Response to the U.S. Department of Treasury request for information, “Strategies to Accelerate the Testing and Adoption of Pay for Success Financing Models”

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Introduction

For the past two years, the Harvard Kennedy School Social Impact Bond Technical Assistance Lab (SIB Lab) has been providing pro bono technical assistance to state and local governments in order to test the pay for success (PFS) model as a tool to improve outcomes, contain costs, stimulate the use of data in policymaking, and create knowledge about which interventions work best for addressing local governments' highest priority issue areas. The SIB Lab initially served Massachusetts and New York State, and is now also working with the governments of Chicago, Colorado, Connecticut, Denver, Illinois, Michigan, Ohio, and South Carolina. Through this hands-on involvement, the SIB Lab has gained insight into the challenges that governments face in developing PFS contracts and has assisted in developing solutions to overcome these challenges.

The PFS model is still nascent, yet many state and local governments are eager to experiment with PFS as a tool for addressing important policy priorities. While the projects in the most advanced stages of planning fall within the corrections/criminal justice realm, more governments are now directing their attention towards early childhood, preventive healthcare, homelessness, and substance abuse, among others, as potential issue areas to address with PFS contracts. The rapid expansion of interest in the model presents an opportunity for the federal government. By capitalizing on energy at the state and local level, the federal government can help accelerate the spread of PFS and the development of solutions to pressing social problems as well as establish collaborative efforts with state and local governments around shared policy goals.

The federal government is well positioned to address two major barriers to the adoption of the PFS approach. First, without federal involvement it is hard for state and local governments to undertake projects when a significant fraction of the benefits accrue to the federal government. In particular, there are many potential projects with overall benefits that exceed costs, but where the state and local benefits alone do not exceed costs. Finding an efficient way for the federal government to participate in these projects is critical to their viability. Second, it is proving difficult to obtain financing for some of the most innovative potential projects, because they are too risky for commercial investors. Given that a successful intervention discovered in one jurisdiction has the potential to spread nationwide, there is a useful role for the federal government in absorbing a portion of the risk so that learning can occur.

The Incentive Fund, managed by the U.S. Department of the Treasury, can serve as the mechanism that enables the federal government to capitalize on the opportunities outlined above. The Incentive Fund has the potential to play a key role in catalyzing the PFS market by mitigating market risks, ensuring that potential projects with diffuse benefits are feasible, and expediting the adoption of the PFS model by new state/local governments.

Specific Questions

1. Instead of focusing on particular programs, the budget language proposing the Fund is broad in scope. What agencies and/or program areas are best suited for the Fund and why?

The Request for Information states that the Incentive Fund will have two purposes: First, the Fund will allow the federal government to pay for outcomes for which some of the savings accrue to the federal government, rather than state/local governments. Second, the Fund catalyze testing of PFS models where there is a federal financial interest. Discussion of the first goal follows, while the latter goal is discussed elsewhere in this response.

The federal government is poised to capture significant portions of potential savings in issues areas where preventative interventions can reduce future federal spending as well as help achieve federal policy goals. Potential examples include:

- Interventions that enable individuals with health impairments to remain in the workforce, thereby reducing federal spending on Supplemental Security Income, Disability Insurance, Medicare, and Medicaid.
- Investments in early childhood programs such as home visiting that reduce federal Medicaid expenditures.
- Pre-school education programs that reduce the need for spending on special education,
- Preventive health care investments in areas like diabetes prevention and asthma management that can reduce federal Medicaid and Medicare expenditures.
- Supportive housing programs that can reduce homelessness and potentially reduce Medicaid spending, emergency cash assistance, and targeted homeless assistance needs and spending,
- Substance abuse programs that reduce federal Medicaid, justice, and other assistance needs and spending, and
- Workforce development programs that raise participant earnings, generating increased tax revenue and reduced spending on income transfer programs.

Within many of these program areas, the expected savings and/or benefits accruing to state and local governments alone do not outweigh the program costs, even though total benefits, including federal benefits, do outweigh program costs. As a result, without federal involvement, many valuable projects in these areas will fail to be pursued. By utilizing the Incentive Fund to provide outcome payments in proportion to federal savings, the federal government can make it possible for these projects to come to fruition.

