Government's Role in Pay for Success

Kristina Costa
Center for American Progress
Sonal Shah
Case Foundation

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

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 Healthly & 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://mckinseyonsociety.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.

Kristina Costa is speechwriter to John Podesta and researcher in economic policy at the Center for American Progress. She is the Center's expert on social impact bonds and researches a range of topics in government reform. Previously, she worked in the US House of Representatives.

Sonal Shah is a senior fellow at the Case Foundation and at the Center for American Progress. An entrepreneur and innovator, she has worked in government, business, and the non-profit sector. Until recently, she was deputy assistant to the President and director of the White House Office of Social Innovation and Civic Participation. Previously, she led Google's global development initiatives for its philanthropy, Google.org, and was a vice president at Goldman Sachs, Inc.