

What is Pay for Success?

Frequently Asked Questions about the PFS financing model

The Department of Labor held a National Listening Session on February 22, 2012 to share information about the goals for the pilot Pay for Success projects, and to invite interested organizations to share their thoughts about the PFS model and how it could be used to address workforce development challenges.

Following the Listening Session ([found here](#)), ETA developed this FAQ, designed to help organizations – including state, local and tribal governments, intermediaries, funders, and service delivery providers – better understand the basic underlying concept of the Pay for Success financing model.

The following questions are not part of the Department’s Pay for Success grant solicitation (SGA). Organizations considering applying under the PFS SGA should consult that document for requirements and criteria of the grant competition.

What is Pay for Success?

The Pay for Success (PFS) model is a new way of financing social services to help governments target limited dollars to achieve a positive, measurable outcome. Under the Pay for Success model, a government agency commits funds to pay for a specific outcome that is achieved within a given timeframe. The financial capital to cover the operating costs of achieving the outcome is provided by independent investors. In return for accepting the risks of funding the project, the investors may expect a return on their investment if the project is successful; however, payment of the committed funds by the government agency is contingent on the validated achievement of results. In this way, the PFS model shifts the burden of investment risk from the government to private investors, effectively creating a social investment market where the government only pays for results.

What entities are involved in projects funded by the PFS model?

Though models put in place for specific projects may vary, the basic PFS model includes the following key players, or partners:

- 1) Government entity: interested in providing a contract or grant for services
- 2) Investors: provide total operating capital for the project
- 3) Intermediary: coordinates the project and selects and funds services providers
- 4) Service providers: deliver services to a target population
- 5) Independent evaluator: validates the results of the project

The target population is another key component in the PFS model, though not a partner in the design or administration of the project, for who the existing provision of services has been insufficient or inefficient in achieving desirable outcomes. This is the group targeted for intervention by the project funded under PFS.

For more information about the roles of the entities involved in the PFS model, as well as other readings, tools, and resources on PFS, you are encouraged to view the Nonprofit Finance Fund's Pay for Success Learning Hub Web-site at <http://payforsuccess.org/>.

Please see the Department of Labor's SGA 11-13 for specific information on the partnership structure required to be eligible for consideration under the solicitation.

Why might state, local, or tribal governments use the PFS financing model?

Pay for Success is particularly well suited to financing preventative social services and innovations that are improvements on, or different from, existing government-funded services offered to the target population. Typical government programs provide funding based upon metrics that tell us how many people we are serving, but little about how we are improving their lives. As part of this Administration's commitment to using taxpayer dollars effectively, we are employing Pay for Success as an innovative new strategy to help ensure that publicly-funded services produce their intended outcomes.

The Pay for Success financing model essentially uses private capital to fund a comprehensive, preventative service delivery strategy whose success is linked to achieving a specific social outcome. In return for accepting the risk associated with funding the intervention, the investors expect a return on their original investment, much like investing in a stock market. However, the government only pays back the investors and provides the return-on-investment if the strategy is successful and if the agreed-upon goal is achieved. As a result, Pay for Success is an innovative way of partnering with philanthropic and private sector investors to deliver better outcomes at lower cost—producing the highest return on taxpayer investments.

Has the Pay for Success financing model been tried before?

The first Pay for Success models are currently being piloted in the United Kingdom and Australia. The United Kingdom model, using the name "Social Impact Bonds," was undertaken at Peterborough Prison in an effort to reduce the overall recidivism rate of the prison. The Australian government of New South Wales is exploring "Social Benefit Bonds" in the policy areas of juvenile justice, parenting support for vulnerable families, disability, homelessness, and mental health. Both projects are in the early stages of implementation, but so far the results have been positive. Several states are also in the early stages of developing their own versions of Pay for Success financing models. In January 2012, Massachusetts issued a request for Pay for Success contracts that address chronic

homelessness and juvenile justice, and hopes to become the first state to invest in PFS social innovation financing.

What is the difference between Pay for Success and Social Impact Bonds?

The Pay for Success financing model is a variation of the Social Impact Bond model, under which “bonds” could be sold to individuals and companies who are interested in supporting promising social services. The return on the bonds would be linked to the success of the project, thereby incentivizing projects to operate more efficiently and to attract more investors. At this early stage, the Federal government is interested in testing the feasibility of the financing partnership between private investors and managing intermediaries and is not requiring that the sale of “bonds” make up any part of the private investment.

How is the PFS financing model different from performance-based contracting?

The PFS financing model relies on independent private funding to provide the working capital for the proposed intervention. Because the up-front money is not provided by the government, the PFS project partners are not constrained by government regulation on how they can spend the money. This financial freedom should allow them to explore, develop, and carry out innovative service delivery strategies that they would have been unable to implement with government dollars. In contrast, performance based contracting is a system whereby government payment is based on achieving benchmarks and sequential outcomes. Partial payments can be received and are usually based on outputs such as the numbers of participants served. Pay for Success differs from this payment arrangement in that the government payment is absolutely contingent on meeting a pre-stated project outcome goal, and typically occurs at the end of the project when outcomes can be measured. Should the PFS project fall short, the government does not pay for the intervention, and the financial risk remains with the private investors, not with the tax payers.

How is ‘success’ measured in the PFS model?

