



# More Than Cost Savings

## A New Framework for Valuing Potential Pay for Success Projects

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Pay for success (PFS) is often framed as a way to pay for programs that promise to save public agencies more money than they cost, thereby generating “net cashable savings” for governments.<sup>1</sup> In practice, however, developing projects that attain net savings within the relatively short time frame required by many policymakers has been challenging.

Recently, PFS proponents have increasingly emphasized that projects can deliver verified outcomes that yield fiscal and nonfiscal benefits, both of which matter to most policymakers. In this brief, we present a framework that uses a simple test, integrating fiscal and nonfiscal factors, to help policymakers evaluate potential PFS projects. In so doing, we make the case for social investments that go beyond the narrow range of programs currently being considered under the more restrictive net-cashable-savings approach.

## An Integrated Framework for Pay for Success

### Limitations of the Traditional Pay for Success Approach

In recent years, a new mechanism has emerged for funding innovation in public programs. PFS financing, also called social impact bonds, shifts risk from a traditional funder (usually a government agency) to a new funder (usually a private investor or philanthropy). The latter pays up front for services to improve

outcomes for a vulnerable population. If an independent evaluation shows that the program achieved the target outcomes, the traditional funder then repays the new funder's investment (potentially with interest).

A major selling point of PFS projects has been the potential that savings to government agencies from an effective program can more than repay up-front project investments.<sup>2</sup> The focus on net cashable savings, or overall public savings even after accounting for project costs, has been an important motivation for many governments exploring PFS projects: a project secures up-front funding from investors for preventive services that avert negative future outcomes (e.g., criminal activity), thereby yielding future government savings (e.g., reduced justice system costs) that are projected to exceed up-front project costs.<sup>3</sup>

However, the focus on net cashable savings narrows the field of social interventions that might be eligible for PFS funding. Many interventions supported by strong evidence have benefits other than calculable, short-term cost savings. To address that concern, researchers at the Center for American Progress and Institute for Child Success developed a useful PFS framework that incorporates both cost savings and public value (Kohli et al. 2015). In this model, government agencies pay for outcomes that reflect three factors:

- well-being benefits: the improvements that accrue to individuals and communities when the outcome is achieved
- the public's willingness to pay: whether the outcome is deemed worth the investment
- cashable savings: the savings that accrue to governments when the outcome is achieved

This public-value approach offers significant advantages. Unlike the net cashable savings model, it allows justification for PFS projects with public-sector savings that do not exceed project costs within a short period. Further, it expressly incorporates both fiscal and nonfiscal policy results, better corresponding to how policymakers and the public actually evaluate options.<sup>4</sup>

## An Alternative Framework

Building on the Center for American Progress's work, this paper further considers how the fiscal and nonfiscal benefits of target outcomes might affect the structure and pricing of PFS projects. Our goal is to provide policymakers with clear and simple criteria for deciding how to proceed with potential projects.

The proposed framework centers on two questions:

- How much are policymakers willing to pay in order to achieve specified outcomes?
- If performance exceeds expectations and saves additional money for government, how much of those savings will policymakers share with the private investors who furnished up-front funding?

Further, this framework requires that project leaders conservatively estimate the project's expected outcomes and cost savings. When the research literature and local context suggests a range of possible outcomes, the PFS arrangement will assume the lower bound of that range. Similarly, if research shows a range of potential savings that particular outcomes could produce, the lower end of the range will be used to define the PFS arrangement. This methodological commitment increases project credibility with both governments and investors. It also sets up PFS projects for success, basing them on conservative expectations rather than unduly optimistic ones.

## Key Steps

Our proposed approach is holistic (it includes both fiscal and nonfiscal outcomes) and integrated (it seeks to combine all outcomes into clear criteria for policymakers). The approach has five key steps (figure 1), described in more detail in appendix A.

- **Step one: Define the project.** As with any PFS project, the partners that constitute the project define it. The definition includes the project's target population, its intervention services, and the up-front cost required to deliver those services.
- **Step two: Define target outcomes.** Based on the available research evidence and local context, project partners identify the project's range of likely outcomes. They select target outcomes from the lower end of this range (i.e., minimum success).
- **Step three: Reach consensus on fiscal impact.** Project partners work with government agency staff to reach consensus on two fiscal impacts:
  1. the public-sector cost savings that specified target outcomes will produce, and
  2. the additional cost savings that will result for each unit in excess of the target outcomes.

