FFTA

July 2005

PERFORMANCE-BASED CONTRACTING: THE BASICS

Written for the Foster Family-based Treatment Association by Fred Wulczyn, Ph.D., Chapin Hall Center for Children at the University of Chicago

• Why States are Interested in Performance-based Contracts

The idea of a performance-based contract is not new. Contracts with the private sector in general, and in the foster care/child placement field in particular, have always carried with them specific expectations with respect to performance. What *is* different today is the specificity and the nature of the expectations. The current shift is away from inputs or process objectives (i.e. service units, quantity of specific services rendered) towards outputs or outcome objectives. Succinctly stated, public child welfare agencies are increasingly interested in purchasing outcomes as opposed to services.

This shift reflects general trends in the field. Public child welfare agencies are using the same lens to evaluate private contractor performance that is being used by the public and the federal government to scrutinize their own performance. In recent years the federal government has increased the level of scrutiny over state and local government performance. Performance-based contracts are one way to pass this scrutiny on to contract service providers.

The newer view of paying for outcomes, not services, reflects the understanding that there are both quantitative and qualitative variations in provider performance, measured as differences in how long it takes to achieve permanency for children. When focused on outcomes, performance-based contracts address the unfavorable dynamics in the fee-for-service system. Performance-based contracts also provide a context for increasing flexibility in the use of funds.

Given the variation in provider performance, all things being equal, states have an obligation to work with providers that do the best job. There are many considerations that go into defining what the best job is. Among them are quality of services, location of services, and cultural relevance. But the fundamental benchmark is the outcomes produced: How do the clients benefit from the services?

FFTA

The Economic Efficiencies of Performance-based Systems

When providers are reimbursed on a fee-for-service basis, improving performance costs money in two ways. First, there are the direct costs associated with upgrading the services provided. Examples of these costs include the cost of providing more staff training, or alternatively, the cost of hiring better trained or more highly credentialed staff. Improved services, to the extent the improvements reduce the need for services, cost an agency in a second, indirect way. Specifically, as agencies more efficiently meet the needs of their clients, the total volume of billable services is reduced. This is the fiscal disincentive built into fee-for-system reimbursement systems.

Currently, the child welfare system provides services within a statutorily categorized funding system. For providers of foster care services, the primary mode of reimbursement is the fee-for-service method. Often, performance-based contracting allows increased provider discretion over the use of funding, depending on how the system is designed, because the performance-based contract relies on a prospective payment that is not linked exclusively to the number of service units provided. The cost of services is included in the contract, but consideration of expected outcomes adds a dimension to the amount of revenue a provider can expect.

Features of Performance-based Systems

All performance-based systems should address the following questions, at a minimum:

- What is the target performance?
- Will savings be reinvested?
- What is the (performance) baseline and is it "risk-adjusted?"
- How will risk sharing be managed?
- How will revenue be disbursed (e.g. retrospectively or prospectively)?
- Will there be upfront investment to stimulate the cycle of improvement?

— *Performance*

It is possible that the number of clients enrolled or the amount and types of specific services could be stipulated in a service contract, including performance-based contracts. However, states increasingly want to contract for outcomes. The essence of a performance-based contract is to specify in detail the most desirable outcomes and align the fiscal incentives in such a way that the underlying contract reinforces good work on the part of the agency. In the foster care system, the outcome considered most desirable is the child's *permanent* exit from the child welfare system. Permanent outcomes are generally comprised of reunification, adoption, guardianship or emancipation (under some circumstances). From a funder's perspective, the goal of the performance-based contract is to increase permanent exits without increasing other non-permanent exits, such as running away. Generally, performance improvement means increasing the likelihood a child will leave placement to a permanent home and in less time than would otherwise be true (i.e. the baseline). However, the range of outcomes is a function of the program type. For example, agencies that provide mental health treatment should expect to have measurable improvements in mental health status as part of the performance built into their contract.

