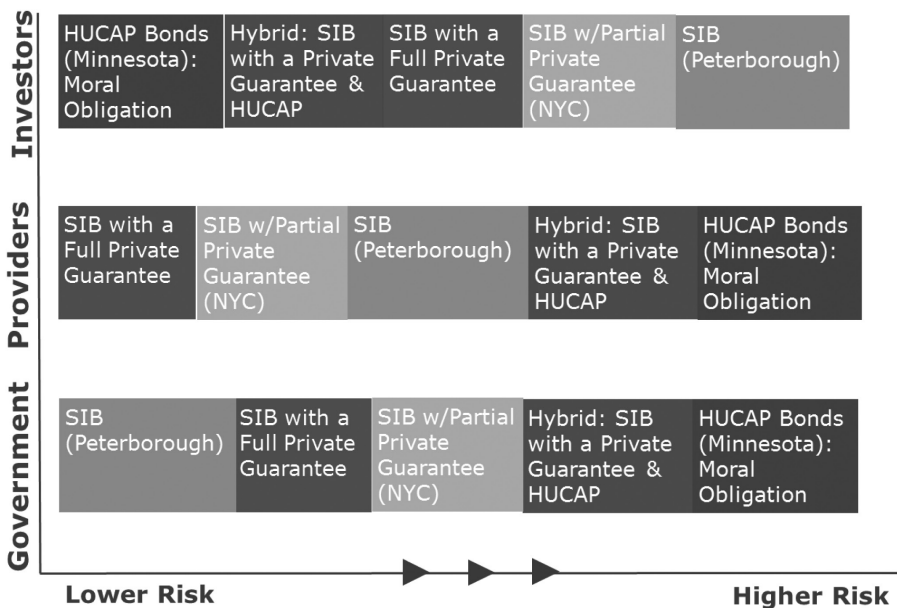
SIBs with a full or partial private guarantee: PFS financing is executed through the SIB structure with success payments to investors fully or partially guaranteed by a private (nongovernmental) enterprise. New York City is using the partial private guarantee structure in its PFS financing pilot.

Human capital performance (HUCAP) bonds: PFS financing is executed through state moral obligation bonds issued in the US municipal bond market—the structure Minnesota is planning to pilot under legislation recently passed in the state.

Hybrid: HUCAP bonds and SIBs with private guarantee: PFS financing is executed with a hybrid HUCAP/guaranteed SIB structure in which providers receive working capital up front from private investors at no cost via HUCAP bond proceeds. Providers shoulder all outcome performance risk but are backstopped by a private guarantee.

If we consider the risk continuum for each stakeholder individually, we can see (Figure 1) that investors, service providers, and government all have different risk preferences depending on the PFS financing structure. When we look at the three stakeholder perspectives combined, however, it suggests that some structures may be preferable to others. For example, a SIB with a full private guarantee might be the PFS financing structure most acceptable to all three stakeholders for a proof-of-concept pilot: it represents the lowest combined risk trade-off position for all three parties. In fact, the usefulness of a guarantee in aligning stakeholder interests in PFS financing pilots was affirmed as a “market-ready” approach in the announced New York City transaction with Goldman Sachs as investor and Bloomberg Philanthropies providing the partial guarantee. The market is also evolving toward lower partial guarantees and subordinated debt as a refinement to this approach.

Figure 1. Pay for Success Financing: Multiple Perspectives



Making Transactions Happen

PFS financing describes a broad category of innovative structures and approaches to financing social programs. Nevertheless, these approaches must have certain core elements in place to maintain the fidelity of the PFS financing approach:

- They finance prevention and early intervention services;
- They access private sources of working capital and/or risk capital to finance these preventative and early intervention services;
- They reduce both the cost and the risk of government funding for social programs;
- They direct private capital to social programs that “work” by achieving independently measured, positive outcomes for individuals, families, and communities of need; and
- They provide private investors with satisfactory and inextricably blended social and financial returns.

Each of these elements carries risk. Understanding how these risks affect PFS financing stakeholders is a critical step toward launching pilot transactions. This understanding will lead to greater openness to a diversity of structures and an increased interest on the part of various parties to participate in PFS financing. First-mover states and cities will likely attract the interest of commercial financial institutions, community development financial institutions (CDFIs), provider intermediaries, and impact investors, along with the needed public and political attention to bring more of this type of financing to the market.

Ultimately, changing the way we fund social services requires a balancing of shared risk and, hopefully, shared reward. Regardless of the success of each individual deal, the legacy of these early efforts will likely be new cross-sector partnerships, a move toward outcomes-based programs and financing, and a willingness to rethink the way we address critical issues in our communities.

Innovation and change do not come without risk. If we embrace the former, we must accept the latter. Our odds of success improve if we create the deal structures we need with an understanding of the motivations and expectations of all stakeholders.

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The Ethics of Pay for Success

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Every application of Pay for Success (PFS) financing (e.g., recidivism, health care utilization, special education) must meet clear, measurable goals to obtain “payout” funding. Much of this journal focuses on how to structure contracts to achieve these goals. But larger questions remain. What is the ethical framework for choosing specific goals or setting programmatic priorities? How is one metric of success chosen over others? Insofar as the PFS interventions considered in this issue are presumed to be meeting societal goals, it is necessary to prioritize projects according to the priorities of society.

An inquiry into the process of selecting which PFS projects to prioritize may seem superfluous because any project that meets a social aim more efficiently than the status quo appears in itself to be sufficiently ethical. That is, finding a way to improve any outcome while spending less would seem to represent a good choice, given government’s economic constraints. Thus, no inquiry into the ethical basis of these decisions would seem necessary.

However, the idea that efficiency in and of itself will properly inform the ranking of goals already presupposes a particular ethical approach, that of utilitarianism. The utilitarian framework is often the default approach for policymakers, particularly those influenced by economists. As a result, absent explicit attention to values, PFS applications are likely to be implicitly utilitarian.

Utilitarian approaches set priorities according to the standard of efficiency. The norm or ideal of a utilitarian ethic is to maximize the ratio of benefit to cost. This approach to ranking social programs makes the most sense when all relevant outcomes can be measured according to a homogenous unit of “benefit.” It makes the least sense when the outcomes have disparate social value and there is no single type of “benefit.” In such cases, simply seeking to get more of any given benefit does not ensure the value of that benefit vis-à-vis other potential goals. In commonsense terms, doing relatively less important things at a bargain rate is poor policy when it leaves more important things undone.

Efficiency itself has no normative or ethical value. Of course it is morally preferable to do “more good” overall by doing each thing efficiently, but what counts as “more good” still has to be established in some way. Rather than treating efficiency as a noun—seeking to create “efficiencies”—we ought to treat it as an adverb—seeking to reduce, for example, illiteracy or obesity efficiently. While this may seem obvious, it entails something less apparent: we need to decide what problems to address and how to design PFS approaches according to societal values that are *independent of the dollars a project might offset*. Lacking this perspective, a PFS approach regresses into taking efficiency itself as its fundamental value.

The error of attributing ethical value to efficiency itself is made repeatedly in social policy. The most common error is to equate equity or justice with the most efficient use of a limited resource, but to do so without any independent ethical rationale. For example, during the early stages of managed health care, an influential health policy leader, David Eddy, made this error in an important article in *Journal of the American Medical Association* on how to ration health care.¹ He literally defined equity in terms of efficiency, stating:

In the context of health care, a preferable definition of equitable is that services should be used in such a way that the services received by each individual should provide them with approximately equal amounts of benefit per unit of resource consumed. Thus, an equitable distribution means equal yield or, more colloquially, equal “bang for the buck.”

We disagree with this definition of equitable. Eddy’s approach does not necessarily consider people or their needs equally; instead, it treats the benefits per dollar equally. People vary in the complexity of their health problems. Thus, they will vary in which medical interventions they need, and how much cost is involved, to address their medical conditions. Consider, for example, two people with cardiac disease who are both good candidates for treatment that can return them to equally productive lives and good health. However, while one can be treated with an inexpensive, noninvasive catheterization, the other—because of a quirk in blood vessel anatomy—will require expensive open-heart surgery. Using an “equal benefit per dollar spent” approach would prioritize the inexpensive treatment, yet this may not be equitable. What if the person needing the more expensive treatment was 20 years old and the other person was 70? Perhaps the fact that the 20-year-old would likely gain many more life years from the surgery could be factored into a more complex measure of efficiency. But what of the ethical consideration that the 20-year-old has experienced less than a fair share of his life? Even if both were likely to live just ten more years, this scenario poses questions of equity or fairness that an “equal benefit per dollar spent” approach alone cannot resolve.

Other influential thinkers, including Amartya Sen² and Norman Daniels,³ have also pointed out difficult policy dilemmas that can arise between equity and efficiency. Often, helping people who are already disadvantaged requires using more resources to get the same outcome as helping more advantaged people. For example, in the case of microcredit loans in developing countries, it was more difficult for loan recipients who were worse off to begin with to achieve the same benefits as others who started with more resources.⁴ Note that there is no inherent reason that maximizing efficiency should disadvantage those most in need—the point is just that efficiency and equity or justice can conflict.

1 David Eddy, “The Individual vs Society: Resolving the Conflict,” *JAMA* 265 (18) (1991): 2399-2401, 2405-2406.

2 Amartya Sen, “Why Health Equity?” *Health Economics* 11 (8) (2002): 659-666.

3 Norman Daniels, *Just Health, Meeting Health Needs Fairly* (New York: Cambridge University Press, 2008); Norman Daniels, “Four Unsolved Rationing Problems: A Challenge,” *Hastings Center Report* 24 (4) (1994): 27-29.

4 Paul Mosley and David Hulme, “Microenterprise Finance: Is There a Conflict between Growth and Poverty Alleviation?” *World Development* 26 (5) (1998): 783-790.

Ethical Considerations for Evaluating Pay for Success

So how are ethical considerations, such as equity, relevant to PFS models? PFS requires a focus on outcomes and efficiency. However, delineating which outcomes to prioritize and which interventions to implement raises additional ethical questions regarding societal priorities and the equal treatment of individuals and communities.

In addition to considerations of efficiency, then, we suggest that PFS policies raise the following ethical questions: (1) Is there a hidden human toll? (2) Are we taking the easy money rather than doing what is more important? and (3) Are we using problematic means to achieve a given end?

Is There a Hidden Human Toll?

Financially rewarding a select outcome can ignore other noxious side effects or hidden costs. In the case of health care, abundant evidence demonstrates that for-profit organizations targeting efficiencies for measured outcomes may provide lower-quality care for unmeasured outcomes. This result could even extend to avoiding or providing no care to more vulnerable or expensive patients.

For example, while health maintenance organizations (HMOs) originally claimed that they would improve care for entire populations by eliminating inappropriate care, studies show that many HMOs have actually excluded sicker and/or vulnerable patients to contain costs. They may be providing more efficient care to their selected patients, but at what cost to the population as a whole? In “Health Care and Profits: A Poor Mix,”⁵ *New York Times* reporter Eduardo Porter gives multiple examples of for-profit health organizations that routinely underserve vulnerable populations. He writes:

Our track record suggests that handing over responsibility for social goals to private enterprise is providing us with social goods of lower quality, distributed more inequitably and at a higher cost than if government delivered or paid for them directly.

We do not believe that there is an intrinsic conflict between seeking profit and seeking quality, but our point is that the incentives need to reflect both aims.

Are We Taking the Easy Money Rather Than Doing What Is More Important?

Selecting a certain social goal and a specific intervention always entails opportunity costs. What goals or approaches were not selected? Attention is needed to ensure that more ethically important endeavors are not passed over because they may not save as much money or result in savings as quickly. Since we can never meet all human needs, perhaps the best way to address this issue is to turn the question inside out, and instead of asking what we are neglecting, ask if we are doing what has a higher priority. Again, saving societal dollars can be a goal in and of itself, but then that goal should be explicit and not cloaked as benefiting

5 Eduardo Porter, “Health Care and Profits: A Poor Mix,” *New York Times*, January 8, 2013.

society in other ways. If the goal is to provide important health and social benefits, then those proposing an intervention should consider whether the project addresses a fundamental human need.

Again, while this may seem obvious, we have seen health policies shipwreck over this issue. When policymakers sought to set priorities to ration Medicaid in Oregon, they faced such a problem. Through a democratic process they established rankings for health care treatments by calculating the number of quality-adjusted life years (QALYs) gained from a treatment divided by the cost. They then set population priorities according to the resulting aggregate value. This utilitarian approach resulted in ranking vasectomies higher than mobility-preserving hip repair surgeries and placing tooth capping higher on the list than lifesaving appendectomies. This “aggregation problem” arises whenever an intervention provides an inexpensive but relatively less important benefit for a large number of people.⁶ We suggest that those designing PFS interventions keep this issue in mind. The most valuable or most important outcome may not be the one that saves the most money or benefits the largest number of individuals.

Are We Using Problematic Means to Produce a Given End?

Finally, another risk of the focus on outcomes in PFS financing is the possibility of ignoring morally unsatisfactory means of producing an outcome. In an elementary school setting, a PFS outcome of value might be reducing the cost of expensive special education classes. Improving preschool quality or initiating earlier screening for developmental delays or reading disabilities could potentially accomplish that goal. Blocking children with educational difficulties from enrolling in the school or hiring cheaper, less qualified teachers would also reduce expenses, but at what moral cost?

In another example from the health care setting, Porter reports that when nursing homes transition from not-for-profit to for-profit status, their quality of care plummets. For example, one study showed that patients were given four times the dosage of sedatives in the for-profit condition as they were given in the not-for-profit condition. Porter quotes economist Burton Weisbrod, who states that sedatives are “less expensive than, say, giving special attention to more active patients who need to be kept busy.”⁷ Efficiency-focused child care facilities could use equally problematic means—such as television for children rather than stimulating, interactive play—to “succeed” at cost reduction.

Thus, using an appropriate ethical framework—beyond just efficiency—to identify the “true” societal goals of an intervention should be an important component of any PFS model. And the measures of success should incorporate these goals in addition to assessing the efficiencies gained as a result of a successful intervention.

6 Daniels, “Four Unsolved Rationing Problems.”

7 Weisbrod, *The Nonprofit Economy* (1988), quoted in Porter, “Health Care and Profits.”

Case Discussion

Consider, for example, the first social impact bond intervention, at Peterborough Prison (Peterborough) in the United Kingdom. In this example of PFS financing, the local community desired to reduce the rate of re-incarceration among short-term prisoners held at Peterborough, 60 percent of whom re-offended within a year of release. With a control group as comparison, the Ministry of Justice signed a contract agreeing to repay investors in full if the recidivism rate was lowered by 7.5 percent over a six-year period as well as pay out an additional percentage of the cost savings for any reduction beyond 7.5 percent. While we lack firsthand knowledge of how the project actually changed the lives of those involved (we base our discussion on a summary description)⁸, we might apply the three ethical questions to assessing such a project as follows.

Is There a Hidden Human Toll?

It is easy to imagine how a recidivism intervention whose singular aim is to keep former inmates out of prison might have other noxious effects. Imagine, for example, an intervention that instructed police to make fewer arrests, just as a for-profit HMO might limit access to health care. This could lead to worse crime rates in the community. Or an intervention might reduce social services for prisoners and families (decreased scrutiny might lead to decreased arrests), resulting in increased domestic violence and strife.

In the actual case of Peterborough, the interventions appear to have been designed to improve the individual and family well-being of the people released from prison, not just to cut costs. At the early formative stages of the project, the input of prisoners, their families, and community social workers was elicited regarding their needs for a successful transition out of prison. These needs appear to have guided the design of the intervention:

Experienced social sector organisations, such as St Giles Trust and Ormiston Children and Families Trust, provide intensive support to prisoners and their families, both inside prison and after release, to help them resettle into the community.⁹

Are We Taking the Easy Money Rather Than Doing What Is More Important?

The Peterborough intervention appears to be meeting an important societal goal. The targeted population—prisoners serving short-term sentences—lacked social services to assist them in returning to their families and communities. The released individuals and their families have important unmet needs, so this does not appear to be a case of simply taking the easy money.

However, to fully address the question of importance involves learning more about the other social ills present in this community. Is preventing recidivism as important for this community as, say, improving the local schools or increasing the availability of well-paying jobs? This intervention has an easily monetized marker of success—dollars not spent on re-incarcerated former inmates. Were other important opportunities for which the outcomes were more complicated, yet still possible to measure, passed over?

8 Social Finance, “Peterborough Social Impact Bond,” 2011, available at www.socialfinance.org.uk/sites/default/files/SF_Peterborough_SIB.pdf.

9 Ibid.

Are We Using Problematic Means to Produce a Given End?

In the case of Peterborough, the means of preventing recidivism involved addressing the unmet needs of the released inmates and their families through the use of experienced social service agencies. This is hardly problematic. Consider if, instead, recidivism were kept down by giving sedatives to former inmates to make them too weak to commit crimes. That may sound implausible, but it is not too far a stretch from prescribing four times the dosage of sedatives to elders in nursing homes to cut costs.

Conclusion

PFS models use financial instruments to incentivize finding an efficient means to produce a measurable outcome. This utilitarian approach to reaching societal goals is practical but not necessarily ethical. To assess the ethics of a proposed project, we need to consider its hidden ethical costs, its relative human importance, and the appropriateness of the means used to achieve the given outcome.

The positive example of the Peterborough project provides an inspiring model for addressing these ethical concerns in future interventions. However, it is notable that the PFS model of Peterborough was funded by philanthropic donors who were already committed to meeting community needs. We are concerned that investors whose overriding aims are financial might not address such concerns unless an explicit ethical standard is developed. The basis for this concern is some observations regarding the early history of HMOs. Policymakers initially conceived of HMOs as improving efficiency by eliminating excessive treatment previously incentivized by the fee-for-service system. In particular, health leaders argued that patient care would improve as costs were reduced. Because of this expectation, little attention was paid to developing explicit safeguards for threats to quality posed by cost containment. In retrospect, those threats are now all too clear. We recommend that the social finance field learn from the shortsightedness of the health services sector and get ahead of such ethical challenges.

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Learning from the Low Income Housing Tax Credit: Building a New Social Investment Model

Barry Zigas

Consumer Federation of America

In this issue, Terri Ludwig notes the parallels between the Low Income Housing Tax Credit (LIHTC) and social impact bonds (SIBs). She rightly points to their public-private structure, market-based pricing, and built-in program accountability measures as evidence of commonality. Importantly, however, the forces that led to the creation of the LIHTC program were rooted in a different set of priorities than those currently undergirding SIBs. In fact, “social impact” was a secondary concern of the LIHTC; the primary concern was the subsidy of below-market real estate development through the tax code. As we consider using tools like the LIHTC more broadly, as Ludwig suggests, it is important to reflect on the thought process that led to its creation in the first place, and to take note of areas where investment tax credits could be successfully tuned to social impact outcomes. This article briefly examines the origins of the LIHTC, delves more deeply into the credit’s business model and social impact features, and offers some suggestions about how the credit could be refined to increase its social impact and equity even further.

Old Bottle, New Wine

Real estate is a capital-intensive, long-term investment that always has depended on a combination of cash flows to work—cash flow from operations, appreciation over time leading to capital gains, and tax benefits (both those available to any capital investor and those specifically tailored to real estate investment.)¹ The crucial dilemma for low-income renters is that the combination of market-rate costs of capital, operations, and investor returns requires rents that are simply beyond their ability to pay with a reasonable share of their income. This is a persistent gap with a long history, but today’s low-income renters face some of the most daunting challenges ever. The Joint Center for Housing Studies of Harvard University estimated in its 2012 “State of the Nation’s Housing” report that nearly half of all renter households were paying more than 30 percent of their income for rent, the

1 In addition to supporting real estate investment, the tax code greatly subsidizes homeownership as well. By allowing the deduction of mortgage interest and property taxes and offering forgiveness of capital gains for individual homeowners, government policy diverts about \$118 billion a year to support homeownership. The Bipartisan Policy Center’s Housing Commission’s 2013 report that tax subsidies for all forms of housing totaled \$138 billion in 2012. “Housing America’s Future: New Directions for National Policy,” Bipartisan Policy Center, February, 2013, p. 107, available at http://bipartisanpolicy.org/sites/default/files/BPC_Housing%20Report_web_0.pdf.

generally accepted federal standard for housing affordability.² For poor families, the figures are much worse. Fully 80 percent of all renter households with incomes below 30 percent of the area median income—roughly \$20,000 per year for a family of four at the national median—paid more than this amount, and nearly two-thirds of them paid more than half of their monthly income on rent. Meanwhile, the supply of homes these families can afford has been shrinking for decades. The need for what the credit provides is inarguable.

National housing policy historically has treated this market failure through one of two major approaches: subsidizing tenants and subsidizing housing producers. For many decades, starting with the public housing program in 1937, the government’s main approach was to subsidize buildings and the people who built, owned, and operated them. In 1968 the policy turned to subsidizing housing built and operated by private owners. The government sought to increase the supply of decent and affordable housing through a combination of mortgage insurance and interest rate subsidies. Tax benefits in the form of accelerated depreciation and other means complemented these direct subsidies. Mismanagement, high costs, poor quality, fraud, and racial and economic segregation exacerbated by tying assistance to specific units in specific places all contributed to discrediting both the public and private programs and dissolving their political support.

These challenges led the Nixon administration to declare a moratorium on the use of appropriated funds for these programs in 1973 and to promote what became the Section 8 rental assistance program in 1974. Providing tenants with housing vouchers, Section 8 was the first widespread use of demand-side subsidies. Under heavy lobbying by the housing industry, labor unions, and housing advocates, Congress added project-specific new construction and rehabilitation components to Section 8 in the Housing and Community Development Act of 1974, using the carrot of long-term rental subsidies to attract private investment to the construction of units that would be dedicated to their use.

National policy long combined these direct subsidies for construction and rehabilitation with special tax treatments like faster depreciation schedules under some of these programs. Tax-exempt bond programs also were harnessed to provide financing for some of the units, and investors were allowed to take all the usual deductions for interest costs and other tax benefits that accrue to all real estate.

By the middle of the second Reagan administration, support for these direct production programs once again had been cut off. Even tenant-based assistance, which the administration touted as a better approach, was zeroed out in the budget released in 1985. While Congress usually declared Reagan’s housing budgets dead on arrival, the budget wars and dramatic fiscal pressure of these years meant greatly reduced direct spending on housing assistance through any means.

When the Reagan administration proposed comprehensive tax reform in 1985, the long-

2 Joint Center for Housing Studies of Harvard University, “The State of the Nation’s Housing 2012.” (Cambridge, MA: Joint Center for Housing Studies of Harvard University, 2012) available at www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2012.pdf.

standing preferential treatment that low-income housing properties enjoyed also was jeopardized. These benefits now comprised virtually the only federal support for construction and rehabilitation of low- and moderate-income housing. In the face of this threat, housing interests from every part of the spectrum rallied to try to preserve them.

But low-income housing advocates, led by the National Low Income Housing Coalition (NLIHC), among others, had long criticized the tax benefits as providing too many benefits to wealthy investors and too few to low-income renters. The NLIHC and other advocates pushed for a “preserve and reform” agenda in housing tax policy. The benefits’ protection from appropriations and the administration’s unrelenting push to eliminate direct spending threw their value into stark relief. But in return for support of the benefits, advocates developed a change agenda that included several key components:

1. Require rents for units receiving tax subsidies to serve tenants with much lower income than in the past so that the subsidies would address the most pressing housing needs.
2. Require investors to remain in the properties and preserve their benefits longer than in the past.
3. Establish tighter compliance requirements and penalties for violations.
4. Tie the subsidies as much as possible to the actual units serving low-income renters at affordable prices, rather than spreading them throughout a property.
5. Change the form of benefit to a credit, which would make it more attractive to a wider range of investors and easier to target to units that serve low-income residents.

This change agenda gained almost no traction in the House of Representatives, which completed its tax reform work in 1985 with only very minor tweaks in the terms of existing tax subsidies for assisted housing. But the game changed completely when Oregon Republican Senator Robert Packwood, chair of the Senate Finance Committee, dramatically announced that he was going to start with “a clean sheet of paper” and rebuild the tax code from scratch. In this atmosphere, the idea of a tax credit, which had been recommended in the NLIHC’s hearing testimony in both the House and the Senate, attracted the attention of Finance Committee staff. Real estate preferences were on the chopping block under Packwood’s plan. But the use of incentives to support affordable housing still had friends on the committee, most notably Senator George Mitchell (D-ME), and they reached out to the reform coalition.

The result was Senate adoption of a new approach in which all of the reformers’ ambitions were realized—the Low Income Housing Tax Credit. The LIHTC provides investors a credit of 9 percent of the cost of the project (excluding land), which can be claimed each year for ten

years.³ The LIHTC was targeted to subsidize equity investments in rental units that had rents no higher than 30 percent of 60 percent of the area median income (AMI). This was a significant tightening from the prior standard of 80 percent of the AMI, although not as deep as advocates had originally demanded. The credits would only be available for the units that met this test, and a property had to have at least 40 percent of its units meet the test in order for any of them to qualify for the credit. (A second project test of at least 20 percent of the units at rents no higher than 50 percent of the AMI also exists but is not widely used.) Investors could lose most of the tax benefits if the property fell out of compliance during fifteen years from initial occupancy, even though the credits would only be available for the first ten years.

Two features that are often cited as critical parts of the LIHTC's success were adopted first as expedients rather than as well-thought-out program features. In one, the final tax credit provisions adopted by Congress capped the amount of credit to a per capita amount (subsequently raised) that would be distributed to each state as a way of limiting how much revenue would be lost. Having capped the credit, Congress had to devise some allocation scheme. Thus, Congress required the states to administer the credits, and in 1989 it further required the states to do so through Qualified Allocation Plans (QAPs). In another move, the final tax act also capped individual taxpayers' ability to use tax preferences to offset income by restricting such "passive" losses to no more than \$25,000 per taxpayer. This at first seemed like an insuperable problem. It would severely restrict the credit's marketability to the traditional consumers of tax preferences—wealthy earners seeking to lower their liabilities. What was not foreseen at the time, but is today one of the most beneficial features of the credit, was that corporations, which were not restricted by the passive loss cap, would become a prime market for the new LIHTC.

Social Impact Model Features

The features that emerged from the 1986 work and subsequent congressional actions refining it strongly prefigure elements that are considered standards of social impact investing.

Private Capital Is Harnessed for Public Good

The credit uses a tax subsidy to attract capital to an investment that is otherwise not attractive or economically desirable. This also was true of the earlier tax subsidies and interest rate subsidies for affordable housing. (Indeed, the same purpose is served through directly appropriated subsidies.) But because of the better targeting and other restrictions driven by the reform coalition, the LIHTC is focused more clearly and cleanly on this objective. Also, the credit pays for investments of equity, which replace debt that would otherwise require cash flow from rents to retire. Lower rents are the result.

3 Where the credits are used to acquire existing properties or are combined with tax exempt bond financing, the credit is 4 percent. Also, both credit amounts are adjusted monthly by the Treasury Department to reflect the credit's net present value, which fluctuates somewhat along with interest rates. Note that as part of the economic recovery program, the credits for new construction were fixed at 9 percent for projects placed in service from July 31, 2008, through December 31, 2013.

Investor Return Is Premised on Social Outcome

The credit is structured so that the benefits flow only to units that meet the public affordability objective, such as rents not above 30 or 60 percent of the AMI. To prevent it from being used to provide only incidental impact, no credit is available for any unit unless a minimum percentage of the units meet the rent/income test. The rents and tenants' incomes must be certified at occupancy and periodically thereafter.⁴

The Benefits Must Be Durable

The properties must be in compliance with the tax credit eligibility rules for a long time. The credit originally set a fifteen-year compliance limit, but Congress has extended this by another fifteen years, and states have extended it even further as part of their allocation and application process. Although tenants are not evicted if their income rises while they occupy a tax credit unit, if a unit becomes vacant, subsequent tenants must generally meet the same eligibility requirement to remain in compliance.

The Investor Must Be at Risk

The project's affordability restrictions are recorded in a Land Use Restriction Agreement. There are significant recapture penalties for noncompliance with LIHTC requirements in the first 10 years, which scale down annually through year 15. The recorded agreement assures that the affordability restrictions will be met for the subsequent fifteen-year period.

