Partnering for Social Change

Funding "Pay for Success" Initiatives and Expanding Social Impact

PRINCETON UNIVERSITY

PRINCETON UNIVERSITY WOODROW WILSON SCHOOL of Public & International Affairs

Authors

The 2013 Fellows of the Public Policy and International Affairs Program at Princeton University's Woodrow Wilson School wrote this report.

Jennifer Arieta
The City College of New York

Fidel Cervantes
University of California, Merced

Kirk Coleman
University of California, Berkeley

Edgar Cruz
Loyola University, Chicago

LaChrista Douglas
University of Florida

Gregory Earnest
Occidental College

Daniel Guerrero
Reinhardt University

Chenelle James
Sacred Heart University

Anna Le
New York University

Samantha Rodriguez
Macaulay Honors College, Hunter College

Sohayle Sizar
Georgetown University

Tevita Tapavalu
University of California, Berkeley

Mitik Zegeye
The College of Wooster

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Table of Contents

Executive Summary 6

Who We Are 6

The Issues 7

Recommendation 7

What is "Pay For Success"? 8

Overview 8

The New Jersey Social Innovation Act 9

Pay for Success: New York City to Peterborough 9

Cultivating Strong Partnerships 10

Intermediary 11

Nonprofit Organizations 12

Government 14

Independent Evaluator 15

Why Get Involved in "Pay for Success"? 16

Bridging Gaps and Building Discourse 16

Increased Impact 16

Emphasis on Services 17

Three Avenues for Involvement 18

Build Nonprofit Capacity to Participate 19

Forms of Investing 21

Conditions for Implementation 23

Actors in Action: Lessons Learned in NYC 24

New York City Case Study: Juvenile Recidivism at Rikers Island 24

Social Innovation Act Pilot: Reducing Health Care Costs in New Jersey 26

Recommendations 28

Glossary 29

Citations 30

Suggested Readings 32

Executive Summary

This report aims to assist The Fund for New Jersey and The Geraldine R. Dodge Foundation in determining whether to participate in the "Pay for Success" social impact investing initiative being considered by the New Jersey Legislature. This report will present three main avenues of participation, along with a comprehensive assessment of how strong partners can be identified and selected to join a pilot Pay for Success program. Given the limited funding resources available to alleviate mounting social issues, the Pay for Success model presents an innovative opportunity to expand the impact of social investing. It is important to note that Pay for Success initiatives are also commonly referred to as Social Impact Bond (SIB); however, we have decided to consciously change the language to "Pay for Success", as this type of performance-based contracting does not actually consist of a bond.

Who We Are

In order to analyze how viable Pay for Success Initiatives are for the philanthropic community, a project team, consisting of thirteen students from the Junior Summer Institute at Princeton University's Woodrow Wilson School of Public and International Affairs, was assembled. Our work and educational experience in diverse fields such as political science, non-profit work, international affairs, government, and sociology have made it possible for us to construct a thorough analysis of the Pay for Success Initiative and its application in the New Jersey Social Innovation Act.

We spent seven weeks analyzing, in detail, the infrastructure, feasibility, advantages, and disadvantages of the Pay for Success program. We paid particular attention to the effects the program has on (1) building community, (2) evaluating nonprofit service providers, (3) what stakeholders should know before investing, and (4) the possible roles of foundations in these initiatives. We also met with numerous of Pay for Success experts to gain a greater understanding of how Pay for Success programs function.

Introduction

The purpose of this project is to give two prospective investors, The Geraldine R. Dodge Foundation and The Fund for New Jersey the tools to thoroughly examine an upcoming social policy known as the "Pay for Success" method. This relatively new concept employs private investment, rather than government resources, to take on specific social problems. Particular attention is paid to the New Jersey Social Innovation Act, which, if passed, would be the nation's third and state's first ever implementation of Pay for Success. The details of this report were designed to fill in knowledge gaps that exist about the Pay for Success process. It will do this by providing a short history on the topic, starting from its first concrete implementation in the United Kingdom in 2011. From there, the report highlights the major players in a typical Pay for Success project (including the investor, intermediary, nonprofit, government, guarantor, and final evaluator). These details provide prospective investors with enough information to visualize how they would fit into the structure of the New Jersey Social Innovation Act. Potential funders for this legislation find themselves in a unique position to invest in an idea on the frontline of social innovation. By aligning the interests of public, private, and nonprofit entities, Pay for Success creates unlikely partnerships to effectuate the greatest impact possible on communities in need.

IMPORTANT TO NOTE:

Although Pay for Success Initiatives are often called Social Impact Bonds, we recommend that they be referred to as Pay for Success Initiatives. "Social Impact Bond" nomenclature presents an obstacle when introducing the concept, because Pay for Success is not a bond. Foundations can play a vital role in clarifying the definition and concept of Pay for Success Initiatives.

Unlike actual bonds, Pay for Success only requires that the government pay back investments if the intervention programs are successful. We propose that from here on, the name Pay for Success be used to describe the Social Impact Bond experiment, as we do not want to confuse critical stakeholders (i.e. the government and private investors) with a false title.

The Issues

Successful nonprofits provide essential resources, services, and opportunities to disadvantaged communities across the country. However, organizations' limited budgets only have the capacity to sustain small-scale projects. Despite substantial expansions in the nonprofit sector over the last decade, there is still insufficient funding to sustain innovative and successful initiatives.

Such challenges in nonprofit funding arise from insufficient government funding opportunities. The Pay for Success method of funding seeks to alleviate this problem by creating a partnership between the government and the private sector to provide immediate capital to nonprofit service providers that have programs with proven success. Upon accomplishing predetermined goals, the funders (private investors and foundations) are repaid by the government. This gives the funders the opportunity to reinvest and expand their impact, and gives the government the confidence that taxpayer dollars are spent on initiatives that actually work. Although Pay for Success is an innovative idea that raises areas of concern, it stands to significantly increase the capital available to successful nonprofit organizations to improve social conditions throughout the nation.

Innovative ideas designed to tackle social issues have been difficult to come by. Lingering unemployment and widening inequality, compounded with significantly smaller government budgets, have left a shortage of resources for social programs geared toward the most vulnerable in our society. Allowing these groups to exist at the mercy of market fluctuations puts them at risk. The current standard of allocating resources to initiatives with immeasurable outcomes cannot be sustained. While not designed for sweeping and immediate change, Pay for Success fills in the gaps where individual nonprofits and the government have fallen short; sufficient funding and measurable results.

Recommendation

After a thorough analysis, we have concluded that The Fund for New Jersey and The Geraldine R. Dodge Foundation should invest in Pay for Success initiatives because of the increased capacity of nonprofit service providers to build communities in which they serve. Furthermore it will increase the increase the funding of programs that have yielded measurable results. If an investment is not feasible, we recommend that the foundations become guarantors, intermediaries, or partners in funding the logistical necessities of the initiative.

What is a “Pay for Success” Initiative?

Overview

“Pay for Success” initiatives (also known as social impact bonds), seek to combine low-risk private investments with successful nonprofit practice in order to ensure efficiency in government grant allocation.

In Pay for Success, a contract is created between the government and one or more non-governmental entities that administer measurable social services. This contract re-allocates the responsibility of social programs to non-governmental agencies. These agencies are intended to (1) reduce taxpayer expenses and (2) provide effective social services that attain specific goals, which are agreed upon by all parties involved.[i]

The involvement of private investors makes Pay for Success unique. Private investors fund the social programs that non-government entities administer. If the non-government entity accomplishes an agreed upon goal, then the government will reimburse investors and compensate them with dividends. If goals are not attained, then financiers will not be compensated for their initial investment.[ii] This helps to reduce inefficiency in government funding of unsuccessful programs.

