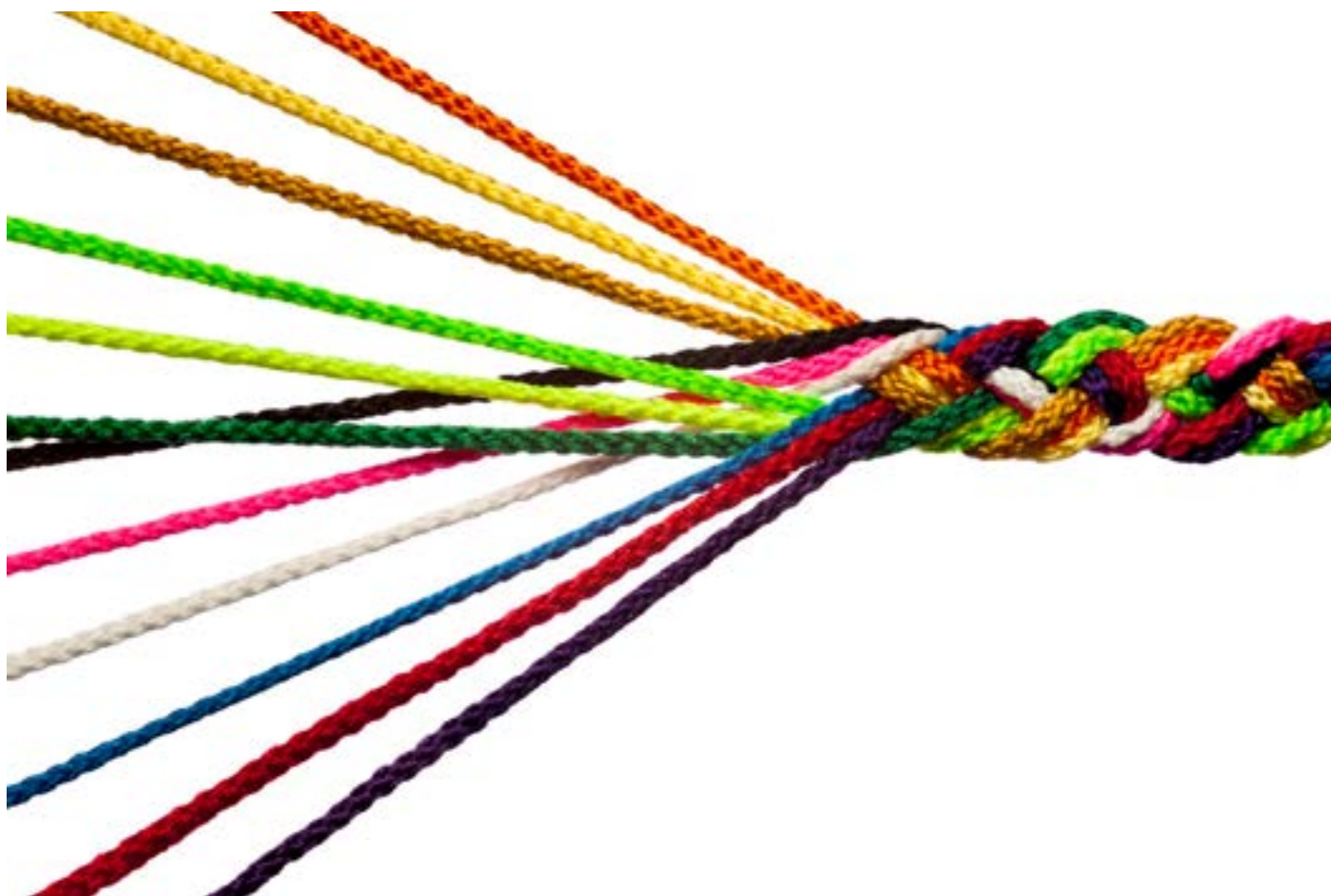


SOCIAL INNOVATION, PUBLIC GOOD

New approaches to public sector productivity

David Hetherington



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David Hetherington is the Executive Director of Per Capita. He has previously worked at the Institute for Public Policy Research, as a consultant to the OECD and for L.E.K. Consulting in Sydney, Munich and Auckland. He has authored or co-authored numerous reports on economic and social policy including *Towards a Fair Go: Design Challenges for an NDIS* (2011), *The Per Capita Tax Survey* (2010, 2011 & 2012), *Employee Share Ownership and the Progressive Economic Agenda* (2009), *The Full-Cost Economics of Climate Change* (2008), *Unlocking the Value of a Job* (2008), *The Investing Society* (2007), *Disability 2020* (2007) and *Would You Live Here?* (2006). His articles have appeared in the Sydney Morning Herald, the Australian Financial Review, the Age and The Australian and he is a regular commentator on Radio National and ABC24. David holds a BA with First Class Honours from UNSW and an MPA with Distinction from the London School of Economics where he won the George W. Jones Prize for Academic Achievement.

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Executive Summary

In one of his first major steps as Prime Minister, Tony Abbott has delivered on his promise to establish a Commission of Audit into the Commonwealth public sector. The exercise is in the image of similar commissions called by incoming Premiers in Queensland, New South Wales and Victoria.

The Commission will find, as its state counterparts have done, that the public sector exhibits poor productivity and should be reduced in size, with important services to be outsourced to the private sector. That this finding can be predicted so confidently in advance should raise questions over its validity. In truth, public sector productivity is a nebulous concept and is being used as a smokescreen to cut spending by governments unwilling to rebuild a broken tax base.

How do you track outputs per hour or per dollar when the desired outputs are so hard to measure? How does one 'price' a well-educated child or a rapidly cured patient?

Since they are unable to do this, governments instead adopt narrow 'target' measures as proxies for productivity, such as hospital waiting times and standardised test scores. But a focus of these narrow measures often results in the target being achieved at the expense of other equally desirable policy outcomes.

Faced with this, governments resort to an 'efficiency dividend', an annual budget cut (typically 1-2% p.a.) which assumes public service agencies can deliver the same outcomes with less resources each successive year. In the absence of hard data on outcomes, the efficiency dividend acts as little more than a crude cost-cutting device.

What then is a sensible way forward, which recognises the need for accountability within the public sector while acknowledging the limitations of private sector productivity measures? This report argues that answers might lie in the not-for-profit sector, where a range of new approaches to performance are being developed.