Public Action Is Subject to Market-Driven Discipline

The threat of losing tax benefits because of noncompliance ensures that investors and their representatives in LIHTC transactions pay close attention to the initial underwriting of project sponsors and to the subsequent operation of the property. The corporations that invest in LIHTC projects are especially sensitive to the reputation and financial risks of noncompliance. While past tax subsidies were consumed by large numbers of small investors who sought and could provide only the most minimal oversight of their investments, tax credit investors' approach is more direct and hands-on. The discipline that this has added to the investment and project selection process is borne out by the program's near-zero record of defaults and recaptures. It also has muted, if not eliminated, the political influence that can plague directly allocated subsidies.

The Subsidy Can Be Tailored to Meet Diverse Needs with Little Bureaucracy

The credit is a uniform and straightforward subsidy that requires little fine-tuning or project-specific tweaking, unlike direct subsidy programs. This commoditization of the subsidy itself has increased take-up among investors. At the same time, the use of state housing finance agencies to allocate the credits has enabled the subsidies to be deployed responsively to meet local needs and desired outcomes. Each state's QAP can focus its credits

⁴ Beginning in 2009, resident incomes in projects where 100 percent of the units are LIHTC qualified are subject to certification only on occupancy.

on priorities of its own choosing. For instance, a state might use the QAP to stimulate greater interest by sponsors in housing that serves people with special needs, or seniors, or formerly homeless households. It can prioritize projects that require compliance beyond the thirty years now required by the program. It can seek to favor projects that preserve existing affordable rental housing or encourage new production, or a mix of both that meets the specific needs of the state. The QAP is where the rubber of incentivizing specific social outcomes meets the investors' road.

Opportunities for Improvement

This array of features and performance certainly makes a strong case for the credit's pedigree as an early and very successful social impact investment model. But in some other important respects, the LIHTC is an imperfect and potentially underdeveloped example.

Property, Not Household Support

The credit is the latest in a long line of subsidies designed to reduce the cost of real estate. It is more progressive than its antecedents, but it is a limited, static subsidy designed to decrease the capital costs of a project, rather than to spur dynamic social outcomes over time. Moreover, the credit is predicated on a project's pro forma financial statement, which is scrutinized by the syndicator placing the equity to insure that the project will meet the credit's requirements before any money is invested. After that, it is the property operator's responsibility to keep the project in compliance.

The benefits in newer social impact models often are pegged to reduced public expenditures generated by the improved outcomes, such as fewer emergency room visits, lower insurance costs, and so forth. There is no analogue in the LIHTC. In fact, government typically has to add additional support to LIHTC projects in the form of below-market rate debt, grants, and Section 8 support for very low-income tenants; without it, projects often cannot meet either the basic tests of the code or the additional tests imposed by states through their allocation process.

Housing needs are greater for the lowest-income renters. States generally organize their QAPs to favor projects serving them, but the credit amount historically has been the same for a project serving households right at the maximum income level as for those that serve tenants with greater needs. The gap typically was filled by other public funds, although states were given wider discretion in setting credit amounts in 2008.

The LIHTC's benefit is tied to a static data point: the rent amount as a percentage of the AMI. Residents have to be income qualified to occupy the units, but their rent is not adjusted for their own income. In other words, a household with income at 50 percent of the AMI would qualify to live in a LIHTC unit and would pay a rent restricted to the LIHTC standard. But it would still be paying significantly more than 30 percent of its income for rent. Because the economics of the real estate deal have to be penciled out before any investor will commit equity, the LIHTC designers were forced to use a test that could be modeled before

any tenants arrived and would be unaffected by potential changes in the tenants' income over time. This does generate genuine social value. But it constrains the credit's impact on housing costs for the lowest-income residents, and it insulates investors by linking their investment to a static outcome that is known from the start. It shifts the burden of increasing any one project's social benefit from the investor to the sponsor and, often, the government through additional subsidies. Investors', lenders', and operators' need for confidence in any project's operating cash flow before committing to the investment makes reconciling equity investments in real estate with emerging themes of social investing more difficult.

On the other hand, this feature also means that residents' rents remain capped even if their income increases. Tenants do not have to move if their incomes rise above the level required at occupancy. This can encourage residents to increase their income without being concerned about the marginal "tax" that is charged by other subsidy programs, like Section 8, which calculate the tenant's contribution as a percentage of income. And it may encourage healthier communities by allowing incomes to become more diverse over time, more closely mirroring market-rate housing than traditional subsidized housing.

No comprehensive data on LIHTC residents were collected at the national level until Congress mandated it in 2008. The data collection process remains in development, but a 2012 study by the Furman Center for Real Estate and Urban Policy at New York University summarized data collected from more than 12,000 properties in fifteen states comprising more than 700,000 apartments and provides the most comprehensive view to date of LIHTC residents' incomes. Not surprisingly, LIHTC units serve residents with somewhat higher incomes than traditional direct subsidy programs. But encouragingly, more than 40 percent of the sampled units served households with incomes below 30 percent of the AMI, while only 7 percent of the residents in the sample had incomes above 60 percent of the AMI. More than 70 percent of the extremely low-income tenants received some form of additional rental assistance, and rent burdens still were highest for tenants earning between 30 and 40 percent of the AMI.⁵ Nevertheless, there are instances where LIHTC equity investments subsidize rents for residents who no longer qualify for the assistance, and many LIHTC residents still pay more than the government's definition of an affordable rent, reducing the credit's social impact outcome.

Where You Live, Not What You Need

Allocating the credits on a per capita basis was an expedient choice that eliminated the need for a federal process. But it meant that all states are presumed to have equal needs and that the best way to allocate a scarce subsidy to support renters in need is to let every state participate regardless of the extent of their need relative to others. This is a hard choice to dispute politically—every state has housing needs, after all, and such a formula short-circuits

5 "What Can We Learn about the Low-Income Housing Tax Credit Program by Looking at the Tenants?" (Furman Center for Real Estate and Urban Planning and Moelis Institute for Affordable Housing, New York University, October 2012) available at http://furmancenter.org/files/publications/LIHTC_Final_Policy_Brief_v2.pdf.

disputes among states or their representatives over the allocation.

But the credit's social outcomes could potentially be improved by rethinking this model. For instance, credits could be allocated on a per capita renter basis, rather than for the entire population. Similarly, the allocation could include factors like rental costs, rent burdens, homelessness, and other indices of need more directly related to the outcomes LIHTCs are meant to generate.⁶

In theory, the large and competitive market for LIHTCs among investors should assure a relatively uniform price, which translates to funds that reach the project. But this is not how things work in reality. LIHTCs are an especially attractive investment for financial institutions. This is partly because financial institutions were already familiar with real estate and quickly adopted existing risk and valuation models to the tax credit world. Another motivator is strong regulatory incentives for them to do so. The Community Reinvestment Act (CRA) requires federally regulated lenders to serve the credit needs of their communities, including low- and moderate-income communities and households. LIHTCs have become a popular way to help meet this test. Competition among lenders in the same markets drives up the price investors will pay for LIHTCs, which is very good news for sponsors in banks' footprints (and for the subsidy's efficiency). But in geographic areas without competing buyers, the price is lower, sometimes significantly so. Thus the actual social value generated from two LIHTC investments that are identical in every respect except for their location can vary greatly. The price the investor pays is not tied to the investment's relative social value, but to its value to the investor. This variation is not inherent in the LIHTC model. It could be ameliorated—though likely not eliminated—if financial regulators credited LIHTC investments anywhere, rather than just in a lender's service area, for instance. Such a change may be forthcoming in a CRA regulatory modernization. But in the meantime, this policy skews the LIHTC's social benefits.

Finally, the LIHTC's benefits do not come without costs. There is considerable value “leakage” caused by layers of sponsors, syndicators, lawyers, accountants, and others needed to create, track, and document the credit. Of course such costs are common to any subsidy effort, and LIHTCs may require fewer such costs than traditional direct investment subsidies do.

Conclusions

The LIHTC is a hugely successful program. Since its adoption in 1986, it has created or preserved over 2.5 million housing units.⁷ It has become the single most important form of federal assistance to preserve and expand the supply of affordable rental housing for low-

6 To make such a change more palatable politically, Congress could increase the overall allocation of credits and use these population-sensitive factors to allocate only the increment, holding states' current allocations harmless. Some states would gain, but none would lose what they have today.

7 National Council of State Housing Agencies, “HFA Factbook: 2010 Annual Survey Results” (Washington, DC: National Council of State Housing Agencies, 2012), pp. 92, 100.

income households. It has done so virtually scandal free and with a default record that any private credit guarantor would die for. It has achieved and maintained bipartisan support through two decades of political climate change. It is the lifeblood of hundreds, if not thousands, of community-based and national nonprofit housing providers who specialize in sponsoring projects for credit investors and use the development fees they earn to support their work. Because its benefits are provided through the tax code, the credit's subsidy flow is not subject to appropriations and does not suffer from the "perils of Pauline" that Section 8 or other direct subsidy programs routinely face. It is equally beloved by community housing advocates, a thriving ecosystem of for-profit and nonprofit housing developers, for-profit and nonprofit intermediaries that collect equity commitments from investors and place them with specific projects on their behalf, and state agencies that allocate the credit. If a program can be judged by its friends, the LIHTC has written the book on how to find them, make them, and keep them.

If it can be judged by its results, the LIHTC is the most successful US government program to support production and preservation of affordable rental homes ever. If it is judged as a model for social impact investing, the LIHTC has been a highly successful means to attract private capital to a social objective, and to hold private investors accountable for the results promised. But as it is currently structured, the LIHTC model also lacks some features emphasized by social impact investing theory and could be improved in certain ways to increase its social impact and its return on the government's expenditures. The architects of the next wave of social finance should take these lessons to heart.

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Using Social Impact Bonds to Spur Innovation, Knowledge Building, and Accountability

David Butler, Dan Bloom, and Timothy Rudd

MDRC

In this article, we propose a vision of a social impact bond (SIB) model that moves beyond just achieving cost-savings to spurring innovation, knowledge-building, rigorous evaluation, and, potentially, outcomes that go beyond cost savings. We discuss two of the key rationales for SIBs: securing new resources to expand programs more broadly and ensuring that government only pays for successful programs that save money. Both are important goals but are also limited. We therefore propose a more expansive vision of the SIB model.

We draw on our experience as the intermediary for a New York City SIB (NYC SIB) project that is attempting to lower recidivism and improve the lives of 16- to 18-year-olds in New York City's Rikers Island jail. This project is the first of its kind in the United States. Over the next year, we will be writing about the experience of designing, implementing, and beginning to test the potential of this program set within a complex and dynamic political and service environment. Other partners include the New York City Department of Correction, the Mayor's Office, Bloomberg Philanthropies, Goldman Sachs, the Osborne Association, Friends of Island Academy, and the Vera Institute of Justice.

What is a SIB?

SIBs are innovative financing arrangements that aim to increase the pool of money available for preventive services. In a SIB, investors provide financing to operate federal, state, or local-run programs that aim to achieve predetermined outcomes. Generally, these outcomes are expected to save government money, for example, by reducing the need for beds in prisons or homeless shelters. The government entity agrees in advance that, if the program meets its goals, it will use the savings to pay back the original investment, plus a return. Usually, an intermediary organization puts the pieces together—identifying appropriate interventions and service providers, making a match between government agencies and investors, helping to structure the financial deal, and monitoring the program as it operates. This is the role MDRC is playing in the NYC SIB. An independent evaluator will confirm that the program has achieved the pre-specified goals and determine whether the government is obligated to pay back the investors.

Using SIBs to Finance Replication of Proven Programs

SIBs have been described as an ideal vehicle for going to scale with proven prevention programs that currently operate on a small scale. Public agencies facing severe budgetary pressure often are caught in a vicious cycle: they must spend money on prisons, shelters, public assistance and other services, leaving less for programs that might reduce the need for such spending in the first place.

SIBs may offer a way out of this bind. However, it is important to consider some complicating factors. Profit-seeking investors will be most interested in social programs or models that are proven—and thus quite likely to produce savings—but identifying “good bets” is easier said than done. Most social programs, including many that are quite well known, have little or no solid evidence behind them. For many others, the available evidence is mixed, limited, or based on problematic evaluation designs. Even successful programs have not necessarily generated impacts of the magnitude necessary to pay for themselves and yield a return for an investor.

The federal government and private foundations have recently begun to articulate a system of tiers to describe the strength of evidence supporting particular social programs. Only those in the highest tier—validated by multiple randomized control trials—are considered “proven,” and there are very few such programs. Therefore, there is a very small pool of potential SIB deals. Perhaps more important, there is a long history of programs that have achieved strong results in small pilots but were not successful when replicated on a larger scale. Social programs and the problems they address are often complex and not well understood. Moreover, interventions have to be delivered within systems—for instance, criminal justice, foster care, or welfare systems—and the rules, regulations, and operating cultures of those systems often vary. When a program achieves positive results, the success may be attributable to a wide range of factors, and it is often difficult to identify exactly why the program worked. This makes it hard to replicate success and, in a SIB context, it puts tremendous pressure on the providers delivering the service and the intermediary responsible for overseeing program implementation. In the NYC SIB, we understood the marketing appeal of calling a program a “safe bet” in trying to attract private investors, but we were also aware of the replication challenges and the resulting risks of failure. Although there was considerable evaluation-based evidence supporting the program model we selected—some might have described it as “proven”—we were careful not to characterize the program in that way and were forthcoming about the implementation and scaling challenges.

Using SIBs to Ensure the Government Pays Only for Successful Programs

The idea of Pay for Success (PFS) is not new: government agencies have been writing performance-based contracts with social service providers for many years. In those contracts, rather than paying providers based on their costs, payment is determined by outputs (such as meeting program enrollment and participation targets) or on outcomes (such as achieving

job placement or job retention goals) or on some combination of the two.

The appeal of such arrangements is clear, particularly when payments are linked to outcomes. However, the record has been mixed, in large part because the outcomes a program achieves can be an unreliable measure of its impact—and impacts are a far more useful indicator of success. Measuring an impact requires accurate information about what would have happened to program participants if they had not received the program’s services. An example of this discrepancy was demonstrated in a study of the Job Corps program, which found little correlation between the impacts that individual programs achieved (as measured in a randomized control trial) and their performance relative to the Department of Labor’s performance measures.

Not addressing the “net impact” question is a significant weakness in the high-stakes world of performance-based contracting because these contracts create powerful incentives for capital-starved service providers to “cream” (target participants most likely to succeed) as a way to maximize revenue. Government agencies have become more sophisticated in trying to minimize the risks of creaming by, for example, referring service populations to contracted providers with “harder to serve” characteristics, or requiring outcomes that are more difficult for people to achieve on their own. While these responses can mitigate the risk of creaming, they seldom eliminate it.

SIBs potentially offer advantages over traditional performance-based contracts. For example, a SIB may provide upfront funding for nonprofit service providers, who cannot wait to be paid after the fact. At least in theory, SIBs also include an independent assessment of the program’s performance. But the SIB structure does not, in itself, address the problem of creaming or the potential mismatch between outcomes and impacts. The only way to ensure that government pays for success is to ensure that the evaluation or validation process compares the outcomes of program participants with those of a reliable comparison or control group.

Expanding the Vision of SIBs

Using SIBs to Spur Innovation and Build Knowledge

Given the dearth of models with strong evidence of effectiveness and the challenges of replicating success, it is important to consider whether SIBs or SIB-like arrangements can be used to spur innovation, build knowledge, and increase the number of truly effective programs. We believe they can.

One might think of tiers of SIBs, corresponding roughly to the evidence tiers described above. The top tier would focus on the small number of programs with strong evidence of effectiveness and demonstrated ability to achieve positive impacts at scale and in diverse settings. In those few cases, the primary purpose of the SIB would be to identify financing to support further replication and expansion. The risk of failure would still exist, but it would be the smallest of the tiers, which might be appealing to certain kinds of investors who are

interested in low-risk ventures and are willing to accept relatively modest rates of return. Commercial banks looking to fulfill Community Reinvestment Act requirements might fit the bill.

A middle tier would include programs that have limited, mixed, or incomplete evidence. Here, the risk of failure is greater, which might warrant a different mix of investors. For example, foundations might need to act as a “backstop” to limit the downside risk for for-profit investors. These might include equity investors, who are prepared to assume higher risks than commercial banks in return for larger returns. The intermediary role would require more detailed program knowledge, and more rigorous and in-depth evaluation would be needed in order to accurately measure program impacts and shed light on the replication/scaling process. Foundations or the federal government might support the evaluations, which would be more elaborate than what might be deemed sufficient for the narrow purpose of determining whether investors should be paid back. For example, it would be optimal to include robust implementation research to understand why replication succeeds in some places and fails in others.

The lowest and riskiest tier would focus on innovation. It would test programs that have a strong theoretical basis and/or promising results from very small-scale studies. In effect, these SIBs would resemble traditional demonstration projects, with tightly controlled implementation and rigorous, in-depth evaluation. The most likely investors for these initiatives would be foundations or the federal government, which have a history of promoting and testing innovation. However, certain kinds of profit-seeking investors might also play a role given that these programs attempt to improve outcomes that may save government money or may simply be something that government is willing to pay for. Rather than selling future promises to pay to investors, it may be feasible for government payments to be reinvested in additional SIBs that focus on innovation, or if the program is successful, the agencies might also agree to pick up the cost of the intervention moving forward so it can continue to run.

Omitting Impact Studies Could Imperil SIBs

In our conversations with potential SIB stakeholders across the country, we have grown concerned that support for high-quality evaluations is not a priority. The pressures to raise sufficient capital to cover the program investment can lead to underfunded evaluations. The political imperative to demonstrate the success of this new financing scheme can create incentives for weaker evaluation designs that are more likely to show positive results but that are spurious.

In this environment, SIBs may forgo plans for serious evaluation and replace them with limited third-party documentation audits. Such a strategy may identify intentionally false or inaccurate reporting, but it will not provide evidence that the program truly led to cost savings. Only in those few cases in which the SIB is replicating an intervention that has been reliably demonstrated to work at scale should SIB parties consider omitting an impact study. In such cases they could perhaps replace it with a combination of outcome measures and an

assessment of fidelity to the model. But even here, investors and government would be left with some uncertainty about effectiveness. Indeed, if there is no risk, no uncertainty, then why would it be in the best interest of government to use a SIB structure? After all, it would cost the government more money not to run a program that saves money.

Broadening the Definition of Success

SIBs have been proposed for programs that are intended to realize government savings in a relatively short time period. These kinds of projects are probably the right place to start in building support for SIBs. However, the goal of most social programs is not primarily to save money but to improve the lives of low-income and at-risk individuals and families. SIBs could be structured to encompass other socially desirable goals that do not lead to government budget savings but do lead to societal improvements, so long as government can decide what it is willing to pay to achieve specific goals. SIBs could be designed to finance a range of different outcomes from increasing high school graduation rates and persistence in college, to improved cognitive and behavioral skills for young children, or better mental health outcomes for adolescents. All of these areas have promising, and perhaps even some proven, interventions with the potential to be scaled up. And additional funding for these kinds of programs is in at least as short supply as funding for programs that may generate short-term savings. But thus far, we have not seriously asked ourselves what we are willing to pay for this kind of success. Whether that amount would be sufficient to cover program costs and pay an acceptable return to investors is an open question worth exploring.

Conclusion

SIBs, as currently described, are a new financing strategy with the potential to attract new money to pay for innovative social programs. At the same time, it is critical to consider how the strategy could be used to continue to build knowledge about what works. There are too few proven interventions, and too many difficulties in replicating even those few programs, to minimize the role of innovation and knowledge-building. Therefore, we have offered a different view of how SIBs could be structured to promote innovation. Unless we consider these and other alternatives, government is likely to end up paying for success that is never realized or the reservoir of SIB-ready ideas will run dry very quickly.

SIBs can also help ensure that government only pays for successful programs, and they are, potentially, a significant advance over earlier PFS approaches. Achieving that goal, however, will require continued support for rigorous evaluation. Finally, if we hope to realize the full potential of SIBs, we must expand our expectations for success beyond immediate government savings to explore how SIBs can be applied to accomplishing other socially desirable goals.

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Dan Bloom directs MDRC's "health and barriers to employment" policy area, which designs and evaluates programs for groups seeking to gain a foothold in the labor market, including former prisoners, disconnected youth, low-income noncustodial parents (usually fathers), welfare recipients, and others. He is currently directing two large-scale federal projects that are testing subsidized and transitional employment programs.

Timothy Rudd is a research associate at MDRC and analyzes the cost and effectiveness of programs across MDRC's policy areas (jails, schools, higher education, employment, and pre-kindergarten) using a variety of frames including benefit-cost analysis. He played a valuable role in the negotiations of the financing for the first US social impact bond.

Social Impact Bonds: Using Impact Investment to Expand Effective Social Programs

*Luther Ragin, Jr.**

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To address the wide-ranging challenges facing the United States, collaboration among philanthropy, government, and the investment community is vital. Social impact bonds (SIBs) offer a new way to advance cross-sector partnerships and introduce innovative financing solutions to scale proven preventative social programs. SIBs operate at the intersection of three important trends: greater funder interest in evidence-based practices in social service delivery; government interest in performance-based contracting; and impact investor appetite for investment opportunities with both financial returns and social impact.

This article focuses on how impact investors in SIBs can help drive improved performance in the US social sector while providing growth capital to effective nonprofit or social enterprise social service providers. The true power of SIBs lies in the discipline that investors can bring to the process of provider selection and delivery of social services. When government, investor, and provider expectations are aligned, SIBs have the potential to bring significant new capital and efficiencies to social service delivery.

A New Vehicle for Impact Investors

Interest in impact investing has grown substantially in recent years. The Rockefeller Foundation and others effectively make the case that addressing complex societal problems requires larger scale funding and greater collaboration among philanthropists, government, and private investors. Although impact investment is only a small proportion of the total assets under professional management, it represents a significant and growing pool of capital that can fund programs to address social problems.

Impact investors have in common a desire to find projects that generate social impact and provide a financial return. The impact investment community is diverse and includes investors who seek to support a wide range of projects in both developed and emerging markets in areas such as affordable housing, accessible health care, financial services for the poor, and clean energy. Financial returns may range from below-market to risk-adjusted market rate, and investments may take the form of debt, equity, credit enhancement, or instruments that

* We would like to thank Min Pease, Global Impact Investing Network and Jill Scherer, Social Finance for their contributions to this article.

combine these elements. They may include program-related investments and mission-related investments, in which, unlike grants, foundations require a high level of confidence in the return of capital. In addition to foundations, diversified financial institutions, pension funds, high-net-worth individuals, and fund managers may make impact investments.

SIBs are a new investment vehicle designed to appeal to impact investors. Pioneered by Social Finance U.K. in 2010, this innovative financial instrument draws on private investment capital to fund prevention and early intervention programs that, if successful, reduce the need for expensive crisis-driven services. The SIB structure enables the government (or other payers) to shift program risk to private investors who finance the service delivery upfront, with ultimate payment to the investors based on the achievement of predefined outcomes. If the outcomes are not achieved, the government is not required to repay investors. In other words, the government only pays for results.

Although the terms are often confused, SIBs are a specific kind of Pay for Success (PFS) contract. PFS contracts are a contracting mechanism in which government (or another payer) pays service providers after they achieve predefined outcomes. Providers entering into these contracts have several options for financing program delivery: internal resources, loans from community development financial institutions (CDFIs) and banks, or grants or program-related investments from foundations. Most of these options impose significant financial risk on the provider. A SIB, by contrast, is a financing mechanism that shifts this risk to investors. By participating in a SIB, a provider working under a PFS contract can obtain operating funds to grow and scale without incurring additional financial risk. Given the scarcity of growth capital and the difficulty providers face in securing resources that enable them to serve a greater proportion of at-risk populations, SIBs can offer an appealing path to scale.

PFS contracts and SIBs share a premise of payment by results, but they differ in purpose. Beyond achieving results, SIBs explicitly seek to create a marketplace for impact investment, supported by rigorous due diligence and analytics. These market-building elements add costs for evaluation, legal, performance management, and other intermediation services necessary for driving social and financial outcomes. Because SIBs must bear these costs, their greatest potential lies where scale and improved performance are principal goals as well as social needs. Uniquely, the capital markets have the depth, flexibility, and rigor to support these aims.

To date, SIBs have mainly attracted grant funders and “impact-first” investors who are using their position in the market to test the model and provide proof-of-concept. To grow and achieve economies of scale, SIBs will need to be structured to also attract more commercially oriented “finance-first” investors.¹ US philanthropy—from individuals, foundations, and others—channels roughly \$300 billion² to the social sector each year, but the capital markets are much larger, with US investments totaling more than \$25 trillion.³ By drawing

1 In its 2009 report, “Investing for Social & Environmental Impact: A Design for Catalyzing an Emerging Industry,” the Monitor Institute defines “impact-first” investors as those who seek to optimize social or environmental impact with a floor for financial returns, and “financial-first” investors as those who seek to optimize financial returns with a floor for social or environmental impact.

2 Giving USA, <http://www.givingusa.org>.

3 The Forum for Sustainable and Responsible Investment, <http://ussif.org>.

on these investors, SIBs represent an opportunity to unlock new capital and expand the overall pool of financial resources for effective service providers. Although philanthropy can finance PFS activity, engaging the capital markets through SIBs can bring significant new resources to the social sector.

Toward Improved Performance in the Social Sector

SIBs appeal to impact investors who believe that private-sector discipline can drive improved performance in service provision. As they do with traditional investments, investors in SIBs conduct rigorous due diligence. They study the evidence base behind the intervention and assess the provider's ability to scale up program activities or replicate the intervention in a new region. They examine the strength of the provider's management team, its financial health, and its historical performance in producing social outcomes for the target population. They also assess the credit risk of the payer government as well as whether the proper legislation has been sought to mitigate appropriations risk. Once a SIB is launched, investors expect their investments to be actively managed and decisions surrounding repayment to be based on accurate social and financial data and transparent performance metrics. Thus, an independent validator tracks and aggregates performance data to determine whether the intervention achieved target benchmarks and consequently whether investors will be paid.

SIBs resonate with some service providers' growing interest in data-driven management. Government and private funders increasingly expect providers to focus on producing outcomes rather than outputs. In response, some high-performing service providers have adopted data collection and performance management practices to better track results. Although these practices are far from universal, others are also conducting rigorous evaluation of their interventions, comparing program participants against a similar group of individuals who did not have access to the program (including using randomized controlled trials) to gain insight on whether outcomes are truly driven by program activities.

Impact investors can help accelerate this shift toward greater accountability, transparent reporting, evidence-based practice, and data-driven performance management. Data-driven providers with strong management and proven interventions are attractive candidates for investment via SIBs. Successful outcomes performance enhances a provider's ability to attract investment capital, creating a virtuous cycle.

As the SIB market develops, intermediary organizations may play a role similar to bridging entities involved in syndicating Low Income Housing Tax Credits. For example, intermediaries like the Local Initiatives Support Corporation and Enterprise Community Partners created pathways for corporate investors to invest in affordable housing for low- and moderate-income families through limited partnerships. These intermediaries structure investments, manage provider partners, provide reporting to investors, make course corrections as necessary, and invest in capacity building to strengthen the community development corporations.

Enabling Impact Investment in SIBs

In the SIB context, intermediaries may play similar functions aimed at enabling impact investors to place capital with confidence. Impact investors in SIBs will demand that providers pay attention to their financial and operational strength. They may look to intermediaries to assemble and support the various stakeholders to launch SIBs, raise the investment capital required, coordinate service delivery among providers, manage performance and investments, and provide reporting to investors over the life of the investment. Intermediaries may also manage the other financial risks involved in the transaction, such as the risk that investors fail to meet their funding commitments or that the government fails to appropriate funds when target social outcomes are achieved. They play an important role to ensure that the collective social objectives are achieved and that value for government and financial returns to investors are maximized. Specialized SIB intermediaries or organizations with financial or subject-matter expertise could play these roles alone or in combination.

Foundations and other grantmakers can help catalyze the participation of impact investors in SIBs by playing four key enabling roles. First, they can provide funds to test new ideas and create an evidence base of what works in various service program areas. Second, they can provide capacity-building resources to help providers implement rigorous measurement and performance management practices. Third, they can fund a portion of the intermediary cost required to bring SIB transactions to market. Finally, they can provide credit enhancement to lower the risk profile for impact investors (which also decreases the cost of capital for the government or other payers) and demonstrate confidence in the intervention and provider.

