INSTITUTE for CHILD SUCCESS

Comments for the Record of the Hearing on

Social Impact Bonds: Can They Help Government Achieve Better Results for Families in Need

In the Subcommittee on Human Resources of the Committee on Ways and Means

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Introduction

The Institute for Child Success is excited by the progress of discussions in Congress surrounding Pay for Success financing models (often called Social Impact Bonds). We thank Representatives Young and Delaney for their leadership in proposing H.R. 4885, and also thank Chairman Reichert for holding a Subcommittee hearing to discuss this topic on September 9, 2014.

The Institute for Child Success respectfully submits the following written comments to the hearing record for your consideration. In these comments, we begin with an overview of our perspective on the benefits of Pay for Success financing, and how these financing models can be particularly advantageous for programs serving our youngest children. We then discuss the substantial benefits of federal involvement, the reasons that legislation is necessary for meaningful federal engagement, and the ways in which H.R. 4885 responds to that need.

Like with any new and exciting innovations, we should also resist the temptation to treat Pay for Success financing as a cure for all ills. Indeed, many have voiced significant concerns – including one of the witnesses at the Subcommittee's hearing on September 9, 2014. We too want to acknowledge the limitations of social impact bonds, and address how 4885 appropriately handles those limitations; we discuss several of these issues at the end of these comments.

Benefits of Pay for Success Financing (or Social Impact Bonds)

Pay for Success financing is a model that can help scale-up effective interventions to improve outcomes for young children, while saving governments money. The fundamental structure is well known to many, so we will only provide a very brief overview here. At its most basic level PFS involves four components:

- A program or intervention that has been tested, and has demonstrated that it produces desired outcomes and that its benefits exceed its costs;
- Investors that provide the upfront capital required to bring the intervention up to a larger scale;
- A government entity that agrees to repay the investor if the agreed-upon outcomes are realized; and
- An independent evaluator that determines whether the intervention accomplishes the pre-determined outcomes and, therefore, the government should make payments to the investor.

Because of the novelty and complexity of these arrangements, a third-party intermediary has also been involved in many of the Pay for Success contracts entered into to-date.

Pay for Success financing provides a number of benefits over traditional government mechanisms for selecting and scaling up interventions, including:

- It allows governments to shift resources towards effective prevention and early intervention;
- It draws on expertise and energy from outside investors (either commercial or philanthropic), who ultimately bear much of the financial risk if a program is ultimately not effective at scale;
- A rigorous cost and savings analysis is necessary to even consider a Pay for Success arrangement, increasing the ability of the government to select interventions wisely; and
- Outcomes measurement is a centerpiece at every step, allowing the necessary tracking processes to be "baked in" to an intervention from the very beginning.

Taken together, these benefits allow for the

- Extension of public-private partnerships;
- Increased efficiency and accountability of social program performance;
- Guarantee that governments only pay for outcomes rather than for services provided.

Pay for Success and Effective Early Childhood Interventions

As we discussed in our January brief on this topic, Pay for Success is particularly well suited to help scale effective early childhood interventions.[1] Many interventions exist today with long-term outcomes that are both independently compelling and result in significant cost savings to governmental entities. Those outcomes include:

- Fewer preterm births,
- Fewer teen pregnancies,
- Fewer closely spaced second births and fewer preterm second births,
- Fewer injury-related visits to the emergency room,
- Reductions in child maltreatment,
- Children more ready for kindergarten,
- Less youth crime,
- Reduced incarceration rates,
- Higher achievement in school or careers,
- More economically independent mothers, and
- Increased lifetime earnings.

Yet despite wide agreement that we should develop and implement these effective early childhood interventions broadly, it is very challenging to do so. Many governmental agencies are working to

[1] Institute for Child Success, *Pay for Success Financing for Early Childhood Programs: A Path Forward*, 2014, available at: http://www.instituteforchildsuccess.org/mydocuments/pay_for_success_ financing_for_early_childhood_program2.pdf.

implement effective early childhood interventions, but those efforts are far from full-scale. Two barriers stand out:

1) **Resources are tied up in responding to problems, leaving little room for prevention.** Governments are busy putting out fires – that is, responding to problems after they happen – and after more cost-effective responses are no longer an option. Given the fiscal pressure faced by all governmental entities, government is rarely able to devote sufficient up-front resources to developing or implementing effective methods to prevent problems in the first place, even if those approaches would save money in the long run. For instance, the Institute of Medicine has documented the costs of failing to focus on prevention, finding that many mental, emotional, and behavioral disorders in young people are preventable, but that prevention remains underfunded.[2]
2) **The costs of wide-scale implementation are immediate, but the payback takes time.** Although many programs will deliver both social and financial returns, those benefits take time. Governments often find it difficult to afford investments with delayed returns.

