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CHAPTER 1: Introduction: outcome-based payment and the reform of public services

Abstract

This chapter introduces outcomes-based commissioning, Payment by Results and Social Impact Bonds (Pay for Success Financing in the US). Payment by Results and Social Impact Bonds are described in brief, along with their origins and current scale. On both sides of the Atlantic their development has been rapid and we place them in the context of the wider social impact investing market.

Key words

Payment by Results, Social Impact Bonds, Pay for Success Financing, Social Impact Investing

Outcomes-based commissioning

Over recent decades on both sides of the Atlantic we have experienced important social gains. Average life expectancy has continued to rise, employment rates have risen, participation in higher education has increased, crime has fallen and technological innovations have provided new opportunities for work and play for many. But change has also brought challenges that include: increasing inequality; an ageing population; rising levels of childhood obesity; changes in family size and structure; loss of traditional industries; new working practices; a more mobile population in Europe and a less mobile population in the US; and the erosion of social capital. Almost 20 years into the new millennium, the 'wicked problems' (Rittel and Webber, 1973) we face are remarkably similar to those we faced at the end of last millennium: adults and families that experience multiple social, economic and health challenges.

Meanwhile the role and structure of the public sector has also changed with government increasing its reach in some areas of social and economic life and withdrawing from others. New models of commissioning and delivering services have evolved and, since 2008 public services on both sides of the Atlantic have experienced budget cuts in real terms.

In this fast-changing world outcomes-based commissioning has become an important element of the public service reform agenda and underpins two distinct but related approaches. On the one hand 'Payment by Results' (Pay for Success or outcomes-based funding in the US) is arguably rooted in New Public Management approaches, whereas 'Social Impact Bonds' (pay for success financing in the US) are associated more closely with the social finance movement and impact investing. However, Social Impact Bonds (SIBs) can also be understood as a class of Payment by Results (PbR) and both analysed as the logical conclusion of outcome-based performance management (OBPM) (Lowe and Wilson 2015), as they are intended to ensure that financial rewards directly flow from the achievement of specified outcomes. OBPM is a general term used for using outcomes as a means of assessing performance (Lowe 2013).

To date the study of payment by results and social impact bonds is limited and emerging. The majority of publications to date are policy briefings produced by government departments, industry leaders, and Think Tanks. Such publications should be treated with caution because their treatment of the (limited) evidence base is often partial, they sometimes 'gloss over' theoretical and ideological debates that are not consistent with their agenda, and the tools they discuss are still in their infancy.

The distinction between Payment by Results/Pay for Success and Social Impact Bonds/Pay for Success Financing

It is important to begin with clear definitions about the two principle theoretical constructs we examine here. In brief, the terms 'Payment by Results'/'Pay for Success' (hereinafter PbR) describe models of outcome-based commissioning where payment is made, in part or entirely, contingent on the achievement by the contracted agent of specified goals or targets.[1] This is a departure from more traditional forms of public

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[1] It is possible, of course, for government to pay up-front, where the PbR/PFS contract includes a repayment clause if the service provider *fails* to meet specific targets. The Social Impact Guarantee Model (Overholser 2017) is an example.

sector funding, where (typically in the UK) payment is often made 'up front' often based on previous service use, demand, and/or staffing levels or (typically in the USA) paid post hoc to cover costs of salaries, services and administrative costs or for specific outputs. In contrast, the terms 'Social Impact Bonds'/'Pay for Success Financing' (hereinafter SIB) describe PbR funding models where the finance needed to make the contract work and to fund social outcomes is provided, not by the service provider, but by private investors.

However, it is important to bear in mind, a particular intervention may entail aspects of both commissioning and funding innovation. Also, there are levels of government to consider; for example, the national or federal government might contract to a local or city government. Hence, in practice the distinctions we draw in theory may be less clear in application.