Credit enhancement is especially important in the current SIB market. At this early stage, the market is led by “impact-first” investors who are willing to accept below-market returns. But even these investors require protection against the risk of capital loss associated with an untested financial mechanism and the underlying model and execution risks in the transaction. Accordingly, some form of capital protection makes SIB investments more attractive. The need for credit enhancement and other risk-mitigating approaches is even greater if SIBs are to pass the test of US financial institutions subject to the Community Reinvestment Act and other “finance-first” investors. SIBs that leverage grant funding or program-related investments to build in a tranche structure, first-loss reserve, or other form of credit enhancement may be particularly attractive to these investors. For example, the guarantee provided by Bloomberg Philanthropies in the New York City SIB transaction helped mitigate risk and attract Goldman Sachs.

The Potential of Social Impact Bonds

By drawing on large pools of private investment capital, SIBs have the potential to help social service providers access flexible, patient working capital at a scale that eclipses traditional funding sources. SIBs are not a one-size-fits-all solution: there are currently a limited number of areas where proven interventions, strong organizations, and opportunities to invest in prevention programs and create public value coincide. Yet, the size of

current challenges in social service provision is immense. For example, a recent McKinsey & Company report on SIBs estimated that US government spending on remedial services for the homeless totals \$6–\$7 billion annually.⁴ A high prisoner recidivism rate drives national corrections spending of more than \$70 billion each year.⁵ Homelessness and prisoner recidivism provide examples where SIBs have the potential to improve service delivery and effectiveness. There is also potential for SIBs to be beneficial in the areas of improving labor force participation for hard-to-employ populations, promoting healthy aging, and managing chronic diseases such as diabetes and asthma.

Philanthropy and government will continue to be vital sources of funding for the social sector. SIBs can complement this funding by serving a niche purpose: providing predictable, long-term capital for evidence-based organizations aiming to significantly expand their programs. By redirecting public spending from remediation to prevention and imposing greater discipline on social service delivery, SIBs have the potential to unlock short-term savings and long-term value at scale, a revenue stream by which government could use to repay investors. The concept is gaining momentum across the nation and around the globe as innovators seek ways to fund preventative programs addressing complex social problems. Though still in its infancy, the SIB model offers a promising new financing tool with the potential to improve the lives of individuals and communities in need.

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4 McKinsey & Company, "From Potential to Action: Bringing Social Impact Bonds to the US" (2012), available at http://mckinseysociety.com/downloads/reports/Social-Innovation/McKinsey_Social_Impact_Bonds_Report.pdf

5 Ibid.

Community Reinvestment Act Banks as Pioneer Investors in Pay for Success Financing

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Pay for Success (PFS) financing, sometimes known as social impact bonds (SIBs) or social innovation financing, has attracted much attention because it offers the promise of governments paying only for successful programs while increasing funding for prevention programs by accessing capital markets. To understand the emerging PFS investment landscape and determine the structures and investors that are most likely to attract incremental capital, we spoke with more than ninety investors and other stakeholders as part of an eight-month research project.¹ Our aim was to highlight distinct investor concerns, preferences, and insights that inform the systems, structures, and sequence critical to building a healthy and sustainable market for PFS financing. During our research, Community Reinvestment Act (CRA) financial institutions emerged as potential early investors in this new market. While philanthropy is expected to fund early PFS financings, CRA capital could prove to be the best bridge to other commercial investors. This article addresses how PFS financing can fit into CRA portfolios and outline some of the opportunities and challenges of executing PFS arrangements within CRA-regulated financial institutions.

Bridging Philanthropy and the Capital Markets

The CRA requires depository institutions to help meet the credit needs of the communities in which they operate, including low- and moderate-income (LMI) neighborhoods, in ways that are consistent with safe and sound operations. Banking regulators evaluate the banks' performance in meeting these goals.² For most US banks, CRA regulatory considerations are a major force driving the execution of their community and economic development strategies. In 2011, US financial institutions made \$209 billion in CRA-related loans including \$47 billion of community development lending.³ CRA banks often work through community development financial institutions, community development corporations, and other intermediaries to realize their community development goals. As mission-driven financial institutions that provide financial products and services to people and communities

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- 1 This article draws heavily from Steven Godeke and Lyel Resner, "Building a Healthy and Sustainable Social Impact Bond Market: The Investor Landscape," 2012, available at <http://www.rockefellerfoundation.org/news/publications/building-healthy-sustainable-social>.
 - 2 Board of Governors of the Federal Reserve System, "Community Reinvestment Act (CRA)," available at www.federalreserve.gov/communitydev/cra_about.htm.
 - 3 Federal Financial Institutions Examination Council website, available at www.ffiec.gov/craadweb/national.aspx.

underserved by traditional financial institutions, these intermediaries can also play an important role in the development of the PFS financing market.

While PFS financing is expected to emerge across a range of programs, early transactions that would qualify for CRA credit will most likely involve the provision of community services to LMI individuals in the form of community facilities. These are defined as “facilities that promote community development by providing community services for LMI individuals such as youth programs, homeless centers, soup kitchens, health care facilities, battered women’s centers, and alcohol and drug recovery centers.”⁴ The first transactions in the United States are expected to specifically address issues such as prison recidivism, juvenile detention, and chronic homelessness.

Opportunities and Challenges

During our conversations, CRA banks highlighted several new opportunities and risks facing the expansion of PFS financing.

Outcome Performance Risk

PFS financing will require CRA banks to underwrite the performance risk of nonprofits. Performance risk encompasses risks related both to the intervention model itself and to the challenges that come specifically with scaling up the intervention to serve more people or to serve them more comprehensively. For example, a specific evidence-based intervention that focuses on changing the behavior of formerly incarcerated juveniles would need to be consistently operated and expanded. Underwriting a social service intervention based on social science research is difficult and will require the banks to assess new risks. “This is new work for the banks” was a common theme at a recent meeting of CRA financial institutions to discuss PFS opportunities. In addition, PFS financing is subject to the same investment committee standards for safety and soundness as other bank investments.

Certain interventions have a track record of success at a specific scale. Evaluating an investment within the context of this track record should reduce some of the intervention model risk. Outcome performance risk should generally decline as track records for PFS financing—and for particular interventions—grow. The participation of an intermediary organization (or active direct investor) to source deals and manage relationships throughout the life of the financing arrangement will help to ensure that only qualified service providers are selected, reasonable benchmarks are set, and communication among stakeholders is clear.

Government Counterparty Risk

No precedent exists to optimize the government’s payment obligation in PFS financing. Political and appropriations risk can arise given the multiyear contingent obligations of the government. The contracts underlying PFS financing are not standard government procure-

4 Office of the Comptroller of the Currency, “CRA: Community Development Loans, Investments, and Services Fact Sheet,” June 2011.

ment contracts and will require the government to create new templates and procedures. Investors will want to be sure that their financial commitments are not jeopardized through changes of administrations and are not susceptible to political whims. Investors will most likely demand some type of escrow account to ensure that the government pays its obligations. A concern often raised by investors was whether it would be possible to pay private investors enough to attract commercial capital without triggering political issues. Some investors fear public backlash against what the public could perceive as the government paying a premium for “outsourcing” social programs.

Government counterparty risk needs to be clarified early in the negotiations and, ideally, be removed as a risk factor. Counterparty risk can be significantly mitigated through legislative or executive action to secure the long-term contingent liability to investors. Governments must be willing to commit to structuring their liability in a way that eliminates this risk as much as possible. For example, in July 2012, the Massachusetts legislature created a \$50 million Social Innovation Financing Trust Fund with the full faith and credit of the state to cover its potential obligations in pending PFS transactions. As PFS financing proliferates, standard contractual templates will also develop.

Transaction Pipeline, Allocations, and Liquidity

Bank investors voiced concerns that dedicating resources to developing PFS capacity will not be met with deal flow large enough to justify the resources allocated. A select set of appropriate issue areas and a limited number of successful interventions within those areas may narrow the market of viable service providers. Nevertheless, PFS financing for some individual interventions could serve enough people and generate sufficient cost savings to create a market large enough to attract investors.

PFS financing presents a clear allocation challenge. For most investors, the decision to allocate to an investment bucket is made before specific investment products are selected. Because PFS financing is an instrument that shares both debt and equity features, deciding where to bucket it in a portfolio will be problematic. Many investors were also not comfortable with the prospect of being locked into an illiquid multiyear PFS position. A sustainable investor market for PFS financing will require a set of successfully executed deals to provide adequate data to price the risk and to standardize elements of a PFS transaction where possible.

Objective Performance Targets

Investors universally stressed that social outcome goals need to be clear, objective, measurable, and nondebatable. The evaluation process must be transparent and clear to all parties before a transaction can be completed. The triggering events themselves were not the problem; rather, investors were concerned about the potentially nebulous nature of social-impact outcome triggers.

Structuring Opportunities

Most CRA bankers see bank participation in the first demonstration projects as critical to building the capacity to underwrite PFS financings and build a sustainable market. While early transactions may require close to full credit enhancement for commercial investors to participate, commercial investors will need some level of outcome performance risk participation to build their capacity to assume more outcome performance risk and position themselves to participate in more deals in the future.

As PFS financing develops a track record, the amount of credit enhancement will likely decrease. Structures with more level repayment schedules could also have lower credit enhancement requirements. Some institutions would not be willing to take any principal risk in an early transaction but would consider some variability in the yield-based outcomes. Other investors thought that some portion of the principal repayment could be contingent on the successful achievement of outcomes. Banks were also generally of the view that any intermediary should assume some level of outcome performance risk.

Various structures such as principal floors, credit enhancements, senior/subordinated tranching, and variable payouts can be used to modify how PFS financing agreements allocate risk. Other creative structuring suggestions that we heard from investors included building in call or put options to provide exit opportunities, having the public sector post underused assets (e.g., undeveloped property) as collateral, sharing risk and upside incentives across all stakeholders (public sector, investors, intermediary, and service provider), and adjusting repayment terms to smooth out risk.

Clear Regulatory Signals

Favorable treatment of PFS financing by CRA regulators will be a key issue for engaging banks although the ability of specific institutions to get CRA credit will vary. To receive CRA credit from bank regulators, a bank's investment must connect directly to LMI communities in the bank's market area. Given the multiple layers of bank regulators, CRA strategies and compliance vary significantly across institutions.

Banks would like to have their CRA regulators signal that PFS financing would earn CRA credit before committing time and resources to specific transactions. Complex PFS financing transactions will also need to compete with more straightforward community development lending transactions that would offer the same CRA credit to a bank. Given that wholesale banks that do not operate branches in specific markets have somewhat more flexibility in their CRA evaluations than their retail banking counterparts do, wholesale banks may be more likely participants in early PFS financing arrangements.

New York City SIB for Incarcerated Youth as Possible Model

In the New York City SIB, credit enhancement from Bloomberg Philanthropies enabled Goldman Sachs to advance a loan to MDRC, the intermediary managing the program serving incarcerated youth. The credit enhancement covers 75 percent of the loan, with Goldman

Sachs assuming 25 percent of the performance risk related to the program's outcome of reduced recidivism. The loan to MDRC was structured by the Goldman Sachs Urban Investment Group and will be made from Goldman Sachs Bank. It is not structured as a program-related investment or foundation grant. Goldman expects to receive CRA credit for the transaction although it is a relatively small portion of Goldman's overall CRA portfolio. Goldman's underwriting analysis for the loan included the following:

- Examination of the evidence base of the intervention as supported by previous studies;
- Assessment of the program partners' capacity to ramp up the program while maintaining the quality of the intervention; and
- Review of the underlying contracts.

The New York City deal demonstrates commercial interest in the PFS financing market. In early deals, it is clear that large collateral or loan guarantees from third parties such as philanthropies will make payoff structures more palatable for commercial investors while still ensuring that they assume some outcome performance risk. However, as the market grows, participation of philanthropic entities as guarantors may not prove scalable. Familiarity with deal structures and evaluation methods, supportive political environments, and longer track records for interventions should contribute to commercial investors' gradually assuming more performance risk with lower levels of guarantees.

Moving the Market Forward

Investors stressed that outcome performance goals need to be clear, objective, measurable, and nondebatable and that government counterparty risk needs to be addressed early in the negotiation. Credit enhancement will also play a major role in bringing commercial investors to the table by providing external collateral or supporting senior positions in capital structures. Creative risk sharing—not risk transfer—will be necessary to address investor concerns about performance risk, illiquidity, and deal flow. However, unless investors ultimately assume significant outcome performance risk, PFS financing may simply cannibalize philanthropic and public funding and fail to increase the capital available to fund the needed interventions.

CRA banks can benefit from viewing PFS financing as a market opportunity to build expertise in the evaluation of social service performance risk. Bank participation in early transactions will require strong institutional leadership as well as a team to structure, negotiate, close, and monitor transactions.

Finally, PFS financing can be an important opportunity for CRA banks to reframe community and economic development to include a broad range of social services. PFS financing provides CRA banks with the opportunity to expand the reach of community and economic development beyond asset-based strategies and to develop methodologies to underwrite outcome risks that can leverage existing community development finance practices.

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Innovation Needs Foundation Support: The Case of Social Impact Bonds

Kippy Joseph

Rockefeller Foundation

For more than 100 years, philanthropy has taken risks other sectors either would not or could not take to advance innovations benefiting poor or vulnerable people. The Robert Wood Johnson Foundation hatched the idea for a national 911 emergency response system. The Ford Foundation promoted the concept of community development corporations that would create jobs, preserve affordable housing, and promote small businesses. The Carnegie Foundation supported the initial development of Pell Grants. The Rockefeller Foundation funded the research behind the ideas that evolved into the US Social Security system.

Foundations are in the unique position to take risks, connect people and organizations with diverse perspectives, and cultivate groundbreaking innovations. And philanthropy is perhaps most useful when it can galvanize and leverage the actions and resources of others to build and sustain ideas that were once considered risky but have proven effective in meeting a pressing societal need.

As society's provider of risk capital, philanthropy has traditionally supported promising new approaches, established the viability of new models, and then handed off those that prove effective and efficient to governments for scaling up. For many reasons—information asymmetries, political entrenchment, and legacy contracts, among others—this process is no longer always operational. Philanthropy is now required to fund innovations into and through a path to a larger scale.

Yet improving social and environmental conditions will require more capital than public dollars, philanthropy, and civil society contributions can provide. With the emergence of the field of impact investing, the marketplace now has viable opportunities to join government and philanthropy to finance capital-intensive social initiatives.

But philanthropy, as noted frequently and most recently in the ImpactAssets issue brief “From Grants to Groundbreaking: Unlocking Impact Investments,”¹ still plays a catalytic role in leveraging these arrangements. Social impact bonds (SIBs) in the United States offer several different opportunities for philanthropy to strategically provide risk capital along the innovation curve, from seed funding to catalyzing capital market evolutions. As interest in the SIB instrument grows, philanthropists may consider the different ways of applying, sequencing, and layering philanthropic dollars, as explored below.

1 Amy Chung and Jed Emerson, “From Grants to Groundbreaking: Unlocking Impact Investments,” ImpactAssets Issue Brief 10, available at www.impactassets.org/files/Issue%20Brief%20%2310.pdf.

Motivation

SIB investors are motivated by different drives. In the first SIB pilot in Peterborough, United Kingdom, the investor group was motivated almost entirely by philanthropic interests. Some were focused on the potential of SIBs to address a problem domain—criminal justice—in which they were deeply engaged. Others were interested in the SIB because of the opportunity it posed as an instrument with potential applications across a range of domains from early childhood education to in-home care for older people.

Since then, many philanthropists and foundations have been influenced by both motivations. In the New York City pilot, well described elsewhere in this journal, Bloomberg Philanthropies was motivated by the application of SIBs to achieve greater outcomes for young men of color. Equally, Bloomberg Philanthropies saw the opportunity, once the hard work of developing the SIB structure and executing the contracts was completed, for the next wave of SIBs to be applied to other priority areas in the city.

Regardless of the motivation, direct investments into SIB pilots are not the only type of risk capital that philanthropies have contributed toward realizing the promise of SIBs. Indeed, foundations provided the grease that got the whole system moving in this direction.

Field and Capacity Building

In 2010, the risk of early failures threatened the long-term potential of SIBs, nearly stunting or killing the innovation altogether before early-adopter nonprofits and localities had the opportunity to test its value.

Specific concerns were the following:

- Political pressure and organizational imperatives could lead to the launch of bonds that were poorly targeted and/or poorly structured. Failure of these early experiments could ultimately create “false negatives” about the innovation itself.
- The “first-to-market” rush of private, interested actors to capitalize on the momentum of the bonds could result in the launch of instruments that meet only the lowest-common-denominator standard. This rush could result in a missed opportunity for robust impact evaluation and data creation. Data capture and the establishment of a measurable track record could have the additional advantage of assisting in the further development of policy in the areas of intervention.
- Though private foundations’ program-related investment (PRI) money was an attractive option to capitalize the first bonds, the terms and structures of PRI-capitalized bonds could “lock out” the private capital markets that constitute the ultimate opportunity to apply the concept on a larger scale.

To ensure appropriate testing of this unproven instrument, philanthropy, including the Rockefeller Foundation, focused on field and capacity building to ensure: 1) the quality of the first social impact bond deals, and 2) the engagement of capital markets and the catalytic role of PRI investments. For the Rockefeller Foundation, this strategy included:

- Support for knowledge creation and broad education leading toward market transparency;
- Support for the first-mover mayors' and governors' offices to increase their capacities to negotiate, structure, and execute bonds;
- Provision of planning grants to a small, select group of intermediaries and service providers;
- Research on the future of SIBs—political trajectories, investor landscape, and possible adaptations to environmental or international development contexts; and
- Demonstration of the highest-leverage role for foundation investment capital in SIBs.

Through the diligent and hard work of the pioneering stakeholders in the SIB space, the United States is on its way to testing several SIBs across the country. But despite this early progress, the field is still in its nascent stages. Different sets of stakeholders still need room to think, plan, exchange ideas, and build upon the SIB instrument.

Foundations can help make this room by providing grant support to ensure robust capacity in government budget offices and agencies, nonprofit service providers, intermediaries, and evaluators to explore and gear up for SIB or SIB-like financing instruments. A secondary, but still vital, set of actors would benefit from support: policy analysts, think tanks, and the media play a key role in ensuring that the SIB instrument can be appropriately tested.

Philanthropy can also help build the capacity to look across deals, discern patterns, and generate knowledge about the impact of SIBs on all actor groups as well as on the beneficiaries of SIB-funded services.

Leverage

Philanthropies also have the flexibility to collaborate with investors, either directly or indirectly, to catalyze larger and newer flows of capital to meet pressing social needs. This role is nothing new—the sequencing and layering of capital for social good has been well described and executed. In the realm of affordable housing, for example, the Ford, MacArthur, and Rockefeller Foundations, among other public and private entities, helped create the New York City Acquisition Fund with the first-tier capital of \$50 million, which allowed commercial lenders such as JP Morgan to provide \$250 million of debt financing.

For SIBs, a sequence, albeit a stretched-out one, could start with grants to help key actor groups to bring their best capacity toward SIB deals. As those deals materialize, philanthropy can increasingly focus on creating credit enhancements for specific SIB deals. Concessionary capital such as recoverable grants, forgivable loans, and other below-market-rate PRIs can provide a subordinated or first loss layer of capital to reduce risk for, and leverage additional capital from, more commercial impact investors. The Godeke Consulting report “The

Investor Landscape” describes this territory in depth.²

As of this writing, several funds are being established for use by intermediaries as first-loss investments or as reserves for SIB deals. The idea of a foundation investment circle or syndicate is also being pursued. These funder collaborations are not only important for the efficiency generated in the capital market for SIB deals; they also create a singular constituency for the government to answer to, enabling public servants to take what might be real political risk in engaging in a SIB deal.

This creativity is only a hint of changes likely to come. A secondary market could develop, with initial investors in a SIB selling their stake to others who want to see some indication of performance or an early track record before investing. Another likely evolution is the use of the SIB instrument to fund innovation. At present, SIB deals ask investors to take a big risk on the SIB model itself. Pilot projects reduce execution risk by backing “proven” interventions with a strong evidence base of efficacy. But on the horizon are deals, not necessarily involving government payment, that employ a SIB to fund both model and execution risk—providing proof of concept of promising but not proven interventions. Here, philanthropy can act as payers or copayers with other private entities for outcomes on the issues that are toughest to measure or where cost savings are not accrued by achievement of social good.

To be sure, SIBs are only the tip of a spear. The changed relationships, knowledge creation, capacity, and track record of SIBs will no doubt bring future innovative financing vehicles into view more quickly and easily than before. For this reason, the Rockefeller Foundation has dedicated itself to building the ecosystem and field for SIBs—which are important in their own right but even more powerful as the precursor of innovations yet to come.

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2 Steven Godeke and Lyel Resner, “Building a Healthy and Sustainable Social Impact Bond Market: The Investor Landscape” (New York: Godeke Consulting, 2012), available at www.rockefellerfoundation.org/news/publications/building-healthy-sustainable-social.

Pay for Success: Opportunities and Risks for Nonprofits

Laura Callanan and Jonathan Law

McKinsey & Company

Across the United States, a variety of social sector stakeholders are looking to “pay for success” (also known as pay for results or pay for outcomes) approaches to enhance the reach and impact of social programs. As a contribution to this national conversation, McKinsey & Company recently published a comprehensive study on the potential for social impact bonds (SIBs) in the US¹

In discussions of the study’s findings,² stakeholders repeatedly stressed that nonprofits are likely to continue providing the majority of social services in the US for some time, even if for-profit or hybrid social enterprises are growing in number and importance. In particular, nonprofits will continue to be the primary providers of programs for poor and vulnerable people, including homeless people, troubled youth and youth aging out of foster care, and low-income seniors. This is why it is critical to understand how Pay for Success (PFS) can strengthen nonprofits’ work and what risks it might create for them.

This article considers those questions and presents four main conclusions:

1. PFS can bring substantial benefits, particularly in areas where nonprofits already have solid experience developing and codifying interventions guided by evidence and ongoing impact assessment.
2. However, PFS is not appropriate for every social program. It is best suited for scaling proven programs rather than innovating, and for supporting behavior change interventions rather than providing social goods and services.
3. Likewise, not every nonprofit is ready to participate in PFS. Those that do will need robust experience in assessment and evaluation, and the infrastructure and capabilities to scale their programs.
4. PFS offers tremendous rewards for nonprofits but also presents significant risk for individual organizations and the sector as a whole. Nonprofits that sign up for scrutiny but fail to meet their targets could suffer real damage to their reputations. And, a sector preoccupied with scaling what’s already been shown to work may find itself starved of innovation. Proceed with caution!

1 McKinsey & Company, “From Potential to Action: Bringing Social Impact Bonds to the US” (2012), available at <http://mckinseysociety.com/social-impact-bonds/>.

2 Including at conferences such as Social Impact Exchange, SoCap12, Independent Sector, and the Council on Foundations.

Reaping the Investment in Assessment

Funding what works—driving more dollars to high-performing nonprofits and their programs—seems an obvious approach, but it has not always been the reality in the social sector. One silver lining of the recent recession is that it has focused funders and service providers on the need to do more with less and on the benefits of putting resources behind programs that have demonstrated success. But results for social programs are difficult to measure, and the work must be driven by the social bottom line, not just dollars and cents. Fortunately, over the past 60 years, our understanding of the science and practice of social impact assessment has grown significantly.

The goal of social impact assessment is to drive improvements that increase the value of programs to the people they serve. Social impact assessment helps organizations to plan better, implement more effectively, and successfully bring initiatives to scale. Assessment also facilitates accountability, supports stakeholder communication, and guides the allocation of scarce resources. Today, top-tier nonprofits develop program interventions based on research, evaluate these interventions while implementing them, and make revisions on the basis of what they learn.³ These nonprofits are continuously evaluating their programs and their organizations to ensure that high-quality interventions are being delivered effectively.

For nonprofit organizations already committed to evidence-based programs, a PFS approach rewards a job well done. PFS recognizes that activities (like workshops) and outputs (like the number of graduates from vocational training) do not necessarily equate with desired outcomes (such as participants obtaining and retaining living-wage jobs). PFS rewards programs that deliver desired outcomes by making some or all of the contracted payment contingent on the achievement of agreed performance targets.⁴

This is all good news for service providers who have invested heavily in developing, refining, testing, and tracking their programs: they can now reap the rewards. But it represents a big shift for the social sector overall, which has often rewarded only good intentions and given an “A” for effort.⁵

3 As part of our recent research on social impact bonds, we identified a variety of registries with more than 300 evidence-based programs, including Coalition for Evidence-Based Policy; Blueprints for Violence Prevention at the Center for the Study and Prevention of Violence; Institute of Behavioral Science; Promising Practices Network; Child Trends’ Lifecourse Interventions to Nurture Kids Successfully; Communities That Care; Office of Justice Programs’ CrimeSolutions.gov; Office of Juvenile Justice and Delinquency Prevention’s Model Programs Guide; and Washington State Institute for Public Policy. Additional registries of evidence-based programs we consulted that focus on other program areas include the Campbell Collaboration and the Cochrane Collaboration, which are health-oriented and internationally focused, and include meta-analysis of related programs. Currently, the Annie E. Casey Foundation is developing a registry of evidence-based programs related to its focus areas of youth and families. Please see mckinseysociety.com/sib for our complete report, *From Potential to Action: Bringing Social Impact Bonds to the US*

4 For some PFS contracts and Human Capital Performance Bonds (HUCAPs), the nonprofit service provider bears the repayment risk and must fund its own working capital needs. Under social impact bonds, social investors shoulder the risk.

5 For a more in-depth discussion of social impact assessment visit lsi.mckinsey.com, which provides detailed information on Learning for Social Impact, McKinsey & Company’s initiative on the topic.

Scaling Up Proven Programs

Some types of program interventions, in particular social goods and services, can be effectively scaled up using variations on market mechanisms. Advanced market commitments⁶ or right-sizing the cost of the product or service with the consumer's ability to pay⁷ are examples of how a traditional market can be tweaked to deliver a social good or service. In these examples, consumers determine whether the good or service meets their needs, and demand reflects their conclusion.

But many social programs are not based on providing a good or service; instead, they aim to alter people's choices and actions. These "behavior change interventions" share information and provide motivation to help individuals change their behavior for positive social benefits. For example, affordable housing—decent, income-appropriate housing for low-income people—is a social good. But permanent supportive housing, which offers permanent affordable housing with comprehensive support services for people who are chronically homeless, seeks to change behavior too; the support services can include substance abuse counseling, vocational training, and case management support.

Behavior change is complex, and programs of this kind typically require a subsidy, because the target constituent is not able or inclined to pay for the intervention. Provided by society, this subsidy interrupts the automatic feedback of supply and demand that a traditional market provides. The end user of the good or service is not the "customer" paying for it. But that customer—typically government or philanthropy—does want to know that the program is delivering results.

PFS is ideal for scaling up proven behavior change interventions to reach more people who need them. A particular benefit is the ongoing assessment component, which requires tracking to ensure the intervention is working as expected.

For example, on the basis of extensive evidence, therapeutic interventions for young people in the juvenile justice system, such as multi-systemic therapy and functional family therapy, are expected to reduce future crime. The impact of these programs is assessed by tracking the reoffending rates for cohorts who receive the intervention against peers who do not. This is how "success" is measured in a PFS program. It is also a valuable source of information on whether replicated programs continue to deliver results when delivered to new communities in new geographies at different points in time.

Like any tool, PFS must be applied appropriately. It may not be the most efficient or cost-effective way to scale up programs based on social goods or services, which can use market-style mechanisms much more easily and with success; but it has great potential for scaling behavior change programs.

6 Advanced Market Commitments create a guaranteed market for goods with social benefits (e.g., vaccines for developing countries). Donors commit funds today to finance the purchase of the product at a pre-determined price and quantity in the future. In exchange for these commitments, the private sector manufacturer for the product legally commits to supply the product at a set affordable price over the long-term.

7 Microfinance, private education for the poor schemes, which collect small school fees on a daily basis, and products geared for the budgets of bottom of the pyramid (BOP) customers like single-use shampoo packets are all examples of right-sizing a product or service with the customer's ability to pay.

Is Pay for Success for Everyone?

