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## Commissioning of Services by Charities in the Third Decade of the Contract Culture: Lessons Learned (or Not Yet)

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### I. Introduction

The question for debate in this chapter is whether Payment by Results (PbR) contracts in general, and, in particular, the use of Social Impact Bonds (SIBs), are an effective means by which charities might be funded to deliver public services. Such payment mechanisms are becoming increasingly common methods to fund charities and other public service providers. Whilst charities might be best placed to deliver certain services, the debate will be framed by arguing that inherent risks of PbR contracts present significant challenges for them. The problems identified are particularly acute for smaller charities, which make up the vast majority of the charitable sector. There will be a critical assessment of potential solutions intended to overcome those challenges, together with analysis of the results of various studies of their use. These suggest that a number of those potentially alleviating measures do not resolve the difficulties that largely remain in place. Discussion of the debate question will conclude that, whilst charities are regarded as important players in the delivery of public services,<sup>2</sup> the PbR funding environment may well prohibit their participation. Whilst this chapter focuses on the UK, which has been a pioneer in this area (in developing the first SIB in the world), similar payment structures are growing in popularity across the globe and are particularly prevalent in Australia and the US.

<sup>1</sup>I would like to thank both the editors and the anonymous review for their helpful comments. Any errors are my own.

<sup>2</sup>See, eg, Cabinet Office, *Civil Society Strategy: building a future that works for everyone*, (HM Government, August 2018). This sets out the steps that government will take to support a framework of collaborative commissioning, so as to create a more diverse marketplace of suppliers. See also speech by the Minister for the Cabinet Office, David Lidington, which preceded the publication of the strategy: David Lidington, 'Chancellor of the Duchy of Lancaster speech to Reform' (Speech at Reform, 25 June 2018) [www.gov.uk/government/speeches/chancellor-of-the-duchy-of-lancaster-speech-to-reform](https://www.gov.uk/government/speeches/chancellor-of-the-duchy-of-lancaster-speech-to-reform).

By way of background, the 1990s saw a marked shift in the UK from state funding for charities through grants, to the awarding of contracts in exchange for the provision of services. This phenomenon was coined the ‘contract culture’ and it brought many problems in its wake, particularly for smaller charities.<sup>3</sup> Early empirical research by the author revealed that contract funding relationships in practice bore little relevance to theoretical legal analysis of those contracts.<sup>4</sup> Furthermore, the contracts often created legal risks to charities of which the trustees were unaware, as well as threats to charitable independence.<sup>5</sup> Since that time, the trend towards service delivery by charities under contract in the UK and elsewhere has continued and gathered pace. The 2019 Civil Society Almanac from National Council for Voluntary Organisations (NCVO) reports that, in the UK, by 2016–17, the sector received £15.8 billion (31 per cent of its total income) from government bodies, and the social services subsector continues to receive the largest proportion of income from government (45 per cent).<sup>6</sup> Data produced for the 2018 almanac reported that 74 per cent of government income for charities was earned through contracts or fees.<sup>7</sup>

As we approach the third decade of this changed funding environment for charities, this chapter will analyse remaining challenges faced by contracting charities. Whilst some legal changes have been positive (for example, the creation of a new legal form for charities, more suited to entering into contractual relationships<sup>8</sup>), changes in public policy and contract provisions have brought additional challenges. It will be seen that the growing influence of market incentives and commercial principles in social welfare provision are crucial factors affecting charities. In addition, austerity measures in place since 2010 led to unprecedented cuts in public expenditure and increased funding pressures on charities delivering front-line public services. This is at the same time that charities’ services are in more demand.

Contracts with PbR clauses present particular problems for charities and are the focus of this debate. Whilst charities can often be best placed to deliver the desired outcomes, the use of PbR funding models may well exclude them from the market. It will be seen that these contracts are simply too risky for charities. The level of financial risk and the amount of up-front capital required in such a

<sup>3</sup> See, eg, D Morris, ‘Charities in the Contract Culture: Survival of the Largest?’ [2000] *Legal Studies* 409.

<sup>4</sup> D Morris, *Charities and the Contract Culture: Partners or Contractors? Law and Practice in Conflict* (Charity Law Unit, 1999).

<sup>5</sup> See, eg, D Morris and K Atkinson, ‘Charities biting the hand that feeds: relationships with their funders’ in D Morris and J Warburton (eds), *Charities, Governance and the Law: The Way Forward* (London, Keyhaven, 2003).

<sup>6</sup> O Chan et al, *The UK Civil Society Almanac 2019* (NCVO, 2019).

<sup>7</sup> C Benard et al, *The UK Civil Society Almanac 2018* (NCVO, 2018).

<sup>8</sup> The Charitable Incorporated Organisation (CIO) is a new legal structure available for charities that wish to be incorporated. The structure was designed specifically for charities, allowing them to register just once with the Charity Commission as an incorporated form of charity which is not a company. See, in general, Charities Act 2011, pt 11.



model will therefore inhibit the participation of charities. Many are choosing to withdraw from this funding environment, offered by commissioners on a 'take it or leave it' basis. Those charities that do participate often pull out once the full level of risk is appreciated. For example, St Mungo's, a large homelessness charity, is one of a number of specialist voluntary sector organisations that withdrew from the Work Programme, which we will see was funded through PbR contracts.<sup>9</sup> PbR contracts may even contribute to the downfall of organisations, such as Eco-Actif Services, a small social enterprise in Surrey that helped find work for the hardest to employ, which was one of at least four organisations that closed in 2012, citing their Work Programme contracts as a major reason in their collapse.<sup>10</sup> More recently, the final annual report of a legal advice charity, Advising Communities, referred to the fact that it was 'managing an increasingly complicated payment on results environment', before a later announcement that the charity was being placed into liquidation.<sup>11</sup> Finally, the collapse in June 2017 of the Lifeline Project – a drug and alcohol charity with 1,300 employees that had served 80,000 people a year – has been directly linked by its administrators to three PbR contracts with different local authorities between August 2015 and January 2016, entered into 'without undertaking the necessary due diligence and [failing] to realise that the targets set were unachievable'.<sup>12</sup>

These examples of charities and other third sector organisations, with the skills and experience necessary to solve current social problems, either withdrawing from the provision of service or ceasing to exist due to the funding environment, raise significant policy issues. Smaller, newer charities, that may nevertheless have the appropriate specialist expertise to provide public services, are often excluded from the market entirely.<sup>13</sup> Not only do charities miss out on the opportunity to participate in the delivery of welfare services, but would-be beneficiaries are deprived of the potentially innovative capacity<sup>14</sup> of the charitable sector. New and emerging providers, with the potential to disrupt the market, are not enabled to participate. It will be seen, for example, that specific contract forms encourage the

<sup>9</sup> Work & Pensions Select Committee, *Can the Work Programme work for all user groups?* (HC 2013–14, 162-1) para 145.

<sup>10</sup> M Buchanan, 'Work Programme under fire as charities shut down' *BBC News* (London, 4 October 2012) [www.bbc.co.uk/news/uk-19822669](http://www.bbc.co.uk/news/uk-19822669).

<sup>11</sup> L Kay, 'Legal advice charity Advising Communities to go into liquidation' *Third Sector* (9 May 2019) [www.thirdsector.co.uk/legal-advice-charity-advising-communities-go-liquidation/finance/article/1584081](http://www.thirdsector.co.uk/legal-advice-charity-advising-communities-go-liquidation/finance/article/1584081).

<sup>12</sup> Insolvency Service, 'Bolton charity boss banned for causing Lifeline Project to sink', press release (Insolvency Service, 6 June 2019).

<sup>13</sup> In 2015/16, voluntary organisations with incomes of £10 million to £100 million received the greatest amounts and proportions of income from government, with 84% of local government funding going to larger voluntary organisations: C Dayson, L Baker and J Rees, *The value of small. In-depth research into the distinctive contribution, value and experiences of small and medium-sized charities in England and Wales* (Lloyds Bank Foundation, 2018).

<sup>14</sup> See, eg, SP Osborne, C Chew and K McLaughlin, 'The Once and Future Pioneers? The Innovative Capacity of Voluntary Organisations and the Provision of Public Services: A Longitudinal Approach' [2008] *Public Management Review* 51.

participation of the largest, most established, providers. As noted in the 2018 Civil Society Strategy:<sup>15</sup>

The commissioning model which applies in many of our public services, including the services commissioned by local authorities, often favours large companies who are better able to navigate complex commissioning systems, bid aggressively (including with “loss leader” bids to take more of the market), and who can carry the financial risk passed on by commissioners to providers.