These cost-savings estimates should have two characteristics:

1. the estimates should represent the low end of likely savings, based on available research literature, and
  2. they should incorporate a limited time horizon (e.g., three or five years) to have credibility for the jurisdiction's policymakers.<sup>5</sup> Savings outside that horizon are not included in calculating the project's net public-sector costs or fiscal gains. However, policymakers are free to consider them as part of their overall analysis of whether the project is worthwhile.
- **Step four: Frame questions for policymakers.** The partners, in collaboration with government agency staff, use the following consensus fiscal analyses to frame key questions for policymakers:

- » **What is the project's net cost?** Net cost is the gross project cost minus the near-term savings that the government agency agrees will result if the target objectives are achieved.
  - » **Are the target outcomes worth the project's net cost?** This question calls upon policymakers to consider both fiscal effects and any nonfiscal gains from the target outcomes. If the answer is yes, then the PFS deal can proceed because the public agency will not spend any money unless the targeted outcomes are achieved for the specified net cost.<sup>6</sup> This is the primary question under our suggested approach because it determines whether or not the project moves forward.
  - » **If target outcomes are exceeded in ways that save additional public dollars, how much will be shared with the investors?** This question about defining “bonus” payments is important, but it primarily helps determine how the project will be structured to attract investors rather than whether the project moves forward.
- **Step five: Structure the agreement.** Clear and rigorous outcome measurement protocols are important considerations in all PFS projects. The choice of protocol will reflect considerations such as measurement costs, accuracy, and sample size. Payment arrangements, such as considering which public agency makes payments if an independent evaluator verifies that target outcomes have been achieved or exceeded, are also important. As illustrated by the examples later in this brief, the agencies that achieve cost offsets might make contributions based on their offset amounts. (Appendix B explores how this framework could also address evaluation and other transaction costs.)

FIGURE 1

Steps in the Integrated Framework



# Strengths of the New Framework

## Broader Scope for PFS Projects

This alternative framework for PFS project development offers several benefits. First, the approach could expand the use of PFS for interventions that are not clearly known to produce net public-sector cost savings. Many programs have demonstrated an ability to reduce some public-sector expenditures, but forecasting the comparative magnitude of costs and savings often involves uncertainties.<sup>7</sup> Those uncertainties make it hard to know whether net savings will result within the relatively short time frame that many policymakers consider when assessing fiscal effects.

Such uncertainties about net fiscal outcomes may apply to interventions for which the peer-reviewed literature provides strong evidence of favorable outcomes that involve public cost savings or for which the evidence suggests potential savings without furnishing definitive proof. The framework proposed here allows stakeholders to pursue PFS in either case, even though net cashable savings are uncertain.

PFS projects often implement interventions that already have highly credible evidence of positive outcomes, in part because such evidence is typically needed to attract investors. That limits the range of potential interventions. Further restricting that range to interventions that are known with certainty to achieve net government savings imposes an additional significant constraint on the issues that PFS can address. The integrated PFS approach proposed here allows for projects where existing evidence shows successful outcomes that yield some public-sector savings within a relatively brief time frame, even when the evidence does not prove those savings exceed intervention costs.

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This expansion in potential PFS scope could have a particularly pronounced effect in two policy areas, illustrated by the two extended examples presented in the next section. First, some interventions target improved health outcomes by addressing underlying socioeconomic conditions that pose health risks, investing in care coordination, or providing preventive services. Such interventions can yield health care cost savings, but whether those savings exceed service costs is often unclear.

For example, many preventive services help with early detection of serious chronic conditions and prompt start of treatment. This can produce cost savings if the illness does not progress to a more developed stage that is expensive to treat. For those whose illnesses are detected, preventive services are likely to cost less than the avoided treatment. However, net savings may not materialize if only a small percentage of those who receive preventive services have illnesses detected as a result. In these and similar cases, the integrated approach discussed here would let a PFS project move forward based on reliable evidence of successful outcomes and cost offsets (regardless of uncertainties about whether those offsets generate savings that exceed project costs).<sup>8</sup>

This PFS framework might also expand investment in policies and practices that are expected to realize net savings, but only after many years have passed. For policymakers concerned with a more immediate time frame, those savings are not seen as “paying for” near-term costs. For example, some early childhood education interventions may require expensive up-front investments. Important outcomes can be achieved within a few years, yielding modest public-sector savings that partially offset up-front service costs. However, the intervention’s full benefits, including savings realized by criminal justice and social service agencies that are likely to exceed the project’s up-front education costs, do not materialize until the children in the project have become adults. The approach outlined in this paper lets such projects move forward, with payment based on the rigorous documentation of specified near-term outcomes that policymakers see as justifying specified net near-term service costs.