PFS represents a departure from the way nonprofits have contracted to deliver social services in the past. Accordingly, not all nonprofits may currently be ready to participate in this brave new world of outcomes and results. Some of the questions nonprofits should ask themselves—and others should consider asking potential nonprofit partners—include the following:⁸

Does the organization have experience with assessment? Has the program been evaluated in the past, and what results has it delivered? For PFS to be implemented successfully, the parties to the contract need to understand social impact assessment generally and be familiar with past assessments of the relevant intervention. Nonprofits signing onto PFS contracts should know what results their program has delivered under past assessments. This serves as the basis for setting performance targets that they can reasonably expect to deliver.

Has the program been evaluated by a third party? Was the program measured against a counterfactual? The more rigorous past evaluations of the intervention have been, the better for future planning. Under a PFS contract, a qualified evaluator will likely be called on to define specific performance targets up front and then determine whether they have been achieved at the end of the contract. If the program has stood up to similar scrutiny in the past, it will have a much better chance of succeeding again.

Is the program intervention suitable for scaling? To be scalable, program interventions will need to have been developed, refined, and codified over several years. If the core, nonnegotiable elements of the program are clear, they can be replicated with fidelity. At the same time, the program can be adapted to reflect the realities of new populations and new circumstances as it is scaled and spread.

Scalable interventions must also address important needs for a sizable population and must face no implementation barriers (such as outsized costs or unique skills requirements) that could stand in the way of replication.

Does the organization have the infrastructure and capacity in place that will enable scaling? As we discussed above, PFS contracts are often intended to scale proven interventions to reach more people who need them. This means the nonprofit delivering the program will be serving new clients. To do this, the organization needs to increase its delivery capacity. This requires the right leadership; staff with the required training, cultural competencies, and programmatic skills; administration and program management capacity (across knowledge management, communication, human resources, information technology, and legal); and project management capabilities related to work planning, budgeting, and risk mitigation.

8 Further detail on these questions is available in a set of diagnostic tools and due diligence tools to assess core capabilities for participation in a social impact bond, developed by McKinsey & Company and hosted by the Nonprofit Finance Fund on the Pay for Success Learning Hub. See the SIB Toolkit at <http://mckinseysociety.com/social-impact-bonds/>.

In paying just for results, PFS contracts do not fund the development and growth of the organizational infrastructure needed for scaling. This means an organization must find other supplemental resources in order to be ready and able to participate. Otherwise, service providers will lack the ability to scale and replicate proven programs successfully, and there won't be any results to pay for.

With Rewards Come Risks

The risk for nonprofit service providers in a PFS world is that failing to deliver results will have real ramifications beyond a single contract. Once outcome targets have been set and measured under one contract, funders, investors, and others doing due diligence before selecting a service provider are likely to ask, “so, did you achieve your goals?” A positive answer should go a long way toward cementing a new relationship, but results that don't measure up will sour the discussion fast.

Before entering into a PFS arrangement, nonprofits need to reflect seriously on whether their program intervention and organization can stand up to the scrutiny and deliver as promised. They are unlikely to get many second chances after failing to meet performance targets in a public setting with credible evaluators reporting missed targets. What's at stake is the organization's license to operate, not simply its reputation.

For the sector as a whole, this can generally be viewed as a good thing. Resources are limited, stakes are high for our neighbors receiving social services, and underperforming nonprofits probably should not be taking resources away from the organizations and programs that are demonstrating success. Nonetheless, the focus on funding at scale what has already been demonstrated to work also raises some important concerns for the social sector as a whole:

- Will innovation and exploration be ignored or starved for funding as everyone focuses on scaling what has already been “proven”? Will this focus on funding what works actually stall the development and improvement of beneficial programs?
- Will the emphasis on PFS eventually drain the capacity of service providers in the sector? Will PFS backfire by encouraging nonprofits to scale while starving them of funds for long-term investment in the infrastructure they need to grow and maintain capacity? Will lack of capacity force bad delivery of good programs?
- Will service providers start “creaming” (i.e., selecting clients who are most likely to succeed under a program to ensure successful results)? How can we guard against the dire unintended consequences of leaving out hard to serve clients who actually need help the most?
- Will service providers be tempted to simply fudge the numbers and make the results look good when they are not? What checks and balances will be required to police a PFS world? And what are their cost and logistical implications?
- Are our social impact assessment tools and techniques of today accurate enough for us to actually know what works?

- Do we have the real capabilities to scale? Can we identify the nonnegotiable, core elements of a “proven” program to ensure quality replication? Do we understand the balance between maintaining fidelity to a demonstrated model and iterating and replicating to respond to new populations and settings?

Final Thoughts

The PFS conversation is an important milestone for the social sector. Promoting effective responses to social problems and linking impact with resources can bring about real change in the world. If applied thoughtfully and in the right settings, PFS could have major impact on our most complex social problems, as well as on the sector itself.

At the same time, the PFS standard poses a challenge for some nonprofit service providers and introduces real and new risks for individual nonprofits and the sector as whole. This approach is valuable, but it represents only one tool in the social sector toolbox.

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Success Begins with a Feasibility Study

Robert H. Dugger

ReadyNation¹

Pay for Success (PFS), a form of social impact financing, is receiving international attention as a way to pay for scaling up high-return interventions, ranging from prisoner rehabilitation to infant health. It is attractive because risk of failure is shifted from taxpayers to the private sector; if programs don't work, government doesn't pay. Government pays for success by rebating a large portion of the savings from programs that work to private investors in those programs. If there are no savings, that is if interventions do not reduce government costs, there is nothing to rebate to investors.

In this article, I review contracting and time-to-completion considerations with particular attention to feasibility studies, the critical first stage of establishing a social impact finance program.

Conduct Feasibility Research

The first step in any social investment program is a feasibility study. This study establishes whether the intervention can generate government savings large enough to repay investors with high confidence. In many respects, a feasibility study is to a social investment asset what a home appraisal is to a mortgage. Every mortgage is secured by a specific residence, at a specific address, in a clearly identified neighborhood. Every social investment asset (whether a bond, bank loan, or preferred stock) is secured by a specific intervention provided by specific providers to a clearly identified population.

Conducting a sound feasibility study is far more difficult than generally understood. The challenges were evident in a recent feasibility study in a city in one of the seven counties of Northern Virginia. To fully appreciate the results, keep in mind that Northern Virginia is the highest-income region of the state and one of the wealthiest regions in the United States.²

Leaders of a prominent pre-K program for low-income children wanted to know if the program might be a candidate for expansion financed by social impact principles. They embarked

1 ReadyNation is dedicated to helping establish strong state coalitions of business leaders who support effective early childhood investment. Establishing and managing PFS enterprises are particularly promising ways for business leaders to work with philanthropy and government to improve child school readiness and life success prospects. To enable business, philanthropy and government to help more children faster, ReadyNation is working closely with early health and early education social investment pioneers in Utah, South Carolina, Virginia and other states; aiding the preparation of reports on the data and methodologies required to conduct sound initial feasibility studies and final savings certifications; and facilitating drafting generic versions of the contracts needed to establish and manage early childhood social impact finance programs. ReadyNation's work in early childhood social impact finance is at "Social Impact Finance Working Groups," available at <http://www.readynation.org/SIB/>.

2 US Census Bureau, available at www.census.gov.

on a pioneering evaluation of the program's role in reducing public school costs. The evaluation was done with the active help and assistance of the county's public school system. The evaluation involved tracking the graduates of the pre-K program over four years and comparing them with similarly situated low-income children who did not attend a pre-K program.

The findings should be kept in mind for anyone considering using social impact finance to pay for scaling up early childhood programs. On the surface the results showed the pre-K program graduates had far fewer instances of special-education, grade-retention and English language learner costs than the non-pre-K children. Deeper analysis, however, revealed that the data and sample sizes prevented the researchers from concluding that the lower costs were solely the result of the pre-K program. The data were incomplete especially with respect to child socioeconomic factors and exposure to prenatal to age 5 intervention services, and sample sizes of pre-K graduates declined quickly, probably as a result of residential mobility. In other words, despite county's wealth and commitment to education, the data were insufficient to do a feasibility study of whether this particular high quality pre-K program was solely responsible for the reduction in public school costs. As a consequence, scaling up this program using social impact finance techniques will likely not be possible until data acquisition improves.

To assess a pre-K program's impact on special-education placement, grade-retention, and English language learner (ELL) costs, the county's public school system must significantly upgrade its information gathering and management capability. Drawing on these findings, pre-K programs in other areas of northern Virginia are working with school districts to improve the information available on families and their children prenatal to age 5. Efforts throughout Virginia will be made easier by Virginia's new statewide longitudinal education data (SLED) system, which will gather early childhood and K-12 information for each child and maintain it in secure unified manner to monitor student progress while protecting privacy and confidentiality.³

To realize the cost benefits of social impact finance programs, the SLED systems of Virginia and other states will need to acquire and maintain information on each child's exposure to early childhood programs, ranging from parent training to maternal health; prenatal care; birth to age 5 health, nutrition, care, and education; disability amelioration; and child abuse and neglect prevention and treatment. Because all of these programs affect a child's performance in elementary school, their effects need to be weighed in initial feasibility studies.

Identify Areas for High Returns: Early Childhood, For Example

Until recently people believed that applying social impact principles to early childhood investment would be impractical because the time frames for results were too long. High

3 Virginia was one of 20 states to receive a federal Longitudinal Data Systems Grant, funded through the American Recovery and Reinvestment Act (ARRA) of 2009. See Virginia Department of Education, Virginia's Longitudinal Data System, "2010 Longitudinal Data System Grant," available at www.doe.virginia.gov/info_management/longitudinal_data_system/vlds_grant/index.shtml.

returns on prekindergarten (pre-K) programs, for example, did not appear to emerge for more than a decade in reduced teenage crime.

Research in Louisiana, Pennsylvania, and Utah reversed that thinking, and confirmed earlier findings from the Perry Preschool Program, Abecedarian, and others of marked reductions in special education placement among low-income children who graduated from good pre-K programs.⁴ More recent research shows that the reductions in public school special-ed assignment, grade-retention, and English language learner costs are very likely to be high enough to cover the costs of providing quality pre-K programs. Because the cost savings are, for the most part, confirmed by the time children are in the third grade, the time frame is short enough to interest investors.⁵

The effects of prenatal counseling may prove to be even more fruitful. Prenatal counseling of at-risk mothers appears to reduce the rate of low-birth weight births.⁶ Because the cost of low birth-weight baby health care can be 10 times the cost of normal birth-weight care, the savings in state and federal health costs may be great enough to cover the cost of providing quality prenatal counseling. Most important, the savings are earned in just 12 months.

Establish Good Governance and Sound Contracts

The initial impetus for a social impact finance program can come from philanthropy, government, social investment bankers, business, or service providers. The central intermediary, sometimes called a Social Investment Enterprise (SIE), can be any of the prior entities or combinations of them.

There is no inherent weakness in government-centered programs, but there may be more flexibility and entrepreneurial energy in programs initiated by private, regional philanthropic and business leaders and social investment bankers. The creativity and speed with which private entities are able to act can reduce the amount of time it takes to set up programs and thereby increase their number and variety. This ultimately helps more people in less time. In addition, if social impact assets are to ever achieve wide investor acceptance,

4 Center for Child Development, “LA 4 Longitudinal Report” (Lafayette, LA: Center for Child Development, University of Louisiana, 2007), available at www.louisianaschools.net/ide/uploads/11515.pdf; S. Bagnato, J. Salway, and H. Suen, “Pre-K Counts in Pennsylvania for Youngsters’ Early School Success: Authentic Outcomes for an Innovative Prevention and Promotion Initiative,” (Pittsburgh: Heinz Foundation and Early Childhood Partnerships, 2009), available at www.heinz.org/UserFiles/Library/SPECS%20for%20PKC%202009%20Final%20Research%20Report%20113009.pdf; J. Dubno and L. Dolce, “A Sustainable Financing Model for High Quality Preschool for At-Risk Children.” Paper presented by Voices for Utah Children & Early Learning Ventures to the Boston National Business Leader Summit on Early Childhood Investment, 2010, available at www.partnershipforsuccess.org/uploads/20110713_SustainableFinancingModelPresentationtoPAESNationalBusinessLeaderSummitBostonJuly222011.pdf.

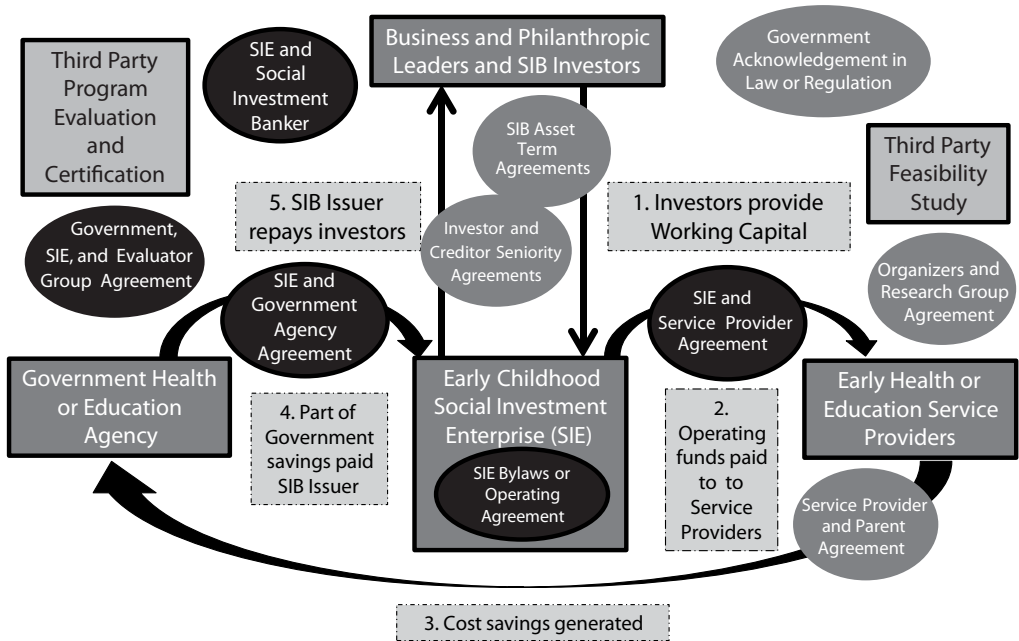
5 Robert Dugger and Robert Litan, “Early Childhood “Pay-For-Success” Social Impact Finance: A PKSE Bond Example to Increase School Readiness and Reduce Special Education Costs” (Kauffman Foundation/Ready Nation Working Group on Early Childhood Finance Innovation, April 2012), available at www.readynation.org/uploads/db_files/Kauffman-ReadyNation%20PKSE%20Report%2012041922.pdf.

6 Emmanuel A. Anum, Sheldon M. Retchin, and Jerome F. Strauss, “Medicaid and Preterm Birth and Low Birth Weight: The Last Two Decades,” *Journal of Women’s Health*, 19(3)(March 2010): 443–451, available at www.ncbi.nlm.nih.gov/pmc/articles/PMC2867587/.

business-sector understanding and support will be needed.

In any fully developed social investment program, there are at least 10 areas of contractual agreement. The five most important are shown as the black ovals in Figure 1. They are: the (1) SIE’s internal bylaws or operating agreement, (2) contracts between the SIE and a social investment banker, (3) contracts between the SIE and the government, (4) contracts between the SIE and service providers, and (5) contracts among the SIE, government, and third-party evaluator and savings certifier.

Figure 1. Example PFS Structure



Note: flow of funds represented by arrows and needed contract agreements by ovals

Adopt Government Savings Certification

The final step in a social investment program is the third-party evaluation and savings certification. The certification study establishes whether the intervention resulted in government cost savings and certifies how large the savings were. The findings feed into the SIE’s contract with the government, which outlines how much of the savings must be paid to the SIE and authorizes the government agency to make the payment. Because feasibility and certification studies rely on the same data, if feasibility can be determined, certification is also possible. From the first step to the last, social investment finance depends on the feasibility study.

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Government's Role in Pay for Success

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Pay for Success (PFS) financing mechanisms, including social impact bonds (SIBs), provide opportunities for multiple stakeholders with different expertise—government, private investors, foundations, and service providers—to work towards common goals. For government agencies at all levels, PFS mechanisms create opportunities for the public sector to reward “what works” or expand access to evidence-based preventive social interventions without requiring taxpayers to shoulder all of the financial risk upfront.¹ But in order for these new mechanisms to work, government must retain a central and important position. Ultimately, it is the government’s responsibility to ensure that these mechanisms are fair and efficient. PFS financing, done well, has the potential to help society better identify and address some of the most endemic, intractable problems in our society in partnership with the private sector and civil society; yet each PFS deal, no matter how exciting, is just one step in a series.

The critical role for government is to first define the technical mechanisms, like SIBs, innovation prizes, or innovation funds that comprise PFS. Most importantly, the government needs to ensure that the mechanisms are used in a responsible, sustainable way, such that each deal is more than a one-off attempt, and to demonstrate a real impact in communities. This requires building a community of practice that convenes stakeholders, galvanizes interest and investment, and sets standards and norms for PFS transactions.

Ultimately, government needs to prove real, long-term results. To achieve that, data and information need to be a crucial component of PFS mechanisms, including setting clear outcomes, making data publicly available, and collecting information on “what works” outside of particular deals.

Innovation, Not Privatization

As PFS tools—particularly SIBs—have gained traction in the United States and abroad, there has been a quiet but steady drumbeat of protest that these financing mechanisms

¹ Cecilia Muñoz and Robert Gordon, “PFS: A New Results-Oriented Federal Commitment for Underserved Americans,” The White House, January 24, 2012, available at <http://www.whitehouse.gov/blog/2012/01/24/pay-success-new-results-oriented-federal-commitment-underserved-americans>.

are little more than a complicated new method to privatize essential government services.² Critics assert that PFS funding will subsume public good to the will of private profit.³ The reality, however, is quite different.

Early advocates of PFS mechanisms, including SIBs, are motivated by the recognition that cash-strapped and tax-averse governments do not have sufficient resources to tackle many of our most pressing social problems, even when strong, evidence-based programs exist that may be successful in improving outcomes for at-risk and hard-to-serve populations. Additionally, PFS mechanisms allow government to focus on the important outcome (e.g., getting people a well-paying job) as opposed to simply an input (enrollment in job training courses) or an output (job training certificates). While both the input and output may be important in this case, what government really wants is to see more people employed (the outcome).

PFS financing is not a zero-sum game; it is a tool to add to government spending on social services by recruiting private capital into double-bottom-line investments that trade some financial payoff for a larger social return. It is widely recognized that opportunities for private investors in PFS deals will not be profit-maximizing.⁴ Furthermore, the incentives involved in designing a PFS deal are inherently different from those that exist in actual privatization models. When a prison system is privatized, for instance, the company's revenue depends on having prisoners to house. The company does not generally have an incentive to rehabilitate prisoners or help them transition back into society. A government agency engaging in a PFS transaction will target an outcome that is socially beneficial—such as “less recidivism,” not “more prisoners.”⁵

Finally, governments at all levels already routinely contract out the operation of many social services to nongovernmental organizations. In 2009, nearly 200,000 government grants and contracts went to some 33,000 social service providers, working in areas including employment assistance, housing, community development, youth services, and education, according to a study by the Urban Institute.⁶ In the United States, it is possible to imagine some social impact bond-like instrument in cases in which a party other than government is already responsible in some legal or moral sense for the wellbeing of a population—a

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- 2 James Clancy, “President’s Commentary: Top 10 Reasons to be Worried about Social Impact Bonds,” National Union of Public and General Employees, January 2, 2013, available at <http://www.nupge.ca/content/5494/presidents-commentary-top-10-reasons-be-worried-about-social-impact-bonds>; Mark Rosenman, “Commercializing the Public Good,” *Huffington Post*, June 8, 2011, available at http://www.huffingtonpost.com/mark-rosenman/commercializing-the-publi_b_869265.html.
 - 3 Rebecca Fairfax Clay, “Health Impact Bonds: Will Investors Pay for Interventions?” *Environmental Health Perspectives*, February 1, 2013, available at <http://ehp.niehs.nih.gov/2013/02/121-a45/>.
 - 4 Steven Godeke and Lyel Resner, “Building a Healthy & Sustainable Social Impact Bond Market: The Investor Landscape” (New York: Godeke Consulting, 2012), available at <http://www.rockefellerfoundation.org/news/publications/building-healthy-sustainable-social>.
 - 5 McKinsey & Company, “From Potential to Action: Bringing Social Impact Bonds to the US” (2012), http://mckinseysociety.com/downloads/reports/Social-Innovation/McKinsey_Social_Impact_Bonds_Report.pdf.
 - 6 Elizabeth T. Boris, Erwin d Leon, Katie L. Roeger, and Milena Nikolova, “National Study of Nonprofit-Government Contracting,” Urban Institute, September 2010, available at <http://www.urban.org/UploadedPDF/412227-National-Study-of-Nonprofit-Government.pdf>.

health insurance company, for instance—and therefore stands to benefit financially from an improved, cost-saving outcome in that population. But such arrangements will be the exception, not the rule. Ultimately, because government will be the payer for innovation prizes, stringent PFS contracts, and social impact bond deals, the government should and will play an active role in defining the parameters and desired outcomes of these transactions.⁷

Roles for Federal, State, and Local Government

While the roles and responsibilities of various levels of government in the United States often complicate the implementation of PFS mechanisms, it is possible to identify distinct roles for federal, state, and local government.

The Federal Role

The federal government is best suited to work along four avenues in promoting PFS financing: 1) galvanizing interest and changing incentives for nongovernmental organizations, 2) convening outside groups across social-service sectors, 3) providing incentives for state and local governments, and 4) setting standards and providing financial support.

The Obama administration has played a key role in galvanizing interest in PFS mechanisms from its earliest days through the Office of Social Innovation and Civic Participation. The creation of the Social Innovation Fund at the Corporation for National and Community Service, the Investing in Innovation (i3) Fund at the Department of Education, and the Workforce Innovation Fund at the Department of Labor all helped direct federal dollars toward high-impact programs and grantees. The Social Innovation Fund, for example, leveraged \$250 million in private funds by competitively awarding \$95 million in federal funds between 2010 and 2012—all money that will go toward programs whose effectiveness will be rigorously evaluated. According to the White House, more than 100 cities in 33 states and the District of Columbia have been impacted by Social Innovation Fund awards.⁸

The White House played a critical role in convening various parties to discuss PFS models in October 2011.⁹ While Massachusetts governor Deval Patrick had already stated his intention to explore PFS financing earlier that year, knowledge of PFS tools like social impact bonds was limited.¹⁰ The White House brought together the most advanced thinkers on the issue at the time and connected them with policy professionals from around the country, who could then take innovative new ideas back to their organizations and governments.

7 Jitinder Kohli, Douglas J. Besharov, and Kristina Costa, “Social Impact Bonds and Government Contracting,” Center for American Progress, May 2, 2012, available at <http://www.americanprogress.org/issues/open-government/news/2012/05/02/11590/social-impact-bonds-and-government-contracting/>.

8 Office of Social Innovation and Civic Participation, “Social Innovation Fund,” available at <http://www.whitehouse.gov/administration/eop/sicp/initiatives/social-innovation-fund>.

9 Nonprofit Finance Fund and The White House, “PFS: Investing in What Works” (2012), available at http://payforsuccess.org/sites/default/files/pay_for_success_report_2012.pdf.

10 Kristina Costa, “Bay State Takes Lead in Innovation Finance,” Center for American Progress, May 11, 2011, available at <http://www.americanprogress.org/issues/open-government/news/2011/05/11/9686/bay-state-takes-lead-in-innovation-finance/>.

The two federal budget lines where the administration has determined sufficient flexibility exists to enable funds to be used for PFS deals—namely, the Second Chance Act in the Department of Justice, which funds recidivism reduction programs, and the Workforce Innovation Fund in the Department of Labor, which funds some workforce development programs—have helped show how the federal government may be able to work with cities and states to use these tools. The Department of Justice and Department of Labor solicited questions about their procurement processes and published those questions and answers online.¹¹ In doing so, these federal agencies have offered concrete answers to pressing questions about the stringency of outcome measures, flexibility of models, and potential roles for different parties. And the White House has included PFS financing in its last two budget proposals, helping to guide the public conversation even though neither request was taken up by Congress.¹²

The federal role in PFS mechanisms will continue to change as more state and local governments engage with the tools and as the market for PFS deals grows and evolves. But the federal government already plays a role in promoting PFS financing as a galvanizer of interest, a convener of parties, a provider of incentives, and a setter of standards.

The State and Local Government Role

Because of the high degree of coordination involved in the most stringent PFS deals, like SIBs, individual deals will likely be primarily negotiated by state or local governments, with the federal government providing support in the form of financial or technical assistance.¹³

Negotiating the details of PFS transactions is incredibly important and challenging. But even beyond this critical task, pioneering states and cities have tackled the thornier technical issues inherent in PFS deals, thereby serving as examples to other governments interested in PFS transactions. For instance, the state of Massachusetts was the first government in the nation to pass through legislation, a full faith and credit guarantee for PFS contracts. In the same legislation, the state established its Social Innovation Financing Trust Fund, to hold up to \$50 million in potential outcome payments for PFS deals.¹⁴ These measures took significant, public steps to address issues around investor confidence in PFS transactions. As more cities and states with potential PFS deals in the pipeline move further along in the process, we can expect to see more local solutions to some of the challenges and risks inherent in these unusual transactions.

11 Bureau of Justice Assistance, “PFS and the Department of Justice’s Second Chance Act Programs: Frequently Asked Questions (FAQs)” (2012), available at <https://www.bja.gov/Funding/12PayforSuccessFAQ.pdf>; Nonprofit Finance Fund, “Questions and Answers Related to DOL SGA” (2012), available at http://payforsuccess.org/sites/default/files/questions_and_answers_related_to_dol_sga_2.pdf.

12 Office of Management and Budget, “Paying for Success,” available at <http://www.whitehouse.gov/omb/factsheet/paying-for-success>.

13 McKinsey & Company, “From Potential to Action: Bringing Social Impact Bonds to the US.”

14 “An Act Making Appropriations for the Fiscal Year 2012 to Provide for Supplementing Certain Existing Appropriations and for Certain Other Activities and Projects,” Mass. S.2112, 2012.

Looking Beyond the Deal

Widespread interest in PFS and SIBs may lead one to assume that these deals are on their way to becoming the preeminent form of financing for social programs. In fact, one *New York Times* article quoted detractors claiming that there was a SIB “bubble,” that there had been too much “hoopla” about the concept, and that there was a “gold-rush mentality” around these deals.¹⁵ Given that, at the time the article was written, there had been exactly one SIB deal finalized in the United States—the \$9.6 million New York City agreement targeting recidivism reduction at Rikers Island—this rather overstated the reality of the PFS landscape in the United States. But this overreaction to the first SIB deal illustrates one of the ways in which government’s role in PFS must continue beyond the details of individual deals.

A broader view is needed because PFS financing—whether in the form of innovation prizes, pay-for-performance contracts, SIBs, or some other mechanism still to be developed—is about more than the narrow technocratic fix. To be sure, many technical policy issues around PFS mechanisms require active decision-making by government (from establishing policies for tax treatment of investments to identifying the most appropriate existing programs to support these deals) and governments at all levels should take steps to address these issues. But it is also the role of government to attend to the larger reasons for PFS financing.

PFS mechanisms are both an alternative and supplement to traditional government financing. In a fact sheet released with the FY 2012 budget proposal, the Office of Management and Budget is upfront about the reasons to employ PFS financing: “For too long, the US Government has funded programs based upon metrics that tell us how many people we are serving, but little about how we are improving their lives,” they write, noting that for PFS funding, “The concept is simple: pay providers after they have demonstrated success, not based on the promise of success, as is done now.”¹⁶ Policymakers at all levels of government must keep an eye on this larger conversation—beyond the details of any individual deal, and beyond the news of the day—and consistently re-orient the debate about these new mechanisms toward better outcomes and a better way of conducting the business of government.

Conclusion

For too long, government business has been conducted in an unchanging fashion. The dearth of progress in any number of social areas shows that we cannot continue on this path. We need to see change beyond incremental improvements. PFS financing provides an opportunity to invest in transformative change. PFS mechanisms allow government to partner with the social sector, philanthropy and the private sector to achieve better outcomes. Local, state

15 Caroline Preston, “Getting Back More Than a Warm Feeling,” *The New York Times*, November 8, 2012, available at http://www.nytimes.com/2012/11/09/giving/investors-profit-by-giving-through-social-impact-bonds.html?pagewanted=all&_r=0.

