"Social Impact Bonds": Implications for Government and Non-Profit Organizations*

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Abstract. In recent years the weak economy has forced state and local governments to cut back on funding for existing programs and to limit investments in new services. All levels of government routinely partner with non-profit organizations to provide social services, and these cutbacks can have serious implications for service delivery and non-profit capacity. One very exciting response to these pressures is the development of a new financing model that raises private money to fund effective social services: the Social Impact Bond (SIB). This new method involves the formation of new partnerships and the re-alignment of roles for the first and third sectors. The purpose of this paper is to provide an overview of the challenges that developing and implementing Social Impact Bonds may produce both on the public administration (PA) and on non-profit service providers (NPOs). Social Impact Bonds ask governments and non-profit service providers to almost completely rethink the way they do business.

Аннотация. В последние годы слабость экономики стала приводить к тому, что во многих странах на уровне правительств и регионов было урезано финансирование существующих социальных программ, а вложения в создание новых услуг ограничены. Власти на всех уровнях регулярно взаимодействуют с некоммерческими организациями в оказании социальных услуг, и поэтому данные сокращения могут сильно повлиять на социальное обслуживание и уменьшить возможности НКО. Одним из весьма интересных ответов на эти вызовы является разработка новой модели финансирования через «социальные облигации» (*Social Impact Bonds*, SIB), которые способствуют привлечению частного финансирования социальных услуг. Целью данной работы является обзор вопросов, которые возникают при реализации «социальных облигаций» — как со стороны госструктур, так и со стороны поставщиков услуг из некоммерческого сектора. «Социальные облигации» заставляют госструктуры и НКО полностью пересмотреть обычные схемы их деятельности.

Keywords: Social Impact Bonds, SIBs, public administration, non-profit service providers, innovative social public service.

INTRODUCTION

Social innovation is a new and emerging concept that has no clear definition. In general, we refer to the European Commission report (2011, 9–10) where social innovations have been defined as "*innovations that are social in both their ends and their means. Specifically, we define social innovations as new ideas (products, services and models) that simultaneously meet social needs (more effectively than alternatives) and create new social relationships or collaborations. They are innovations that are not only good for society but also enhance society's capacity to act*."

In this sense, the term *innovation* can be referred to as the capacity to create and implement novel ideas which are proven to deliver value; while the

* «Социальные облигации» и их применение в государственных и некоммерческих организациях.

term *social* can be referred to as the kind of value that innovation is expected to deliver: a value that is less concerned with profit and more with issues such as quality of life, solidarity and well-being.

In the public and scientific debates, there are developing innovative solutions and new forms of organization and interactions to tackle social issues. In this sense, social innovations can be seen as dealing with the welfare of individuals and communities, both as consumers and producers.

In any case, they bring about new references or processes. In particular, an important aspect of social innovation is the process of social interactions between individuals to reach certain outcomes. This process of social interactions is participative, involves a number of actors and stakeholders who have a vested interest in solving a social problem, and imposes a change in the respective roles of the private, public and third sectors.

In times of economic recession and austerity, governments are under pressure to do more with what they have: most major cities and states are facing staggering budget deficits and taxpayers and politicians are not willing to risk their public money for testing programs that are not a guaranteed success. In addition, publicly funded attempts to help poor or vulnerable population are often remedial, ineffective and expensive. In the meantime, there are prevention-focused interventions with proven efficacy that are not being identified, taken up and scaled by government or that require more capital than governments can provide upfront.

At the same time, sponsorships and donations to support the social sector have experienced declines and non-profit organizations and charities have recognized a need to explore new revenue-generating models to achieve financial sustainability. Further cutbacks in government spending accompanied by reduced investment from the second and third sectors has required the use of innovative, sustainable and multi-stakeholder approach for the investment in social welfare.

Sometimes, these new methods involve the formation of new partnerships and the re-alignment of roles for the first, second and third sectors. Indeed the implementation of SIBs program provides another opportunity to assess the relationship between nonprofit organizations (NPOs) and public agencies.