There is great potential for Pay for Success Initiatives to unite private, public, and nonprofit sectors. Pay for Success allows for greater accountability and private sector discipline in nonprofit organizations. In addition, Pay for Success necessitates public-private partnerships. It encourages the two sectors to work together to mitigate current social issues by increasing the availability of resources. However, this enterprise is not flawless. Private investors expect a return and will only invest in social issues that are measurable and attainable. As a result, systemic societal ills such as poverty and racism are less likely to receive investment from the private sector. Therefore, it is important to understand that Pay for Success is no silver bullet—it is simply one mechanism, among many, that attempts to combat social problems. Nonprofits that yield successful initiatives can benefit from Pay for Success in order to scale, sustain, and reproduce their results. This makes Pay for Success extremely attractive in a time when federal and state governments are cutting social services.

A New Form of Program-Related Investments

In many ways, Pay for Success Initiatives can be likened to program-related investments. Acting as an investor, a foundation can receive a return on contributions. These returns can then be recycled to support organizations for longer periods of time than traditional grant-making. Investments made in a Pay for Success pilot program thus contribute toward a foundation’s payout requirements; if they choose to use funds from their endowment to invest in a Pay for Success project apart from their grant-making budget, the foundation should be free of the IRS restrictions.[iii] In other words, as long as a foundation makes Pay for Success investments that accomplish one or more of its exempt purposes, then contributions fall under the IRS legal definitions of a program-related investment.

The New Jersey Social Innovation Act

In terms of legislation, policymakers are beginning to understand the potential benefits that the Pay for Success model can bring to their constituencies. They realize that repeating the same outdated social policy models will only reproduce the same ineffective and inefficient outcomes. When a promising new idea like Pay for Success comes along, it behooves politicians and funders alike to explore this non-traditional method of social uplift. For that reason, policymakers in the state of New Jersey are beginning to take action.

The New Jersey Social Innovation Act, introduced by Assemblyman Angel Fuentes, bridges the gap between socially responsible policy and economic and political feasibility. The "NJSIA" establishes a pilot program and study commission on Pay for Success Initiatives in the state of New Jersey. The proposed pilot addresses rising health care expenses. By creating preventative healthcare agents, the pilot will concentrate on reducing the financial burden of emergency room visits by uninsured residents on New Jersey taxpayers.

THE BACKGROUND STORY: *Inspiration from Camden*

The New Jersey Social Innovation Act was inspired by the work of Camden Coalition of Health Providers. The coalition provides health services to the local residents of Camden and achieves cost savings by reducing emergency room visits through holistic and preventative healthcare measures.

In fact, according to the Camden Coalition of Healthcare Providers, a large majority of residents visiting the Emergency Room go for common illnesses that can be treated at preventative clinics or with over-the-counter medication.

The importance of effectively allocating taxpayer money becomes more crucial when dealing with medical services for the state's uninsured. According to the Camden Coalition Healthcare Providers, the total expense of uninsured residents for hospital usage in 2002-2011 was $100 million per year with its most expensive patient costing the taxpayers $3.5 million – 30% costs came from 1% of patients and 80% came from 13% of the patients. By focusing on preventative care, the coalition saves the government money and improves the health of the residents of Camden.

There is potential for furthering government savings through the Act by replicating this model to other areas where preventative interventions are appropriate.

Pay for Success in Action: From Peterborough to New York City

Part of the New Jersey legislature's decision to invest stems from the past performance of similar social investment programs. The current model contains few hard-defined statistics and evidence, but by observing other governments' Pay for Success ventures taken over the past two years, we can identify positive attributes and mitigate risks and challenges.

Peterborough Prison, UK

In 2011, the British government initiated a social financing contract with the public sector. The project aimed to decrease recidivism rates in HM Peterborough Prison, UK.[iv] From the onset, it was deemed by many as an innovative enterprise capable of saving the government millions of pounds by combining the resources of nonprofit organizations, financial intermediaries, and the government. Following the publicity of this social bond pilot, several major cities in the United States, including Boston, Kansas City, and New York gained interest in social impact bonds.

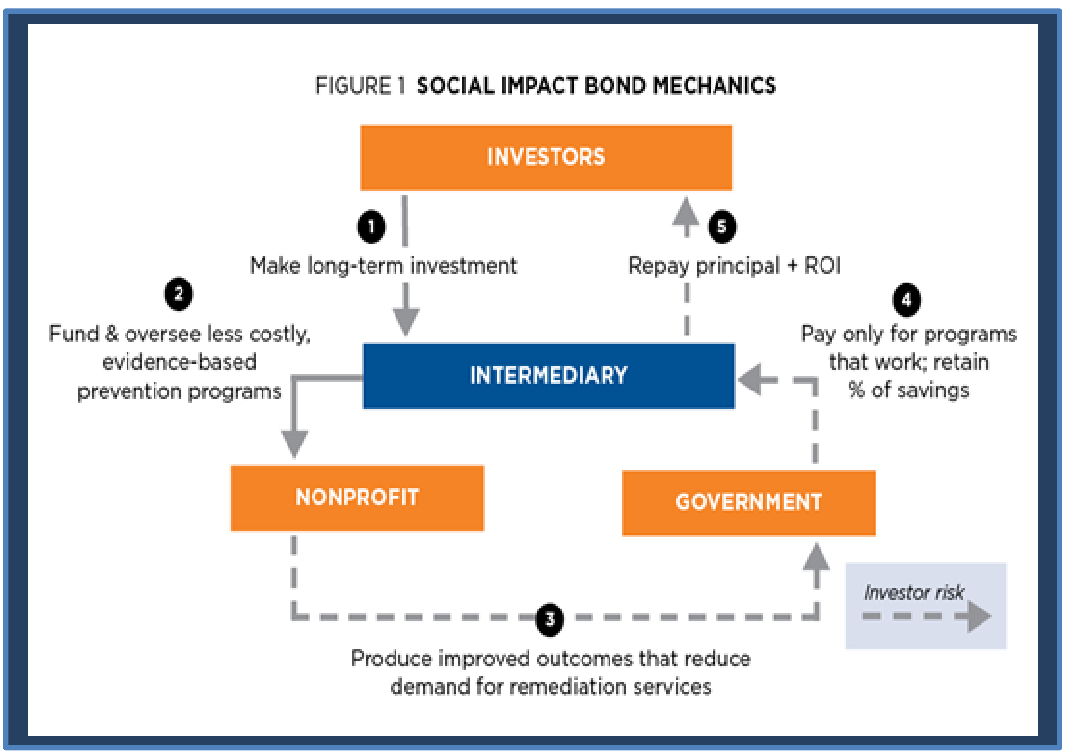
Rikers Island, NYC
In January 2012, New York City's Pay for Success Initiative was announced. It is still too early to determine the accomplishments of the New York Social Impact Bond project as we will have to wait until August 2015, when the Vera Institute of Justice will conduct an independent evaluation of the project. The results will be measured in benchmarks depending on the success of the nonprofits in decreasing the re-incarceration rate at Rikers Island.

Cultivating Strong Partnerships

Even without the long-term results of the New York and UK projects, it is encouraging to note the seamlessness in which private enterprise and government work together to implement the initiatives. This is the way Pay for Success should function. Nonprofits, foundations, and the government partner with a new entity, an intermediary, in order to create an efficient and effective model for fostering social impact. Each stakeholder plays an essential role in the financial and logistical success of the project.

