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Private finance for public goods: social impact bonds

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Social impact bonds (SIBs) attract private investment to social programs by paying a market rate of return if predefined outcome targets are met. SIBs monetize benefits of social interventions and tie pay to performance, limiting governmental control once the contract is designed. Despite policy enthusiasm across the globe, SIBs have failed to attract private market investors without substantial additional guarantees. SIBs raise questions about government's ability to ensure broader public values. Using literature on contracting, performance management, and public private partnerships, this exploratory analysis focuses on institutional design, transaction costs, and performance measurement, outlining the opportunities and concerns SIBs present.

Keywords: Social impact bonds; private investment; social services; performance measurement; public private partnerships

JEL Classifications: H53, L33, L31, H72

Introduction

This paper explores the dynamics of an emerging innovation, the social impact bonds (SIBs) currently being piloted in the USA and the UK. SIBs attract private financial investment into highly contentious and complicated areas of social policy, such as offender rehabilitation, youth disorder, childcare, and homelessness. This paper looks at three emerging SIB schemes to assess some of the challenges in institutional design. The cases explored are: Peterborough, UK (prisoner re-entry), New York City (youth offender rehabilitation), and Alexandria, VA (early childhood education).

SIBs are, in essence, a form of outcomes-based contract between public or nonprofit service providers and private investors, in which private financiers provide upfront funding for interventions to improve specific targeted social outcomes. SIBs operate over a fixed period of time but do not guarantee a fixed rate of return. Rather, investors can expect to receive a return on their investment, based on the savings government makes once service providers meet predetermined outcome targets. Thus, in theory, government is able to reduce the costs to the taxpayer by transferring the financial risk of performance to the private sector.

The rationale behind SIBs is akin to the payment-by-results schemes associated with target-based performance management that became so popular under the Blair government in the UK during the 2000s. Linking contracts to specific outcomes encourages goal clarity and gives organizational leaders the leverage required to focus on key areas of activity. However, the financialization of social services raises questions

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regarding creaming of the population most likely to benefit, transaction costs of program design, budget liability and risk, and potential stifling of further program innovation in order to ensure continued private returns. This paper presents an exploratory analysis of this new innovation in social service finance and outlines areas for future research. The paper proceeds as follows. First, I present the basic structure of a SIB. Next, I introduce some theoretical perspectives for studying SIBs borrowing from experience with contracting, performance measurement, and public private partnerships (PPP). I then follow with a comparative case analysis of three newly designed SIBs in the USA and the UK. I conclude with an agenda for future research.

What is a SIB?

SIBs represent a new innovation in social program finance. Although not a bond in any real sense, the idea behind a SIB is that private investors can be attracted to invest in social service interventions that have a positive payoff. Government programs, particularly those targeted at the poor and underserved, often underinvest in prevention and instead pay for remediation once the social problem becomes clear. This is typically the case in homelessness, juvenile delinquency, prisoner re-entry, and early childhood education. These societal groups typically lack voice and visibility in the broader political system to attract preventive investments.

SIBs are very new. In September 2010, the UK partnered with Social Finance Ltd to design the first SIB (Disley et al. 2011). The program is designed to reduce recidivism in the Peterborough prison. Since that time, the idea of social impact investing has travelled quickly across the ocean to the USA, Canada, and Australia (Von Glahn and Whistler 2011). In the USA the Obama administration has set aside funds for social impact financing experiments at the national level (White House 2011), and Governor Duval of Massachusetts passed a law promoting SIBs in that state (Greenblatt 2011). In summer 2012, the city of New York launched a SIB for youth offender rehabilitation (Chen 2012). Also, in 2012, the Working Group on Early Childhood Finance Innovation published a design for a SIB in preschool education (Dugger and Litan 2012), which Alexandria, VA, is planning to implement. SIBs have not taken off in practice the way they have in discourse, and I could only find two cases that had actually been implemented in 2012 when research for this paper was conducted.¹

SIBs integrate philanthropy, venture capitalism, performance management, and social program finance into an innovative new mix. Because SIBs are becoming a popular new innovation, it is important they be reviewed. The social service sector has long been plagued with frustration that successful outcomes are hard to achieve, and often government programs fund remediation rather than prevention. As a former vice mayor of NYC describes it, SIBs can create a kind of Schumpeterian disruption of traditional ways of doing business and provide the financial and political capital for risk taking. This can promote change and innovation by funding programs that pay for success. In fact, another common name for SIBs is Pay for Success Bonds.

How do SIBs work? First, you need an intervention that has been tested and proven to provide a certain rate of success. It could be a prisoner re-entry program that reduces recidivism by a certain amount or a preschool program that reduces special education placements by ensuring more children are ready to enter kindergarten. The key is that

these successes must be carefully measured and monetized so that they can be used to structure the private investment.