The mixed economy of providers, an essential element to provide choice and encourage innovative approaches to long-standing problems, is difficult to achieve. When considering the difficulties experienced by small charities, it is important to note that these affect the vast majority of organisations that make up the charitable sector. Over 85 per cent of registered charities in England and Wales have a turnover of under £500,000.<sup>16</sup>

This chapter will explore the increasingly popular but risky PbR model. It will look at some potential solutions that could reduce charities’ exposure, in particular SIBs. These are a particular form of commissioning tool aimed at enabling organisations to deliver PbR contracts. With a SIB, social investors pay for the project at the start, and then receive payments based on the results achieved by the project. This chapter will analyse research findings on SIBs’ usage that suggest little efficacy at solving the problems identified. In short, the thrust of the argument is that whilst there is much political support for PbR, evidenced in a number of initiatives intended to enhance its use, existing mechanisms do not make the inherently risky PbR environment safe for charities. PbR contracts are not therefore conducive to charities’ participation in the provision of public services.

The next section will illustrate how this increasingly common commissioning model works and will begin a critical examination of the implications of its use for charities.

## II. Payment by Results

Contracts containing clauses that allow for PbR have become more prevalent in the last decade. This means that charities providing welfare and other social services may be funded based on the prescribed and measured outcomes (results) achieved for a target population (for example, getting unemployed people back into work) rather than the services provided (for example, running job clubs). With PbR, financial rewards are dependent on the delivery of results, so that the state pays for services only if they are perceived to ‘work’ by reference to pre-defined expected outcomes. If, for any reason, the provision of service does not result in

<sup>15</sup> Cabinet Office, *Civil Society Strategy: building a future that works for everyone* (HM Government, August 2018) 105.

<sup>16</sup> See: [www.gov.uk/government/publications/charity-register-statistics/recent-charity-register-statisticscharity-commission](http://www.gov.uk/government/publications/charity-register-statistics/recent-charity-register-statisticscharity-commission).

outcomes defined as success, the provider of the service (be it a commercial entity or a charity) bears the consequences. This helps to cut wasteful public spending by transferring financial risk to the provider. However, when the provider of the service happens to be a charity, it is charitable funds that are effectively wasted.

PbR was introduced in UK welfare provision in 2009 as part of the Labour Government's Flexible New Deal<sup>17</sup> programme for the unemployed<sup>18</sup> and its use has increased in recent years. As part of the UK Coalition Government's wider reforms to public services, set out in the Cabinet Office's 2011 White Paper, the virtues of PbR were extolled:<sup>19</sup>

Open commissioning and payment by results are critical to open public services ... Payment by results will build yet more accountability into the system – creating a direct financial incentive to focus on what works, but also encouraging providers to find better ways of delivering services.

The previously documented problems for charities working within the contract culture are exacerbated by the introduction of clauses in those contracts providing for PbR. Legal analysis of PbR contract terms undertaken on behalf of NCVO and involving providers from voluntary, community and social enterprise organisations<sup>20</sup> found similar results to previous research on the contract culture in general. Conclusions, which mirror earlier findings on PbR, include: contracts are designed without consultation on a 'take it or leave it' basis; charities are not seeking legal advice before signing up; and, contract terms and reality of practice are not in line with each other. Many of these issues are inherited from previous poor contracting practice and are due to the absence of charity providers in the crucial early design, commissioning and negotiation stages of contracting.<sup>21</sup> After over two decades of public service commissioning, this is very disappointing.

One potential advantage of the shift in risk towards the provider in PbR is that this should be reflected in the contract terms, which should be less prescriptive around the specifics of service delivery. Where charity providers are being paid for the results achieved, as opposed to services provided, charities should be free to deliver appropriate interventions so as to secure the agreed outcomes. It should not be necessary, for example, to specify in the contract that the commissioner

<sup>17</sup>The Flexible New Deal was compulsory among those who had been claiming Jobseeker's Allowance for 12 months. It was delivered by Jobcentre Plus and private providers. It sought to provide support more tailored to an individual's needs and typically involved the individual undertaking a four-week work experience placement. In June 2011, a new Work Programme began to provide a holistic and comprehensive range of services for all claimants expected to look for work.

<sup>18</sup>Department for Work & Pensions, *Ready for work: full employment in our generation* (Cm 7290, 2007).

<sup>19</sup>HM Government, *Open Public Services* (White Paper, Cm 8145, 2011) paras 5.4, 5.16.

<sup>20</sup>D Hunter and R Breidenbach-Roe, *Payment By Results Contracts: A Legal Analysis of Terms and Process* (NCVO, 2013).

<sup>21</sup>One of the key themes to emerge from a literature review of 93 studies of PbR contracts was the limited amount of discussion and negotiation which takes place between commissioners and providers at all stages of the process, from considering whether PbR might be an effective approach, through specifying outcomes and incentives, to designing the contract itself: R Webster, *2016 Payment by Results: Lessons from the Literature* (Oak Foundation, 2016) 3.

is to be notified in advance of any changes to the charity personnel involved in the delivery. However, research has found such provisions within contracts examined.<sup>22</sup> This was often found to be the case where pre-existing contracts have simply been re-tendered as ‘re-badged’ PbR contracts with new payment terms, but all the delivery terms remained the same as they were previously.

It might be considered that another benefit of PbR terms is that they may facilitate innovations in terms of methodologies adopted and interventions made. However, research shows that many PbR contracts have been used to further develop or scale up existing programmes that have a proven track record of success, rather than to encourage experimental work. For example, an international study tested the innovative nature of 22 worldwide PbR schemes, funded through SIBs, and found that more than half of the examined schemes funded the expansion of an existing programme or the implementation of a programme already proved to be successful.<sup>23</sup>

Government now has a growing portfolio of PbR schemes including for the provision of welfare, housing and criminal justice, where payment depends, at least in part, on the provider achieving specified outcomes. A 2015 National Audit Office (NAO) report identified 52 programmes across six central government departments<sup>24</sup> with PbR elements to their funding, worth around £15 billion.<sup>25</sup> Despite this, the efficacy of outcome-based commissioning is still questionable. A literature review of over 90 studies of worldwide PbR contracts (covering the UK, Australia and US) concluded that ‘there is a consensus that the evidence base is not able to give a clear indication as to whether payment by results works.’<sup>26</sup> One of the reasons for the lingering uncertainty is that results are often to be achieved over a long period of time. With SIBs, for example, few have produced their final outcomes. It will be seen that although there are several reviews that summarise the performance of these bonds, they are based on a relatively small number of cases and they generally offer only provisional or interim findings.

### III. The Challenges of PbR Contracts for Charities

In responding to the debate question posed at the start of this chapter, the next four sections will tease out some of the specific challenges that are presented to charities

<sup>22</sup> D Hunter and R Breidenbach-Roe, *Payment By Results Contracts: A Legal Analysis of Terms and Process* (NCVO, 2013).

<sup>23</sup> M Arena et al, ‘Social Impact Bonds: Blockbuster or Flash in a Pan?’ [2016] *International Journal of Public Administration* 927.

<sup>24</sup> The schemes are operated by the Department for Work & Pensions, Ministry of Justice, Department for Communities and Local Government, Department for International Development, Department for Education, Department of Health and their related bodies.

<sup>25</sup> National Audit Office, *Outcome-based payment schemes: government’s use of payment by results* (HC 2015–16, 86) para 1.8.

<sup>26</sup> R Webster, *2016 Payment by Results: Lessons from the Literature* (Oak Foundation, 2016) 36.

when faced with PbR contracts, supporting the view that they are not conducive to charities' participation in the provision of public services. These focus on: risks of PbR; costs associated with PbR; the impact on beneficiaries; and problems around measurements of results in PbR contracts.

## A. Charity Trustees' Duties and Risk

Legal obligations around management of risk have specific resonance for charity trustees when considering entering into PbR contracts and may well deter their participation.

Charity trustees must comply with a duty of prudence which requires them to act responsibly, reasonably and honestly.<sup>27</sup> As part of this duty, they must ensure that their charities' assets are used only to support or carry out their charitable purposes, and they must avoid exposing their assets, beneficiaries or reputation to undue risk. Whilst risk is an everyday aspect of most charities' work, especially those providing contracted services, PbR contracts introduce additional elements of risk. As there is no guarantee of payment, charities will incur expenditure without the certainty of receiving income through the contract to offset it. It will be seen that this element of uncertainty is not susceptible to control by the charity provider.

Charity trustees, as part of their effective governance of their charities, must consider the appropriate levels of risk to adopt and put measures in place to manage those risks.<sup>28</sup> Trustees of charities over the audit threshold<sup>29</sup> must report on the major risks to which the charity is exposed, confirming that they have 'satisfied themselves that systems or procedures are established in order to manage those risks'.<sup>30</sup> Charities that are incorporated under company law (other than small companies, as defined by company law) must prepare a strategic report, and this must contain a description of the principal risks and uncertainties facing the company, together with an explanation of how they are managed or mitigated.<sup>31</sup> The trustees of smaller charities with gross income below the statutory audit threshold are also advised to make a risk management statement as a matter of good practice.<sup>32</sup> The regulator of charities in England and Wales, the Charity Commission, considers that 'major risks' are those that 'have a major impact and

<sup>27</sup> See, generally, Charity Commission, 'The essential trustee: what you need to know, what you need to do' (CC3) (Charity Commission, May 2018).

