



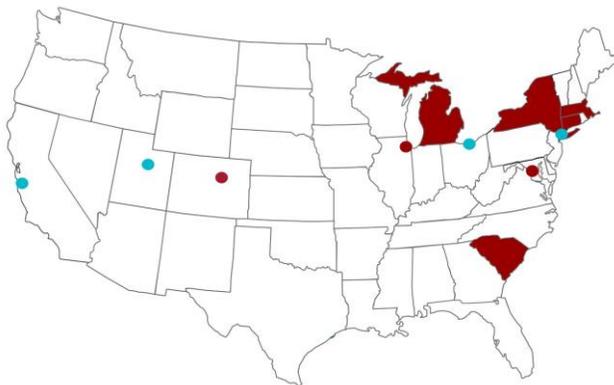
# Social Impact Bonds 101

## I. Introduction

As of February 2017, 15 Pay for Success (PFS) contracts using social impact bonds (SIBs) have been launched in the U.S. In combination, these projects are scheduled to deliver approximately \$130 million in services and serve more than 20,000 individuals. These projects tackle issues in homelessness, criminal recidivism, early childhood education, maternal and infant health, child welfare system reform, and substance abuse treatment.

This policy brief discusses the reasons that governments around the country are testing the Pay for Success approach. It also explains the PFS model, describes PFS projects in the US to date, and presents some of the lessons that have been learned from the initial U.S. PFS projects.

**Launched PFS Projects in the US as of February 2017**



- : City or county government
- : GPL-assisted project
- : Non-GPL-assisted project

## II. The need for a new approach

Each year, governments spend hundreds of billions of dollars addressing social problems. In most cases, we have no idea how effective this spending is. Performance is rarely assessed, and measurement tends to focus on tracking the quantity of services provided rather than the impact of those services on the lives of the individuals served. Once a social program gets in a government’s budget, it becomes nearly immortal. It develops a constituency and then receives funding year after year, usually without any serious attempt to determine how effective the program is.

At the same time, tight budgets cause us to underinvest in prevention even when we know that the underinvestment will lead to greater expenditures on remediation down the road. Tight budgets can also stifle innovation – how can we come up with the resources to test promising new ideas when we can’t even afford to pay for everything that we are already doing?

More fundamentally, business-as-usual methods of contracting for social services are hindering our ability to make progress in addressing complex social problems. Responsibility for solving serious social challenges is often split among government agencies, service providers, and other community stakeholders, but government agencies and providers are unable to sustain the long-term data-driven collaborations that are necessary to make significant progress on these difficult problems. Governments know that recidivism, homelessness, child maltreatment, substance abuse, and many other social problems pose serious challenges, yet they fail to manage their social service contracts in a purposeful way to improve systems and generate better outcomes.

Governments should be systematically identifying high-risk populations and referring them to the services that best fit their needs. Instead, providers are left to identify clients and fill slots in their programs in an ad hoc manner, allowing needy individuals to fall through the cracks and dollars to be allocated inefficiently. Governments should also be actively managing social service contracts, meeting regularly with service providers to review performance data,

and collaborating on improving the systems through which vulnerable populations are connected with needed services. Instead, most governments treat contract management as a back office function limited to processing invoices and verifying compliance with contract terms.

Pay for Success contracting using social impact bonds offers governments a leadership tool to overcome each of these three barriers – lack of performance assessment, under-investment in prevention, and inability to collaborate effectively with service providers around improving systems. By doing so, it has the potential to speed up progress in addressing challenging social problems.

### III. The Pay for Success model

Pay for Success contracting using social impact bonds combines two tools—a performance contract and an operating loan.

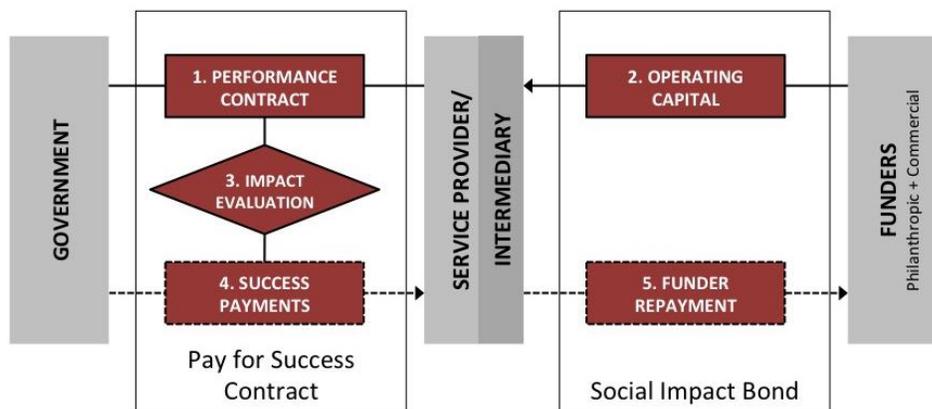
**Performance contract.** Under a performance contract, the government purchases social services aimed at a specific target population. Instead of paying for the quantity of services delivered, the government pays based on the outcomes that are achieved by the services -- e.g., the number of ex-offenders prevented from returning to prison, the number of unemployed individuals who succeed in finding stable employment, or the reduction in low birthweight births. These outcomes are measured by an independent evaluator. The parties to the contract agree to the target outcomes, the metrics that will be used to evaluate whether the outcomes are achieved, the method of