Next, you need willing partners: government, investors, program implementers, and evaluators. Most program designs involve an intermediary that coordinates the investors, the program deliverers, and the evaluators. While government sets the terms of the arrangement, it ultimately cedes most control to the intermediary. This makes process design especially important and difficult. SIBs also require willing investors. To date, investors have come primarily from the nonprofit and foundation sectors – patient capital with a willingness to bear high risk and an interest in creating social returns. Finally, evaluators are required, as improvements in outcomes need to be carefully monitored in order to accurately calculate the return that will be paid (or not) to investors. A schematic of how most SIBs are structured is provided in Figure 1.

SIBs involve a complex set of partners, agreements, and guarantees to ensure the program is carried out using the agreed upon intervention, evaluations are undertaken with a high degree of scientific accuracy (typically involving intervention and control groups), and payments are appropriately structured to ensure intervention targets are met and private financial risk is adequately priced and compensated (rate of return). Liebman (2011) argues that SIBs only work for projects with the following features: (1) high net benefits and short-term payout, (2) excellent performance measures (you cannot support what you cannot measure), (3) clearly defined treatment population to avoid cream skimming and encourage integrated programs that meet multiple needs, and (4) credible impact assessment – randomized, quasi-experimental, before/after studies with a neutral authority to measure outcomes and resolve disputes between financiers and government.

Theoretical perspectives for analysing SIBs

SIBs represent an extreme expansion of new public management precepts into social program delivery. They draw from three elements in the New Public Management repertoire: contracting, performance measurement, and PPPs. SIB’s primary reliance on

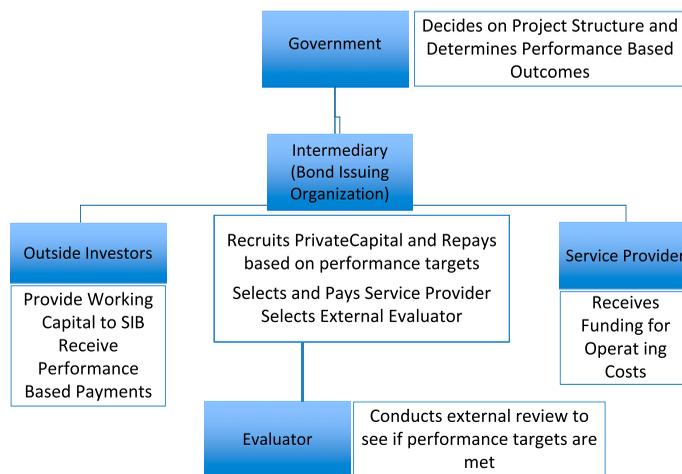


Figure 1. Organizational structure of a SIB.

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the contract and performance management scheme to cover all aspects of governmental interest in the project reflects a simplistic view of contracting and performance management that public administration scholars have long since challenged. Although SIBs avoid some of the common problems with PPPs, this has resulted in limited ability to attract private for profit investors.

Contracting

The literature on contracting has moved beyond simple conceptions of the benefits to be gained from outsourcing public services to private markets, to a more sophisticated understanding of problems with contract design and high transaction costs (Williamson 1999; Van Slyke 2007; Hefetz and Warner 2012), monitoring (Johnston and Girth 2012), lack of competition (Girth et al. 2012), and the need for ongoing market regulation (Dijkgraaf and Gradus 2007; Albalade et al. 2012). SIBs reflect a continued reliance on the contract to capture all important elements of program design. Competition is replaced by a rigid evaluation, and monitoring is ceded to the external evaluator. These evaluation and payout schemes substitute for broader public debate. Regulation is critically important as SIBs are developed for fragile clients with limited rights (children, prisoners). But, SIB discussions are silent on regulatory challenges, assuming the market will provide the necessary discipline.

Transactions costs of SIB contract design are high as they now involve not only the identification of the intervention, provider, and evaluation process, but also the recruitment of private financiers and the structuring of investment repayment schemes, which can be quite complex. Experience with basic local services contracting has shown lack of cost savings (Bel, Fageda, and Warner 2010), lower rates of consumer satisfaction (Clifton and Diaz-Fuentes 2010), and erosion in service quality, which has led to high rates of contract reversals (Hefetz and Warner 2004, 2007; Warner and Hefetz 2012). However, architects of SIBs show a naïve faith in the process of contract design, external evaluation, and private profit incentive to ensure contract compliance (Liebman 2011; Von Glahn and Whistler 2011).