A Social Impact Bond is a multi-stakeholder partnership in which philanthropic funders and impact investors — not governments — take on the financial risk of expanding proven social programs. Non-profits deliver the social program to more people who need it; the government pays only if the program succeeds.

In this way, SIB reduces the role of the state or local government in funding or supervising social welfare programs; it attempts to increase the role of private investment and the responsibility of non-government organizations in the provision of social welfare and to allay the underperformance and underfunding afflicting the non-profit sector (Bolton, 2010; Bolton & Savell, 2010; Mulgan *et al.*, 2010 a, b; Liebman, 2011; Von Glahn & Whistler, 2011; Siddhart, 2012, p. 4).

Under a SIB, *a payer — usually a government at a national, regional or local level — agrees to pay for measurable improved outcomes of social projects, and this prospective income is used to attract the necessary funds from commercial, public or social investors to offset the costs of the activity that will achieve those better results* (Mulgan *et al.*, 2011, 5).

The approach introduced by the SIB can pay for holistic, collaborative community development because it captures disparate benefits and enforces accountability. It brings together organizations that often work in isolation and encourages client service that can better lead to outcomes, rather than just outputs. The rationale behind SIBs is akin to the payment-by-results schemes associated with target-based performance management.

In the remainder of this paper:

- Section 2 seeks to explain the SIB concept by examining the limited literature and the existing reports on the SIB's pilot projects implemented in the world;
- Section 3 discusses the effects of "Social Impact Bonds" on government and
- Section 4 highlights some implications, which this new model produced on non-profit service providers.

2. THE SOCIAL IMPACT BONDS

Despite the recent development of the SIB concept, the review of the limited literature on the subject (Strickland, 2010; Azemati *et al.*, 2012; Mulgan *et al.*, 2010; Disley *et al.*, 2011; Wongetal, 2013; Warner, 2013; Ragin & Palandjian, 2012) and the examination of some reports edited by consultants, foundations and financial services firms (Rockefeller Foundation, 2010; Center for American Progress, 2011; The Young Foundation, 2011; McKinsey & Company, 2012; Harvard Kennedy School Social Impact Bond Technical Assistance Lab, 2013; MaRS, 2013) is sufficient to reveal the theoretical basis for the Social Impact Bond.

Before presenting how the SIB works, it is important to make two clarifications about the term

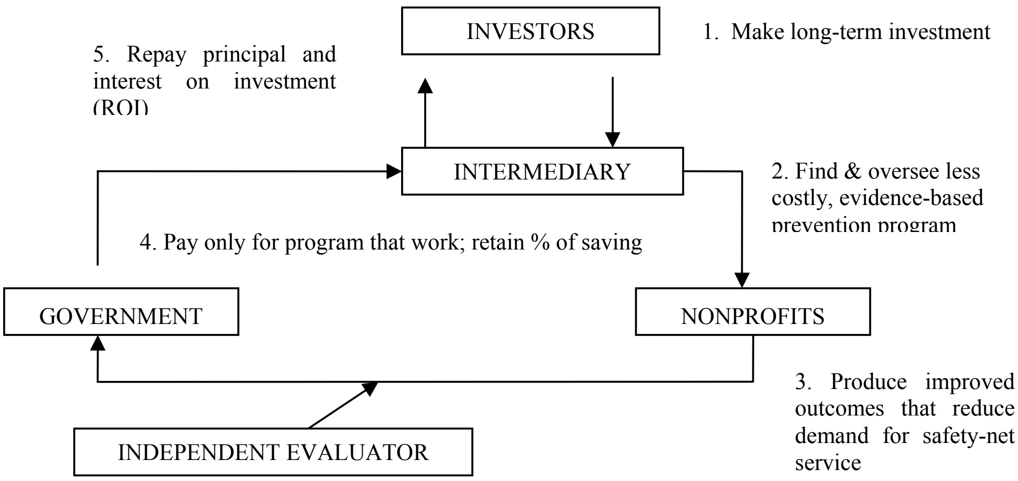

Figure 1. Social impact bond model.

"Social Impact Bond" which sometimes can lead to confusion.