In addition to specific issue areas, collective impact projects – community-oriented projects that rely on the commitment of a group of important actors from different sectors to a common purpose of solving a specific social problem[1] – also have the potential to generate substantial societal and taxpayer benefits. However, collective impact projects often are not viable without federal support. Collective impact projects are challenging within the traditional PFS framework because they are highly dependent on coordination efforts, and funding coordination may be less attractive to investors or philanthropists than funding a single program. Furthermore, the economic benefits of these projects span multiple agencies and levels of government, making them unattractive from a single agency or government perspective.

Projects in any of the specific issue areas outlined above, and those that would be considered collective impact, should be high priority for the Innovation Fund. For issue areas that primarily involve federal benefits (e.g., helping workers with health impairments stay in the workforce), the federal government should actively seek proposals for pay for success projects -- because state and local governments will be unlikely to develop such projects on their own.

What level of evidence exists in these areas about interventions that work? What is the threshold of evidence that a program should have in order to merit consideration for a PFS approach? What other factors should be considered in setting resource priorities for the Fund?

An evidence threshold is relevant to the development of PFS projects in two important respects. First, the existing evidence base of an intervention will ultimately determine the level of risk associated with any PFS project, impacting the rate of return expected by investors and the outcome payment amount governments will be expected to make. The terms of PFS projects are heavily dependent upon the evidence base of interventions, which plays a key role in negotiations between parties involved in a contract. Establishing a minimum evidence threshold for interventions to be considered for a PFS contract, though, could interfere with the development of contracts that would test some of the most innovative program models. If commercial investors and foundations are willing to absorb the risk, and governments are willing to at least partially compensate for that risk, PFS contracts may be a powerful tool to test nascent or particularly innovative programs. The second way in which evidence thresholds are relevant to PFS projects is their role in determining the evaluation methodology used to measure impact and trigger payments. In this aspect, the federal government could establish standards for rigorous evidence, ensuring that projects result in new, reliable knowledge about program effectiveness. The creation of this knowledge, which can be used to guide future policy, is one of the most important benefits produced by PFS projects. Thus, the federal government has a strong incentive to ensure that rigorous evaluation methodologies are employed. In this respect, minimum evidence thresholds could be established at the federal level and used to evaluate projects for the Incentive Fund.

2. The budget proposal encourages maximizing the leverage of Federal funds by engaging intermediaries, including state, local and tribal governments. What other kinds of groups should be considered as intermediaries? Are there other organizational constructs that should be considered?

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[1] John Kania and Mark Kramer, "Collective Impact," *Stanford Social Innovation Review,* Winter 2011.

State/local governments are positioned to be the best intermediaries[2] of federal dollars from the Incentive Fund. In order to successfully implement a PFS project, it is necessary for a government entity to monitor and manage the project as it is implemented. This ensures fiscal responsibility and protects the interest of government, project beneficiaries, and taxpayers. State/local governments are best suited for the role of intermediary as they have the greatest capacity to be fully immersed in a project at a local level.

The ability to demonstrate whether a PFS intervention produces the desired results is the backbone of the model. How can the Federal government encourage the adoption of low-cost yet rigorous outcome measures? What are some of the barriers to using administrative data in a PFS scenario, and how might they be addressed?

Data collection is often the single greatest expense associated with conducting a rigorous evaluation. The cost of evaluations can therefore be contained by relying on administrative data that is already collected by governments and other public organizations. Unfortunately, barriers to utilizing administrative data, including restrictive usage policies, an inability to link data across agencies, and limited information technology capacity within government, can limit the feasibility of this approach. The federal government could remedy this challenge by supporting the following efforts:

First, offering streamlined access to federal data sets, such as Social Security earnings histories, would reduce the need to collect data solely for the purpose of an impact evaluation. This would also improve the precision of evaluations that require tracking individuals across state borders (ex. program recipients move during the project's implementation). It would also enhance evaluations, allowing for additional outcomes to be tracked, regardless of whether or not they will be tied to PFS payments.

Next, the Incentive Fund could be used to support state/local governments in improving or enhancing their administrative data capacity. This would enable better access to data needed initially for feasibility studies and eventually for rigorous evaluations. Funding could be allocated to support upgrades to existing IT systems, developing capacity to link data sets across agencies, creating streamlined data access and usage policies, and increasing the number of staff who are knowledgeable about how to access and analyze data.

Finally, there may also be a role for the Incentive Fund in subsidizing or covering the cost of evaluating PFS projects. The investment would be beneficial from a federal perspective as the knowledge created could be utilized to guide future policies nationwide. In a complimentary fashion, the parties in a PFS project could also raise funds from philanthropic sources in order to bolster the evaluations to gather and analyze data points that may not trigger outcome payments, but that will enhance this knowledge base.