SIBs attempt to create an arms-length process by ceding most control to the intermediary (Kohli 2010). This stands in contrast to the increased attention public administration scholars are giving to transaction costs of incomplete contracts and the importance of accountability in network governance arrangements (Sclar 2000; Johnston and Rozmek 2008). Milward and Provan (2000) argue the need for a strong principal actor in social service networks to ensure coordination and that service quality goals are met. While the SIB schemes cede considerable power to the financial stakeholders and often give the intermediary institution the power of the coordinating node, the SIB payment schemes also set up a harder sanction, as payment is tied to performance targets and linked to a rigorous external evaluation process. This may address Salamon's (2002) concern about weak sanctions under a facilitated network governance approach, but not the accountability concerns. SIBs harken back to a rigid concept of contracting that trusts evaluation and profit mechanisms to ensure contract compliance while the contracting literature has found those mechanisms to be inadequate and shifted its attention to studies of relational contracting and networked governance.

Performance management

Reliance on performance management reflects the trajectory of new public management reforms in public administration that emphasizes payment for outcomes rather than

inputs (Hood 1991; Osborne and Gaebler 1992). Performance management is found in payment and budget schemes in many sectors, but has been gaining increased interest in social service sectors, especially education (Heinrich and Choi 2007). One of the challenges is that performance management systems do not always achieve the multiplicity of objectives to which government programs aspire. Problems with goal alignment in such schemes have been raised at both the theoretical level (Lowery 1998) and empirically in voucher-based systems related to job training services (Hipp and Warner 2008) and childcare (Warner and Gradus 2011). Reliance on performance measurement is the key to the SIB process as this is how the rate of return is determined in project design and payment is triggered only when performance targets are met. This reflects a faith in the ability of performance management to adequately align the multiplicity of public value outcomes in the process of service delivery.

Because of the need to quantify and monetize returns for the financial investors, SIB schemes rely on traditional positivistic evaluation designs that maintain a control group and an experimental group – preferably with randomized assignment. While positivistic designs work well in some scientific applications, the evaluation field itself has moved on from positivistic approaches, to ones that incorporate all actors in a collective reflection process that motivates articulation of a theory of change – and change in that theory based on experience – not rigorous adherence to an experimental/control research design (Greene 1994; Weiss 1999; Benjamin and Greene 2009). There is a vibrant academic debate between positivists, who believe what is important can be known and measured objectively, and critical theorists who argue that perception and context matter, and thus more collaborative and constructivist forms of research should take place (Guba and Lincoln 1994). While leading evaluation theorists have moved in the critical theory direction focused on developmental evaluation as a means to understand the dynamics of innovation, especially of social programs (Patton 2011), positivistic approaches have gained power through performance measurement-based policies (such as No Child Left Behind) that require rigid measures of outcomes and leave little room for critique and concepts that fall outside the model (Lincoln, Lynham, and Guba 2011). SIBs codify the performance measurement approach and link financial return to rigid metrics. While SIBs are based on interventions that challenge traditional approaches, the concern with the SIB evaluation schema is that it may privilege interventions that have proven metrics at the expense of experimenting with more interactive program designs and this could stifle further innovation, beyond those measures which determine payout. Such rigid adherence to program evaluation models also creates incentives for creaming and for ignoring downstream effects or impacts on related interventions, a concern that SIB designers recognize (Costa 2012).

Public private partnerships

SIBs may be understood as a variant of the private sector investment in physical infrastructure projects through PPPs that is becoming more common across the world (Hodge and Greeve 2005). PPPs are designed to enhance private sector investment, speed project development, and promote user fees (tolls) to finance investment as a means to relieve public sector budgets (Geddes 2011). Critics of PPPs have argued that the long time frames (25–75 years) are inappropriate to the life of the infrastructure and that risk is more often transferred from the private to the public sector (Dannin 2010). Noncompete clauses, confidentiality agreements, and guaranteed market share or user payments are advocated by PPP proponents as essential to attract private investors

(Istrate and Puentes 2011). But, these elements are contrary to the logic of market-based risk and competition. PPPs, in effect, undermine the market competition basis on which efficiency claims are made. Further concerns have been raised about the lack of adequate public oversight or planning in PPPs (Sclar 2009) and the inadequate understanding on the part of public partners regarding the true transaction costs up front, and the financial securitization that can occur after the project is initiated (Bel and Foote 2009; Whittington 2012). This onward sale of income streams has led to serious under-pricing of public assets and increased risk to public service provision (Siemiatycki 2010; Ashton, Doussard, and Weber 2012; Siemiatycki and Farooqi 2012).