## **Potential for Enhanced Credibility and Investor Interest**

Another benefit of this framework is that it enables projects to better incorporate uncertainty when forecasting outcomes. For example, proponents of a PFS project may agree with criminal justice agencies that a given reduction in young adult arrest rates will yield a certain range of savings in police, jail, and court costs. Rather than ask the parties to agree on the precise amount of likely savings (sometimes a challenging endeavor), our approach requires agreement only on the range of likely savings. It then uses the bottom end of that range to help determine both (1) the project’s net public-sector cost if it achieves target outcomes and, (2) the range of bonus payments that performance exceeding these targets will produce.<sup>9</sup>

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Incorporating uncertainties into the framing of a PFS project could strengthen its credibility with policymakers. Doing so may also increase investors’ interest, especially because the outcome targets themselves are set at the least favorable, most likely end of the range suggested by available research. Premising PFS projects on uncertain outcomes relating to net cashable savings can be risky. Instead, the

approach discussed here conservatively establishes performance targets and bonus metrics that increase the likelihood of outcomes that generate payouts, regardless of whether the public sector achieves net fiscal gains within a brief time frame.

## **Refocus on Reliable and Verified Outcomes**

The approach discussed here focuses on PFS's rigorous measurement of whether specified outcome targets have been achieved. It thus avoids conflating *reliability of evidence* with *assurance of net cashable savings*. Comments like the following from leading PFS papers and reports can create confusion among policymakers:

“The concept of Pay for Success is simple: pay for services if and when they achieve the desired results that achieve social outcomes and ultimately save money” (Nonprofit Finance Fund and the White House 2012).

“With increasingly strained budgets and growing social need, how can government funding be directed towards evidence-based programs that offer demonstrated cost-savings? [PFS] and Social Impact Bonds ... have emerged as potential mechanisms for making smart investments in effective social interventions by changing the way Government allocates and invests its resources – focusing on results and outcomes. In short, funding what works” (Third Sector Capital Partners 2013).

A key conceptual question facing PFS stakeholders is whether PFS seeks to base policy on (1) reliably documented outcomes or (2) the subset of reliably documented outcomes that generate net government savings. Without ignoring fiscal impact, the approach discussed here unambiguously endorses the former goal. It incorporates cost offsets into the decisionmaking formula while focusing PFS projects on verified accomplishment of agreed-upon outcomes.

## **A Clear and Logical Starting Point for Dividing Agency Responsibilities**

Finally, this approach suggests a logical distribution of financial responsibility among the agencies that fund services and the agencies that realize cost savings. Namely, if target outcomes are achieved, the saving agencies share the agreed-upon portion of their resultant cost savings, and the funding agencies pay the remaining “net costs” to provide project services. If targets are exceeded in ways that save more, the agencies that achieve those additional savings make the agreed-upon bonus payments. For example, an after-school program for at-risk youth may be funded by the local education agency but generate cost savings for the criminal justice system. Our approach helps facilitate the allotment of financial responsibilities. Based on the consensus fiscal impact estimates determined under step three of this framework, (1) if target outcomes are achieved, justice agencies could pay the cost savings they realized from such outcomes, and the education agency would pay the remaining up-front service costs; and (2) if target outcomes are exceeded, justice agencies could pay the agreed-upon percentage of additional savings such agencies obtained from performance beyond target levels.

## Examples of the Framework

Below are two examples that illustrate how this PFS framework might work in practice, demonstrating its application in two common policy contexts. In the first, net cashable savings appear uncertain or unlikely to be achieved because available evidence does not prove that public-sector cost savings will exceed up-front project costs. In the second, projected cost savings appear likely to exceed project costs but only in the long term. Under some common rubrics that require PFS projects to achieve net government savings within a relatively brief time frame, neither of the following policy contexts offers good candidates for PFS projects. As shown, however, the framework presented in this brief makes both of them viable for PFS consideration.

### Example 1: Targeted Treatment of First-Episode Psychosis

#### THE INTERVENTION AND ITS EXISTING EVIDENCE

For young people with mental illness experiencing their first episode of psychosis, immediately delivering an intensive set of comprehensive health and social services decreases the incidence and severity of subsequent episodes. Very strong evidence, based on randomized controlled trials, shows that such treatment

- reduces the rate of later psychiatric hospitalization, and
- increases rates of employment and participation in education programs (Srihari et al. 2015).<sup>10</sup>

Less strong but still substantial evidence<sup>11</sup> suggests additional gains, including

- shorter hospital stays in those cases where hospitalization occurs, and
- fewer arrests and other contacts with the criminal justice system (Breitborde et al. 2015).

