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Community Development INVESTMENT REVIEW

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Pay for Success Financing

Community Development INVESTMENT REVIEW

The Community Development Department of the Federal Reserve Bank of San Francisco created the Center for Community Development Investments to research and disseminate best practices in providing capital to low- and moderate-income communities. Part of this mission is accomplished by publishing the *Community Development Investment Review*. The *Review* brings together experts to write about various community development investment topics including:

Finance—new tools, techniques, or approaches that increase the volume, lower the cost, lower the risk, or in any way make investments in low-income communities more attractive;

Collaborations—ways in which different groups can pool resources and expertise to address the capital needs of low-income communities;

Public Policy—analysis of how government and public policy influence community development finance options;

Best Practices—showcase innovative projects, people, or institutions that are improving the investment opportunities in low-income areas.

The goal of the *Review* is to bridge the gap between theory and practice and to enlist as many viewpoints as possible—government, nonprofits, financial institutions, and beneficiaries. As a leading economist in the community development field describes it, the *Review* provides "ideas for people who get things done." For submission guidelines and themes of upcoming issues contact David Erickson, Federal Reserve Bank of San Francisco, 101 Market Street, Mailstop 215, San Francisco, California, 94105-1530, David.Erickson@sf.frb.org. The material herein may not represent the views of the Federal Reserve Bank of San Francisco or the Federal Reserve System.

CENTER FOR COMMUNITY DEVELOPMENT INVESTMENTS

Community Development INVESTMENT REVIEW

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CENTER FOR COMMUNITY DEVELOPMENT INVESTMENTS

Making Performance-Based Contracting Work for Kids and Families

Patrick Lawler and Jessica Foster
Youth Villages

Done right, performance-based contracting (PBC) offers a win-win-win to government, providers, and, most importantly, the people being served. Government spends funds more effectively, higher-quality providers thrive, and recipients get better services. Take Tennessee's experience introducing PBC to its child welfare system. Significantly more children are exiting care to stable homes, providers deliver better outcomes and receive incentive payments to reinvest in strengthening their work, and the Department of Children's Services (DCS) has kept its budget steady and is getting more bang for its buck.

The idea of paying for performance is not new. In child welfare–the field in which our organization, Youth Villages, works–a 2009 study identified fourteen states with performance-based contracts for at least one service.[1] But PBC is far from ubiquitous, and its implementation is inconsistent.

The concept has generated excitement recently with the inclusion of $100 million for Pay for Success (PFS) or social impact bonds (SIBs; i.e., private low-risk loans to the government, intended to fund what works) in President Obama's 2012 budget. But if the end goal is achieving better social outcomes in the most efficient way, the PBC dialogue spurred by PFS/SIBs has been too narrow. While private financing represents a promising tool to motivate behavior change in government, the use of it does not in and of itself solve many of the barriers to successful PBC adoption and execution. In our experience proposing performance-based contracts to government agencies, budget size is not the greatest hurdle. We need to broaden the conversation if PBC is to fulfill its true promise. A deeper discussion on structuring incentives and cultivating a sustainable commitment within government is needed.

Youth Villages just celebrated twenty-five years of helping emotionally and behaviorally troubled children and their families live successfully. Last year we worked with more than 20,000 children and families from fifteen states and Washington, DC. Most of our funding comes through typical pay-for-outputs government contracts. In our experience, getting government commitment to issue and fund a performance-based contract is a heavy lift. Great barriers exist, including political pressure to retain weak providers, lack of contracting know-how, and restrictions on how government funds can be used. We have been part of Tennessee's child welfare PBC effort since it began in 2006, and it has been an eye-opening experience for us. We would like to share our experiences and what we have learned about PBC.

1 Quality Improvement Center, "Examples of Performance Based Contracts in Child Welfare Services." (July 27, 2009).

Barriers to Performance-Based Contracting Implementation

Political pressure to retain weak providers. Government agencies often have an idea about how strong or weak their providers are, but summoning the political will to act on that knowledge can be hard. When budgets need to be cut, it can be easier to issue rate cuts across the board and limit service duration or eligibility than to make decisions based on provider performance.

Lack of contracting know-how. PBC is complex and requires skilled leaders and trained personnel in both the government agency implementing the PBC and in private providers to structure and monitor contracts. Outside expertise can help, particularly if in-house talent is developed in parallel. Technical assistance and the creation of effective learning communities around PBC are essential for achieving desired results.

