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Pay For Performance Contracting

There are a few basic principles that all students are taught when they take Economics 101: the fundamentals of supply and demand, the concept of GDP and, of course, how to incentivize individuals in order to achieve the most effective and efficient outcome. Using incentives as a way to maximize outcomes is fundamental to everyday economics and nearly everyone encounters the practice in one way or another.

The idea of incentives begins at an early age, whether it's a gold star for doing well on a spelling test or an ice cream party for making the honor roll in elementary school. Eventually, these incentives evolve into job promotions or salary increases. Whether consciously or not, the use of incentives is ingrained at an early age as a way to push individuals or groups to do their best work.

With this in mind, it should come as no surprise that incentives are used in government contracts as a way to motivate private and public entities to reach certain goals. Typically referred to as either performance-based contracting or pay for performance (PFP),[1] these contracts are specially formulated so that contracted entities are paid for the outcomes or results of their work, and not just the services that are provided. PFP contracts also minimize the financial risk to taxpayers by allowing the government entities to only pay providers when the provisions in the contract are successfully met.[2]

While all companies and agencies are eligible to bid for PFP contracts, some experts in the field suggest that contracts contingent on performance favor larger companies,[3] due to the fact that larger companies are "better able to absorb the early costs and wait for a payout at the finish line."[4]

1 While PFP and Performance-based contracts have slight differences and can be implemented in different ways, the general concept behind the two is the same.

2 Pay for Performance in WIOA: An Opportunity for better Innovation and Better Outcomes. January 2016.

3 Jon Densenberg (Performance Insititute), as referenced in Performance Procurement. Government Executive magazine, February 2008. Accessed August 8, 2016 at www.govexec.com/magazine/features/2008/02/performance-procurement/26214

4 Ibid.

Who uses Pay for Performance Contracts?

PFP contracts are used in both the public and private sector as a way to incentivize either the most effective and efficient outcome, or to incentivize outcomes that would be unlikely if they were not targeted with an incentive. Recently, the Federal Workforce Innovation and Opportunity Act[5] (WIOA) authorized that "Pay for Performance" contracts could be used by state and local governments to incentivize public-private partnerships using federal grants provided through the program. Typically, PFP contracts under WIOA address social challenges that go unaddressed and are costly to taxpayers.[6] The issues can include incentives to help those who are dealing with long-term unemployment, returning veterans, and at-risk youth.[7]

By using PFP contracts, state and local governments are able to detail the specific outcomes that are expected from the project and hold service contractors responsible for meeting those objectives. Since the specific intentions of the project can be laid out in the contracts, governments no longer have to judge programs solely by the amount of people they "serve," but instead can assess the effects the program has on those individuals.[8] For example, under a typical contract, a reemployment office specifically set up to help veterans may be considered a success if it advised 100 veterans a day; but, if none of these veterans are able to gain employment, the true goal of the program has not been achieved. Under a PFP contract, governments can instead reward a program that advises fewer individuals, but has more success placing them in new careers, with the added benefit of discovering which programs are actually working.

PFP and Performance-based Implementation and Results?

There are many examples of PFP contracts working in both the private and public sector. A joint study out of the University of Pennsylvania and Yale University examined whether or not performance-based contracts (which are similar in nature to PFP contracts) led to more successful outcomes than typical "time and materials" contracts. The study used data from a major aircraft engine manufacturer and found that, on average, product reliability was 25-40 percent higher when using performance-based contracts.[9] The study found that with performance-based contracts, the engine manufacturer performed "more [frequently] scheduled maintenance" on engines that were in use and that there was "better care performed in each maintenance event."[10]

5 WIOA Overview. United States Department of Labor.
6 Workforce Innovation and Opportunity Act and Pay for Success. America Forward. July 2014.
7 Pay for Performance in WIOA: An Opportunity for better Innovation and Better Outcomes. January 2016.
8 Workforce Innovation and Opportunity Act and Pay for Success. America Forward. July 2014.
9 Impact of Performance-Based Contracting on Product Reliability: An Empirical Analysis. The Journal of Management Science. 2012.
10 Impact of Performance-Based Contracting on Product Reliability: An Empirical Analysis. The Journal of Management Science. 2012.

The Florida Department of Families (DCF) also uses their own version of performance-based funding to track the outcomes of their contractors. Instead of tying contractor compensation to performance, DCF uses performance indicators to judge whether or not a contract should be renewed.[11] Shortly after the program was implemented in 1998, contractor success was analyzed by the Florida DCF staff. The assessment, which evaluated 516 performance-based contracts, found that 80 percent of all contractors either met or exceeded the contract requirements.[12] Experts have used this example as evidence that the establishment of performance standards in contracts may lead to greater contract performance.[13]

States and cities outside of Florida have also had success using PFP and performance-based contracts. In Minnesota, the "Twin Cities R!SE" program has provided job training to individuals for more than 20 years.[14] For most of that time the program has been under a performance-based contract with the state of Minnesota. Since the beginning of the contract, the state has received a $7 to $1 return on its investment, and a significant number of individuals have been placed in good, stable jobs.[15]

Conclusion

Performance-based and PFP contracts can lead to increased efficiency and more successful outcomes when applied correctly in the right environment. While these types of contracts may not have success where outcomes cannot be fully controlled, they have been found to enhance outcomes in a variety of fields. Government agencies should look to enter PFP and Performance-based contracts when applicable, which will, in turn, minimize taxpayer risk and maximize project outcomes.

11 Review of Performance Based Contracting Models in Child Welfare. Casey Family Programs.

12 Performance Based Contracting for Human Services: Does it Work?. The Haworth Press. 2005.

13 Performance-Based Contracting for Human Services: Lessons for Public Procurement. The Journal of Public Procurement. 2002.

14 ABOUT US, History. Twincitiesrise.org.

15 Pay for Performance/Pay for Success in the Workforce System: A Review and Discussion. America Forward. July 2016.

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