Foremost among these is social return on investment, which seeks to measure the social benefit of an initiative against the financial investment required to deliver it. This happens to describe neatly the productivity task facing public service agencies: maximise your social benefit given a fixed investment of taxpayers' money.

In fact, governments have begun to apply these new approaches to traditional public sector tasks using social impact bonds. These instruments involve private and philanthropic investors investing their own capital to deliver public good outcomes. The first bond in the UK sought to reduce recidivism while three new bonds in NSW aim to assist vulnerable children, reduce the need for out-of-home care, and prevent adult reoffending.

These experimental new approaches are to be welcomed but they should not be seen as replacements for public sector capacity. If we continue to steadily shrink our public sector capacity, as has happened in NSW, QLD and VIC in recent years, we will lose thousands of years of accumulated know-how and experience. Should we decide that these cutbacks have been misguided, this know-how and experience will be impossible to replace.



Instead, governments should seek to experiment with these innovative new approaches *within* the public service. Per Capita proposes that governments trial social impact bonds with Treasury acting as the independent investor and groups of public sector staff acting as the agents of innovative change.

Under this model, public sector staff within a specific agency or departmental unit could opt-in to a 'public service venture'. This venture would agree to specific policy targets and a budget with Treasury and would be given a wide degree of operational autonomy to pursue these targets without intervention from above. Examples of such targets might include the on-time running of a district bus service, reducing obesity levels within a local population or speeding the recovery and return of injured workers to the workplace.

If the targets are met within the agreed timeframe, the venture's staff would receive incentive payments in excess of their usual salaries. The staff share in the risk of the venture too, so they face loss of income or other entitlements should the venture fail to achieve its targets.

This sharing of risk and reward is a central feature of the social impact bond model, and there is no reason why motivated public sector staff should not be able to access similar opportunities. If early trials of the public sector venture model are successful, it may evolve such that external investors are able to fund groups of staff that have earned greater autonomy through performance.

If, on the other hand, we fail to experiment with new approaches to unlock public sector innovation, we may one day find we have outsourced invaluable capability from the public sector that we can never replace.