The first is about the use of the word "bond". SIBs are not bond or debt instruments but rather multi-stakeholder partnerships managed through a series of contracts. To avoid this confusion, in some countries the SIBs have been called *Pay for Success Bonds* (e.g. U.S.) and *Social Benefit Bonds* (e.g. Canada).

Indeed, SIBs share features of both debt and equity or fixed-income instruments that are often used for infrastructure or other capital projects: generally, SIBs offer returns more similar to an equity instrument, rather than a bond; their returns are variable like equity, rather than fixed as with a bond.

The second clarification concerns the use of the terms "Social Impact Bond" and "Pay for Success Bonds" as synonyms: this is wrong because the SIBs are a specific kind of Pay for Success (PFS) contract.

PFS contract is a contracting mechanism in which government (or another payer) pays service providers after they achieve predefined outcomes. Providers entering into these contracts have several options for financing program delivery: internal resources, loans from community development financial institutions and banks, or grants or program related investments from foundations. Most of these options impose significant financial risk on the provider. A SIB, by contrast, is a financing mechanism that shifts this risk to investors. By participating in a SIB, a provider working under a PFS contract can obtain operating funds to grow and scale without incurring additional financial risk. Given the scarcity of growth capital and the difficulty providers face in securing resources that enable them to serve a greater proportion of at-risk populations, SIBs can offer an appealing path to scale.

PFS contracts and SIBs share a premise of payment by results, but they differ in purpose. Beyond achieving results, SIBs explicitly seek to create a marketplace for impact investment, up ported by rigorous due diligence and analytics. These market-building elements add costs for evaluation, legal, performance management, and other intermediation services necessary for driving social and financial outcomes. Because SIBs must bear these costs, their greatest potential lies where scale and improved performance are principal goals as well as social needs. Uniquely, the capital markets have the depth, flexibility, and rigor to support these aims. According to Warner (2013, 305) *SIBs represent an extreme expansion of new public management precept into social program delivery*. Indeed SIBs are characterized by two concepts: the creation of a partnership and the use of performance measurement.

At its core, Social Impact Bond has a public private partnership that has the potential to substantially transform the social sector, support poor and vulnerable communities, and create new financial flows for human service delivery by offering an innovative way to scale what works and break the cyclical need for crisis-driven services. SIBs signify a new paradigm of public-private partnerships in the wake of the financial crisis, one that privatizes the risks and shares the gains. Collaboration among philanthropy, government, and the investment community is vital.

According Ragin & Palandjian (2012, 63), Social Impact Bonds offer a new way to advance cross-sector partnerships and introduce innovative financing solutions to scale proven preventative social programs. To achieve this goal, strong relationship

Table 1. Benefits to stakeholders of successful SIBs.

Government	Accountability for taxpayer funds Reduction in the need for costly downstream remediation Increased supply of effective services for citizens without financial risk
Non-profits	Access to growth capital to scale up operations Access to a stable and predictable revenue stream without labor-intensive fundraising Facilitated coordination with organizations working on overlapping problems
Investors	Achievement of financial returns and social impact Participation in a new asset class with portfolio diversification benefits
Communities	Access to an increased supply of effective social services Reduction in the need for crisis-driven interventions

Adapted from: Social Finance, Rockefeller Foundation, *New Tool For Scaling Impact: How Social Impact Bonds Can Mobilize Private Capital to Advance Social Good*, p. 11

management skills are vital, so that the perspectives and concerns of the different realms — from policy maker to social entrepreneur, from financier to public service commissioner — can be taken on board and made intelligible to all the parties involved in creating a SIB.

The partnership is among four actors — investors, the public sector, an intermediary and non-profit (social service provider) — where each acts independently with the common goal of creating increased positive social outcomes in a more efficient way. Figure 1 depicts the relationship among the key actors and explains how the SIBs would work. In detail:

1. The intermediary issues the SIB and raises capital from private investors;
2. The intermediary transfers the SIB proceeds to non-profit service providers, which use the funds as working capital to scale evidence-based prevention programs. Throughout the life of the instrument, the intermediary would coordinate all SIB parties, provide operating oversight, direct cash flows, and monitor the investment;
3. By providing effective prevention programs, the non-profits improve social outcomes and reduce demand for more expensive safety-net services;
4. An independent evaluator tracks and aggregates performance data to determine whether the intervention achieved target benchmarks and consequently determines whether the target outcomes have been achieved according to the terms of the government contract. If they have, the government pays the intermediary a percentage of its savings and retains the rest. If outcomes have not been achieved, the government owes nothing;
5. If the outcomes have been achieved, investors would be repaid their principal and a rate of return. Returns may be structured on a sliding scale: the better the outcomes, the higher the return (up to an agreed cap).