The following is a description of the role of each player in a Pay for Success Initiative in order to allow for prospective participants to make a decision regarding whether or not to support them and, if so, what type of support to provide.

Figure 1 describes the mechanisms of a Social Impact Bond or, as referred to herein, a *Pay for Success* Initiative.



I. Intermediaries

The intermediary is the middleman that works with the government, non-profit organizations, and the investor.[v] The State will pay the intermediary based on whether the associated nonprofits achieve the goals set forth by the government. The intermediary then pays a portion of the payment from the government to private investors, who provided start-up capital to the non-profit organizations.

The intermediary plays a vital role in the maintenance and execution of the Pay for Success program: without it, there would be no functioning Pay for Success model. The above graph[vi] depicts how the intermediary functions with the main stakeholders in Pay for Success. The intermediary has three critical functions that aid in the distribution of resources and funds:

- *Creating Pay for Success Contracts with the Government*

  The intermediary is responsible for applying for Pay for Success grants through the government. If the government confirms the intermediary, a Pay for Success contract will be drafted, stating the specific social goals for the society. If the goal is met, the government will pay the intermediary a premium. The fee paid to the intermediary should be less than the expected cost savings of the intervention, thus saving the government revenue overall. However, if the goals are not met, the intermediary is not paid.

- *Finding Viable Non-Profit Organizations*

  The intermediary is responsible for finding nonprofits with a proven track record of undertaking the social program needed. The intermediary will then create a procurement contract with partner nonprofit organizations, outlining the specific goals set for them to accomplish. It is in the intermediary's best interest to seek nonprofits who have exhibited consistent and remarkable results since the intermediary's pay is contingent on these results.

- *Raising Capital from Private Investors*

  The intermediary is responsible for finding private investor capital. The private investors provide the upfront capital for the intermediaries to utilize. The intermediary will then allocate a share of the payment from the government to private investors once the nonprofits have achieved the pre-set goals.

Advisory Roles of Intermediaries[vii]
In addition to the main roles mentioned, intermediaries should also be able to perform a host of other functions to ensure the viability of the social program, including:

- Providing data analysis and economic modeling for promising programs
- Integrating risk assessment
- Handling negotiations amongst partners
- Structuring transactions for partners
- Allowing an outlet for continuous communication amongst partners

Concerns with Intermediaries

Given an intermediaries introduces new costs and additional "middle-men" to government funding of nonprofits, there is potential for new complications to arise. Toby Eccles, founder of *Social Finance*, explains that governments are generally skeptical of 'middle-men' agencies, seeing them as an unnecessary expense.[viii] Furthermore, many officials are skeptical that intermediaries are not yet developed enough to handle the large-scale skills and experience that are required of them. There is a risk that intermediaries can falsify data to garner more investors and more government contracts at the expense of taxpayers' dollars. However, the following factors mitigate the concerns of introducing intermediaries:

- Programs in which Pay for Success is applicable, the government stands to save funds that substantially exceed the cost of the intermediaries
- The increase in demand for intermediaries will increase their efficiency and decrease their cost
- Government oversight and third-party evaluations of programs ensure that they function equitably, cost effectively, and are equipped to support large-scale projects

In conclusion, a good intermediary has significant experience working with nonprofit organizations and establishing solid performance contracts. Intermediaries are responsible for identifying viable Pay for Success service providers and funders. Effective intermediaries will have large networks from which to draw potential partners.

II. Nonprofits

The role of nonprofits in Pay for Success initiatives is crucial to meeting the established benchmarks that will lead to social change. Nonprofits must have the capacity to provide services that are large in scale, efficient, and measurable. To further analyze the function of nonprofits, the following points will be explained:

1. Characteristics of a nonprofit suitable for Pay for Success Initiatives
2. The role nonprofits play in Pay for Success
3. Concerns with the role of nonprofits
4. Possible applications of Pay for Success for nonprofits

Nonprofits Suitable for Pay for Success Initiatives

Nonprofits need to meet certain criteria in order to meet their goals in Pay for Success. The nonprofit organization is responsible for implementing social impact programs that will fulfill the desired goals. These nonprofits will be allocated a set amount of funding at the onset of the Pay for Success Initiatives, which it will use to finance the specific projects.

The Role of Nonprofits in Pay for Success

The nonprofit has three critical functions that aid in the distribution of resources and funds:

- *Working Directly with the Target Groups by Implementing Social Impact Programs*

  The nonprofit is responsible for applying for Pay for Success grants through the government. If the New Jersey Government confirms the grant, a Pay for Success contract will be drafted, stating the specific social goals the government seeks the nonprofit to accomplish. If the goal is met, the nonprofit will continue to be funded. However, if the goals are not met, funding to the nonprofit will cease.

- *Recording and Reporting Results to the Intermediary*

  The nonprofit is responsible for ensuring that data is well recorded, as future funding is contingent on the success of their program. It is important for the nonprofit to be accurate and honest in reporting their data. It is especially important since an outside evaluator will be responsible for auditing the nonprofit to reduce likelihood of fraud.

- *Maintaining Capital and Saving Face*

  As with any nonprofit, a Pay for Success nonprofit is responsible for maintaining capital. This is the primary incentive to the nonprofit to take measures that will bring successful outcomes.

  Apart from maintaining funding, the nonprofit must be conscious about keeping a clean track record. With Pay for Success Initiative the nonprofit will be analyzed thoroughly and will not want to tarnish a clean reputation.

Concerns with the Role of Nonprofits

Among the concerns raised regarding the role of nonprofits in Pay for Success Initiatives is the fear that having nonprofit management emulate the rules, deadlines and regulations of corporate management will adversely affect the dynamics of social activism.

Another concern regarding nonprofits dealing with Pay for Success is the idea that a high-stress environment may cause key players to undermine the process. Managers and employees of nonprofit organizations, faced with the added pressure to perform well and meet the benchmarks established for them by the government, may engage in fraudulent transactions and recordkeeping.

Possible Applications of Pay for Success for Nonprofits

In order to maximize the probability of success, nonprofits that specialize in areas such as education, the environment, or the arts, for instance, will implement programs in accordance to their respective areas of interest.

One such example is in New York City, where the nonprofits at the forefront of the Rikers Island prison recidivism reduction project are The Osborne Association and Friends of Islands Academy. These two nonprofit organizations will conduct the cognitive behavioral intervention at Rikers Island. Friends of Islands Academy and The Osborne Association were given grants to implement the program at Rikers. The nonprofits' intervention focuses on personal responsibility education, training, and counseling, with the goal of reducing the likelihood of re-incarceration.

The New Jersey Social Innovation Act, if enacted, will fund an unspecified nonprofit with the aim of reducing emergency room visits by people of low income who most often visit emergency rooms for minor ailments.

III. Government's Role with Pay for Success

For policymakers, this new approach on social uplift will demand more tightly focused and precisely defined policy objectives and performance measures. The model also aims to fill in the areas where these programs have historically fallen short. The government currently faces four significant challenges in funding social programs:

- Government funding does not focus on results and performance
- Insufficient performance evaluation allows ineffective programs to persist
- The proof of concept process for social innovation is slow
- Preventative programs often do not get funded from the budgets they aim to reduce

Pay for Success addresses these issues in the following ways:

- Focusing government agencies and social service providers on achieving program objectives and improving performance in ways that are transparent to taxpayers
- Placing an emphasis on evaluations as a fundamental component of the Pay for Success payment mechanism
- Connecting payments to the achievement of outcomes by enabling Pay for Success to break down the budget silos that hinder investments in preventive measures
- Pay for Success creates a market-based mechanism for financing operating costs and increasing social accountability

The government office involved with the Pay for Success Initiative can lead to the success or failure of the program. Foundations considering partnering with the government for a Pay for Success Initiative should ensure that the office has clear goals in place, bureaucratic capacity to implement the initiative, and the political wherewithal to see the program from start to finish.

