



Five Steps to Pay for Success

Implementing Pay for Success Projects in the Juvenile and Criminal Justice Systems

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Cover photograph © 2010. Associated Press/Morry Gash. A youth is escorted down a hallway at the Wisconsin Department of Corrections Ethan Allen School in Wales, Wisconsin.

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Executive Summary

Pay for success (PFS) is a new method of forming public private-partnerships. Private investors finance a social program with a specific performance goal. If an independent evaluator certifies that the program achieves its goals, the investors receive their principal and a return. If the program does not achieve its performance targets (such as recidivism reduction), some or all of the investment is forfeited.

Early PFS Adopters

The first PFS project, called a social impact bond (SIB), was developed in the United Kingdom (UK) and there are now more than a dozen operational SIBs in the UK. In 2012, New York City partnered with Goldman Sachs to develop the first American SIB to provide cognitive behavioral therapy to prisoners.

Advantages and Disadvantages of PFS Funding

Pay for success transfers the risks of program failure from the government to the private sector, resulting in more efficient public spending. It offers a new approach to delivering services to vulnerable populations that result in better social outcomes and complement existing programming. The process encourages the adoption of evidence-based program and rigorous, objective evaluation. 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. PFS funding offers the flexibility to pool resources across government departments, addressing the *wrong pockets* problem and supporting regional collaboration.

PFS financing is also legally and operationally complex, requiring significant expertise. The focus on programs with demonstrated track records may limit innovation. The private sector partnership may alter the service populations or priorities of the social service sector, and may direct private capital away from needed projects.

Developing a PFS Project

Before beginning PFS, a strategic planning process includes a rigorous assessment of justice system cost and population drivers for a well-defined problem, identification of service gaps, development of evidence-based solutions, and a determination of the suitability of PFS funding. Training partners are identified to provide potential PFS partners with the right set of skills to develop a PFS project (i.e., modeling economic outcomes, structuring deals or transactions, managing complex relationships with intermediaries, investors, service providers, and government). Developing PFS projects for the justice system is a five-step process. Steps one through three develop the deal by pricing the PFS product and setting performance targets based on existing evidence; arranging financing; and building infrastructure. In steps four and five the program is implemented and results evaluated.

The next steps in the PFS process include developing instruments that make PFS pricing process consistent and solidifying the role of research in selecting PFS projects.

Implementing Pay for Success Projects in the Justice System

Pay for success (PFS) financing directs private capital to social programs, with the opportunity for a return on investment if the programs achieve performance targets. This report provides a five-step model for ensuring the sustainability and quality of PFS programs. The five-step guide stakeholders through a process that identifies drivers of populations and costs, develops evidence-based solutions for identified service gaps and barriers, empirically derived prices, returns on investments, and performance targets to give investors transparent guidance on risks and benefits, provides governments the best chance to achieve their policy objectives, and ensures that key populations receive the best possible evidence-based services (see appendix A for more tools and resources).

Statement of the Problem

While there are numerous models of PFS, they all share a core concept: using private capital to support social programming and promising a return if the program attains specified performance targets. An independent evaluator monitors the progress of the program and empirically determines whether the intervention achieves its performance goals. If the program achieves its goal, the government pays program investors the principal they invested plus a return. If the program does not achieve performance goals, the investors lose some portion or the entire principal and any potential return. Usually, an intermediary organization manages the process by identifying social problems and the programs to target them, negotiating with investors and the government, and overseeing service delivery (Liebman 2011; Callanan, Law, and Mendonca 2012).¹ Injecting private capital into the public sector provides a new avenue for addressing the problem of widespread underfunding of public-sector interventions and innovations.

Juvenile and criminal justice systems have extensive barriers to achieving more cost-effective programming. As currently constituted, the juvenile justice and adult criminal justice systems

- focus on remediation rather than prevention, if they are therapeutically oriented at all;
- frequently choose business as usual over evidence-based practice ;
- retain little capital for operations (such that effective programs are not scalable), avert risk (such that effective programs with variable outcomes are not funded) and often remain suspicious of innovation;
- use stove-piped subagencies, such that the fiscal beneficiaries of better outcomes from evidence-based programs are not the subagency that bears the costs (the *wrong pockets* problem), and thus fail to incentivize for those subagencies to choose evidence-based programs; and
- use systems that tend to be isolated from the rest of government, particularly with respect to information sharing and knowledge transfer.

Such practices result in inefficient systems that may do more harm than good.

Pay for success addresses all of these issues. By seeking private financing, it solves the under capitalization problem and shifts risk to the private sector. By moving the funding mechanism from the subagency (such as a department of corrections) to the agency level (the criminal justice system writ large), it solves the wrong pockets problem. Formulation of the transaction requires that data is acquired and shared and that knowledge is transferred. For the PFS transaction to be properly priced, it is critical that monetized effect sizes are calculated to provide transparency to all parties, and that data and knowledge are shared across sectors.

The process described in this report is intended to maximize the effectiveness of PFS in practice. The challenge for the first generation of PFS has been to demonstrate that a PFS transaction can occur. The challenge for the next generation will be to broaden the purpose of PFS to not only fund a specific

intervention with a known outcome, but also to fund a portfolio of evidence-based interventions that target the specific drivers of costs and populations that would benefit most from programmatic reforms. Thus, there are two components to PFS: strategic planning to identify those cost drivers and evidence-based solutions, and implementation of the PFS transaction.

Development and Adoption

Early Model Development

Early work on social impact bonds (SIBs) focused on describing the core structure of the model: the government contracts with an intermediary organization that in turn contracts with nonprofit service providers to deliver evidence-based social service programming that is designed to prevent future negative outcomes and increase social welfare. To execute this program, the intermediary solicits investors to support the program with private capital. Investors can receive a return on investment paid by the government if the program meets a set of performance targets. An independent assessor determines if these metrics are met (Callanan et al. 2012; Liebman 2011). By focusing on preventative programs, paying only for successful results, and using private capital, the SIB model offers a way to reduce the need for expensive interventions (such as prison) while reducing the political risks often associated with changing the nature or allocation of social programming (Kohli, Besharov, and Costa 2012a).

Social impact bonds seek to tap into the burgeoning field of impact investment by soliciting private capital and offering a return. Impact investing attracts those that make investments that are expected to produce a *double bottom line*: positive social outcomes and profits for the investor (Lachman-Messer and Katz 2011). To obtain a double bottom line, impact investors are often willing to accept below-market rates of return on their investment (Overholser and Whistler 2013). In 2011, there were \$4.4 billion impact investments made (Harji and Jackson 2012).

Social impact bonds exist within this broader field of impact investment as a subset of a particular class of financial transactions referred to as *pay for success* (PFS). The terms in this field are still in flux and may be redefined later, but for our purposes, PFS refers broadly to the idea of paying for evidence-supported results after a program has been executed rather than paying for a program upfront where government bears the entire risk (Galloway 2013). An increasingly common convention is to refer to products and investments that follow the SIB model as social impact bonds (e.g., the Rikers Island SIB and the Utah SIB), while referring to the concept and model behind these products as pay for success.

This early social impact bond work also identified key challenges to the feasibility of broad adoption of the SIB model. Early SIB projects confirmed the expected challenge the process of devising the metrics for measuring and evaluating success would pose. It takes considerable collaboration and social science expertise (Disley et al. 2011). Using the SIB model also requires the government to cede significant operational control of social-service programming to outside organizations (Kohli et al. 2012a), which is an unusual relationship for government partners that have traditionally exercised control over the services they contract. Governments are also more used to paying for activities (outputs) than outcomes, so government partners interested in executing SIBs will need to find ways to modify many of their existing operating procedures (Kohli, Besharov, and Costa 2012b). Equally challenging is the process of identifying high-performing programs and quantifying their impact (Fox and Albertson 2011). Finally, the procurement process in most jurisdictions is designed to request specific interventions, not to solicit a *priori* unspecified partnerships; thus SIBs are difficult to finance through conventional procurement processes.

