Social Impact Bonds: An explanation, an application, and cautions.

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I.

In public policy, the eternal struggle between policies to pursue often comes down to what we as a community (local or global) are willing to pay for. That question reveals telling details about our individual and collective values. Answering that question also displays the different logical approaches we can take in solving our societal problems. As a community, we can take on more risk together than as individuals and that is advantageous for several reasons.

In public finance, we are exercising our ability to raise revenue through taxes and fees in order to pay for public goods. We also exercise our ability to borrow funds to pay for public goods over long periods of time and gradually pay off those borrowed funds with interest. As a community, through government, we weigh the benefits and costs and determine what risks we are willing to incur.

The tension between the level of risk some individuals are willing to take on that others are not, is an enormous political challenge nationally and it is often the same at the state and local level. Do we pay for more preventative and efficient educational services early in a person’s life or do we spare those early costs and pay for a limited amount of remedial services later in a person’s adult life? How extensively should we provide those services? Is the ultimate cost of not paying for effective early social services the very high costs of welfare programs and incarceration?

This research paper will explain a very new and innovative public financing concept known as Social Impact Bonds (SIBs), also coined in the U.S. as Pay for Progress (PFP) agreements [6]. Additionally, we will explain how we could use SIBs to address the funding gap for a specific social policy, early childhood education, in the U.S. and lastly we will explore some drawbacks
of the SIB discussion and SIBS themselves. Readers will gain the understanding that social impact bonds can further innovation in public finance but they cannot replace traditional revenue streams entirely.

II.

II. The pioneering concept of social impact bonds (SIBS) or also known in the United States as Pay For Progress (PFP) agreements can be simplified in this way: “private investors pay the upfront costs for providing social services, and government agencies repay the investors with a return--if and only if a third party evaluator determines that the services achieve agreed-upon outcomes [3].” Non-profit agencies or other direct service agencies are still typically the delivery systems for the social services. Below is a diagram created by the Center for American Progress with a more step-by-step explanation following. [3].
• A government agency sets a specific and measurable outcome they want to be achieved within the target population over a specific period of time.

• The government contracts with an outside organization or intermediary, which is responsible for ensuring that outcome is met.

• The intermediary hires and delegates to services providers who carry out the interventions intended to achieve the specific outcome goals.

• The government does not pay until or unless the outcome goals are achieved

• The intermediary raises the funds from outside investors including but not limited to: CDFI’s, private, Foundations, wealth managers, investment banks,

• The investors will be repaid and receive a return on their investment for taking on the risk of the intervention programs as long as target outcomes are met and to what degree [2].

The private sector finds SIBs appealing for several reasons. According to McKinsey and Company’s reports, the targeted performance outcomes and interconnectedness of the stakeholders have the potential to transform public financing systems for the better [2]. In addition, Goldman Sachs Investment Bank which invested $10 million dollars in the first SIB stateside in New York City, is encouraged by this new tool of leveraging private capital for public good [9]. The firm invested again in Massachusetts, joining philanthropists and foundations, to address recidivism there [5].

From the private sector perspective, SIBs are a win-win. While there is risk, it is not as great as the average day on Wall Street and they are thus far investing relatively small amounts which
may already be from charitable funds. They benefit from the positive media exposure and receive a modest return on their investment. The real test of the private sector’s commitment to SIBS will come if they are asked for even bigger investments and for SIBS to become a more normalized and standardized practice across the country. This initial interest hasn’t translated throughout the private sector yet.

III.

Social impact bonds have developed rapidly over the last four years; growing from a single pilot in the United Kingdom to multi-million dollar investments across half a dozen projects in the United States and growing. Below is a brief timeline to help orient us.

- 2010: The U.K. launched an $8 million dollar intervention program in Peterborough to cut the prison recidivism rate by 3,000 prisoners over six years, financed by SIBs [8].
- 2011: Massachusetts issued a request for information (RFI) for suggestions on pay for success projects and selections of ideas and intermediaries were made in August 2012. Projects will address juvenile defenders and chronic homelessness [6].
- 2012: New York City created the first U.S. SIB aimed at reducing recidivism and related costs in 3000 young offenders from Rikers Island prison, the $9.6 million dollar investors are Goldman Sachs Investment Bank and Bloomberg Philanthropies [6].
- 2013: Harvard’s Kennedy School of Government offers technical assistance to four more states and local governments pursuing SIBs [6].
● 2011-2013: President Obama proposes pay for success funding in each budget year with the Department of Labor issuing a grant solicitation for $20 million in pay for success contracts in 2012, some of those contracts going to New York State and Massachusetts [6 & 11].

● 2014: Center for American Progress and Council on Foundations published findings of informational interviews and discussions of various potential SIB investors explaining the basic concept of SIBs and stating the importance of the interconnected network of the SIB structure. These discussions and interviews were based around case study exercises to explore the differing points of views of the potential investors [3 & 4].