The Need for Impact Evaluation

The government and nonprofit entities should expect that rigorous and precise performance measures be set in order to allow for the measurability of the social impact goals that the parties aim to achieve. According to a report by InterAction's Evaluation and Program Effectiveness team, impact evaluation investigates the changes brought about through interventions. Other organizations have a narrower description, which only include evaluations consisting of the 'counterfactual' – that is, an estimation of what would have occurred if the intervention had not taken place. In such cases impact evaluations are based on models of cause and effect and require a credible and rigorously defined counterfactual to control for factors other than the intervention that might have caused the change.[ix]

Common Pitfalls with Evaluation Mechanisms

Understanding the current problems with impact assessment is a prerequisite for identifying the appropriate method of evaluation. The majority of measurement obstacles are typically associated with the following examples:

1. Most measurement methods focus on the quantity of people served or services provided, rather than concentrating on the outcomes that are achieved or how the results have affected the target populations. The Harvard Kennedy School Social Impact Bond Technical Assistance Lab described it as paying for inputs instead of paying for outcomes or success.[x]
2. Some evaluation approaches lose sight of what is crucial for performance measurement since social impact is difficult to measure.
3. Certain social programs have assessment plans that are not well tailored to their long-term strategic goals.
4. Some evaluation requirements create perverse incentives in which an evaluator indirectly encourages nonprofits to engage in behavior that is detrimental to their objectives.

Impact Evaluation Strategies

Before selecting an evaluation methodology, it is necessary to assess how precisely the outcomes can be measured at the intended sample sizes and the extent to which controlling for covariates can reduce that variability. A series of analyses need to be conducted for each type of evaluation approach. Strategies include:

- **Randomized controlled trial-** a rigorous way of determining whether a cause-effect relation exists between treatment and outcome, and for assessing the cost effectiveness of a treatment
- **Regression discontinuity design-** comparing outcomes of those just below and just above program eligibility thresholds. If this approach is used, it is necessary to establish that a sufficient fraction of the population lies near the eligibility thresholds.
- **Variance in differences comparison**- changes in outcomes for individuals offered the service versus similar ones that were not offered the service. For this method, it is important to show that the treatment group and comparison group outcomes have moved in parallel in the past.
- **Historical baseline comparison-** comparison of past outcomes for similar individuals. If results will be compared to a historical baseline, it is better to establish that the baseline has been stable over time.

An Independent Evaluator

Of course, having evaluation metrics set in place is insufficient. It is also recommended that the evaluating entity be independent from the government, the intermediary, and the service providers in order to validate the results of the project. The independent evaluator in Pay for Success Initiatives should have a strong track record of utilizing appropriate measurement mechanisms. Pay for Success is feasible only if success and impact can be measured.

Depending on the evaluation methodology chosen, the independent evaluator may need to:

- Identify individuals eligible for the service on a weekly or monthly basis
- Randomize to select the individuals to be provided the service
- Keep track of which individuals are assigned to the treatment group and which individuals are in the control group

- Provide the eligible nonprofit with a list of treatment group individuals to serve
- Obtain administrative data outcomes for sample members and produce regular outcome reports

Despite the benefits of independent evaluators, some stakeholders do not view external or independent evaluations as the best method because the data gathering and interpretations may be affected by their lack of familiarity with the context. For this reason, it may be useful to include local evaluation experts on the team who understand the context, history and comparative interventions done by other agencies.

We recommend foundation involvement with Pay for Success Initiatives only if strong partners are identified. Foundations should not engage with Pay for Success Initiatives if a good intermediary, service provider, government organization, and independent evaluator cannot be identified.

Why Get Involved in Pay for Success?

Bridging Gaps and Building Discourse

The success of Pay for Success initiatives is based on the cooperation of nonprofit organizations, the government, investors, and charitable foundations. Each player makes a significant contribution to ensure the success of these social impact investments. Creating a community that allows for meaningful discourse and dialogue between the various stakeholders of the 'Pay for Success' model plays a huge role in enabling these models to thrive in the state of New Jersey. The following are ways in which communities of discourse can be built:

- *Collaboration among foundations and philanthropic investors*

  There needs to be an understanding of the core concepts and benefits of Pay for Success models among the philanthropic community in order to further improve the social impact of the NJ Social Innovation pilot program.

- *Conduct workshops for different city treasuries across New Jersey*

  The performance-based payment model is a fairly recent idea in financial intervention. As such, the majority of the government agencies, specifically the city treasuries in New Jersey, are not well exposed to the benefits. Conducting workshops that explain the model and the role of government in it will be helpful in building discourse communities.

- *Cross-sector collaboration*

  Partnerships between government, NGOs, and private investors are essential to solve shared problems and increase social impact. Collaboration across the different sectors involved in the model will enhance the effectiveness of the pilot program.

Increased Impact

To further solidify the dedication between actors in social policy, performance-based contract models, such as the New Jersey Social Innovation Act, must be implemented. These are desirable among foundations and social investors because:

- The investors will get regular performance assessments of the initiatives they are funding

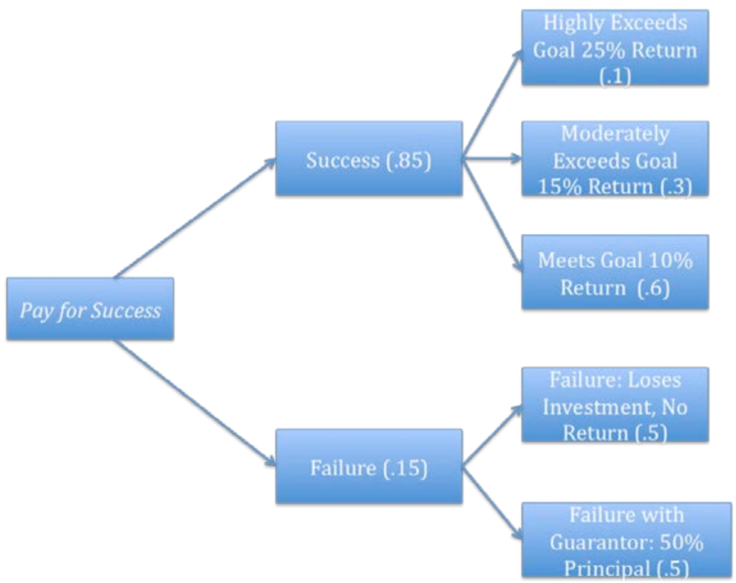
- The model will offer a way to scale up these initiatives through government funding, if they are successful

Pay for Success Initiatives selectively target successful nonprofit initiatives and aim to scale them in order to facilitate a larger outreach, as well as granting efficiency on the part of the government. Given the successful nature of these models and programs, there is low risk in the initial investment. Funds paid back by the government for reaching and exceeding the goals of the program will allow the foundation to reinvest in other initiatives. In this way, foundations can maximize their assets for the betterment of the community.

Furthermore, Pay For Success Initiatives have the potential to work well in:

1. Policy areas where there is underinvestment in prevention of social problems
2. Promising programs that are ready to scale-up
3. Substantially funded programs that have serious concerns about performance targets

The figure below displays the likelihood of returns on investment in a Pay for Success Initiative:



Pay-for-Success initiatives resemble low risk investments. By scaling programs with proven success, the funder takes little risk in supporting the program with initial capital. Guarantor capital on the investment further aids in reducing the impact of failure, and encouraging investment in the private sector.

