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Hearing on Social Impact Bonds and Families in Need

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Chairman Reichert, Ranking Member Doggett, and Members of the Ways and Means Subcommittee on Human Resources:

I appreciate the opportunity to testify on Social Impact Bonds (SIBs), Pay for Success (PFS) and their potential to help achieve better results for families in need and communities across the nation. **I strongly support the adoption of House legislation HR 4885,** as introduced by Congressman Todd Young (R-IN) and Congressman John Delaney (D-MD).

As a brief background, I was for ten years a member of Capital One's founding management team and then went on to build North Hill Ventures, a venture capital firm based in Boston. I currently serve as a board member for Vistaprint, Inc., a company that has created thousands of American jobs. But for the last twelve years, I have focused almost exclusively on working within our social sector, helping high-performing nonprofits raise about $350 million dollars of needed philanthropic capital and co-founding a nonprofit called Third Sector Capital Partners, Inc.

Our mission at Third Sector Capital Partners, Inc. is to accelerate America's transition to a performance-driven social sector. We are doing so through our advisory work on Pay for Success (PFS) contracting, and Social Impact Financing (SIF). **PFS is a new form of social service procurement, where services are paid for based on whether or not improvements in social outcomes are actually achieved**. This stands in sharp contrast to traditional social service contracting, where payments are based on a reimbursement concept, and where providers are required to follow certain programmatic recipes as a precondition for payment. SIF is a frequent companion to PFS contracting that involves **private loans (also called social impact bonds) used to bridge the payment timing delays that are inherent to measuring whether PFS outcomes have been achieved.** SIF also plays the vital role of shifting financial risk away from both the government and from vulnerable service providers, and of attracting private stakeholders (particularly valuable for conducting due diligence and maintaining continuity over long stretches of time) into the social services arena.

Third Sector is a leading practitioner in this fledgling industry. We helped launch the Massachusetts Juvenile Justice Pay for Success Initiative, the largest PFS project to date, and have many other PFS/SIF projects in various stages of development. Indeed, PFS/SIF has been catching on rapidly, not only here at the Federal level, but also at the state, county and local levels. To date, there are four launched PFS projects in the country, involving close to $60 million of pay-only-if-it-works government commitments. We estimate that there are at least eleven additional PFS projects in later stage construction, plus fifteen or more in the feasibility assessment stage. The list of **PFS-active states, cities and counties** is diverse and cuts across party lines. It includes **Massachusetts, South Carolina, Ohio, New York, Connecticut, Michigan, Minnesota, Illinois, Utah, Colorado, New York City, Boston, Chicago, Los**

Angeles, San Francisco, Washington DC, Philadelphia, Santa Clara County, Fresno County, Pima County, Cuyahoga County, Salt Lake County, Alameda County and Orange County.

With millions of lives affected, and $800 billion of annual social spending resources at hand, PFS/SIF offers a potential **breakthrough for America's most vulnerable communities** and for taxpayers at large. It also represents an **opportunity to tap into large quantities of private risk capital**, as well as **private sector expertise** that would otherwise not be brought to bear on important social issues.

Certainly, a **breakthrough is needed**. For many decades, America has been unable to move past the unacceptable conditions (and particularly the underlying causes) that afflict our most vulnerable families and communities. Real **median incomes for the poorest Americans have not budged** over the last forty years, **nor have math and reading test scores**.[1] Why, when we have as a nation managed to double real GDP per capita since 1970 and halve death rates from coronary heart disease, do social outcomes remain so intractable?[2]

Experience has taught me that when we examine the topics like recidivism, foster care, drug addiction, school readiness, homelessness, poverty and the like, we must include government as a key part of the picture. The philanthropic sector is just too small to work alone. For example, during my time at Nonprofit Finance Fund, I helped to raise hundreds of millions of dollars for high-performing nonprofits that worked in these areas. The results of these efforts were gratifying. **But compared to the government resources that were lined up against these same issues, the philanthropic dollars are frankly miniscule.** In this era of mega-wealth and the giving pledge, philanthropy is more powerful than ever; but **if we hope to tackle large social problems, we absolutely need government to be an active partner**.

Several years ago, I began to examine the way government goes about funding social programs and quickly saw that **we currently have a fund-what-*once*-worked** system. In other words, our system of lawmaking and procurement tends to lock old innovations into place, leaving little room (and creating little incentive) for the adoption of new and better approaches. It works like this: At some time and some place, perhaps thirty years ago, a form of social intervention becomes popular. A politician sees the potential and says "You know what, this is a good approach. It ought to be written into a law, so that more people can benefit." After much wrangling, the **program description is written up like a recipe card, enshrined into law, and attached to a spending stream** that says, in effect, "Anyone who follows this recipe will be reimbursed." But – and here's the thing – "If you come up with **some other recipe, you won't be eligible for reimbursement**. So whatever you do, don't change the recipe!"

