Pay for Success: Opportunities and Risks for Nonprofits

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Across the United States, a variety of social sector stakeholders are looking to "pay for success" (also known as pay for results or pay for outcomes) approaches to enhance the reach and impact of social programs. As a contribution to this national conversation, McKinsey & Company recently published a comprehensive study on the potential for social impact bonds (SIBs) in the US[1]

In discussions of the study's findings,[2] stakeholders repeatedly stressed that nonprofits are likely to continue providing the majority of social services in the US for some time, even if for-profit or hybrid social enterprises are growing in number and importance. In particular, nonprofits will continue to be the primary providers of programs for poor and vulnerable people, including homeless people, troubled youth and youth aging out of foster care, and low-income seniors. This is why it is critical to understand how Pay for Success (PFS) can strengthen nonprofits' work and what risks it might create for them.

This article considers those questions and presents four main conclusions:

1. PFS can bring substantial benefits, particularly in areas where nonprofits already have solid experience developing and codifying interventions guided by evidence and ongoing impact assessment.
2. However, PFS is not appropriate for every social program. It is best suited for scaling proven programs rather than innovating, and for supporting behavior change interventions rather than providing social goods and services.
3. Likewise, not every nonprofit is ready to participate in PFS. Those that do will need robust experience in assessment and evaluation, and the infrastructure and capabilities to scale their programs.
4. PFS offers tremendous rewards for nonprofits but also presents significant risk for individual organizations and the sector as a whole. Nonprofits that sign up for scrutiny but fail to meet their targets could suffer real damage to their reputations. And, a sector preoccupied with scaling what's already been shown to work may find itself starved of innovation. Proceed with caution!

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1 McKinsey & Company, "From Potential to Action: Bringing Social Impact Bonds to the US" (2012), available at http://mckinseyonsociety.com/social-impact-bonds/.

2 Including at conferences such as Social Impact Exchange, SoCap12, Independent Sector, and the Council on Foundations.

Reaping the Investment in Assessment

Funding what works–driving more dollars to high-performing nonprofits and their programs–seems an obvious approach, but it has not always been the reality in the social sector. One silver lining of the recent recession is that it has focused funders and service providers on the need to do more with less and on the benefits of putting resources behind programs that have demonstrated success. But results for social programs are difficult to measure, and the work must be driven by the social bottom line, not just dollars and cents. Fortunately, over the past 60 years, our understanding of the science and practice of social impact assessment has grown significantly.

The goal of social impact assessment is to drive improvements that increase the value of programs to the people they serve. Social impact assessment helps organizations to plan better, implement more effectively, and successfully bring initiatives to scale. Assessment also facilitates accountability, supports stakeholder communication, and guides the allocation of scarce resources. Today, top-tier nonprofits develop program interventions based on research, evaluate these interventions while implementing them, and make revisions on the basis of what they learn.[3] These nonprofits are continuously evaluating their programs and their organizations to ensure that high-quality interventions are being delivered effectively.

For nonprofit organizations already committed to evidence-based programs, a PFS approach rewards a job well done. PFS recognizes that activities (like workshops) and outputs (like the number of graduates from vocational training) do not necessarily equate with desired outcomes (such as participants obtaining and retaining living-wage jobs). PFS rewards programs that deliver desired outcomes by making some or all of the contracted payment contingent on the achievement of agreed performance targets.[4]

This is all good news for service providers who have invested heavily in developing, refining, testing, and tracking their programs: they can now reap the rewards. But it represents a big shift for the social sector overall, which has often rewarded only good intentions and given an "A" for effort.[5]

3 As part of our recent research on social impact bonds, we identified a variety of registries with more than 300 evidence-based programs, including Coalition for Evidence-Based Policy; Blueprints for Violence Prevention at the Center for the Study and Prevention of Violence; Institute of Behavioral Science; Promising Practices Network; Child Trends' Lifecourse Interventions to Nurture Kids Successfully; Communities That Care; Office of Justice Programs' CrimeSolutions.gov; Office of Juvenile Justice and Delinquency Prevention's Model Programs Guide; and Washington State Institute for Public Policy. Additional registries of evidence-based programs we consulted that focus on other program areas include the Campbell Collaboration and the Cochrane Collaboration, which are health-oriented and internationally focused, and include meta-analysis of related programs. Currently, the Annie E. Casey Foundation is developing a registry of evidence-based programs related to its focus areas of youth and families. Please see mckinseyonsociety.com/sib for our complete report, *From Potential to Action: Bringing Social Impact Bonds to the US*

4 For some PFS contracts and Human Capital Performance Bonds (HUCAPs), the nonprofit service provider bears the repayment risk and must fund its own working capital needs. Under social impact bonds, social investors shoulder the risk.