Emphasis on Services

In addition to a lack of evaluation, government and nonprofit organizations face significant challenges when attempting to scale and sustain services. In the private sector, profitable or effective ventures are immediately recognized and scaled. In the public sector, however, decades can pass before a successful service program is successfully expanded. Public services scale at a slower rate because doing so requires immense information and capital. Private entities can overcome the challenges of expanding programs by utilizing investments and loans. However, the expansion of public services is contingent on the budget and bureaucracy. In the private sector, CEOs and individuals who stand to profit from risk-taking ventures exercise partial control over budgets. In the public sector, funding is largely dependent on legislatures and funders. As a result, effective social programs fail to grow and achieve maximum public benefit.

Pay for Success Initiatives allow public service providers to scale successful programs by providing capital up front for an extended period of time. This component of Pay for Success completely changes the manner in which public services are administered and delivered. Service providers can procure the resources and tools they need, when they need them, opposed to waiting for another fiscal year to arrive, a budget to be approved, or funds to open up. With this fiscal change, service providers can focus all of their efforts on achieving outcomes.

Private funding in the form of investments is a unique and beneficial feature of Pay for Success. These investments allow service providers to overcome budget constraints over an extended period of time. Private funders supply capital and performance management, and thus are effectively absorbing most of the financial risks associated with the project: these characteristics are particularly useful for government institutions.

Impact investing has recently proliferated due to mounting social issues, which clearly illustrate that the nonprofit sector and government alone do not have the capacity or resources to address all of society's problems. Innovation in the private sector accounts for the overwhelming majority of US economic growth. Government services and nonprofit organizations need to achieve a similar rate of development as they are facing more obstacles than ever before. According to a survey of more than 2,500 nonprofit organizations, a majority of development director positions are vacant for extended periods of time. The individuals in such positions are often under-qualified, experience high rates of turnover, and the organizations are generally unhappy with the performance of its leadership.[xi]

Public service providers have recently faced additional pressures as budgets have tightened while demand for services has increased. The unique nature of Pay for Success allows for foundations to help nonprofit and government organizations provide critical services.

Foundations can play an important role in minimizing the risks that nonprofits face when entering into a new Pay for Success contract. As investors, foundations can do this by committing to offset the burden of evaluation required to demonstrate success while ensuring that Pay for Success investments supplement, rather than replace, traditional funding sources for general operating support.

Three Avenues for Involvement

Aside from removing the burden of evaluation, foundations can contribute in a multitude of ways. They can help promote an infrastructure that is conducive to Pay for Success, invest in capacity building that would better equip nonprofit organizations to participate in Pay for Success, serve as the investor in the impact investment itself, or play the role of a guarantor of the private investors' funds. We will discuss ways in which foundations can help build Pay for Success awareness and community while emphasizing ways in which foundations can continue to strengthen New Jersey service providers.

Since Pay for Success projects are new, investors and legislators are skeptical of endorsing pilot programs. Foundations can assist in making Pay for Success Initiatives more familiar and accessible to parties who wish to get involved by hosting workshops to educate investors, nonprofit organizations, potential intermediaries, or government offices about the logistics and details of Pay for Success. Furthermore, foundations can cultivate discourse communities that specialize in impact investing and Pay for Success.

Build Nonprofit Capacity to Participate

Promote Performance Management

Pay for Success Initiatives distinguish themselves from other forms of policy by virtue of their emphasis on performance management. Typically, private sector firms invest time, money, and labor to collect data and address organizational inefficiencies. Contrarily, government and nonprofit organizations have a propensity to set vague goals and under-finance performance data analysis. In addition to lacking measurable outcomes, the public sector commonly emphasizes outputs or spending as a measure of success. Consequently, government and nonprofit organizations disproportionately focus on the amount of revenue that is spent on services instead of the impact the services create.

The Organization for Economic Co-Operation (OECD) informs us that the United States spent $7,960 on health per head in 2009, two-and-a-half times more than the OECD average of $3,223. Yet a comparison in 2007 with Australia, Canada, Germany, New Zealand and the UK showed that the U.S. health care system ranked last or next-to-last on quality, access, efficiency, equity and healthy lives.

Pay for Success can mitigate the major discrepancies between measuring outputs and measuring outcomes. According to calculations by former officials from the Obama and Bush Administrations, "less than $1 out of every $100 of government spending is backed by even the most basic evidence that the money is being spent wisely."[xii] Performance management in the American healthcare system is neglected even further. Less than $1 out of every $1,000 the government spends on *ObamaCare* will go towards evaluating program efficiency. Public sector failure to collect and analyze data about social services results in enormous spending and undeterminable results.

Neutral oversight of public programs shifts the emphasis from quantity of spending to quality of services. The majority of public sector firms spend less than one percent of agency budgets on testing and developing best practices; however, Pay for Success is different. With Pay for Success, money is allocated for an independent evaluator to measure outcomes. Moreover, data is collected throughout the duration of the project. Pay for Success Initiatives also differ from current methods of service delivery because private investors overlook the efficacy and efficiency of the nonprofit. Instead of spending money as a means to achieve outputs, public agencies can align policy objectives and implementation by setting and meeting meaningful goals.

If a nonprofit organization lacks the capacity to collect and analyze performance data, they would not be an effective service provider in a Pay for Success Initiative. Foundations can promote Pay for Success Initiatives by helping nonprofit organizations establish systems of performance management.

Promoting successful nonprofits

We understand that foundations have a strong history of supporting innovative programs to address root causes of social issues. KIPP (Knowledge Is Power Program) and Teach for America serve as examples of recent education organizations that grew rapidly due to strong foundation support. In order to make the jump from a small- and medium-sized nonprofit into a large nonprofit, organizations require unwavering support early on from foundations. Innovative programs originally supported largely by foundation funding can be implemented on a larger scale through a Pay for Success initiative.

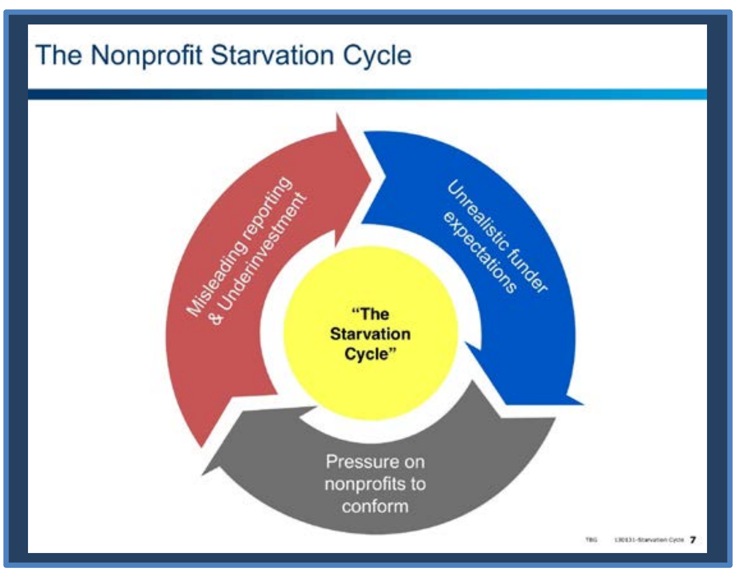
Additionally, some important questions foundations may be considering are:

1. What contribution can foundations make beyond serving as investors?
2. How can foundations utilize the momentum around Pay for Success to further their own mission?

