

Sharing Risk

How Pay for Success Can Make Government More Efficient

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Education, public safety, and health care agencies make decisions every day about how to spend limited public dollars. Additional support from private foundations helps ease the strain but is insufficient given the scale of social problems. A new financing mechanism uses private capital to improve social welfare by connecting with nontraditional public-sector investors who are interested in a financial return on their investment. If the privately funded program achieves its objectives, the government saves money by reducing future spending, the investor benefits from a profit, and the public receives a positive social outcome. This fact sheet introduces the pay for success (PFS) model, its advantages and disadvantages, and the steps necessary to minimize failure and maximize success.¹

What Is Pay for Success?

At its core, PFS is a new method of forming public-private partnerships. Private investors finance a social program with a specific performance goal. This goal is based on outcomes (e.g., reduction in juvenile recidivism or reduction in the number of emergency room visits) rather than outputs (e.g., 500 hours of counseling for incarcerated youth or 500 visits from a home health aide). This shifts the focus from the *amount* of services provided to the *effect* of those services. If an independent evaluator finds that the predetermined performance goals are met, then the government repays the investor for the cost of the program plus a return on their investment, where the total payout is less than the government would have spent with traditional financing. If the program does not achieve its performance target, then the investor forfeits some or all of the investment.

PFS in Practice

There are 14 PFS-financed innovations in the United Kingdom, where the first PFS projects were developed (called social impact bonds or SIBs). Others have begun in Australia, the Netherlands, and the United States. The first US SIB provides cognitive behavioral therapy to prisoners and was developed in 2012 as a partnership between New York City and Goldman Sachs. Today, 3 states have active PFS programs and 12 states are exploring the idea. So far, these efforts have focused on criminal justice, education, and health outcomes, but PFS financing is not limited to these areas.

Advantages of PFS

Pay for success transfers the risks of program failure from governments (that usually pay for these services whether they work or not) to the private sector, resulting in more efficient public spending. Since investors want to minimize their risk, they will target programs that are least likely to fail (i.e., evidence-based programs). These prevention programs serve vulnerable populations and, if successful, result in better social outcomes that complement existing publicly funded programming. PFS can help overcome the “wrong pockets” problem, when costs to one agency result in savings to another (e.g., a housing department funds a successful supportive housing program for the chronically homeless, which translates to savings on incarceration spending for corrections facilities). Overall, engaging private investors allows PFS to bring new capital to the social sector, scaling effective programs and social innovation, as well as building social infrastructure.

Potential Disadvantages

Pay for success financing is legally and operationally complex, requiring parties with significant research and finance expertise. Further, the safest investment is a program with a proven track record of success; therefore, innovative and new ideas may have difficulty attracting PFS investor capital. Lastly, the private-sector partnership may alter the service populations or priorities of the social service sector, and it may direct private capital away from valuable projects that are not attractive to investors.

Creating a PFS-Ready Sector

PFS-funded programs differ from traditional programs. They require funded programs with measurable costs and outcome that comport with evidence-based best practice. And, they require government to define success. The best candidates for PFS are those that cannot be funded through traditional financing: programs with high up-front costs, risky or unsympathetic target populations, and long-term outcomes. Creating a PFS-ready sector requires careful strategic planning, where government moves from knowing what it spends to also understanding what it buys. It requires data-sharing and knowledge transfer across sectors, along with new procurement processes that allow governments to pay for outcomes in future years.

Identifying a PFS Candidate Program

City, county, state, governments as well as the federal government should complete a strategic planning process that includes a rigorous assessment of cost and population drivers for a well-defined problem, existing service gaps, evidence-based solutions, and the suitability of PFS-funding for the solutions. The goal is to move from well-intentioned projects to evidence-based interventions. The strategic planning process will identify appropriate community-based service providers with strong evidence of efficacy. It will also identify a knowledge intermediary with the right skills to develop a PFS project (i.e., someone experienced in translating the existing research base into a strategic plan for best-practice interventions).

Five Steps to Pay for Success

Once the strategic planning is done and a portfolio of evidence-based practices is identified, developing a PFS project is a five-step process.

1. Price the PFS product. Experts determine the investment necessary to implement the program and estimate the potential savings for the government.
2. Review existing evidence and set reasonable performance targets that, if met, save the government money and trigger a payout to the private investor.
3. Develop the deal, arrange financing, and build infrastructure.
4. Provide the service to the target population.
5. Engage an independent researcher to evaluate the program and determine if the performance goals have been met.

Next Steps

The PFS community has two important needs. Today, each PFS transaction is unique. Actors start from scratch in every deal. Integrating meta-analytic research (studies that synthesize many prior studies of the same program) with local costs and benefits will lower the burden for interested governments and speed the launch of new PFS-funded programs. Additionally, new efforts should solidify the role of research in selecting PFS projects that place primacy on identifying evidence-based solutions to scalable problems.

Note

1. For a more thorough discussion on the topics presented, see John K. Roman, Kelly Walsh, Sam Bieler, and Samuel Taxy, *Five Steps to Pay for Success: Implementing Pay for Success Projects in the Justice System* (Washington, DC: Urban Institute, 2014).

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