Since the development of the initial SIB/PFS model, a great deal of work has been done communicating the basic structure. However, only recently has work been developed on how SIBs and PFS projects will function in the broader legislative and regulatory framework of the US financial- and government-procurement system. Determining how legislative and regulatory structures will govern the development of PFS financing is the next step in the field.

PFS in the State Legislative Context

One of the most important questions for the growth of PFS is how these instruments will interact with the legislative framework governing appropriations. One of the advantages of SIBs and other PFS projects is that they can provide long-term capital for social services that might otherwise be constrained by the relatively short-term nature of government funding and philanthropic grants (Social Finance Inc. 2012). However, while PFS projects are designed to provide long-term capital, governments are generally not authorized to make payments, even payments made under enforceable contracts, unless the legislature has voted to appropriate that money. Such appropriations are usually done annually, meaning that a government in 2024 might have to vote to pay for a contract made by a government in 2014 (Goldberg, 2012). Unless provided by legislation, investors have no legal recourse to sue the state for reneging on the contract if a state does not appropriate funds to pay a SIB contract in the year that repayment is required, thus further complicating the issue (Goldberg 2013c). This exposes PFS investors to significant risk—legislation facilitating PFS and addressing this challenge has been and will likely continue to be an important part of building public confidence in social impact bonds (Costa and Shah, 2013).

As of February 2014, California, Connecticut, Hawaii, Massachusetts, Maryland, New Jersey, and Pennsylvania have either proposed or adopted some form of legislation to initiate or facilitate PFS projects.² The scope and reach of the proposals in these seven states differ significantly. Massachusetts's legislation provides the most security to investors by authorizing the government to make PFS payment obligations supported by "the full faith and credit" of the state of Massachusetts. Full faith and credit guarantees provide investors with significant legal authority to sue the state for failing to pay a contract. Additional security could be provided if the statute expressly waived a legal protection particular to states called *sovereign immunity*.

Legislation in New Jersey and Connecticut provides less rigorous protection to investors: a special set-aside fund is established for social innovation. The laws authorize specific accounts into which funds may be deposited that will be used to pay for a SIB. Money can be retained in these accounts until they are used for SIB payment. This ensures money is available so that, at the time of payment, future governments are not encumbered by the spending decisions of prior governments. However, there are no protections in place to prevent future governments from reappropriating the already deposited funds for other purposes (Goldberg 2012). Moreover, the government's contract authority in Connecticut is subject to legislative review, which may have the effect of slowing the PFS development process (Goldberg 2013a).

The scope of other states' legislation is more limited. Maryland (Goldberg 2013c) and California (Goldberg 2013b) have proposed bills to define what a SIB is in the state context and establish government authorities for SIBs. Maryland's bill defines SIBs specifically and includes the achievement of savings as part of the definition.³ California's language takes a broader approach on PFS and defines performance-based contracting where, based on the attainment of success measures, the government pays a provider more or less. Hawaii's legislation restricts itself to commissioning a feasibility study to determine if SIBs are viable for addressing social problems in the Hawaiian context. Pennsylvania legislators announced a plan to release social impact bond legislation soon (Goldberg 2013c). The increase in legislative activity, however, has raised a separate SIB concern that these instruments may be a mechanism to allow prior governments to obligate future government spending without the consent of elected representatives. It remains to be seen what the best practices are for enabling legislation and how SIBs will interact with existing federal banking regulations.

Pay for Success and the Community Reinvestment Act

One trend in the field of pay for success is an increasing focus on the ability of pay for success projects to meet banks' obligations under the Community Reinvestment Act (CRA). The CRA requires banks to meet all the credit needs of the communities they serve, including low and moderate income communities. Banks that fail to do so may be denied various business opportunities, including, most importantly, the ability to open new branches. Banks can meet their CRA obligations by making credit available to services and economic development activities directed toward low- and moderate-income communities (Goldberg 2013c). CRA-related loan activity in the United States is immense, totaling \$209 billion in 2011 alone

(Godeke 2013). Thus if PFS projects qualify as meeting a bank's CRA obligations, there is a potential to open up vast volumes of non-impact investment capital to PFS-financed projects. However, this also introduces an additional challenge for PFS: if PFS projects meet CRA-requirements, there is a potential for PFS to reallocate the existing pool of social investment between financial products, rather than attract new impact investment.

Whether SIB- and PFS-related activity will qualify as being in support of a bank's CRA obligations is still unclear. Financial tools are more likely to qualify under CRA requirements if they use innovative or complex and specialized transactions to meet the credit needs of the community so SIBs may be more likely to meet CRA requirements than traditional loans (Goldberg 2013b). However, willingness to use SIBs for CRA purposes currently appears to vary across financial institutions, with some more risk-averse institutions more interested in meeting their CRA compliance requirements with more traditional financial tools (Godeke and Renser 2012). Going forward, clear signals from Federal regulators regarding the status of PFS projects in meeting CRA obligations for various types of banking institutions will be crucial in determining the degree to which PFS projects attract or reallocate capital (Godeke 2013). Given these questions, it is clear that there is still work that needs to be done to further develop the PFS model. Results from the initial pilots will likely provide valuable insights into the next steps for such development.

Prevalence and Early Adopters

The United Kingdom launched the first SIB to address recidivism in 2010. The program targeted 3,000 short-stay prisoners in cohorts of 1,000 at the Peterborough prison over a six-year period. To support a wrap-around reentry program called One Service, 17 investors brought together £5 million. This program contracts with four nonprofit service providers to deliver pre-and post-release services to both inmates and their families, including accommodation, medical services, connection to benefits, and employment support. Success is measured by recidivism over a 12-month period following release. A maximum return of 13 percent on investment is possible (Social Finance 2011; Social Finance 2012). The program is considered to have succeeded if recidivism for the program group is 10 percent below that of comparison groups established at 30 similar prisons (von Glahn and Whistler 2011). Interim results for the Peterborough SIB have been promising as recidivism among the group has fallen against a general rise in recidivism in the United Kingdom (Elkins 2013). Internationally, PFS projects are now underway in Australia, and under study in Canada, France, Germany, Ireland, Israel, and Korea (Patton 2013).

In 2012, New York City launched the first American SIB. This SIB raised \$9.6 million from Goldman Sachs to provide cognitive behavioral therapy to 16- to 18-year-old adolescents in the Rikers Island jail (the primary jail for New York City). The program, the Adolescent Behavioral Learning Experience (ABLE), is provided by two organizations, the Osborne Association and Friends of the Island Academy. MDRC serves as the intermediary organization and the Vera Institute of Justice is the independent evaluator.⁴ As in the Peterborough SIB, returns are paid on a sliding scale: the break-even point for Goldman to recoup its investment is a 10 percent recidivism reduction, with a 20 percent recidivism reduction offering the maximum possible return on investment (approximately \$2.1 million) and long term savings to New York City of \$20.5 million.⁵ One feature of the New York SIB is a \$7.2 million loan guarantee provided by Bloomberg Philanthropies. Also known as a credit enhancement, the loan guarantee reimburses Goldman for the first \$7.2 million lost if the program fails to attain its performance goals, effectively limiting potential loss on the principal investment to \$2.4 million (Rudd et al. 2013).

Since this initial project, the federal government has made significant investments in supporting the use of PFS financing. During 2012 the US Department of Justice offered priority grant consideration to applicants using pay for success financing for Second Chance Act reentry program funding to encourage the integration of PFS financing and justice system programming (Bureau of Justice Assistance [BJA] 2012). In 2013, the US Department of Labor awarded nearly \$24 million in grants to support PFS pilots.⁶

At the state and local level, the range of domestic PFS projects is also expanding. In Utah, Goldman Sachs, the J.B. Pritzker Foundation, and United Way of Salt Lake partnered to support an early childhood education program.⁷ In Fresno, California Social Finance, Inc. and Collective Health collaborated to

launch the first health-focused social impact bond in the United States, targeting asthma (Social Finance, Inc. 2013). Governments in Colorado, Connecticut, Denver, Illinois, Ohio, and South Carolina have received support from the Rockefeller Foundation and the Harvard Kennedy School's SIB Lab to develop PFS projects.⁸ New Jersey's Assembly has advanced legislation to use PFS to reduce the cost of health care⁹ and the Maryland (Roman 2013; Leventhal 2013) and Washington, DC legislatures have held exploratory hearings (Walsh and Roman 2013).