While the issue area of initial Pay for Success efforts may not fall within a foundation's funding priorities, participating within local Pay for Success Initiatives appear to be worthwhile for diverse funders. This is why foundations have an interest in providing technical assistance to promote the capacity building of their grantees and local nonprofit community.

Preventing Underinvestment

In order for Pay for Success Initiatives to take the next step in becoming sustainable and transformative, contracts issued to nonprofits must differ from conventional government contracts that pay for program costs but not operational costs. Due to the scarcity of general operating funds, nonprofits may accept restricted dollars that do not cover the true costs of high performance. As a result, overhead costs such as fundraising and evaluation can become hidden or insufficiently funded. The Bridgespan Group refers to this challenge as the "Nonprofit Starvation Cycle."[xiii]



The Stanford Social Innovation Review highlights the need for funders to set realistic expectations in order to alleviate the burden nonprofits face. This cycle sheds light on potential pitfalls of Pay for Success. Goals and projected government savings must take into account the true costs of scaling up interventions. If they do not, there is a potential for misleading reporting and under-investing in organizations. Emphasis on the planning stages and thoughtful set up of evaluation metrics (rather than a rapid roll out) will be critical for the sustainability of Pay for Success. Foundations can serve as advocates for sufficient funding of overhead costs prior to drafting contracts.

Offsetting Evaluation Costs

As mentioned earlier, investment in evaluation leads to successful nonprofits and stronger Pay for Success candidates; therefore, it would be a missed opportunity to invest solely on the consulting costs of evaluators. Foundations are in a position to provide technical assistance to nonprofits throughout the Pay for Success cycle in order to improve their internal capacity to evaluate data while continuing to create innovative interventions.

Forms of Investing

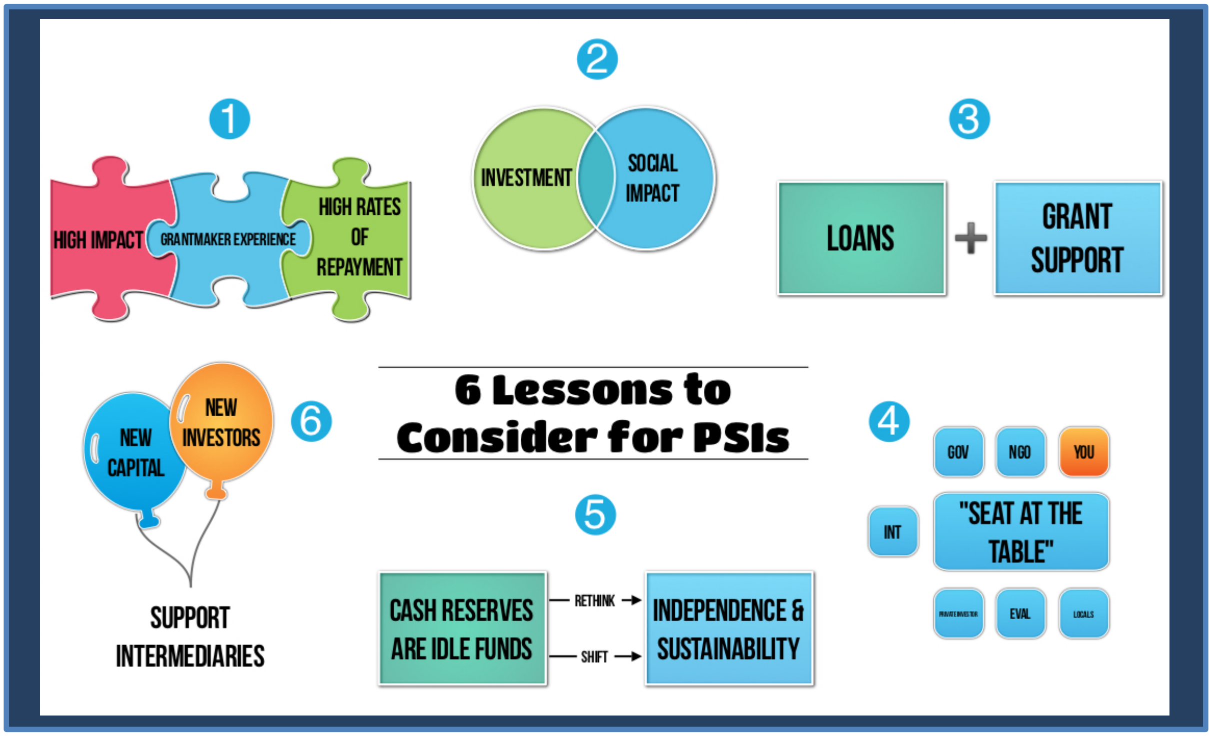
A helpful way to decide which role to pursue with regard to the New Jersey Social Innovation Act is to visualize it as an opportunity to make a program-related investment. Within Pay for Success, a foundation has two investment options: serve as the investor or provide a guarantee. There are two main forms of financial involvement.

Take on the Investor Role

Since the success of early pilots are reliant on long-term capital, financial involvement is one of the strongest and most direct methods of fostering Pay for Success as a tool to scale impact in the community. A vast amount of literature on "Social Impact Bonds" focus on the potential economic benefits of social impact investing (repayment, dividends, the ability to reinvest and increase impact). We have found that the overall assessment of investment is that early pilot investors will likely come from the philanthropic community. Since foundations have a vested interest in creating impact through their grant dollars, they are better positioned to serve as investors that prioritize true impact versus financial returns. Here we will discuss the ideal conditions necessary for investing should you be interested in serving as investors in a New Jersey Pay for Success pilot program.

Considerations for Investment

The diagram below will shows the 6 lessons to consider for Pay for Success Initiatives:



Lessons learned from program-related investments are directly applicable to Pay for Success and shed light on best practices for foundations interested in investing in new initiatives, including the NJSIA pilot program. They serve as new ways of looking at how Pay for Success can complement a foundation's grant-making program.

Here is a summary of six key lessons learned by the Ford Foundation after two decades of program-related investment.[xiv] These lessons should be applied to Pay for Success in order to ensure impact and accountability:

1. **The greatest impact & repayment records come from projects directly related to grants programs.** Grant-maker experience in the field helps determine key questions to ensure success.
2. **Program focus.** The selection of PRI should be based on program strategy and potential social impact, coupled with financial analysis. Projects should not be chosen based on loan opportunities alone.
3. **Borrowers need some project equity in the form of grants**. This is especially the case for costs that are difficult to raise elsewhere (example: costs related to intermediary and evaluation overhead)
4. **PRIs give foundations a "seat at the table."** Foundations provide insight on the needs of nonprofits and can help create and negotiate terms with private lenders.
5. **Find and support intermediaries.** This will help develop institutions that can raise new capital and distribute to organizations.

6. **Stimulate rethinking of funders' assumptions on nonprofit financial management**. PRIs shift view of cash reserves as idle money (and the community practice of emphasizing program spending) towards cash reserves and investments as promoting independence and sustainability.

Furthermore, the foundations should keep in mind the following evaluation requirements for investing in an effective "Pay for Success" project:

- Pay for Success Initiatives require a large initial scale of at least 200 individuals served per year in order to determine whether the final outcome was produced by the intervention.[xv] If the sample size is small, it will be difficult to obtain enough statistical precision to judge whether the intervention was successful. Alternatively, if a large sample size is unattainable, there needs to be a realistic vision for scaling up the Pay for Success Initiative into a larger project.
- Performance-based contracts are applicable only when the available outcome measures, such as earnings, school test scores, recidivism, or healthcare expenditures, are highly correlated with an initiative's overall social impact goals. If the measures of the results are not significantly correlated with the program's success, then the performance payments will be based on imperfect measure.
- A project should not set overly ambitious initial performance targets, as it may lead to a final assessment that the intervention failed, even though the performance-based payment model succeeded in terms of public sector savings.

