



Social Impact Bonds

A promising new financing model to accelerate social innovation and improve government performance

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Introduction and summary

Current approaches to government funding of social services create significant barriers to innovation. Funding streams tend to emphasize inputs rather than program objectives and are often overly prescriptive, requiring grantees to use a particular delivery model. In many cases, program outcomes are not rigorously assessed, allowing unsuccessful initiatives to persist for years.

Meanwhile, the public sector is slow to adopt new program models, even those proven to be highly effective. There is no systematic process through which philanthropically funded interventions with demonstrated success receive the government funding necessary to expand. Investments in preventive services can be particularly difficult to finance because the funding streams that support such services are often in different accounts from the programs in which the cost savings accrue.

Consider the new federal “home visiting” program. This grant program, which pays for nurse and social worker home visits to low-income mothers, was enacted last year—33 years after the first randomized controlled trial demonstrated the benefits of such visits. Among the benefits we put off for more than three decades: healthier children and families, and lower Medicaid costs for taxpayers.

We must find better ways to support and scale-up successful social innovations. Imagine the social benefits and reduced taxpayer burden if we could:

- Increase kindergarten readiness among low-income children
- Increase college completion rates
- Reduce criminal offenses and incarceration rates among minority youth
- Raise the future earnings of laid-off workers
- Reduce hospital readmissions among patients with chronic illness

This report analyzes social impact bonds, a promising new approach to the government financing of social service programs or social “interventions.” By combining performance-based payments and market discipline, the approach has the potential to improve results, overcome barriers to social innovation, and encourage investment in cost-saving preventive services.

How a social impact bond works

Under the social impact bond model, a government contracts with a private-sector financing intermediary we'll call a "social impact bond-issuing organization," or SIBIO, to obtain social services. The government pays the SIBIO entirely or almost entirely based upon achieving performance targets. If the bond-issuing organization fails to achieve the targets, the government does not pay. In some cases, the government payments may be calculated as a function of government cost-savings attributable to the program's success.

The bond issuer obtains operating funds by issuing bonds to private investors who provide upfront capital in exchange for a share of the government payments that become available if the performance targets are met. The bond issuer uses these operating funds to contract with service providers to deliver the services necessary to meet the performance targets.

The United Kingdom Justice Ministry is currently conducting the first test of this approach. The ministry has contracted with a bond-issuing organization to provide services designed to discourage prisoner recidivism at a prison in Peterborough, England. The government will make payments to the SIBIO only if the reoffending rate among prisoners released from the prison falls by at least 7.5 percent relative to the recidivism rate in a comparison group of similar prisons.

The social impact bond model uses private financing to overcome existing barriers to performance-based pay for social service providers. Today, most providers would be hard-pressed to come up with sufficient capital to provide services upfront and only receive payments after performance targets were met. And most social service providers would be unable to absorb the risk of failing to meet performance targets. But in a social impact bond scheme, private investors provide the upfront capital and absorb most of the risk.

The private investors also perform an important form of quality control. That's because service providers must convince the private investors that their program model and management team are likely to achieve the performance targets. The investors and bond-issuing organization also have strong incentives to rigorously monitor and improve program performance; if performance targets are missed, they will lose the money they invested. Overall, the social impact bond model offers the following three main benefits:

Improved performance and lower costs

The model focuses government agencies and social service providers on achieving program objectives and improving performance in a way that is transparent to taxpayers. Programs that fail to achieve results would not continue to receive funding year after year, as they do today.

Accelerating adoption of new solutions

Government agencies, which might otherwise continue to fund the same old approaches they have funded in the past, would have an incentive to invest in promising new strategies, including preventive services. That's because the risk of wasting taxpayer dollars if the new approaches fail is transferred to the private sector.

More rapid learning about what works

The social impact bond approach embeds rigorous ongoing evaluation of program impacts into program operations, accelerating the rate of learning about which approaches work and which do not.

Key challenges

Because of how they are structured, social impact bonds will work only for interventions that meet the following five main criteria:

The interventions must have sufficiently high net benefits

The most significant obstacle to making social impact bonds work is identifying interventions with sufficiently high net benefits to allow investors to earn their required rates of return. If one-third of projects fail, the annualized rates of return on the remaining projects would likely need to be more than 20 percent. Given the history of impact evaluations of government-funded social programs, achieving a sufficient level of success will be difficult.

The interventions must have measurable outcomes

Performance-based payment schemes can by definition work only for funding those programs that can be evaluated by reliable performance measures. And those measures must be highly correlated with a comprehensive assessment of a program's social net benefits. Imperfect measures—those that are only weakly correlated with comprehensive program success or that measure a narrow component of a program's performance—have the potential to distort performance in a way that is equivalent to “teaching to the test.”