Critiques

Criticism of the PFS model has fallen into two categories: operational and philosophical. Operational criticisms have challenged the ability of the social impact bond to successfully transfer risk and produce cost savings for the government. From this perspective, the additional costs imposed by contract negotiations and evaluation fees, as well as limited marginal savings, make it unlikely that SIB-financed programs could be cost beneficial for the government (McKay 2013).¹⁰ Other operational criticisms have focused on the ability of the evaluation to accurately gauge the impact of the program. Given the primacy of evaluations in determining payment, there is concern that the metrics used to evaluate programs will be subverted.¹¹ There are also concerns that, even with rigorous evaluation, the results will be inconclusive, making it impossible to make payments (McKay 2013). Other reviews have suggested that the PFS model may have a deleterious effect on the nonprofit sector by encouraging silo-thinking and functional specialization as organizations reorient themselves specifically to hit certain benchmarks.¹²

Philosophical critiques of PFS focus on the implications of the introduction of private, for-profit capital into the social service sector. In this view, funding social services through for-profit ventures rather than government funding supported by increased revenues represents an abrogation of government's responsibilities to address social problems.¹³ Proponents of this view also suggest that PFS models may offer the for-profit sector undue influence in determining what social services will be funded, in turn potentially for the subordination of public to private interest (Mendell and Gruet 2012).¹⁴ Given the comparatively recent development of PFS as a funding mechanism, it remains to be seen if these critiques will be borne out as the field develops.

Strategic Planning

Governments interested in developing a PFS-financed project should first complete a four-part strategic plan. Strategic planning involves a comprehensive analysis of a site's criminal justice systems to identify inefficiencies and solutions. By the end of the strategic planning process, governments will have a comprehensive understanding of the inefficiencies of their justice system, a portfolio of evidence-base solutions to address these inefficiencies, and a list of which solutions can be most effectively implemented using PFS-financing. Engaging in a strategic planning process before developing a PFS transaction will improve the likelihood of successfully bringing high performing programs to scale. Additionally, once completed, findings from the process can serve as the foundation for multiple rounds of justice system reform, both PFS-financed and otherwise.

The Justice Reinvestment Initiative (JRI) has helped to make strategic planning become a more common practice in the criminal justice sector. JRI, a public-private partnership between the Bureau of Justice Assistance and the Pew Charitable Trusts (Pew), emphasizes comprehensive justice system analyses to identify inefficiencies and develop evidence-based policy options to remedy those inefficiencies. JRI has been carried out in 17 states (La Vigne et al. 2014) and in 18 locales through the Justice Reinvestment at the Local Level (JRLL) project (La Vigne et al. 2013). The strategic planning process used to guide the JRI and JRLL process provides a useful model for the PFS strategic planning process for both justice system and non-justice system PFS projects. There are four steps in the strategic planning process:

1. Identify the cost and population drivers.
2. Identify the target problem.

Steps in Strategic Planning for Pay for Success

1. Identify cost and population drivers.
2. Identify the target problem.
3. Find evidence-based solutions.
4. Assess PFS suitability.

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Identify Cost and Population Drivers

Identifying cost and population drivers is the first part of strategic planning. Cost and population drivers are factors that disproportionately affect criminal justice system populations and drive criminal justice spending. For example, a common driver in the criminal justice system is delays or denials of parole for eligible prisoners. For eligible, low-risk offenders, parole is significantly less expensive than incarceration: in Fiscal Year (FY) 2012, Georgia's daily cost of parole supervision was \$4.94 compared with \$51.19 for incarceration.¹⁵ Despite the potential efficiencies and cost savings available if more offenders were transitioned to parole, parole grant rates have declined in many states. From 1980 to 2008 South Carolina's parole grant rate declined from 63 percent to 10 percent while the prison population rose (Pew Charitable Trusts 2010). Another common cost and population driver in the criminal justice system is insufficient supervision and support services in the community for reentering offenders. Though supervision populations in some states have grown, available resources have remained static or even declined. This, in turn, may limit the capacity for community services to prevent recidivism, and thus require more costly incarceration interventions (La Vigne et al. 2014). The first step in strategic planning is to identify cost and population drivers like these.

Cost and population driver identification can be either comprehensive or targeted. Comprehensive identification involves a complete analysis of the government's laws, enforcement practices, and social support systems associated with the criminal justice system (BJA 2013). An even more expansive review could assess the drivers of juvenile justice or related health and human services system costs. Alternatively, the process can take a more targeted approach in which one specific facet of the criminal justice system (e.g., jails, courts) is investigated to determine key drivers.

The process of identifying cost and population drivers, though it will vary based on the government, will often require the collection of both population and financial data. Population data means the people who enter the justice system, their movement through the various stages of the justice system (e.g., arrest, trial, incarceration), and the time between each stage of the system. Financial data identifies the costs associated with each stage of the justice system, and can help identify areas that consume a disproportionate volume of resources. The Urban Institute's *Justice Reinvestment at the Local Level Planning and Implementation Guide* provides a detailed overview of what this process might look like at the local level (La Vigne et al. 2013).

Collaboration between all partners in a PFS deal, including local stakeholders, can greatly improve the strategic planning process. PFS initiatives will often require collaboration between multiple agencies (Azemati et al. 2013), so involving multiple agencies early in the process can help facilitate collaboration that may improve the ability of the PFS project to attain its objectives. Moreover, stakeholders may have valuable insights or recommendations that will refine the cost and population driver analysis and ensure that there is consensus around the eventual findings. One-on-one meetings with key agency personnel, focus groups, and stakeholders can both provide additional insight into cost and population drivers, and help build collaboration and consensus while providing valuable analysis insights (La Vigne et al. 2014).

Whether at the federal, state, or local level, identifying cost and population drivers can be a complex, and time consuming enterprise. Criminal justice data systems are often not designed to facilitate querying or analysis. Additionally, certain important data items may not be systematically collected. Particularly at the state level, state authorities may lack a way to systematically collect comprehensive information from a broad array of service agencies. Therefore, this step will be most successful if conducted in collaboration with a research partner, referred to as the *knowledge intermediary* in this document, that can compare the operations of the current system to research on best practices from the research literature. For example, Pew and the Justice Center of the Council of State Governments facilitated JRI analyses (La Vigne et al. 2014).

Critical to this process is identifying existing administrative data that can inform cost- and population-driver identification. At the simplest level, data can be aggregated to determine which sectors

contribute disproportionate costs. A better approach, though more resource intensive is to link data about individual service receipt across agencies (and thus identify people, families, and places that consume disproportionate services). Such an effort would constitute a substantial reform for most jurisdictions and improve their ability to be cost efficient by identifying absent or redundant service provision. The greater the data integration, the greater the transparency of the PFS transaction, reducing uncertainty for investors is reduced and likely reducing the profit required for investment as well, saving government costs.

Where possible, building on prior analyses like those done through JRI or JRLL can leverage prior justice reform efforts when the analyses is used to guide both JRI or similar initiative efforts and PFS projects.

Identify the Target Problem

Identifying a government's cost and population drivers will provide a list of problems in the justice system, often taking the form of gaps or barrier in justice system infrastructure. A government must then identify which problem or problems they wish to address. Gaps in the justice system infrastructure tend to take one of three areas: in digital infrastructure, resulting in the inefficient exchange of data and knowledge; in human capital, leading to a lack of capability or capacity to deliver prevention or intervention services; or in the social service infrastructure, where there is insufficient supply of high-quality, evidence-based prevention and intervention services relative to the demand.

