Launching the First U.S. Pay-for-Success Contract: Youth Recidivism in Massachusetts

Submitted on March 20, 2012

Michael Belinsky and Angela Wyse
Candidates for Master in Public Policy
Harvard Kennedy School of Government
This Policy Analysis Exercise is submitted in partial fulfillment of the requirements for the degree of Master in Public Policy.

EMBARGO
The authors of this document have requested the Harvard Kennedy School of Government to embargo the document in whole for no less than six months following the date of publication.

ACKNOWLEDGEMENTS
We thank Professor Jeffrey Liebman and Deputy Commissioner for the Department of Youth Services (DYS) Edward Dolan. Professor Liebman introduced us to pay-for-success contracts, and offered invaluable guidance throughout our work for the Massachusetts DYS and the Executive Office of Administration and Finance. Mr. Dolan has contributed countless hours to shepherding this innovation in government from an idea to a reality.

CONTACT INFORMATION
Michael Belinsky can be reached at mikebelinsky@gmail.com.
Angela Wyse can be reached at angela.wyse@gmail.com.

Copyright © 2012 by Michael Belinsky and Angela Wyse
Executive Summary

DOING WHAT WORKS

On January 18, 2012, Massachusetts became the first U.S. state to launch pay-for-success contracts. These contracts allow the government to pay only for programs that achieve their goals. The pay-for-success model holds promise for bringing new vigor to government efforts to tackle social issues, while also improving the performance of social programs and saving taxpayer money.

Under one of the contracts announced in January, the Executive Office of Administration and Finance (EOAF) and the Department of Youth Services (DYS) are seeking private sector or nonprofit partners to help reduce recidivism among youths who age out of DYS jurisdiction. Under the other contract, EOAF and the Department of Housing and Community Development (DHCD) are seeking partners to provide stable housing for the chronically homeless. In both contracts, the state plans to partner with at least two different entities: 1) one or more service providers, whose primary role will be to engage with the selected population, and 2) an intermediary, whose primary roles will be to provide upfront funding for service provision and to monitor performance. Pay-for-success contracts that involve an intermediary are known as Social Impact Bonds (SIBs).

As the first such contracts in the United States, and part of only a handful of projects underway worldwide, the Massachusetts initiative will help set the course for future experimentation with the pay-for-success model. This document, which summarizes the involvement of a team from the Harvard Kennedy School of Government in launching the youth recidivism contract, aims to serve as a reference to the government of Massachusetts and to other actors considering pay-for-success contracts.

FINDINGS

Chapter I provides an overview of pay-for-success contracts. These contracts address some of the main challenges to innovation in the public sector, including: 1) a timing mismatch between paying for, and seeing the benefits of, preventive services, 2) the lack of a good mechanism to scale up proven interventions, and 3) the current weak incentive for governments to discontinue inefficient or failed programs. Pay-for-success contracts address these problems by allowing governments to pay only if an intervention succeeds, which also allows them to pay for preventive services out of realized cost savings.

Chapter II presents case studies of other pay-for-success initiatives currently underway. We find that, although initiatives differ in terms of their chosen interventions, outcomes of choice, and contracting process, existing pay-for-success contracts have centered on three populations: at-risk youth, adult offenders, and the homeless. We also note that the current pilot projects tend to treat a relatively small number of individuals (between 140 and 1,000), that all of these interventions have drawn on external support, and that successful interagency coordination, and particularly chief executive buy-in, is vital to success.

Chapter III summarizes key features of the two Massachusetts pay-for-success contracts. The first contract is designed to reduce recidivism and improve education and employment outcomes for youth discharged from juvenile corrections and probation systems. The second contract aims to provide stable housing and other services for several hundred chronically homeless individuals.
Chapter IV reviews interventions to address recidivism that have undergone rigorous evaluations. In general, we find that interventions that focus on rehabilitation, rather than deterrence or incapacitation, produce the best results. Other success factors include an emphasis on family involvement, and a focus on changing youth’s surrounding environment. For the DYS population, the most promising models include Multi-Systemic Therapy, which provides intensive therapy to an individual in a home setting, and Functional Family Therapy, which also takes place in a home setting and focuses on improving the family environment. In addition to these evidence-based models, a variety of promising models exist that have not undergone a rigorous evaluation, such as Wraparound Milwaukee’s O-YEAH program and Missouri’s Aftercare program.

Chapter V addresses questions that arose during the contract planning period regarding the program concept, procurement process, and contract terms. Given the unique nature of the pay-for-success model, we find several considerations to be particularly important in answering these questions: 1) effective targeting of high-risk youth, 2) balancing program size and risk for intermediaries, 3) deciding whether to prioritize evidence or learning in selecting an intervention, 4) assessing the cost-effectiveness of the intervention and the benefits of reduced crime, and 5) the need to establish a valid counterfactual.