Introduction

It's becoming a pattern. Each time a new conservative government is elected in Australia, they immediately establish a commission to investigate government spending. The Newman government in Queensland hired Peter Costello. In NSW, Barry O'Farrell launched not one but two inquiries, the Lambert Review and the Schott Report. New Prime Minister Tony Abbott has delivered on his promise to establish a Commission of Audit into the Commonwealth public sector.

The findings are uniform. Waste, we are told, runs rampant. Public services are bloated. The taxpayer is not getting value for money. That governments are servicing ever-bigger populations with shrinking revenue per person is barely noted.

The answer, we are told, is productivity. Public services must learn to do more with less. Just as private sector businesses rely on productivity growth - higher output per unit of input - to stay competitive, the public sector must learn to do the same.

Yet public sector productivity is a vexed question. At a fundamental level, of course public services should become more efficient over time - innovating, improving their processes, and delivering more and better services for each dollar spent. Defining public sector output, however, is far trickier than defining its private sector equivalent. Private companies deliver a given number of valves or audits or airline trips which we can benchmark against the labour and capital they use to produce these things. Certainly they have other non-financial obligations - social and environmental - but as long as these are met to a given minimum standard, it's really only the financial outputs that count.

The public sector is different. Take vocational training as an example. Unlike their private training counterparts, public TAFE providers are expected to meet a set of community service obligations in addition to their training provision. They typically provide the most costly-to-deliver, capital-intensive courses which private colleges choose not to provide. Yet recent changes in Victoria mean TAFEs will no longer receive extra funding for these specialist services.

Instead governments have used the introduction of private provision to argue that a new benchmark has been set which shows that training can be provided more cheaply. This is certainly true, but at what cost to regional or disadvantaged students or those in more expensive courses? What appears at one level as an increased efficiency in service delivery turns out to be a diminution of quality.

This short paper explores the idea of productivity in public services. It begins by questioning the longstanding practice of equating government inputs with outputs and the fashionable notion of assumed efficiency dividends. It then considers new approaches popular amongst philanthropists known as social impact investment, and specifically the social impact bond. After examining existing examples of social impact investment, it asks whether public service agencies could themselves form ventures to deliver outcomes under social impact bonds. Finally, the paper identifies several potential opportunities for social impact bonds which might be delivered by public sector agencies in Australia.



Section I: Myths and conventions in public sector productivity

There are a number of myths and conventions surrounding public sector productivity that must be addressed before we can explore alternative approaches to productivity assessment. The first is the convention amongst economists prevalent until recently that government's contribution to national income could be measured by its spending, that is, its inputs into public service production. This is essentially an accounting identity. The value of government's economic contribution is equal to the value of spending by government. The UK's Atkinson Review rightly rejected this approach, observing that it encounters two major problems:

"(a) in the case of collective services such as Defence or Public Administration, it is hard to identify the exact nature of the output, and (b) in the case of services supplied to individuals, such as Health or Education, it is hard to place a value on these services, as there is no market transaction." (2005: 12)

Atkinson further observed that it renders impossible any notion of value creation by public service agencies through productivity, efficiency or innovation. It simply assumes that government dollars are transformed into services of equal value, no matter what the service or process used to deliver it. For these reasons Atkinson argues that wherever possible outputs of public services should be used for evaluation, rather than inputs. This development is a welcome one and has been embraced in many jurisdictions, but one that brings its own challenges, not least the difficulty of identifying and measuring outputs alluded to by Atkinson in the quote above.

This brings us to the second challenge of public sector productivity. The adoption of direct output measures has been embraced by politicians because it allows them to make tangible electoral promises against which they can be judged – reductions in hospital waiting lists, smaller class sizes, better on-time performance in public transport.

The problem is that these promised targets, while outputs, are still only a narrow and interim measure of the desired final outcome. Shorter waiting lists are a stepping stone to better public health, and smaller class sizes are (arguably) a stepping stone to better educated children. A further difficulty is that such targets can distort the behaviour of those charged with delivering them. For example, hospitals may decide some patients are not sufficiently ill or better treated elsewhere to keep their waiting lists down. Transport timetables may be restructured to deliver better on-time running through less frequent services.

A final challenge with targets is that they can fail to recognise interconnectivity: the effect of one agency's behaviour on another's outcomes. Much public service delivery relies upon a interdependent matrix of actors, and limits on one actor's behaviour can lead to unexpected consequences for others. For example, a directive to a hospital to reduce its inventories to minimum levels can have spillover effects if other hospitals in a pool are dependent on excess inventories for emergency situations.