5 For a more in-depth discussion of social impact assessment visit lsi.mckinsey.com, which provides detailed information on Learning for Social Impact, McKinsey & Company's initiative on the topic.

Scaling Up Proven Programs

Some types of program interventions, in particular social goods and services, can be effectively scaled up using variations on market mechanisms. Advanced market commitments[6] or right-sizing the cost of the product or service with the consumer's ability to pay[7] are examples of how a traditional market can be tweaked to deliver a social good or service. In these examples, consumers determine whether the good or service meets their needs, and demand reflects their conclusion.

But many social programs are not based on providing a good or service; instead, they aim to alter people's choices and actions. These "behavior change interventions" share information and provide motivation to help individuals change their behavior for positive social benefits. For example, affordable housing–decent, income-appropriate housing for low-income people–is a social good. But permanent supportive housing, which offers permanent affordable housing with comprehensive support services for people who are chronically homeless, seeks to change behavior too; the support services can include substance abuse counseling, vocational training, and case management support.

Behavior change is complex, and programs of this kind typically require a subsidy, because the target constituent is not able or inclined to pay for the intervention. Provided by society, this subsidy interrupts the automatic feedback of supply and demand that a traditional market provides. The end user of the good or service is not the "customer" paying for it. But that customer–typically government or philanthropy–does want to know that the program is delivering results.

PFS is ideal for scaling up proven behavior change interventions to reach more people who need them. A particular benefit is the ongoing assessment component, which requires tracking to ensure the intervention is working as expected.

For example, on the basis of extensive evidence, therapeutic interventions for young people in the juvenile justice system, such as multi-systemic therapy and functional family therapy, are expected to reduce future crime. The impact of these programs is assessed by tracking the reoffending rates for cohorts who receive the intervention against peers who do not. This is how "success" is measured in a PFS program. It is also a valuable source of information on whether replicated programs continue to deliver results when delivered to new communities in new geographies at different points in time.

Like any tool, PFS must be applied appropriately. It may not be the most efficient or cost-effective way to scale up programs based on social goods or services, which can use market-style mechanisms much more easily and with success; but it has great potential for scaling behavior change programs.

6 Advanced Market Commitments create a guaranteed market for goods with social benefits (e.g., vaccines for developing countries). Donors commit funds today to finance the purchase of the product at a pre-determined price and quantity in the future. In exchange for these commitments, the private sector manufacturer for the product legally commits to supply the product at a set affordable price over the long-term.

7 Microfinance, private education for the poor schemes, which collect small school fees on a daily basis, and products geared for the budgets of bottom of the pyramid (BOP) customers like single-use shampoo packets are all examples of right-sizing a product or service with the customer's ability to pay.

Is Pay for Success for Everyone?

PFS represents a departure from the way nonprofits have contracted to deliver social services in the past. Accordingly, not all nonprofits may currently be ready to participate in this brave new world of outcomes and results. Some of the questions nonprofits should ask themselves–and others should consider asking potential nonprofit partners–include the following:[8]

Does the organization have experience with assessment? Has the program been evaluated in the past, and what results has it delivered? For PFS to be implemented successfully, the parties to the contract need to understand social impact assessment generally and be familiar with past assessments of the relevant intervention. Nonprofits signing onto PFS contracts should know what results their program has delivered under past assessments. This serves as the basis for setting performance targets that they can reasonably expect to deliver.

Has the program been evaluated by a third party? Was the program measured against a counterfactual? The more rigorous past evaluations of the intervention have been, the better for future planning. Under a PFS contract, a qualified evaluator will likely be called on to define specific performance targets up front and then determine whether they have been achieved at the end of the contract. If the program has stood up to similar scrutiny in the past, it will have a much better chance of succeeding again.