The treatment population must be well-defined up front

It will be much easier to evaluate program impacts and negotiate a performance-based contract if the treatment population is clearly defined in a way that cannot be manipulated by the service provider. The U.K. pilot provides a good example. The treatment population in that case is all prisoners in Peterborough Prison, not just the subset that receives services from the service provider. Defining the population upfront and independent of service delivery avoids cream-skimming and gives the bondholders the proper incentive to marshal whatever combination of services is necessary to achieve good results for the entire targeted population.

Impact assessments must be credible

To evaluate the success of a program, you not only need measurable outcomes, but also a way of assessing what the outcomes would have been in the absence of the program. There is a range of methods for assessing impacts, from randomized experiments to quasi-experimental techniques to simple “before and after” comparisons. For social impact bonds to achieve their objectives, payments must be based on a credible assessment of program impacts.

Unsuccessful performance must not result in excessive harm

Bondholders could have an incentive to shut down operations if it becomes clear they will not meet performance targets and get paid. The shutdown in operations could strand the population being served. Therefore, all social impact bond contracts should include contingency planning for performance and financing failures. The duty to avoid harming treatment populations may limit social impact bonds to programs that don't provide “core” services.

Next steps

The U.K. social impact bond experiment has prompted interest among U.S. philanthropists, policymakers, and investors in conducting proof-of-concept tests in this country. In order to get pilot programs up and running here within the next one to two years, the following actions need to be taken simultaneously:

Identify promising pilot applications

At the proof-of-concept stage, it makes sense to apply the social impact bond model to programs that have already proven effective. Ideal applications for this initial phase will have recently demonstrated their effectiveness in rigorous evaluations and have sufficiently high net benefits to satisfy investor-required rates of

return. Some of the initial demonstrations should be programs in which successful implementation will provide savings to the government that exceed program costs.

Establish the first U.S. pilot tests at the local level

Most social services in the United States are delivered at the state and local level. It is therefore likely that the first U.S.-based tests will be established by social entrepreneurs working with innovative city and state governments. Initial investors are likely to include socially minded individuals and foundations.

Identify additional areas where the bonds are most likely to spur social innovation

In addition to identifying already proven models for initial tests, think tanks or foundations should host more strategic discussions to review the social problems most urgently in need of innovative solutions, and to consider whether social impact bonds are likely to be a good fit for each particular domain.

Assess the potential investor market

In order to determine how ambitious to be in selecting applications, a rigorous assessment is needed of the potential size of the social impact bond market. For example, if they were to be used to finance the nationwide rollout of a program on the scale of Head Start, the market might need to be in the tens of billions of dollars. But if social impact bonds end up combining equity-like risk with bond-like returns, then the market will likely be limited to philanthropic and socially minded investors willing to accept lower returns in exchange for promoting social goals. The “impact investment” community, which promotes financial investments that solve problems while generating profits, should commission a reliable market assessment.

Develop government, evaluative, and private-sector capacity

The United States needs to take three capacity-building steps to create social impact bonds. First, governments will need to develop or acquire the capacity to write effective pay-for-performance contracts. Second, a neutral authority to measure outcomes and resolve disputes, independent of both the government and the bond-issuing organization, will need to be identified or created. Third, and most important, one or more social impact bond-issuing organizations will need to be created, with the capacity to raise capital from private investors, negotiate performance-based contracts with the government, and hire and manage service providers.

Seek congressional authority to expand use of long-term performance contracts

While a number of federal programs provide sufficient flexibility to experiment with the social impact bond model, traditional appropriations statutes are not a good fit. Appropriations laws usually make funds available for only a one- or two-year period,

well before the full results of these bonds would be known. Moreover, the government will need to make initial obligations under the assumption that all performance targets are met. These obligations will be higher than the final results-based payments because not all projects will achieve all of their performance targets.

Congressional appropriators, who operate under spending caps, will be reluctant to appropriate funds in excess of what is actually going to be paid out, since agencies would have to return the unused funds to the Treasury. Congress should therefore pass an appropriations statute that authorizes long-term contracts and allows for future redirection of any unused funds, for another closely related high-priority purpose.

The remainder of this report examines the social impact bond model in further detail. It begins by reviewing why existing government approaches to financing social services create barriers to social innovation. Then it describes the social impact bond model and the U.K. Peterborough Prison test. A discussion follows of the key challenges in selecting promising applications of the social impact bond model. A concluding section discusses work that will need to be done in order to establish the first U.S.-based tests of the model.

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