SIBs codify the performance measurement approach and link financial return to rigid metrics. For this reason it is fundamental that social outcome goals need to be clear, objective, measurable and non debatable and the evaluation process must be transparent and clear to all parties. McKinsey & Company report (2012) proposes seven stakeholders that are involved in social impact bonds model:

1. *Governments:* Public entities establish policy on social impact bonds and commit to making future payments to private partners if specific outcome goals are achieved and public sector costs lowered.
2. *Investors:* Philanthropic and other social innovation investors finance social impact bond projects, providing the upfront capital to service providers to cover the costs of service delivery.
3. *Non-profit service providers:* These organizations directly deliver social interventions to affected populations.
4. *Intermediaries:* Intermediaries are typically non-profit organizations that manage social impact bond projects on behalf of governments and create a separation between service providers and public agencies to minimize the potential for government micromanagement that could limit providers' flexibility to achieve targeted outcomes. They are responsible for raising funds from investors, selecting the service providers to deliver interventions, receiving success payments from governments, and repaying investors if program goals are reached.
5. *Independent assessors:* Assessors perform the critical task of measuring program performance to determine whether outcome targets are met.

6. *Evaluation advisers:* Evaluation advisers work with intermediaries to provide ongoing monitoring and refinement of social impact bond programs.

7. *Constituents:* Program beneficiaries receive the social services delivered.

SIB will function effectively only if every stakeholder is willing and able to uphold its end of the deal and fulfill its unique roles and responsibilities. It is clear that the power of SIBs lies in their ability to align all stakeholders' interests around achieving common objectives. In fact, all stakeholder — nonprofits, investors, government, and communities — benefit from successful of SIB programs as it was evidenced in the Table 1.

SIBs operate at the intersection of three important trends: greater funder interest in evidence-based practices in social service delivery; government interest in performance-based contracting; and impact investor appetite for investment opportunities with both financial returns and social impact.

The idea of a Social Impact Bond has generated significant interest in multiple developed countries — e.g. UK, U.S., Australia, Canada, Ireland and Israel — that are now in varying stages of exploring, developing and/or implementing SIB pilots. To date these have been focused mostly on criminal justice, homelessness, workforce development and youth services, but work is underway to develop applications in new sectors like health, social care, affordable housing (Disley *et al.,* 2011; Greenblatt, 2011; Pauly & Swanson, 2012; Siddhart, 2012).

The pilot projects — as described in some reports — demonstrate that there is no one approach to designing and negotiating a social impact bond. SIBs have great potential in a range of preventive social programs: this means that SIBs are a vehicle that can be used in a range of areas, but not for every area of social need.

SIBs are not a one-size-fits-all solution: there are currently a limited number of areas with proven interventions, strong organizations, and opportunities to invest in prevention programs and create public value (Warner, 2012). Moving from remedial programs to preventive solutions requires a public-private partnership to shift the risk from government and allow a transformation to occur in the current system.

As highlighted before, not all social issues or interventions are suitable for a SIB model, there are shortcomings to the SIB model that will limit its effectiveness to specific situations and, in particular, the value of this funding innovation will be strongly context-dependent (Pauly & Swanson, 2012).

3. SOCIAL IMPACT BONDS: THE ROLE AND THE EFFECT ON GOVERNMENT

For social problems, each year, governments spend hundreds of billions of public money, but the citizens have no idea how effective this spending is. Performance is rarely assessed, the measurements tend to be too operationally focused and the results have not lived up to expectations (Atkinson and McCrindell, 1997). Unfortunately, no single performance measure is appropriate, and the results do not always meet the needs of relevant stakeholders: the measurements, for example, focus on tracking the number of people served and the amount of service provided rather than the outcomes that are achieved (Behn, 2003).