One 2015 study found that, during the six months preceding implementation of the intervention's clinical and psychosocial supports, inpatient hospital costs averaged \$27,480 per person and criminal justice costs averaged \$8,604 (Breitborde et al. 2015). Net fiscal gains of intervention could include short-term savings in these areas and longer-term fiscal gains produced by increased employment rates and higher levels of education.

Public savings for states could be considerable. As a general rule, services provided at adult psychiatric hospitals are ineligible for federal Medicaid funding. When an initial schizophrenic episode leads to later psychiatric hospitalizations at adult facilities, states typically bear the resultant health care costs in their entirety. Consequently, states spent an estimated \$8.7 billion on such hospital services in fiscal year 2012, the most recent year for which data are available.<sup>12</sup> Whether or not the savings that this intervention produces outweigh its costs, policymakers may be interested in providing effective services to such a vulnerable group as long as net costs are not too large.

## STRUCTURING THE PFS PROJECT

In table 1, we show how this example could be approached using the five steps established earlier.

TABLE 1

### Structuring a First-Episode Psychosis Treatment PFS Project Using the Integrated Framework

Step one: Define the project	<ul style="list-style-type: none"> <li>■ <b>Population:</b> People ages 16 to 45 who experienced their first psychotic episode within the previous five years.<sup>a</sup> In the research trials, participants' mean age was under 23, and 60 percent of participants were within six months of the initial onset of psychosis, so policymakers could conceivably use this narrower set of targets (Srihari et al. 2015).</li> <li>■ <b>Services:</b> Specific, comprehensive treatment protocols of demonstrated effectiveness that go significantly beyond what most young people typically receive following their initial psychotic episode.</li> <li>■ <b>Costs:</b> Project partners would need to estimate the gross cost required to deliver those services to a defined cohort of project participants.</li> </ul>
Step two: Define target outcomes	<ul style="list-style-type: none"> <li>■ <b>Outcome targets:</b> The project team defines the following targets, with numbers chosen toward the bottom of the range of likely results, based on the research literature. <ul style="list-style-type: none"> <li>» W percent fewer psychiatric hospitalizations</li> <li>» X percent more employment</li> <li>» Y days shorter average hospital stays</li> <li>» Z percent fewer criminal justice contacts</li> </ul> </li> </ul>
Step three: Reach consensus on fiscal impact	<ul style="list-style-type: none"> <li>■ <b>Fiscal estimates:</b> PFS stakeholders work with government agencies to reach agreement on three estimates: <ul style="list-style-type: none"> <li>» The minimum near-term public-sector savings that the specified outcome targets would produce<sup>b</sup></li> <li>» The minimum near-term public-sector savings that each increment of improved outcomes exceeding the targets would produce</li> <li>» The cost of the project before savings offsets or outcome payments (this might include evaluation costs and legal fees, as discussed in appendix B)</li> </ul> </li> </ul> <p>Savings would need to be estimated for each relevant agency. For example, the state behavioral health agency would need to agree on the savings it would realize from each percentage-point drop in adult psychiatric hospitalization rates; police and court agencies would need to agree on the criminal justice savings they would experience from each percentage-point reduction in arrest rates; and so on.<sup>c</sup> Estimates would represent reasonable lower-bounds of likely savings within a defined time horizon (e.g., three or five years).</p>
Step four: Frame questions for policymakers	<ul style="list-style-type: none"> <li>■ <b>Net cost:</b> Subtract from total project costs the estimated resultant savings from achieving the outcome target. This produces a net public-sector cost estimate of \$N.</li> <li>■ Policymakers are then asked the following question: "Are you willing to spend \$N dollars, on net, to achieve, among young people who recently experienced their first schizophrenic episode, the above-specified target outcomes within three years?"</li> <li>■ If the answer to the question is yes, policymakers from the benefiting agencies are asked to specify the percentage of public-sector savings that will be shared with investors if outcome targets are exceeded. Policymakers could limit their cost exposure by capping the total amount of such bonus payments.</li> </ul>
Step five: Structure the agreement	<ul style="list-style-type: none"> <li>■ <b>Outcome measurement:</b> As with all PFS projects, partners must agree on an independent evaluator and a rigorous evaluation design to assess whether the project has achieved its outcomes. For example, if resources do not permit all eligible young people to receive intervention services, and if the jurisdiction is large enough to have many eligible people, those who qualify could randomly be assigned to control and treatment groups.</li> <li>■ <b>Payment arrangements:</b> Many payment arrangements are possible. Given this approach, however, the following setup seems like a logical division of responsibility. <ul style="list-style-type: none"> <li>» If target outcomes are achieved or exceeded <ul style="list-style-type: none"> <li>■ the government agencies that experience savings, based on the fiscal</li> </ul> </li> </ul> </li> </ul>