[2] Note that the term intermediary here is used to describe the entity that directly receives money from the Treasury's Incentive Fund. It is not used to describe the use of a social impact bond intermediary organization.

3. Outcome payments and financing support (e.g., credit enhancement, loans or advances) are two forms of assistance meant to complement one another in stimulating PFS approaches. What criteria should be used to decide how to split the Fund between these two forms of assistance? Should a certain proportion of the fund go toward outcome payments versus financing support, such as 50/50, 30/70, etc.?

Outcome payments and financing support can both be used to stimulate PFS projects. In projects where a portion of savings accrue to the federal government, making the economics difficult from a solely state or local perspective, the most valuable and direct form of support would be outcome payments. Federal payments that are tied to medium term proxies for long-term outcomes could be especially useful, as projects would be relieved from holding investor capital for a long period of time. This would dually ensure that investors are willing to endow projects with longer payoff timelines, and that government does not allocate excessive resources to compensating investors for the time value of their money. The long-term outcomes of almost any intervention are of great interest to government. Ensuring that these outcomes are rigorously measured would enhance the value of many PFS projects. The federal government can support this process by financing outcome payments, while requiring long term tracking of results as a condition of the federal support.

Alternatively, a well-calibrated credit enhancement could also be used to align the project economics through reducing risk and ultimately lowering the amount of payment required from the state/local government.

In projects where the federal government may not accrue savings, but would nonetheless like to create performance incentives and subsidize learning, the Incentive Fund could be used either to boost investor returns (as a "bonus" payer) or mitigate risk (through credit enhancement), making projects more attractive to potential investors.

There are important trade-offs to consider regarding the different forms of support. Credit enhancement may distort risk management from the investor's perspective. If one of the benefits of the PFS model is to bring performance management expertise from the private sector to the provision of social services, reducing the private sector's risk may limit this benefit. If credit enhancement is executed in the form of a guarantee, there is also reputational risk, as the federal government would only be paying for projects that do not achieve pre-determined outcomes (perceived as failures). Credit enhancement in the form of senior/subordinated tranching may be the most desirable type of credit enhancement as it ameliorates these challenges.

Intervening as a bonus payer rather than through credit enhancement may also have its disadvantages. Many investors, for example, have expressed that they are more sensitive to downside loss than to an equivalent upside return.[3] This means that investors are likely to respond more positively to financing support that protects their principal, rather than to equivalent additional outcome payments that boost returns.

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[3] "Building a Healthy & Sustainable Social Impact Bond Market: The Investor Landscape," *The Rockefeller Foundation,* December 12, 2012.

As the market for SIBs develops and new projects have begun to emerge, it is increasingly apparent that every project is unique. The parties most intimately involved with a project's construction will ultimately have the best sense of the form of federal support that would be most likely to enable the project to come to fruition. In some cases, support in the form of outcome payments may be necessary in order for a PFS project to even be considered from a state/local perspective. In other cases, credit enhancement may ensure that promising projects are able to attract some investors that may be unwilling to put all of their principal at risk. In order to achieve maximum leverage, the Incentive Fund should allow for flexibility in determining the best use of Incentive Funds, and state/local governments should play a central role in proposing the best use of the funds in particular projects.

4. Is there an optimal structure for both the timing and tiering of outcome payments? For example, should the projects allow for some degree of "progress payments" based upon achievement of early outcomes? Should the projects allow for "bonus payments" for extraordinary performance? What are the trade-offs of adapting different structures to different projects versus supporting a standardized approach?

From a government perspective, it is best for outcome payments to be made after data collection is complete, and evaluators have been able to assess a program's full impact on the population served. This will typically occur at the end of the PFS timeline, often several months after service delivery is complete. While postponing outcome payments will ensure that the government is confident that payments reflect what has actually been achieved, it is expensive to retain investor capital for multiple years. The longer that investors must wait to be repaid, the greater the return they will demand on their investment. Thus, in practice, many PFS projects are likely to incorporate interim progress payments based on early evaluation evidence. Later payments can "true up" the initial payments by paying the difference between the ultimate amount of performance related payment earned and the amount paid initially.