Payment by Results (PbR)

Over recent years, there has been increasing interest in PbR as a model for commissioning services in the public sector. A PbR contract links payment to the outcomes achieved, rather than the inputs, outputs or processes of a service (Cabinet Office 2011). By making some or all of payment to a service contingent on delivering agreed outcomes, PbR supposedly reduces 'micro-management' on the part of the commissioner, encourages innovation and transfers risk away from the branch of government commissioning the service towards the service provider or investor (in the case of SIBs) because government will only pay if outcomes are achieved. From government's perspective payments for service are deferred. Given the need to reduce public sector spending, both the transference of risk and deferring payment for services are attractive propositions for government. Typically, where payment by results is used to commission services in the UK it only constitutes a part of value of the contract. The proportion varies widely. For example, in the UK, PbR accounted for approximately 80 percent of the value of the Work Programme contracts, but only around 10 percent of

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Although a form of outcomes-based commissioning, it might rather be termed "Repayment for Failure" than Pay for Success.

the contracts for offender rehabilitation under the Transforming Rehabilitation programme.

Many PbR programmes in the UK are delivered by private sector providers, sometimes working in partnership with the not-for-profit (NFP) sector. These private sector 'prime' contractors are primarily motivated by financial profit, although they are of course also delivering social outcomes. Not all PbR programmes in the UK have involved the private sector. For example, in the Troubled Families programme uses a PbR model to commission local authorities to deliver services to families with complex needs.

Social Impact Bonds (SIB)

In a PbR contract production of social goods must be carried out before any results – success or otherwise – can be observed and hence payment made. Deferred payment may favour some classes of organisations (those with large capital reserves or those that can raise capital) at the expense of other classes of organisation (those whose constitution places restrictions on how they use capital reserves or those that cannot raise capital). It is partly to address this issue that Social Impact Bonds were developed (Social Finance 2009). A SIB is a class of PbR contract where the finance needed to make the contract work is provided, not by the service provider, but by private investors. To date, these have usually been social investors: investors who consider both social and financial returns. Social Impact Bonds are also associated with a broader 'social investment' movement (discussed below). In its strategy for *Growing the Social Investment Market*, the UK Coalition Government (2010 – 15) identified SIBS both as a mechanism for expanding the use of Payment by Results (HM Government 2011, paragraph 4.3) and as an investment vehicle to expand the social investment market, likened to a type of Social ISA[2] (ibid, paragraph 5.6).

Social Impact Bonds are not strictly speaking bonds (that is to say, debt instruments), but rather are a class of PbR contract where the up-front finance for the contract is provided by third-party investors rather than providers. In this sense SIB funded provision of public services is analogous to the UK's Private Finance Initiative (PFI)

[2] An Individual Savings Account with a tax free allowance set by government to encourage individuals to save.

funded provision of public infrastructure. However, early proponents distinguished SIBs from other forms of outcome-based payment by emphasising their alignment of social and financial returns on investment, that service provider costs are covered by investors up-front minimising risk transfer to smaller, third sector providers and the potential for them to bring together groups of social investors and portfolio's of interventions (Social Finance 2009).

SIBs have several distinct elements:

- An investor. To date investment has tended to come social investors (Ronicle et al. 2014), although some initial programs in the US had private investors and other projects had alternative financing structures (Mulgan et al. 2010, Social Impact Task Force 2014);
- A programme of actions to improve the prospects of a target group (Mulgan et al. 2010), that is to say, a group in need of public services; and
- Commitments by a commissioner (to date, usually national or local Government) to make payments linked to particular social outcomes achieved by the group (Mulgan et al. 2010).

Although different models of SIB are possible (see for instance Mulgan et al. 2010 and Ronicle et al. 2014), a common model is a SIB that is delivered through a Special Purpose Vehicle (SPV): a legal entity, owned by investors, service providers, or an intermediary or some combination thereof, created to undertake specific objectives while insulating the owners from financial risk. The SPV holds the contract with the commissioner (payer) and contracts with one or more organisations which will provide the interventions required to achieve the outcome(s) specified in the contract between the SPV and the commissioner. This structure was used in the first SIB at HMP Peterborough (Disley et al. 2011). Ronicle et al (2016: ii) note that organisations are still innovating to develop new contractual and financial structures and therefore any attempts to constrain the definition of a SIB are "likely to stifle such innovation, within what is a relatively new and developing area of contracting for services".