So we need broader output measures more closely related to the ultimate social outcome the service is intended to deliver. We'll return to this notion in Section II below.



The final convention that should be challenged in the context of public sector productivity is the assumed 'efficiency dividend' that serves as a blanket justification for expenditure cuts. Such efficiency dividends are now widely used by Australian governments. To take one example, the NSW Government's efficiency dividend was introduced in 2005-06 and imposes a 1% per annum reduction in like-for-like funding, which increased to 1.5% from 2011-12.

The theory behind the assumption of an efficiency dividend is sound. All organisations expect to see improvements in their processes which allow them to produce the same output with fewer resources. As such, they should be able to achieve an efficiency dividend. However, its weakness is in its application. Too often, governments use it as a blunt instrument whose goal is not to generate innovation in service delivery but to cut costs without improving either service levels or service quality. Reductions in nurse-to-patient ratios are but one example of the effect of the efficiency dividend.

The question then becomes: what are less crude, more sophisticated approaches to public sector productivity that stimulate innovation rather than relying on inputs, narrow output targets or assumed efficiency gains that serve as cost-cutting smokescreens? A good starting point to answer this question is to explore an emerging related concept: social return on investment.



Section II: Social return on investment

Social return on investment (SROI) is a new evaluation approach that has grown out of the philanthropy sector. Social Ventures Australia defines SROI as “a form of stakeholder-driven evaluation blended with cost-benefit analysis tailored to social purposes” (2012: 3). This is a formal way of describing an approach in which the social benefits generated by an activity are measured against the cost of that activity. It is a traditional return on investment measure, but applied to social outcomes rather than private ones.

In practice, SROI has worked as follows. A non-profit organisation embarks on an activity that addresses some form of social need – most commonly, generating jobs for people with high barriers to work, such as a disability, substance addiction or a mental illness. The jobs are usually created in a low-skill commercial activity like cleaning, laundry and recycling. Employees’ high barriers to work mean that the commercial service is more costly to deliver than competing services. In order for the service to remain viable, a social investor must be willing to cover the gap in cost of provision between the non-profit organisation (also called the ‘social enterprise’) and competing private providers. The social investor might be a philanthropist who provides seed funding in expectation of a reduced return, or a purchaser who is willing to pay above market rates for the service (‘social procurement’).

In either case, the value of the investment is set against the value of the jobs created to calculate the rate of SROI. When a social investor is weighing up alternative proposals, they can compare forecast SROI rates in making their decision.

What does this have to do with public sector productivity? There are several similarities. The first is that both are simple efficiency ratios - measures of inputs to outcomes. A second similarity is that both seek to measure social outcomes, unlike most other return measures which focus on private outcomes. A final, related similarity is that the social outcome measures of both approaches are notoriously difficult to value – how do you quantify the value of a job, or a better-educated child, or a cleaner hospital? These similarities give us some clues as to how SROI might assist us in navigating public sector productivity.

To date, SROI has been largely confined to the philanthropic, non-profit and social enterprise sectors. Yet governments have watched SROI with growing interest, and have recently begun to undertake this kind of social investment themselves. (Note that in a broad sense, governments are actually undertaking social investment every day.)

In 2011, the Federal Government established the Social Enterprise Development and Investment Fund (SEDIF) which provided \$20m in seed funding, matched by other social investors, to invest in social enterprises with the expectation of social and financial returns. SEDIF states that these social enterprises “will assist communities by creating innovative and cost effective solutions to complex and entrenched social problems like unemployment, poverty, disadvantage and homelessness” (DEEWR, 2011).



A different kind of government social investment initiative is the social impact bond. In this case, government raises funds from investors which are repaid with a return only if certain social outcomes are achieved. Britain has been the frontrunner in the evolution of social impact bonds, with at least 14 either launched or in development since 2010. The first of these funded a project in Peterborough seeking to reduce prisoner recidivism, while others have targeted homelessness and provided therapy for disadvantaged children.