The “success” of the PFS model is defined by specific, measureable outcomes. PFS projects seek to improve a social metric of a target population, such as the rate of unemployment. Pay for Success is best suited to fund interventions that address the needs of a target group where there is either no existing provision of services or the current provision of services is inadequate, and the problem can’t be fixed with current funding sources.

A project financed under the PFS model, will need a way to evaluate progress in solving the problem. The entities involved will want to think about whether there’s a way to reliably determine whether a new or different intervention is improving outcomes for the target population. In order to do this, they will need to consider what existing or new data could reliably indicate performance, and determine whether it is possible to identify an

appropriate comparison group or historical baseline against which the target population can be measured.

Who can invest in a PFS proposal?

A wide range of entities can invest in a PFS financing model. A central member of the PFS partnership is the managing intermediary, one of whose key roles includes raising sufficient private capital to run the project. Therefore, it is up to the intermediary to pitch the service delivery proposal to potential qualified investors (such as foundations, corporations, individuals, and either for-profit or non-profit entities) and raise enough money to fund the entire strategy. The PFS financing model is designed to be unrestrictive as to the type of qualified organizations and individuals that can invest in a promising intervention strategy.

How are savings to the government measured in the PFS model?

A project financed under the Pay for Success model will need to be able to measure actual cost savings to the government—in a specific program area or others—that would result from the improved outcomes. Projects financed through the PFS model work when the cost of this new intervention, plus the rate of return to investors, still results in short- and long-term savings to the public sector. Project partners need to think about what it currently costs them to address the target problem and population and what the new Pay for Success funded intervention will cost, including what savings are generated by the new intervention. Partners might want to consider both the direct and/or other costs associated with this problem. For example, direct costs could include the government services that are currently provided. Other costs and non-monetized benefits could include dependence on other government services or benefits or lost tax revenue.

Are the intermediaries, service providers, or government allowed to make a profit on the return on investment?

Because the private investors bear the financial risk of the proposed PFS intervention, they are the ones who realize a profit from a successful project; ideally, some or all of this financial return could be re-invested into further social capital initiatives. As contractors, service providers and their day-to-day costs and any profit margins are managed and funded through the managing intermediary, with funds raised from private investors. The operating costs of the intermediary, who is also a contractor, are also paid for with up-front funding from the investors, so it is expected that their administrative expenses, overhead, profit margin, and any other costs are included in the total capital amount to be raised. While the government partner will not make a profit from a successful PFS intervention, by design, these projects should result in savings that accrue to the government – both in programmatic cost savings or in efficiency gains.

Is the return on investment derived from the actual cost of the services to each participant, or is it a multiple of the money saved overall?

The return on investment envisioned in the PFS financing model represents an incentive payment for the private investors. A key part of the design of these projects is a financial analysis that determines the level of cost savings or efficiency gains that the government will see. Included in the financial analysis is this return on investment, the idea being that the cost of the proposed intervention and the return on investment payment will still result in an overall savings for the government entity. Once the expected total cost of the intervention has been determined, a fair and reasonable return on investment needed to finance the project's entire period of performance should be proposed. In the PFS financial model, the rate of return is determined through negotiations between the project partners. It must be attractive enough to entice investment, yet not so large as to discourage the government partner from supporting the project, and reasonable compared to the overall valuation of the outcome. Careful planning and design is needed to make sure that the predicted operating costs of the intervention are as realistic as possible, and that the return on investment is satisfactory to all parties.

What are some of the negative effects, or perverse outcomes, that could result from poor target population selection or a poorly designed PFS approach? How are they avoided?

Target population selection and definition is essential to a project being financed through PFS. Because these projects are best suited to preventative services and measures that complement existing programs, it is very important that the demographics of the target population be as clearly defined as possible. Projects are measured in terms of overall impacts on either the total target population or the intent-to-treat group, not merely on individual results or participation numbers. For this reason, the 'success' payments will only be made on overall impacts, not simply on the results of participating individuals. Perverse incentives that could arise from poor target population selection include: serving only the easiest to reach (cream skimming), avoiding the hardest to impact (parking) or using selective criteria that pre-screens applicants that could receive services. Projects should not seek to pre-screen applicants based on potential to succeed with an intervention. Once the target population has been broadly, yet clearly, defined, the partnership may seek to provide multiple services and strategies that best serve different groups of eligible customers.

In the end, perverse outcomes, such as actively discouraging certain members of the target population NOT to partake in a particular intervention, can be avoided through careful project design. The social issue and target population must be of interest and concern to all project partners. The resulting cost savings must be significant enough that the government entity is willing to pursue the project. The return on investment and intervention strategy must give potential investors a reasonable level of confidence to underwrite the financial risk. Because there are multiple checks and balances to the PFS

financing model, open and clear discussions are needed to ensure a transparent design process that all members of the PFS partnership will feel comfortable signing off on.

Where can I learn more about Pay for Success?

A Pay for Success Learning Hub (www.payforsuccess.org), run by the Non-Profit Finance Fund, brings together organizations interested in the Pay for Success concept. There you will find articles, recordings, transcripts, research, and videos from around the world on the progress of Pay for Success and other contemporary projects. Also available on the site is a Provider Toolkit, with resources for nonprofits and other service providers; a Networking section, linking people providers and key organizations; and finally, an Events calendar to stay up to date with the latest PFS goings on.