Governments are starting to recognize the need for a new approach to social services that places its emphasis on identifying innovative ideas, testing their effectiveness, and scaling up the interventions that prove successful. In this direction, according to Liebman and Sellman (2013, 6) there are three features of current funding mechanisms that inhibit innovation in social services:

1. Government budgeting focuses on paying for inputs rather than achieving outcomes;
2. Budgets are built in a backward-looking manner;
3. Time horizons are too short.

Most social service spending today funds organizations to deliver a set quantity of services rather than to produce results. Outcomes are rarely assessed, making it hard, for example, to reallocate resources based on the comparative performance of different service providers or to stop spending money on programs that don't work. Instead, a properly implemented performance measurement system can provide the data necessary to identify strengths and challenges in local government programs so those programs can be adjusted to perform at acceptable levels, thus saving scarce resources and improving citizen satisfaction.

Most budgets are built around funding the same things that were funded the previous year with small adjustments for inflation. In some cases, legislatures require that the same providers be hired year after year to deliver the exact same, possibly ineffective, services. Governments lack a systematic way to work with innovative non-profits to test and scale up promising new solutions. And fear of public scrutiny makes it hard to take the risks associated with trying new things and rigorously assessing them.

While it is relatively easy for a governor or mayor to set up an interagency task force to tackle a tough issue and to get the task force to meet a few times, rarely these efforts manage to sustain energy over several years necessary to achieve results. Political leadership turns over; new priorities emerge; or inadequate provision of staff time and other resources dooms the effort. Moreover, fiscal realities make it difficult to make preventive investments even when those investments can deliver large savings in future budgets. This problem is exacerbated when the required investments would occur in one agency's budget, while the savings would appear in another's.

Trough the SIBs, governments will have access to better data that enable rigorous assessment of various program alternatives and inform responsible public investment. In addition, governments may begin to measure success using outcomes rather than outputs, driving greater accountability within the public sector.

4. SOCIAL IMPACT BONDS: IMPLICATION FOR NON-PROFIT SERVICE PROVIDERS

As noted, non-profit sectors world-wide account for 5–10 percent of GDP; providing a variety of quality-adjustable goods and services that often contribute to civil society (Powell & Steinberg, 2006; Anheier & Toepler, 2010). All levels of government routinely partner with non-profit organizations to provide services especially when, in this way, they may save money and provide more effective services to its citizens. However, the relationship between government and non-profit organizations is not without problems and, as Van Slyke has noted (2006, 157), *contextual changes at the national and local level have led to a transformation from governance by authority to governance by contract*, to governance in which public organizations increasingly devolve the implementation of public policies to cross-sectorial collaborations networks, alliances, or partnerships among public and for-profit organizations (Borgonovi, 1995; Zangrandi, 2000).

This reliance on public funds imposes a special fiduciary duty to society for non-profits to deliver services efficiently. However the ways in which non-profits actually use public funds to create value is poorly understood and, usually, the information is self-reported and does not require external appraisal (Krishman *et al.,* 2006).

Unfortunately the current modes of contracting, relying overwhelmingly on what we call inputs-based and performance-based contracts, and social impact measurement are far from perfect. The problem seems to be two-fold: on the one hand, non-profits are rarely as transparent and accountable as society has a right to expect; on the other hand, governments are both bad at monitoring because they might not have the technology or the funds to spend on monitoring, and unreliable in their long-term provision of funds (Boris *et al.*, 2010).

From the non-profit or service provider perspective, the SIBs introduce innovation, rigor and effectiveness to the social sector by emulating the incentives and outcome-focus of private markets.

First of all, while in the current contracts the government is overly prescriptive, specifying how funds should be used and what services should be provided, in a SIB the government does not dictate how they will perform the service: the success of the SIB is not determined by the execution of particular programs or activities, but by achieving a social outcome.