SIBs represent a very different variant to the physical infrastructure PPP. Like PPPs, they articulate clear metrics for return, based on specific contract and process designs. Unlike PPPs, SIBs are *not* characterized by long-term contracts, noncompete clauses, confidentiality agreements, or guaranteed market share. SIBs pay only for outcomes achieved and these outcomes are measured by rigorous evaluation methods. As such, SIBs may provide a better model than PPPs to transfer performance risk to the private investor. However, these very market features have made SIBs unattractive to private investors without substantial guarantees. Thus, while PPP investors require guarantees in usage rates, market share, and toll increases, private investors in SIBs (to date) have required substantial loan guarantees or subordinated debt.

One goal of SIBs is to motivate private investment in prevention-focused social programs that have been unable to attract public will for investment. Given the high levels of returns found in prevention-focused social programs, such as job training, prisoner re-entry, and early childhood education, private, socially oriented financiers have been looking for ways to make investments which will yield a high level of both social and private return (Liebman 2011). The challenge has been how to link positive social returns that accrue to individual client success, to a mechanism that could compensate private investors. Earlier efforts focused on securitizing payback from the recipient, but this bore too closely to indentured servitude models to hold any political salience in the twenty-first century (Warner 2009). SIBs derive their financial return for private investors from potential reductions in future public program budgets due to lower rates of recidivism (for prisoners) and special education (for young children) as a result of increased investment in preventive programs. SIBs, thus, represent a potential expansion in social service funding, if private investors can be attracted without substantial additional cost to government or nonprofit investors.

As with PPPs, the discourse on SIBs is proliferating across the globe and some actors, such as Social Finance, are active on both sides of the Atlantic. However, unlike the case with PPPs, thus far SIB designers have not addressed the concerns internationalization might create for managing the contracts. Internationalization and liberalization have created challenges for managing public service monopolies and contractors (Gerbasí and Warner 2007; Clifton, Comin, and Diaz-Fuentes 2011). Recent scholarly research has led to more thoughtful analysis of the welfare propositions that should govern contracting (Del Bo and Florio 2012; Florio 2013), but SIB's primary welfare consideration is attracting investment to a successful model program. Unlike PPPs where user fees figure prominently, SIBs give no voice to the consumer (children and prisoners do not pay user fees). In SIBs, primary voice is given to the external evaluator and the private investor in a process shielded from direct citizen input. Like SIBs, PPP schemes also typically have highly technical designs negotiated in private (Dannin 2010). Under SIBs, the lack of consumer (client) voice puts great pressure on

institutional designers to make sure they get the market and client protection mechanisms right.

Institutionalist approaches to the study of public policy (Hall and Taylor 1996) recognize the social, economic, and political context in which policies (and political ideas) emerge. SIBs are the intellectual descendants of new public management's emphasis on markets and performance management. One of the goals of SIBs is to introduce the rigors of private sector investors, the standards of positivistic scientific evaluation, and the discipline of market mechanisms to determine payment and the allocation of risk. Increasingly, scholars are raising concerns about the financialization of public services and how this process alters the balance between social and financial objectives elevating the latter at the expense of the former and undermining the universal service ideal (O'Neill 2010; Dahl and Soss 2012; Siemiatycki and Farooqi 2012). The PPP literature regarding long-term infrastructure projects is replete with examples and cautions regarding this shift in stakeholder power and the privileging of financial considerations over a broader array of public concerns (Hodge and Greeve 2005; Sclar 2009; Ashton, Doussard, and Weber 2012). Will similar concerns arise with SIBs?

This paper explores the institutional design of SIBs, their use of contracting and performance management, and the implications for transactions costs, risk transfer, and the ability of government designers to exercise ongoing control to ensure broader public objectives are met. Institutional design is the key. Regulatory protection for clients and goal alignment among all the actors in these networked systems (government, financier, provider, intermediary, and evaluator) are critical to ensure the SIB achieves outcomes of core interest, prevents creaming client population or gaming of data, and promotes ongoing innovation. In the analysis below, I look at actors, innovative process, finance mechanism, and outcome measurement to discuss the institutional design challenges SIB architects are facing in the SIB schemes launched to date.

Methodology

Despite the widening policy interest in SIBs, I could only find two examples of SIBs that are actually in operation; most are still under development. Little has been written on actual program impacts because SIB projects are still under design and development. Given the limited amount of program documentation to date, my research strategy involved reading a number of documents and proposals on the websites of many of the social investment promoters in the USA and UK. Written information on SIBs typically does not become publicly available until after all the details have been worked out. To get a sense of the issues and challenges that are addressed in the design process, I supplemented my reading with interviews with some of the architects of SIBs from the Center for American Progress (a leader in developing the USA case for SIBs), the Alexandria, preschool intervention, and the NYC youth offender rehabilitation intervention. These included policy architects, private investors, and government leaders. In this analysis, I present a comparative, exploratory cross-case analysis of two cases currently being implemented in the prisoner re-entry field and one case under development in the early childhood education field. These cases span the UK (where the SIB innovation began) and the USA where the innovation is gaining policy interest.