Is the program intervention suitable for scaling? To be scalable, program interventions will need to have been developed, refined, and codified over several years. If the core, nonnegotiable elements of the program are clear, they can be replicated with fidelity. At the same time, the program can be adapted to reflect the realities of new populations and new circumstances as it is scaled and spread.

Scalable interventions must also address important needs for a sizable population and must face no implementation barriers (such as outsized costs or unique skills requirements) that could stand in the way of replication.

Does the organization have the infrastructure and capacity in place that will enable scaling? As we discussed above, PFS contracts are often intended to scale proven interventions to reach more people who need them. This means the nonprofit delivering the program will be serving new clients. To do this, the organization needs to increase its delivery capacity. This requires the right leadership; staff with the required training, cultural competencies, and programmatic skills; administration and program management capacity (across knowledge management, communication, human resources, information technology, and legal); and project management capabilities related to work planning, budgeting, and risk mitigation.

8 Further detail on these questions is available in a set of diagnostic tools and due diligence tools to assess core capabilities for participation in a social impact bond, developed by McKinsey & Company and hosted by the Nonprofit Finance Fund on the Pay for Success Learning Hub. See the SIB Toolkit at http://mckinseyonsociety.com/social-impact-bonds/.

In paying just for results, PFS contracts do not fund the development and growth of the organizational infrastructure needed for scaling. This means an organization must find other supplemental resources in order to be ready and able to participate. Otherwise, service providers will lack the ability to scale and replicate proven programs successfully, and there won't be any results to pay for.

With Rewards Come Risks

The risk for nonprofit service providers in a PFS world is that failing to deliver results will have real ramifications beyond a single contract. Once outcome targets have been set and measured under one contract, funders, investors, and others doing due diligence before selecting a service provider are likely to ask, "so, did you achieve your goals?" A positive answer should go a long way toward cementing a new relationship, but results that don't measure up will sour the discussion fast.

Before entering into a PFS arrangement, nonprofits need to reflect seriously on whether their program intervention and organization can stand up to the scrutiny and deliver as promised. They are unlikely to get many second chances after failing to meet performance targets in a public setting with credible evaluators reporting missed targets. What's at stake is the organization's license to operate, not simply its reputation.

For the sector as a whole, this can generally be viewed as a good thing. Resources are limited, stakes are high for our neighbors receiving social services, and underperforming nonprofits probably should not be taking resources away from the organizations and programs that are demonstrating success. Nonetheless, the focus on funding at scale what has already been demonstrated to work also raises some important concerns for the social sector as a whole:

- Will innovation and exploration be ignored or starved for funding as everyone focuses on scaling what has already been "proven"? Will this focus on funding what works actually stall the development and improvement of beneficial programs?
- Will the emphasis on PFS eventually drain the capacity of service providers in the sector? Will PFS backfire by encouraging nonprofits to scale while starving them of funds for long-term investment in the infrastructure they need to grow and maintain capacity? Will lack of capacity force bad delivery of good programs?
- Will service providers start "creaming" (i.e., selecting clients who are most likely to succeed under a program to ensure successful results)? How can we guard against the dire unintended consequences of leaving out hard to serve clients who actually need help the most?
- Will service providers be tempted to simply fudge the numbers and make the results look good when they are not? What checks and balances will be required to police a PFS world? And what are their cost and logistical implications?
- Are our social impact assessment tools and techniques of today accurate enough for us to actually know what works?

- Do we have the real capabilities to scale? Can we identify the nonnegotiable, core elements of a "proven" program to ensure quality replication? Do we understand the balance between maintaining fidelity to a demonstrated model and iterating and replicating to respond to new populations and settings?

Final Thoughts

The PFS conversation is an important milestone for the social sector. Promoting effective responses to social problems and linking impact with resources can bring about real change in the world. If applied thoughtfully and in the right settings, PFS could have major impact on our most complex social problems, as well as on the sector itself.

At the same time, the PFS standard poses a challenge for some nonprofit service providers and introduces real and new risks for individual nonprofits and the sector as whole. This approach is valuable, but it represents only one tool in the social sector toolbox.

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