<sup>28</sup> See, generally, Charity Commission, 'Charities and risk management' (CC26) (Charity Commission, June 2010).

<sup>29</sup> See Charities Act 2011, pt 8, ch 3.

<sup>30</sup> Charities (Accounts and Reports) Regulations 2008, 2008/629, reg 40(2)(b)(ii)(ee).

<sup>31</sup> Companies Act 2006, s 414A and s 414(C)(2)(b).

<sup>32</sup> Charity Commission, 'Charities and risk management' (CC26) (Charity Commission, June 2010) para 3.3.

a probable or highly probable likelihood of occurring.<sup>33</sup> If they occurred, they would have a major impact on some or all of the following areas: governance; operations; finances; environmental or external factors such as public opinion or relationship with funders; or a charity's compliance with law or regulation. Unfortunate examples exist to suggest that failure of PbR contracts may well fall within this category.<sup>34</sup>

Although financial experience and risk appetite may well vary amongst charity trustees, the vast majority of charity trustees are volunteers<sup>35</sup> with strong emotional links to the charitable cause, leading them to err on the side of caution<sup>36</sup> when it comes to taking financial risks. The duty of prudence, together with the public benefit requirement that all charities must satisfy,<sup>37</sup> underpin the charity governance model and may mean that PbR financing and the risks that it entails are difficult for charity trustees to accept.<sup>38</sup>

## B. Financial Cost of PbR Contracts

The prevalence of low reserves across the charitable sector often means that charities cannot afford to enter into PbR contracts, due to the particular funding structures and flows that are involved in such contracts.

With PbR there is a delay between the provision of the service and the ability of the commissioner to determine whether the required results have been achieved. If payments are deferred for too long, this gap can undermine the financial viability of the service provider, with the risk of insolvency. This means that charity providers often have to cross-subsidise their PbR work or seek loans to cover cash flow issues caused by delay in payments.<sup>39</sup> Many charities simply do not have the means to sustain their activities until delayed payments are made. Charities tend to have low reserves, so it is unlikely that many will be able to draw on them for such purposes. In fact many charities, especially smaller ones, operate with no reserves

<sup>33</sup> *Ibid*, para 3.2.

<sup>34</sup> See earlier discussion (in the introduction to this chapter) of a number of charities whose closure is at least partly attributed to their engagement with PbR contracts.

<sup>35</sup> In 2017, the Charity Commission reported that, in response to a question on charities' Annual Returns as to whether charities pay any of their trustees for their role as trustees, there was an overall positive response from some 2,000 charities or 1.6 per cent of respondents: Charity Commission, 'Taken on Trust: Awareness and Effectiveness of Charity Trustees in England and Wales' (Charity Commission, 2017).

<sup>36</sup> See, eg, Peridot Partners, *The Governance Paradox* (Peridot, 2018) noting the current trend towards risk-averse governance in charities.

<sup>37</sup> Charities Act 2011, s 2(1)(b).

<sup>38</sup> These factors have been cited as reasons why charities have pulled out of PbR bidding; F Sheil and R Breidenbach-Roe, *Payment by Results and the voluntary sector* (NCVO, April 2014) 11.

<sup>39</sup> NCVO, *The Work Programme-Perceptions and Experiences of the Voluntary Sector* (NCVO, 2012) 13.



at all,<sup>40</sup> and research commissioned by the Charity Commission in 2018<sup>41</sup> revealed that few larger charities even appear to fully understand what their reserves are or how to disclose them correctly.<sup>42</sup> Many seemed to assume that their charity had more unrestricted funds available to draw on than was in fact the case, particularly where significant amounts of funds were tied up in buildings. A separate survey in the same year<sup>43</sup> found that the 157 best-known charities (in a Charity Brand Index) had an average of four months' worth of spending in reserves. With long-term PbR contracts, this would not be sufficient to bridge the gap. In addition, the very nature of reserves is that they may be needed in the short to medium term and therefore trustees should ensure that they are readily realisable as cash, when needed.<sup>44</sup> This would suggest that they should not be tied up long term in supporting PbR contracts.

Delivery of service (and consequent achievement of outcomes) is sometimes impossible due to referral volumes to charities differing from those originally anticipated when PbR contracts are signed and charities' budgets are calculated. For example, referrals to charities to provide services in the Work Programme, discussed further below, were consistently lower than originally forecast,<sup>45</sup> supporting the view that smaller charities are simply 'bid candy' used by the main contractor (often a commercial entity) to improve the attractiveness of their tender.<sup>46</sup> If charities do not receive referrals under PbR contracts, they will not get paid. One civil society organisation has described signing a 140-page-long contract only to have received no referrals at the time of the report.<sup>47</sup>

In the previous section, it was noted that charity trustees have a requirement to be prudent with charity funds. This can mean that charities choose to stick with tried and tested methods of delivery rather than to take on the financial risk associated with innovative models. In a survey of providers in 2014, over 80 per cent surveyed reported concerns about financial risk from PbR contracts.<sup>48</sup> Researchers noted that social sector providers (including charities) were 'especially concerned about these dynamics undermining their ability to innovate through

<sup>40</sup> C Benard et al, *The UK Civil Society Almanac 2017* (NCVO, 2017).

<sup>41</sup> Charity Commission, 'Reserves policies: demonstrating and building resilience' (Charity Commission, November 2018).

<sup>42</sup> The results echoed earlier research for Charity Finance magazine; R Preston, 'Largest charities "overstating free reserves by almost 20 per cent"' *Civil Society* (1 June 2017).

<sup>43</sup> L Kay, 'Best-known charities hold an average four months of reserves' *Third Sector* (13 April 2018).

<sup>44</sup> See, eg, Charity Commission, 'Charity reserves: building resilience (CC19)' (Charity Commission, September 2018) 11.

<sup>45</sup> NCVO, *The Work Programme-Perceptions and Experiences of the Voluntary Sector* (NCVO, 2012) 7.

<sup>46</sup> See, eg, the evidence of the chief executive of St Mungo's, a charity which withdrew from the Work Programme delivery, having received no referrals: HC Work & Pensions Select Committee, *Can the Work Programme work for all user groups?* (2013–14, HC 162-1) para 145.

<sup>47</sup> NCVO, *The Work Programme – Initial Concerns from Civil Society Organisations* (NCVO, 2011) 5.

<sup>48</sup> D Crowe, T Gash and H Kippin, *Beyond Big Contracts. Commissioning public services for better outcomes* (Institute for Government, 2014).

building close relationships with citizens and communities.<sup>49</sup> A 2013 survey<sup>50</sup> found that 42.1 per cent of voluntary sector provider respondents believed (as did 28.2 per cent of local authority respondents) that the capital requirements and financial risks involved ‘completely’ limited their capacity to compete for PbR contracts. The NAO report on PbR<sup>51</sup> also referred to evidence<sup>52</sup> of smaller welfare-to-work providers withdrawing from contracts due to the time lag between investment and payment.

PbR models may therefore present challenges to charities which mean that they cannot participate. This is particularly the case for small charities that may lack access to reserves or working capital to be able to invest in delivering a service upfront prior to receiving the funding.

### C. Impact on Beneficiaries

When charity providers are more concerned about how they report their results, in order to be paid via their contracted terms, or when certain beneficiaries come with more of a ‘cost’ than others, charitable beneficiaries may well lose out.

Lowe and Wilson argue that outcomes-based monitoring turns the performance management of social interventions into a simplified game, which does not deal well with complex realities.<sup>53</sup> Instead of serving the needs of their beneficiaries who, as human beings, lead complex real-world lives, charity providers may focus their efforts on how to produce the necessary performance information. The clear need to evidence results can mean that needs of beneficiaries are almost secondary for the charity providers.

This may also mean that charities concentrate their activity on areas where outcomes are easily measurable.<sup>54</sup> This may explain why some PbR programmes have reported good outcomes. An empirical study of an Australian local non-profit organisation, whose youth services provision was funded through a PbR contract, sums up the situation well in the report of an interview with a staff member:<sup>55</sup>

It’s constantly looking at numbers. Yeah, and the quality and depth of the client contact has really declined in the last couple of months because of the pressure of the new data

<sup>49</sup> *ibid* 6.