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- estimates to which they agreed, pay those savings (plus, if warranted, the specified amount of bonus savings) to investors after independent evaluators have verified the project’s outcomes; and
    - the remaining “net cost” of services is paid by the agency responsible for the intervention (either the behavioral health agency or the Medicaid agency).
  - » One fiscal agent could be designated to collect funds from the applicable government agencies and then disperse them to the project investors.
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**Notes:**

<sup>a</sup> Policymakers could either use this definition or narrow the target population to focus on young people relatively soon after their first psychotic episode.

<sup>b</sup> The cost estimates in this case may need to include the public-sector cost of increased participation in subsidized education programs.

<sup>c</sup> Similarly, either behavioral health or Medicaid agencies would estimate savings from each percentage-point decrease in average length of hospital stays, depending on whether such stays involved psychiatric or other hospitals; and social service agencies could estimate near-term savings from increased employment, with resultant reduced use of cash assistance and other benefits.

For the fifth step, payment arrangements should be negotiated well before payout, during the initial structuring of the PFS contract. Table 2 illustrates the possible payment arrangements under this example. If the outcome targets are met, the behavioral health agency, the agency responsible for hospital costs, and justice agencies contribute \$A, \$C, and \$E, respectively. For each percentage point by which targets are achieved, they pay \$B, \$D, and \$F, respectively. Although the specified educational and employment outcomes will eventually yield public benefit savings, those savings are not included in the fiscal calculations or payouts in the example presented here.

**TABLE 2**  
**Potential Arrangement for First-Episode Psychosis Treatment PFS Project**

Target outcome	Consensus Short-Term Public-Sector Savings		
	If target achieved	For each percentage point by which target is exceeded	Agency that saves
W% fewer psychiatric hospitalizations	\$A	\$B	Behavioral health
X% more employment		None, in near term	Social services
Y days shorter average hospital stays	\$C	\$D	Agency paying hospital costs (either behavioral health agency or Medicaid) <sup>a</sup>
Z% fewer criminal justice contacts	\$E	\$F	Police and corrections

**Note:**

<sup>a</sup> Which of these agencies saves depends on whether the hospitalization involves so-called Institutions for Mental Diseases, which are generally ineligible for Medicaid reimbursement.

## Example 2: Reading Recovery

The previous example fits our suggested approach to PFS projects because the intervention promises to generate rapid cost offsets even if they do not exceed the intervention's up-front costs. Our second example illustrates a different situation. Some interventions achieve net cost savings for government and have offsets that exceed up-front costs, but the net savings do not materialize until many years after the intervention has ended. Programs targeting younger populations, such as early childhood education interventions and home-visiting programs for new parents, may demonstrate (1) important, positive short-term outcomes that yield limited cost savings for government; (2) longer-term positive outcomes that achieve substantially greater savings; and (3) results that help achieve societal goals that policymakers consider important regardless of their public-sector cost savings. Here, we provide one example of how our suggested approach to PFS can handle this broad category of program.

### THE INTERVENTION AND ITS EXISTING EVIDENCE

Reading Recovery is a short-term (12–20 week) intervention targeting first-grade students in the lowest-achieving quintile for reading and writing. Specially trained teachers provide daily individual lessons. The Reading Recovery model has undergone several strong evaluations, including one of the largest randomized controlled trials ever implemented in education (May et al. 2016).

Students participating in the intervention have achieved important early educational outcomes, including significantly improved reading fluency, comprehension, and other general reading skills (What Works Clearinghouse 2013). Some evidence suggests that Reading Recovery may also decrease the number of children reading at a low level who qualify for special education and decrease the number of children who must repeat first grade (Baenen et al. 1997).

School districts may achieve some near-term cost savings involving special education expenses, grade retention, and other services for struggling learners. But most savings and benefits to individuals and families in the program, and to taxpayers and society at large, are realized in the longer term.

One source estimates an average program cost of \$1,895 per child against projected benefits of \$18,603 over 50 years. Participants would realize approximately two-thirds of those benefits, but an estimated \$4,410 would accrue to taxpayers, significantly outweighing the program's up-front costs.<sup>13</sup> The predicted public-sector savings, however, mainly result from greater future earnings associated with higher test scores, which are not achieved until many years after services have been provided but which ultimately reduce public-benefit and criminal-justice costs.