In the analysis that follows, I describe the actors involved and then focus on the financial payment scheme based on performance measurement of outcomes from an innovative process. I contrast the SIB approach to approaches more typically found in contracting and PPPs to illustrate some of the key similarities and differences. A brief

analysis of actors, innovative model, and outcome payment schemes is provided for each of the cases below. See Table 1.

Analysis

Actors

The mix of actors involved in SIBs raises the complexity beyond simple contracting to a network of actors connected by a series of contracts and performance payment schemes. SIBs expand the range of actors beyond government, service providers, and clients to also include private financiers and external evaluators networked by an intermediary. Private investors include foundations (through their program-related investment units), private venture capitalists and investment firms.

The complexity of SIB design requires an intermediary for ongoing management after the contract is let. Each case analyzed here is managed by a nongovernmental intermediary. Two are primarily financial intermediaries, Social Finance in the UK case and Capital Partnership in Alexandria, VA. The third, MDRC, in the NYC case, is a policy think tank. Governmental oversight is provided by Ministry of Justice in the UK case, NYC Department of Corrections and the Mayor's Office in the NYC case, and the Alexandria City School District in the Alexandria case. This reflects the national, city, and school district scale of the three different SIB cases.

Service providers are specially selected nonprofits in the Peterborough and NYC case, but the Alexandria case allows clients to choose the provider from a market mix of providers. While government exerts strict control over prisoners, it shows respect for parental choice in the early education market. The cases provide a comparison between an oligopolistic contract with one provider (the NYC and UK cases) and the wider market-based provider design in the Alexandria case. The Alexandria model also helps address the consumer voice concerns raised above by giving parents some choice of provider.

Despite all the attention given to attracting private financial investors, SIBs to date are primarily a form of venture capital philanthropy. Judith Rodin of the Rockefeller Foundation argues "innovative finance is the next big step in solving social problems" and SIBs create a "win-win-win" for government, investors, and service recipients (Rodin 2013). Although British investors Sir Ronald Cohen and David Blood are credited with bringing SIBs to market and founding Social Finance, which is now promoting SIBs in both the UK and the USA, most of the SIBs today rely on philanthropic investment or social investors (Greenblatt 2011). The inability of SIBs to attract significant private venture capital may be due to the stringent performance payback schemes and the significant risk transfer to the private investor. Only in the NYC case is a private for profit investor, Goldman Sachs, involved. But, they required a guarantee of \$7.2 million for their \$9.6 million investment in order to participate. This guarantee was made by Bloomberg Philanthropies, the foundation supported by NYC Mayor Bloomberg. Goldman Sachs stands to gain a 20% return on investment if model program results are achieved. Even with a proven model and high promise of returns, the private investor requires a large guarantee. While significant power is transferred to the private investor, SIBs so far have not been able to deliver on their promise of attracting private capital.² Thus, while SIBs claim to only "pay for success," the only private investor attracted to date, Goldman Sachs, requires a substantial guarantee in the form of a loan guarantee or subordinated debt. Thus, SIBs are not that much different from PPPs in

Table 1. SIB cases.

	Actors	Innovative model	Outcome payment
Peterborough, UK In process	Social Finance (intermediary), Social Impact Partnership of LP, Ministry of Justice, Big Lottery (will make the pay back), Peterborough Policy LTD, St Giles trust (to deliver services), Independent Assessor	Innovative Model – St Giles “through the gate” service intervention. Pro Bono Economics (2010) analyzed and found a 40% reduction in reoffending. Investment – £5 million pounds. Focus on short sentence offenders (under 1 year)	Outcome payment – if reduce reoffending by 10% then investor gets an IRR of 7.5–13%. First outcome payment is 3–4 years after initial investment. Expect 1000 offenders in 2 years – large enough to see if a 10% reduction in reconviction is achieved. Societal Outcome – New goal in the UK is to reduce recidivism – that was not the goal before
Rikers Island, NYC In process	City of New York Mayor’s Office, NYC Department of Corrections, MDRC (intermediary), Osborne Association and Friends of Island Academy (service providers), Bloomberg Philanthropies (\$7.2 million loan guarantee to MDRC), Goldman Sachs (private investor). Vera Institute of Justice (evaluator)	Adolescent Behavioral Learning Experience – cognitive behavioral therapy to reduce recidivism in Rikers Island Investment – \$9.6 million	Outcome payment – if recidivism (currently at almost 50%) drops by 10%, Goldman will be repaid the full investment, if is drops more, it could make up to \$2.1 million in profit. If recidivism does not drop by at least 10%, then Goldman would lose as much as \$2.4 million. Bloomberg Philanthropies is providing a \$7.2 million loan guarantee to MDRC so they can pay back Goldman Sachs. But if the program meets its targets, the NYC Department of Corrections will pay Goldman Sachs and MDRC will be free to reinvest these funds in other SIBs. Societal Outcome – reduced recidivism, more funds to experiment with innovations
Alexandria, VA Under development	Alexandria City School District, Capital Partnership (intermediary), Virginia Early Childhood Foundation, private investors, early education providers (public, non profit and private), business and philanthropic leaders (to promote the program), parents (who get to choose Pre School provider)	Preschool studies have shown significant impact in better school performance and life outcomes but still many children begin kindergarten unprepared. Use privately financed bonds to fund scholarships for preschool Investment – \$800,000	Outcome Payment – Increase enrolment in Preschool to reduce later special education placements (100 children in first year – 50 3-year olds, 40 4-year olds, 50 children per year thereafter). About \$800,000 in SIBs issued. Payback is based on a reduction from 18 to 7% in special education placements. Societal Outcome – increased preschool attendance, reduced special education placement, broader societal (private sector) investment in early childhood education