<sup>50</sup> Compact Voice, ‘Local Compact survey results 2013: Payment by Results’ (Compact Voice, 2013) [www.compactvoice.org.uk/sites/default/files/payment\\_by\\_results-2013\\_local\\_compacts\\_survey\\_results.pdf](http://www.compactvoice.org.uk/sites/default/files/payment_by_results-2013_local_compacts_survey_results.pdf).

<sup>51</sup> National Audit Office, *Outcome-based payment schemes: government’s use of payment by results* (2015–16, HC 86) para 3.15.

<sup>52</sup> HC Work & Pensions Select Committee, *Can the Work Programme work for all user groups?* (2013–14, HC 162-I), vol II: *Additional Written Evidence*, Ev w10.

<sup>53</sup> T Lowe and R Wilson, ‘Playing the Game of Outcomes-based Performance Management. Is Gamesmanship Inevitable? Evidence from Theory and Practice’ [2017] *Social Policy & Administration* 981.

<sup>54</sup> See, eg, M Hudson et al, *The influence of outcome-based contracting on provider-led pathways to work*, Research Report No 638 (Department for Work & Pensions, 2010).

<sup>55</sup> L Keevers et al, ‘Made to Measure: Taming Practices with Results-Based Accountability’ [2012] *Organization Studies* 97, 114.

and monitoring requirements. We don't get the funding unless we meet the targets. It's really changed the way we work.

In what the authors describe as 'taming social justice practice' they note that 'intra-action with RBA [results-based accountability] performance measurement practices risks translating quality into only quantity'.<sup>56</sup>

The level of monitoring required might be higher than when entering into regular contracts, adding to the costs of participation. An in-depth study of four UK SIBs found that some third sector stakeholders were of the view that the degree of micro-management built into the contract was actually reducing their flexibility to autonomously pursue their social mission.<sup>57</sup> Some felt that the resources and time that went into these additional forms of performance management and measurement could be better spent on front-line services.

It can also mean that certain beneficiaries are more likely to be helped than others. With such a focus on meeting targets, there is a temptation to 'game' the system, with PbR contracts leading to some classes of charities' beneficiaries being left behind so that the 'easier' targets can be pursued. For example, under the Work Programme (which replaced the Flexible New Deal), where 80 per cent of the budget was linked to PbR, it has proved most lucrative to target young unemployed people, who pick up skills quickly, rather than focusing on harder-to-help claimants, particularly those furthest from the labour market, such as those aged over 50 and disabled people. Contractors spent less on people in these groups,<sup>58</sup> with some being neglected, despite the fact that the differential payment model<sup>59</sup> offered providers higher payments for achieving job outcomes for those considered harder to help. 'Creaming and parking' describes the situation where providers prioritise certain service recipients because they believe them to be easier to help and therefore most likely to deliver a financial return in a PbR model.<sup>60</sup> At the same time, those service recipients least likely to achieve a desired outcome, because their needs are too costly and complex to address, are 'parked' by giving them minimum attention or passing them on to other organisations within a supply chain.<sup>61</sup> Beneficiaries who need the most help may not get it, even where payment tariff structures seek to incentive personalised attention, by reflecting the cost to

<sup>56</sup> Ibid, 115.

<sup>57</sup> D Edmiston and A Nicholls, 'Social Impact Bonds: The Role of Private Capital in Outcome-Based Commissioning' *Journal of Social Policy* [2018] 57, 65.

<sup>58</sup> There was strong evidence of this in research commissioned by the Department for Work & Pensions which explored the influence of outcome-based contracting upon the delivery of the Provider-led Pathways to Work programme. See M Hudson et al, *The influence of outcome-based contracting on provider-led pathways to work*, Research Report No 638 (Department for Work & Pensions, 2010) ch 5.

<sup>59</sup> The payment structure is summarised in Department for Work & Pensions, *The Work Programme* (Department for Work & Pensions, 2012) [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/49884/the-work-programme.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/49884/the-work-programme.pdf).

<sup>60</sup> See, eg, E Carter and A Whitworth, 'Creaming and Parking in Quasi-Marketised Welfare-to-Work Schemes: Designed Out Of or Designed In to the UK Work Programme?' [2015] *Journal of Social Policy* 277.

<sup>61</sup> See below where the use of sub-contractors in PbR contracts is considered.

providers of achieving successful interventions. Each beneficiary has a price – those for whom a positive ‘result’ is more likely (for example, those who volunteer to benefit from the service provision or those who may have achieved the desired outcome without support) are much more valuable to the charity provider than those with greater or more complex needs (for example, those for whom engagement with the service is compulsory) for whom such a ‘result’ will be harder to achieve. Charities that want to provide personalised attention to the most vulnerable may well struggle to adapt to provision funded through PbR, where they may be forced to ‘cherry pick’ those beneficiaries who are least expensive to help. NCVO’s survey of Work Programme sub-contractors found that 13 out of 98 had to ‘park’ service users because the cost of the intervention exceeded the payment, and of the 78 that stated that they had not ‘parked’ service users, 35 had to subsidise delivery from their own reserves.<sup>62</sup> The same research found that 29 out of 98 respondents believed that service users who would have benefitted from their expertise were not being referred to them.

The particular structure of funding, with the explicit focus on reportable results, therefore means that charities providing services through PbR may not be able to prioritise the needs of their beneficiaries.

#### D. Measurement and Linkage

In principle, a shift from the somewhat blunt instrument of target-driven outputs to outcomes is welcome. However, social outcomes are notoriously difficult to measure. Even if outcomes are measurable, there is also a question around linkage.

One challenge in the Peterborough Social Impact Bond, to be discussed later, was generating a ‘methodologically robust outcome measure, which had the confidence of all stakeholders.’<sup>63</sup> Outcomes will rarely be achieved via one specific intervention. In reality, success or failure will be due to a diverse range of inter-related reasons, many of which may well be beyond the control of a specific service provider. PbR contracts tend not to reflect this inability of providers to have effective control over many of the external factors that determine whether or not a result is achieved.<sup>64</sup> The payment metrics upon which all PbR programmes depend are necessarily simplified top-down targets which force providers to ignore the complex and messy lives of the real people with whom they work. The provider

<sup>62</sup> NCVO, *The Work Programme-Perceptions and Experiences of the Voluntary Sector* (NCVO, 2012).

<sup>63</sup> E Disley et al, *Lessons learned from the planning and early implementation of the Social Impact Bond at HMP Peterborough* (Ministry of Justice, 2011) 36.

<sup>64</sup> See, eg, N McHugh et al, ‘Social Impact Bonds: A Wolf in Sheep’s Clothing?’ [2013] *Journal of Poverty and Social Justice* 247, 249, who make this point, noting that, due to the complexities involved, both unsuccessful and successful outcomes may be due to factors external to the activities of the service provider.

may well retain considerable risks for outcomes that it is unable to control. For example, an unemployed person using a PbR employment service may contemporaneously benefit from housing and health services. The quality of the provision of the combination of these services will have an impact on the person's ability to secure employment. This means attribution of outcomes to the provision of specific services is difficult to achieve, making the real success of the contracted provision impossible to judge. The necessarily long duration of some PbR contracts makes this linkage even more difficult to determine. The 2015 NAO Report<sup>65</sup> concluded that PbR should only be used where results can be measured and attributed to providers' interventions.

Whilst there is some support for the effectiveness of outcomes-based performance management,<sup>66</sup> it is questionable, in particular where the provider is a charity, whether PbR should be used in difficult, real-life situations, where outcomes are the product of complex, inter-related factors, most of which are beyond the control or influence of any specific programme and its contracted providers.

#### IV. Structural Alleviating Measures for Charities Entering into PbR Contracts

A number of challenges of PbR contracts, which support the argument that PbR contracts are not conducive to charities' participation in the provision of public services, have been examined. In order to fully consider the debate question further, the next two sections will explore the impact of certain enabling mechanisms built into PbR contract structures, which may help charities to overcome these hurdles. Whilst each mechanism could be seen as a potential enabler for the further involvement of charities and smaller providers in PbR contracts, close examination will question whether or not this is borne out in practice. It will be seen that each mechanism has not provided a panacea but has brought its own specific challenges.

##### A. The Use of Sub-Contractors in PbR Contracts

One enabling feature of PbR contracts, that may support the involvement of charities in the delivery of service, at least in theory, is the way in which many large PbR

<sup>65</sup> National Audit Office, *Outcome-based payment schemes: government's use of payment by results* (2015–16, HC 86) para 8.