16 Office of Management and Budget, “Paying for Success.”

and national governments testing PFS, prizes, and innovation funds in the United States and around the world are demonstrating a real and sincere desire to invest in results and outcomes. PFS financing is still in its early days, but with more open data, greater transparency and ever-improving technology, we have an opportunity to try new mechanisms, assess new models, and push for change. Given tight public-sector budgets and a growing impatience about the limited number of measurable, verified outcomes resulting from social interventions, we have an imperative to invest in what works and measure for impact. PFS funding provides an opportunity for government to set clear outcomes, ensure that money flows increasingly toward programs that work, and see people's lives measurably improved by public-sector endeavors. We should continue to assess these programs to ensure that they achieve better outcomes.

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Rikers Island: The First Social Impact Bond in the United States

John Olson and Andrea Phillips

Goldman Sachs

In August 2012, Goldman Sachs Bank's Urban Investment Group (UIG) announced the first social impact bond (SIB) in the United States, a \$9.6 million loan it would make to support the delivery of therapeutic services to 16- to 18-year-olds incarcerated on Rikers Island.¹ The loan will be repaid based on the actual and projected cost savings realized by the New York City Department of Correction as a result of the expected decrease in recidivism. This unique public-private partnership between the City of New York, MDRC, the Osborne Association, Bloomberg Philanthropies, and Goldman Sachs leverages high-quality nonprofit capacity, private-sector capital, and philanthropic support to address a pressing community challenge.

Financing the provision of therapeutic services to inmates at Rikers Island represented a unique opportunity to fulfill UIG's commitment to double bottom line investing by making a real difference in the lives of the adolescents imprisoned at Rikers Island while earning a modest return in line with traditional community development financing products. In addition to the social and financial returns associated with this transaction, UIG also saw it as an opportunity for Goldman Sachs to make a significant contribution to the development of a new financial instrument that has the potential to transform the way service providers, governments, and financial institutions collaborate to address pressing social issues with evidence-based interventions.

Several trends have made SIBs a topic of much interest. Local government budgets are increasingly strained, leaving governments unable or unwilling to finance preventative interventions. The social service sector is under increasing pressure to focus on evidence-based interventions that work. At the same time, nonprofit providers are looking for reliable sources of long-term funding. In this context, the Rikers Island transaction represents a first step in developing the potential of the SIB to harness these trends.

Transaction Structure

The Goldman Sachs loan is structured as a \$9.6 million multiple-draw term loan to MDRC, an experienced intermediary known for bringing together public and private funders to test new policy ideas. MDRC will use the proceeds of the loan to provide funding to the service provider, the Osborne Association, which has extensive experience in providing services to incarcerated youth. MDRC, through a contract with New York City, will oversee the

¹ The Rikers Island transaction is technically not a bond; it is a loan. But the expression *social impact bond* is in such regular use that for ease of recognition, we refer to the transaction as a social impact bond.

day-to-day implementation of the project and is responsible for any payments to Goldman Sachs. The Vera Institute of Justice, an independent, nonpartisan, not-for-profit center for justice policy, will serve as the evaluator of the program and will evaluate the extent to which the program has reduced the rate of recidivism among Rikers Island inmates participating in the program. Based on the results of the evaluation (at twelve- and twenty-four-month postrelease intervals), New York City will provide success payments to MDRC based on the actual and projected cost savings from the reduced recidivism rate, according to the payment schedule shown in Figure 1. MDRC then repays the Goldman Sachs loan from the New York City success payments.

Figure 1. Success Payment Schedule for the Rikers Island Social Impact Bond

| Reduction in Re-Admission Rate | Projected Long Term City | |
|--------------------------------|--------------------------|----------------------|
| | Net Savings (\$) | City Payment to MDRC |
| ≥20.0% | \$20,500,000 | \$11,712,000 |
| ≥16.0% | \$11,700,000 | \$10,944,000 |
| ≥13.0% | \$7,200,000 | \$10,368,000 |
| ≥12.5% | \$6,400,000 | \$10,272,000 |
| ≥12.0% | \$5,600,000 | \$10,176,000 |
| ≥11.0% | \$1,700,000 | \$10,080,000 |
| ≥10.0% (<i>breakeven</i>) | \$ ≥ 1,000,000 | \$9,600,000 |
| ≥8.5% | \$ ≥ 1,000,000 | \$4,800,000 |

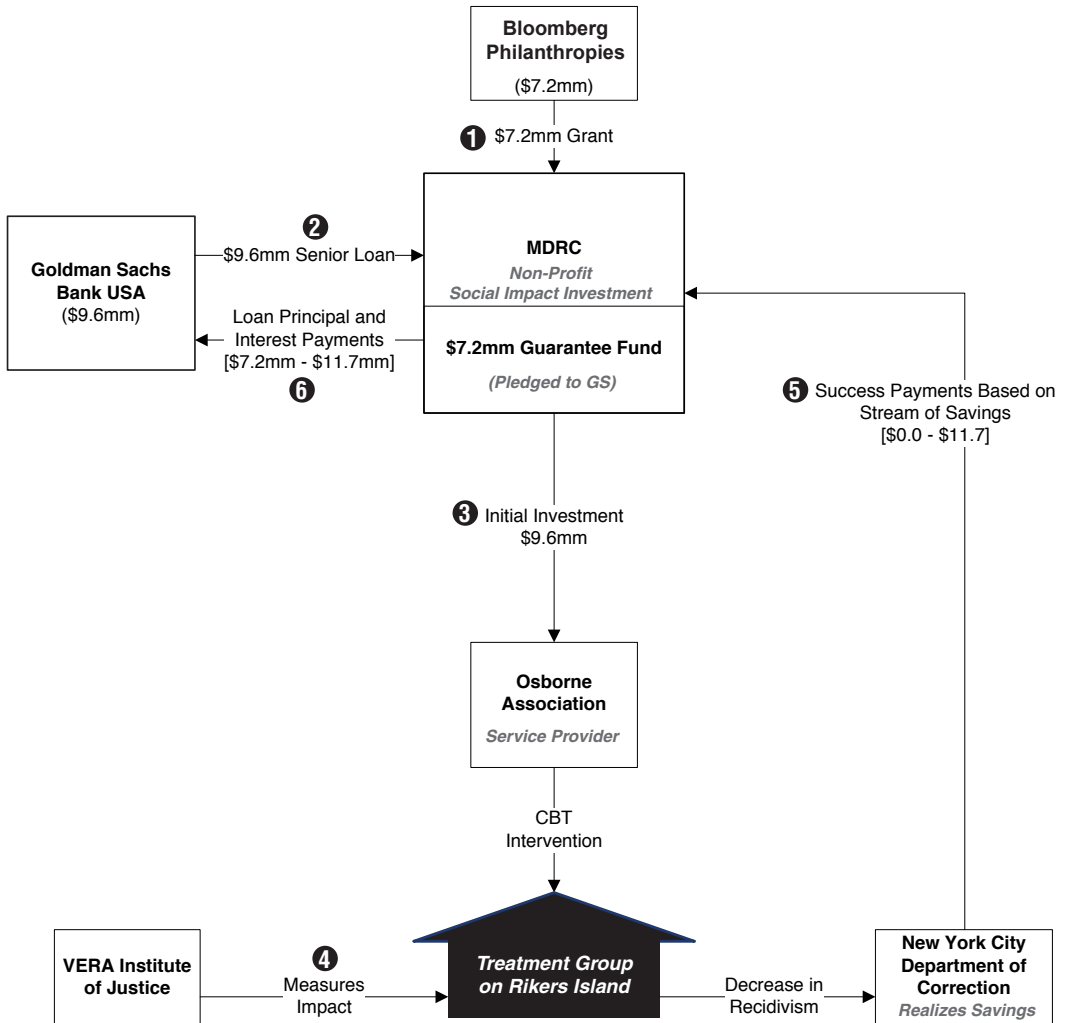
The transaction benefits from a guarantee provided by Bloomberg Philanthropies. The foundation provided a \$7.2 million grant to MDRC to guarantee a portion of the loan, thus reducing Goldman Sachs' risk. However, the grant is paid over time in such a way that at any given time, there is Goldman Sachs capital at risk in the transaction. Any unused portion of the guarantee fund will remain with MDRC to support future efforts of this sort. Figure 2 depicts the flow of funds among the parties.

Risks and Mitigants

Impact Risk

Because the financial outcomes of an SIB transaction depend directly on successfully achieving social outcomes, evaluating the proposed intervention and the service providers implementing it is an important part of the due diligence process. Goldman Sachs' due diligence included a review of the capabilities of both the Osborne Association and MDRC, and a review of the efficacy of the program to be provided at Rikers Island by the Osborne Association. The deep experience, expertise, and accomplishments of the partners in the transaction, MDRC and Osborne, grounded Goldman Sachs' confidence that the social outcomes would be achieved. In addition, the review of the efficacy of the proposed

Figure 2. Flow of Funds for Rikers Island Social Impact Bond



- 1 BP will make a \$7.2mm grant, funded annually over 4 years, to MDRC.
- 2 GS will make a \$9.6mm senior multiple draw term loan to MDRC paid out quarterly over 4 years.
- 3 MDRC will provide funding of \$9.6mm paid out over 4 years to Osborne, in order to support the direct costs associated with the program.
- 4 Vera will measure the impact of the program at 12 and 24 month intervals post release
- 5 NYC will realize a stream of savings from the decrease in recidivism and will make up to two Success Payments to MDRC for a maximum of \$11.7mm. These payments will be based on the threshold decreases in recidivism as measured by Vera
- 6 After 3 years, MDRC will repay GS \$2.4mm from the Success Payments or from the guarantee fund. After 5 years, MDRC will repay GS the Success Payments and, if necessary, an amount from the guarantee fund needed to repay the GS principal.

intervention uncovered an extensive body of research that shows that the type of therapy that would be provided is effective in significantly reducing recidivism rates.²

Execution Risk

The SIB model relies on a complex, interrelated set of contracts. For example, MDRC juggled a loan agreement with Goldman Sachs, a grant agreement with Bloomberg Philanthropies, a contract with New York City, and a contract with the Osborne Association. The entirety of the transaction consists of a complex set of contracts and agreements that, if properly executed, aligns the participants' incentives in a mutual agreement that serves the needs of all parties. Managing the multiple contracts required extensive diligence and review by legal counsel on all sides.

Performance Risk

Another consequence of the multiparty nature of the SIB model is that the success of the transaction depends on all parties fulfilling their obligations throughout the duration of the various contracts. In the negotiations for the Rikers Island transaction, a number of contingencies were imagined—for example, the risk that the city would not appropriate funds for the program, or that the service providers would not implement the required intervention—and such risks were mitigated with appropriate contractual protections. Ultimately, however, the strength of the transaction did not come from the detailed contracts but from the quality, professionalism, and strong track records of all the parties to the transaction.

Going Forward

The Rikers Island transaction came about because a remarkable confluence of factors made it a good candidate for the first SIB in the United States. The transaction included strong partners on all sides—New York City, MDRC, the Osborne Association, the Vera Institute of Justice, Bloomberg Philanthropies, and Goldman Sachs—and demonstrated that such transactions could be structured in a way that would benefit all parties. The efficacy of the intervention services is well documented and researched, and the savings expected as a result of successful intervention are quantifiable. While this structure worked in this transaction, new models and new structures will no doubt emerge as more SIBs are completed.

A number of other SIB transactions are already underway that will apply this approach to other interventions including early childhood education, job placement and employment services. We expect that future transactions will explore different levels of risk sharing between the investor, service provider, intermediary, and government (in the Rikers Island transaction, only Goldman Sachs and Bloomberg Philanthropies had some downside risk). We also expect that rapid learning will take place as different structures and models are developed and implemented, and that the terms and agreements in SIB transactions will become

² See, for example, Mark W. Lipsey, Nana A. Landenberger, and Sandra J. Wilson, "Effects of Cognitive-Behavioral Programs for Criminal Offenders," *Campbell Systematic Reviews* (6) (2007), which is a meta-analysis of fifty-eight research studies, available at www.campbellcollaboration.org/lib/download/143/.

standardized over time. The role of impact evaluations will be a key area of focus, particularly as these efforts begin to increase in scale.

While Goldman Sachs is cautiously optimistic that the SIB as a financial instrument can be replicated and brought to a larger scale, we are also very aware that more examples of successful transactions will be needed before the SIB has fully realized its much-discussed potential. We look forward to participating in the ongoing evolution of the SIB and helping this new financial instrument reach its full potential.

John Olson recently joined Goldman Sachs to lead Goldman Sachs Bank USA's Community Reinvestment Act (CRA) compliance program. Prior to joining Goldman Sachs, he was a manager in the Community Development Department at the Federal Reserve Bank of San Francisco.

Andrea Phillips, vice president in the Goldman Sachs Urban Investment Group, leads deal teams with a focus on social innovation and economic development financing as well as access to capital for small businesses as part of the Goldman Sachs 10,000 Small Businesses initiative. She led the investment in the Rikers Island social impact bond. Prior to joining Goldman Sachs, she was president of Seedco Financial.

Goldman Sachs' Urban Investment Group (UIG), established in 2001, deploys the firm's capital by making investments and loans that benefit urban communities. Through its comprehensive community development platform, UIG has committed more than \$2.8 billion to catalyze the revitalization of underserved neighborhoods, financing nearly 13,000 housing units for low-, moderate- and middle-income families, 1.9 million square feet of commercial and retail space, and more than 1.3 million square feet of facilities serving a variety of community needs, and providing capital to mission-driven intermediaries that provide financing to small businesses as part of the Goldman Sachs 10,000 Small Businesses initiative. UIG is also the business unit responsible for fulfilling the Community Reinvestment Act (CRA) obligations of Goldman Sachs Bank USA.

Human Capital Performance Bonds

Steve Rothschild

Invest in Outcomes

The concept of the “new normal” has infiltrated the thinking of policymakers, employers, and service providers. Brought about by demographic and technological changes, the new normal demands change: business as usual will no longer work.

For human service providers, the new normal poses some big challenges. Faced with tighter budgets, federal, state, and local governments are cutting back on discretionary programs, often human services. Ironically, these same human services, funded appropriately, could help remedy public budget imbalances over the long run because they deliver preventive measures and social change. Numerous studies have shown that the best human services programs deliver more in benefits than they cost: for example, early childhood learning, workforce training, post-incarceration programs, chemical dependency treatment, supportive housing, and counseling for long-term caregivers.

Social impact investing provides an answer to the question: How can we identify and fund those human services that improve the health of our communities over the long run and pay for themselves? Like traditional investing, it recognizes that certain social interventions provide financial gains to investors. Unlike traditional investing, it also provides improved social and financial outcomes to clients and taxpayers.

So far, activity is limited to a few places, and each place is moving forward with its own version of social impact investing. Great Britain launched its effort in 2010 with investments in its Peterborough prison. New York City recently began a pilot in its Rikers Island prison. Both Massachusetts and Minnesota have passed legislation for pilot projects, although implementation has yet to commence. Others, from Connecticut, Ohio, and California in the US to Australia, Germany, and the UK are developing other pilots.

There are a variety of models of social impact investing, including variations on the social impact bond (SIB) and the human capital performance (HUCAP) bond. The HUCAP bond has two key design features that distinguish it from SIBs: (1) payment to social enterprises is based on their performance, and (2) it uses bond funds for capital.

In 2011, the Minnesota legislature passed the “Pay for Performance Act,” which authorized the sale of \$10 million in annual appropriation bonds to finance a HUCAP pilot project. HUCAP bonds are based on the premise that many social enterprises create financial value from the social benefit they create. This financial value can be measured, captured, and used as a source to attract market-rate investors such as pension funds, 401k plans, and insurance companies to buy bonds.

Origins of the HUCAP Bond

The Minnesota HUCAP bond model is based on experience from a 15-year Pay for Success (PFS) contract between the Minnesota Department of Employment and Economic Development (DEED) and Twin Cities RISE! (TCR!), a workforce development nonprofit that provides intensive education and training services to difficult-to-employ individuals. TCR! is paid only when a client is placed in a job earning more than \$20,000 per year and where the change in their income is at least \$10,000. The amount of TCR!'s payment is directly related to the economic value that the change in income created from higher income and sales taxes and lower public costs for low-income health care, child care, subsidized housing, and incarceration costs. TCR! is paid half at placement and half after one year of retention on the job. Over the last 15 years the state has enjoyed a return on investment (ROI) of more than 600 percent.

This long-term arrangement suggests that social outcomes can be defined, economic data can be measured, and providers can be rewarded on the basis of the financial value they create for the state from their successful interventions. It also suggests that high-performing social enterprises would benefit from this PFS arrangement.

HUCAP Bond: Starting with Performance

With the HUCAP bond, the government enters into contracts with service providers. The payment is not a fixed amount, but varies with the performance of the provider. The more financial value human service providers create, the more they are paid. Meanwhile, the state sells conventional bonds to create a pool of cash for paying the human service providers when they perform. As the state begins to reap the financial benefits, it sets these aside to pay interest, amortize the principal, and cover administrative costs (totaling approximately 13 percent per year for a 10 year bond).

Because service providers get paid only if, and not until, outcomes are substantiated, a separate working capital fund will be established from which they can borrow.

Paying providers for the value they create encourages them to continually improve performance. The mere creation of a tool to measure ROI has workforce training providers asking, "What's my ROI?" Ideally, best practices will become known and disseminated to help all providers improve their ability to serve their clients.

Moreover, the common problem of "cherry-picking" (choosing to serve only the easiest cases because the payment doesn't vary) is diminished. Because providers are paid for their value-added, they will be compensated more for good results with harder to serve clients. In workforce training, for example, the outcomes are more dramatic for clients who have been out of the workforce longer, or incarcerated, or heavily reliant on public benefits.

Infusion of Capital into Human Services

The HUCAP structure is designed with state bonds¹ for one primary reason—to facilitate the largest pool of capital investment, which is market-rate bond investors. By using a government bond, investors do not have to conduct due diligence about the service providers, or indeed, have any concern about their performance; it is the government’s credit rating they care about. The use of state bonding takes advantage of existing structures for rating agencies, underwriters, and bond sales. This enables the HUCAP bond to minimize transaction costs, keep the cost of capital low, and scale-up to levels of investment commensurate with the opportunities identified. There are \$3.7 trillion of municipal bonds outstanding in the US

Major Shift in Budgeting Practices

The HUCAP bond also creates a major shift in the way governments budget. Using bonds to finance human services is an implicit recognition by the state that benefits often accrue over a number of years. For example, we don’t educate five-year-olds because we hope they’ll be contributing members of society by the time they are seven. Government currently tends to underinvest in social services, because budgeting rules only recognize short payback periods. A 10-year bond enables human services to invest for the highest long-term social and financial return.

Budgeting also tends to take place in silos—that is, government budgeting is usually done at the agency level, without taking into account the costs or benefits from their activities that accrue to other departments. As the workforce training example suggests, costs and benefits can be spread over many agencies. With conventional budgeting, Minnesota’s DEED pays for the services. But the Departments of Human Services and Corrections see reductions in their spending as a result, and the government’s coffers grow from increased tax revenue. The HUCAP bond provides a way of accounting for all of these costs and benefits by accumulating all new revenue and cost savings across government agencies. The HUCAP bond will help public agencies see and act on the bigger picture impact of human services.

Third, the focus shifts from activity to outcomes. How can we identify and fund those human services that contribute to the health of our communities over the long run? Government budgets are notorious for funding activities (such as seat time for school children) rather than meaningful outcomes (such as how much did they learn or did they graduate). Part of the problem is that defining and measuring outcomes can be very difficult. It’s no easy task, but it can be done, and part of the HUCAP bond pilot program will be developing and testing such a measurement system for a variety of areas.

Finally, the focus shifts from cost to value. There is a tendency to underinvest in more

1 It is also possible for another entity such as a financial institution, consortium of nonprofits, or housing authority to issue bonds provided there is an iron clad contract with the relevant government to “pay for success” based on the economic value created. Ultimately we believe the market will evolve in this way as the risk and return of the HUCAP bond becomes established. While more expensive to issue, this evolution will potentially enable more HUCAP bonds as states and counties usually have limits on the amount of bonding that they can issue.

intensive services because they are more costly. Such budgetary decisions ignore the other side of the equation—what benefits are being created? Analyses of workforce training programs in Minnesota, for example, showed that programs offering more intensive services tended to produce superior outcomes. By measuring ROI instead of cost, the focus shifts to providing services with the highest returns to the individual, society, and taxpayers.

Questions About the HUCAP Bond

There are three common concerns about the use of bonding for social services:

1. *The service provider takes too much risk.* While it is true that the service provider takes most of the risk in this approach, much of it is reduced in practice. Only high-performing human services whose interventions create economic value above the government's cost of paying its debt obligation will be interested or invited to participate. (Other providers will be incented to improve their outcomes so that they can participate.) And during the pilot period, half of the working capital provided to participating nonprofits is expected to be nonrecourse debt.
2. *The cost of borrowing working capital is too high.* Working capital loan rates can be kept low by seeking funds from foundations' equity, program-related investments (PRIs), and banks' Community Reinvestment Act funds. The working capital is also leveraged by the eventual performance payments. For example, for \$10 million in bonds, \$3 million of working capital is expected to be required. If interest rates were as high as 6 percent on the amount borrowed, the effective interest rate on loans to the providers would be one-third of that, or 2 percent.
3. *Many states or countries already have too much debt.* The HUCAP bond is a bond that pays for itself. Bond funds are only expended by government in an amount no greater than the financial benefit the government receives. If service providers fail to perform, the bond could be called, with little interest cost expended.

The Similarities and Difference Between HUCAP Bonds and SIBs

Both SIBs and HUCAP bonds are intended to provide incremental investment in high-performing social enterprises. They both make payments based on the economic value that the social interventions create. They also share the need for accurate and transparent measurement.

They differ in the structure of the investment. Although they're called bonds, SIBs are not actually a bond or a debt instrument. Rather, they are more like a social venture capital investment or a form of equity. HUCAP bonds are government issued bonds just like those issued for infrastructure. And although both use PFS approaches based on the economic value being created, they apply it differently. In SIBs, all the risk and incremental reward accrues to the investor. With the HUCAP bond, the risk is primarily borne by the service provider, but this is its opportunity to earn higher payouts for better performance. This enables the

HUCAP bond's cost of capital to remain low, equivalent to the government's bond rating (at 3 percent for a taxable AA bond today) versus rates up five times higher for the SIB. To date, SIBs have either attracted social investors (wealthy individuals and foundations) or required a foundation guarantee (the NYC model), whereas HUCAP bonds are targeted to market-rate investors, a much larger pool of available capital. The HUCAP bond approach, if successful, can scale up quickly across the country, and indeed in other countries, to potentially billions of dollars given the size of the bond market globally.

The Status of the HUCAP Bond

Legislation to create a HUCAP bond pilot was passed in Minnesota in 2011. It authorized \$10 million in annual appropriation bonds for the pilot project. An oversight committee was established to oversee the work of Minnesota Management and Budget, the state agency responsible for issuing the bonds. Invest in Outcomes, the Minnesota nonprofit that developed the HUCAP bond model, provided economic analysis in five areas of potential piloting. The state chose to pilot in workforce development and supportive housing.

The issuance of the bond was held up for more than a year by a legal case against another appropriation bond. The Supreme Court of Minnesota provided a positive ruling in November 2012 enabling the issuance of HUCAP bonds to go forward. Bonds are expected to be issued in 2013.

What's Needed to Move Forward

The development of HUCAP bonds and SIBs could be accelerated by specific actions on the part of players in the social enterprise, government, and investment sectors.

Social enterprises, especially nonprofits, must begin identifying their social outcomes—that is, the long-term benefit of their interventions, not just the outputs that are the standard fare today. They further must start identifying and measuring these outcomes and also work with economists as they develop ROI calculations necessary for a social impact investment.

Governments must think and act more as investors rather than mere spenders of tax dollars. They must refine their measurement and accounting systems to track and capture the value of preventive interventions. They also must be open to rewarding providers and/or investors for the value that their actions created.

The federal government should use its existing waiver authority to share the financial benefits it receives as a result of the actions of states and municipalities that implement these investment vehicles. In some programs, such as Medicaid, the federal government garners at least half the savings created by state and municipal interventions because it pays at least half the cost. It should share part of its benefit to incentivize additional local investments.

The existing infrastructure of banks and consultants can play an important role in spreading and refining these models. Banks can provide capital, advise governments on the

opportunities, and underwrite bonds. Consulting networks can help providers and government learn how to establish and implement these investment opportunities.

There is confusion about the term SIB, or social impact bond, given that it really is not a bond. The HUCAP structure offers an alternative that is a bond. It would be helpful if there were agreement about what the field should be called (social impact investing perhaps) and clarity about the various alternative models. The current situation is not helpful to providers, governments, or investors who are trying to understand this new area of social investing.

Social impact investing is in a nascent stage. It has the potential to provide significant levels of new capital to help solve a wide array of social issues. Yet it is so new that it will be important to pay careful attention—no matter what the model—to “design” failures and successes and distinguish them from “execution” failures and successes. Have we accurately measured financial value? Is the model workable from all points of view—service providers, government, and investors? How can we improve the model? Can this idea be brought to scale?

As the actual risk and return is better understood through implementation of additional pilots new investment vehicles that attract additional investors interested in different combinations of risk and reward will emerge. The HUCAP bond will be one of an array of investment vehicles that can finance important social enterprises, just like in the commercial world.

Steve Rothschild is the president of Invest in Outcomes, the nonprofit he founded to develop the human capital performance bond. He is also the founder and chair of TwinCities Rise!, an award winning anti-poverty, workforce nonprofit. Previously he was executive vice president of General Mills where he launched its Yoplait Yogurt subsidiary. He is the author of The Non Nonprofit: For-Profit Thinking for Nonprofit Success.

Pay for Success: Building On 25 Years of Experience with the Low Income Housing Tax Credit

Terri Ludwig

Enterprise Community Partners, Inc.

Pay for Success (PFS) has been touted as the hot new innovation in social investing. Over the past year, investors and governments across the country have committed millions of dollars to exciting new tools like social impact bonds (SIBs), which deliver a financial return only when specific social goals are met.¹ But this approach is not new. Indeed, socially driven investors have used the PFS model for more than a quarter century.

Consider the Low Income Housing Tax Credit (LIHTC), the primary tool for financing affordable housing development in the United States since the mid-1980s. Under this program—which deployed more than \$8 billion in private capital last year alone—private investors front the money for a developer to construct rental housing that is affordable to low-income families, defined as those making less than 60 percent of the area’s median household income. In exchange, the investor is given a tax credit from the federal government, redeemable only when construction is completed and the low-income family moves into their new home. The rent must stay affordable for a 15-year window, throughout which the government can recapture the tax credit in the event of noncompliance.