One of the most important cautions regarding progress payments is that they should not be used to fund remaining years of service delivery. If a PFS project is designed to feature 4 years of service delivery so that a sufficient sample size of individuals will be observed to inform future policy decisions, it is critical that the initial investment be sufficient to cover the cost of all 4 years of service costs. Thus, progress payments at the end of year 1 or 2 should not be used to fund the remaining years of service delivery in years 3 and 4. Otherwise the project might shut down before there is sufficient evidence to assess its impact, and some individuals may be stranded without receiving full services.

It has become increasingly clear that governments will need to absorb some of the risk in most PFS contracts; it is simply too expensive to pay the private sector to absorb all of the risk. In this respect, one alternative to progress payments would be to tie some payments to those outcomes considered to be less risky. Investors are more likely to accept a longer payback schedule if they are confident that they will recoup at least a portion of their investment.

The decision of whether to allow for bonus payments for extraordinary performance would be best determined by the parties most intimately involved in a project's construction. In some cases, if extraordinary performance results in additional government savings, and if bonus payments are viewed by service providers as an incentive for exceptional performance, it could be beneficial to accommodate these payments. While bonus payments should be a permissible use of the Incentive Fund, we think few projects are likely to use them. As previously outlined, investors have shown much greater sensitivity to downside risk than to upside return. Mitigating this downside risk (for example, by structuring a portion of outcome payments to targets that are very likely to be achieved if services are delivered effectively) will be more likely to attract commercial investors to a project than bonus payments will.

5. Among the possible forms of financing support, would credit enhancements, loans or advances be most helpful? What role would financing support play in the overall structure of a PFS structure?

See response to question 3.

As previously described, the parties most intimately involved with a project's construction will ultimately have the best sense of the form of financing support that would be most beneficial to the specific project. The fund should therefore have the flexibility to deliver the specific support required for each particular project.

6. Please suggest one or more examples of promising PFS projects or programs. For each example, what are its characteristics or features that make it a good candidate for PFS? Who would be the key partners and what would be their roles? How would the activity be funded? How would risks be shared and interests aligned among the partners? What might be appropriate outcomes and metrics? Over what timeframe would outcomes be determined?

The following are illustrative examples of PFS projects for which the Incentive Fund would be well-suited. These hypothetical projects would be good candidates for federal support as they either a.) would allow the federal government to pay for outcomes for which some of the savings accrue to the federal government, rather than state/local governments or b.) spur policy innovation and performance assessment in areas where there is significant federal policy interest.

Disability Project
There is a significant need for new interventions to be developed that help workers with health impairments remain in the workforce. However, state and local governments have little incentive to develop such interventions since most of the costs associated with providing benefits to disabled individuals are borne by federal programs. A pay for success initiative that shared the savings from reduced DI and SSI spending with state governments that established successful initiatives in this area could serve to better align federal and state incentives.

Prenatal & Early Childhood Home Visiting
Home visiting programs for low-income pregnant women and their children have been shown to improve maternal and child health, prevent child abuse, and increase school readiness. These programs result in healthier children and families and lower costs for

taxpayers, yet many of these benefits accrue to the federal, not state or local, government. By providing outcome payments for some of these federal benefits, particularly Medicaid savings, the Innovation Fund could spur PFS projects in this area. Key partners in a PFS contract would include the Federal and state/local governments as outcome payers, service providers who deliver evidence-based home visiting models, and potentially an intermediary organization to raise capital and manage the project. Appropriate short-terms outcome metrics, which could be measured within two years, could include reductions in low weight births, reductions in Emergency Room utilization during the first years of life, and improved child cognitive and social functioning. Longer-term outcome metrics, which could be measured in 4-6 years, could include utilization of special education services, receipt of TANF and other cash assistance, and increased maternal wages/earnings.

Permanent Supportive Housing
There is some indication that permanent supportive housing programs for chronically homeless individuals can reduce utilization of government-funded services, including hospitals, shelters, drug treatment facilities, and jails/prisons. These benefits are likely to be greatest for programs that target the highest utilizers of these services. These interventions have the potential to reduce federal Medicaid spending and to reduce the need for some types of emergency assistance and criminal justice spending. The Federal government could support local initiatives in this policy area either by make a share of the performance based payments or by providing incremental housing vouchers to partially pay for the supportive housing units. Key partners in a PFS contract would include the Federal government and state/local governments as outcome payers for services, service providers who deliver evidence-based support models, and potentially an intermediary organization to raise capital and manage the project. Appropriate short-terms outcome metrics, which could be measured within two years, could include decreased utilization of the government-funded services outlined above. Longer-term outcome metrics, which could be measured in 4-6 years, could follow-up on usage patterns in addition to tracking housing permanency, and employment and earnings.

