

Invest to save: can innovative funding of public services help address the fiscal black hole?

Introduction

As we argued in our first paper in this series *Invest to save – it's a good answer so why is it so hard?* (<http://www.i-a4e.com/blog/wp-content/uploads/2010/01/VF-Invest-to-Save-1.pdf>)

there are key obstacles to overcome before innovative funding arrangements are applied across wider public spending areas.

Since we published our first paper, the UK General Election has taken place (on 6 May 2010) and a new Conservative Liberal Democrat coalition government has taken power.

Whilst no political party was prepared to address in more than roundabout terms the cuts in public expenditure required to meet the structural fiscal deficit in the run up to the election, announcements made since emphasise how large and significant the cuts will be.

We are starting to hear more about DEL and AME and the DEL – AME switch, which underpins invest to save programmes, as the search to find new means of funding delivery of public services gets underway. (Definitions of these terms are repeated at the back of this paper for those in need of a refresh on the technical details.)

Therefore, in this paper we:

- explore invest to save's wider application at international, national and local levels and the role of innovative financing models to put it into effect;
- review new social impact bonds and other outcome focused financing models in detail; and
- analyse the issues faced by procurement teams in contracting for social outcomes especially where this explicitly allows for 'black box' models and greater degrees of consumer choice in the design of public services.

Finally, we argue that genuine savings in public expenditure are realisable. Yet it will require significant bravery and trust on the part of both governments and suppliers if they are to share the risks and rewards.

Update on invest to save in the UK

The former Labour Government had begun the procurement process for three-year invest to save pilot programmes in welfare to work as the first major implementation of the concept.

The coalition government's announcement that all welfare to work contracts will be incorporated into a single programme may delay the invest to save pilot procurement timetable.

However, the explicit references to both DEL - AME and invest to save in *The Coalition: our programme for government* means that its importance remains high, and has almost certainly increased.

- DEL – AME is specifically mentioned in the context of welfare reform:
"We will reform the funding mechanism used by government to finance welfare to work programmes to reflect the fact that initial investment delivers later savings through lower benefit expenditure, including creating an integrated work programme with outcome funding based upon the DEL/AME switch."
- and the invest to save concept is also floated in the context of reducing reoffending rates.
"We will introduce a 'rehabilitation revolution' that will pay independent providers to reduce reoffending, paid for by the savings this new approach will generate within the criminal justice system."



Wider application of I2S

Invest to save and similar approaches in the areas of welfare and re-offending have been successfully tried in other countries. Examples from Israel, the Netherlands and the US are summarised below.

Israel

Israel initiated an invest to save programme in the welfare to work arena in 2005. The programme had the explicit objective of reducing welfare payment levels by moving benefit recipients into sustained employment.

Delivery was outsourced to private sector providers, paid from the savings they made in welfare benefit payments. A4e was responsible along with a local partner for delivery of the pilot programme in East Jerusalem.

Though controversial because of the rules applied to reduce the number of welfare recipients, the programmes ran until early 2010.

The most interesting innovation in the design of the contract was a requirement that suppliers indemnify the Government on performance through an insurance bond. The bond would pay out if the provider did not succeed in reducing welfare payments in line with contractual terms. As it turned out, performance was such that the bond was never needed.

Essentially, any potential shortfalls from contract underperformance are indemnified through the use of this performance bond. This overcomes one of the main objections to increasing current spend, especially in a time of austerity, as a down payment on future savings that may not materialise.

Netherlands

In 2004, the Dutch Government introduced the Work and Social Assistance Act, shifting the focus of welfare policy to municipalities, giving them greater policy freedom and financial responsibility.

They were made responsible for paying welfare benefits, welfare to work measures and tackling fraud.

Municipalities receive a budget for social assistance (income budget) and an additional budget to use as they see fit to get benefit claimants back to work. They keep any underspend in the income budget but receive no compensation if they overspend (although there is protection against an unforeseen inflow of claimants). This gives them a clear incentive to get as many out of work claimants into work as quickly as possible.