For example, if insufficient or ineffective community support is driving the high recidivism rates that fuel a government's corrections costs the problem could be that services are ineffectively targeted because information on offenders is unavailable or difficult to share (a digital infrastructure problem), there are insufficient services (a social service infrastructure gap), or there is a lack of staff in the district who are able to provide effective evidence-based services (a human capital gap). Governments should work with the knowledge intermediary to identify what type of gap needs to be addressed to remedy their cost and population drivers, and to align the operation of their system with evidence-based best practices.

Often, a government's strategic planning process will identify multiple infrastructure gaps, and it may be beyond their ability to immediately remedy all of the gaps. The knowledge intermediary can help identify which problem to target first to generate the greatest impact on justice system operations.

Find Evidence-Based Solutions

Once a problem is identified, the next step is to find evidence-based solutions to address it. An evidence-based solution refers to programs, policies, and practices that have been objectively evaluated and found to have a positive impact on their primary outcomes. There are several compilations of evidence-based programs addressing a wide variety of interventions in criminal and juvenile justice.¹⁶ These compilations generally are derived from a formal, systematic review, known as meta-analysis, which empirically identifies effective interventions.

Choosing programs objectively through a review of existing research is essential to the development of PFS. The process encourages government and philanthropy to engage with a large body of empirical evidence about what programs are and are not effective. Doing so will also dramatically improve the transparency of a PFS transaction as risks can be empirically enumerated. This can increase investors' confidence and reduce the premium government must pay to attract capital to a program. A collaborative partnership with a knowledge intermediary will increase the likelihood that this step can be effectively implemented.

The goal of this stage of the strategic planning process is to identify a portfolio of evidence-based candidate programs that solve specific justice system problems. Developing a portfolio of programs has several advantages when compared with implementing PFS one program at a time. After a government has valued the program and assessed its likelihood of success, it negotiates with potential investors. A portfolio of programs can also be sequenced to maximize the likelihood of successful implementation and to leverage prior successes. Finally, during the first step of PFS, candidate programs can be ranked

according to their expected impact. Programs that are likely to yield the greatest returns can be undertaken first, potentially allowing the generated savings to fund the next program in the queue.

Assess PFS Suitability

Once a cost driver, a target problem, and an evidence-based solution have been identified, the candidate intervention must be assessed for suitability for PFS implementation. Not all evidence-based programs are suitable for PFS implementation even if they have a strong probability of attaining their performance goals. There are four dimensions on which programs must be evaluated to determine their feasibility for PFS implementation: *evaluability*, the program has measurable outcomes and positive social benefits; *program safeguards*, protections that ensure that neither the treatment population, nor investors are harmed by the PFS transaction; and *instrument appropriateness* and *financial viability*, determinations that PFS is the most cost-effective way to implement the intervention and that both investors and the government can attain cost-savings and program efficiencies using PFS.

For example, there may be an evidence-based program that serves mentally ill, chronically homeless returning prisoners who are driving system costs. However, in smaller cities, that population might be too small to allow for a control group to be identified, and thus there can be no means to determine if the PFS-funded program meets outcome-based performance targets. While an evaluation could determine if the program met the goals for the treatment group, without a comparison group it would not be possible to determine if this success was attributable to the program. A more in-depth discussion of each of these steps can be found in appendix B.

There are three possible determinations that may be reached when evaluating a PFS program under these standards. The first is that PFS is a strong vehicle for bringing capital to the program in the absence of sufficient public support. The second is that PFS financing is the only solution: this may occur because effective program funding and implementation is not possible with traditional government funding because of political barriers to program implementation, siloed areas of funding, and responsibility among government agencies, or other institutional, legal, or operational barriers. One example of this type of problem is *the wrong pockets problem*, where the entity or agency that funds a successful program is not the agency that receives the savings from it. In those cases, using PFS as a way to pool costs and benefits can remove the barrier to successful implementation. The third possible determination is that PFS is not the optimal mechanism for implementation. Traditional government funding or other innovative financing mechanisms may be a more appropriate way to support the program. The Urban Institute has developed a general PFS feasibility assessment diagnostic tool to facilitate this determination, but government stakeholders can also engage local-knowledge intermediaries to perform the diagnostic step.

Five Steps to Pay for Success

Once the strategic planning process is complete, the process of developing a PFS transaction for the candidate programs can begin. The five-step PFS model integrates evidence-based solutions to the selection, valuation, and evaluation of PFS transactions. These steps place knowledge transfer at the center of the PFS development process, maximize the opportunity for programs to be successful, create transparency for investors and government, and support positive social outcomes.

Five Steps to Pay for Success

1. Value the PFS product, assess risk, and set performance targets
2. Develop the deal
3. Develop infrastructure
4. Deliver service and targeted technical assistance
5. Evaluate the program

Step One: Value the PFS Product, Assess Risk, and Set Performance Targets

Valuing a PFS transaction, assessing risk, and setting appropriate performance targets is likely to present the largest challenge to government stakeholders. Because local procurement rules and policy priorities will have a significant impact on the pricing of PFS transactions, better tools need to be developed to support a standardized valuation process so that PFS can be a consistent investment class. Until the development of such valuation mechanisms, PFS projects will need to be developed on a site-by-site basis.

Four factors influence PFS pricing: how much infrastructure needs to be built and capital needs to be raised to support the program; what the performance targets for the PFS program will be and the time it will take to reach them; what the savings will be for the government and what portion of these savings will be *cashable* (recoverable); and how risky the project is and what return investors will require to support it.

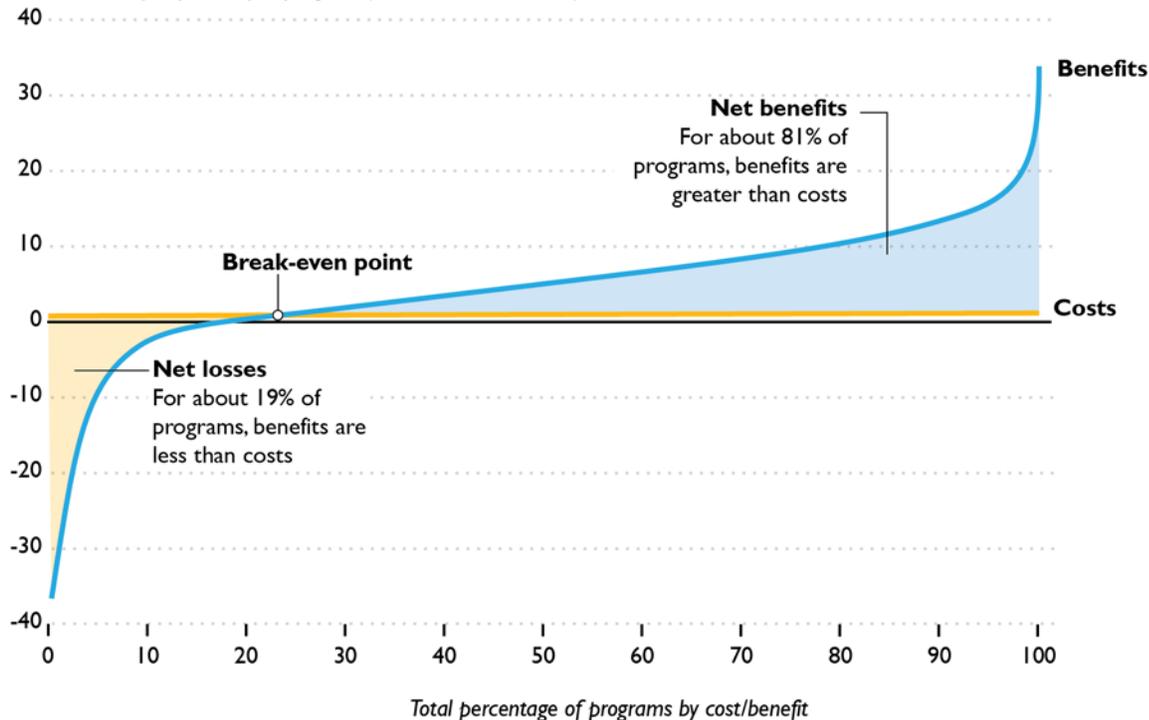
Whether savings from a PFS project are cashable is an important question. If a clearly defined savings can be identified and captured in a budget, and can be used to pay off investors, the savings are cashable (and in these instances, the PFS does perform similarly to a bond). More commonly in the criminal justice system, the savings, while real, are not cashable. This would be the case for programs that reduce recidivism, but not enough to meaningfully change the size of correctional populations, or where enhanced public safety is the primary benefit.