I have examined the recipe language that is baked into many of our social service laws. Quite commonly, *even after thirty years,* the substance of the recipes remains unchanged. Think of it this way. **If we did music the same way we fund social spending, we would all be required to listen to Meatloaf on an eight-track, or else not be reimbursed.** Because thirty years ago, when Meatloaf and the eight-track were cutting edge, someone would have said, "There ought to be a law!"

[1] Jon Baron. "Applying Evidence to Social Programs". New York Times "Economix" blog. November 29, 2012, available at http://economix.blogs.nytimes.com/2012/11/29/applying-evidence-to-social-programs/
[2] George Overholser and Caroline Whistler. "The Real Revolution of Pay for Success:
Ending 40 years of Stagnant Results for Communities." Federal Reserve Bank of San Francisco Community Development Investment Review; Volume 9, Issue 1, 2014. Available at http://www.thirdsectorcap.org/wp-content/uploads/2013/05/Real-revolution-pay-for-success-ending-40-years-stagnant-results-communities.pdf

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I believe that PFS/SIB gets to the heart of this very fundamental flaw to the way we enact social policy. It **replaces follow-the-recipe-or-don't-get-reimbursed with an incentive to come up with better recipes**. And it **connects a rigorous evidence feedback loop to the money**, so that **taxpayer dollars will be better deployed**.

To use the music metaphor, PFS/SIF allows (in fact inspires) the progression from Victorola to 78, to 45, to LP, to eight-track, to cassette deck, to boom box, to Walkman, to compact disc, to iPod, to iPod mini, to the iPhone and Android, to Pandora, to Spotify, and so on. Any single step may not be large, but over time, the "unfrozen" journey leads to a complete transformation.

At this point, I'd like to highlight two promising observations.

First: **The cost of measuring social impact, *with rigor*, has plummeted and will continue to do so**. Just as Moore's Law transformed so many other industries, we are now finding that administrative databases, a by-product of running social programs, are finally in good enough shape to be used for social science purposes. As has been well-documented by the Coalition of Evidence Based Policy, it is now possible in many cases to conduct gold standard randomized control trials (RCTs) at a cost of merely a few hundred thousand dollars or less, rather than the many millions we are used to. Moreover, by harnessing administrative data in an ongoing way, we are able to replace one-time RCT "snapshots" with ongoing "movies" of whether or not a social impact strategy continues to achieve impact. Perhaps even more important, we are **now able to construct inexpensive "government-side" evaluation methodologies that establish a common basis for comparisons** across multiple program strategies and service providers. As many lawmakers and government officials have shared with me, the current world of every-provider-brings-its-own-cherry-picked-data makes it almost impossible to discern what truly works for our communities. A common government-side evaluation methodology is sorely needed and, thanks to Moore's Law, is also finally affordable.

The recently revamped **Illinois foster care system provides a striking example** of how built-in, government-side evaluation techniques can be used to insert – at strikingly low cost – a permanent and highly rigorous evidence feedback loop into social service procurement. The idea is simple: In Illinois there are about twenty providers of foster care services for children four and under. With their new approach (and after ensuring an appropriate fit of services and geography) the state uses a rotational assignment system to choosing among providers to serve any given family. Then, using the administrative data that is a by-product of running foster care, each provider is monitored to determine important outcomes such as how many days elapsed before a permanent home was found for the child, or what percent of children served went on to experience trauma. Of course, the work of first implementing this new system was not simple. Procurement reform never is. But now that it is in place, Illinois has a "movie" (not an old "snapshot") of highly rigorous impact evaluation to work with, and a government-side standard yardstick that allows for fair comparisons across their many providers. Because, for all practical purposes, randomization through rotational assignment is now built into the fabric of procurement, and because the outcomes data is already captured as a byproduct, **its ongoing costs are close to zero.** (I should add that a Federal program, the 4(e) Waiver, which enables Illinois to claim half the costs of installing the allocation and tracking systems, was a critical catalyst to making these exciting changes happen.)

Second: As was highlighted in the Chairman's introductory comments, **very few of today's social outlays actually bring about more than a barely discernible amount of impact** on people's lives, whereas **others truly stand poised to make a difference**. This powerful statement, which relates to almost $800 billion of annual outlays, implies that there is in fact *no shortage of funds*, but rather an **opportunity to reallocate many billions of dollars** towards higher uses.

With these optimistic points –there is a great deal of **wrongly allocated money**, a **newfound ability to measure impact rigorously at low cost**, and **effective interventions waiting to be funded** – it seems to me that we have **no excuse but to move away from the frozen recipe law approach** I described above, and to embrace the newly possible evidence-driven methods of PFS/SIF.

My professional background includes serving on the original Capital One Financial Corporation management team, a company which started in the early 1990s as a consulting assignment for the credit card division of a small Virginia bank. In many ways, the **Capital One story resembles what we are seeing today in the field of social policy**. At Capital One, our strategy was to make empirical testing the centerpiece of our credit card product design and marketing functions. The early days required wrenching change, as we infused data-savvy people into an industry that had never grappled with statistics, and learned how to apply science to the field of credit card marketing. But over the course of just a few years, we got the point where we could **conduct hundreds of rigorous RCT tests per year**, thus learning which few of our many innovations actually worked in the real world. Armed with the proof of rigorous RCTs, we were able to build internal consensus around the winning innovations, and to roll them out with much greater confidence and conviction than would otherwise be possible.