In the four years to 2007, the number of households in receipt of benefit fell from 336,000 to 298,000 (the lowest figure for 25 years). The inflow to benefits fell from 110,000 in 2003 to 99,000 in 2005, and in the same period outflows rose from 93,000 to 105,000. Some of this improvement could be attributed to relatively good labour market conditions, but a preliminary analysis by the Netherlands Bureau for Economic Policy Analysis indicated that the impact of the new legislation had been substantial.

These arrangements gave municipalities an incentive to invest in skills and economic development activities - to generate more employment opportunities for local people. Provision of services is through a mixed economy of public and private sector organisations. By allowing municipalities discretion to reinvest any 'income budget' underspend, a virtuous cycle has been created.

In other words, municipalities have an invest to save incentive built in to the payment mechanism.

United States

The United States has one of the highest imprisonment rates in the world, driven in part by strict rules on breaches of parole and probation conditions which put large numbers of offenders back into prison.



Ineffective resettlement programmes in both prisons and the deprived communities from which a disproportionate number of inmates come and return to, has led some states to an approach termed 'justice reinvestment'. A concept developed by Open Society, a New York organization founded by George Soros, justice reinvestment is based on a redirection of the money spent on imprisonment from the State back to the community.

In 1998, Oregon introduced a justice reinvestment model with a view to reducing juvenile imprisonment. Deschutes County received a grant from the State, equal to the amount the State was spending to imprison youths from the County, to use as they saw fit. However, if the County decided to send a youth to the state run prison, it would have to pay the cost to the State. The model gave the community an incentive to keep its youths out of prison and encouraged the County to levy community service sentences that brought benefits to the community instead. The initiative exceeded expectations and resulted in a 72% reduction in juvenile imprisonment.

In an effort to prevent youth re-offending in Maryland, the Maryland Opportunity Compact introduced 'Multi-systemic Therapy (MST)', a multi-faceted, home-based approach aimed at modifying the factors (family, school, community, peers) in a youth's environment that may lead to anti-social behaviours. According to a Department of Juvenile Justice study, re-arrests were reduced by 43% after just over a year of MST treatment.

Connecticut passed the Act Concerning Prison Overcrowding in 2004. The goal of the Act was to reduce probation revocations, modify the parole process for low-risk offenders and create comprehensive re-entry plans in the most affected communities to reduce recidivism. Nearly \$13m of the \$30m was saved from the state budget and reinvested in various community projects, including those aimed at increasing and improving mental health/substance abuse provisions, adding

probations officers and focusing on re-entry transitions.

As a result, probation violations dropped and what was a growing prison population began to shrink.

These examples, and others, from the Netherlands and the United States demonstrate how invest to save programmes can positively impact at a local authority or community level and help prevent initial offending rates.

Social Impact Bonds

As the new government is making abundantly clear, the UK's fiscal position is such that finding money to invest in programmes that will pay back over the next few years is not going to be easy.

In our view, this will be a spur to financial innovation, one existing example being Social Impact Bonds (SIBs). A Social Impact Bond is a contract between a public sector body and Social Impact Bond investors, in which the former commits to pay for an improved social outcome. Investor funds are used to pay for a range of interventions to improve the social outcome and investors receive a payout only if performance targets are achieved.

This concept was developed by Social Finance (initially set up to cycle dormant account monies into social investments) and the first pilot SIB funded programmes were announced in the last Budget in March 2010.

The Ministry of Justice has agreed to a bond being issued to finance interventions aimed at reducing re-offending rates of short sentence prisoners at HM Prison Peterborough. The bond return is designed on a ratchet linked to the savings derived from the successful reduction in re-offending rates. The greater the savings the higher the returns to investors.

As a result, bond investors will receive both a financial and a social return while Government gains new funding aimed at improved social outcomes, with the risk taken by bond holders.



In the same Budget announcement, an SIB approach to improving health and social care outcomes in Leeds was announced. This is at an earlier stage of development and is aiming to save money by improving community based services to lower demand for hospital admissions and stays.

SIBs are a fledgling new investment instrument and market. However, the potential to fund interventions aimed at specific social outcomes, often using third sector providers that are highly effective but constrained by limited resources, is great.