The design of social impact bonds is evolving as the concept becomes more widespread. The first bonds gave investors a high annual return if the agreed outcome was met, but saw them lose their entire investment if they fell too far short. For example, the Peterborough project pays 13% p.a. if the full recidivism target is met, but wipes out all investors' funds if recidivism doesn't fall by at least 7.5% (Social Finance, 2011: 7). More recent bonds have sought broader appeal by reducing the risk faced by potential investors. Goldman Sachs has invested in a social impact bond in a recidivism project at New York's Rikers Island prison in which the amount of money it can lose is capped by a guarantee from a philanthropic foundation.

Another feature is the expansion of social impact bonds to include retail investors which has been pioneered by Allia, a British charity. This has required the bond to blend a social impact venture with other safer assets that provide a minimum level of guaranteed return.

In Australia, the NSW Government signed the country's first social impact bond in March 2013. This bond seeks to raise funds from investors to fund the Newpin program run by UnitingCare Burnside which seeks to return children in out-of-home care safely to their families. Social Ventures Australia has marketed the bond to potential investors, and raised \$7m by July 2013. If the project reaches its targets, investors stand to receive a return of up to 10-12% on their principal over a seven year term (SVA: 2013). Two further social impact bonds are now in development in NSW.

The emergence of social impact bonds tells us there is a growing appetite amongst governments to capture social returns which have not been explicitly targeted in the past. What's more, they hope to do so in a way which shifts both the capital outlay and the attendant risk to an external party. Whether this latter attempt will be successful is open to question, but either way, governments are right to be trying to structure incentives to create new solutions to difficult social problems.

The relevant question for this paper is whether similar structures can be used to unlock and track productivity in public services.



Section III: Social investment and public services

Like most organisations, public sector agencies do some things better than others. Typically, they do a good job of managing large-scale repeat interactions with the public. On the other hand, they often struggle with new ways of doing things – new systems, strategy and delivery models. In part this is because staff do not enjoy sufficient autonomy to experiment and learn from success. Many agencies are highly risk averse, not least because their political bosses are in turn sensitive to risk. Much of the infamous ‘red tape’ attached to bureaucracies is the price of risk management and probity required by governments and the public.

The social impact bond model holds intriguing possibilities to offer public sector staff an ‘earned autonomy’ to tackle the productivity challenge by developing new ways of doing things. It is simply one new approach rather than a silver bullet for improving public services but, structured thoughtfully, it could enable risk-sharing between Treasury and public sector staff, with financial benefits flowing to staff if agreed targets are achieved, and some risk of loss if the targets in question are not met.

Why should staff share risk with Treasury by exposing themselves to a loss in the event of underperformance? The primary reason is that governments will want some incentive to co-operate in this model. At present, they are being offered outsourcing options by private facilities management companies which promise, although don’t necessarily manage, to reduce government outlays for equivalent outcomes. If they are to invest additional funds in a model similar to social impact bonds within the public service, they will want to ensure that they are ‘paying for performance’ and that their loss is reduced in the case of non-performance. These notions are central to the risk-sharing model.

How might this work in practice? The basic idea is that a group of public service workers, possibly a departmental division or the staff at a particular worksite, would enter into an agreement with a ‘social investor’ to work towards a negotiated set of targets, within a specified budget and timeframe. These targets might be based on outputs, outcomes or productivity. Let’s call this group a public sector ‘venture’.

There are several ways that incentives, or ‘return’ could be structured. Under one approach, if the targets are met in full, the venture members would receive a fixed annual percentage of the project budget above their normal salaries, say 5-10%. Of course, these percentage levels must be set at levels that both Treasury and the venture is willing to accept.

On the flip side, how is the downside risk shared with public sector staff? There are several approaches that might work. Under the most extreme model, if targets are not met, staff salaries would be reduced by an agreed percentage, say 2-5%, but this should involve the commensurate bonuses being lifted.

Another approach might be that venture members agree to forego annual wage increases if targets are not met, which secures their starting pay level but carries the risk of real wage erosion. A third method of dealing with downside risk might involve non-financial items, such as the loss of additional leave entitlements where targets are not achieved. However, these non-financial exposures will have less power than their financial equivalents.

Who might act as social investor in the model? In the near term, the most likely social investor would be Treasury. To date, social impact bonds have transferred risk and the need for upfront capital investment from



governments to external social investors. However, before public sector social impact bonds are proven, it is unlikely that external investors would be willing to invest in such public sector ventures.