Chapter VI analyzes recidivism data for a cohort of youth that aged out of the DYS system in 2006. We find that within three years of release from DYS, about 60% of all youth have been convicted of a crime. Aside from gender, the available data did not reveal any statistically significant predictors of recidivism that would allow us to target the intervention to a high-risk subgroup. We also find that the intervention would have to produce large reductions in recidivism in order to be able to recoup the average, as opposed to the marginal, costs of incarceration.

FOUR KEY TAKEAWAYS

Public officials, service providers, and other actors who are interested in the pay-for-success model may find the following four takeaways particularly useful.

1. “Success” need not take the form of bottom-line savings to taxpayers.

Governments may find it worthwhile to adopt a pay-for-success contract that does not fully pay for itself through direct budgetary savings. All of the pay-for-success contracts we have observed have the potential to create large and durable social benefits, in addition to budgetary savings. In the case of recidivism, for example, studies show that individuals may be willing to pay tens of thousands of dollars to avoid being the victim of a crime, which can be far greater than the savings from an avoided incarceration. The benefits to youth themselves and their families will also be substantial. When exploring potential pay-for-success applications, governments may benefit from not limiting themselves only to contracts that pay for themselves in a narrow budgetary sense.

Moreover, social interventions could create unexpected or long-term financial benefits that do not immediately show up in the budget. For example, an intervention that puts youth on a better course in life may affect public finances through higher tax revenue, lower public healthcare expenses, and decreased demand for public assistance programs.

Short-term budgetary savings nonetheless remain an important component of these contracts’ appeal, particularly in their pilot applications. When public funds are scarce, policymakers will be hard-pressed to allocate additional funds to social services for disadvantaged populations. However, even without monetizable savings, pay-for-success contracts hold an advantage over traditional
contracts. Because the state pays nothing unless the intervention achieves its intended outcomes, the consequences of failure are politically and financially less damaging.

2. Most of the early support for pay-for-success contracts and Social Impact Bonds (SIBs) is likely to come from governments, philanthropies, and socially minded investors—not the private sector.

Some commentators envision social impact bonds as a new form of financial instrument. As an asset class, SIBs would have the advantage of being largely uncorrelated with market trends and could therefore offer benefits for portfolio diversification. Such a SIB market, however, remains far in the future. One hurdle is that SIBs investments entail equity-like downside risk but offer only bond-like upside returns. Another problem lies in the high uncertainty currently associated with SIBs. Without a sufficient number of pilot applications, investors will find it difficult to assess the amount of risk associated with a given SIB.

Although limited in their use as a financial instrument, pay-for-success contracts have much to offer to the nonprofit and public sectors. Most of the early financial support for these contracts is likely to come from these sectors. Benefits to these actors include improved social outcomes, potential cost savings, and faster learning about what interventions work.

Recent experience with pay-for-success contracts bears out this prediction. So far, the drive to implement pay-for-success contracts has come from nonprofits like Social Finance UK and Nonprofit Finance Fund, foundations like the Rockefeller Foundation, and the public sector. Advocates of these contracts may therefore wish to initially focus their efforts on the public and nonprofit sectors, and only later focus on private funding.

3. Some service providers may have the operational and financial capacity to take on the role of the intermediary.

The social impact bond (SIB) version of the pay-for-success model, where an intermediary raises capital and selects and monitors service providers, has drawn particular attention in the media and academic circles. Proponents of SIBs make three arguments for a separate intermediary role. First, the intermediary is uniquely capable of meeting the large capital requirements providers need to deliver services. Second, the intermediary transfers the risk of failure that could otherwise prove prohibitive for small service providers. Third, intermediaries can select and manage a set of service providers better any of the providers could do by themselves.

In practice, we have seen service providers challenge these arguments and credibly claim the ability to take on the role of the intermediary. Service providers with strong records of successful operations may be able to raise funds from philanthropies with shared missions. They may even be able to convince their donors to bear the risk of contract failure if the donor values the non-financial benefits of the contract. Providers also point to existing sub-contracting relationships as evidence of their ability to manage several organizations in service delivery. These arguments suggest that governments may occasionally be able to eliminate the intermediary from the model and contract directly with service providers.
4. Pay-for-success contracts have yet to show promise in areas other than social service provision.

To date, each effort to introduce pay-for-success contracts has focused on the provision of social services to disadvantaged populations. This narrow focus raises the question of whether pay-for-success contracts offer a suitable solution to other types of public problems, such as energy efficiency. In the future, pay-for-success actors may wish to experiment with different populations and different types of interventions to test the model’s broader applicability.