The Harvard Kennedy School of Government’s Social Impact Bond Technical Assistance Lab highlights many important considerations before determining if SIBs are an appropriate tool to utilize. The lab stresses the following discerning steps and process for making the determination. First decide if SIBs are right for your organization then decide what would be a suitable policy to pursue. Navigate the analysis tools needed, create financing models for how the SIB would be executed, and then determine the proper legal and organizational structure, formalize these structures so all parties are accountable. Begin implementing and monitoring the SIB project, and finally you arrive at completion with outcome measurements and payments according to agreements [6].

IV.

Let us take a real policy problem and determine if and how SIBs could be applied. Early childhood education is funded through a myriad of public and private revenue streams at the
national, state, and local level. Some states include pre-kindergarten in their statewide funding formula but most do not [1]. Policy makers debate everything about this issue from funding levels to whether it should be funded at all, to quality of teaching and curriculum, to the true long term impact it really has on individuals through their lives and especially as they matriculate through the public education system [10].

This issue is ripe for the use of SIBs for the following reasons. Decades of research confirm that it is indeed a preventative intervention if implemented effectively [10]. The New York Times, citing the prominent research of Dr. James Heckman, notes that the annual return on investment for early childhood education ranges from seven to ten percent [7]. The savings come from educational remediation that is not needed later in their educational career, welfare services not needed in such a high degree, and lower incarceration rates. Without the same type of comprehensive legal and legislative protections that K-12 education has though, early childhood education has always been vulnerable and lacked the same obligatory funding security. It is a proven program though; particularly programs that include family supports, alignment with the rest of the educational pipeline, and high quality teachers given a well-rounded curriculum.

Often the strongest early childhood education systems blend different revenue streams to maximize outcomes and service. Weaving SIBs into an existing early childhood education network would potentially have an amplifying effect. SIBs could expand the number of children enrolled, better equip teachers, measure outcomes for students, and bring families more directly into the educational environment and empower them to continue learning at home. In effect, if
could take a good or adequate early childhood education system to great or outstanding while reaching more families and students.

V.

To use SIBs as a stand alone funding would not be an appropriate use of this tool [6]. A demonstrated capacity from the intermediary and the service providers to carry out the work required for the desired outcomes is key. The due diligence process for SIBs should carefully examines this aspect of any proposed project. Thus one of the drawbacks of SIBs is that they cannot be universally applied in all policy areas or in all communities. Some networks are primed to execute this concept and some are not. The next steps for the positive development of this tool should be initial success of the first pilot projects and continued investments from existing and new private investors.

Why do we even need alternative public financing mechanisms? A tension exists between the attention spans of an electorate and their leaders and with the time it takes for the deliverables of preventative policy to be visible. Traditional taxes and levies are subject to that short attention span. SIBs have the potential to ease that tension which is so often a barrier to any progress when it comes to public policy. Finding ways to mitigate that tension is vital to move progressive policies forward and should be a priority for all sectors if we want to move beyond the trite partisan debate that prevents the public’s interest from being served.

We are barely four years into the development and implementation of SIBs with the first results not expected from the original Petersborough recidivism prevention project until 2015. We are
still developing proof of concept and it may be some time before we can have confidence in the internal validity of initial project data, let alone derive external validity we can form broader policy around. The rapid escalation of policy interest and cross sector investments in these four years may be a symptom of the economic decline and partisan stalemate that currently exists in the United States. Necessity is the mother of invention after all. It may also be derivative of the trend in Western governments in particular to take cross sector approaches and apply more market based tools to evaluate governmental impact.

The danger of looking solely to innovative new approaches like SIBS, is if we neglect the efficiencies and improvements we can make to the existing financing mechanisms. Advocating for robust funding of public education and social services is still needed. Others in academia and the media have pointed out others concerns about SIBs. An over reliance or blind faith in the motives of private sector investors is a risk this concept allows. How far do we want to go do you take a public private partnership before public services are privatized to the point where they lose sight of the original public interest? That question is a vital one and it should be a touchstone for policy makers as they determine how best to scale up SIBs.

If we continually work in the margins, we may leave the core funding mechanisms increasingly vulnerable. SIBS cannot replace traditional taxes and levies that fund our school systems; they can only help to improve them. If we neglect the responsibility to adequately fund public education, SIBs or social impact spending in general will only distract us from a rapidly increasingly tide of social and educational inequality. If the private investors like investment banks are driven by returns and if policy makers see SIBs as an excuse to cut primary funding for
their current obligations for education or social services, then we have lost sight of our policy objective: better educational outcomes for children and families means better long term economic outcomes for adults and for communities as a whole.

Ultimately one of the greatest benefits of SIBs is that it gives government the freedom to be innovative. In the private sector, innovation has great risks and great rewards but the actors understand that is part of market structure of creative destruction. In government, policy makers and policy actors cannot afford to take great risks required for innovation, which means inefficiencies persist and output is often valued more than outcomes. SIBs guard against the risk using a cross sector approach and can push progressive social policy that is outcome driven while appealing to the bottom line drive approach of the more market-based point of view. It eases the tension we explain throughout this paper and forms common ground for opposing points of view to work together.

Perhaps the most encouraging thing about social impact bonds is that they have the potential to spur policy makers back into their intended roles as collaborative problem solvers by appealing to values held by progressives and conservatives alike.
Works Cited