evaluation, and a payment schedule. The government commits to pay for achieved outcomes— if the intervention fails to achieve the minimum target, the government does not pay. Payments typically rise for performance that exceeds the minimum target, up to an agreed-upon maximum payment level.

In most cases, performance is rigorously measured by comparing the outcomes of individuals referred to the service provider to the outcomes of a comparison or control group that is not offered the services – so the payment is based on the *impact* of the intervention.

### Operating loan/social impact bond (SIB)

A social impact bond is not a “bond” but rather a loan from private funders. Most social service providers do not have the financial capacity to deliver services, wait several years for performance to be assessed, and only then receive repayment for the services that were delivered. And most are not positioned to absorb the risk associated with a large portion of reimbursement being based on performance. To overcome these obstacles, PFS projects generally include an operating loan from **private funders** who provide upfront capital in exchange for the lion’s share of the government payments that become available if the performance targets are met. If the targeted level of outcomes is achieved, the loan is repaid with interest from the government’s performance payments. If the minimum outcomes are not achieved, investors can lose all of their principal. In many PFS projects, the government contracts with an **intermediary organization** that holds both the performance contract and the operating loan. The intermediary uses the



operating funds raised from investors to contract with one or more service providers to deliver the interventions necessary to meet the performance targets. Though some governments have chosen to include the service provider as a party to the PFS contract in addition to the intermediary, others have contracted with only an intermediary.

If PFS contracts were simply a financing mechanism to allow governments to procure services today and use the generated budgetary savings to pay for the services in the future, they would be of limited value, since a government could simply borrow funds and pay directly for the services at interest rates generally be lower than the expected rates of return paid to PFS investors. Similarly, if SIBs were primarily a mechanism for the government to purchase insurance against program failure, they would be a dubious instrument since governments can spread risk over their entire tax base and shouldn't be paying a premium to risk-adverse investors to take on risk.

But PFS projects backed by social impact bonds are much more than a financing device. They are a way to overcome barriers to shifting spending toward preventative services. They are a way to expand promising interventions, while rigorously assessing their effectiveness and protecting taxpayers against the risk that an ineffective program will continue to receive funding. And most importantly, they are a way of binding government agencies and providers together in a multi-year data-driven effort to improve service delivery and thereby make progress on a difficult social problem. These PFS benefits are significant because none of them are easy to accomplish using standard public sector management practices.

#### ***IV. The Experience with PFS in the U.S.***

The world's first PFS project was launched in Peterborough, England in 2010. It provided services designed to reduce recidivism for individuals being released from jail. The first three U.S. PFS projects were also criminal justice projects. In August 2012, New York City launched a PFS project that provided cognitive behavioral therapy to juveniles incarcerated at Rikers Island; in December 2013, New York State launched a PFS project that is providing employment services to men released from state prison; and in January 2014, Massachusetts launched a project to provide education and

employment skills to young men involved in the criminal justice system. As of February 2017, 15 PFS projects have been launched in the US, 9 of which received government-side technical assistance from the Harvard Kennedy School Government Performance Lab.

In addition to the early criminal justice projects in Rikers Island, New York State, and Massachusetts, a fourth recidivism project in Salt Lake County (UT) was launched in late 2016. It is no coincidence that many of the initial PFS projects were in criminal justice policy. The potential budgetary savings from reducing incarceration are large. There are outcomes measures -- employment rates and subsequent convictions and incarcerations -- that capture most of what the interventions are trying to achieve. The data necessary to measure these outcomes is already collected by the government. And most of the budgetary savings from reduced incarceration accrue to the same level of government that is funding the preventative investments.

Five PFS projects -- in Massachusetts, Denver (CO), Cuyahoga County (OH), Santa Clara County (CA), and Salt Lake County (UT) -- are providing supportive housing to formerly homeless individuals or to families struggling to maintain stable housing. These projects aim to improve the well-being of formerly homeless individuals and to reduce the budgetary costs associated with homelessness -- shelter and jail usage costs, emergency room and hospitalization related expenses, behavioral health costs, and foster care expenses.