Conditions for Implementation

Prior to investing, foundations should take into consideration conditions for implementations that keep the objectives of the Pay for Success in mind. With respect to the New Jersey Social Innovation Act, the following should inform the decision-making:

Study Commission Makeup

The legislation requires the New Jersey Social Innovation Study Commission to include a member of the Department of Human Services, Department of Health, and Director of the Office of Faith Based Initiatives. While this is a good starting point, it is also important that this commission be comprised of members more directly involved in the healthcare program. These include a member of each of the following groups: a physician from a local hospital, a member of the investment group (preferably a person with expertise in social finance) and an adult from the treatment group.

No more than twelve members (ideally 8) should be appointed to the Study Commission. A smaller size commission can simplify meetings at any time the chair of the commission deems necessary. The commission's wealth of expertise should help lower their reliance on government resources for research. As the New Jersey state government will be obligated to provide full access to professional assistance, it is in their best interest to work with a commission that is well versed in public and private matters so that unnecessary meetings with officials can be avoided. This way, productivity in the other departments will not be affected by the added burden of employees providing extra reports and attending more meetings.

Application Process

Before the project funding can move forward, nonprofits providing services must be thoroughly vetted. Greater favorability will be placed on nonprofit organizations that have a long history of servicing the people of New Jersey, with five years of operation serving as the baseline. With experienced nonprofit service providers, it will be easier to evaluate the results of their previous health-related endeavors.

The efforts of the Fund for New Jersey and Geraldine Dodge Foundation will be taken into consideration, as there is an overlap amongst organizational objectives. As a public policy issue, the Social Innovation Act seeks to utilize your organization's grant funding to cover the basic operational costs of the Study Commission. The rationale is that there is mutual agreement that the funding formula can open the door to a new method of governmental procedures.

Minimizing risks during implementation

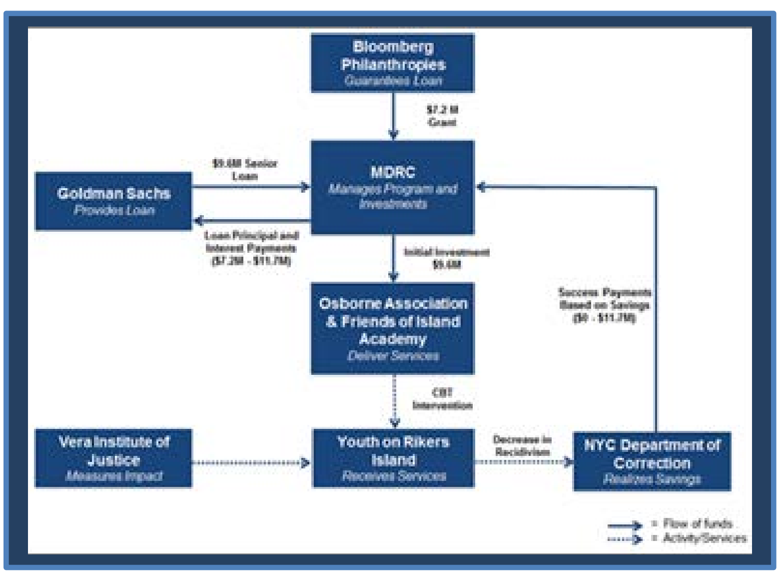
Foundations have the potential to minimize the risks that nonprofits face by establishing sustainability. Nonprofits invest a significant amount of time and resources to submit an application for funding. Because the concept of the Pay for Success is fairly modern, many organizations unfamiliar with it may be overeager to apply to receive long-term funding. In order to save organizations the cost of submitting a full proposal - and minimize time spent by a review committee on unqualified applicants - foundations can offer their expertise on developing a strong applicant pool.

Additionally, foundations can contribute to the creation of orientation and self-assessment systems specific to the local Pay for Success Initiative. The Rapid Suitability Questionnaires (RSQs) developed by McKinsey & Company and Nonprofit Finance Fund serve as a starting model for such systems.[xvi]

Actors in Action: Lessons Learned in NYC

New York City Case Study: Juvenile Recidivism at Rikers Island

In January 2012, policymakers in New York City from Mayor Bloomberg's office met to discuss the benefits and potential problems of bringing a Pay for Success program to the city. On August 2nd, 2012, the City of New York, Bloomberg Philanthropies, Goldman Sachs, and the Manpower Demonstration Research Corporation (MDRC) announced the nation's first social impact "bond".[xvii]



The graphic displays outflows and inflows of funds and services of the NYC Pay for Success Program

I. Obstacles/Opposition

As is usual in legislative and appropriation processes, this proposal was heavily scrutinized. One obstacle faced during the initial process was skepticism from legislators who emphasized that such a program had never been effectuated in the United States.

Critics of the model pointed at the initial cost city taxpayers would have to undertake to establish the framework for the pilot. They also claimed that even debt financing part of community services under this model would be expensive and involve overly complex transactions.[xviii]

II. Implementation

After the monies were secured by MDRC for the pilot, Friends of Islands Academy and The Osborne Association were given grants to implement a recidivism reduction program at the penitentiary on Rikers Island.

In January 2013, the program was expanded to serve all youth within the target population. The program will run for three years, from September 2012 to August 2015.

III. Accountability/Results

It is too early to determine the accomplishments of the New York Social Impact "Bond". The Vera Institute of Justice will conduct an independent evaluation of the project in August 2015. The results will be measured in benchmarks, and depending on the success of the nonprofits in decreasing recidivism rates at Rikers Island, the City of New York will pay MDRC (and subsequently Goldman Sachs), while saving money simultaneously.

IV. Lessons Learned

Although the New York City Pay for Success Initiative has not yielded any measurable results, there are several takeaways that can be useful in implementing the prospective New Jersey Social Innovation Act.

The three main lessons learned are:

1. Private investors are largely unwilling to invest in Pay for Success Initiatives if there is no substantial guarantee on their loan. If Bloomberg Philanthropies had not guaranteed Goldman Sachs $9.6 million loan by up to 100 percent, it can be assumed that the firm would not have invested. This introduces an alternative role that foundations can play in the Pay for Success process. As guarantor, the foundation would effectively work as an insurer on the initial investment made by the private entity. Since Pay for Success has had limited case studies to pull from, the guarantor will play a particularly important role in building confidence in this new innovative method.

2. Timing is imperative. Representatives of MDRC acknowledged it could have produced more efficient results if they had been provided with more time to develop their intervention programs. It is essential that a Pay for Success Initiative be handled exclusively and meticulously. All parties want the project to succeed, which is why it is in the interest of the stakeholders to have a well written strategic plan that can effectively be carried out.

3. The type of project that is best suitable for a Pay for Success Initiative was discovered through this project. It proved to be practical and measurable enough to qualify for government funding. Other Pay for Success Initiatives should analyze this pilot as a reference when working towards implementing their own social innovation acts.