In particular, the shift in monitoring, evaluating and reporting from outputs to outcomes, introduces management principles and tools more appropriate to these organizations (Anthony & Young, 2008) and to the goals of the SIB's program and allows to better understanding and managing outcomes. As known, a better performance management is key to achieving better outcomes within the populations these organizations serve and to increasing the social impact generated (Gibbon & Dey, 2011; Jackson, 2013; Perrini, Giordano & Vurro, 2013, 53).

Service providers struggle to access the capital needed to complement the limited funds currently available from government and philanthropy. SIB is an attractive tool to nonprofits, which need more resources, considering also that, usually, the blame of their limited success is the lack of funding. SIBs may influence larger shifts within the non-profit: this new source of capital, which relies on demonstrated results, will encourage non-profits to develop robust data collection methods, create performance metrics, and measure social outcomes. A greater clarity around performance is essential for the efficient and sustainable provision of value-for-money services in a competitive environment. Therefore, management accountants in non-profit bodies need to be more proactive in developing and implementing good information systems to provide necessary information (Preite, 2011).

Social impact bonds will also allow NPO organizations to do their work at a greater scale because the bonds are designed to fund large, multi-year contracts. The long-term funding allows social service providers to improve their financial planning and resourcing, and operate on a timeframe required to achieve the target social outcomes. This fosters a culture of collaboration creating alliance, network among the different non-profit service providers. More specifically, in this way NPOs can obtain resources to meet programmatic needs, sharing the goals and reaching the ideal organizational dimension (Dyer and Singh, 1998; Guo and Acar, 2005; Cho and Gillespie, 2006).

To avoid the drift of SIB's mission, non-profit service providers must ensure that SIB programs and the associated target outcomes are aligned with their missions and their organizational size and — while they continue to adapt to address different social issues — they must adapt to play new roles in different organizational models.

As So and Jagelewski noted (2013, p. 10) the most existing SIBs, service providers have taken two different roles:

- working as part of a collaboration in a "wrap-around" model,
- or scaling up their intervention and operating as the sole service provider.

While in sole service provider model only one service provider organization is accountable for meeting the performance standards specified in the service provider contract, in " wrap-around" model, a set of providers works together as a coalition to achieve the defined outcome for the target population. As known, the contracting out of social services to different bodies is often canvassed as a more efficient way of achieving the objectives that are been fixed. No primary service provider is identified, and the providers are each accountable to the performance standards specified in their contracts with the SIB delivery organization. In this case, however, there is a clear need for a strong co-ordinating body to manage multi-agency solutions that intermediates between frontline provision and government strategy (Graddy, Chen, 2006).

CONCLUSION

The SIB concept is emerging on the policy agendas of many countries' governments as a novelty, and study of its theoretical foundations, potential applications and steps is necessary for its implementation. The current spending squeeze in each European Community country — and also in the others around the world — means that there is more interest than ever, both in tools to achieve greater social value, and ones that can tap new sources of finance for social goals. SIB is an attractive tool to non-profit organizations, which frequently feel undercompensated, need more resources, and blame their limited success on lack of funding. NPOs service providers will benefit from the growing number of resources to learn about and engage with SIBs.

SIBs should not be viewed solely as a financing mechanism and should not be relied upon as the sole funding source, indeed they present a solution to several problems in funding social services, including performance measurement and the distribution of risk.

SIBs improve innovation process and learning: indeed, government agencies will need to learn to ceding some control to the external organization — non-profit service providers they partner with — and, with appropriate but limited oversight, trusting that organization to act to best achieve the desired outcome. Also, whereas traditional procurement contracts reward a service provider's adherence to prescribed program models, the SIB model rewards a provider's ability to improve the efficiency and effectiveness of its services. Therefore service providers have the opportunity to analyze the feasibility of applying the SIB model to their interventions and they may proactively engage governments to consider their proposals.

In this sense, social innovation should not be seen as simply a way of privatizing social services. It is intended to rather encourage an existing change of behaviour by people and institutions regarding the responsibility of finding the most appropriate solutions to respond to unmet social demands. This objective may be served by a flexible borderline between business innovation and social innovation that exploits their complementarities.

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