Our proposed model allows for the establishment of interim measures, such as improved reading scores, as both intrinsically desirable and as proxies for long-term outcomes that include, but also go beyond, public-sector cost savings. If policymakers are interested in those outcomes and willing to make measured investments in longer-term human capital development, a PFS project may be possible.

### STRUCTURING THE PFS PROJECT

We use the same five steps as in the previous example to illustrate our approach.

TABLE 3

## Structuring a Reading Recovery PFS Project Using the Integrated Framework

Step one: Define the project	<ul style="list-style-type: none"> <li>■ <b>Population:</b> Low-performing first-grade children who meet specified criteria.</li> <li>■ <b>Services:</b> An approach taught to teachers through a year-long graduate-level course. Those teachers then deliver the intervention to students through 30-minute lessons provided over 12 to 20 weeks (May et al. 2016, 6).</li> <li>■ <b>Costs:</b> The program is typically delivered at multiple schools within a district to take advantage of cost efficiencies. Project partners need to estimate the gross cost required to deliver those services.</li> </ul>
Step two: Define target outcomes	<ul style="list-style-type: none"> <li>■ <b>Outcome targets:</b> The project team defines the following targets, with numbers chosen toward the bottom of the range of likely results, based on the research literature: <ul style="list-style-type: none"> <li>» W percent fewer special education placements</li> <li>» X percent fewer children repeating a grade</li> <li>» Y level of improved reading test scores</li> </ul> </li> </ul>
Step three: Reach consensus on fiscal impact	<ul style="list-style-type: none"> <li>■ <b>Fiscal estimates:</b> PFS stakeholders work with government agencies to reach agreement on three estimates: <ul style="list-style-type: none"> <li>» The minimum public-sector savings that achieving the specified outcome targets would produce (within the agreed-upon three- or five-year time horizon)</li> <li>» The minimum near-term public-sector savings that each increment of improved outcomes that exceeds the targets would produce (within the agreed-upon three- or five-year time horizon)</li> <li>» The total gross cost of the project<sup>a</sup> (this might include evaluation costs and legal fees, as discussed in appendix B)</li> </ul> </li> </ul>
Step four: Frame questions for policymakers	<ul style="list-style-type: none"> <li>■ <b>Net cost:</b> Subtract the savings estimate (from achieving the outcome target) from the total project cost. This produces a net public-sector cost estimate of \$N.</li> <li>■ Policymakers are then asked the following question: “Are you willing to spend N dollars, on net, to support struggling first graders and achieve the following outcomes: W percent fewer special education placements, X percent fewer children repeating a grade, and Y level improvement in test scores?”</li> <li>■ If the answer to the question is yes, then the school district is also asked to determine the percentage of its near-term savings that will be shared with the investors if outcome targets are exceeded (perhaps with a payment cap to limit total cost exposure).</li> </ul>
Step five: Structure the agreement	<ul style="list-style-type: none"> <li>■ <b>Outcome measurement:</b> As with all PFS projects, partners must agree on an independent evaluator and an appropriate evaluation design. The evaluation will verify the project’s outcomes. The project should seek out the most rigorous design possible, which may be a randomized controlled trial, particularly if resources do not suffice to serve the entire eligible population. If waiting lists are used, children could randomly be assigned to a Reading Recovery group or to a group of students who receive standard services for children reading below grade levels.</li> <li>■ <b>Payment arrangements:</b> In this example, the agency that realizes near-term cost savings is the school district, which is also the implementing agency. Thus, the district agrees to pay investors full project costs if the independent evaluator certifies accomplishment of the specified target outcomes. The district also agrees to make bonus payments if outcomes exceed targets in ways that yield public savings within three or five years.</li> </ul>

**Note:**

<sup>a</sup> Reading Recovery includes significant up-front costs associated with the implementation of the program, primarily related to labor and training. PFS stakeholders might develop a single cost-estimate of services per child, which would be multiplied by the number of children who will be allowed to participate in the project.

The payment arrangements in step five are negotiated during the initial structuring of the PFS contract. Table 4 illustrates possible payment arrangements under this example if the target outcomes

are met or exceeded. If the targets are met, the school district pays \$A plus \$C. For each percentage point by which targets are achieved, the district pays \$B or \$D, depending on the applicable outcome.