Restrictions on how funds are used. For instance, the largest category of federal funding for child welfare is Title IV-E, which can be used primarily for purchasing out-of-home care. Without a waiver, a state cannot shift those dollars to other kinds of services that could better achieve permanency. Nor may it be possible for a state agency to legally hold budgetary savings from one budget year to another in order to use them for incentive payments. These restrictions limit the services and timeframe a performance-based contract can cover to achieve desired outcomes.

How Tennessee Has Used Performance-Based Contracting to Get Better Outcomes for Kids in Child Welfare

In 2000, Tennessee agreed to settle a lawsuit brought against its child welfare system. Too many kids were getting stuck in out-of-home care and not returning to their communities. The state relied heavily on group homes and institutions (known as congregate care) for thousands of emotionally and behaviorally troubled children. Many children also remained in emergency shelters and other "temporary" placements for six months or more. And there were not enough foster families or services to help children reunify with their biological families. The "Brian A." lawsuit settlement required comprehensive reform of the system. But three years later, an independent monitor's report found that the DCS had failed to comply with many of the settlement's provisions.

PBC came about as part of the state's response to these failures. Viola Miller, DCS commissioner who was hired in 2003, championed PBC as a way to achieve a clear goal–moving as many children as possible, as quickly as possible, out of congregate care into a stable and secure parenting relationship, or what the child welfare world calls permanency.

The Tennessee DCS performance-based contract measures include care day utilization (i.e., days in care), exits to permanency, and reentries into care. Providers are reimbursed for services at the time the services are delivered and later receive financial rewards for improving performance and penalties for performing below expectations. These rewards and penalties are a fraction of the total contract size; for Youth Villages our incentive payment has ranged from 0 to 7 percent. Overall this contracting structure has been a success for the welfare of children in Tennessee. In the first three years, care day utilization went down by 8 percent, and permanent exits went up 6 percent–without any increase in reentries to care. In other words, more children were leaving the child welfare system for stable homes. These percentages may sound like fairly small improvements, but they are pointing in the right direction and mean that hundreds of children each year are achieving permanency. The budgetary implications have been neutral.

Other signs suggest that Tennessee's child welfare PBC has been successful. It grew in scale, expanding from five providers at its outset to include all child welfare and juvenile justice providers five years later. And it weeded out lower performers–the number of child welfare and juvenile justice providers in the state has dropped by a third from over seventy before the PBC initiative began.[2] Children's Rights, which filed the original lawsuit against DCS in 2000, noted in a 2011 report, "While some providers could not adjust to the new service environment, many others thrived within and profited from it."[3]

So what happens to this "profit"? In a private sector pay-for-performance contract, a firm can use the incentive money as it chooses–for executive bonuses, dividends, you name it. Tennessee has an expectation that providers will reinvest their incentive payments to improve performance. Youth Villages has performed well under PBC and we have reinvested the incentive payments, along with additional privately raised funds, in ways we believe will produce better outcomes. We have developed intensive family-finding strategies to identify permanent homes for more youth. We have invested in evidence-based practices such as Trauma-Focused Cognitive Behavioral Therapy to provide the most effective treatments to the youth we serve. And key tenets of our model–including smaller caseloads for each counselor; stronger supervision and clinical consultation; and a data collection and analysis system that lets us monitor performance, outcomes, and customer satisfaction–are far beyond what our government funders ask for but have been critical to achieving our outcomes.

What's the Best Way to Structure a Social Services Performance-Based Contracting System?

While the PBC system has achieved success overall, the contract is highly complex, and multiple elements have posed problems for providers and created perverse incentives. Basing our observations on our experience with this contract, as well as discussions with experts in the field and a review of recent literature on the subject, we believe a PBC system needs to get a few things right if it is to deliver better outcomes and end up paying for success.

Define clear outcomes and performance measures. Measures must be objective, collectable, and tied to the desired societal outcome goals. Here, the outcome metric of reentries to care has been particularly effective. It measures whether the child is stable in his or her home

2 Casey Family Programs, "Tennessee and Youth Villages Common Knowledge Case Study." (June 2010).
3 Children's Rights, "What Works in Child Welfare Reform: Reducing Reliance on Congregate Care in Tennessee." (July 2011).

a year after discharge from services and thus ties directly to the goal of permanency. Even though the data are available, it is incredibly rare for providers to be held accountable for this measure in our field because reentry occurs long after the government payments are made and falls outside of the service year's budget.