the guarantee they have to provide to attract private investors; the only difference is the form that guarantee takes (rather than guaranteed market share, or toll increases, it is a loan loss guarantee from a foundation).

Innovative model and outcome payments

SIBs are justified because they promote process innovations that are not widely accepted in current social programs. The process innovations in each of the three example cases are based on solid research that found clear cost savings that could be monetized into performance payback structures. In Peterborough, the innovative model is St Giles “through the gates” service intervention, which has been found to offer a 40% reduction in reoffending (Pro Bono Economics 2010). In Rikers Island the innovative model is the Adolescent Behavioral Learning Experience, a cognitive behavioral therapy proven to reduce recidivism. The Alexandria case is based on the Philadelphia experience of the impact of preschool on kindergarten performance and subsequent reductions in special education placements (Dugger and Litan 2012).

The structure of the outcome payments in the three examples specifies the rate of return based on different levels of outcome. In Peterborough, if the intervention reduces reoffending by 10%, then the investor gets an IRR of 7.5–13%. This first outcome payment will be made 3–4 years after the initial investment. The designers expect 1000 offenders in two years, a large enough cohort to see if a 10% reduction in reconviction is achieved. In Rikers Island, if recidivism (currently at almost 50%) drops by 10%, Goldman Sachs will be repaid the full investment; if it drops more, it could make up to \$2.1 million in profit. In Alexandria, payback is based on a reduction from 18 to 7% in special education placements. In each case, government makes the payback from savings to the government program budget. In Peterborough, Big Lottery will make the payback. In Rikers Island, the NYC Department of Corrections will pay Goldman Sachs. In Alexandria, the school board will pay back private investors from savings in the school budget. In each case, funds come from the general government budget, so, if other conditions or unanticipated downstream impacts cause overall prison or school costs to increase, government would still be required to make the payback as long as performance targets in the intervention are reached.

Each of these interventions were selected because it has delivered proven results. In fact, that is one requirement of SIBs – that the intervention be well documented so that the outcome payments can be calculated. The careful documentation and detail used to set up the investment requirements, program costs, and outcome payments schemes is well illustrated in Dugger and Litan (2012) which provides the basis for the Alexandria, preschool intervention. The Alexandria project has engaged Nobel laureate James Heckman at the University of Chicago and others in the Soros-funded Human Capital and Economic Opportunity Global Working Group to oversee evaluation design.

Comparison to contracting and PPPs

While SIBs combine elements of contracting, performance management, and PPPs, they differ from these earlier models in several important respects. First, performance management is reified as the sole criteria for payment. Second, implementation risk is transferred to the private partner. Third, time frames are purposely kept short.

SIBs give the New Public Management trajectory a more explicit market turn, with payment, not for services delivered, but only for outcomes. This raises the stakes for

external providers beyond the renegotiation of contracts in the next contract cycle, to concern over whether they will be paid at all for services rendered if they fail to meet agreed upon outcomes. Unlike contracts where providers are paid for services delivered (outputs), or PPPs where private investors require all sorts of protection from risk (noncompete clauses, guaranteed payment streams), SIBs only pay for services if performance targets (outcomes) are met. Each of these outcome payment schemes rely on careful analysis based on model program data. SIB investors are willing to take on implementation risks, but not model risks. This is why only proven intervention models receive investment. This raises questions about the ability of SIBs to promote further process innovation.

