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-backstopped 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.

Daniel Stid is a partner in The Bridgespan Group's San Francisco office. He leads Bridgespan's performance measurement practice and coordinates the organization's engagement with government at the federal, state, and local levels. Prior to joining Bridgespan, Daniel worked at The Boston Consulting Group, served as a congressional fellow on the staff of the Majority Leader in the U.S House of Representatives, and taught political science at Wabash College.