Origins and scale

Commissioning for outcomes

Payment by Results is not a new phenomenon, dating back, in education at least, to Victorian England (Mitch 2010). Although there was some success at first in the Victorian application of PbR, in the end, the experiment was abandoned, in part because the Treasury felt the costs of administration and evaluation made the overall project inefficient. There were also concerns that the system was unfair to some church and volunteer run schools and liable to corruption in the "results" measure (ibid.). These same concerns are often highlighted in the modern PbR literature.

The UK Coalition government (2010-15) committed to "introducing payment by results across public services" (Cabinet Office 2011: 9) and introduced schemes across diverse areas of policy including welfare to work, substance misuse, criminal justice, family interventions and overseas development. In a thorough review of the current situation in the UK, the National Audit Office (NAO) (2015) identified over 50 schemes worth a combined total of at least £15 billion. Subsequently the re-organisation of probation services and creation of Community Rehabilitation Companies involved a PbR element (MoJ 2013).

Social Impact Bonds

Early arguments for SIBs emphasised their potential to bring more private and public investment into early intervention and preventative measures, an area that historically, charitable trusts and foundations had addressed (Social Finance 2009). Social Finance (2009) give various examples including that of £92 billion health expenditure in England, only 3.7 percent is spent on preventative interventions, that in relation to mental health £10 billion is spent on benefit payments alone, while only £2 million is spent on mental health promotion and that the government spends almost £1.5 billion on school truancy and exclusion, but only £111 million on preventative initiatives. Early arguments also drew on a wider trend towards 'social investing' including interest from investors and philanthropists in combining commercial and social returns; advances in government methods for assessing the impact of public investments on human capital, widespread experience of private finance initiatives and public private partnerships, the development of markets for carbon trading, and experiments in health around advance market commitments (Mulgan et al. 2010).

Social Impact Bonds, it was argued, would align stakeholder interests around specific social outcomes. The long-term vision was ambitious:

> "Social Impact Bonds enable foundations, social sector organisations and government to work in new ways and to form new partnerships. By aligning the interests of all parties around common social outcomes, Social Impact Bonds have the potential to address some of society's most intractable problems." (Social Finance 2009: 4)

Thus, SIBs would supposedly enable change in four distinct ways: by unlocking an unprecedented flow of social finance; creating an incentive to develop the evidence base; creating an incentive to innovate; and changing the role of government so that its focus was on defining social priorities and bringing resources and expertise to bear (Social Finance 2009).

The Cabinet Office's Centre for Social Impact Bonds[3] reports that there are now 32 Social Impact Bonds across the UK, supporting interventions in areas such as: youth unemployment; mental health; and homelessness (Ronicle et al. 2014, Tan et al. 2015). Nearly twenty SIBs in the United States have started delivering services, primarily clustered in three areas: criminal justice; early childhood education; and homelessness. Ronicle et al. (2014) note that a key difference between UK and overseas experience is that SIBs outside the UK have tended to be funded by institutional rather than social investors; for example Goldman Sachs in the US. However, more recent experience indicates the US is moving back toward social investors.

Social impact investing

Social Impact Bonds are one element of an international social impact investing movement. The OECD (2015: 10) defines social impact investment as: "the provision of finance to organisations addressing social needs with the explicit expectation of a

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[3] https://data.gov.uk/sib_knowledge_box/home [Accessed 14-03-15]

measurable social, as well as financial, return." The Social Impact Investment Taskforce established under the UK's presidency of the G8 in 2013 was given the objective of "reporting on 'catalysing a global market in impact investment' in order to improve society" (Social Impact Investment Taskforce 2014: unnumbered). In 2014 its report *Impact Investment: the Invisible Heart of Markets* it was claimed that:

> The world is on the brink of a revolution in how we solve society's toughest problems. The force capable of driving this revolution is 'social impact investing', which harnesses entrepreneurship, innovation and capital to power social improvement. (Social Impact Investment Taskforce 2014: 1)