Despite this, Treasury could still share its risk with the venture (although it would not be immediately relieved of the capital investment). By demonstrating success in public service ventures, agencies would be entitled to a greater 'earned autonomy' in operational practices. In the longer term, once the model has demonstrated success, it should be possible to attract external investors who would absorb both risk and upfront capital requirements from government.

This approach includes several points that differ from standard public sector incentive structures, and would need to be considered carefully in the development phase. Firstly, the venture should be structured so that all participants are comfortable with, and keen to work in, the new environment. For this reason, ventures would comprise a selection of volunteers from across the agency in question – the model will only work on an 'opt-in' basis. Volunteers from any part of the agency would apply for a secondment to the new venture. In this way, the venture is likely to be formed from participants best suited to more innovative and risky project environments.

Secondly, the targets should be sufficiently granular that they can be accurately tracked and attributed directly to the venture. Many of the output targets listed in Section II above fail that test. Within reason, the venture must be free from political interference in its pursuit of the targets, and progress should be evaluated by an independent statutory authority such as an ombudsman. The ventures must enjoy sufficient autonomy such that progress cannot be stymied by interference from above, and budgets should cater for organisational support that falls outside the specific control of the venture (e.g. IT systems and support).

Thirdly, where appropriate, the targets should include some form of user feedback to ensure that quality is not compromised as a means to achieving the project goal. Too often in the public sector, quality suffers and service levels fall because costs are under pressure. It is critical that the improved service is more than just greater volume; higher throughput with falling quality is a retrograde step. For this reason, each venture requires an appropriate starting budget and a feedback loop to continuously monitor service quality.

Examples of public service 'ventures'

The next question is what type of public service activities might lend themselves to successful ventures? I would suggest three areas as potential examples – public health, local transport, and workers' compensation provision.

A first potential venture might focus on population health. The staff of a hospital serving a regional town would form a venture to reduce long-term incidence of heart disease, stroke and/or obesity amongst local residents. A specialist unit within the hospital would develop targeted strategies with local GPs, nutritionists, sports clubs and schools to educate the population on the role of salt, trans-fats, simple sugars and lack of exercise in the development of these non-communicable diseases. The social benefits of improving these health outcomes are considerable, and they can be readily tracked through hospital admissions, death certificates and population health surveys. One feature of this venture is a relatively long timeframe, so staff within the specialist unit might sign onto and depart the venture over time, and be eligible for a proportionate share of the gain or loss.



A public transport venture could centre on local bus services within a particular district. The objective would be outstanding on-time performance, with maintenance of high quality standards (safety, cleanliness and courtesy) and without diminution of service frequency. Outside of an agreed number and quality of buses provided by Treasury, all other operating parameters would be within the control of the local staff within the venture – drivers, depot managers, cleaners and maintenance staff. The venture’s staff would have complete freedom to structure the operations as they choose. The operating budget, safety benchmarks and service frequency would be agreed at the outset, and on-time performance and service quality would be monitored by the scheme’s ombudsman. If the targets are met, staff receive a percentage bonus of the venture’s budget, while if they are not, a different percentage is deducted from the staff salary pool.

A third venture would aim to speed the return of injured workers to the workplace. Again, a dedicated staff unit within a state workcover authority would form a venture in which they took responsibility for improving overall rates of return to employment amongst injured workers. They would negotiate an operating budget and a set of return-to-work targets with Treasury. Outside these parameters, they would be free to structure their operations as they saw fit. Obviously, there is a range of other practitioners involved in returning workers to employment and the unit would need to develop productive working relationships with all of these actors. In particular, they would require a multi-party sign-off to ensure an injured employee is ready to return to work and that no undue pressure has been applied to rush the process.

In addition to these suggestions, there are numerous existing social impact bond trials that lend themselves to replication in the public services. Among these are the experiments described above with recidivism (where a venture might be undertaken by the corrections service), and homelessness and the safe reunification of vulnerable children with parents (both of which might be undertaken by community services). The breadth of these experiments suggests no shortage of possibilities for social impact investment by public service ventures.

Section IV: Concluding thoughts

This paper has explored existing notions of public service productivity and asked how emerging social investment approaches, particularly social impact bonds, might unlock productivity in public sector agencies in new ways. Specifically, we have reviewed the limitations of existing productivity metrics, such as equating outputs with inputs and the use of efficiency dividends, and argued that they are ill-suited to genuine productivity improvement.

