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 incarcerated 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 though 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.

Jonathan Greenblatt is special assistant to the president and director of the Office of Social Innovation and Civic Participation in the Domestic Policy Council. In this role, he is leading the Office's efforts to leverage human capital and financial capital to elevate community solutions. This portfolio includes issues such as national service, civic engagement, impact investing, and social enterprise. Before joining the White House, Jonathan founded the Impact Economy Initiative at the Aspen Institute, a program focused on the nexus of public policy and impact investing. He served as an operating partner at Satori Capital, a private equity firm focused on conscious capitalism, and was an active angel investor. He also served as a member of the faculty at the Anderson School of Management at UCLA where he developed and taught its coursework on social entrepreneurship. Greenblatt earned an MBA at the Kellogg Graduate School of Management at Northwestern University and graduated cum laude with a BA from Tufts University. He is a Henry Crown Fellow of the Aspen Institute and a Next Generation Fellow of the American Assembly

Annie Donovan is on assignment with the Council on Environmental Quality serving as senior policy advisor for new financial instruments. She closely coordinates with the Office of Social Innovation and Civic Participation to work on a range of projects in the Office's portfolio. In this role, Ms. Donovan draws from an extensive background in community finance, capital markets and financial innovation. Ms. Donovan's most recent experience was as chief operating officer for NCB Capital Impact, a national, nonprofit community development financial institution that provides financial services and technical assistance to help make high-quality housing, health care, healthy foods, education and eldercare more accessible and attainable for low-income communities. As COO of Capital Impact, Ms. Donovan was responsible for leading the company's efforts in community lending, technical assistance, strategy formation, product innovation and policy development. Until her current assignment, Ms. Donovan served as president of the New Markets Tax Credit Coalition, and sat on numerous boards and advisory committees. She has published papers for the National Academy for Public Administration, the Federal Reserve Bank of San Francisco and the Federal Reserve Bank of Boston. Ms. Donovan has an undergraduate degree in economics and an MBA in finance.