The valuation process is especially important for governments. By understanding the evidence-based costs and benefits of a program, the government can enter negotiations with perspective investors (step two) with transparent data for the investors' consideration and suggestions on reasonable rates of investor return should performance targets be attained. This information allows governments to make an evidence-based decision about whether the returns necessary to attract investors exceed the value of the program to the government.

Investors will likely prefer to invest in programs with a strong evidence base, especially if it also can empirically demonstrate cost, benefits, effect sizes, risks, and uncertainty. Risk is the predictable and measurable variation in the outcome of a program while uncertainty is the unpredictable and unmeasurable variation (Knight 1921). Investors will support risky ventures for the right level of return but are less likely to support uncertain ventures (Bewley 1989). An evidence base gives researchers the tools to understand the probability of a successful program, transforming uncertainty into risk. For example, using the Urban Institute cost-benefit engine (figure 1), an examination of electronic monitoring for probation in Washington, DC found that implementing the program would prevent a sufficient number of arrests to be cost-beneficial 81 percent of the time (Roman et al. 2012). These types of data can be used by investors to determine the likelihood that a transaction will be successful and what returns are reasonable. Similarly, the government can use these data to determine how much capital needs to be raised, what the appropriate performance targets are, and what returns are reasonable from its perspective. At this stage, involvement of a financial intermediary, an organization with financial expertise to structure the contract and attract investors, is likely warranted.

Figure 1. Results from a Meta-Bayesian Cost-Benefit Analysis of Electronic Monitoring for Offenders on Probation

Costs/Benefits per person, per program (in thousands of dollars)



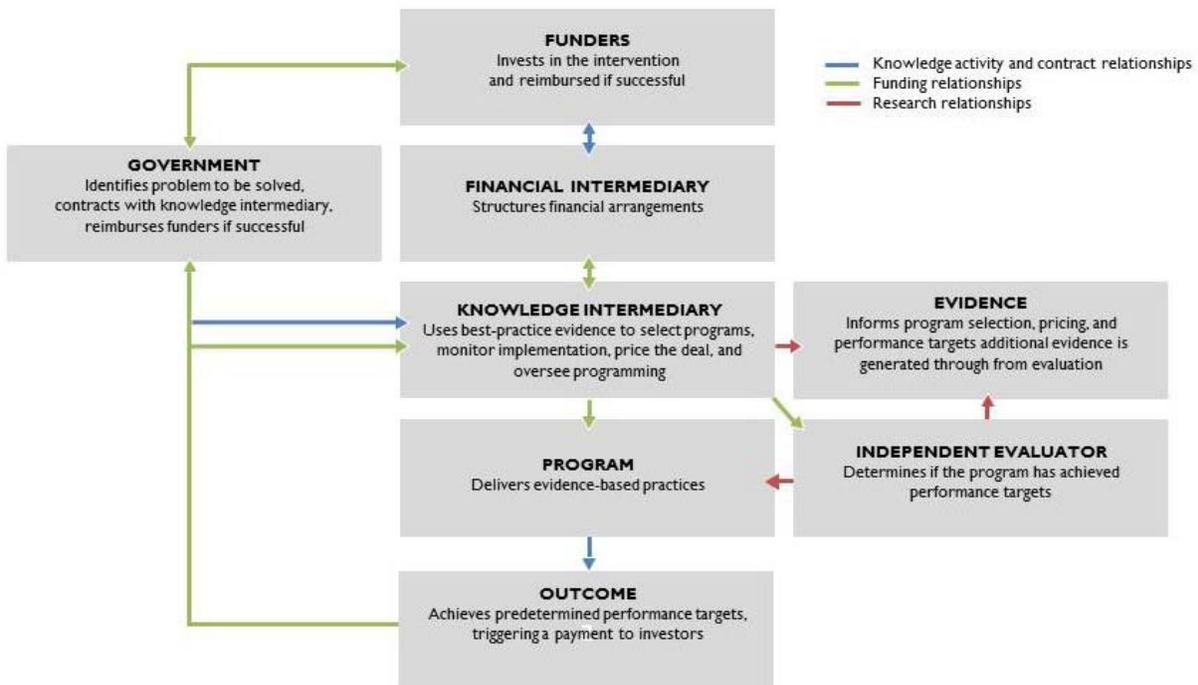
Source: Roman et al. (2012).

Step Two: Develop the Deal

Once the product is priced and performance targets are determined, negotiations for the financial transaction commence. Five actors are essential to a PFS program (figure 2): governments, investors, financial intermediaries, knowledge intermediaries, and independent evaluators.

- **Governments** identify problems to target and pay if the program achieves its goals.
- **Investors**¹⁷ contribute capital in the program and receive their principal and a return if the program is successful.
- **Financial intermediaries** structure the deal and solicit investors—role may be filled by a single organization, or multiple organizations with different responsibilities.
- **Knowledge intermediaries** identify and recommend high-performing programs, price the product, and oversee implementation.
- **Independent evaluators** determine if the program has met its performance goals.

Figure 2. Actors and Relationships in a PFS Project



By the end of the development process, the value and returns of the PFS project will likely differ from the initial valuation developed by the government in step one. This is a result of the differing incentives at play: Investors will seek easily attainable performance targets and high returns, while governments seek the opposite. Preserving the integrity of the valuation process will be a priority for the financial intermediary—especially with a government’s initial PFS transaction. The first transactions will build knowledge and infrastructures to support implementation and identify the impact of local context (such as procurement rules), on the deal structure. Governments will have to remedy barriers to PFS implementation, like committing future governments to pay back investors for successful transactions. Additionally, they will need to determine where present day budget allocations will be made.¹⁸ Once these procedures are determined, future transactions will be substantially less complex.

The structure of early adopters’ PFS contracts has not yet been made public. It will likely be several years before there are enough PFS projects to make substantive determinations of what contracting mechanisms support the most effective PFS financing process. Additionally, since each contract, especially in pilot projects, will be tailored to the unique circumstances and legal environment of the program and government, specific contract structure and language will likely vary significantly between PFS projects. However, Kohli, Besharov, and Costa (2012b) developed a contract template that identifies components important for effective PFS implementation.¹⁹ Their template contract defines the responsibilities of each party in the deal, the social science terms crucial to the project, and the deal’s payment structure.

The first responsibility of the contract is to define the parties in the deal, their relationships, and responsibilities. The roles of the government, intermediary, and assessor are all defined as well as what the powers of each party are, and what limits exist on those powers. For example, the authority of intermediaries to engage subcontractors, and any limits on that authority, like the need for government assent before engagement of a contractor, will need to be codified. The relationships between these groups are also defined in key areas, like how program publicity will be carried out, and what expectations each party should have for their partners’ performance. Finally, the contract includes a series of *safety valves* for both the government and intermediary: conditions under which program termination or emergency

intervention in the program is acceptable. These safety valves include provisions to ensure that there is adequate time for the needs of the treatment population to be addressed if the program is terminated.

Codifying the social science terms and procedures by which the PFS project will operate is a second core contract component. Agreeing on the definitions of what outcomes the success of the project were judged by was a major challenge during the Peterborough SIB and required significant social science expertise (Disley et al. 2011). When agreement on these terms is reached, it will be important that the contract codify that agreement. The contract should also lay out the criteria for participation in the program's treatment and control groups, and what parties are responsible for the collection of the data that will be used to evaluate the program.