<sup>66</sup> See, eg, S Kelman and J Friedman, 'Performance Improvement and Performance Dysfunction: An Empirical Examination of Distortionary Impacts of the Emergency Room Wait-Time Target in the English National Health Service' [2009] *Journal of Public Administration Research and Theory* 917.

schemes use a range of providers to deliver services. This means that some organisations, including small charities, may be able to participate in such arrangements through a chain as a sub-contractor. For example, under the Work Programme, the Department for Work & Pensions (DWP) contracted with large 'prime' providers, who in turn passed work onto smaller sub-contractors (often smaller charitable providers). DWP estimated that in September 2013, there were 858 organisations acting as sub-contractors for the 40 Work Programme contracts, and 363 (42 per cent) came from the voluntary or community sector.<sup>67</sup>

However, the challenges discussed previously may well be felt even more acutely by charity sub-contractors, who are beholden to a larger organisation which is the primary contractor with the direct link to the commissioner. As one 'social sector'<sup>68</sup> provider put it: 'I would never sub-contract with a government prime contractor as they appear money driven and not socially driven.'<sup>69</sup>

The level of the risk in PbR contracts is usually designed at scale, but there is evidence to suggest that prime contractors are often not absorbing any of the risk and are simply passing down the terms of the head contract to sub-contractor charities in the supply chain.<sup>70</sup> This risk then becomes disproportionate, as each required result involves a higher level of financial risk the further down the chain it passes. To take one example, complex data reporting requirements may be acceptable for the prime contractor, but they may be disproportionate or unmanageable for sub-contractors without the appropriate resource.

Research exploring the influence of outcome-based contracting upon the delivery of the Pathways to Work programme found an imbalance of power in prime provider and supply chain relationships, leading to 'creaming' of clients.<sup>71</sup>

The common prime provider strategy was, broadly speaking, to focus on job ready clients and encourage supply chain focus on clients requiring more intensive support and assistance to return to work.

This is despite the fact that government requires prime providers working with the DWP to comply with the 'Merlin Standard'. The 2018 refreshed standard is built upon eight fundamental and integrated principles<sup>72</sup> and within each principle there are a number of criteria which provide a structured, professional and

<sup>67</sup> Department for Work & Pensions, *Guidance: Organisations that supply services to the Work Programme providers* (Department for Work & Pensions, 2013 [withdrawn 2016]).

<sup>68</sup> According to the survey authors, this includes 'voluntary and community organisations, charities, social enterprises, co-operatives and mutuals': D Crowe, T Gash and H Kippin, *Beyond Big Contracts. Commissioning public services for better outcomes* (Institute for Government, 2014) 14.

<sup>69</sup> *Ibid.*, 39.

<sup>70</sup> See, eg, Work & Pensions Committee, *Can the Work Programme work for all user groups?* (2013–14, HC 162) paras 153–67.

<sup>71</sup> See M Hudson et al, *The influence of outcome-based contracting on provider-led pathways to work*, Research Report No 638 (Department for Work & Pensions, 2010) 64.

<sup>72</sup> The eight principles are: Design, Procure, Contract, Funding, Develop, Performance Manage, QA & Compliance, and Review & Close. See [www.merlinstandard.co.uk](http://www.merlinstandard.co.uk).

engaging approach to achieving excellence in supply chain management. The aim is to support the development, recognition and promotion of sustainable excellence, and positive partnership working within supply chains. For sub-contractors, there is an expectation of working in an environment and culture of respect, honesty, transparency and mutual support. When prime contractors are engaged in creaming and parking clients, this is inconsistent with the Merlin Standard ethos.

Charities also need to carefully consider the status of the prime contractor, including its reputation, working methods, ethos and track record, before agreeing to enter into such relationships.<sup>73</sup> Legal duties of charity trustees require them to act with care to protect their charities' assets, reputation and beneficiaries, all of which could be damaged, should there be adverse publicity around the prime contractor and its association with charity sub-contractors.

Whilst the use of sub-contracting arrangements in PbR contracts may facilitate involvement by charity providers, it has been seen that charities' participation in this capacity may also exacerbate some of the problems surrounding PbR contracts which have been considered above.

## B. SIBs as a Way of Funding PbR Contracts

It has been seen that in PbR contracts a charity must use its own money to front up the costs of providing its contracted service, in the hope that, eventually, outcomes from its service provision will generate payments to cover the costs. If commissioners are keen to attract smaller enterprises and charity providers as bidders, they may need to consider a source of social investment to run alongside the PbR contract. One way in which government has sought to support charity participation in PbR contracts is through the encouragement of the use of social bonds which transfer the financial risk of deferred or non-payment away from charities, on to third party social investors. Social bonds (or social investment/impact bonds – generally known as SIBs) are a form of PbR contract which leverage private investment so that providers (including charities) do not have to front the cost of delivery and bear the risk of non-payment through failure to achieve the pre-defined outcomes.

By way of a SIB, private non-government social investors provide the upfront capital to set up services under a PbR contract, and they are paid back if and when payment is made for the social outcomes achieved as a result of the contracted service provision. In this way, the investors bear the financial risk of failure, not the charities and other service providers. If a charity's contracted provision results in improved social outcomes, this leads to savings for government (which will not need to pay for services that would otherwise be used by individuals with poor

<sup>73</sup> See, eg, Charity Commission, 'Guidance for charities with a connection to a non-charity' (Charity Commission, March 2019).

social outcomes) and wider benefits to the community. There may well be a direct link between provision and cost saving; for example, where charity provision prevents a released prisoner re-offending, the re-imprisonment costs are saved. In other situations, savings are based on less defined cost savings brought about by, for example, an estimated contribution to a longer-term reduction in crime. The government agrees to pay a proportion of these savings back to the investors as a return on their investment, where payments for results exceed running costs and bond repayments.

While current data on investors is limited, a 2017 report noted that every UK SIB that had published information on outside investment has received some (or all) of that investment from either philanthropic trusts and foundations or via government-backed social investment funds.<sup>74</sup>

For investors that are charities themselves, a SIB offers a 'blended return' that is a potential financial return on investment that may not be as high as other possible returns, but one which is 'mission-aligned', allowing them to fulfil their charitable aims by investing in an area that fits with their specific charitable mission. In other cases, investors may be private investors with a social conscience or even simply a private profit motive. Through what can be described as the privatisation of social policy, financial institutions such as JP Morgan and Goldman Sachs and consulting firms such as Deloitte, KPMG and McKinsey & Co have all been involved in SIBs.<sup>75</sup> For example, in the US, Goldman Sachs was a pioneer investor in the SIB concept.<sup>76</sup> Through the private sector funding charities to provide services in this way, a profit incentive is introduced, and some of the public sector savings (or 'profit') from successful programmes will revert to private sector investors. In this way, public money is diverted into private hands.

If positive results are not achieved and payment is not forthcoming from the public sector commissioner to the charity, it is the investor that does not recoup its expenditure, not the charity. The financial return is tied to agreed outcomes laid down in the contract at the start of the bond issue. Whilst these are commonly called bonds, SIBs do not have a guaranteed rate of return, in line with the conventionally understood financial definition of a bond.<sup>77</sup>

<sup>74</sup> Social Spider CIC, *Social Impact Bonds, An Overview of the Global Market for Commissioners and Policymakers* (Centre for Public Impact, 2017). The report was commissioned by the Centre for Public Impact from Social Spider CIC.

<sup>75</sup> M Joy and J Shields, 'Austerity in the making: reconfiguring social policy through social impact bonds' [2018] *Policy & Politics* 681–95, 683.

<sup>76</sup> Eg, in 2012, Goldman Sachs helped to fund a programme aimed at reducing the recidivism rate for adolescent offenders at the Rikers Island correctional facility in New York City: J Olson and A Phillips, 'Rikers Island: The First Social Impact Bond in the United States' [2013] *Community Development Investment Review* 97–101. This SIB did not achieve its targets.

<sup>77</sup> Social Finance (the intermediary in the Peterborough SIB) describes it as 'a hybrid instrument with some characteristics of a bond (eg, an upper limit on returns) but also characteristics of equity with a return related to performance': E Bolton, *Social Impact Bonds. Unlocking investment in rehabilitation* (Social Finance, September 2010).



The first worldwide pilot SIB was the Peterborough SIB, established in 2010 by the Ministry of Justice and supported by the Big Lottery Fund to provide for ex-offenders who had been released from Her Majesty's Prison (HMP) Peterborough after short prison sentences of less than one year.<sup>78</sup> The aim was to break the cycle of offending by offering personal support to ex-offenders so that they could reintegrate into society.<sup>79</sup> It was a modest scheme but very important as a pilot. It was originally intended to run until 2017, funding the delivery, largely by charities, of the One Service scheme to work with three cohorts of around 1,000 released prisoners. However, this plan was overtaken by events; the roll-out of a new national statutory programme – Transforming Rehabilitation – to reform probation services for all short-sentenced offenders in the UK would have resulted in duplication of service and the inability to measure the impact of the SIB-funded provision against a control group. While the pilot operated through a PbR contract for the first two cohorts of released prisoners, the third cohort was supported by a fee-for-service arrangement, paid by the Ministry of Justice, rather than under the original SIB-funded PbR model.<sup>80</sup> The SIB was coordinated by Social Finance, a not-for-profit financial intermediary, which obtained investment funding of around £5 million from 17 private individuals and charities. A return on investment was to be paid if a minimum threshold of a 7.5 per cent reduction in reconviction events was reached across the pilot, compared to a matched control group. Additionally, there was an option to trigger an early payment if a 10 per cent reduction was noted in the number of reconviction events in individual cohorts. Ultimately, the reduction across both cohorts was estimated to be 9 per cent,<sup>81</sup> so the outcome payment was triggered and investors received a single payment representing their initial capital plus a return of just over 3 per cent per annum for the period of investment.<sup>82</sup> The returns were paid out of the savings that arose from the reduction in the costs associated with recidivism.

