Unrealized Gains: Investing in Our Region's Economic and Human Capital Potential

Capital for Communities: Pay for Success Financing

Philadelphia, PA

November 4, 2015

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President and CEO
Federal Reserve Bank of Philadelphia

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Organized by the Community Development Studies & Education Department
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Introduction

Thank you for attending this Capital for Communities event exploring pay for success financing.

I would like to thank Inglis and Philanthropy Network Greater Philadelphia for their partnership in planning this event. I would also like to thank the talented speakers who have joined us from near and far to share their insights on pay for success financing, a new tool that has the potential to generate societal cost savings through an evidence-based social investment approach.

Lastly, I thank the Community Development Studies & Education Department of the Federal Reserve Bank of Philadelphia for organizing today's event.

Across the Federal Reserve System, the Community Development function provides research and gathers stakeholders to explore emerging trends and issues in low-income areas throughout the country. We are pleased that our colleagues from other Federal Reserve Banks and the Federal Reserve Board of Governors have joined us today.

Research-informed practice and practice-informed research are key goals of the Community Development Studies & Education Department. Today's event will highlight pay for success, an emerging model that allows the public, private, and nonprofit sectors to work together to move from good intentions to good outcomes. This model uses metrics that not only track success but also allow us to learn from potential failures. It is wonderful to see practitioners, researchers, and policymakers here today as we explore strategies to support research-informed public investments.

Our Region's Potential

I believe this region has incredible potential. Greater Philadelphia is home to some of the world's most renowned centers for higher education and cutting-edge applied research. We are seeing connections emerge among these institutions with technology transfer centers, entrepreneurs, and investors working together to reshape our city into a center for innovation. Our region's economy has been strengthening since the recession, with unemployment in Philadelphia County down to 7.6 percent as of August 2015 from a January 2013 rate of 11.9 percent.[1] According to figures from the Economy League of Greater Philadelphia, from 2009 to 2013, Philadelphia experienced new business growth of nearly 9 percent, equating to 2,700 new firms. Additionally, Greater Philadelphia has experienced a surge of 45 percent in international visitors over the past decade. Whether to see the Pope or to attend the upcoming Democratic National Convention, people are coming to Philadelphia and taking advantage of the wide variety of local restaurants, shops, and cultural attractions.

Despite this, not everything in Philadelphia is rosy. We have our share of challenges, too. Philadelphia is the second poorest large city in America, with a poverty rate of 26.5 percent, according to the latest U.S. Census figures. Philadelphia also has the highest deep poverty rate of the nation's 10 most populous cities; that is, people with an income below half of the poverty line. While Philadelphia has experienced recent job growth, the rate of growth has been slower than that of other U.S. cities, and the jobs are predominantly low-wage jobs that perpetuate rather than reverse the cycle of poverty.

[1] Bureau of Labor Statistics Local Area Unemployment Statistics (LAUS) Unemployment Rate: Philadelphia County/City; http://beta.bls.gov/dataViewer/view/timeseries/LAUCN421010000000003.

Despite the Philadelphia area being home to a number of leading colleges and universities, only 24 percent of city residents have a bachelor's degree or higher, and nearly 20 percent of the adult population does not have a high school diploma, according to the latest U.S. Census figures. Other significant human capital issues plague our region as well. More than 106,000 youths and young adults aged 16 to 24 in Greater Philadelphia are not in school and not working. Philadelphia has one of the highest incarceration rates of any large U.S. city, with 8,300 individuals in the Philadelphia Prison System. Further, these individuals face significant challenges when reentering society, contributing to a costly recidivism problem. A recent report by the Pew Charitable Trusts showed that the City of Philadelphia spends 7 cents out of every tax dollar on holding people in its jails, which is more than it spends on the streets and health departments combined.[2] Nearly 60 percent of these prison inmates return to the Philadelphia Prison System within three years of their release. How do we combat this problem? Experts cite supportive housing, mental health and substance abuse services, and workforce reentry as service gaps that directly relate to recidivism.[3] As the cost figures in this example show, there is a strong economic case for delivering successful preventative social interventions.

Targeted investments in preventative social services could help our region capture unrealized economic gains by unleashing the full potential of human capital improvements. However, traditional sources of capital to address these problems are limited. We know this capital is unlikely to come from the public sector. Municipal governments are under stress: Revenues are insufficient to cover basic expenditures; the costs associated with debt service, pensions, and other post-employment benefits are consuming a substantial share of scarce resources. And for many cities, the unreserved balance in the general fund provides little financial cushion for the

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[2] Claire Shubik-Richards, *Philadelphia's Crowded, Costly Jails: The Search for Safe Solutions,* The Pew Charitable Trusts Philadelphia Research Initiative, 2012, available at http://ow.ly/PXqS2.
[3] Anna Fogel, Jeff Shumway, and Anant Udpa, *Roadmap for Pay for Success in Philadelphia,* Social Finance, 2015, available at http://ow.ly/PXrpy.

future.[4] At the same time, federal government programs are not growing, and the philanthropic sector can only do so much.

Pay for success offers a new potential source of investment capital, but as with any proposed solution or program, we need to better understand the nature of our challenges. We also need to assess how this tool can contribute to a vision that is sustainable and inclusive, bringing opportunity to every neighborhood of our city and every city in our region.

A Potential Solution: Pay for Success Finance

The strength of our economy greatly depends on the skills, ability, and financial stability of our workforce. Investing in human capital is a strategy that can ultimately lead to both improved quality of life and economic growth.