Pay for Success can help address both of those barriers. Governments are able to implement tested interventions without immediately burdening the budget, since the model allows government to wait until the relevant outcomes are met before payments must be made. If those interventions are ultimately effective at scale, then the resulting cost-savings can be used to repay the investors' principal and any premium that is agreed to at the outset. Moreover, if the interventions do not produce the agreed-upon outcomes, and the government doesn't realize the cost savings as a result, then the investors (who bear the financial risk) and are not repaid.

It is important to note: all parties benefit from having investors who are mindful of the outcomes and want the program to succeed. The interventions that are currently best suited to Pay for Success financing have already been rigorously tested at a smaller scale. Much of the risk, then, relates to the difficulties inherent in scaling a program to a significantly larger size and serving different populations, which are challenges with which some investors have significant expertise. In other words, while the investors bear the risk of failure, they can also help reduce that risk in some cases.

Why Does the Federal Government Need to Get Involved

One of the questions that often arises in discussions about Pay for Success is this: Why is it important for the federal government to get involved? The simple answer is that many effective interventions

[2] National Research Council (US) and Institute of Medicine (US) Committee on the Prevention of Mental Disorders and Substance Abuse Among Children, Youth, and Young Adults, *Preventing Mental, Emotional, and Behavioral Disorders Among Young People: Progress and Possibilities*, 2009, available at http://www.ncbi.nlm.nih.gov/books/NBK32775/

produce positive results and save money at both the federal and state or local levels and, for many of those, the federal government has a significant interest.

For example, some pre-natal interventions result in the reduced pre-term births, which also reduces risks of traumatic and costly medical complications.[3] For infants from low-income families, those improved birth outcomes also result in significant savings to Medicaid. For a state that only pays for 30% of Medicaid services, however, most of the long-term savings (70%) will be passed on to the federal government. Congress should, therefore, position federal programs to foster and leverage those outcomes. If it does so, both states and the federal government will benefit, as more cost-effective interventions will be viable for Pay for Success financing.

In addition, the federal attention and funding will incentivize jurisdictions around the country to increase accountability for outcomes in government programs. Identifying the most effective programs and tracking their outcomes requires capacity and effort. This legislation will support and incentivize jurisdictions to build that capacity. The result will be more cost-effective government programs and better outcomes for our communities and our country.

Why Do We Need Legislative Action to Encourage Pay for Success

The typical appropriations process presents two significant barriers that prevent agencies from engaging in meaningful Pay for Success deals, both of which are addressed by H.R. 4885. First, Federal appropriations typically have to be "obligated" by September 30 of any given fiscal year. What we've learned over the last few years is that many of these deals take more than one year to develop to the contract-signing phase. Knowing that the money may vanish after months of diligent work, but before a deal is finalized, is a substantial hurdle.

Second, federally appropriated dollars typically have to be disbursed within 5-years after the fiscal year in which they are appropriated (under 31 U.S.C 1552(a)). Many Pay for Success contracts are best suited to something a little longer than a 5-year window, if only because most programs take a couple of years to reach scale, and long-term outcomes may take several years to be fully measured after that. As an example, the first Social Impact bond out of the United Kingdom was a 6-year contract.

Both of those barriers require Congressional action, but the fix is relatively simple: provide appropriations that are expressly available for a longer amount of time. H.R. 4885 does so. However, there is a larger challenge the federal government will face as it engages in Pay for Success deals, and that is a challenge of human capital. Federal entities are generally not experienced in this field, and we

[3] Institute of Medicine, *Preterm Births: Causes, Complications, and Prevention,* 2006, available at: http://www.iom.edu/~/media/Files/Report%20Files/2006/Preterm-Birth-Causes-Consequences-and-Prevention/Preterm%20Birth%202006%20Report%20Brief.pdf.

need to develop that expertise in a deliberate fashion. H.R. 4885 creates an interagency working group that is led by Treasury and includes officials from several agencies. Through that mechanism, we can begin building expertise throughout the federal systems, allowing us to operate more sustainably in this field going forward.

What are the Limitations and Challenges of Pay for Success

As with any exciting policy innovation, it is easy to lose sight of the limitations and challenges. There are some problems for which Pay for Success is simply not a solution. For example, it does not provide a sound model for funding programs, or for encouraging better evaluation of programs, that are already operating at scale. It also is poorly suited to fund untested innovations (though, a robust Pay for Success mechanism might encourage novel innovations to look to robust evaluation early).