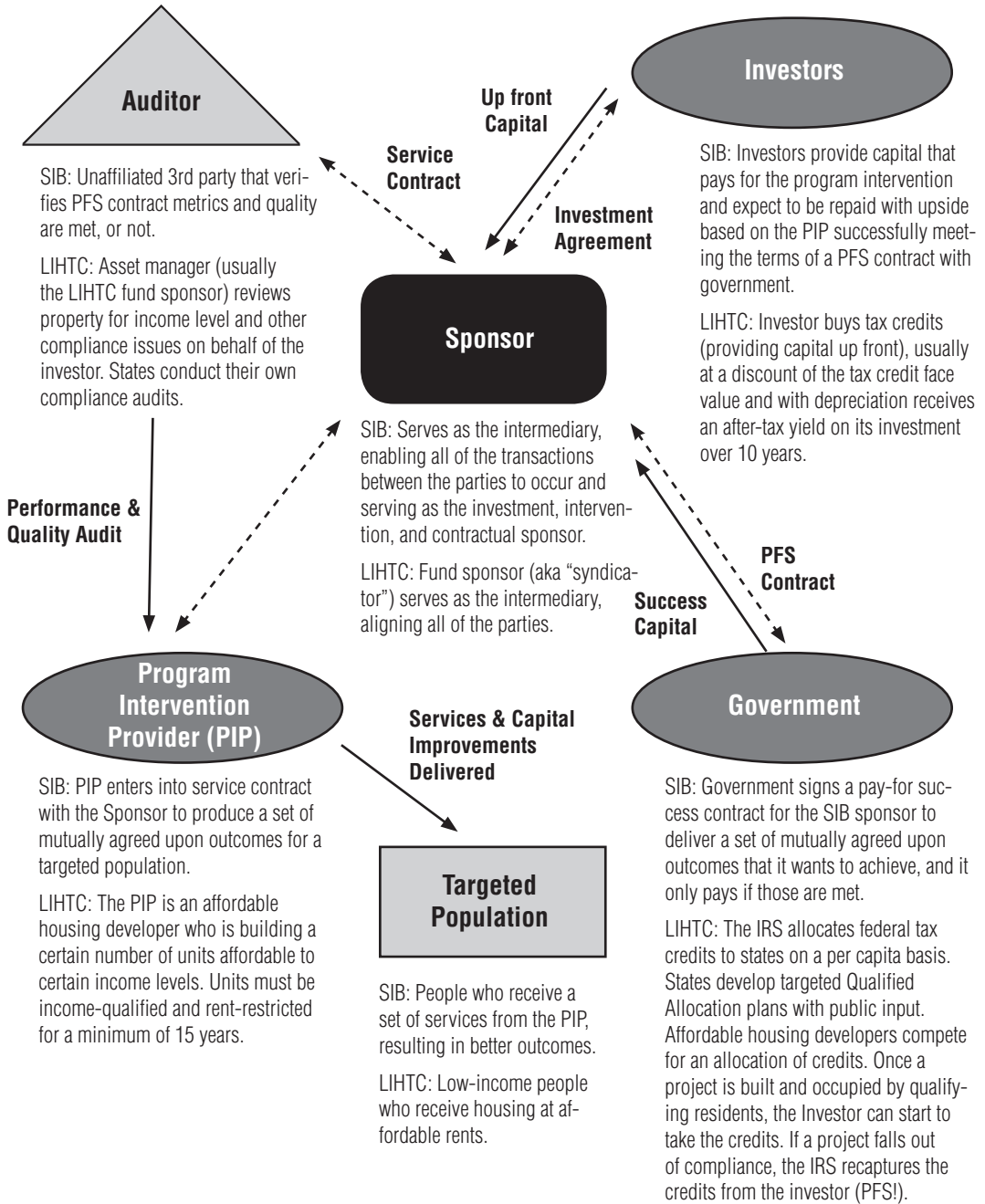
In other words, the federal government only pays if the program is successful—in this case if an affordable home is actually built and inhabited by a low-income family at affordable rents for at least 15 years.² If that goal is not met, private investors, not taxpayers, are on the hook.

Sound familiar? In a basic SIB agreement, a private investor provides initial capital for a social program, say one that serves the chronically homeless. With the help of an intermediary, all stakeholders agree to a set of measurable performance goals, say cutting the number of chronically homeless by half in a certain number of years. A government entity then agrees to pay the full cost of the program plus a premium to the investor, but only if that goal is met. If the program falls short, the private investor loses money.

1 For more information on SIB deals today, see Kristina Costa and Jitinder Kohli, “New York City and Massachusetts to Launch the First Social Impact Bond Programs in the United States” (Washington, DC: Center for American Progress, November 2012), available at www.americanprogress.org/issues/economy/news/2012/11/05/43834/new-york-city-and-massachusetts-to-launch-the-first-social-impact-bond-programs-in-the-united-states.

2 In reality, units funded through the LIHTC are required to be rented at affordable rates for a 30-year period. After the 15-year recapture period, there is an additional 15-year covenant on the land that requires that the rent stay affordable. However, the federal government can only recapture tax credits over the initial 15-year period.

Figure 1. How SIBs and LIHTCs are Similar PFS Models



Of course, these are both oversimplified summaries, and the details vary greatly from deal to deal. Still, one thing is clear: as we seek to ramp up SIBs and other PFS tools in the coming years, we need not start from scratch—we have more than 25 years of LIHTC experience to draw on.

This article lays out the lessons investors, governments, and service providers can learn from tried-and-true PFS models, with a particular focus on the LIHTC. It also presents a recent example of how Enterprise Community Partners is working to tackle a pressing social problem—the intersection of rising health care costs and senior housing—by employing new PFS tools.

Lessons Learned from the Low Income Housing Tax Credit

The LIHTC was created in 1986 as an efficient and resilient public subsidy for affordable housing development. Instead of simply writing a check and hoping for the best, Congress devised a way to share risks with private investors and tie subsidy payments to the actual production and maintenance of affordable rental homes.

Since 1986, a sophisticated market has evolved around the LIHTC, composed of developers (in PFS terms the “service providers”), governments (the “payers”), investors, auditors, and intermediaries (also known as “syndicators”). We’ve learned from this experience that certain ingredients are essential to a successful PFS agreement:

A strong and proven service provider. Achieving real-world impact is central to any PFS agreement, and that starts with the individuals on the ground who are working for social change. The provider must be committed to the end goal and have a well-documented record of successful outcomes.

A motivated government entity. The government partner must be able to sign a long-term contract without extensive legislative or bureaucratic delay. It must also be trusted to make good on its financial obligations and ensure that reliable data are collected and shared within a reasonable timeframe.

Flexible and socially driven investors. Most PFS deals will not compare directly with more traditional financial products. Sometimes the risks will far outweigh the potential returns, other times those risks will be difficult even to quantify. That requires a special brand of investor who is mutually interested in social and financial benefits.

A trusted intermediary. Although the model seems simple, these deals are often very complicated. An intermediary is crucial to manage relationships, handle financial transactions, and collect and verify performance data. With so many players, each with his or her own motivations and priorities, it is important to have an experienced coordinator who has some skin in the game, even if it is just reputational risk.

Toward a More Collaborative, Performance-Based Approach to Financing

Despite the successes of the LIHTC over the past two decades—2.5 million affordable homes developed,³ nearly \$100 billion in private investment leveraged,⁴ hundreds of thousands of jobs created⁵—the program is far from perfect. For example, money from the tax credit can only be used for capital investments, meaning resident services require alternative funding sources.

One challenge before policymakers today is to develop similar PFS models that link housing production with related services, such as health care, child care, and transportation. Often these programs work toward common goals—such as building healthy, thriving communities—but are isolated by program-specific funding streams and other restrictions.

At Enterprise, we are developing new ways to build on our 30 years of experience to help fill this financing gap. Our solution: move away from today’s siloed, appropriations-based approach to funding social programs and toward a more collaborative, performance-based approach that engages the private sector.

Of course, that’s much easier said than done. Here’s one example of putting that model into practice today.

A Case Study in PFS: Senior Housing and Health Care in Vermont

For more than 30 years, the mission-driven Cathedral Square Corporation has provided high-quality affordable homes to 2,000 low-income seniors in Vermont. The organization relies on a variety of subsidy programs, including LIHTC, with Enterprise Community Partners often assisting as an intermediary.

Over the years, Cathedral Square has come to understand the day-to-day needs of its residents and has uncovered gaps in their services. Recently, they realized a pressing need for coordinated medical and wellness services. In one instance, a resident was discharged from the hospital late on Friday night, but returned home to discover that all transitional support was unavailable for the entire weekend. In another, a resident’s medical information was inadvertently switched with a different patient’s, leading to a medication overdose. Without a medical advocate on hand, the patient was diagnosed with dementia rather than attributing the problem to a clerical error.

None of these were “housing problems” per se, but they certainly affected the lives of Cathedral Square’s residents. Something had to be done.

Using funding from Vermont’s Medicare reform pilot, Cathedral Square established the

3 In 2010, Low Income Housing Tax credits financed 50 percent of all multifamily housing starts, according to the National Association of Home Builders.

4 The LIHTC program leveraged \$75 billion in private investment between 1987 and 2008, according to Ernst & Young. Since then, an additional \$7-8 billion has been leveraged each year. For more information, see <http://www.enterprisecommunity.com/low-income-housing-tax-credits-policy>.

5 According to the National Association of Home Builders, the LIHTC program supports the creation of roughly 95,000 jobs each year. For more information, see http://www.nahb.org/fileUpload_details.aspx?contentID=151606.

Support and Services at Home program, which provides a nurse and care coordinator for each group of 100 seniors. In its first year alone, the program saved Medicare 30 percent in health care costs, mostly through improved monitoring, better coordination of services, and more at-home care.

Soon after, Cathedral Square realized that the physical layout and condition of their units and common areas were contributing to additional health problems, resulting largely from trips and falls. Small capital investments could generate further savings, as well as better outcomes for residents. Such capital investments, however, could not be made with Medicare funds. Cathedral Square needed a new source of capital that focused on real-world outcomes—such as improved health and lowered health care costs—rather than narrow funding streams. That’s where Enterprise stepped in to help.

Working with Cathedral Square and other stakeholders, Enterprise is developing a new PFS product called the Socially Aligned Value Investment, or SAVI. The SAVI is structured more like equity than a bond, but it is rather consistent with the SIB model. Here’s how it works:

- The Vermont government or possibly an Accountable Care Organization—which ever has exposure to the health care costs of this population and is interested in reducing cost—acts as the “payer” and sets measurable goals for improved health outcomes and reduced costs. If those goals are met, the payer agrees to cover all associated costs plus a premium.
- Private investors provide upfront capital for the necessary services and capital improvements. If the goals are met over a defined period of time, they are repaid plus a premium. If not, they lose this initial investment.
- Cathedral Square provides the necessary services and capital improvements, with meaningful discretion over how the money is spent.
- Enterprise serves as the sponsor or intermediary of the transaction, coordinating and implementing all of the contractual relationships among investors, Cathedral Square, and the payer.

As we work to integrate these services into an outcome-based model, all stakeholders will need to be flexible. Cathedral Square will need to meet reporting and risk criteria for investors and the payer. The payer will need to set reasonable metrics of success that are both ambitious and achievable. The investor will need to accommodate a return that may not be comparable to more mature investments where risk can be better quantified. Enterprise will need to find ways to independently verify progress and settle disputes if they arise.

If all goes well in the end, Cathedral Square will finally receive the funds and flexibility they need to discover new ways to improve services and lower costs. The payer can test innovative cost-cutting solutions without spending a dime if they fail. Private investors carry the most risk, but they are given a rare opportunity to pursue meaningful social change alongside financial returns.

Next Steps

In an era of fiscal austerity, it is more important than ever to maximize the real-world impact of every available dollar, whether it comes from the government, a philanthropist, or a for-profit investor. That is the primary goal of the PFS model.

Our team at Enterprise is exploring new ways to use PFS to solve our most pressing social problems. As our work in Vermont and throughout the country takes off, we will diligently monitor our progress and expand on what works, both in the solutions we pilot and the financing tools we use to fund them.

Terri Ludwig is president and chief executive officer of Enterprise Community Partners, Inc., a national nonprofit provider of development capital and expertise to create affordable homes and rebuild communities. Prior to joining Enterprise, Ms. Ludwig served as president of the Merrill Lynch Community Development Company and president and CEO of ACCION New York, the largest nonprofit micro-lender in the United States. Ms. Ludwig has 23 years of experience in investment banking and nonprofit leadership, was a presidential appointee to the US Department of the Treasury Advisory Board for Community Development and Financial Institutions, and was recently named to Forbes Magazine's first-ever "Impact 30," a roster of 30 of the world's leading social entrepreneurs.

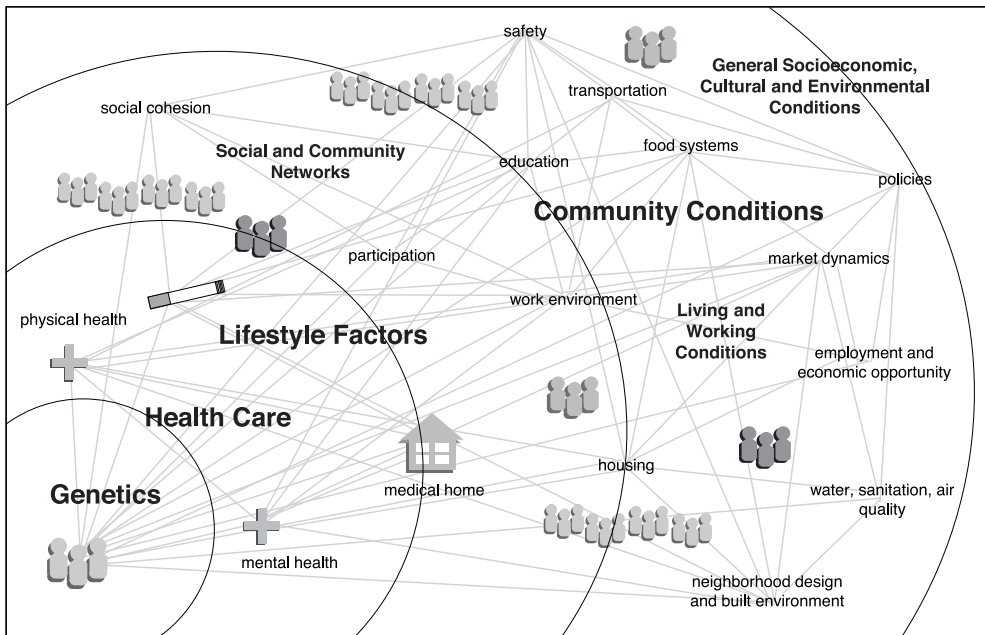
Can Pay for Success Reduce Asthma Emergencies and Reset a Broken Health Care System?

Rick Brush

Collective Health

I blame Len Syme and the social epidemiologists for disrupting my otherwise steady trajectory as a high-flying health insurance executive. It was Len, the University of California Berkeley professor emeritus, who spoiled for me the simple notion that “access to high-quality, affordable care” (our industry mantra) would solve our nation’s health crisis. Medical care, it turns out, accounts for just 10 percent of what makes us healthy or sick.¹ So what’s the other 90 percent?

Figure 1. Health Occurs in a Context



Source: Collective Health LLC, 2013

¹ S. A. Schroeder “We Can Do Better – Improving the Health of the American People,” *New England Journal of Medicine*, 357 (2007): 1221-28, available at www.nejm.org/doi/full/10.1056/NEJMsa073350.

It's a pretty gnarly sweater once you start unraveling it. After nearly a decade in health insurance, I left the comfy confines of my corporate office to follow a thread Len so eloquently describes as "intricately and infinitely intertwined" with our social, economic, and environmental circumstances. What matters most to health is the context in which we live our lives.²

This calls for a profoundly different health delivery and financing system, I've come to learn, with some pretty hefty obstacles in the way. But it is possible to meet these challenges. In this article, I look at a path forward for one chronic condition, childhood asthma, and the potential for spreading this approach to the broader health system.

Following a Thread

Here's what I uncovered in the past few years of thread-following. A growing body of research makes clear that if we want to improve health in a meaningful and sustainable way, we need to look upstream at the underlying factors that drive so many more of us into the care system in the first place.³ For instance, we know that education matters to health: college graduates live five years longer, on average, than those who do not complete high school.⁴ We know that the influence of social relationships on the risk of death are comparable to those of well-established risk factors such as smoking and alcohol consumption, and they exceed the influence of factors such as physical inactivity and obesity.⁵ And we know that our environment, including the air we breathe inside our own homes, matters to health: an estimated 21 percent of US asthma cases are attributable to dampness and mold exposure.⁶

One might conclude that if we simply follow this thread we would ignite a new market for preventive "medicine." Doctors would prescribe college preparatory courses. Big Pharma would give us social-networking pills. Health insurers would begin covering home improvements. The problem is that the thread has a few knots in it. Big knots.

Unraveling

The first knot is that our health care system is designed for downstream treatment of

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- 2 World Health Organization, "CSDH Final Report: Closing the Gap in a Generation: Health Equity Through Action on the Social Determinants of Health." In Commission on Social Determinants of Health, edited by WHO (Geneva: World Health Organization, 2008), available at www.who.int/social_determinants/thecommission/finalreport/en/index.html.
 - 3 T. R. Frieden, "A Framework for Public Health Action: The Health Impact Pyramid," *American Journal of Public Health*, 100(4)(2010): 590-95, available at www.ncbi.nlm.nih.gov/pmc/articles/PMC2836340/pdf/590.pdf.
 - 4 Robert Wood Johnson Foundation, "Education and Health. National Longitudinal Mortality Study: 1988-1998." Issue Brief 6 (New York: RWJF, Commission to Build a Healthier America, 2009).
 - 5 J. Holt-Lunstad, T.B. Smith, and J.B. Layton, "Social Relationships and Mortality Risk: A Meta-analytic Review," *PLoS Medicine*, 7(7) (2010): e1000316, available at www.plosmedicine.org/article/info%3Adoi%2F10.1371%2Fjournal.pmed.1000316;jsessionid=A98C70481A057B040F38C1BBD6D4AC31.
 - 6 D. Mudarri and W. J. Fisk, "Public Health and Economic Impact of Dampness and Mold," *Indoor Air Journal*, 17 (2007): 226-235, available at www.iaqscience.lbl.gov/pdfs/mold-2.pdf.

illness rather than improving upstream determinants of health. In fact, of the \$2.7 trillion⁷ per year we spend on health care in the United States, just 3 percent goes toward preventing disease.⁸ Compared with other countries, American medicine is good at late-stage interventions, such as reducing cancer death rates and helping those who reach age 75 to live longer. However, American medicine is worse (often far worse) in many key health indicators, from infant mortality to life expectancy at birth to diabetes, obesity, heart disease, chronic lung disease, and disability.⁹

The second knot is that traditional health care financing—such as fee-for-service payment systems in which doctor and hospital revenue is based on volume of patients and procedures—is plagued with misaligned incentives that drive more use of health care rather than better health outcomes. This creates a powerful self-reinforcing loop: money continues to flow while costs continue to grow.

Third, the challenge is made more complex by the highly fragmented nature of health care financing. Government accounts for 45 percent of US health care spending, through federal, state and local programs with differing payment systems, incentives, and reimbursement levels.¹⁰ Private payers such as health insurers, employers, and individuals account for 55 percent of spending.¹¹ Payers invest billions each year in health care analytics, disease management, and wellness. Yet most efforts to contain costs fail to address the underlying social and environmental causes of disease. With health care spending at 17.9 percent of US gross domestic product and growing, it seems likely the system will unravel, even as we pick at the knots.¹²

A New Thread?

If we pressed “reset” on the US health system, we’d probably make some fundamental design changes. We’d aim for better health outcomes rather than more health care. We’d follow the evidence and economics to determine what levers to pull for the greatest health and financial return. And we’d align the money flow between payers and providers with new terms of success.

Of course, Pay for Success (PFS) is not new in health care. For more than a decade the

7 Centers for Medicare and Medicaid Services, “National Health Expenditures” Table 1, (Washington, DC: CMS, Office of the Actuary, National Health Statistics Group, 2012), available at www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/tables.pdf.

8 Ibid.

9 National Research Council, “US Health in International Perspective: Shorter Lives, Poorer Health” (Washington, DC: National Academies Press, 2013).

10 Centers for Medicare and Medicaid Services, “National Health Expenditures by Type of Sponsor: Calendar Years 1987-2011” Table 5 (Washington, DC: CMS, Office of the Actuary, National Health Statistics Group, 2012), available at www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/tables.pdf.

11 Ibid.

12 Centers for Medicare and Medicaid Services, “National Health Expenditure Projections 2010-2020” (Washington, DC: CMS, April 2012), available at www.cms.gov/Research-Statistics-Data-and-Systems/Statistics-Trends-and-Reports/NationalHealthExpendData/Downloads/proj2010.pdf.

industry has experimented with PFS and “value-based purchasing,” where health care providers are rewarded for meeting measures of quality and efficiency. Results have been mixed¹³ and barriers include insufficient measurement systems, ineffective incentive structures, unintended consequences, and added administrative and infrastructure costs that may actually increase PFS spending in early years.¹⁴

More recently, the introduction of accountable care organizations (ACOs) and other strategies supported by the Patient Protection and Affordable Care Act are testing new forms of shared risk/shared savings arrangements. However, to become profitable as ACOs, most providers will need to substantially invest in infrastructure, and upfront financing can be a barrier, especially for small to medium sized health care providers.¹⁵

Still, spending a little more now might yield tremendous savings down the road. Trust for America’s Health found that a \$10 per person annual investment in community-based prevention over five years could produce 5 percent reductions in Type 2 diabetes, high blood pressure, heart and kidney disease, and stroke—with a return of \$5.60 for every dollar invested.¹⁶ Another research effort, using a dynamic simulation model of the US health system, reported that enabling healthier behavior and improving environmental conditions, when added to expanded health insurance coverage and better preventive and chronic care, could save about 140 percent more lives and reduce costs by 62 percent in 25 years.¹⁷

In a newly reset health system, we would find a way to pull forward these future savings so that we could make smart investments in prevention today, and then re-invest again; in economic terms, we’d flip from a vicious to virtuous cycle of health spending. Unlike current health care financing, the new model would access sufficient upfront capital, tolerate longer payback periods, and support scale-up and spread of programs that work.

In early 2011, I was part of a small research team led by Len Syme and supported by The California Endowment that looked at funding mechanisms to address these challenges, including social impact bonds. (Full disclosure: it was David Erickson, this journal’s editor, who first suggested we consider social impact bonds.)

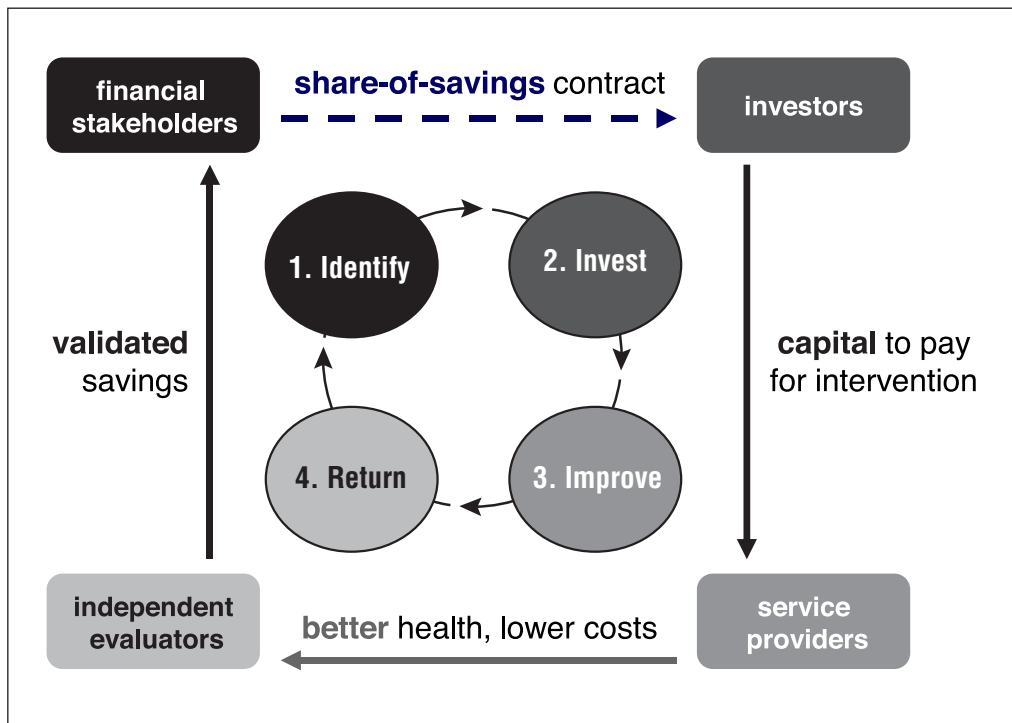
Learning from the small number of social impact bond experiments under way, we

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- 13 M.B. Rosenthal, R.G. Frank, Z. Li, and A.M. Epstein, “Early Experience with Pay-for-Performance: From Concept to Practice,” *JAMA*, 294(14) (2005):1788-93.
- 14 T. Bhattacharyya, A. A. Freiberg, P. Mehta, J.N. Katz, and T. Ferris, “Measuring the Report Card: The Validity of Pay-for-Performance Metrics in Orthopedic Surgery,” *Health Affairs*, 28(2009):2526-32. For research on ineffective incentive structures see G. Flodgren, M. P. Eccles, S. Shepperd, A. Scott, E. Parmelli, and F.R. Beyer, “An Overview of Reviews Evaluating the Effectiveness of Financial Incentives in Changing Healthcare Professional Behaviours and Patient Outcomes,” *Cochrane Database of Systematic Reviews*, 7 (2011), article no. CD009255. For research on unintended consequences see Chen Tsung-Tai and Lai Mei-Shu, “The Unintended Consequences of Pay-for-Performance,” *Health Affairs*, 31(5)(2012):1127. For research on added administrative and infrastructure costs see C. L. Damberg, “Hospital Pay for Performance” (Santa Monica, CA: RAND Corporation, 2009), available at www.rand.org/pubs/technical_reports/TR562z12.
- 15 S. F. Delbanco, K. Martin Anderson, C. Eikel Major, M. Kiser, and B. Wammack Toner, “Promising Payment Reform: Risk-Sharing with Accountable Care Organizations.” Publication no. 1530 (New York, NY: The Commonwealth Fund, July 2011).
- 16 J. Levi et al., “Trust for America’s Health (TFAH), Prevention for a Healthier America: Investments in Disease Prevention Yield Significant Savings,” *Stronger Communities* (2009).
- 17 B. Milstein, J. Homer, P. Briss, D. Burton, and T. Pechacek, “Why Behavioral and Environmental Interventions Are Needed to Improve Health at Lower Cost,” *Health Affairs*, 30(5) (2011): 823-832.

began applying the concept to health. Here’s how the resulting model, what we call a “Health Impact Bond,” works:

- Identify opportunities to improve health and lower costs, and forecast the potential savings for financial stakeholders—public and private health plans, self-insured employers, health care providers with aligned incentives, and other government and commercial payers—who agree to share a portion of validated savings to pay back investors.
- Invest in prevention by engaging impact investors—foundations, individuals and institutions—who provide upfront capital in exchange for agreed financial and social returns.
- Improve health outcomes and lower costs through evidence-based interventions delivered by qualified service providers.
- Share the return, based on health care cost savings validated by independent evaluators, with investors in the form of principal plus interest, and potentially re-invest a portion of the returns for program scale-up and sustainability.

Figure 2. Health Impact Bond: How it Works



Source: Collective Health LLC, 2013

Figure 3. Health Impact Bond: What's Required

- 1. Hot spot:** significant and costly health issue that can be improved
- 2. Evidence-based intervention** and service providers with demonstrated results
- 3. Net savings potential and method** for measuring/validating actual cost savings (insurance-claims-based)
- 4. Payers** that agree to share savings:
 - Public/private health plans
 - Self-insured employers
 - Providers with aligned incentives (Accountable Care Organizations, Patient-Centered Medical Homes, capitated)
- 5. ROI/IRR:** acceptable investor risk-return and payback period

Source: Collective Health LLC, 2013

We believe Health Impact Bonds may have broad application: seven in ten American deaths each year, and more than 75 percent of health care costs, result from chronic diseases that are preventable.¹⁸ But before we take on the entire health care system, we've set our sights on demonstrating that this model can work with one major chronic condition. Childhood asthma is a good place to start because: 1) The cost and health impacts are significant; 2) There is a proven and underused approach to controlling the disease that forces us to look upstream at underlying causes in addition to good medical care; and 3) Use of emergency and hospital services for asthma can be substantially reduced, and generate returns for financial stakeholders and investors, over a relatively short period (12 to 24 months).

Asthma: Biology and Environment Intertwined

Asthma is one of the most prevalent and costly chronic diseases, too often treated in the emergency department rather than through comprehensive management and prevention.¹⁹ Worldwide an estimated 235 million people suffer from asthma, and it is the number one chronic disease among children.²⁰

18 H.C. Kung, D.L. Hoyert, J. Q. Xu, and S. L. Murphy, "Deaths: Final Data for 2005," National Vital Statistics Reports, 56(10)(2008), available at www.cdc.gov/nchs/data/nvsr/nvsr56/nvsr56_10.pdf; Institute of Medicine, For the Public's Health: Investing in a Healthier Future. (Washington, DC: IOM, 2012), available at www.iom.edu/Reports/2012/For-the-Publics-Health-Investing-in-a-Healthier-Future.aspx.

19 A. J. Atherly, "The Economic Value of Home Asthma Interventions," *American Journal of Preventive Medicine*, 41(2S1)(2011):S33–S47.

20 World Health Organization, "Asthma Fact Sheet," no. 307 (Geneva: WHO, 2011), available at www.who.int/mediacentre/factsheets/fs307/en/index.html.