Instead, the paper argues that a social impact bond approach could be applied to public service delivery. Public service ventures could pursue agreed policy targets, with funds provided under budgets negotiated with Treasury. Where targets are met, a share of the social dividend in the form of a financial bonus is paid to the venture's staff. If the targets are not met, a share of the salary pool is deducted. In subsequent bond rounds, external investors may commission public service ventures to deliver social outcomes, with Treasury offering investors a dividend for performance and penalties for failure to deliver.

I conclude the paper with two final observations. The public service venture model is likely to involve considerable operational and cultural challenges for the staff involved. For this reason, the government may wish to invest in developing new capacity for promoting innovation in public service delivery.

In recent years, the best practice examples have been public cross-sectoral institution like Britain's NESTA, Denmark's MindLab and Finland's Helsinki Design Lab. However, emerging thinking on large-scale organisational strategy suggests that such a centralised model might not be ideal.

Instead, an alternative approach enjoying some success is the 'dual hierarchy' model described by Kotter (2012). In this model, volunteers opt in to strategic projects in parallel with their regular work. In these projects, the traditional organisational hierarchy is set aside for a much flatter and more nimble project structure. Over time, the organisation builds a parallel hierarchy of capacity which allows it to pursue more rapid and responsive strategic change. This approach would work equally well for a government department that embarked on successive public service ventures and in doing so built up a parallel network capable of delivering strategic change over time.

Finally, a word of caution. The embrace of public service ventures involves risks for public sector staff. The most obvious of these is a loss of income should the venture fail to meet its targets. This outcome should sit wholly within the control of the venture's staff, but it remains a risk nonetheless.

A larger potential risk in championing the social impact bond model is that governments build on early experiments by undertaking more partnerships with external providers, without offering the public sector the opportunity to participate. The net effect of this would be more outsourcing, as has been experienced under the British Government's 'Big Society' model. Even attempts to include staff in such outsourcing – so-called public service mutuals – ultimately result in an irreversible process where public sector capacity is lost and, as a result, service quality declines.

While the social impact bond idea offers some promise for public sector productivity gains shared between staff and the state, proponents must remain aware of its risks as a discussion around it unfolds.



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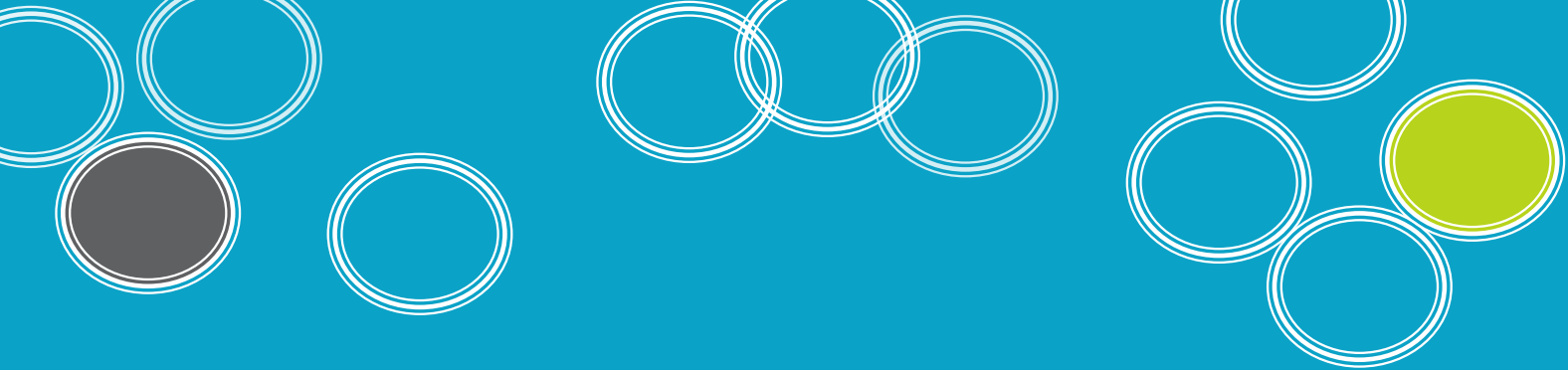
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