Four projects address early childhood. Two projects, in Utah and in Chicago, are expanding slots in pre-kindergarten programs, with the goal of improving student achievement and reducing special education costs. Projects in Michigan and South Carolina are expanding prenatal and early childhood care with the goal of improving child outcomes and reducing costs associated with low birthweight births and child maltreatment.

One PFS project aims to improve child welfare practices. A Connecticut PFS project is providing substance abuse treatment to parents in child-welfare-involved families with the goal of reducing out of home placements.

The PFS model is also spreading beyond social services. In September 2016, The DC Water

authority issued the US's first environmental impact bond to fund installation of green infrastructure intended to reduce stormwater and sewage runoff into polluted waterways.

Table 1 at the end of this piece presents additional information about the 15 launched U.S. PFS projects.

More than a dozen additional projects are under development across the country, including projects targeting substance use treatment, adult basic education, and troubled youth.

As of February 2017, three of the U.S. projects – the New York City Rikers Island project, the Utah pre-K project, and the Chicago pre-K project – had reached the point at which outcomes were measured and payments determined.

In May 2016, the first payment was earned for the Chicago PFS project, an expansion of high-quality pre-K services. The payment earned was based on intermediate measures that included kindergarten readiness.

In the Rikers Island project, 16 to 18-year-old youth who were offered cognitive behavioral therapy experienced 5 percent *more* days of incarceration than an earlier cohort of youth who were not offered this therapy. Because the intervention did not achieve the target 10 percent reduction in incarceration, no payments were made to investors and the program was discontinued.

In the Utah pre-K project, a weak evaluation methodology generated controversy. In this project, payments are being made for every pre-K enrollee who does not require special education services each year from Kindergarten through sixth grade. In 2015, an initial evaluation determined that only 1 of 110 at-risk children who received pre-K required special education, and \$267,472 in success payments were made. However, because there was no comparison group, it is impossible to know to what extent this outcome was an improvement over what would have happened without the program, and critics have challenged the project's claims of success.

Fortunately, nearly all of the other active U.S. PFS projects are using more rigorous evaluation methodologies, including seven that are basing payments on the results from randomized controlled trials.

## ***V. Lessons from the Early PFS Projects***

The early U.S. PFS projects have demonstrated the model's potential to increase resources dedicated to tackling challenging social problems, while simultaneously generating evidence revealing which interventions work and minimizing the risk that ineffective programs continue to receive funding year after year.

More importantly, the early projects have demonstrated the model's potential to improve the delivery systems for social services.

In Massachusetts and Denver, Pay for Success projects around homelessness drove much needed restructuring in the way that supportive housing units were funded and assigned. Before the PFS projects, housing funding streams were walled off from the support services many chronically homeless individuals need, preventing the government from effectively housing these individuals. In Denver, the PFS project created a platform through which the local housing authorities, regional Medicaid managed care organization, City Finance Department, and State housing finance organization were able to combine resources in support of a project strategically targeting the highest need individuals. As a part of the project, the City became the catalyst in generating new models for how governments can better leverage existing resources in combination with new flexible funding, allowing homelessness organizations to provide comprehensive services to the most vulnerable individuals within the community. The PFS projects led the government to combine those funding streams and re-engineer the way in which housing was assigned to prioritize those individuals with the greatest need for coordinated services.

The New York State prisoner re-entry PFS project provides another example of the type of lasting systems change that a PFS project can produce. During the project's planning phase, the State analyzed the size and historical rates of recidivism and employment for various populations in order to identify the appropriate target population. This process was informed by a 2012 study, which demonstrated that the intervention is most successful for high risk individuals who were recently released. Using these analyses, the State then specified the criteria to identify the target population as they

exit prison and to refer them to receive job placement and employment training services by the provider, CEO. During the course of the four year enrollment period, the State, the provider, and other stakeholders held weekly meetings to talk about any challenges or opportunities for improvement on the ground. For example, as soon as the enrollment rate falls below the pre-specified target enrollment rate, the parties brainstorm possible course corrections to get back on track. This active contract management approach is strikingly different from business as usual social service contracting, where governments sign a contract and process invoices for program slots that are filled with little attention to matching the right people to the right program and to performance.

As a third example, the Connecticut Department of Children and Families redesigned the way that families with indications of substance use are evaluated and referred to the substance use and parenting service expanded under the department's PFS project. This improvement in the referral process deploys department data and a consistent triage process to allow the department to identify high-risk families early in the investigation process and make services available to them.

