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INSIDE

Can we generate economic value by creating social good?

Human capital performance bonds would reward nonprofits that improve lives while reducing the cost of state programs

By Steve Rothschild

This much is clear: Minnesota's budget problems won't disappear at the end of the biennium or at the end of the recession. The latest 25-year forecast by the state economist predicts that state revenues will grow at a reduced rate of 3.9 percent a year while health care costs escalate at 8.5 percent and education barely stays even with inflation at 2 percent growth. This means that everything else, including early childhood education, job training, anti poverty and drug rehabilitation programs and infrastructure spending will decline at about 3.9 percent per year. Ten years from now we will have 35 percent less to invest if these trends persist. The factors driving this scenario are in large measure fixed: Our aging population will reduce state revenue growth while also dramatically increasing spending on pensions and health care. The consequences of this scenario are daunting: more school drop outs, higher poverty, and greater criminality.

This "new normal" challenges our society's well-being. Either we accept these consequences or we find a way out.

The solutions often proposed during the election season were to cut spending drastically, increase taxes, or a combination of both. Most informed observers agree that these "solutions" by themselves are no more than a short-term band aid on a hemorrhaging patient.

> Can social value translate into economic value? Yes, in most areas of social spending. A successful pay-for-performance model has existed for more than 13 years in the state of Minnesota.

There are a number of efforts underway to redesign the way government provides services in an attempt to make state spending more efficient and effective. We need to encourage these efforts and implement the best of them soon.

To solve our budget problem, we need to successfully accomplish two broad objectives: improve outcomes from current state spending and increase investment in high performing social service programs. But doing so requires that we solve our budget problems with a new approach.

Let's start with a financing system that attracts new investment capital while also holding providers (most of whom are nonprofit agencies) and government accountable for generating quantifiable economic value from social programming. We can then reward the accomplishment of positive long-term outcomes rather than the bogus accomplishment of simply increasing our outputs (e.g., the number of people served by a program), which is what we typically do now.

Once nonprofits start demonstrating economic value, and government captures that value in the form of higher tax revenues and lower costs, government can interest private investors in providing long-term capital to finance even more economic (and social) gains.

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Here's how it works: Nonprofits whose programming leads to meaningful economic gains would qualify for a "pay-for-performance" payment. The size of the payment would be directly related to the size of the incremental economic value the state receives from increased tax collections, lower public subsidies and lower prison costs. Government has millions of examples of value being created as incomes increase and subsidies go away. For example, successful job training programs create incremental increases in sales and income taxes and lower welfare payments and corrections costs when clients' incomes rise. The same economic value occurs when individuals successfully leave subsidized housing, medical rehabilitation or drug treatment. This economic value is equivalent to cash and has the same financial value as cash flow in a business. Businesses use the promise of future cash flow to borrow long term or to sell securities to finance even greater growth. Governments could do the same from these new incremental funds.

Unlike other bonds the state now issues, human capital performance bonds carry considerably lower risk for the state. Only high-performing nonprofits would qualify to participate; providers are only paid once they successfully perform.

The mechanism would likely be a government "moral obligation" bond that is either taxable or tax exempt. Investors would purchase these human capital performance bonds (HCPB's) based on their assessment of risk and return, much like any other investment. Government would establish the economic value equation for service providers (i.e. a share of the incremental value created) and set up a mechanism to measure, capture and pay a performance pool for interest and principal reimbursement. A reputable third-party administrator, such as an accounting firm, would prequalify providers based on the likelihood of their programming to create value, oversee the operations of the performance pool, and report on results. Underwriters and rating agencies also would weigh in to assure the fidelity of the investment.

Is this financing system possible? Yes. Government already borrows large sums from private investors and bonds for a wide variety of purposes, including infrastructure projects. In the case of a bridge, a tunnel or a stadium, lenders are paid back from future tolls or special taxes. A human capital performance bond would work similarly. Interest and principle payments would come from the incremental cash flows that high-performing providers create for government.

There is precedent for moral obligation bonds. The Minnesota Housing Finance Agency, for example, issued low-income housing bonds in 2009. Bond underwriters are very receptive to moral obligation bonds as legitimate investment vehicles.

But can social value translate into economic value? Yes, in most areas of social spending. A successful pay-for-performance model has existed for more than 13 years in the state of Minnesota.

Twin Cities RISE! (TC RISE!) is a Minnesota nonprofit dedicated to alleviating chronic poverty. TC RISE! works primarily with people whose families have been poor for generations, most with a history of homelessness, poor job histories, low academic achievement and criminal convictions. After an intensive year-long focus on remedial education, skills training, coaching, internships and empowerment (in other words, transformation into accountable and hopeful human beings), graduates are placed in jobs that pay an average of $25,000 annually plus benefits, an annual increase of almost $20,000 from the time they enter the program. One- and two-year job retention averages are 82 percent and 73 percent, respectively.

