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With a Few Pay-for-Success Plans Under Way, the Idea Is Gaining Currency and Criticism

By Nicole Wallace

Social-impact bonds, one of the most talked-about ideas in the nonprofit world, are quickly building momentum—and sparking controversy over the unproven financing mechanism.

The goal behind the new form of financing is to help government agencies shift from reimbursing nonprofits for the number of people they serve to paying for measurable results.

Sometimes referred to as pay-for-success contracts, social-impact bonds allow private investors to pay for a social program that has performance goals, such as reducing the number of ex-offenders who return to jail. If an independent evaluator certifies that the program has met the goals, the government repays the investors' principal and, depending on the results, may provide a profit. If the program fails to deliver, investors lose their money.

Pay-for-success contracts are an important development because governments spend hundreds of billions of dollars on social programs every year, often with little to show for it, says George Overholser, chief executive of Third Sector Capital Partners, a nonprofit that advises government agencies, charities, and others on the new form of financing.

"If we can take even a subset of that world and make it more performance-driven, we've done more than what could ever be accomplished philanthropically," he says. "Government spending is vastly larger than all of philanthropy combined."

Some nonprofit leaders, however, think the excitement about social-impact bonds is premature. "It's been overpromoted and oversold," says Jon Pratt, head of the Minnesota Council of Nonprofits. "We have yet to have a single transaction completed, and yet multiple states and multiple agencies are jumping ahead."

One of his chief concerns is the potential for cheating: "You're definitely creating incentives that would be considered corruption pressures."

Only a handful of pay-for-success contracts have been signed, but enthusiasm for the idea is growing:

- In June, Representatives Todd Young, a Republican from Indiana, and John Delaney, a Democrat from Maryland, introduced the Social Impact Bond Act, which would appropriate $300-million for state and local social-impact bonds and set up a council to coordinate federal efforts in pay-for-success.

- Pay-for-success contracts were on the agenda at a roundtable at the White House last month, as part of a broader discussion about impact investing.
- After Goldman Sachs invested in the first social-impact bond in the United States, the company heard from investors who wanted to participate in future deals. So the bank created the Goldman Sachs Social Impact Fund, which will invest in domestic impact investments, including social-impact bonds. The company hopes to raise more than $100-million in capital.
- The Social Innovation Fund, a program of the Corporation for National and Community Service that helps nonprofits expand effective programs, will award up to $11.2-million to nonprofits and city and state governments that aim to use social-impact bonds to advance innovative approaches to difficult social issues. The fund is accepting proposals until July 31.

Taking On Recidivism

New York City, the State of New York, and Massachusetts have started pay-for-success efforts to reduce recidivism, while Utah has used the new financing method to make high-quality preschool available to more children from low-income families.


Anatomy of a Deal: How New York State's Pay-for-Success Project Works [PDF]

Other states, cities, and counties are exploring ways to apply the approach to other problems.

For example, Cuyahoga County, in Ohio, is developing a program to help homeless mothers regain custody of children in the foster-care system. In Fresno, health groups are testing a program to help low-income families manage their children's asthma to reduce the cost of emergency treatment—and pave the way for a social-impact bond to expand the effort.

Social-impact bonds have the potential to spread proven approaches to tough problems, says John Roman, a senior fellow at the Urban Institute.

"We find that an intervention works with a difficult population, and then we never get beyond serving 2 percent of that population," he says. "What social-impact bonds and pay-for-success do is potentially unlock the capital that's necessary to make that big leap from the pilot stage to the business-as-usual stage."

A Chevy, Not a Cadillac

Two years into the nation’s first pay-for-success contract, the leader of the nonprofit chosen to carry it out has mixed feelings.

In 2012, New York City raised $9.6-million from Goldman Sachs to pay for a behavioral-therapy program designed to reduce the number of young inmates who commit another crime after they’re released.

Elizabeth Gaynes, executive director of the Osborne Association, which is running the program, thinks her organization is making a real difference, but she’s disappointed that the group isn’t able to work more with the inmates after they’re released.

According to Ms. Gaynes, because Department of Education facilitators that Osborne thought would be available to help run the program fell through, the group had to reassign to the prison employees who would have otherwise provided post-release services. As a result, the group had to cut back on services in the community

Ms. Gaynes also wishes that the contract included more money for activities: "Idle time in jail is a recipe for disaster."

But the ultimate goal, she says, is not just for this project to be successful but to come up with a program the city will pay for going forward. If the cost is too high, she says, that won’t happen.

"We think these kids deserve a Cadillac," says Ms. Gaynes. "But maybe it’s more realistic that they get a Chevy."