The size of the social investment market is difficult to estimate because of definitional issues (OECD 2015). The Global Impact Investing Network (GIIN) (2017: 58) defines impact investing a "investments made into companies, organizations, and funds with the intention to generate measurable social and environmental impact alongside a financial return". The 205 respondents to its annual survey invested $22.1 billion into nearly 8,000 impact investments in 2016 and in total, 208 respondents were currently managing $114 billion in impact investing assets. This implies that the total market is larger, because not all investors will be captured by the survey. A subset of respondents to the GIIN survey who had answered repeated annual surveys reported increasing their impact investing assets under management from $25.4 billion in 2013 to $35.5 billion in 2015 an annualised rate of growth of 18 percent (GIIN 2016).

The OECD notes that, as in traditional finance, social investment instruments can include grants, loans, guarantees, quasi-equity, bonds and equity and, at the moment most social investment is still in the form of grants. Social Impact Bonds represent a small but innovative element of the market. This is borne out by the GIIN (2017) report where pay-for-performance instruments such as Social Impact Bonds accounted for 0.2 percent of the $114 billion of assets under management in 2016.

Some key questions raised by outcome-based commissioning

This book addresses three, recurring themes that, crudely, raise technical, economic and political questions about outcome-based commissioning:

- Technical: As a technical innovation, does outcome-based commissioning lead to better services? Does outcome-based commissioning encourage innovation in service design? What (dis)incentive structures do these models create both for service delivery organisations and individuals that work or volunteer within them? If there are gaps in the evidence-base, why is this and how might they be filled?

- Economic: It has been argued, particularly in the UK, that outcomes-based commissioning is part of a trend to 'marketise' the delivery of traditionally public services. This debate, absent in the USA, often sidesteps the question of policy makers' incentive structure, implicitly assuming an *a-priori* bias towards public-sector outsourcing. We take a step back and consider the political/economic rationale of such commissioning and the developments of markets in delivering public services in the context of PbR and SIBs.
- Political: What is the potential scope of outcomes-based commissioning – where might this emerging 'market' go next, what is its potential to expand and what are the alternatives? What do 'social finance' and 'impact investing models' suggest for the future of traditional charitable and philanthropic activity? More fundamentally, what does outcome-based commissioning suggest to us about the changing role of the state and its relationship with citizens as service users and the public, private and not-for-profit sectors as service providers?

About this book

This book reviews the UK and US experience of PbR and SIBs, and asks whether these approaches to commissioning services are efficient ways to unlock new capital investment in order to advance social goods.

It is the first academic publication to attempt a comprehensive synthesise experience and evidence from the UK and US. In many ways, we will see that there are parallel developments between the two nations, but different back-stories. Whereas in the UK, the primary driver of outcomes-based commissioning has been the public sector, as government seeks to sub-contract already existing public services, in the USA, the primary driver is the provision, by the private or philanthropic sector, of new public services.

This book will provide a balanced overview of a field where much of existing evidence is sparse. We will build on and develop the limited theoretical discussion and, in particular, explore two themes: one that PbR and SIBs drive efficiency and innovation in the delivery of social outcomes; the other that attempts to reconcile corporate profits and social goods may lead to perverse incentives and inefficiency. We will also consider the impact of these approaches on not-for-profit and smaller players in the market for social outcomes.

This book is intended for academic researchers and students in the fields of social innovation, social policy, political science and economics, as well as policy-makers in the UK, US and Europe who are being urged by politicians to consider this form of policy innovation.

In Chapter Two we set out some key theoretical issues that are raised by outcome-based payment systems and argue that, to date, this area is theoretically under-developed. In Chapters Three and Four we provide an overview of the current situation in the UK and the US. We describe how outcome-based payment has developed and pay particular attention to describing all current SIBs in both countries and the infrastructures that have developed to support them. In Chapter Five we report the findings of a structured review of all published evaluations of PbR and SIBs in the UK as well as a brief overview of SIB evaluations published in the US. In Chapter Six we draw conclusions from the evidence we have reviewed, address the theoretical issues set out in Chapter Two and discuss, briefly, future directions.