This **strategy enabled Capital One to grow** from a relatively tiny shop to a top-ten credit card issuer within less than a decade. Over one three-year period, **we were the single most-appreciated stock in the New York Stock Exchange**. At the same time, I like to think that we rolled out great improvements in the quality and scope of products offered by the entire credit card industry. Indeed, **just 15 years later, the entire credit card industry had caught up** to employ the same rigorous randomized testing that Capital One pioneered back in the mid-nineties. I believe that a **similar industry transformation could take place in the way government procures many of our social services**. It may be a ten- or fifteen-year journey, as it was for the credit card industry, but this is a journey well worth taking.

From my experience at Capital One, I learned two important lessons that are relevant to PFS. First: **Even our most highly regarded "experts" were unable to predict which innovations would work best**. This meant that the hard work of **relentless empirical testing was surfacing innovations that otherwise would never have been embraced**.

Second: **None of our tested and successful innovations lasted**. Indeed, to remind employees of this fact, we created posters that we put up throughout the company with a picture of an ice cream cone and the slogan, "It Melts Like Ice Cream!" This second lesson is especially applicable to innovations in social services. **Unlike the physical sciences where discoveries like "hydrogen and oxygen make water" stay true forever, the social behaviors are forever changing**. I hasten to add that the issue of melting ice cream was not one, in the jargon of social services, of failing to replicate our innovations with "fidelity to the model". Indeed, our ability to replicate programs was close to perfect, and our statistical sample sizes typically numbered in the tens of thousands. It's just that the world would change, and, over time, the innovations would no longer work.

With these two insights in mind – empiricism trumps intuition and "it melts like ice cream" – it is easy to appreciate why PFS, with its built-in evaluation and powerful financial incentives, has begun to catch on so rapidly across the country. Rather than numbly complying with the tired recipes that constrain traditional spending streams, **PFS shifts**

the focus to achieving outcomes and asks providers and their partners who come up with new and **better ways of addressing social problems**. As a further catalyst for innovation, **PFS shifts the risk of testing new innovations away from taxpayers**, making it **easier for government officials to become champions** of change that works.

Economically, PFS makes it harder for our $800 billion of annual social spending to be squandered, and if Jon Baron is correct in his assessment that 9 out of 10 of these spending streams currently make little to no difference, then PFS can help us to **reduce the waste of $720 billion per year, while redirecting much of that funding towards programmatic strategies that actually do make a difference**.

Social Impact Bond loans help further by creating a new asset class that on the one hand taps into private capital to relieve financial pressures for government and providers, and, on the other hand, offers a **profoundly improved philanthropic proposition for the donors who make SIB loans**. Consider just how much better a deal it is to "donate" to a SIB vs. write a traditional grant. With a traditional grant, you write the check for a program you like and a year or two later you get a thank you letter that says "We've run out of money, can we have some more?" With SIBs, you write a check for that same program you like, and a year or two later you also receive a letter. But this time the letter shares rigorous proof about the difference you made to people's lives *and* there's a check inside that allows you recycle your donation (again and again) towards the program you like so much. I personally believe that there are billions of philanthropic dollars, waiting in the wings that will be drawn to this profoundly attractive proposition.

Critics often point out that there is an added expense to the PFS/SIF approach, and that government ought to just "do its job" and simply fund what works. I have a long list of responses to this. First, something has got to change, because clearly the $800 billion we spend each year is not working anywhere near as well as it ought to. To the contrary, we **cannot afford to continue with ineffective "fund what *once* worked/frozen recipe" policy.** We have to measure impact *rigorously*, and we need to do it *continuously*. Second, the **cost of measuring impact has plummeted and will continue to do so**. Third, the **first-time cost of building these transactions is much higher than it will be in the future**, once they can be replicated and once the average size of a transaction becomes much bigger. Fourth, the **financing is actually inexpensive compared to the risk**. Indeed, unless there is close to a 100% success rate on these PFS contracts, government will actually *save* significantly more money (by not having to pay success fees) than will be paid out as interest for the loans. Think of it this way: If a 5% interest loan succeeds, it earns 5%. But if it fails it loses 100%.

As I mentioned earlier, PFS/SIF is **primarily a state and local phenomenon**. But for the state and local efforts to succeed, there is a **critical Federal role** that must be played. For change to happen, cities, counties and states need the catalyst of a Federal bill. HR 4885, introduced by Congressman Todd Young (R-IN) and Congressman John Delaney (D-MD) sets **much needed standards**, it provides the **political impetus** of a match, it pays for **feasibility studies** for which state and local governments have no current funding and, critically, it makes it more possible for state and local PFS initiatives to **incorporate Federal level savings into the cost-benefit analyses** that undergird the PFS model. I am **strongly in support of the bill and hope you will be too**.