— *Reinvestment*

Performance-based contracts, if successful, will lead to increased rates of permanency for children placed in foster care. In the simplest terms, the average time in care will drop. As a consequence, the changes in performance yield a net reduction in the demand for foster care, a change that results in overall savings in the out-of-home care system. What should be done with the unexpended foster care funds that are no longer needed? Those concerned with the well-being of children should insist that these funds remain in the system as a reinvestment in the quality of care. The reinvestment of savings is important to all agencies but they are particularly important to agencies that are less efficient because those savings can be used to improve the quality of their care. Otherwise the imperative to improve services destabilizes the agency's financial equilibrium. Reinvestment can provide short-term relief.

— *Baselines*

The purpose of a performance-based contract is to improve outcomes relative to a baseline. The baseline expresses what the funder expects under a "business as usual" scenario. That is, without a concerted effort to improve the services families receive, the agency will reunify children at about the same rate observed in the past. The baseline captures the historical performance. The performance-based contract expresses what the funder expects in terms of better performance. The funding offered as part of the contract accounts for the baseline and expectations for future performance. An accurate and appropriate baseline is crucial to both funder and the contract agency. Good baselines are adjusted for risk so as to address the fact that children experience different outcomes (i.e. infants are more likely to be adopted than older children) and the fact that agencies differ with respect to the populations they serve.

— *Risk Sharing*

The baseline performance described in the contract is essentially a projection of what will happen in the future. Given that revenue is connected to the baseline, if the baseline is wrong for some reason, expenditures and revenue will not align. Funders and their contract partners should know in advance how risk will be handled. Explicit risk sharing agreements should define who bears the risk and under what circumstances risk will be shared. This is another reason the definition of the baseline is so important since the baseline clarifies the source of the risk and opens the options for sharing risk.

— *Cash Flow and Revenue*

Performance-based contracts typically rely on some form of prospective reimbursement. That is, the baseline is used to project the amount of revenue the agency can expect, given the assumptions embedded in the baseline. Prospective payment systems break the unity of cash flow and revenue. With revenue defined at the outset, funders and agencies have to decide how the cash will flow to the agency over the contract period. There are various methods of doing this. Providers can be paid prospectively, retrospectively, or through a process that relies on both approaches. Funders may also seek to hold back some funds as part of the risk-sharing plan.

— *Upfront Investment*

Performance-based contracting and financial flexibility are predicated on the idea that rearranging fiscal incentives will initiate a virtuous cycle of program improvement. It is, however, important for both policy makers and providers alike to understand that improving the system often requires an upfront investment to stimulate the first round of improvement. With that in mind, a central question is, should the changeover to performance-based systems be "seeded" from the outset? If so, how much upfront money should be invested and how should this investment be made? And, how does this *initial* investment relate to the *reinvestment* strategy discussed earlier?

FFTA

Conclusions

Performance-based contracts offer advantages to both the provider and the funder. For providers seeking greater control over the way revenue is spent, a performance-based contract may provide a context for improving outcomes for children through investments in higher quality services. To the extent the contract reduces fiscal disincentives, the prospective payment system may also provide a solid platform for short to medium range planning. For government agencies, the performance-based contract offers a chance to clarify program goals and expectations. Since the lack of fiscal flexibility frustrates government funders for the same reasons it frustrates providers, the performance-based contract offers a way around categorical funding dilemmas without an unreasonable increase in financial risk.

That said, there is a temptation to save money, especially during difficult economic times. Performance-based contracts should not be treated as a way to reduce costs, at least not in the short run. Quality services connected to outcomes should be the first priority. Over time, experience may offer an opportunity to redirect resources to other parts of the child welfare system. Indeed, the focus on outcomes will be an important source of feedback as funders think about how best to invest in services for children and families. Finally, it is important to note that there is no substitute for a well-designed contract. Inevitably, contracts offer a mix of incentives and disincentives. A well designed contract highlights both, and offers a clear-cut way to manage both by focusing attention on what is best for children and families.