Detailing the payment structure is the final role of the contract. There must be clarity on what outcome or outcomes produce what payment. If different payments are to be made for attaining different outcomes or different levels of a particular outcome that also needs to be codified. The role of the independent assessor in certifying this outcome must also be outlined, and include guidelines for how the assessor will report whether outcomes have been met, and what measures will be taken to ensure transparency in their evaluation.

Step Three: Develop the Logic Model

After the PFS project has been priced and the structure of the deal is agreed upon, the logic model and implementation plan to deliver the program can be developed. A plan for collecting outcome data must be considered as part of the program infrastructure so that there is a way to measure if a program ultimately reaches the targets that trigger payment to investors. Two questions will guide this process: who will provide the targeted training and technical assistance (TTA) and what evidence informs implementation. TTA refers to the providing of the skills, knowledge, and expertise needed to deliver programming. TTA providers are brought in to provide the training necessary to ensure service providers have the capacity to deliver the intended program. Some governments will need to identify and engage external partners if there is insufficient local TTA expertise to develop the necessary infrastructure. The TTA provider or, in some cases, knowledge intermediary, will identify implementation research specific to the program to maximize fidelity to best practice, smoothing the process of developing infrastructure and limiting the resources that must be spent.

Implementation and Evaluation

Step Four: Deliver Service

In step four, the deal moves from planning the program to implementing it. The logic model developed in step three is used to deliver services to the target population. Throughout step four, the knowledge intermediary manages and provides oversight of service providers to ensure fidelity to the model devised for the program. Monitoring and supporting fidelity to the evidence-based program provides the strongest possible chance of positive results being achieved and of investors achieving a return.

A key part of the service delivery process is ensuring the continued provision of services even if it becomes clear that the program will fail and investors will not achieve a return. Ensuring that targeted populations are addressed even if the program fails is essential to preserving the legitimacy of the PFS model as a positive contributor to the social sector.

Step Five: Evaluate the Program

PFS transactions conclude with an evaluation, in which the independent evaluator determines if the project has achieved the agreed upon performance targets. A randomized control trial (RCT) is the preferred study design, as it is the most effective way to control for competing explanations of a program's effect, and limit spurious findings. These evaluations determine the impact of a program, whether the government should pay the investors, and build evidence on effective justice system interventions.

RCTs have been characterized as unsuitable for use in PFS transactions because they are perceived to be more costly than other evaluation types. That has led to concern that RCTs will increase the

administrative costs of the PFS transaction and reduce the chance that cashable benefits will exceed investor principal and profit. This concern, however, is misplaced. The primary driver of evaluation costs is data collection and these costs do not vary significantly by evaluation design. The random assignment of potential clients to treatment and control, the hallmark of the RCT, does not add significant cost to a project. Existing justice system data may be insufficient or ill-suited for the evaluation of all program outcomes, making a random assignment design where the evaluator keeps track of outcomes an even more suitable methodology.

An additional evaluation barrier may be the choice to serve all of an identified population, such that there are no individuals available for the control group. Some interventions target individuals with severe problems (such as chronically homeless, mentally ill returning prisoners) who consume substantial resources but are a relatively small population. In those cases, demonstrated fidelity to evidence-based best practice may be the best metric to evaluate success. A PFS transaction can use performance metrics rather than evaluation results in these instances, if all parties agree to the transaction.

A key part of the evaluation process is making sure evaluations develop and provide results in a way that promotes transparency and agreement among all parties involved in the process. Ensuring that all parties agree with the result of the evaluation and certify its legitimacy is important to preserving the integrity of the payment process and building the consistency, stability, and viability of PFS as a financial instrument.

Advantages of Pay for Success

PFS offers advantages over traditional government financing: risk transference, accountability, infrastructure building, and flexibility. Because the government only pays for a program if the program achieves specific objectives, PFS funding can *transfer some or all of the financial and political risk* of program implementation from the government to the private investors. The transference of risk allows the government more opportunities to support social programming as taxpayer funds will only be expended on programs that are independently verified as successful (Kohli et al. 2012a). This *accountability* is a second advantage of PFS: because payment is dependent upon results, there is more incentive to pick evidence-based programs and to empirically validate results. The focus on developing and using evidence-based social programs may also spur innovation in the social sector as programs compete and are adopted based on the strength of their evidence and track records of success.

PFS has the potential to *build community-based service delivery infrastructure*, which can remain in place after the financing transaction is complete, providing sustainable community benefits. Finally, the *flexibility* in PFS has advantages over traditional financing. The PFS transaction can include funding from numerous agencies whose resources might otherwise be separated or *siloes* because of the funding structure of government agencies. By providing a structure through which multiple agencies can pool resources, PFS avoids siloing (Costa et al. 2012) and allows for the development of multi-departmental or even regional social service initiatives.

Risks of Pay for Success

Broad adoption of PFS has the potential to dramatically alter the social service sector, but there are risks. The first generation PFS transactions are complex arrangements requiring significant legal, empirical, institutional, and financial expertise, the confluence of which may be difficult or expensive for government stakeholders to acquire and manage. In addition, government procurement rules at all levels of government may prove to be impediments to PFS; rules preventing funding of solicitations initiated by the private sector and submitted to government are common and may limit the ability of the private sector to support PFS.

One question about PFS is what impact it will have on the populations and outcomes targeted by social service providers. Since private investors are assuming the risk in these transactions, they may prefer to support low-risk, low-need, low-reward populations rather than targeting high-risk populations. Similarly, private investors may want to focus on the social goals that can provide the most cashable benefits and therefore the highest rates of return, rather than those social concerns that are most

pressing. In turn, this may impact what outcomes service providers focus on as they seek to attract capital (Kreigsburg 2011).

PFS could also alter the behavior of private investors, particularly banks subject to the requirements of the Community Reinvestment Act (CRA).²⁰ Rather than bringing new money to support social goods, PFS could result in a reallocation of existing CRA funds from current activities to PFS, maintaining rather than increasing the net investment in social services. Similarly, PFS could change the delivery of services as private or nonprofit service providers, supported by PFS, are tapped to provide services previously provided by the public sector.²¹ While PFS may encourage innovation through competition, it could also induce service providers to stop developing new programs and concentrate on existing programs with a strong evidence base.

Each of these risks represents a challenge that will require careful monitoring to avoid, but none compromise the essential value or integrity of the PFS model. The federal government, in particular, has a key role in monitoring the attributes of PFS transactions, and can stimulate change in the PFS sector if challenges emerge that represent a systemic threat to the use of PFS as a tool for positive social change. In addition, the state or local government, whichever entity is running or testing the PFS model, will be able to make significant contributions to monitoring the transactions and operations of these projects.

Conclusion

Initial PFS projects have made important strides in demonstrating that a PFS-financed program can be executed, but much work remains to be done to demonstrate the viability of this tool. The next step in the development of PFS is demonstrating that the concept can move from unique, bespoke arrangements to broadly adoptable tools available to any interested government. Scaling PFS in this way requires developing a standard process that can reliably meet the needs of all parties in a PFS transaction.

Using the five-steps to pay for success process, guided by strategic planning, can build the stability and legitimacy of PFS financing. Identifying cost and population drivers, and the high-performing evidence-based programs to address these problems, helps ensure that all parties in a PFS deal have reasonable chances to attain their objectives. Governments can effectively target some of their most pressing justice system challenges by identifying their cost and population drivers, while investors can improve their chances of obtaining a return by targeting these problems with evidence-based programs implemented with fidelity. Assessing program risk and return can also help encourage investment by demonstrating that the risks and rewards of a project are reflected in the PFS transaction. Impact investors will also be able to improve their confidence that their investments are targeting the most pressing social problems. Moreover, using the evaluation techniques recommended in the process will increase the trust of all parties by transparently indicating whether a program has attained the goals set for it.

Scaling the adoption of PFS will require additional research to give governments the tools they need to finance and price programs. A critical next step in this process will be the development of consistent criteria and models that accurately assess potential program risks and returns. Further research should help government partners develop these metrics. Transparent metrics and consistency will build investor confidence, thus opening up new sources of capital to support the implementation and scaling of evidence-based programs.