SIBs require a more complex organizational structure than standard contracting and typically an intermediary institution is selected to coordinate with government, organize private financiers, contract with the nonprofit provider, and select and oversee the external evaluator. Faith in performance measurement is so strong that SIB advocates at the Center for American Progress assert that a hands-off approach to management is one of the advantages to government of the SIB. “First it [government] does not need to decide which approaches to back. Instead, it decides only on what outcomes to target. It is for Social Finance [the intermediary in the Peterborough case] to work out the most effective approach to reduce reoffending. Social Finance and investors in the bond bear essentially all the risk” (Kohli 2010, 2).

However, my interviews with government program architects show more interest in government maintaining some control and less faith in ceding control to the outcome measurement and financial return process managed by the intermediary. In the NYC case, MRDC will be the manager/evaluator, but the city has retained more control over provider selection and evaluation. The city did this because it recognized that youth offenders are a group with weak voice and the city could not devolve its oversight role to an external actor.

As one private investor noted, most SIBs involve a high-risk investment with a low to middling rate of return. To secure financing, the integrity of the cost benefit analysis is key. But it is not the only criteria of interest to government planners. Time frame for analysis, protection of clients from undue risk, the ability to continue to innovate, and not get locked into a particular reform for a long evaluation time (to ensure private sector payout) are also important. For example, in the NYC case, the mayor’s office has other reforms going on simultaneously and does not want these stifled and held in place during the evaluation period. Balancing the need for rigorous evaluation and testing (to determine payment targets) must be weighed against the responsibility to improve services, especially for the most at risk groups. Government designers, in contrast to SIB advocates, expressed concern about the reified focus on the outcome evaluation and performance target as the sole mechanism of control. They recognized their exposure to risk was much broader, but felt politically compelled to try it to raise political interest in future investment in an innovative model. As one NYC city leader said, “If we had the ability to invest in new programs within the city budget, then why would we do this?”

In PPPs, the private financiers typically have more knowledge about finance, risk, and onward sale than the public partners. This leads public partners to under-price assets and end up holding more risk than anticipated (Ashton, Doussard, and Weber 2012). The risks are less likely under SIBs because the payout structure (no payout unless performance targets are reached) discourages investors who lack a social mission, and the commonality of social mission may help to ameliorate concerns arising

from power differentials and goal alignment problems. To ensure government budgets will actually achieve a savings if outcomes are met, most deals have been structured based on lower success than what model programs would indicate. For example, in the preschool case, the model program data suggest special education placements would be reduced from 18 to 2.5% of children but the payback is based on a reduction from 18 to 7%. So, if the program achieves model program results, then the savings from 4.5% of children not placed in special education will be a savings that accrues to the school district that can be invested in other programs.

SIB design is built on the notion of actual risk transfer to the private financier. This has limited private financial interest in SIBs to date. As one interviewee noted, due to the risk premium payment structure, SIBs are not attractive to most private sector investors, such as “the cowboy capitalists” found in some other PPP schemes. However, he argued that while government may consider a 40% success rate too low, for a private venture capitalist a 40% success rate is high (Dugger 2012). The introduction of private finance policy logic into the evaluation of social impact could broaden public policy willingness to take risks, as SIBs are a mechanism to take innovations to scale and may encourage “crowd in” from private investors. Other interviewees argued SIB’s role lies primarily in showcasing that model programs can offer wider success, and thus create the evidence base for a broader shift in public funding.³ Interviewees described SIBs as a tool to “create room for investment and innovation when the tax base will not permit it,” and as a “tool to move the field and create the evidence base for new interventions.”

Over time as the SIB experiment matures, designers will need to be careful as financial experts attempt to structure secondary markets to bundle SIBs and sell future contracts. Already efforts are underway to encourage state governments to make SIBs tax-exempt in order to increase private financial interest (Dugger and Litan 2012). Although SIBs represent a new financial innovation – they differ from other innovations (securitization, debt default swaps) that have been created in the last 20 years and led to high complexity, limited understanding, and great risk (leading to the Great Recession) (The Economist 2012). The key to the SIB innovation is that both government and private financiers, through the intermediary, are closely linked to the funding target and this local knowledge, generated from the evaluation, helps ensure goal alignment and appropriate pricing and controls on the contract. In fact, one city leader commented that SIBs bring a level of precision to budget analysis as payments are linked to clear milestones.

Innovation and knowledge generation regarding what works are two of the goals of SIBs. But, who owns this knowledge and for how long is the intervention held static? If a new intervention has positive impact, will its diffusion be slowed so that the rigorous evaluation of the intervention vs. the control group can proceed and so that the private investor can continue to reap maximum returns from the differential outcomes? While SIBs promote innovation in the short term, there is the risk that they could stifle diffusion in the medium term. Diffusion can be slowed by the need to maintain a control group to compare to the treatment group in the out years. This is one reason why all three examples keep both the intervention and the ongoing evaluation time period short. The intervention in each case is less than a year and the follow on evaluation occurs over several more years to make sure the positive impacts of the intervention hold. None of these experiments extend beyond 5–10 years. As one city leader said “in core critical government services you have a responsibility to do it in a way that doesn’t bind you for a long time.” This stands in stark contrast to the 20–50-year time spans of many PPP contracts.