Similarly, Pay for Success might not make the most sense in those rare circumstances where success is nearly guaranteed, because the model does involve premium payments in exchange for investors bearing the risk of failure. In a case where there is very little risk, then the investment would be less beneficial from a financial perspective. Even in that scenario, however, Pay for Success financing may provide governments the fiscal relief they need to help shift resources from remediation towards prevention by enabling them to pay at the end of the project rather than at the beginning.

Moreover, Pay for Success financing deals are just difficult to put together, from a technical perspective. We expect those technical challenges to diminish as the number of deals increase, which H.R. 4885 would facilitate. At the moment, though, Pay for Success deals are only appropriate for projects that are large-scale enough that the benefits exceed the transaction costs.

What are some of the technical challenges of Pay for Success financing?

- **Identifying rigorously tested interventions:** We have to find and develop interventions with rigorous evidence of outcomes. There are many interesting interventions out there with great confidence in, but little proof of, their results. So the first hurdle is identifying the rigorously tested programs, and then also encouraging promising programs to develop the kind of evidence that investors and governments need. H.R. 4885 wisely emphasizes the importance of feasibility studies to address both of these issues.

- **Identifying governmental entities:** One difficulty here flows from the fact that cost savings, especially from early childhood interventions, often cross governmental domains - from Medicaid to juvenile justice to education. It is sometimes difficult to find a single agency that reaps enough of the benefits to afford the full costs of a successful program. H.R. 4885 addresses this issue in two ways. First, the interagency working group is a single entity that can look at benefits across the federal government and, second, the legislation is created to support state and municipal deals that have a federal component.

- **Identifying appropriate outcome metrics:** We have to be very cautious to identify outcome metrics with which the service providers, the investors, and the government are all comfortable. This is one of the most challenging elements, particularly with respect to concerns over creating perverse incentives. PFS financing should also avoid the danger that providers will "game the system." It can avoid that risk by evaluating outcomes compared to a control group or a matched comparison group. If the evaluation is well designed, any changes in how outcomes are measured will affect both the program group and the control group equally, and thus will not translate into misleading results. This challenge is also why building expertise and collaboration within the federal contracting system – as H.R. 4885 proposes – is critical to long-term success.

- **Building the system to measure success:** As mentioned above, a centerpiece of Pay for Success financing is rigorous and ongoing outcome measurement, which is challenging for even the best-resourced programs. Pay for Success, however, builds that evaluation into the model from beginning to end, and in such a way that it cannot get lost in the shuffle – investors only invest, and only get a return, if successes are measured and verified by an independent evaluator. H.R. 4885 supports that model by expressly requiring that the evaluation mechanisms be identified at the beginning.

Given these difficulties, why is so much progress happening anyway?

- **Investors are asking for it:** We frequently hear from bank executives that their high-net-worth clients increasingly seek investments that are in line with their values. More and more, the industry is focusing on generating both direct financial returns *and* positive social outcomes.

- **Governments are looking for more cost-effective strategies to achieve public goals:** Governments – at all levels – spend a tremendous amount of resources responding to crisis situations and providing remediation services. Those governments would normally have to sacrifice some of those critical services to invest resources in early interventions. Pay for Success allows governments breathing room to pay for interventions out of the long-term savings they produce. This is also a phenomenon that makes Early Childhood an ideal sector for Pay for Success financing, given the magnitude of long-term savings produced. Moreover, Pay for Success financing helps governments move in a direction they are increasingly interested in: toward analyzing benefits and costs of specific strategies and choosing the ones that produce the best value for taxpayers.

Conclusion

Pay for Success Financing is a very promising model for scaling effective early childhood interventions while saving governments money in the long term. The Institute for Child Success is very encouraged by the attention this financing model has received by our elected officials at the federal level, and we are even more encouraged by the introduction of legislation like H.R. 4885. This financing model is challenging, especially for the federal government, but has tremendous potential for improving our collective fiscal position while directly improving social outcomes. We look forward to continued work with the Subcommittee and Congress on this issue in the weeks and months to come. Thank you for the consideration of these comments.

About the Institute for Child Success

The Institute for Child Success is a research and policy organization that leads public and private partnerships to align and improve resources for the success of young children in South Carolina and beyond. A partnership of the Greenville Health System's Children's Hospital and the United Way of Greenville County, ICS supports those focused on early childhood development, healthcare, and education—all to coordinate, enhance, and improve those efforts for the maximum effect in the lives of young people. For more information: www.instituteforchildsuccess.org.