Ensure that data collection is transparent and consistent across providers. All parties must understand what data are being collected, have access to the data, and understand how data are linked to incentives and penalties. To make the system consistent and feasible, the agency should manage the data rather than requiring each provider to adopt new systems and processes. Some providers may not have adequate technology, so having DCS collect all data is essential. However, currently Tennessee providers do not have access to the methodology and data manipulation performed to calculate rewards and penalties; thus they are not able to easily predict and prepare for the financial impact they will face or evaluate data for inaccuracies. When Youth Villages has made data requests and been able to dig into numbers, it has not been uncommon to find inconsistencies across data sets. So while DCS greatly enhanced its data sophistication, which is a big win, the lack of transparency has been a significant hindrance.

Give providers flexibility. Government agencies will always need to write specific standards into contracts to ensure client safety and guard against corruption, but a performance-based contract should allow providers enough latitude to get results. In one state in which we operate, the state's regulations concerning staff credentials, clinical team structure, session length, and the reporting requirements for reimbursement are so restrictive and cumbersome that we are forced to modify our model, manage substantially greater complexity, and devote more resources to administrative duties. The focus should be on the ultimate outcomes and not the programmatic components that lead to them. Fortunately in Tennessee, prior to implementation of PBC, DCS had a continuum of care model that allowed providers substantial flexibility in determining the most appropriate setting and services for children in their care; the continuum model continued under PBC.

Identify and correct perverse incentives. Almost any incentive system is bound to produce some unintended consequences. For example, in education the talk of incentives immediately sparks intense debate about teaching to the test and score fixing. A PBC system should spend time upfront collecting data, testing its application, and identifying and fixing ways that parties may game the system. The Tennessee DCS contract formula produces an unintended consequence stemming from the tying of rewards to the timing of admissions and discharges within a fiscal year–meaning that the same outcomes could be rewarded or penalized depending on the month a youth was admitted. This may lead some providers to reject a child simply because of the month in which the youth needs services.

PBC incentives and penalties should be separate from cost reimbursement. Tennessee has shown that an effective monetary performance incentive need represent only a small percentage of a contract's value. Youth Villages' contracts on average have zero margin; therefore, having a very small portion of our reimbursement at risk is highly motivating and risky for us–having as little as 5 percent withheld or lost would likely represent losses and an inability for us to cover our expenses. Some recent PBC model ideas have proposed withholding 25 percent of reimbursement for one to two years after service completion. If the basic costs of delivering a service are tangled up with the incentive structure, it could wreak havoc with providers who are working hard to get better but have not hit the mark yet. This idea would put even strong providers out of business.

Ensure that all providers are compared against common benchmarks. In Tennessee, initial provider resistance to a performance-based contract, and the fear that the penalties might force some providers out of business, led to outcome goals based on each provider's own past performance. A provider that moved from poor to average performance would get a larger reward than an excellent provider that continued to produce the best outcomes for kids. Ultimately, everyone needs to be aiming at the same benchmark so that government funds consistently promote the strongest outcomes.

Take each provider's population mix into account. While there should be standard benchmarks, these targets must be adjusted to reflect the fact that not all providers serve the same mix of clients. Providers with the most challenging clients should not be penalized for doing the hardest job. We see a similar concern in medicine, where it is feared that PFS might lead doctors and hospitals to shun the oldest and sickest patients.

Over time, shift "market share" to providers producing the best outcomes. Government contracting is never going to look like a perfectly competitive market, but a well-functioning PBC system ultimately will start identifying longer-term winners and losers based on its performance measures. This visibility should result in the better-performing providers doing a larger share of the work, in contrast to business as usual in government. In Tennessee, even though some of the weaker providers have gone out of business, there has not been an intentional effort to shift market share to higher performers. Absent that redistribution, the state will fall short of delivering the best possible outcomes for its troubled youth.

Can Performance-Based Contracts Save Money?

Tennessee was not aiming to reduce its children's services budget. It was trying to get better results with that budget and reinvest the savings for quality improvement. But in this era of fiscal austerity, PBC inevitably emerges as a good way to trim government cost. The 2007 California Performance Review report, for example, said the state "should use performance-based contracting activities to save money."[4] (The report also saw PBC as an opportunity to "maximize performance, encourage innovation and competition and improve services.") In our view, savings are to be had–sometimes for a specific agency and in a particular fiscal year, sometimes for the system overall over a longer time horizon.