From this narrative, SIBs appear to have great potential as a mechanism for involving charities in PbR contracts. SIBs may enable improvements in social outcomes by aligning the priorities of public sector commissioners, charities and socially motivated investors around a common goal, which is the better delivery

<sup>78</sup> Reoffending has been a persistent problem for the UK criminal justice system, with national re-offending rates for short-sentenced offenders at around 60% when the Peterborough SIB was designed. Until recently, there was no statutory support for them on release. Many prisoners do not have a home or a job to go back to and are often battling mental health and substance misuse problems: Social Finance, 'World's 1st Social Impact Bond shown to cut reoffending and to make impact investors a return', press release (Social Finance, 27 July 2017).

<sup>79</sup> The details of this SIB are described in E Disley et al, *Lessons learned from the planning and early implementation of the Social Impact Bond at HMP Peterborough* (Ministry of Justice, 2011) 1.

<sup>80</sup> E Disley et al, *The payment by results Social Impact Bond pilot at HMP Peterborough: final process evaluation report* (Ministry of Justice, 2015) 1.

<sup>81</sup> J Anders and R Dorsett, *HMP Peterborough Social Impact Bond – cohort 2 and final cohort impact evaluation* (National Institute of Social and Economic Research, June 2017).

<sup>82</sup> Social Finance, 'World's 1st Social Impact Bond shown to cut reoffending and to make impact investors a return', press release (Social Finance, 27 July 2017).

of social interventions for the public good. However, a closer examination again reveals that a potentially enabling mechanism for charities is not without its own challenges. One of the main difficulties is caused by the complexity of the structures surrounding a SIB.

SIBS are technically extremely complicated, involving contractual arrangements and financial instruments which are resource-intensive to set up,<sup>83</sup> leading to high transaction costs. Often the creation of a SIB has included the creation of a Special Purpose Vehicle (SPV) to manage the activity covered by the SIB contract.<sup>84</sup> The SPV may be owned by investors, intermediaries or delivery organisations – or sometimes a combination of all three.<sup>85</sup> A case study of the Peterborough SIB concluded:<sup>86</sup>

[T]he costs of establishing the necessary metrics,<sup>[87]</sup> baselines, legal arrangements and financial calculations are sometimes so high that the SIB is infeasible without additional funding.

The overhead costs of the SIB financing mechanism, including legal fees, intermediary costs, evaluation expenses and costs associated with investor due diligence, are primarily fixed costs and will constitute a smaller proportion of the total project as the size of the intervention grows. Therefore, in one US study<sup>88</sup> it was suggested that generally these costs will only be worth incurring for a SIB contract worth at least US\$20 million. Due to their necessary scale, the SIBs that have existed so far have tended to involve larger, rather than small, charities. Many of the latter will neither be familiar with nor have the necessary skills to deal with complex contracts. NCVO has identified that the skills required to engage in PBR contracting will include: improved understanding of costs, margins and pricing; complex modelling tools; understanding of the cost and process of acquiring capital and an ability to make a compelling case to funders; an ability to identify, assess and mitigate risk; and, greater analysis of investment and asset management opportunities.<sup>89</sup>

<sup>83</sup> MJ Roy, N McHugh and S Sinclair, 'Social Impact Bonds – Evidence-based policy or Ideology?' in B Greve (ed), *Handbook of Social Policy Evaluation* (Cheltenham, Edward Elgar Publishing, 2017) 267.

<sup>84</sup> See, eg, the final evaluation of the London Homelessness SIB, the second SIB to be established (after the Peterborough Prison SIB) where the establishment of an SPV for one of the providers, St Mungo's, is described: P Mason, R Lloyd and F Nash, *Qualitative Evaluation of the London Homelessness Social Impact Bond (SIB). Final Report* (Department for Communities and Local Government, November 2017).

<sup>85</sup> Social Spider CIC, *Social Impact Bonds, An Overview of the Global Market for Commissioners and Policymakers* (Centre for Public Impact, 2017).

<sup>86</sup> A Nicholls and E Tomkinson, 'The Peterborough Pilot Social Impact Bond' in A Nicholls, R Paton and J Emerson (eds), *Social Finance* (Oxford, Oxford University Press, 2015) 362.

<sup>87</sup> See E Carter et al, *Building the tools for public services to secure better outcomes: Collaboration, Prevention, Innovation*, Evidence Report (Government Outcomes Lab, 2018) appendix, for a list of all the outcome metrics used within UK SIBs up to 2018.

<sup>88</sup> H Azemati et al, 'Social Impact Bonds: Lessons Learned So Far' [2013] *Community Development Investment Review* 23, 27.

<sup>89</sup> F Sheil and R Breidenbach-Roe, *Payment by Results and the voluntary sector* (NCVO, April 2014) 12.

There is also an added dimension in the inevitably complex contracting arrangements that SIBs entail, and that is the involvement of an investor in the relationship and the inescapable introduction of a profit incentive into the equation, particularly where private for-profit investors are involved. The concerns expressed earlier about the impact of PbR arrangements on beneficiaries may be exacerbated. As well as the charity provider serving the commissioning master, there is also the investor to be considered. The chances of the service users – the charities' beneficiaries – having a voice in any discussions around service provision are even less than usual. This time, accountability and reporting systems are likely to be focused on the needs of the private investors rather than the public commissioners. Ideologically, it could be argued that SIBs support the wider agenda of public sector reform, the privatisation of social policy, and the marketisation of charities.

Despite the concerns outlined above, by July 2018, 45 SIBs had been launched in the UK to address diverse social problems in areas such as criminal justice, homelessness, health, educational underachievement, and long-term unemployment. There are over 100 worldwide.<sup>90</sup> These tackle complex social issues such as refugee employment support, loneliness among the elderly, rehousing and retraining homeless youth, and diabetes prevention.<sup>91</sup> Bearing in mind the drawbacks of SIBs, the question remains as to whether they may nevertheless support the delivery of better social interventions. An in-depth study of four UK SIBs examining the effect of the introduction of private capital in outcome-based commissioning concluded that:<sup>92</sup>

[T]here is, at present, very little definitive evidence [to suggest that services funded through such a mechanism lead to any relative improvement in social outcomes compared to more conventional PbR commissioning models. In great part, this is due to the poor availability and standards of evidence that are currently available, and the challenges associated with accurately identifying the attainment and cause of complex social outcomes over time. However, where there is evidence available, it is rather mixed.

A further potential disadvantage of charity involvement in SIB-funded schemes is that they have tended to attract media attention due to their political sensitivity or novelty or size. This was especially the case with the pilot Peterborough SIB. For charities as service providers, this brings additional risk of reputational damage in the event of failure.

<sup>90</sup> E Carter et al, *Building the tools for public services to secure better outcomes: Collaboration, Prevention, Innovation*, Evidence Report (Government Outcomes Lab, 2018) 9. In the US, these are often referred to as 'pay for success': JK Roman et al, *Five Steps to Pay for Success Implementing Pay for Success Projects in the Juvenile and Criminal Justice Systems* (Urban Institute, June 2014).

<sup>91</sup> Social Finance, 'World's 1st Social Impact Bond shown to cut reoffending and to make impact investors a return', press release (Social Finance, 27 July 2017). For a full list of programmes worldwide, see <https://sibdatabase.socialfinance.org.uk>.

<sup>92</sup> D Edmiston and A Nicholls, 'Social Impact Bonds: The Role of Private Capital in Outcome-Based Commissioning' [2018] *Journal of Social Policy* 57, 73.

Whilst one of the intentions behind the SIB mechanism is to better support the role of smaller charities in PbR contracts, this is yet to be achieved due to the complexity and scale associated with its use.