It also allows preventative programmes, which tend to pay back over longer time frames than political expediency allows, to be funded.

A further attraction for the new administration is that SIBs can support growth in third sector provision, fitting with the wider 'Big Society' concept and its encouragement of civic involvement when solving social problems.

Procurement issues

As we outlined in our first paper, there are several challenges to the design and implementation of invest to save schemes. Once past the generic objections of finance ministries (e.g. hypothecation), there are further issues for procurement teams to overcome.

Experience from Israel, for example, shows that finance ministries can be indemnified in case contract performance fails to deliver as expected. As it turned out the insurance was not needed and the costs of the bond was, of course, reflected in the contract negotiation. It can be argued that this cost is not therefore ultimately borne by the supplier.

As a result, there is some interest and thinking developing around pain and gain share models which have long been used in commercial contracts between, for example, water utilities and their suppliers of infrastructure services.

Pain and gain share contracts work on the basis that actual costs of delivery will vary from estimates. The mechanism for sharing cost underruns and overruns is a pooling of outcomes over a period of time. Any surplus at the end of the period is shared between the contracting parties to a pre-agreed formula.

In this way, suppliers are incentivised to improve performance and the customer gains from any savings generated. The same principle can be applied in invest to save contracts especially where a new approach is being taken and where exact costs will only emerge once the contract is underway.

Pain and gain share contracts work on the basis of long-term commitments by both sides, a degree of fairness in the distribution of gains and trust on the part of the buyers in the ability of its suppliers to improve their delivery.

Black box delivery models

In the welfare to work sector the Department for Work and Pensions (DWP) has been more innovative in contracting for Flexible New Deal (fND). Bidders were encouraged to propose their own 'black box' solutions rather than respond to a set of 'input' requirements laid down by the Department.

This recognises that rigid contracting and measurement of suppliers by inputs does not necessarily lead to the best outcomes. Nor does it encourage supplier innovation and improvements once contracts have been won.

The fND contracts also changed payment profiles towards outcomes (in this case measured by sustained job placements) - and in so doing have transferred risk to the supplier base. Payment profiles based on outcomes clearly incentivise suppliers to work to improve performance during the life of contracts.

Implicit in a 'black box' contracting model is a high degree of trust in a supplier's ability to deliver successfully.

Although the financial risk of failure is clearly mitigated by the payment model, the political risk of contract failure remains with Government. In this sense, the development of a mature public services industry with a demonstrable track record across different areas of public services delivery is a pre-requisite.

The UK is one of the world's leading countries in terms of its public services industry with a relatively mature base of both private and third sector providers.

As trust and capabilities build over time, the logical end point for 'black box' contracting is for Government to give suppliers a 'license to operate' either in managing certain interventions or across a range of interventions such as health, employability, skills, debt, legal advice and others.

Allowing public services to be delivered across a range of interventions would help us move towards more joined up government on a large scale. As noted in our first paper, to date most invest to save budgets have been spent on joining up services only on a small scale.

Conclusions

Invest to save does provide a means for Government to continue to meet front line public service expectations with funding models based on shares of future savings.

Even in the fiscal circumstances we face in the UK in 2010, there is scope for finding sources of capital to make the initial investment.

However, to get to this point, Government and suppliers will need to work more closely on models and measures that share the risk and reward balance in a way that works for both parties.

Definition of DEL-AME

DEL stands for "Departmental Expenditure Limit" and AME for "Annually Managed Expenditure". These technical terms are explained in the box below

A Departmental Expenditure Limit (DEL) comprises spending which "can sensibly be controlled". It is a "firm limit" for the department's spending set over a three-year period following a Spending Review. For example, the Department for Work and Pensions' (DWP) DEL includes its own running costs (notably on JobCentre Plus) as well as its expenditure on its various Welfare to Work programmes.

Annually Managed Expenditure (AME) covers spending which the Treasury argues cannot sensibly be planned in advance, and which is set annually in the relevant Budget. The DWP's AME – benefit and pension payments – is the single largest element of AME across government and indeed the single largest budget across both AME and DEL.



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