We are here today to explore a new financing tool that allows for that investment in human capital. This new social finance tool, known as pay for success financing or social impact bonds, has been applied to reducing recidivism and homelessness and improving educational performance and public health. These are all endeavors that, if successful, could lead to higher labor market participation and lower unemployment, and thus promote economic growth.

After years of seemingly stagnant results in addressing certain social problems, many people are optimistic that pay for success financing will bring solutions in the form of new capital to support program delivery, improve accountability, and increase rigor in performance measurement. Pay for success financing shifts the risk of a preventative social service from taxpayers to investors who finance these programs and who receive government repayments if, and only if, the agreed-upon performance metrics are achieved. Third-party evaluators measure a program's success, which encourages research-informed practice that can deliver measurable results.

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[4] Keith Wardrip, *Fiscal Stress in the Small Postindustrial City: Causes, Consequences, and Implications for Community Development*, Special Report, Federal Reserve Bank of Philadelphia, May 2014, available at https://www.philadelphiafed.org/community-development/fiscalstress.

Last year, Fed Chair Janet Yellen cited research on the importance of early childhood education as a building block to opportunity that could reduce rampant inequality. She noted that, and I quote, "Research shows that children from lower-income households who get good-quality pre-Kindergarten education are more likely to graduate from high school and attend college as well as hold a job and have higher earnings, and they are less likely to be incarcerated or receive public assistance."[5]

Chair Yellen also explained that gains in early childhood education enrollment have stalled since 2010; only 41 percent of children were enrolled in state or federally supported programs in 2013. Access to these programs, most of which are specifically designated for lower-income families, is limited by the available state or local funding, and since the Great Recession, many programs have sustained budget cuts.

Pay for success financing is a potential strategy to preserve these important investments in social programs by leveraging private capital during times of fiscal stress. Taxpayer dollars are only deployed once cost savings through social outcomes have been realized.

Although only eight pay for success projects have been structured nationwide to date, nearly 50 are currently in development. Throughout the Third District, stakeholders are beginning to explore applications of this investment model. For example:

- In Philadelphia, a group is working to secure investments in housing for persons with disabilities to give them the opportunity to live in integrated community settings while delivering cost savings by shifting from institutional-based care toward home and community-based services.
- In the Lehigh Valley, a task force was assembled to promote investments in early childhood education aimed at improving educational performance outcomes over time.

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[5] Yellen, Janet. "Perspectives on Inequality and Opportunity from the Survey of Consumer Finances," speech given October 17, 2014, available at http://www.federalreserve.gov/newsevents/speech/yellen20141017a.htm.

- In Camden, a collaborative effort is underway to provide investments in supportive housing to decrease homelessness and generate societal cost savings from reductions in emergency room visits from those considered high-utilizers of the health-care system.

There has been widespread enthusiasm about the potential of this innovative model, but at this early stage, important questions still need to be explored, including:

- What is an appropriate investment term that will also allow enough time for a program to yield results, and how are successful programs sustained after the investment period ends?
- Could there be unintended consequences from this approach?
- And lastly, how can projects be best structured to allow for learning from potential failures as well as sharing of best practices from successes?

Our Event

Preventing problems such as homelessness, educational underperformance, recidivism, and poor public health is critical for the long-term economic health and prosperity of our region and our nation. Philadelphia native Benjamin Franklin, a father of American innovation, said, “An ounce of prevention is worth a pound of cure.” The Federal Reserve Bank of Philadelphia is hosting this meeting because it makes economic sense to explore new ways to prevent the social problems that plague our society today. And, we know that successful social investments will contribute to a stronger economic future. The presence of both local and national leaders here today is a testimony to the broad interest we share in exploring innovative ways to work together toward these goals.

Today’s discussion will provide opportunities to understand and to focus on different perspectives about the purpose, appropriate uses, challenges, and risks of pay for success financing. The goal of this event is to create a community of interest around the development of social impact bonds and to identify opportunities for government officials, potential investors, and service providers to leverage pay for success financing to implement or scale social innovations.

Conclusion

Over the past few weeks, I have been traveling across the District, and I have been struck by a number of things: How different our economies are from community to community and how hard our residents, community organizations, and the public sector are working to effect change. One exchange in Allentown, however, really stood out for me.

We met with a private developer who has made various investments to revitalize the downtown area. He was celebrating the successes and envisioning the future for a new and improved Allentown. In mid-conversation, he voiced his concern that the low- and moderate-income residents of Allentown were not seeing themselves in the bright economic future of the city. They were not applying for the new jobs that were available. They were not shopping in the new stores. And they were not eating in the new restaurants. He asked some folks representing the local nonprofit community what he needed to do to make sure that this changed – that the Allentown of the future was an Allentown for all residents. I mention this because it highlights a critical component for today's meeting. There is interest from the private sector to find solutions, and this interest can be leveraged to bring about transformative change. For real change to occur, however, conversations have to begin, which brings us back to the purpose of our event today.

This meeting highlights the importance of connecting a diverse group of stakeholders and creating a dialogue that encourages a collective approach to local issues and opportunities. This challenging work requires an approach that is at once creative and forward looking. The strategies you will learn about today exemplify how social finance innovations can unite public, private, and nonprofit stakeholders by allowing risk, return, and impact to be allocated so that everyone's needs are met while delivering social outcomes that cannot be achieved by one party alone.

A shift toward evidence-based public investment will not be made without significant effort, and it would be easier to stick with the status quo and hope for the best. But let's not let the fact that there is no handbook on how to do this stop us from innovating in ways that could potentially improve the lives of some of our most vulnerable neighbors while also saving scarce public resources. After all, the handbook on innovation is not read; it is created.

Thank you.