Notes

1. While PFS is sometimes called a social impact bond (SIB), the two do not share characteristics with bonds (specified revenue streams for paying returns, or guaranteed payouts). A more appropriate analogy might be to a mortgage, an initial public offering (IPO), or an equity option.
2. Utah proposed SIB legislation but failed to pass the bill.

3. “A contract between the State and a private or nonprofit organization in which the organization provides up-front funding for a project aimed at a particular social objective, with repayment and earned interest contingent on the achievement of specified social outcomes and financial savings to the state.”
4. City of New York, “Mayor Bloomberg, Deputy Mayor Gibbs and Corrections Commissioner Schriro Announce Nation’s First Social Impact Bond Program,” news release, August 2, 2012, <http://www.nyc.gov/html/om/html/2012b/pr285-12.html>.
5. Michael R. Bloomberg, “Bringing Social Impact Bonds to New York City,” City of New York, August 2, 2012, http://www.nyc.gov/html/om/pdf/2012/sib_media_presentation_080212.pdf.
6. US Department of Labor, “US Labor Department Awards Nearly \$24 Million in Pay for Success Grants,” news release, September 23, 2013, <http://www.dol.gov/opa/media/press/eta/ETA20131936.htm>.
7. The J.B. and M.K. Pritzker Family Foundation, “Pritzker, Goldman Sachs Announce \$20 Million First Phase of Early Childhood Innovation Accelerator Initiative,” news release, June 13, 2013, <http://www.businesswire.com/news/home/20130613005888/en/Pritzker-Goldman-Sachs-Announce-20-Million-Phase#.U2epCfldU-I>.
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10. James Clancy, “President’s Commentary: Top 10 reasons to be worried about Social Impact Bonds,” *National Union of Public and General Employees*, January 2, 2013.
11. Matt Steinglass, “I’ll Put \$2.4m on Recidivism to Fall,” *The Economist*, August 6, 2012.
12. Joe Kriesberg, “Op-Ed: Will Social Impact Bonds Improve Nonprofit Performance,” *Nonprofit Quarterly*, March 8, 2011.
13. Mark Rosenman, “Commercializing the Public Good,” *Huffington Post*, August 6, 2012.
14. James Clancy, “President’s Commentary: Top 10 reasons to be worried about Social Impact Bonds.”
15. “Parole Supervision,” Georgia State Board of Pardons and Paroles, accessed May 2, 2014.
16. See The National Institute of Justice, “Crime Solutions.gov,” accessed May 1, 2014, <http://www.crimesolutions.gov/>; Washington State Institute of Public Policy, <http://www.wsipp.wa.gov/>; Vanderbilt University Peabody College, “Peabody Research Institute,” accessed May 1, 2014, <http://peabody.vanderbilt.edu/research/pri/>; Blueprints Program, <http://peabody.vanderbilt.edu/research/pri/>; The Campbell Collaboration, <http://www.campbellcollaboration.org/>; The Urban Institute, “District of Columbia’s Crime Policy Institute: Cost-Benefit Analysis,” accessed May 1, 2014, <http://www.dccrimepolicy.org/costbenefitanalysis/index.cfm>; The Council of State Governments Justice Center, “What Works in Reentry Clearinghouse,” accessed May 1, 2014, <http://whatworks.csgjusticecenter.org/>.
17. Since PFS projects are expected to offer below-market returns, critics have questioned whether a market for PFS products exists. The positive response of the financial industry to PFS thus far, however, has not borne these concerns out. In part, this is because PFS may satisfy Community Revitalization Act (CRA) requirements for investing in low- and moderate-income neighborhoods. Additionally, investment banks can use PFS investments as a way of reducing risk in their clients’ portfolios as PFS investment returns are uncorrelated with anything else in a portfolio.
18. At this time, details of the three operational PFS transactions are not public. Some governments have discussed allocating PFS funds to economic development authorities for administration. These would become hubs, where agencies shared allocations and knowledge to resolve the wrong pockets problem and reduce political pressures.

Some have also discussed using the authority as a place to create an endowment, where some of the savings from successful PFS transactions beyond those paid to investors can be used to seed future PFS transactions.

19. A copy of their model agreement can be found in their report.
20. The CRA requires that banks meet the credit needs of low- and moderate-income communities. Banks that fail to meet their CRA requirements may have limits imposed on their ability to expand or merge (Marsico 2001).
21. Rosenman, Mark, "Commercializing the Public Good."

Appendix A: Getting Started

A number of resources are available for organizations interested in learning more about PFS or developing PFS projects.

Pay for Success Information and Toolkits

Social Finance, United States: Social Finance in the United States is the US partner of Social Finance in the United Kingdom, the organization that developed the Peterborough social impact bond. They have produced material including detailed reports on pay for success theory and practice, case studies, and technical guides for developing pay for success projects in criminal justice.

(<http://www.socialfinanceus.org/pubs/socialfinance>)

Center for American Progress (CAP): CAP has published foundational articles on the use of PFS, including documents that provide a government perspective in the discussion of the theory and use of PFS. They have also developed template contracts that offer insight into issues that must be addressed during the contract process.

(<http://www.americanprogress.org/issues/economy/report/2012/12/05/46934/frequently-asked-questions-social-impact-bonds/>)

Pay for Success Learning Hub: The Pay for Success Learning Hub, a project of the Nonprofit Finance Fund, includes numerous tools to inform the development of PFS projects. The site provides information on the latest developments in PFS, tools to assess the readiness of a program partner for implementing PFS, information on other types of impact investments, and model documents to facilitate PFS, such as sample contracts, PFS authorizing legislation, and requests for proposal model.

(<http://payforsuccess.org/>)

Evidence-Based Practice Databases

CrimeSolutions.gov: The Office of Justice Program's Crimesolutions.gov is a repository of programs designed to offer evidence-based strategies to improve the operation of all facets of the justice system. Programs are rated on their effectiveness and the strength of the research indicating how effective the program will be. (crimesolutions.gov)

Washington State Institute of Public Policy (WSIPP): WSIPP's website offers reviews of the efficacy of social programs in justice, employment, welfare, child welfare, health care, education, and mental health. The site also provides cost-benefit analyses of various policies that use WSIPP's cost-benefit analysis engine to generate accurate ratings of these programs. (<http://www.wsipp.wa.gov/>)

Peabody Research Institute: Vanderbilt University's Peabody Research Institute conducts research to improve the effectiveness of programs designed to support children and families. They provide information on programs that reduce youth crime and delinquency, including meta-analyses that provide superior estimates of program effectiveness. (<http://peabody.vanderbilt.edu/research/pri/>)

Blueprints for Violence Prevention: Also call Blueprints for Healthy Youth Development, Blueprints is a project of the Center for the Study and Prevention of Violence at the University of Colorado Boulder. The Blueprints project has reviewed over 1,100 programs and identified a small set of them as model programs. These programs have proven effective at reducing violence, delinquency, and drug use among youth, as well as improving education, health, and emotional well-being for youth.

(<http://www.blueprintsprograms.com/>)

The Campbell Collaboration: The Campbell Collaboration is an international research network that develops in-depth reviews of pressing social questions, summarizing what is known about these problems and what strategies have been effective in addressing them. Reviews are conducted across all

areas of social policy including housing, crime, and employment.
(<http://www.campbellcollaboration.org/>)

Urban Institute Meta-Bayesian Cost-Benefit Analysis: Developed as part of the District of Columbia Crime Policy Institute (DCPI), the Urban Institute's meta-Bayesian cost-benefit analysis model provides precise cost-benefit analyses of justice system programs. The model also provides separate estimates of cashable and societal benefits so that policymakers have a more complete picture of what types of benefits they can expect from specific programs.
(<http://www.dccrimepolicy.org/costbenefitanalysis/index.cfm>)

The National What Works in Reentry Clearinghouse: Established in 2008 by the Second Chance Act and operated as a partnership between The Urban Institute and the Council of State Governments, the What Works in Reentry Clearinghouse rates the effectiveness of a broad array of reentry programs and practices, including programs dealing with substance abuse, mental health, housing, and employment. Programs are rated both on their effectiveness and on the rigor with which they were evaluated. (<http://whatworks.csgjusticecenter.org>)

Appendix B: Assessing a Program’s PFS Suitability

The suitability of a program for implementation using pay for success should be assessed on four factors: *evaluability*, the ability of a program to be evaluated effectively and transparently; *program safeguards*, the protections a program offers to investors and the treatment population; and, under the umbrella of applicability, *instrument appropriateness*, whether PFS is uniquely suitable for implanting the program; and *financial viability*.