The response of charities to social-impact bonds ranges from excitement to wary skepticism, says Antony Bugg-Levine, chief executive of the Nonprofit Finance Fund.

While groups that have worked hard to measure and improve the results of their programs see a huge opportunity, he says, "there’s a much larger group who don’t quite understand what this is and say, ‘We just got used to the last set of hoops we were told to jump through, and here’s another one.’ "

Several Hurdles

One potential danger is that the contracts will pay for charities to ramp up services but not build the organizations’ capacity to support that growth, says Mr. Bugg-Levine.

"Even though they might deliver on the social-impact bond in the short term," he says, "it could weaken their sustainability as an organization for the long term."

Other hurdles stand in the way of widespread use of social-impact bonds. In most jurisdictions, experts say, government has to pass new legislation to allow it to enter into multiyear, conditional contracts.

Negotiations to draw up the complicated agreements are also time-consuming. It took 18 months to hammer out the pay-for-success contract in Massachusetts.

"It’s like building a fine Italian shoe, one at a time," says Ben Hecht, chief executive of Living Cities, which invested $1.5-million in the Massachusetts deal.

As participants learn from early social-impact bonds, the time it takes to work out the contracts should decrease, according to Mr. Hecht, who says that it took almost a decade of experimentation for low-income housing tax credits to become an efficient tool.

"They’re costly to produce," he says of the early pay-for-success contracts. "Those who work on them, like us, are investing the money and time because we want to create the market and accelerate its development, not because we think they’re smart and efficient transactions right now."

State Efforts

Despite the challenges, social-impact bonds pique the interest of state and local governments still smarting from the recession.

The California Pay for Success Initiative, a program run by the Nonprofit Finance Fund to help cities, counties, and nonprofits in the state develop social-impact bonds, expected to get 10 to 15 submissions. It received proposals for 38 projects.

"Our budgets are packed tight," says Glen Shor, secretary of administration and finance for Massachusetts. "Too many promising ideas get left on the cutting board."

In January, Massachusetts announced a $27-million pay-for-success effort designed to reduce recidivism among young men leaving the juvenile-justice system.

Government struggles to pay for prevention programs in which there’s an upfront investment, but the savings are realized over time, says Mr. Shor. Having a mechanism in which the government pays only if the program is successful makes the programs less risky, he says: "It really enables us to break through this barrier to investing in new things."

Some government officials, however, question the potential for savings.

The Department of Legislative Services in Maryland studied whether the state should use social-impact bonds to finance programs designed to reduce the number of people who return to prison after being released.

No Cost Savings

The study concluded that the extra costs, such as paying for independent evaluations and the return to investors, would exceed the cost savings to the state, even if the program was very successful.

The problem is that proponents of social-impact bonds don't take into consideration the corrections system's fixed costs, says David Juppe, senior operating budget manager.

If the cost of running a prison for a year divided by the number of inmates comes to $30,000, that doesn't mean the state will save that much for each person who doesn't return to prison, he explains.

"You save a few thousand dollars per inmate," says Mr. Juppe. "But you don't save $30,000 because the facility has all these fixed costs—the correctional officers, the lighting, the air conditioning."

Santa Clara County, in Calif., is developing two pay-for-success projects: one to improve treatment for the mentally ill and another to help the chronically homeless.

Attracting Resources

Gary Graves, the county's chief operating officer, thinks that if the mental-health project is successful, it will generate what he calls "cashable savings" that could be used to pay returns to investors, something he doesn't expect from the program on homelessness.

But the county is going ahead with the plan, he says, because fighting homelessness is a priority, and officials think the attention the program gets could draw other sources of funding.

"If there's a possibility of drawing additional resources to solve a problem, we're not doing our jobs if we're not willing to explore these ideas and to see if they can actually deliver," says Mr. Graves. "That's certainly the reason why I climbed on this train."

Changing Minds

Working on the pay-for-success contracts, which are still in development, is changing the mind-set of the board of supervisors, says Mr. Graves.

"My board members are already much more focused on measuring outcomes and evaluation and pay for success," he says. "They want to be investing in programs that will deliver."

For nonprofits, the promise of a reliable source of income that rewards results is the biggest lure of social-impact bonds.

"It's really hard to move the needle if you have to magically put money together every 12 months," says Molly Baldwin, chief executive of Roca, the nonprofit that was chosen to carry out the first pay-for-success contract in Massachusetts.

She says her organization jumped at the opportunity to prove its approach.

"We believe that we can do this, and our data suggest we can," she says. "If we don't, we should close our doors."