SOCIAL INNOVATION ACT PILOT: *Combating Health Care Costs in New Jersey*

While the aims of social impact bonding more generally extend to a variety of social issues, the specific aim of the New Jersey Social Innovation Act is lowering healthcare costs. After the recession in 2008, state budgets have been strained by the increase in assistance for state residents and a decrease in state revenue:

> "The recession of 2007 to 2009 produced unprecedented declines in state revenue collections across the nation — and New Jersey fared no differently. The collapse affected all of New Jersey's major revenues, from the "big three" (income, sales, and corporation), which represent 72 percent of all state revenues, to smaller taxes such as realty transfer, inheritance, motor fuels, etc…"[1]

In New Jersey, a recent study by the National Association of Community Health Centers found that as much as a third of all emergency room visitors are not sick enough to warrant a trip to the ER. The most common reasons for visiting the emergency room in New Jersey are headaches, stomachaches, and the flu. The estimated cost to tax payers is approximately 400 million dollars a year.[1] The Social Innovation Act will provide governmental loan guarantees for a social impact bond pilot program aimed at early intervention for such illnesses. According to the state's budget report, New Jersey is an expensive state in terms of long term care for the elderly ($16,483 per enrollee) and people with disabilities ($20,554)[1]; New Jersey spends much more than the average state in the nation on nursing home care, and less on home and community based services where the residents are the sickest, poorest, and rely on Medicaid for financial support for their medical needs. It is projected that by eliminating the need for emergency care, the intervention provided by a nonprofit health organization could save the New Jersey taxpayers millions of dollars in expenses,

This pilot program will serve as a stepping-stone for possible further investment in social impact bonds. The New Jersey Social Innovation Act has the political support to pass in the New Jersey legislature, and is in need of support from foundations and investors to further its mission.

Serving as a Guarantor

Having the ability to set conditions is a critical part of being a guarantor, considering the fact that guarantors agree to pay for another organization's debt if the organization defaults on the loan. Guarantors should be concerned with advocating for a community, tackling a social issue, and meeting set goals. In the case of Pay for Success, the guarantor would pay back the investor if the predetermined goals were not met. Guarantors promote Pay for Success Initiatives because they ensure that the government and investor do not lose a significant amount of money if the service program fails. When a guarantor backs a Pay for Success Initiative, investor participation begins to take the form of a loan instead of a grant. This loan is not as risky because the investor will get a portion of their money back regardless of how the service program performs. Guarantors change the nature of Pay for Success Initiatives by making social investing less of a gamble.

Guarantors also provide political stability. Since Pay for Success Initiatives are policy making mechanisms, investors may be reluctant to participate because they fear that new administrations will cut payment to the investor. When a guarantor backs a Pay for Success Initiative, an investor's stake is safer from a new administration's political will than it would be otherwise. Guaranteeing a Pay for Success gives foundations an opportunity to serve as an ally in Pay for Success Initiatives and Impact Investing. Guaranteeing provides a stable environment where other parties are encouraged to contribute and participate.

Terms of Agreement

The details that govern a guarantor's duties are largely defined by an agreement the guarantor signs. Many agreements release a guarantor from their duties after a term in which the service provider makes all repayments on time. This term can be one year or several. Guarantors also may waive additional rights, such as ability to contest charges, as defined by a guarantor agreement.[xix]

Financial Responsibility

An investor is able to take action against a guarantor to recoup losses incurred by the borrower. For example, consider a situation in which the Pay for Success Initiative fails to save enough government funds to repay the investor. Without a guarantor, the investor will lose all of the money they put towards the program. When there is a guarantor, the investor may not make a profit but they do not stand to lose money because of program outcomes.

While a funder has the legal leverage to seek payment from a guarantor if the primary borrower fails to make a payment, it is unlikely that a funder would force the guarantor to cover the missed payment. Instead, a funder would wait until the project is terminated before seeking payment for service afterwards. This would force the guarantor to cover all missed payments as well as any loss in value suffered should the property not sell for the amount still owed.[xx]

In Practice

The New York City Pay for Success Initiative illustrates the tremendous influence a guarantor can have. As an investment alone, the Rikers Island program had such a low guarantee for a return on investment that the initiative to address recidivism would not have happened if the guarantor, Bloomberg, did not commit. The Rikers Island Program would not have attracted funders without a guarantor because the investment is a significant sum of money. In order to justify committing such a large sum of money, investors require significant backing or data to ensure they are not going to lose their funds. Guarantors make Pay for Success Initiatives safer and smarter business transactions.

Additionally, guarantors provide a safety net for the state as well as investors. If a Pay for Success Initiative fails, the investor could pressure the government to repay the investment. Since Bloomberg came on as a guarantor, New York City does not have to repay Goldman Sachs if the recidivism project fails.

The commitment from the guarantor allowed for the project to move forward. The project is on its way to achieving the goals set by the city of New York.

Recommendations

By investing in the Pay for Success model, you are taking a great step onto the forefront of social innovation. Government agencies are reluctant to take on socially risky programs; therefore, Pay for Success Initiatives help by tackling complex social issues without placing the risk on government. We recommend you get involved with Pay for Success in the following three ways:

1. *Financial Involvement*

The Fund for New Jersey and the Geraldine Dodge Foundation could participate in the New Jersey Social Innovation Act as either an initial funder or guarantor. As funders it would allow you to invest in a new product that seeks to fund solutions to major social problems. Guarantors on the other hand would act as a safety net for the project, thus alleviating the risks of investors. This contributes to Pay for Success by ensuring that projects can be initiated without any delay.

Financial involvement, however, should depend upon the presence of strong partners such as: capable intermediaries, nonprofit service providers with proven track record of success, effective independent evaluators, and government agencies committed to efficient and effective service delivery.

2. *Capacity Building*

The Fund for New Jersey and the Geraldine Dodge Foundation can further the scope of Pay for Success impact by enabling nonprofits to be exceptional candidates for the New Jersey Social Innovation pilot program. Assisting the nonprofits in the following ways will greatly increase their chances of being eligible to participate in Pay for Success:

- Providing technical assistance, building databases and infrastructure for running effective evaluation systems by training the leadership, staffing, and shifting towards evaluation that assesses social impact.
- Both foundations are already invested in the success of their grantees; thus, they can lead this initiative by investing in the evaluation systems of their grantees. Alternatively, a New Jersey wide training initiative can be created that utilizes the resources of a funding network/grant maker's circle that provides training for various grantees in the state.

3. *Community Building*

The Fund for New Jersey and the Geraldine Dodge Foundation can organize workshops and engage in community discourse to help insure that nonprofits and community lenders understand the value of Pay for Success.

Glossary

Guarantor: An entity who guarantees to pay for another entity's debt if it should default on a loan obligation; one who gives a guaranty

Intermediary: also known as the Pay for Success Initiating Organization is the middleman amongst the government, nonprofit organizations, and the investor, who plays a vital role in the maintenance and execution of pay for success initiatives

MDRC: A nonprofit, nonpartisan education and social policy research organization based in New York City and Oakland, CA, which serves as the intermediary for the New York City Pay for Success Initiative pilot program

New Jersey Social Innovation Act: A legislative bill created by Assemblyman Angel Fuentes that aims to expand nonprofit healthcare delivery programs in urban areas of NJ by creating a new method of generating capital

Nonprofit: An organization that conducts business for the benefit of the general public without a profit motive

PSI - Pay for Success Initiatives: *(also known as Social Impact Bonds)* An innovative way partnering with private sector investors and philanthropic organizations to create new strategies and methods addressing social policy issues

Private Sector: Part of the economy that is not state controlled, but is ran by individuals and companies for profit

Public Sector: Part of the economy concerned with providing basic government services

SIB - Social Impact Bonds: A contract with the private sector in which a commitment is made to pay for improved social outcomes that result in savings for the public sector

Social Innovation: New concepts, strategies, ideas, and organizations that meet social needs of all kinds- from education and working conditions to community development and health

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