Evaluability

Four components are important for ensuring that PFS programs are technically feasible: measurable outcomes, sound evaluation methods, definable costs, and a strong evidence base. Without these components, it will be difficult to evaluate the impact and outcomes of the PFS program in a way that is transparent and provides reasonable assurances of a program’s success.

Measurable outcomes mean that the program has clear outcomes (which can be agreed upon) that can be used to determine whether it was successful. Measurable outcomes are essential to a PFS program for two reasons. First, outcomes determine if the program has been successful and, if so, how successful the program has been. This is important information for determining whether the government must pay the intermediary and how much the government must pay. Second, measurable outcomes ensure that the PFS program evaluation will contribute to the knowledge base on what programs are effective interventions, so that even PFS programs that do not reach their performance goal will generate value by creating knowledge on social innovations. Determining what outcomes will be used to evaluate program success is a complex task that requires developing consensus between all parties to the deal. One challenge in the Peterborough SIB was generating a “methodologically robust outcome measure, which had the confidence of all stakeholders” (Disley et al. 2011, 36).

Sound evaluation methods means that the PFS program is evaluated using high-quality research designs. Using sound evaluation methods to determine the impact of a PFS program assures that, in the event of success, government payments really are “paying for success” and, in the event of failure, assures investors that the program actually failed to achieve its performance targets. The Maryland Scale of Scientific Methods (MSSM) provides a general benchmark for assessing the quality of such evaluations. MSSM provides five levels of evaluation quality with ratings from one to five, with five, a randomized control trial (RCT) analysis of comparable groups, being considered the most reliable types of evaluation (Sherman et al. 1998). Levels four and five, comparisons of multiple units that control for other factors, provide the level of rigor needed to accurately and transparently assess a PFS program. Level three, a comparison of one group with the program and one without, and the levels below do not provide the rigor necessary to soundly and transparently evaluate PFS programs.

It is important that the problems addressed by a PFS program have *definable costs* to determine whether the benefits of implementing a PFS-funded program would outweigh the costs. Without costs, pricing PFS will be impossible: it will be difficult for the government to determine the value of the services to be provided and the level of return that should be paid to investors.

Using PFS to support only programs with a *strong evidence base* preserves the integrity of the model by making sure investor capital is only directed toward programs that can reasonably be expected to attain the goals set for them. A strong evidence base also is necessary to encourage investors to support a program through PFS. Prior evidence and evaluations let investors know how risky it will be to invest in the program by letting them know how likely it is that the program can achieve its performance targets. An evidence base reduces the uncertainty about whether a program will be successful by providing a general sense of how effective the program has been in previous implementations. Even high-risk programs will be more likely to attract investors than uncertain programs, because high risk can be compensated for with a higher promised return, while higher uncertainty cannot be compensated for in this way.

Program Safeguards

Because PFS is a new concept, it is essential to ensure that such programs meet basic safeguards that preserve the safety of the population and the rights of the investors. Two protections, treatment group safeguards and public-private partnership potential, should be evaluated before engaging in a PFS project.

Ensuring that the implementation of a program under a PFS has sufficient *treatment safeguards* is essential to maintaining the credibility of PFS as a mechanism for supporting the social sector. A commonly cited scenario where the treatment population would be in jeopardy is one in which an initial evaluation suggested that the program would not reach its performance targets. In this case, the intermediary has a strong incentive to pull out of the program to preserve what resources they have remaining, since payment will not be forthcoming (Liebman 2011). Similarly, if government funds targeted for use in social programming and set aside for PFS are returned to a general fund upon the failure of a program, instead of being repurposed for a different social program, failed PFS projects would drain funding from the social sector rather than increasing it.

Determining if the program can be implemented as a *public-private partnership* is the second PFS safeguard. PFS programs require close consultation with the public sector and may involve the replacement or enhancement of services the public sector currently provides. Because of this potential for enhancement, it is important to ensure that the PFS program can legally and operationally be implemented through private means, and can easily interact with government programs and structures. If there are legal or operational barriers that would prevent the implementation of the PFS program as planned, these should be identified before implementation to determine if they render program implantation unfeasible.

Applicability: Instrument Appropriateness and Financial Viability

While the government has significant monetary incentives to use PFS, some projects and programs are more suited to PFS than others. Barriers between government agencies, reasonable duration, and least expensive source of capital should be assessed to determine the cost-effectiveness of PFS.

Barriers between government agencies refers to the regulatory and administrative partitions between government agencies that can make it difficult to pool resources across agencies on a single problem, even if both agencies have an interest in the problem's resolution. Because PFS can draw payments and capture savings from multiple agencies effectively, PFS can be a uniquely cost-effective tool for financing social programs whose support structure (e.g., funding, data, and staff) might be spread across multiple different government agencies.

The *duration* of the PFS funding program is the second measure of cost-effectiveness. PFS is not designed to sustain the funding of a program over the long term. Additional costs in the PFS system, such as the independent evaluator, make it an expensive way to sustain long-term programming. PFS funding should only be used to fund programs for six to eight years at the most, or to build infrastructure that will be supported by other funding sources later. If PFS is intended to provide ongoing or permanent support for a program or policy, other solutions should be considered.

Least expensive source of capital is the third dimension that should be explored when considering the cost-effectiveness of PFS. Before supporting a project with PFS mechanisms, other available options for funding a program or program portfolio should be explored to ensure that PFS is the most effective method of raising capital to a project. Other funding methods that should be investigated include obtaining grants from public or private sources or issuing public debt. These options do not require paying for the services of an intermediary or an independent evaluator, they cost less, and they may be more appropriate for some programs. Because of the additional costs associated with a PFS model, it is generally advised to seriously consider any other available methods for financing a program.

Even if the PFS mechanism is viable for the program, it may not be cost-effective or financially viable way for the government to support a program. The savings that will result from a program are essential to determining whether the government should turn to PFS financing. Three factors should be used to evaluate potential PFS savings: cashable benefits, societal benefits, and risk. Understanding these dimensions requires the use of a strong cost-benefit model that provides realistic estimates of the costs and benefits that can result from the implementation of a program and that provide an estimate of the probability that the program will result in cost savings.

Cashable or recoverable benefits refer to the liquid savings the government will realize by implementing a PFS program. Cashable benefits are savings that the government would not spend due to private investors paying upfront and could then repurpose. An example of cashable savings would be a program that reduced crime or recidivism sufficiently to close an entire prison facility, allowing the government to reallocate money that would have been used to operate the prison. A successful PFS program with no or minimal cashable savings will require governments to pay investors with other funds.

Societal benefits are savings to society that do not result in liquid assets accruing in the government. Examples of societal benefits include losses in productivity and injuries that do not result when a program successfully prevents crimes from occurring. While these are social goods, these types of savings do not provide the government with capital that can be reallocated or used to pay investors.

Risk is the probability that a program will attain cost savings. Risk is important because it provides the government and investors with an estimate of the likelihood that a program will be successful and that investors will receive a return. Risk from cost-benefit models must be interpreted carefully as many provide only a point estimate of cost or benefit of the most likely outcome of program implementation. More detailed engines, like the Urban Institute's Meta-Bayesian cost-benefit engine provide more reliable estimates by providing the percent probability that a program will attain cost savings.

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