## V. Additional Government Support for Contracting Using PbR

Despite the mixed evidence on effectiveness to date, the UK Government is keen to support the further development of contracting using PbR. For example, in 2012, the Cabinet Office set up the £20 million Social Outcomes Fund to provide a ‘top-up’ contribution to outcomes-based commissions (SIBs or PbR) that aim to deal with complex and expensive social issues.<sup>93</sup> In the Spending Review and Autumn Statement 2015, the government pledged additional support for SIBs, investing £105 million over the Parliament to help deal with issues including homelessness, poor mental health and youth unemployment.<sup>94</sup> It will be seen in the following two sections that, in addition to this important direct financial support, the UK Government has introduced two additional initiatives to stimulate more interest in social impact investing and other PbR pilots, by way of the introduction of Social Investment Tax Relief in 2014 and legislative clarity around the ability of charities to make social investments in 2016.

### A. Social Investment Tax Relief

Since 2014,<sup>95</sup> by way of Social Investment Tax Relief (SITR), individuals making eligible investments<sup>96</sup> in social enterprises can deduct 30 per cent of the cost of their investment from their income tax liability, either for the tax year in which the investment is made or the previous tax year. The investment must be held for a minimum period of three years for the relief to be retained. If individuals have chargeable gains in that tax year, they can also defer their capital gains tax (CGT) liability if they invest their gain in a qualifying social investment. Tax will instead be payable when the social investment is sold or redeemed. Investors also pay no CGT on any gain on the investment itself, but they must pay income tax in the

<sup>93</sup> Cabinet Office and The Rt Hon Nick Hurd MP, ‘New boost to help Britain’s most vulnerable young adults and the homeless’, press release (Cabinet Office, 23 November 2012).

<sup>94</sup> HM Treasury, *Spending Review and Autumn Statement 2015* (Cm 9162, November 2015) para 1.285.

<sup>95</sup> The legislation giving effect to SITR is in Finance Act 2014, schs 11 and 12, amending the Income Tax Act 2007. See pt 5B as amended.

<sup>96</sup> Investments must be made into charities, Community Interest Companies or Community Benefit Societies that carry out a ‘qualifying trade’, have fewer than 500 employees and have assets of no more than £15 million.

normal way on any dividends or interest on the investment. Initially the maximum amount of investment eligible for relief was around £300,000. This was raised to £1.5 million in April 2017. Investments in companies (including SPVs) set up to carry out a SIB are eligible for SITR, provided that the company has received accreditation as a 'Social Impact Contractor' from the Cabinet Office.

So far, use of SITR has been limited, and the data available on this use is also limited.<sup>97</sup> A report published by HM Revenue & Customs in May 2018<sup>98</sup> shows a total of £5.1 million raised by (up to) 35 charities and social enterprises over the first three years of SITR, compared to a predicted figure of £83.3 million – based on Treasury estimates of the cost of the relief. The first two SIBs to benefit from SITR saw 15 per cent capital raised from individuals, with their predicted returns boosted from 7 per cent per annum to equivalent of 19.3 per cent per annum as a result.<sup>99</sup> However, a 2019 report<sup>100</sup> acknowledges that SITR has not been a major success to date and identifies five reasons for this: lack of awareness from charities and social enterprises; slow pace of legislative change (to improve its attractiveness to investors); lack of fitness for purpose (with wholesale copy and paste model from mainstream tax reliefs that apply for business investment schemes); process challenges (of proving and satisfying eligibility requirements); and lack of pipeline or mismatch between supply and demand (with investors in charities looking for opportunities that do not exist and vice versa). Positive change may follow a 2019 government call for evidence on SITR effectiveness.<sup>101</sup>

## B. Making Social Investments and Fiduciary Duties of Trustees

While charitable foundation support for other charities has a long history, the extent to which charity law supports investments in social projects (as opposed to those purely aimed at financial return) has often been questioned.<sup>102</sup> This has led to queries about charity trustees' ability to invest in SIBs. For example, one investor

<sup>97</sup> D Floyd, 'WHAT A RELIEF! A review of Social Investment Tax Relief for charities and social enterprises' (Social Investment Business, 2019).

<sup>98</sup> HMRC, 'Enterprise Investment Scheme Seed Enterprise Investment Scheme and Social Investment Tax Relief. Statistics on Companies raising funds' (HMRC, May 2018).

<sup>99</sup> Ambition East Midlands and Aspire Gloucestershire were awarded PbR contracts with the Department for Communities and Local Government and Cabinet Office. The investors would only receive their interest and capital payment if the organisations were successful in meeting their targets for housing and supporting almost 500 vulnerable young people into education, employment and training. The capital raised enabled the charities to deliver the programmes ahead of being able to claim for outcome payments. See SB James, 'Social investment tax relief for homelessness social impact bonds' (*Third Sector*, 5 February 2015).

<sup>100</sup> D Floyd, 'WHAT A RELIEF! A review of Social Investment Tax Relief for charities and social enterprises' (Social Investment Business, 2019).

<sup>101</sup> HM Treasury, 'Social Investment Tax Relief: call for evidence' (HM Treasury, 24 April 2019).

<sup>102</sup> See, eg, *Harries v The Church Commissioners for England* [1992] 1 WLR 1241.

in the Peterborough SIB reported concerns that undertaking social investment (and accepting a blended return) may conflict with fiduciary obligations of charity trustees to maximise financial return on investment.<sup>103</sup> There was a lack of clarity in the (then) charity investment guidance from the Charity Commission,<sup>104</sup> and some trustees were taking a cautious reading of it. This is despite the fact that the guidance (and the law upon which it was based) did not prohibit social investment.

Charities invest so as to further their charitable aims and, whilst it is recognised that usually the best way to further those aims is to achieve the best financial return within the level of risk considered to be acceptable, it is for trustees to decide whether or not this is the case, exercising their own discretion. Charity trustees may also determine that they want to use a charity's assets directly to further its aims in a way that may also produce some financial return for the charity. The justification for making this kind of 'programme-related investment' is to further the charity's aims, rather than maximise financial returns. In making this kind of investment, trustees are not bound by the legal framework for financial investment, because their decision is about applying assets directly in furtherance of the charity's aims. Alternatively, 'mixed motive investment' where the investment is for the specific purposes of both furthering a charity's aims and generating a financial return, is also acceptable.

Despite the fact that the law already facilitated both these kinds of investment, because of concerns and reluctance on the part of some trustees to accept this, as part of the government's social investment strategy,<sup>105</sup> the Charities (Protection and Social Investment) Act 2016 introduced a statutory power for charities to make social investments.<sup>106</sup> Whilst it could be argued that this was unnecessary, and potentially undermines the pre-existing permissive position at common law, it does provide welcome<sup>107</sup> clarification of charities' ability to make social investment, and clarifies the duties of charity trustees when authorising social investment. This is defined as a 'relevant act'<sup>108</sup> of a charity which is carried out 'with a view to both directly furthering the charity's purposes and achieving a financial return for the charity'. The new legislation does not alter or override trustees' general common

<sup>103</sup> E Disley et al, 'Lessons learned from the planning and early implementation of the Social Impact Bond at HMP Peterborough' (Ministry of Justice, 2011) 28.

<sup>104</sup> See now, Charity Commission, 'Charities and Investment Matters: A Guide for Trustees' (CC14) (Charity Commission, January 2017).

<sup>105</sup> Cabinet Office, 'Social Investment: A Force for Social Change. 2016 Strategy' (HM Government, 2016).

<sup>106</sup> See now Charities Act 2011, s 292B.

<sup>107</sup> Responses to the Law Commission consultation that preceded the legislative change (Law Commission, 'Social Investment by Charities' Consultation Paper No 216, 2014) revealed 'a sense that the law is unsatisfactory, or at least in need of clarification, and a desire for reform that would engender more certainty and would give greater confidence to charity trustees who are currently held back by uncertainty and, many consultees felt, by risk-averse advice'. See Law Commission, 'Social Investment by Charities. The Law Commission's Recommendations' (September 2014) para 1.22.

<sup>108</sup> A 'relevant act' is: an application or use of funds or other property by the charity; or taking on a commitment in relation to a liability of another person which puts the charity's funds or other property at risk of being applied or used, such as a guarantee: Charities Act 2011, s 292A(4).

law duties, but introduces new statutory duties that apply to all charity trustees when making decisions about social investments.<sup>109</sup> These duties apply in place of statutory duties in the Trustee Act 2000, which relate specifically to financial investments. Before exercising any power to make social investments, trustees must: consider whether in all the circumstances any advice about the proposed social investment ought to be obtained; obtain and consider any advice which they conclude ought to be obtained; and, satisfy themselves that it is in the interests of the charity to make the social investment, having regard to the benefit they expect it to achieve for the charity, by directly furthering the charity's purposes and achieving a financial return. Trustees must also review their charity's social investments from time to time.