These long-term outcomes create the economic value that enabled TC RISE!, with the help of economists Arthur Rolnick and Gary Stern of the Minneapolis Federal Reserve Bank, to approach the state to develop the pay-for-performance model that it employs today. In 1995, the state determined that each time a person is placed in a job that pays more than $20,000 annually with health benefits, a job that is at least a $10,000 improvement in their income, the state gains $3,800 per year from increased tax revenue and lower subsidy payments. The discounted present value of these future benefits over 15 years was calculated at $31,000. TC RISE! is paid a performance payment of $9,000 for each individual placement, and another a year later if the person is still employed in a job that's at least as good. TC RISE! shares the economic value that its programming creates for the state and takes all the risks; there is no payment for failure. Since 1997, when it was first enacted, the state of Minnesota has enjoyed a return of $5.42 for each dollar paid to TC RISE! That's a 452 percent return on its investment.

TC RISE! is not unique in its ability to generate economic value from the social good it performs. Any social enterprise whose quality programming creates incremental tax revenues and/or reduces public subsidies in the short to medium term could create high returns for the state and payments for itself. Examples include workforce and drug treatment programs, health care, subsidized housing and higher education, among others. Some nonprofits are doing it already; they (and the government) just don't know it because returns aren't being measured or captured by the state.

While an overwhelming number of areas could apply human capital performance bonding, the financing system won't work everywhere. It won't work in areas where there is no direct link between social value and economic value, such as museums, zoos or public media, or where social investment takes many years to pay off, as in early childhood education.

Here's how such bonds could work:

- External investors buy human capital performance bonds that are linked to clear economic criteria established by the state.

- The state deposits these invested funds in a "performance pool," where the money is invested and held until the payout terms are met by the nonprofit. The pool is overseen and administered by an independent trustee to insure the pool's fidelity. (Working capital could be provided to nonprofits from this pool, too.)
- The pool pays out to the nonprofit over the bond term, based on the nonprofit's ability to meet performance goals set by the state. The amount of the payment is related to the amount of value created (return on investment).
- The state pays the performance pool for bond interest and principal repayment from the cash benefit it receives from incremental tax receipts and cost avoidance.
- A third party administrator annually validates the performance value (ROI) to the state and adjusts the payout formula.
- If performance targets are met, the state receives a high return on investment which generates cash flow to fund interest and principal repayment. The state retains residual cash returns to lower the cost of government.
- If performance targets are not met, the state has use of the funds for principal repayment, interest, or other purposes until the bond period terminates since nonprofits are paid only when they perform.
- The structure ends at the end of the bond term. Alternatively, the performance pool continues operating, funded by the incremental cash returns reinvested by the state.

Unlike other bonds the state now issues, human capital performance bonds carry considerably lower risk for the state. Only high-performing nonprofits would qualify to participate; providers are only paid once they successfully perform. The higher tax receipts and lower state costs created by the nonprofit pool provide a dedicated flow of cash to pay interest and principal to investors. While nonprofits assume more risk in this scenario, they have the potential to earn considerably more financial support than under current (and future) state spending plans. That's a prospect that high performers should relish.

Obviously, we'll need a transitional structure while government and nonprofits tool up to work in this way. The benefits will be well worth the effort as each stakeholder has a lot to gain.

State government will have a new source of dollars to invest from private investors. Social spending could increase as outcomes improve, instead of the likely prospect of continuing cuts in social spending funded exclusively from state spending. Cash returns from the highest-performing nonprofits will not only pay for the financing costs but also could provide incremental returns.

The highest-performing nonprofits will have access to significant new capital for growth. The amount depends on their outcomes. They will make more strategic, higher-return investments as a bond pool life is longer term than the two-year government budget cycle. Nonprofits will seek to improve their outcomes to participate.

As the best-performing nonprofits grow, clients will be served by higher-quality programming, leading to better outcomes. More individuals will leave poverty, obtain quality employment and achieve higher levels of education.

Investors will have a new quality investment opportunity that adds real value to the economy. Banks will be especially interested because human capital performance bonds qualify for community reinvestment act credit. Socially conscious investors will be large supporters since HCPB's meet their mission and financial requirements.

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Taxpayers will gain greater transparency and accountability for their tax dollars. As investments pay off, the cost of government will come down.

More than 70 organizations, including economists, underwriters, business leaders, nonprofit and foundation executives, civic officials and thought-leaders representing every major political viewpoint have endorsed a pilot project to test human capital performance bonds during the upcoming biennium. The Citizens League is considering endorsement in December. We are now in the process of drafting legislation, creating a bond term sheet, establishing the economic value to both nonprofits and the state, and establishing a governance structure for the approval of the legislature and governor-elect.

We face a crisis in our country and state. Our investment in social programming isn't paying off adequately and we have too little capital to finance those nonprofits that demonstrate the best results. The old financial model isn't working and doing more of the same won't lead to a different outcome. We need a new model that can make a difference. Human capital performance bonds have that promise. ●

Steve Rothschild is founder and chair of TC RISE! He serves on the boards of the Greater Twin Cities United Way, Minnesota Public Radio and the Hubert H. Humphrey Institute for Public Affairs and is a former executive vice president for General Mills, Inc.