TABLE 4

**Potential Arrangement for Reading Recovery PFS Project**

Target outcome	Consensus Short-Term Public-Sector Savings		
	If target achieved	For each percentage point by which target is exceeded	Agency that saves
W% fewer special education placements	\$A	\$B	School district
X% fewer children repeating first grade	\$C	\$D	School district
Y level of improved test scores	None, in the specified three- or five-year term		Social services, criminal justice

## Conclusion

The PFS model is significantly constrained if it is limited to projects that generate short-term, cashable savings. Realizing the limitations of that approach, many PFS thought leaders are increasingly suggesting that these projects generate verified outcomes yielding both fiscal and nonfiscal benefits. The approach we suggest builds that analytic progress into a framework that enables PFS to be applied to interventions where savings may not exceed costs in the near-term or at all. The framework integrates fiscal and nonfiscal gains into a simple, clear formula that can be appealing to policymakers and investors alike. This framework may prove useful as a starting point for future conversations about the applicability of PFS as a financing mechanism for health-related or social interventions.

## Appendix A. Complete Steps for Applying the Integrated Framework

1. Based on the available literature, project partners or intermediaries who are structuring the PFS contract identify a range of outcomes the project will likely produce.
2. Project partners define A, B, and C as the target outcomes. These are chosen from the lower bound of the range of likely outcomes. In other words, they are both more probable and smaller than other outcomes within the range.
3. Project stakeholders or intermediaries also consult the literature to develop a range of likely near-term cost-savings that would result if
  - a. outcomes A, B, and C were achieved; and
  - b. if outcomes A, B, and C were exceeded by specified increments.
4. Intermediaries and the government agency that would realize fiscal gains from project success agree on consensus savings estimates at the lower end of each range described in step three:
  - a. If outcomes A, B, and C are achieved, savings within a specified number of years (e.g., three years or five years) will equal \$S.
  - b. If outcomes A, B, and C are exceeded, then each increment of additional results will yield \$X in savings within that same number of years.
5. The gross costs of implementing the PFS project are \$G. Policymakers are uncertain whether outcomes A, B, and C justify spending \$G.
6. However, based on the consensus savings estimate in step 4a, achieving outcomes A, B, and C would yield a cost offset of \$S, reducing the net cost from \$G to \$N. Policymakers are willing to spend \$N in order to achieve outcomes A, B, and C. That willingness enables the PFS project to move forward.
7. Policymakers also agree that if outcomes A, B, and C are exceeded, then the government will share with investors P percent of the savings that such additional success produces. Based on the consensus savings estimate in step 4b, the government would pay an additional P percent of \$X for each increment by which outcomes A, B, and C are exceeded. By creating the possibility of a payout that exceeds up-front service costs by a nontrivial amount, this agreement may attract investors to support the PFS project.
8. Rigorous and independent evaluation assesses whether outcomes A, B, and C were achieved or exceeded.
  - a. Suppose they were achieved. The investors are repaid the gross service costs of \$G, plus interest. (Note that the PFS arrangement can be structured to include or exclude interest.)
  - b. Suppose the outcomes were exceeded. The sponsoring government agency then pays the investors, in addition to \$G (perhaps plus interest), P percent of \$X for each increment by which outcomes exceeded target levels.

## Appendix B. Accounting for Project Evaluation and Legal Costs in This Approach

Unfunded transaction costs can be an obstacle to PFS projects. Two major components are legal fees and payments to independent evaluators. Partners can address this obstacle by including some or all of those costs within the PFS contract. Several examples illustrate a broader range of possibilities:

- The government's transaction costs for entering into the PFS contract could be classified as part of the project's net public-sector costs. If specified outcomes are achieved, the pay-out would be reduced to reflect those costs. For example, suppose a PFS project involved \$100,000 in gross costs and \$60,000 in offsetting savings, resulting in a net cost of \$40,000. Suppose the government agency incurred \$10,000 in legal costs to negotiate the PFS contract, and the parties agreed to include this within gross project costs. The gross project costs would then be calculated as \$110,000 rather than \$100,000. Policymakers would need to agree on a net public-sector cost of \$50,000, rather than \$40,000, before the PFS project could begin. If specified outcomes were achieved, the government agency would pay the PFS project investors \$40,000 because it already would have incurred the remaining \$10,000 in up-front transaction costs.
- Evaluation costs could be classified as gross project expenses along with the actual intervention cost. Under this approach, investors fund the evaluation contract and are repaid if the project achieves specified outcomes. Continuing with the above example, if the independent evaluator's contract costs \$20,000, gross project costs would rise from \$100,000 to \$120,000. The net cost to which policymakers must agree would increase from \$40,000 to \$60,000. If the project achieves specified outcomes, the investors would be repaid both the \$100,000 intervention cost and the \$20,000 cost of the evaluation contract. (The same approach could be used to cover project partners' legal fees.)
- Only some of the \$20,000 evaluation costs could be covered by the payout if minimum outcomes are achieved. Project partners might agree to pay half of those costs, without any prospect of reimbursement, classifying the other half as gross project costs. In that case, the gross project cost is \$110,000, the net cost is \$50,000, and if the project achieves target outcomes, investors are repaid \$100,000 for intervention costs and \$10,000 towards the evaluation contract. If the project yields bonus payments to investors, they might view the first \$10,000 of those payments as covering the remaining evaluation costs. (A similar approach could help with project partners' legal fees.)