Conclusion

This paper has presented a preliminary analysis of SIBs drawing upon comparisons to contracting, performance measurement, and PPPs. Emergence of SIBs is a product of New Public Management style reforms that argue only results matter, and that market processes are superior to government processes in designing, implementing, and financing social programs. What is clear from this analysis is the governance processes in design and implementation are critical. SIBs are very complex. Goal alignment, network management, evaluation design to ensure core outcomes are measured, and risk management for investors, government, and clients are challenges that raise the transactions costs of SIB schemes. SIBs are being promoted for two primary reasons: to bring rigor to social service interventions and to attract private finance to areas where public investment is lacking. While such evaluation rigor is critical for structuring the private investment scheme, it may undermine developmental evaluation approaches which encourage critical reflection and ongoing program innovation. Experience to date shows private investors do not appear willing to invest in proven programs, even with high returns, unless their risk is guaranteed by a subordinated investor. Thus, the core rationales behind the SIB movement may not hold up.

As SIBs continue to gain political interest around the globe, future research should give more attention to the institutional design challenges of SIBs. SIB contracts are complex and the time and transactions costs to develop them are high. At the operational level, some SIB schemes, such as Peterborough, cede control over grantee selection and evaluation of outcomes to private investors. This second order, devolved contracting may weaken government control over services and create opportunities for collusion. Results-based funding also may promote creaming of client population and narrow conceptions of program design – crowding out effects toward those elements that lend themselves to measurable outcome evaluation. A further concern is that benefits achieved in one social arena may be transferred as costs to another arena – outside the scope of the SIB evaluation-based repayment scheme.

SIBs require a sociological institutionalist approach that interrogates the evolving rules and standards governing the process of decision-making by key actors. How might the institutions and policies evolving around SIBs shift the norms and practices of social service delivery and finance? What implications does ceding control to private investors have on the willingness to address the underlying structural causes of the problem (e.g. poverty)? What motivational effects will SIBs have on the ethics of service delivery professionals? Will it involve a shift from broader attention to the whole person or broader educational impact, to just those elements remunerated in the SIB scheme?

Rosenman (2013), a critic of SIBs, sums up these concerns regarding failure to address structural causes, complexity of SIB design, cost, and conflict of interest.

If you are perpetuating a model, that is dysfunctional at its core, I don't believe it is better than nothing, although it's a great way for a new industry to make money. These SIBs will create an industry of intermediaries and deal makers and brokers and accountants and lawyers and they'll be making a lot of money, I am sure taking this money off the top before it ever makes it to underpaid nonprofit workers or the beneficiaries of the program. (Rosenman 2013)

Future research also should track accountability. SIBs to date have been explicit and relatively open about the structure of payments after the deals are finalized. But, what

will happen as the projects proceed outside the limelight? Antecedent experience in the PPP world shows private financial actors typically request confidentiality, freedom from public political approval, and protection from competition (Dannin 2010). SIBs do not involve competition at the outset, and the intermediary structure may shield government from full knowledge, creating opportunities for collusion between investors, providers, and intermediaries. Concerns for creaming client populations and gaining of data may require more than an outside evaluator to ensure they do not occur. The intermediary and private investors have strong incentives for positive evaluation results as their payout is at risk.

Finally, future research should explore the fundamental public values at stake in the SIB innovation. Will SIBs contribute to greater investment in prevention programs that work, and thus contribute to social well-being? Or will SIB's financialize basic investments in human development and encourage the further encroachment of the market on the state? Will SIBs enhance the ability of cities and states to address pressing social problems, or further constrain possible solutions to only those that generate high returns – measureable in a performance management framework?

Notes

1. In July 2013, the United Way of Salt Lake City, Utah, announced a SIB to expand access to high-quality early education for 3- and 4-year-olds. This will be the first SIB for preschool in the USA (Stewart 2013).
2. The recently announced SIB in Salt Lake City also has attracted private investor Goldman Sachs (up to \$4.6 million), but Goldman Sachs required a guarantee (\$2.4 million provided by the Pritzker Family Foundation). The nonprofit United Way is the intermediary who ultimately bears the risk (Stewart 2013).
3. Indeed, the Salt Lake preschool SIB, announced in July 2013, was developed after a legislative attempt to raise funding for preschool in Utah failed in spring 2013 (Stewart 2013).

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