Collective Impact Initiatives
A major challenge for federal funding of social programs is that they generally operate in silos. A given neighborhood or vulnerable population may receive benefits from a large number of different funding streams. Usually these funding streams simply pay for slots in programs. No one is accountable for the overall success of the neighborhood or population. The Treasury Innovation Fund could dedicate some of its resources to investing in pay for success projects that attempt to better coordinate the large number of dollars that the federal government (along with local governments and philanthropic organizations) is already spending in high poverty neighborhoods. Such an effort could be coordinated with other place-based initiatives such as Promise Zones.

7. What process would be most helpful to states, local governments and tribes to apply for either outcome payments or financing supports? What do states and localities need in order to be ready to participate in a competitive process and resulting projects?

Incentive Funds should be allocated through a competitive procurement process at the federal level. While we recommend a strategy below for how to structure this process, the critical feature is that it allow simple and timely access to allocated funds. Regardless of how projects are evaluated for awards, it is imperative that state/local governments have a clear understanding of important deadlines, including dates of submission and award/receipt of funds, in order to plan for projects accordingly. Delays in any part of the process will cause uncertainty, impacting not only the government, but also the service providers and investors involved in the transaction. Therefore, in structuring the procurement process, it is recommended that a strong focus be directed toward transparency and the development of an expedited timeline that both the federal and state/local governments strictly adhere to.

Two of the most important aspects of the application process will be flexibility and timing. Elements of the procurement process, including the type of information to solicit from respondents, length of response period, and evaluation criteria, should be determined in a deliberate manner that is accommodating to respondents. Examples of flexibility include allowing state/local governments to submit partially developed proposals or proposals that include letters of interest from potential service providers and investors in place of formal partnership agreements. In scenarios where formal commitments from multiple parties are required, timing will become critical. Allocating sufficient time for parties to develop relationships, negotiate, and collaborate on a project proposal will ensure that applicants are able to adhere to deadlines.

We suggest structuring federal procurement as a two-tiered process. First, the Department of the Treasury should collaborate with specific federal agencies that have a strong interest in utilizing PFS projects to address important priorities. These agencies could then issue distinct procurements, seeking proposals from state/local governments who have developed or plan to develop PFS projects in the pre-specified issue areas. This approach is similar to the process used by the Department of Labor in 2012-2013.

Concurrent with the Department's collaboration with specific federal agencies, Treasury could also lead its own procurement effort that is more general in scope. This effort would allow projects addressing additional issue areas to benefit from Incentive Fund support. PFS projects that span multiple agencies and issue areas, for example collective impact projects, would benefit from this type of broad procurement process. Given the complexity of assembling these projects and the uncertainty about when projects will reach the stage to be ready for engagement with the federal government, it would probably make sense for Treasury to run an initial procurement process with a specific application deadline, and then to accept additional proposals on a rolling basis after that deadline.

Responding to a federal procurement through either of these avenues would require state/local governments to submit detailed written proposals of PFS projects. Proposals would likely require substantial planning in order to document enough detail to warrant consideration by the federal government. While some state/local governments may be prepared for this process, it will likely be challenging for most governments without technical assistance and guidance. The SIB Lab currently addresses this capacity challenge with ten state/local governments by providing a full-time Government Innovation Fellow who is solely dedicated to the PFS project. We have found that devoting at least one FTE government employee to the project has been critical to success to date. State/local governments need this type of support in order to develop a project proposal, particularly if they plan to respond to a federal procurement.

8. The ability to ensure that outcome payments are available for successful projects, either directly or via credit enhancement has been a significant risk that the Fund would help to address. Are there other functions that the Fund should serve in order to accelerate adoption and testing of the PFS model?

The activities of the Innovation Fund should be structured to maximize the amount of information about the PFS model that is gathered and disseminated. A condition of federal involvement should be a requirement that all project details, including transaction structures, evaluation methodologies, performance targets, payment schedules, and PFS participant contracts be made publicly available. Transparency around PFS transactions will help the model spread more rapidly, as follower localities can benefit from the experiences of initial adopters. Requiring beneficiaries of federal incentive funds to release full details about their financing and evaluation methodologies will result in standardized frameworks, tools, and contract terms which will spur the adoption of best practices and enable future transactions to be developed more rapidly.