While genetics play a role in asthma, development and severity of the disease depend on a complex interplay of biological and environmental factors.²¹ Exposure to indoor allergens, such as dust mites, mold, cockroaches, and pet dander, is a significant risk factor for asthma.²²

Comprehensive asthma management that integrates clinical care, education, and remediation of home-based environmental triggers can significantly reduce asthma emergencies.²³ For children and adolescents with uncontrolled asthma, a home-based, multi-trigger, multi-component approach is the only one recommended by the Centers for Disease Control and Prevention's Community Preventive Services Task Force. The recommendation is based on "evidence of effectiveness" (23 studies) and "savings from averted costs of asthma care" (13 studies).²⁴ It is also consistent with the Coordinated Federal Action Plan to Reduce Racial and Ethnic Asthma Disparities²⁵ and the National Asthma Education and Prevention Program.²⁶

However, in practice, significant gaps remain in most efforts to control asthma and avoid unnecessary emergencies. A 2008 survey of people with asthma found that fewer than one-half were taught how to avoid triggers, and almost one-half (48 percent) of adults who were taught did not follow most of this advice.²⁷ Lack of sustainable funding is part of the problem, but so are the knotted and misaligned aspects of our health care system and the social-environmental dynamics that drive health context and choices.

Meanwhile, the number of people with asthma in the United States continues to grow,

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- 21 F. D. Martinez, "Genes, Environments, Development and Asthma: A Reappraisal," *European Respiratory Journal*, 29 (1) (2007): 179–84.
 - 22 A. Custovic and A. Simpson, "The Role of Inhalant Allergens in Allergic Airways Disease," *Journal of Investigational Allergology & Clinical Immunology: Official Organ of the International Association of Asthmology (INTERASMA) and Sociedad Latinoamericana de Alergia e Inmunologia*, 22(6)(2012):393–401.
 - 23 D. Crocker et al., "Effectiveness of Home-Based, Multi-Trigger, Multicomponent Interventions with an Environmental Focus of Reducing Asthma Morbidity: A Community Guide Systematic Review," *American Journal of Preventive Medicine*, 41(2S1) (2011):S5-S32; E. Woods et al., "Community Asthma Initiative: Evaluation of a Quality Improvement Program for Comprehensive Asthma Care," *Pediatrics*, 129 (2012):465; P. Hoppin et al., "Investing in Best Practices For Asthma: A Business Case: August 2010 Update" (Dorchester, MA: Asthma Regional Council of New England, 2010); Asthma Health Outcomes Project, "Asthma Programs with an Environmental Component: A Review of the Field and Lessons Learned" (Ann Arbor, MI: Center for Managing Chronic Disease, University of Michigan, 2007).
 - 24 Centers for Disease Control and Prevention, "Asthma Control: Home-Based Multi-Trigger, Multicomponent Environmental Interventions; Task Force Finding and Rationale Statement Interventions for Children and Adolescents with Asthma" (Atlanta, GA: CDC, Community Preventive Services Task Force, The Guide to Community Preventive Services: The Community Guide, June 2008), available at <http://thecommunityguide.org/asthma/rchildren.html>.
 - 25 "Coordinated Federal Action Plan to Reduce Racial and Ethnic Asthma Disparities" (Washington, DC: President's Task Force on Environmental Health Risks and Safety Risks to Children, Asthma Disparities Working Group, May 2012), available at www.epa.gov/children/taskforce/federal_asthma_disparities_action_plan.pdf.
 - 26 National Institutes of Health, "Expert Panel Report 3 (EPR3): Guidelines for the Diagnosis and Management of Asthma" (Bethesda, MD: National Heart, Lung, and Blood Institute, National Asthma Education and Prevention Program, Coordinating Committee, 2007), available at <http://www.nhlbi.nih.gov/guidelines/asthma/asthgdln.htm>.
 - 27 Centers for Disease Control and Prevention, "Vital Signs: Asthma Prevalence, Disease Characteristics, and Self-Management Education - United States, 2001-2009," *Morbidity and Mortality Weekly Report*, 60(17) (2011): 547-52.

from about 20 million in 2001 to 25 million in 2009.²⁸ Asthma-related medical expenses have increased from \$48.6 billion in 2002 to \$50.1 billion in 2007.²⁹

Threading It All Together

Fresno County, California, is an asthma hot spot: 17.3 percent of the population and 20.2 percent of children aged 5-17 have been diagnosed with the disease, compared to 8 percent of adults and 10 percent of children nationally.³⁰ Rates are significantly higher for Latino, African American, and low-income community members. Fresno County has the highest poverty rate in the state (27.1 percent).³¹

Every day in Fresno nearly 20 people end up in the emergency department and at least three are hospitalized for asthma.³² Asthma emergency department visits and hospitalizations cost Fresno health insurers and other payers nearly \$35 million per year.³³

At this writing, we are in the first phase of an asthma demonstration project in Fresno. The California Endowment has awarded grant funding to Collective Health and Social Finance, Inc., a nonprofit organization that mobilizes investment capital to drive social progress. The project aims to prove the dual social and financial benefits of investing in comprehensive asthma management, and to lay the foundation for an asthma Health Impact Bond to scale the effort and ensure sustainability.

Collective Health and Social Finance are working with local partners to implement a one-year comprehensive home-based intervention to reduce asthma emergencies and costs among 200 high-risk children in Fresno. This includes:

- Quarterly home visits by bilingual community health workers (CHWs) and monthly follow-up calls to monitor and re-enforce self-management;
- Asthma education focused on medications and triggers;
- Home environmental assessment and trigger remediation;
- Clinical assessment and coordination, asthma action plan, and referral to specialists.

This intervention fills a critical gap outside the doctor's office by improving indoor air

28 Ibid.

29 Ibid.

30 California Health Interview Survey 2009 (Los Angeles, CA: CHIS, UCLA Center for Health Policy Research, 2009); CDC, Morbidity and Mortality Weekly Report, 2011.

31 US Census Bureau, American Community Survey 2010. As cited in S. Bohn, "Just the Facts: Poverty in California" (San Francisco, CA: Public Policy Institute of California, December 2011), available at www.ppic.org/content/pubs/jtf/jtf_povertyjtf.pdf.

32 State of California Office of Statewide Health Planning and Development, "2010 Hospital Annual Utilization Data" (Sacramento, CA: OSHPD, 2010).

33 Hospitalization calculation based on OSHPD 2010 utilization and unit cost data; emergency services calculation based on OSHPD 2010 utilization data and unit cost estimate from two sources: 1) Florida Center for Health Information and Policy Analysis, "Emergency Department Utilization Report 2009" (Tallahassee, FL: Florida Center for Health Information and Policy Analysis, Agency for Health Care Administration, 2009) [\$2,064 average charge per emergency department visit (2009 data)]; and 2) Indiana State Department of Health, *The Burden of Asthma in Indiana*, 2d ed. (Indianapolis, IN: Indiana State Department of Health, 2008) [\$1,028 average cost per emergency department visit (2005 data)].

quality and removing environmental triggers in the home that are most frequently linked to avoidable emergency department visits and hospitalizations. The CHWs are central to this effort because they are hired from within the very communities they serve. They can connect with participating families in ways that go beyond basic health literacy and treatment compliance. They help kids and their families address myriad causes of asthma emergencies and other health-related issues, they keep them out of the emergency room, and they substantially reduce health care costs.

The intervention design and implementation is being led by Fresno clinical and community partners with proven track records and existing capacity: Central California Asthma Collaborative, which addresses the burden of asthma in underserved populations of the San Joaquin Valley, and Clinica Sierra Vista, a network of comprehensive health clinics serving ethnically diverse populations with low- to moderate-incomes. With technical assistance from Regional Asthma Management and Prevention, enhancements have been made to improve the home remediation component based on a literature review and cost-benefit analysis.

Collective Health is providing an actuarial-based savings methodology using insurance claims data to measure reductions in emergency and hospital services, and to calculate the resulting health care cost savings to payers covering these individuals. We have engaged two local Medi-Cal plans and several self-insured employers, and we will confirm final partners in the initial months of the project. Program participants will be identified based on multi-year claims, clinical assessment, and geographic clusters. A third-party actuary will validate savings.

In our target population, we estimate that asthma-related emergency department and hospital costs currently average \$16,371 per person per year. By reducing those service areas by 30 percent and 50 percent, respectively, we believe we can bring down annual costs by \$7,773 per person, with an anticipated \$1.6 million in savings for the targeted 200 individuals in the first year following the intervention.³⁴

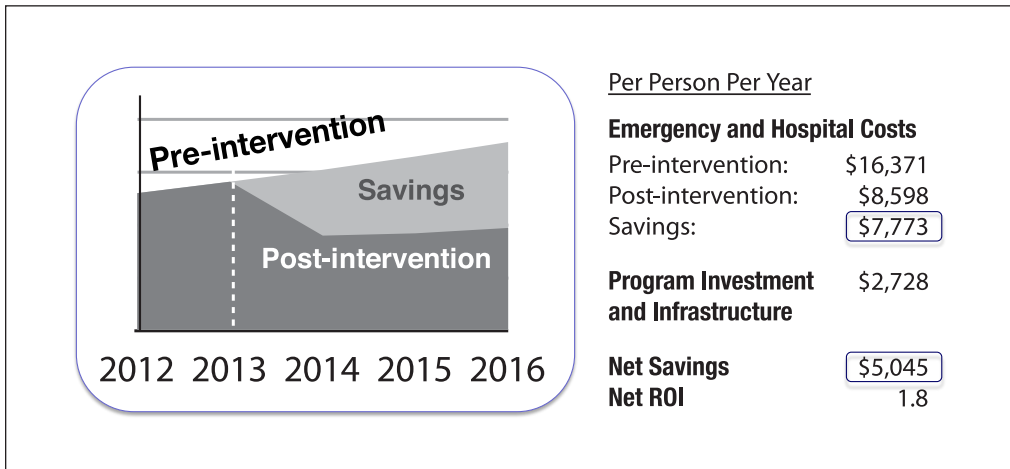
Those savings can be leveraged to expand this valuable program to many more children who can benefit. Social Finance and Collective Health will lead an advisory group of public and private payers, legislators, and other stakeholders to design and structure a Health Impact Bond for scale-up beyond the demonstration project. We estimate that a five-year program with 3,500 participants could yield \$27 million in reduced costs.³⁵

34 Savings calculation assumptions:

- Targeted high-risk patients with average utilization of 1.5 ED visits and 0.75 hospitalizations per year;
- Cost of ED visit: \$1,375 (estimate based on sources noted above);
- Cost of hospital stay: \$19,078 (OSHPD 2010);
- Total baseline cost: \$2,063 ED + \$14,309 hospital = \$16,371 per person; 200 patients = \$3,274,200;
- Reductions from intervention: 30 percent emergency department and 50 percent hospital (Crocker et al., "Effectiveness of Home-Based, Multi-Trigger, Multicomponent Interventions"; Woods et al., "Community Asthma Initiative"; Hoppin et al., "Investing in Best Practices For Asthma");
- Total savings: \$7,773 per person; \$1,554,600 for 200 patients.

35 \$7,773 per person x 3,500 patients = \$27,205,500.

Figure 4. Reducing Asthma Emergencies: Projected Savings



Source: Collective Health LLC, 2013

Conclusion

A new health system does not happen overnight. Efforts to reform the system have shown that pulling at knots from one end of the thread sometimes tightens them further. But we think Health Impact Bonds have the potential to begin to transform the system from within by uncovering real value for all stakeholders: payers who realize significant savings; providers who create new revenue opportunities based on what works; investors with an opportunity to achieve both social and financial returns; healthier people and thriving communities. The success of PFS will drive greater alignment, availability of upfront capital, and tolerance for longer-term investment.

As Fresno moves forward, we are pursuing asthma Health Impact Bonds in additional communities with similarly vulnerable populations, and applications in other areas of preventive health. For instance:

- Diabetes risk reduction through programs such as the National Diabetes Prevention Program;³⁶
- Other proven in-home care models such as PACE, the Medicare and Medicaid Program of All-inclusive Care for the Elderly,³⁷ and the Nurse-Family Partnership approach to at-risk maternal and child health;³⁸
- Addressing the complex needs of individuals with serious mental illness and

36 "National Diabetes Prevention Program," Centers for Disease Control and Prevention, National Center for Chronic Disease Prevention and Health Promotion, Division of Diabetes Translation, last updated October 5, 2012, available at www.cdc.gov/diabetes/prevention/about.htm.

37 "PACE," Centers for Medicare & Medicaid Services, accessed January 28, 2013, available at www.medicare.gov/your-medicare-costs/help-paying-costs/pace/pace.html.

38 "Beginning with Trust, Ending with Extraordinary Outcomes," Nurse-Family Partnership, accessed January 28, 2013, available at www.nursefamilypartnership.org/about.

- multiple chronic conditions through Assertive Community Treatment;³⁹ and
- The multidisciplinary team approach, such as that practiced by the Camden Coalition of Healthcare Providers, to coordinate social and clinical care of “superusers” of emergency and hospital services.⁴⁰

Although initial Health Impact Bonds will likely focus on the hot spots—the top 20 percent of the population that accounts for 81.2 percent of the nation’s health care spending⁴¹—the approach could someday be expanded to drive fundamental changes in social and environmental conditions required for long-term population health. One might imagine, for example, community-wide efforts to improve education, job opportunities, transportation, housing, and food access, those underlying conditions that the social epidemiologists tell us matter most to health. These efforts could be paid for by future reductions in health care costs, better quality of life, higher productivity, and other health dividends.

And here’s a key point: there’s a role in this for the social epidemiologist and the high-flying insurance executive. Health impact investing requires the best evidence in the lab translated by the best actuaries in the business. We may be threading the needle. But isn’t that the first step in sewing a new system?

Rick Brush is founder and CEO of Collective Health, which provides health analytics, evidence-based programs, and innovative financing solutions. Mr. Brush founded Collective Health in 2011 to address the underlying causes of poor health and sustainably reduce costs. He has led strategic innovation at large corporations and start-ups for more than 20 years, primarily in the health care and financial services sectors. Most recently, Mr. Brush was chief strategy and marketing officer for the large employer segment at Cigna, the fourth-largest US health insurer, where he served in a variety of executive roles from 2002 to 2011. While at Cigna, Mr. Brush co-founded the company’s Communities of Health venture, launched new business units and products, and led multi-stakeholder initiatives around the country to improve population health. He has held executive positions at Ford Motor Credit Company, Bank One, KPMG, and a marketing consulting firm, and has worked extensively with communities and nonprofits to improve social and financial impact. Mr. Brush is a graduate of the University of Massachusetts at Amherst.

39 “Assertive Community Treatment (ACT),” National Alliance on Mental Illness, accessed January 28, 2013, available at [www.nami.org/Content/NavigationMenu/Inform_Yourself/About_Mental_Illness/About_Treatments_and_Supports/Assertive_Community_Treatment_\(ACT\)1.htm](http://www.nami.org/Content/NavigationMenu/Inform_Yourself/About_Mental_Illness/About_Treatments_and_Supports/Assertive_Community_Treatment_(ACT)1.htm).

40 “Care Management Program,” Camden Coalition of Healthcare Providers, accessed January 28, 2013, available at www.camdenhealth.org/programs/care-management-program/.

41 The Henry J. Kaiser Family Foundation, “Health Care Costs: A Primer. Key Information on Health Care Costs and Their Impact,” publication #7670-03 (May 2012), available at www.kff.org/insurance/upload/7670-03.pdf. Calculations using data from US Department of Health and Human Services, Agency for Healthcare Research and Quality, Medical Expenditure Panel Survey (MEPS), Household Component, 2009.

Supporting At-Risk Youth: A Provider's Perspective on Pay for Success

Lili Elkins

Roca Inc.

Roca is currently negotiating with the Massachusetts Executive Office for Administration and Finance to establish one of the first Pay for Success (PFS) pilot projects in the United States. These negotiations involve the Department of Youth Services, the Office of the Commissioner of Probation, and Third Sector Capital Partners, as well as New Profit Inc., which will serve as the project's intermediary. This partnership has provided Roca with a unique learning experience and allowed Roca to develop skills critical to participating in the PFS pilot.

Through the pilot project, Roca will provide its cognitive behavioral Intervention Model to approximately 900 "high-risk" young men aging out of the Department of Youth Services (DYS), aging out of juvenile probation, and/or already on adult probation.¹ These young men have extremely high rates of reincarceration. For example, of those aging out of DHS, 65 percent will be reincarcerated within five years of release.

Roca is at a unique moment in its history. Participating in this project offers Roca an opportunity to take the organization to the next level and move toward long-term sustainability. Roca will demonstrate its model through a rigorous program evaluation while scaling its impact across the state. Concurrently, Roca will implement a clear path for governments in both Massachusetts and across the country to avert and/or reduce incarcerations for this high-risk group of young men and in turn demonstrate significant government cost savings.

Roca believes this project will create a sustainable public funding source to support work with very high-risk young people. Further, because Roca has taken on a portion of the risk from the project itself, this project offers Roca the ability, if outcomes are achieved, to generate revenue—above and beyond success payments—that will support ongoing organizational operations and growth.

While the pilot has not yet been implemented, Roca has spent the last twenty-five years preparing for such an opportunity and has learned many lessons as part of the project's planning and implementation processes. We believe that to effectively engage in PFS contracts, organizations must: 1) demonstrate significant government cost savings while addressing a substantial need, 2) administer a strong, evidence-based service delivery model, 3) clearly understand program outcomes and have a strong ability to track results, and 4) be able to manage risk internally and communicate risks to investors.

¹ "High-risk" young men are defined as those young men, aged 17 to 24, who are not connected with programming and have the highest propensity for incarceration or reincarceration.

Demonstrated Cost Savings to the Government

For a PFS project to be successful, payments must be tied to clear, significant expenses for the government, and cost savings should exceed program implementation costs, so that ultimately the government is paying for successful services.

Every year, approximately 4,000 high-risk young people “age out” of the juvenile justice system or are on adult probation in the Commonwealth of Massachusetts. According to the Commonwealth, 68 percent return to prison one or more times within six years of release,² costing the Commonwealth on average \$47,000 per prisoner annually.³ Since each of these reoffenders spends an average of 28 months in a correctional facility within six years after release,⁴ this population generates over \$300 million in additional incarceration expenses for the Commonwealth. Similar cost savings are apparent for high-risk young men on juvenile and adult probation. This is the target population for the PFS pilot project. These young people were selected because they incur the most costs for the Commonwealth, are the most likely to be reincarcerated, and are the most likely to be positively impacted by Roca’s Intervention Model.

Roca’s Intervention Model is projected to save Massachusetts significant money. The cost of putting someone through four years of Roca’s Intervention Model is \$25,355, a significant cost savings when compared to the average cost of \$112,800 for one 2.4-year incarceration.

A Strong Service Delivery Model Based on Evidence

The most effective PFS projects will be created using strong, evidence-based service delivery models. Roca is an outcome-driven organization that has served high-risk young men since 1988. Roca developed and operates an Intervention Model designed to help the highest-risk young men break destructive cycles of poverty, violence, and perpetual incarceration.

Roca’s Intervention Model pushes young men to identify, confront, and overcome destructive behaviors and learn skills needed to reengage and succeed in society, education, and the economy. Each year, Roca serves over 700 men between the ages of 17 and 24 who are involved in the juvenile and/or adult criminal justice systems, have risk indicators predictive of adult criminal justice involvement, have no work histories, and have limited educational background (i.e., no high school diploma or general equivalency diploma [GED]). Roca’s participants are typically unready, unwilling, or unable to participate in traditional programming or work. Roca helps these young people change their behaviors over time, helps them stay out of prison or jail, and prepares them to get and retain employment.

Building off of Roca’s success to date and drawing from evidence-based practices in behavioral health, criminal justice, and workforce development, the Intervention Model includes two years of intensive programming with two additional years of follow-up for

2 Commonwealth of Massachusetts, Department of Youth Services internal analysis, 2012.

3 Pew Center on the States, “One in 31: The Long Reach of American Corrections: Massachusetts.” (Washington, DC: Pew Center on the States, 2009).

4 Commonwealth of Massachusetts, Department of Youth Services internal analysis, 2012.

retention and sustainability. The Intervention Model effectively combines relationship building and targeted programming (life skills, education, and employment) to support young people in developing the necessary skills to create positive behavioral changes. Once consistent relationships are established, they become the foundation for cognitive-behavioral change, helping young people move through a long-term, stage-based plan for improving their lives and creating opportunities as they make educational, life-skills, and employment gains. Youth workers are trained in various evidence-based and clinical techniques for promoting behavioral change, specifically cognitive restructuring, an approach designed to help people identify and change dysfunctional thoughts that contribute to problem behaviors; motivational interviewing, a client-centered counseling style designed to help clients resolve ambivalence; stage-based learning, which helps young people practice academic and prevocational skills needed to achieve social and economic independence; and transitional employment, a stage-based approach for helping individuals gain and practice critical entry-level employment skills while earning a subsidized wage.

A Clear Understanding of Program Outcomes and the Ability to Track Results

For any PFS project to work, projected outcomes must be realistic and attainable. Successful programs must not only understand their own outcomes but be able to demonstrate those outcomes over time and have the ability to track long-term results. The Massachusetts PFS pilot project is being developed with the goal that all project outcomes will be measured through a randomized controlled trial and that all outcomes must be measurable against a clear counterfactual, in this case developed using administrative data.

Roca's outcome projections for this project are based on a review of six years of Roca's own historical data. Roca believes it has created what can become a systemic response to violence, poverty, and incarceration for high-risk young men. Each component of Roca's Intervention Model is designed to drive toward measurable, positive outcomes. Of the very high-risk young men who graduated from the model in 2012, 79 percent retained employment, 70 percent made educational gains, 90 percent had no new arrests, and 100 percent had no new technical violations during the retention phase of the program. Further, Roca's outcome projections for the PFS pilot have been supported by a preliminary comparison of Roca's data to administrative data, made by the Commonwealth.

Equally important, Roca maintains a comprehensive, performance-based management system allowing it to measure results against the counterfactual. Over the past seven years, Roca underwent three Theory of Change processes helping to hone and refine the model and has engaged in a systemic cycle of research, design, action, data tracking, and use of data for continuous improvement to deliver an intervention worthy of the young people we serve. Because of this learning and commitment to performance management and continuous improvement, Roca made significant progress in the design and coaching of the model and the development of a performance management system. This intensive work has prepared us for this unique opportunity.

Manage Risks Internally and Communicate Risks to Investors

Service providers must be able to raise (with an intermediary if appropriate) the financial resources to support cash flow and address risk if outcomes are not met. In the case of Massachusetts, investor funds are being solicited by both the intermediary and Roca to ensure that all programmatic cash flow needs are met. Because investors risk not being paid back if outcomes are not delivered, Roca has worked closely with the intermediary on fundraising and management of risk expectations for funders, providing a realistic picture of programmatic outcomes and organizational capacity. Consequently, all of Roca's financial and programmatic estimates have been as conservative as possible. Further, Roca itself is acting as one investor in the project, taking on 15 percent of the risk internally.

Through the use of private capital, PFS represents a dramatic departure from traditionally structured government funding for social services. But, just as importantly, the advent of PFS marks the arrival of a higher standard for outcome measurement and financial accountability for nonprofits seeking public dollars. Had Roca not spent the last twenty-five years sharpening its service delivery model, honing its ability to produce and track competitive outcomes (both social and financial), and developing productive, trusted relationships with private investors, it would not be prepared for this project. So while PFS holds great promise for generating cost savings for government across a wide spectrum of services, the future of this approach ultimately rests with service providers' preparedness and performance.

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Tax Increment Finance: A Success-Driven Tool for Catalyzing Economic Development and Social Transformation

Toby Rittner

Council of Development Finance Agencies (CDFA)

In the wake of an economic downturn, many cities are left with sites, projects, districts, or entire urban cores requiring redevelopment. The need for social improvements such as community centers, school rehabs, and parks has also become a critical development challenge. However, the ongoing risks of the development market require communities to be even more diligent and aware when entering into the use of public financing mechanisms such as Pay for Success (PFS) financing. One such mechanism, tax increment finance (TIF), has the potential to forge a new path for communities to fund development projects on the basis of their success.

What Is Tax Increment Finance?

TIF is a targeted development finance tool that captures the future value of an improved property to pay for the current costs of those improvements. This mechanism can be used to finance costs typically pertaining to public infrastructure, land acquisition, demolition, utilities, planning, and more. TIF funds have also been used to help support community amenities such as parks, recreational facilities, schools, and network infrastructure.

TIF can focus attention on a problematic area and catalyze development that addresses both the economic needs of a community and the quality-of-life advancements that improve cities. Dozens of TIF projects have been introduced throughout the country, including the University North Park project, which adds both mixed-use development and a beautiful park to Norman, Oklahoma, and the “Green Corridor” project, which aims to create a business park as well as to clean and connect waterfront public spaces in Baltimore, Maryland.

The TIF process begins when the community establishes the TIF district’s geographic boundaries. Next, the initial value of all land within the district is assessed, and the current value of property (or other) tax revenue is established as a baseline. As development occurs and revenue from property taxes rises, the increase—or increment—above the baseline is used to pay debt service for the improvements made to the district. In this way, municipalities are able to build infrastructure and incentivize development without raising taxes. In fact, only the new tax revenue generated by the development is used to finance the improvements, thus creating a sustainable pool of resources for the project.

The benefits of this model have made TIF a popular development finance tool, particularly for addressing blight and promoting district-oriented development. TIF is currently

authorized in forty-eight states and the District of Columbia and is employed by cities of all sizes. In the most creative places, like Chicago, Illinois, and Columbus, Ohio, TIF is being used to develop both private enterprise and community assets.

TIF is designed to effect both physical and social changes in a community. In fact, the best TIF projects are public-private partnerships in the truest sense, where developers and investors receive incentive payments only if the project is successful. This model is called “pay-go” and implies that as the project moves forward successfully, the community pays for its share of the related and financed infrastructure. The “pay-go” model is used throughout the country and allows communities to continue to invest in infrastructure while limiting potential risk from project challenges.

An example of this financing model is the Shops at Worthington Place in Worthington, Ohio. This nontraditional redevelopment of an obsolete mall is being financed using the “pay-go” model over the course of the next twenty years. As the developer makes improvements to the mall, the city reimburses the developer for qualified infrastructure improvements. The city only pays as estimated tax revenue projections are achieved, making this arrangement a true win-win project for the city and the developer. The project has achieved early success and has spurred a second, new project adjacent to the mall, catalyzed by the initial investments from the developer and the city.

What Makes Tax Increment Financing Successful?

TIF can be effective for addressing blight and promoting development, but this is not a given. The nation’s newspapers are filled with stories of both successful and unsuccessful uses of TIF. Unfortunately, these articles rarely indicate (at least, not explicitly) what separates the good TIF districts from the bad.

Much of the time, unsuccessful TIF districts are the result of insufficient awareness or transparency. In other cases, the project needed additional support or planning on the financial side of the equation. Successful operation of TIF districts requires attention to both project financing and best practices. TIF districts also need to be rational and entail a commitment from both the public and private partners to the transaction.

Best Practices in Tax Increment Financing

Best practices are important in the use of any development finance tool, but this may be particularly true for TIF. Once property (or other) taxes have been frozen and any TIF bonds (revenue bonds issued and supported through debt service payments by the future tax increment generated by the new development) have been issued, revenue collected from the TIF district has the potential to become a sore point among community stakeholders, including area residents, school districts, and others. Following best practices in creating and operating the TIF district can help ensure that the community remains committed to the project.

The first area of TIF best practices is related to public policy and statutes. For example, a TIF

project should be clearly eligible according to the state’s authorizing statute. In most cases, in order to ensure appropriate use of tax revenue, the project should remain viable even if it did not receive any TIF assistance. The project should yield a positive net gain for the community.

The second area of TIF best practices is focused on the mechanics of the project. Identifying the experience and financial history of the developer is a crucial early step. The municipality and developer should determine up front when TIF funds will be needed and whether the project will require TIF bonds. In assessing the financial viability of the project, consideration should be given to whether the development or redevelopment has a high likelihood of maintaining an enduring presence in the community.

The third—and often forgotten—area of TIF best practices is community support and buy-in. The municipality should identify the project’s broader stakeholders, which include neighborhood groups, business leaders, school districts, and elected officials. A plan for communicating the importance of the project, as well as information on how the project will be financed, should be developed and executed.¹

Pairing Tax Increment Financing and Other Development Finance Tools

Unfortunately, strict adherence to best practices does not always determine the financial viability of a project, and TIF alone may be insufficient or inappropriate for some or all of a project. This may be the case when some particular problem with the area—such as environmental damage or acute poverty—causes a project to have particularly high initial costs or long-term risk. In such a case, an additional development finance tool may be necessary to attract investors, complete a project, or lower the cost of TIF bonds.