4 California Performance Review, "Increase the Use of Performance-Based Contracting," (2007), available at http://cpr.ca.gov/cpr_report/Issues_and_Recommendations/Chapter_7_Statewide_Operations/Procurement/SO71.html.

Youth Villages' intensive in-home service program costs approximately one-third the cost of traditional out-of-home care. We divert youth from placement, achieving better outcomes and costing the agency less per child served. However, those per-person savings may not equal budgetary savings.

A major determinant of whether budgetary savings emerge is the overall demand for congregate-care beds. While shifting more youth from out-of-home placements to in-home settings opens the door to facility savings, cost reductions only materialize if the state does not fill the beds. In states with a waiting list for beds and with strong providers who will market their services to get their beds filled, this is unlikely. And looking specifically at the fixed costs associated with running facilities, savings do not occur until the system hits the threshold of reduced demand that allows for closing part or all of a facility. The politics here are also challenging because government typically divides youth among all providers to share the business, leaving some open capacity everywhere rather than filling the best facilities and emptying the others.

Even if cost reductions do occur, additional complexity may make the savings fall to another department or budget year. In some states, the payer for in-home services is different from the payer for out-of-home care, so the in-home payer cannot repurpose per-youth savings achieved through a preventive or diversion service. And sometimes the savings are over a time horizon that expands beyond the budget year, as is the case with longer-term reductions in emergency room, disability, and unemployment costs.

Finally, there is a moving-target issue. As interventions improve and become more cost-effective, so does the baseline cost benchmark. The difference between the "traditional" government intervention and the new one narrows along with the cost savings.

Overall, cost reductions represent real value. Accessible budgetary savings are motivating. But given the inherent complexities in capturing them, savings should not be the leading indicator of a performance-based contract's success.

Do We Want More Performance-Based Contracts?

At Youth Villages we want more performance-based contracts because we want more kids to be part of strong families, more youth to achieve their educational and vocational goals, and fewer citizens to spend their youth and young adulthood behind bars. The current system of pay-for-outputs government contracting is not focused enough on the real outcomes that we–providers, government, everyone who cares about kids and families–seek. Consider what this idea might mean for the 3.7 million children involved with the child welfare system across the United States.

We believe that PBC–for all its challenges–has potential to achieve better results on limited budgets. At Youth Villages, we hope and expect to spend considerable energy over the next few years working with state agencies and political leaders, the federal government, child and family advocates, and some very committed philanthropists to move PBC forward. It is one of the best ways we know to help children and get the value we need from the public's money.

Patrick W. Lawler is the founder and chief executive officer of Youth Villages, one of the largest private providers of services to troubled children and their families in the country. Under his leadership, Youth Villages has established an array of specialized treatment programs operated by an effective team of more than 2,700 employees in 66 locations across 11 states and the District of Columbia. Since 1986, the organization has changed the lives of more than 80,000 children despite overwhelming odds and an even more overwhelmed system. Driven by a passion to take on the toughest child services cases he can find, Lawler has revolutionized the field of child welfare in America with Youth Villages' Evidentiary Family Restoration approach. This approach proves that troubled children can achieve success rates twice that of traditional services at one-third the cost of traditional care. Lawler was recognized in 2006 as one of "America's Best Leaders" by U.S. News & World Report *in conjunction with the Center for Public Leadership at Harvard University's John F. Kennedy School of Government. He was recently featured in the book* Everyday Heroes: 50 Americans Who Are Changing the World One Nonprofit at a Time. *Mr. Lawler's leadership and Youth Villages' success are profiled in Ken Stern's 2013 book* With Charity for All: Why Charities Are Failing and a Better Way to Give *as a prime example of nonprofits that are achieving results and merit donor investment.*

Jessica Foster, director of strategy, reports to Youth Villages' CEO and partners with the senior leadership team to support the organization's continued growth. She facilitates strategic planning processes, oversees business development and government relations, coordinates and manages mergers and special projects, and helps communicate Youth Villages' strategy and results to various audiences. Foster joined Youth Villages from the Boston Consulting Group, where she supported the strategy and design of multiple-site implementation plans for a global corporate merger-and-acquisition project, evaluated and recommended improvements to performance management of a large public school district, and developed government advocacy strategies for a consumer packaged goods company. Previously she was a consultant at the Monitor Group and a legislative aide for U.S. Senator Arlen Specter, whom she advised on foster care, adoption, welfare, economic development, public housing and nonprofit issues. Foster holds a BA in public policy from Brown University and an MBA in marketing from the Wharton School.