Despite the recent momentum, the PFS model is facing some significant challenges. Most projects continue to require two years or more and significant technical assistance to assemble. Many cost savings are split between levels of government, but it has been challenging to enlist the federal government as a partner payor with state and local governments on projects where a substantial share of the budgetary savings will accrue to Medicaid and other federal programs. Some legislation to facilitate a greater federal role in specific policy areas has passed but a more comprehensive approach is still pending. It has also become clear that there are relatively few intervention models with sufficient evidence bases to attract commercial financing at rates of return competitive with government's usual cost of borrowing. Many projects still rely on a mix of philanthropic and commercial funds, and some recent projects have struggled to attract new philanthropically-minded investors to take the place of the pioneering philanthropies who financed the initial deals.

In response to these challenges, the PFS field is starting to experiment with new models, such as projects in which 80 percent of costs are paid up

front by the government and only 20 percent are reimbursed based on program impact. The question is whether having 20 percent of payments at risk is sufficient to generate the same focused attention on improving results, without needing to raise as much capital from investors.

In addition, PFS practices are starting to be incorporated into core government operations, even when no investors or performance-based payments are involved. For example, the Government Performance Lab has helped several governments institute "active contract management" practices for their key social service contracts. The governments and service providers meet regularly (typically monthly) to collaboratively review data and identify opportunities to improve results and re-engineer systems.

### **Conclusion**

We have witnessed enormous growth in the PFS field in a few short years, from our work on the very first state projects in New York and Massachusetts to our 2015 national competition for technical assistance that received thirty applications from state and local governments. It remains to be seen how far the "classic" PFS social impact bond model can expand. What seems clear though is that the PFS approach of data-driven collaboration between government agencies and service providers is here to stay.

The Government Performance Lab at the Harvard Kennedy School conducts research on how governments can improve the results they achieve for their citizens. An important part of this research model involves providing pro bono technical assistance to state and local governments. Through this hands-on involvement, the Government Performance Lab gains insights into the barriers that governments face and the solutions that can overcome these barriers. For more information about the Government Performance Lab, please visit our website: [www.govlab.hks.harvard.edu](http://www.govlab.hks.harvard.edu).

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**Table 1: Launched Social Impact Bonds Across the U.S. as of February 2017**

Jurisdiction	Issue area	# of individuals served	Private & philanthropic \$	Project initiation date*
<b>Projects receiving GPL technical assistance</b>				
New York	Criminal justice: Recidivism reduction through life skills education, job coaching, and transitional employment	2,000 individuals over 5.5 years	\$13.5M	12/09/2013
Massachusetts	Juvenile justice: Intensive outreach, education and employment support, and life skills training to youth at high risk for juvenile justice involvement	Up to 1,036 individuals over 7 years	\$19.6M	1/1/2014
Chicago, IL	Early education: Expansion of high quality pre-K program that engages both with children and their parents	2,620 children over 4 years	\$16.9M	10/7/2014
Massachusetts	Homelessness: Permanent supportive housing for chronically homeless individuals	Up to 800 individuals over 6 years	\$3.5M	12/8/2014
Denver, CO	Permanent supportive housing and wraparound services for chronically homeless individuals	At least 250 individuals	\$8.6M	2/16/2016
South Carolina	Home visitation program to improve maternal and prenatal health for expecting mothers and babies	3,200 first-time mothers and their babies	\$17M	2/16/2016
Connecticut	Substance abuse and parenting services for families involved in the child welfare system	500 families over 4.5 years	\$11.2M	2/16/2016
Michigan	Early childhood/pre-natal care for low-income mothers and their children	1700 mothers over 5 years	\$7M	9/1/2016
DC Water	Green infrastructure installation to reduce storm water runoff in the Rock Creek sewershed		\$25M	9/29/2016
<b>Projects without GPL technical assistance</b>				
New York City, NY	Juvenile justice	4,000 individuals a year for 4 years	\$9.6M	8/2/2012
Salt Lake County, UT	Expansion of pre-K services	Up to 3,500 children	\$7M	9/1/2013
Cuyahoga County, OH	Foster care + homelessness	135 homeless parents with children over 12-15 months	\$4M	1/1/2015
Santa Clara County, CA	Homelessness	150-200 individuals over six years	\$6.9M	8/14/2015
Salt Lake County, UT	Homelessness	315 individuals over six years	\$4.4M	12/16/2016
Salt Lake County, UT	Recidivism	225 individuals over six years	\$4.6M	12/16/2016

\*Project initiation date: Date of executed contract, service launch, or official announcement of either executed contract or project launch.