Each of these options has trade-offs. If the PFS contract classifies public or private transaction expenses as gross project costs, the public agency must agree to a corresponding increase in the project's net cost, which may reduce policymakers' support for the PFS project. On the other hand, if attorneys' fees or evaluation costs prevent a particular PFS project from moving forward, project

partners could consider covering some or all of these expenses within the PFS transaction—an approach that has not yet been tried during the brief history of PFS initiatives.

This approach is limited to initial testing of innovative policy approaches. It is hard to envision significant public support for funding PFS transaction costs when an intervention is operating on an ongoing basis.

## Notes

1. See, for example, David Hammond and Bill Jaeger, “Guest Commentary: Pay-for-Success Works,” *Denver Post*, April 10, 2015, last updated April 24, 2016, <http://www.denverpost.com/2015/04/10/guest-commentary-pay-for-success-works/>.
2. See, for example, Liebman (2011) and “Frequently Asked Questions,” Nonprofit Finance Fund, accessed March 1, 2017. <http://www.payforsuccess.org/learn/faq/>.
3. Another approach, used in the United Kingdom, is “rate cards.” If a service provider documents the accomplishment of a specified outcome, the government agency pays the provider the amount the agency stated on the card. This approach does not explicitly consider public-sector savings (although the prospect of such savings may help convince policymakers that the specified outcomes are worth funding). For more information, see Matthew Eldridge, “How the UK Pays for Success,” *PFS Perspectives* (blog), Urban Institute, May 23, 2016, <http://pfs.urban.org/pay-success/pfs-perspectives/how-uk-pays-success>.
4. Although there are many theories on the weight of specific factors, most political scientists agree that public policy decisionmaking is informed by both fiscal and nonfiscal concerns. See, for example, Hill (2013).
5. To achieve consensus on these fiscal estimates, project partners may need to work with government agencies’ budget staff, not just the program staff.
6. As noted, project partners have committed to the specified gross service costs, and the agency’s staff has already agreed that the target outcomes will produce public-sector savings that reduce costs to the specified net levels.
7. See “Benefit-Cost Results,” Washington State Institute for Public Policy, accessed May 1, 2017, <http://www.wsipp.wa.gov/BenefitCost>.
8. An important limitation on PFS projects in this area involves the extent to which Medicaid’s federal matching funds can cover PFS service costs that fall outside the federal statutory definition of covered Medicaid services. See Lantz et al. (2016).
9. One option not yet used in a PFS project is sharing bonus payments with service providers as well as investors. For example, bonus payments up to a specified amount of money could all go to investors, whereas those above that level could have a stated percentage (e.g., 25 percent) that is shared with providers. Such an arrangement would increase providers’ financial incentives for excellent performance while still preserving investors’ returns (albeit at a somewhat reduced level).  
  
One impact of this option is that it changes the nature of the PFS intervention. With this option, the intervention would financially incentivize providers to exceed specified target outcome levels. If a PFS project with this feature succeeds and the sponsoring government agency decides to fund the program on a broader scale, the agency may need to include financial incentives for providers roughly comparable to those in the PFS project to retain the providers’ behavioral effects of such incentives.
10. Other peer-reviewed publications also find positive results from such interventions. See, for example, Dixon et al. (2015).
11. Although they do not use randomized controlled trials, the latter studies are published in peer-reviewed journals and employ other valid research methodologies, such as “difference-in-difference” or quasi-experimental designs. See “What Is the Evidence Rating,” Agency for Healthcare Research and Quality, accessed May 1, 2017, <https://innovations.ahrq.gov/help/evidence-rating>.

12. Authors' calculations using table 10 and figure 13 of Substance Abuse and Mental Health Services Administration (2015). Out of \$9,209.70 million in state spending on psychiatric hospitals, 94 percent is for adults.
13. See the summary of Washington State Institute for Public Policy's Reading Recovery program: "Reading Recovery (K-12 Tutoring), Washington State Institute for Public Policy, last updated April 2012, accessed May 1, 2017, <http://www.wsipp.wa.gov/ReportFile/1444>.

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