For example, consider a property blighted by environmental damage caused by a previous owner. The high initial costs and risks of redeveloping this property may make TIF bonds less than ideal for at least the first phase of redevelopment. Brownfield finance programs may finance the site’s cleanup costs to a sufficient level to make a later bond issuance on the property viable.

Brownfield programs, which are another targeted development finance tool, often pair well with TIF districts and projects. The US Environmental Protection Agency offers several brownfield programs, including a tax incentive and assessment grants. State and local development agencies also frequently offer support for brownfield cleanup. Payment-in-lieu-of-taxes (PILOT) programs, tax abatements, and grants are common forms of brownfield cleanup financing.

Regardless of the program type, brownfield programs help reduce the costs and risks of redeveloping properties blighted by environmental damage. Depending on the needs and wants of the community, the TIF district can be put in place before the cleanup or after it. This decision will have a significant effect on the district’s frozen value—and therefore on the district’s potential to generate TIF revenues. In either case, issuing TIF bonds after the cleanup risks have been borne out will likely result in a more favorable financing structure.

¹ The Council of Development Finance Agencies (CDFA) works openly with community stakeholders and municipalities to position TIF projects for success.

Other TIF projects that may require additional financing are those that take place in districts encompassing low-income census tracts. These projects may be considered particularly risky, as a financial analysis could well indicate that businesses will be reluctant to invest in such areas. In these cases, an investment tool such as the New Markets Tax Credit (NMTC) Program could be paired with TIF redevelopment to make low-income areas attractive to stakeholders, including investors, businesses, developers, and nonprofits.

The NMTC Program is designed to incentivize investment in businesses located in low-income census tracts. Receiving financing for a qualified project also requires working with a community development entity that has received a tax credit allocation. A TIF district covering a blighted area may well meet NMTC requirements.

The benefit of the NMTC Program for a TIF district is that the tax credits can provide an additional source of equity for a project that costs more than TIF bonds alone can bear. TIF revenue can be put toward the related public costs of infrastructure, while developer and tax credit equity can go into the bricks-and-mortar development to be located within the district. These two programs may work particularly well in states that strictly limit the use of TIF revenue to infrastructure costs alone.

Getting the Most out of Tax Increment Financing

Although complicated and occasionally challenging to implement, TIF has much to offer communities and businesses looking to redevelop sites that are neglected or otherwise blighted. Atlanta has used TIF to redevelop the entire BeltLine transportation corridor surrounding the city; Washington, DC, has used the tool to facilitate redevelopment and establish a popular new museum; and communities throughout the country have used TIF to add business parks, repair blighted properties, and improve parks. These communities have all incorporated a variation of the “pay-go” model, paying for success as the projects prove successful.

Economic development finance agencies should utilize TIF as part of their development finance toolbox and promote the benefits of this tool to their constituents. By following best practices and creatively pairing district revenue with other financing tools, communities can employ TIF to effectively provide targeted redevelopment. And ensuring that developers adhere to PFS principles will allow communities to reward positive development and protect against challenging economics.

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Bringing Success to Scale: Pay for Success and Housing Homeless Individuals in Massachusetts

Joe Finn

Massachusetts Housing and Shelter Alliance

Jeff Hayward

United Way of Massachusetts Bay and Merrimack Valley

Valentino became homeless after struggles with gambling and alcohol addictions left him with nothing. For more than a decade, Valentino stayed in shelters in the Greater Boston area—or in the hospital. Valentino had three heart attacks while he was homeless, each one worse than the last. He was unable to take care of his health without a stable, safe place to live.

Now, Valentino lives in permanent housing through the Massachusetts Housing and Shelter Alliance (MHSA) Home & Healthy for Good (HHG) program, which is a partnership between MHSA and its member agencies like Pine Street Inn, where Valentino lives. Access to permanent housing has turned Valentino’s life around. He is no longer plagued by his addictions. “No more gambling, no more drinking,” he says. His health has improved—he is down from taking fourteen prescription pills per day to only five—and his quality of life is better as well. He is able to watch what he eats and treat his heart condition and diabetes properly. Housing has increased Valentino’s opportunities for personal success and decreased his health costs in the process.

Unfortunately, many others who, like Valentino, just need a chance to access stable, supportive housing still struggle to survive in shelters or on the streets of Massachusetts. MHSA and United Way of Massachusetts Bay and Merrimack Valley (UWMB) have long sought ways to bring permanent supportive housing to scale in Massachusetts. For this reason, MHSA, in partnership with UWMB and the Corporation for Supportive Housing and with the assistance of Third Sector Capital Partners, is negotiating the first Pay for Success (PFS) contract with the Commonwealth of Massachusetts to house frequent users of services for the homeless population.

A growing body of evidence in mental and public health literature shows dramatic improvement in health outcomes, residential stability, and costs to society when homeless people receive supportive medical and case management services while living in permanent affordable housing units. Lack of stable housing is associated with significant health concerns, and consequently homeless people have disproportionately poor health. It has been well documented that mortality rates in homeless individuals are approximately 3.5

times higher than in the general population,¹ and homeless people are hospitalized for medical issues five times as often.² The Housing First model anticipates better outcomes, including health outcomes, if people are supported in a permanent housed environment rather than targeted for intensive services in shelters or streets. Once stabilized in housing, chronically homeless individuals are able to utilize mainstream health care resources in a far more effective and less expensive manner.

Housing First, or “low-threshold housing,” has been implemented in several cities, including Seattle, San Francisco, New York City, and Philadelphia. Outcome data have been reported on chronically homeless people with severe mental illness who were housed in New York City between 1989 and 1997.³ This study showed that supportive housing interventions resulted in lower rates of emergency public service usage and their associated costs for more than 4,600 people. Following placement in supportive housing, homeless people in this study experienced fewer and shorter psychiatric hospitalizations, a 35 percent decrease in the need for medical and mental health services, a 38 percent reduction in jail use, and a greater than 60 percent reduction in shelter usage.

In Massachusetts, we have gone beyond looking at overall cost savings and have focused specifically on the cost reductions to Medicaid that result from supportive housing interventions. Through the HHG Housing First initiative administered by MHSA, we have demonstrated that supportive housing, when targeted to the appropriate high-cost population, actually reduces Medicaid costs. HHG has provided housing with support services to more than 600 chronically homeless individuals. Actual pre-housing and post-housing Medicaid costs were obtained from MassHealth in March 2009 for the first ninety-six HHG participants. Total Medicaid costs reported include any medical service that was paid for by MassHealth, including inpatient and outpatient medical care, transportation to medical visits, ambulance rides, pharmacy, and dental care. Before housing, the mean annual Medicaid cost per tenant was \$26,124. After housing, the mean annual Medicaid cost dropped to \$8,500. Extrapolating this number suggests that successfully housing this population saved Medicaid nearly \$1.7 million. Simply put, providing housing and supportive services to chronically homeless individuals is a much more efficient use of resources than managing their medical conditions on the streets or in shelters. More recent analysis of the entire HHG cohort shows similarly promising results.

In April 2011, under the administration of Governor Deval Patrick, the Massachusetts Executive Office for Administration and Finance began to look at the possibility of utilizing

1 Jonathan R. Hibbs et al., “Mortality in a Cohort of Homeless Adults in Philadelphia,” *New England Journal of Medicine* 331 (1994): 304-309; Stephen W. Hwang et al., “Causes of Death in Homeless Adults in Boston,” *Annals of Internal Medicine* 126 (8) (1997): 625-628.

2 Jon V. Martell et al., “Hospitalization in an Urban Homeless Population: The Honolulu Urban Homeless Project,” *Annals of Internal Medicine* 116 (4) (1992): 299-303.

3 Randall Kuhn and Dennis P. Culhane, “Applying Cluster Analysis to Test a Typology of Homelessness by Pattern of Shelter Utilization: Results from the Analysis of Administrative Data,” *American Journal of Community Psychology* 26 (2) (1998): 207-232.

social innovation financing to direct capital to unique and promising innovations aimed at resolving complex social problems. MHSA and UWMB immediately saw an opportunity to bring two long-held concerns to the forefront of public discussion: outcome-based investment and the benefits associated with Housing First. After a public procurement process, MHSA, with UWMB as its fiscal agent, won the right in July 2012 to negotiate a contract with the Commonwealth of Massachusetts to be the intermediary for the first PFS contract to address the problem of long-term homelessness through housing. Contract negotiations began in earnest in January 2013.

The concept of social innovation financing is a “brave new world” within both government and the nonprofit sector. To date, there is no empirical evidence to suggest that the model works—and yet social innovation financing has caught on with a level of enthusiasm seldom seen. We find ourselves at times caught between its promoters, who proclaim it as salvation for charitable institutions struggling to achieve difficult ends, and its detractors, who view it as the latest privatization scheme or the product of snake-oil salesmen meant to further less noble objectives. As with most things, we believe the truth rests somewhere between the extremes. Our experience with HHG reminds us that new innovations are often greeted with doubt, and progress would be impossible without some level of risk. We have entered this fray because it represents one of the first serious attempts to discuss the important relationships between public agencies, outcome measurement, appropriate capital financing, and the appropriate role of the private sector.

Although we have yet to fund a single housing unit through PFS, we have learned a great deal that is worth sharing. First, social innovation financing is a broad concept. Although its most public iteration is the social impact bond, a number of financing models are in fact available to achieve a social objective. All of these models are premised on the concept of private capital preceding public investment. However, the practical implications of such models can affect public procurement reform and philanthropic support, as well as the engagement of the private investment world in socially meaningful ventures. At this stage of development, all avenues should be explored. MHSA and UWMB now have the opportunity, not only to consider new aspects of financing the nonprofit sector, but also to reconsider the relationship between government and the nonprofit sector.

Second, the introduction of social innovation financing lays bare the critical question of our time: what is the obligation of the public sector to address the most complex and difficult social ills, such as poverty, homelessness, addiction, and mental health? In an age of scarcity and incredible deficit, such questions become even more pressing. What remains uncertain at this point—and clearly needs to be part of negotiations with any public entity—are the objectives that social innovation financing must meet. Both social and fiscal objectives are in play. While the social objectives are often good in themselves, the premise that the incredible needs that exist can all be met through the savings produced through innovative initiatives (like Housing First) remains untested. What responsibility does a state have to ensure that severely disabled persons are not relegated to the street or mass shelters, and

who bears that cost? MHSA and UWMB believe that the social innovation financing process provides an opportunity to struggle with such important questions and that novel financing approaches that address both social and fiscal objectives are possible.

If someone asked Valentino the difference Housing First makes, he would likely not focus on financing models. Instead, he would share the significant stabilizing impact housing has had on his life. MHSA and UWMB remain committed to creating more housing opportunities for people like Valentino—simply because it is worth doing. We have set out on this journey in the faith that there must be new and exciting ways to finance such important initiatives. The discussions it has promoted have made the journey thus far worth the effort.

Joe Finn has been executive director of the Massachusetts Housing and Shelter Alliance (MHSA) since 2003. Mr. Finn has worked on homelessness issues for nearly 15 years. Prior to coming to MHSA, he served as executive director of Shelter, Inc. in Cambridge and Quincy Interfaith Sheltering Coalition in Quincy. Mr. Finn is a 1978 graduate of Siena College. He earned a master of arts degree in Theology from the Washington Theological Union, a master of arts degree in Sociology from the New School for Social Research, a Juris Doctorate from the New England School of Law and an Honorary Doctor of Humanities from Bentley College. In 2001, Mr. Finn was elected City Councilor for the City of Quincy. He and his wife Dolores McIlmail have seven children.

Jeff Hayward is chief of external affairs at United Way of Massachusetts Bay and Merrimack Valley. Mr. Hayward is responsible for overseeing the annual strategic investment of nearly \$35M in initiatives and agencies contributing toward the United Way of Massachusetts Bay and Merrimack Valley's mission and vision. He is also responsible for shaping, executing and managing United Way's public policy strategy and agenda. Mr. Hayward also oversees the United Way efforts to engage volunteers in furthering the United Way agenda and leads a team responsible for major giving and transformational gifts along with grants and foundation giving. Mr. Hayward previously served as chief of staff to the Mayor of Lynn for five years. He later served as a member of the Massachusetts House of Representatives before becoming the New England vice president for development and marketing for a national, publicly traded health care company. He was also a member of the MA Policy Academy on Ending Family Homelessness charged with developing a 10-year plan to eliminate family homelessness; and was a member of the MA Department of Transitional Assistance's Housing and Homeless Advisory Committee appointed by the Commissioner of DTA. More recently he served on the Massachusetts Commission to End Homelessness which developed a five year plan to end homelessness in MA under the Patrick Administration.

Making Performance-Based Contracting Work for Kids and Families

Patrick Lawler and Jessica Foster

Youth Villages

Done right, performance-based contracting (PBC) offers a win-win-win to government, providers, and, most importantly, the people being served. Government spends funds more effectively, higher-quality providers thrive, and recipients get better services. Take Tennessee's experience introducing PBC to its child welfare system. Significantly more children are exiting care to stable homes, providers deliver better outcomes and receive incentive payments to reinvest in strengthening their work, and the Department of Children's Services (DCS) has kept its budget steady and is getting more bang for its buck.

The idea of paying for performance is not new. In child welfare—the field in which our organization, Youth Villages, works—a 2009 study identified fourteen states with performance-based contracts for at least one service.¹ But PBC is far from ubiquitous, and its implementation is inconsistent.

The concept has generated excitement recently with the inclusion of \$100 million for Pay for Success (PFS) or social impact bonds (SIBs; i.e., private low-risk loans to the government, intended to fund what works) in President Obama's 2012 budget. But if the end goal is achieving better social outcomes in the most efficient way, the PBC dialogue spurred by PFS/SIBs has been too narrow. While private financing represents a promising tool to motivate behavior change in government, the use of it does not in and of itself solve many of the barriers to successful PBC adoption and execution. In our experience proposing performance-based contracts to government agencies, budget size is not the greatest hurdle. We need to broaden the conversation if PBC is to fulfill its true promise. A deeper discussion on structuring incentives and cultivating a sustainable commitment within government is needed.

Youth Villages just celebrated twenty-five years of helping emotionally and behaviorally troubled children and their families live successfully. Last year we worked with more than 20,000 children and families from fifteen states and Washington, DC. Most of our funding comes through typical pay-for-outputs government contracts. In our experience, getting government commitment to issue and fund a performance-based contract is a heavy lift. Great barriers exist, including political pressure to retain weak providers, lack of contracting know-how, and restrictions on how government funds can be used. We have been part of Tennessee's child welfare PBC effort since it began in 2006, and it has been an eye-opening experience for us. We would like to share our experiences and what we have learned about PBC.

¹ Quality Improvement Center, "Examples of Performance Based Contracts in Child Welfare Services." (July 27, 2009).

Barriers to Performance-Based Contracting Implementation

Political pressure to retain weak providers. Government agencies often have an idea about how strong or weak their providers are, but summoning the political will to act on that knowledge can be hard. When budgets need to be cut, it can be easier to issue rate cuts across the board and limit service duration or eligibility than to make decisions based on provider performance.

Lack of contracting know-how. PBC is complex and requires skilled leaders and trained personnel in both the government agency implementing the PBC and in private providers to structure and monitor contracts. Outside expertise can help, particularly if in-house talent is developed in parallel. Technical assistance and the creation of effective learning communities around PBC are essential for achieving desired results.

Restrictions on how funds are used. For instance, the largest category of federal funding for child welfare is Title IV-E, which can be used primarily for purchasing out-of-home care. Without a waiver, a state cannot shift those dollars to other kinds of services that could better achieve permanency. Nor may it be possible for a state agency to legally hold budgetary savings from one budget year to another in order to use them for incentive payments. These restrictions limit the services and timeframe a performance-based contract can cover to achieve desired outcomes.

How Tennessee Has Used Performance-Based Contracting to Get Better Outcomes for Kids in Child Welfare

In 2000, Tennessee agreed to settle a lawsuit brought against its child welfare system. Too many kids were getting stuck in out-of-home care and not returning to their communities. The state relied heavily on group homes and institutions (known as congregate care) for thousands of emotionally and behaviorally troubled children. Many children also remained in emergency shelters and other “temporary” placements for six months or more. And there were not enough foster families or services to help children reunify with their biological families. The “Brian A.” lawsuit settlement required comprehensive reform of the system. But three years later, an independent monitor’s report found that the DCS had failed to comply with many of the settlement’s provisions.

PBC came about as part of the state’s response to these failures. Viola Miller, DCS commissioner who was hired in 2003, championed PBC as a way to achieve a clear goal—moving as many children as possible, as quickly as possible, out of congregate care into a stable and secure parenting relationship, or what the child welfare world calls permanency.

The Tennessee DCS performance-based contract measures include care day utilization (i.e., days in care), exits to permanency, and reentries into care. Providers are reimbursed for services at the time the services are delivered and later receive financial rewards for improving performance and penalties for performing below expectations. These rewards and penalties are a fraction of the total contract size; for Youth Villages our incentive payment

has ranged from 0 to 7 percent. Overall this contracting structure has been a success for the welfare of children in Tennessee. In the first three years, care day utilization went down by 8 percent, and permanent exits went up 6 percent—without any increase in reentries to care. In other words, more children were leaving the child welfare system for stable homes. These percentages may sound like fairly small improvements, but they are pointing in the right direction and mean that hundreds of children each year are achieving permanency. The budgetary implications have been neutral.

Other signs suggest that Tennessee’s child welfare PBC has been successful. It grew in scale, expanding from five providers at its outset to include all child welfare and juvenile justice providers five years later. And it weeded out lower performers—the number of child welfare and juvenile justice providers in the state has dropped by a third from over seventy before the PBC initiative began.² Children’s Rights, which filed the original lawsuit against DCS in 2000, noted in a 2011 report, “While some providers could not adjust to the new service environment, many others thrived within and profited from it.”³

So what happens to this “profit”? In a private sector pay-for-performance contract, a firm can use the incentive money as it chooses—for executive bonuses, dividends, you name it. Tennessee has an expectation that providers will reinvest their incentive payments to improve performance. Youth Villages has performed well under PBC and we have reinvested the incentive payments, along with additional privately raised funds, in ways we believe will produce better outcomes. We have developed intensive family-finding strategies to identify permanent homes for more youth. We have invested in evidence-based practices such as Trauma-Focused Cognitive Behavioral Therapy to provide the most effective treatments to the youth we serve. And key tenets of our model—including smaller caseloads for each counselor; stronger supervision and clinical consultation; and a data collection and analysis system that lets us monitor performance, outcomes, and customer satisfaction—are far beyond what our government funders ask for but have been critical to achieving our outcomes.

What’s the Best Way to Structure a Social Services Performance-Based Contracting System?

While the PBC system has achieved success overall, the contract is highly complex, and multiple elements have posed problems for providers and created perverse incentives. Basing our observations on our experience with this contract, as well as discussions with experts in the field and a review of recent literature on the subject, we believe a PBC system needs to get a few things right if it is to deliver better outcomes and end up paying for success.

Define clear outcomes and performance measures. Measures must be objective, collectable, and tied to the desired societal outcome goals. Here, the outcome metric of reentries to care has been particularly effective. It measures whether the child is stable in his or her home

2 Casey Family Programs, “Tennessee and Youth Villages Common Knowledge Case Study.” (June 2010).

3 Children’s Rights, “What Works in Child Welfare Reform: Reducing Reliance on Congregate Care in Tennessee.” (July 2011).

a year after discharge from services and thus ties directly to the goal of permanency. Even though the data are available, it is incredibly rare for providers to be held accountable for this measure in our field because reentry occurs long after the government payments are made and falls outside of the service year's budget.

Ensure that data collection is transparent and consistent across providers. All parties must understand what data are being collected, have access to the data, and understand how data are linked to incentives and penalties. To make the system consistent and feasible, the agency should manage the data rather than requiring each provider to adopt new systems and processes. Some providers may not have adequate technology, so having DCS collect all data is essential. However, currently Tennessee providers do not have access to the methodology and data manipulation performed to calculate rewards and penalties; thus they are not able to easily predict and prepare for the financial impact they will face or evaluate data for inaccuracies. When Youth Villages has made data requests and been able to dig into numbers, it has not been uncommon to find inconsistencies across data sets. So while DCS greatly enhanced its data sophistication, which is a big win, the lack of transparency has been a significant hindrance.

Give providers flexibility. Government agencies will always need to write specific standards into contracts to ensure client safety and guard against corruption, but a performance-based contract should allow providers enough latitude to get results. In one state in which we operate, the state's regulations concerning staff credentials, clinical team structure, session length, and the reporting requirements for reimbursement are so restrictive and cumbersome that we are forced to modify our model, manage substantially greater complexity, and devote more resources to administrative duties. The focus should be on the ultimate outcomes and not the programmatic components that lead to them. Fortunately in Tennessee, prior to implementation of PBC, DCS had a continuum of care model that allowed providers substantial flexibility in determining the most appropriate setting and services for children in their care; the continuum model continued under PBC.

Identify and correct perverse incentives. Almost any incentive system is bound to produce some unintended consequences. For example, in education the talk of incentives immediately sparks intense debate about teaching to the test and score fixing. A PBC system should spend time upfront collecting data, testing its application, and identifying and fixing ways that parties may game the system. The Tennessee DCS contract formula produces an unintended consequence stemming from the tying of rewards to the timing of admissions and discharges within a fiscal year—meaning that the same outcomes could be rewarded or penalized depending on the month a youth was admitted. This may lead some providers to reject a child simply because of the month in which the youth needs services.

PBC incentives and penalties should be separate from cost reimbursement. Tennessee has shown that an effective monetary performance incentive need represent only a small percentage of a contract's value. Youth Villages' contracts on average have zero margin; therefore, having a

very small portion of our reimbursement at risk is highly motivating and risky for us—having as little as 5 percent withheld or lost would likely represent losses and an inability for us to cover our expenses. Some recent PBC model ideas have proposed withholding 25 percent of reimbursement for one to two years after service completion. If the basic costs of delivering a service are tangled up with the incentive structure, it could wreak havoc with providers who are working hard to get better but have not hit the mark yet. This idea would put even strong providers out of business.

Ensure that all providers are compared against common benchmarks. In Tennessee, initial provider resistance to a performance-based contract, and the fear that the penalties might force some providers out of business, led to outcome goals based on each provider's own past performance. A provider that moved from poor to average performance would get a larger reward than an excellent provider that continued to produce the best outcomes for kids. Ultimately, everyone needs to be aiming at the same benchmark so that government funds consistently promote the strongest outcomes.

Take each provider's population mix into account. While there should be standard benchmarks, these targets must be adjusted to reflect the fact that not all providers serve the same mix of clients. Providers with the most challenging clients should not be penalized for doing the hardest job. We see a similar concern in medicine, where it is feared that PFS might lead doctors and hospitals to shun the oldest and sickest patients.

Over time, shift "market share" to providers producing the best outcomes. Government contracting is never going to look like a perfectly competitive market, but a well-functioning PBC system ultimately will start identifying longer-term winners and losers based on its performance measures. This visibility should result in the better-performing providers doing a larger share of the work, in contrast to business as usual in government. In Tennessee, even though some of the weaker providers have gone out of business, there has not been an intentional effort to shift market share to higher performers. Absent that redistribution, the state will fall short of delivering the best possible outcomes for its troubled youth.

Can Performance-Based Contracts Save Money?

Tennessee was not aiming to reduce its children's services budget. It was trying to get better results with that budget and reinvest the savings for quality improvement. But in this era of fiscal austerity, PBC inevitably emerges as a good way to trim government cost. The 2007 California Performance Review report, for example, said the state "should use performance-based contracting activities to save money."⁴ (The report also saw PBC as an opportunity to "maximize performance, encourage innovation and competition and improve services.") In our view, savings are to be had—sometimes for a specific agency and in a particular fiscal year, sometimes for the system overall over a longer time horizon.

4 California Performance Review, "Increase the Use of Performance-Based Contracting," (2007), available at http://cpr.ca.gov/cpr_report/Issues_and_Recommendations/Chapter_7_Statewide_Operations/Procurement/SO71.html.

Youth Villages' intensive in-home service program costs approximately one-third the cost of traditional out-of-home care. We divert youth from placement, achieving better outcomes and costing the agency less per child served. However, those per-person savings may not equal budgetary savings.

A major determinant of whether budgetary savings emerge is the overall demand for congregate-care beds. While shifting more youth from out-of-home placements to in-home settings opens the door to facility savings, cost reductions only materialize if the state does not fill the beds. In states with a waiting list for beds and with strong providers who will market their services to get their beds filled, this is unlikely. And looking specifically at the fixed costs associated with running facilities, savings do not occur until the system hits the threshold of reduced demand that allows for closing part or all of a facility. The politics here are also challenging because government typically divides youth among all providers to share the business, leaving some open capacity everywhere rather than filling the best facilities and emptying the others.

Even if cost reductions do occur, additional complexity may make the savings fall to another department or budget year. In some states, the payer for in-home services is different from the payer for out-of-home care, so the in-home payer cannot repurpose per-youth savings achieved through a preventive or diversion service. And sometimes the savings are over a time horizon that expands beyond the budget year, as is the case with longer-term reductions in emergency room, disability, and unemployment costs.

Finally, there is a moving-target issue. As interventions improve and become more cost-effective, so does the baseline cost benchmark. The difference between the "traditional" government intervention and the new one narrows along with the cost savings.

Overall, cost reductions represent real value. Accessible budgetary savings are motivating. But given the inherent complexities in capturing them, savings should not be the leading indicator of a performance-based contract's success.

Do We Want More Performance-Based Contracts?

At Youth Villages we want more performance-based contracts because we want more kids to be part of strong families, more youth to achieve their educational and vocational goals, and fewer citizens to spend their youth and young adulthood behind bars. The current system of pay-for-outputs government contracting is not focused enough on the real outcomes that we—providers, government, everyone who cares about kids and families—seek. Consider what this idea might mean for the 3.7 million children involved with the child welfare system across the United States.

We believe that PBC—for all its challenges—has potential to achieve better results on limited budgets. At Youth Villages, we hope and expect to spend considerable energy over the next few years working with state agencies and political leaders, the federal government, child and family advocates, and some very committed philanthropists to move PBC forward. It is one of the best ways we know to help children and get the value we need from the public's money.

Patrick W. Lawler is the founder and chief executive officer of Youth Villages, one of the largest private providers of services to troubled children and their families in the country. Under his leadership, Youth Villages has established an array of specialized treatment programs operated by an effective team of more than 2,700 employees in 66 locations across 11 states and the District of Columbia. Since 1986, the organization has changed the lives of more than 80,000 children despite overwhelming odds and an even more overwhelmed system. Driven by a passion to take on the toughest child services cases he can find, Lawler has revolutionized the field of child welfare in America with Youth Villages' Evidentiary Family Restoration approach. This approach proves that troubled children can achieve success rates twice that of traditional services at one-third the cost of traditional care. Lawler was recognized in 2006 as one of "America's Best Leaders" by US News & World Report in conjunction with the Center for Public Leadership at Harvard University's John F. Kennedy School of Government. He was recently featured in the book Everyday Heroes: 50 Americans Who Are Changing the World One Nonprofit at a Time. Mr. Lawler's leadership and Youth Villages' success are profiled in Ken Stern's 2013 book With Charity for All: Why Charities Are Failing and a Better Way to Give as a prime example of nonprofits that are achieving results and merit donor investment.

Jessica Foster, director of strategy, reports to Youth Villages' CEO and partners with the senior leadership team to support the organization's continued growth. She facilitates strategic planning processes, oversees business development and government relations, coordinates and manages mergers and special projects, and helps communicate Youth Villages' strategy and results to various audiences. Foster joined Youth Villages from the Boston Consulting Group, where she supported the strategy and design of multiple-site implementation plans for a global corporate merger-and-acquisition project, evaluated and recommended improvements to performance management of a large public school district, and developed government advocacy strategies for a consumer packaged goods company. Previously she was a consultant at the Monitor Group and a legislative aide for US Senator Arlen Specter, whom she advised on foster care, adoption, welfare, economic development, public housing and nonprofit issues. Foster holds a BA in public policy from Brown University and an MBA in marketing from the Wharton School.