When introducing the new power in the House of Lords, Lord Bridges of Headley said that the intention was to 'help charities to make social investments so that they can fulfil their mission in new and innovative ways' and he said that it would 'give charities the confidence and certainty to invest in this growing sector'.<sup>110</sup> It is difficult at this stage to measure the impact of this power. Not long after the power was introduced, one law firm advised a Christian mission charity on how to apply the new power, and the chair of its trustee board later commented:<sup>111</sup>

[Our charity] has been committed to social investments since 2008, and as trustees we were used to dealing with the legal framework that existed before the new power. Once we understood the background and intention of the new power, it proved to be a solid platform for our considerations and helped us think creatively and confidently about how we could use [our charity's] resources in the most impactful way.

If more charities were given such advice and then acted similarly, the new power could have significant potential. Early signs are promising. Data published in 2018 on foundation giving trends<sup>112</sup> note that in 2016–17, 34 (11 per cent) of the top 300 charitable foundations identified programme-related or social investments in the balance sheet or notes to their accounts and that these were worth just over £120 million – a real annual increase in value of 18 per cent.

## VI. Charities in the New Contracting Environment – Towards the Future

Having examined the PbR contracting environment and the challenges that it raises for charitable service providers in particular, this final section will assess the

<sup>109</sup> Charities Act 2011, s 292C.

<sup>110</sup> HL Deb 10 June 2015, vol 762, col 801.

<sup>111</sup> O Hunt, 'The new social investment power – what does it mean for trustees?' (Big Society Capital, 15 March 2017) [www.bigsocietycapital.com/latest/type/blog/new-social-investment-power-what-does-it-mean-trustees](http://www.bigsocietycapital.com/latest/type/blog/new-social-investment-power-what-does-it-mean-trustees).

<sup>112</sup> Cathy Pharoah and Catherine Walker with Emma Hutchins, *Foundation Giving Trends 2018* (Association of Charitable Foundations, 2018) 13.

realistic chances of their successful participation, looking towards the future and some potentially positive developments on the horizon.

Whilst PbR as a concept, where charities are paid for what they achieve rather than what they do, may seem on first sight instinctively attractive, it has been seen that current commissioning processes continue to be a major threat to the survival of smaller charities that may well find it difficult to negotiate this new funding model. The importance of this conclusion cannot be overestimated, bearing in mind that the vast majority of charities are small.<sup>113</sup> There is a frequent lack of recognition by funders of the true costs to charities of delivering the vital services being commissioned. In short, the financial structures of PbR have the effect of excluding the expertise of many charitable providers, either because they choose not to participate or are unable to do so. The amount of upfront capital required to set up and sustain services until payment is achieved can be a challenge in a sector where reserves are limited, and the additional risk of non-payment may create a barrier for charity trustees, who must be prudent with charity funds. The account of the Peterborough SIB (and its interruption due to external policy changes in the form of a national restructure of probation services) reminds us that the impact on programme outcomes of the unpredictable dynamic, extraneous policy environment and political climate should not be underestimated.

The contract culture environment per se is difficult for charities to negotiate. It has been seen that PbR adds a further layer of complexity and potential legal liability where the stakes are very high. PbR demands certain financial skills from providers which may not have been required before from charity trustees. Smaller charities will struggle even more to access these skills. Where charities are being funded through PbR contracts, they will also need sufficiently sophisticated data management systems in place to ensure that the specified necessary results do in fact trigger requests for payments.

It has also been seen that the funding structures of PbR contracts, with the need for upfront absorption of costs, may well exclude smaller charities that operate with minimal or non-existent reserves with little access to working capital to invest in up-front costs. Traditionally, the retail banks have been reluctant to lend to charities because of low returns, the insecurity of contract-based work and the general risk profile of the sector.

Whatever payment structures are used, they must offer sufficient funds for working with all charity beneficiaries, no matter how complex, sustained, or expensive their needs might be. This will help to guard against practices such as 'creaming and parking', discussed earlier in the context of the Work Programme. One way to use PbR to really incentivise providers to work with those with more complex needs may be to move away from a binary approach to outcomes and to introduce staged payments where 'mini' targets trigger payments for progress as

<sup>113</sup> [www.gov.uk/government/publications/charity-register-statistics/recent-charity-register-statistics-charity-commission](http://www.gov.uk/government/publications/charity-register-statistics/recent-charity-register-statistics-charity-commission).



well as ultimate outcomes.<sup>114</sup> For example, where the ultimate outcome may be that an unemployed person finds employment, an interim payment could be made if that person completes a training course.

Looking towards the future, the government's stated vision for public services is encouraging at least. The 2018 Civil Society Strategy talks of 'collaborative commissioning' and states:<sup>115</sup>

This means that in the future, local stakeholders will be involved in an equal and meaningful way in commissioning and all the resources of a community, including but not confined to public funding, will be deployed to tackle the community's challenges. People will be trusted to co-design the services they use.

There are also plans for a welcome return for increased use of grant funding alongside contracted funding for charities. A blended funding model will introduce into commissioning a more proportionate attitude to risk. The Strategy notes:<sup>116</sup>

In addition to Social Impact Bonds, and to social impact investment ... the government wishes to broaden the range of funding options for community initiatives. This includes a revival of grant-making – "Grants 2.0" – to reflect the fact that grants can combine flexibility with the accountability and performance rigour of a contract, and also bring "additionality", such as philanthropic or in-kind investment.

Grant funding is particularly suited to facilitating innovation from charitable providers, something which PbR contracts have largely been unable to realise.<sup>117</sup> Even within a commissioning scenario, a hybrid model, with an element of upfront funding together with remaining payments being triggered by the attainment of pre-agreed results, would reduce risk and incentivise innovation. This element of grant funding may better support diversity of provision and give the space and capacity to trial and test ideas.

A further positive development on the horizon is that there are plans to strengthen the Public Services (Social Value) Act 2012, which currently requires commissioners to consider the economic, social and environmental, and wider value a contract can bring. It is intended to extend its requirements in central government to ensure all major procurements explicitly evaluate social value where appropriate, rather than just 'consider' it, as is currently the requirement.<sup>118</sup> This will assist charities when competing for contracts and should shift the balance of

<sup>114</sup> These are often referred to as 'distance travelled' measures. See, eg, M Roberts, 'By their fruits ... Applying payment by results to drugs recovery' (UK Drug Policy Commission, 2011) 12.

<sup>115</sup> Cabinet Office, *Civil Society Strategy: building a future that works for everyone* (HM Government, August 2018) 106.

<sup>116</sup> *Ibid.*, 111.

<sup>117</sup> The Labour party's civil society strategy commits to greater use of grant funding for small charities: Labour Party, 'From Paternalism to Participation. Putting civil society at the heart of national renewal' (Labour Party, June 2019).

<sup>118</sup> Cabinet Office, 'Social Value in Government Procurement. A consultation on how government should take account of social value in the award of central government contracts' March 2019, (HM Government, March 2019).

power somewhat when charities are involved as sub-contractors in supply chains in which the prime contractor's social credentials are less obvious.

Another tool for charities to resort to in the future may be the Compact,<sup>119</sup> which is currently almost defunct. The Compact is the agreement between the government and the voluntary sector that outlines best practice for partnership working. It talks of government using diverse funding models so as to enable smaller organisations to become involved in delivering services where they are best placed to achieve the desired outcomes. It also requires prime contractors to adhere to the terms of the Compact in allocating risk proportionately. It has not been renewed since 2010, but a revitalised agreement<sup>120</sup> may well support a better funding environment for charities.

## VII. Conclusion

The question for debate was whether PbR contracts in general, and, in particular, the use of SIBs, are an effective means by which charities might be funded to deliver public services. Arguments made in this chapter in responding to this question and backed up by evidence suggest that PbR contracts are inherently risky for charities. Measures introduced to support charities and other non-profit providers wishing to use their expertise to support their beneficiaries through the provision of public services have not as yet alleviated the difficulties presented by PbR contracts. These difficulties are exacerbated for small charities which make up the majority of the sector.

Perhaps in the future charities will take their rightful place in the contracting landscape, operating as well-funded providers of social and other services in a domain in which they retain expertise and are able to deploy it to maximum effect. If and when it becomes common practice for commissioners to enter into pre-procurement dialogue with providers, co-design payment models and outcomes, and use the learning from this collaboration to inform and improve future commissioning strategies, lessons will have finally been learned from decades of the contract culture.

<sup>119</sup>The terms of the most recent Compact, published in 2010, under the Coalition government, can be read here: [www.gov.uk/government/publications/government-voluntary-and-community-sector-agree-new-compact-for-working-in-partnership](http://www.gov.uk/government/publications/government-voluntary-and-community-sector-agree-new-compact-for-working-in-partnership).

<sup>120</sup>The Labour party's civil society strategy commits to updating and reinvigorating voluntary sector compacts: Labour Party, 'From Paternalism to Participation. Putting civil society at the heart of national renewal' (Labour Party, June 2019).