

Social Impact Bonds for Public Health Programs: An Overview

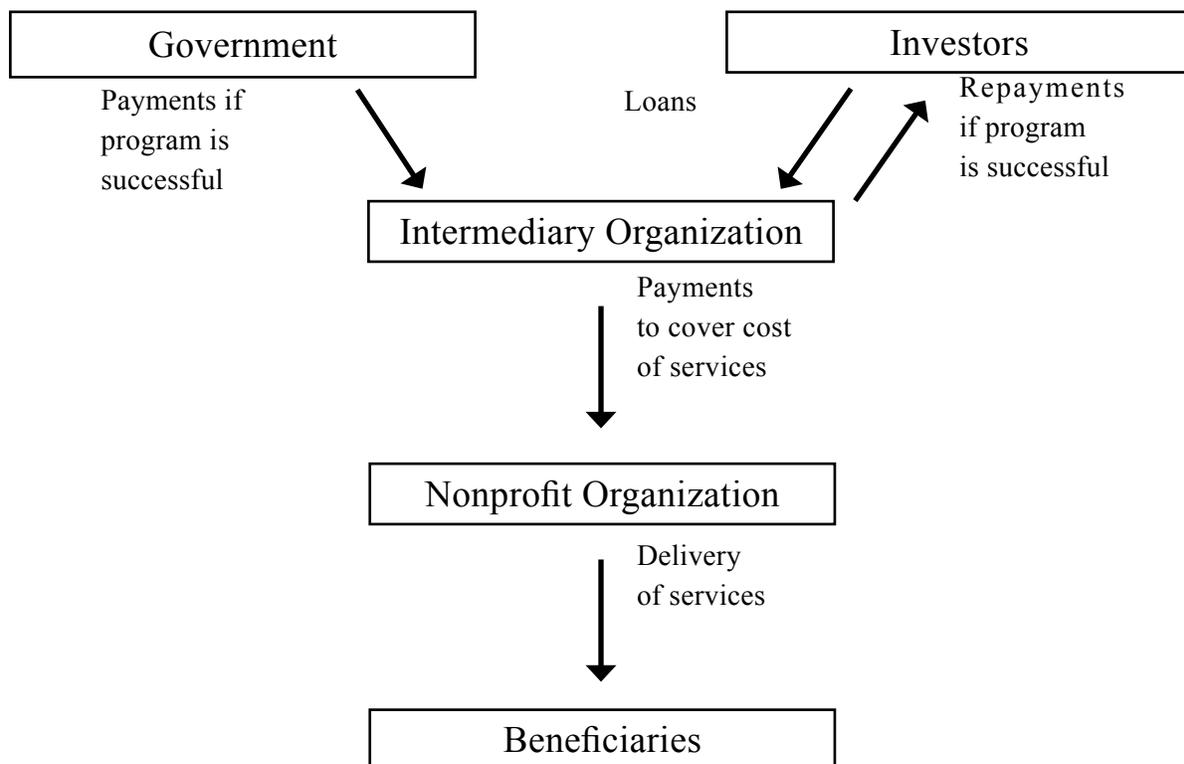
Summary

The desire to improve health care outcomes and reduce costs has led states to rethink how they deliver health care services. One approach is to focus on the underlying social determinants of health, which is why governors are incorporating public health, community, social support, and other nonclinical services into their efforts to transform their states' health care systems.¹ Effective delivery of such services requires innovative programs.

Social impact bonds (SIB) are a financing mechanism that states can use to support such innovative programs

(see Figure 1 below). Governors can use a SIB model to provide funds to nonprofit organization that can successfully deliver social, health, or educational services on a small scale. The funding from a SIB is used to scale up the nonprofit's program, a process done through an intermediary organization that private investors finance. The intermediary organization contracts with the nonprofit to cover the cost of the scaled-up activities and with investors to negotiate an appropriate rate of return. That intermediary in turn has a contract with the state government that requires the government to pay the intermediary only

Figure 1. A Typical Social Impact Bond Arrangement



¹ Deborah Bachrach, Helen Pfister, Kier Wallis, and Mindy Lipson, *Addressing Patients' Social Needs: An Emerging Business Case for Provider Investment* (Manatt Health Solutions, 2014), http://www.commonwealthfund.org/~media/files/publications/fund-report/2014/may/1749_bachrach_addressing_patients_social_needs_v2.pdf (accessed November 14, 2014).

if the nonprofit successfully produces the measurable outcomes specified in the contract. The intermediary is responsible for dispersing those government payments to the nonprofit and investors. Several experiments are underway in states and cities across the country that use SIBs to finance innovative programs that improve access to quality health care and reduce the per-capita cost of care.² Areas that such programs address include maternal and child health, substance abuse, diabetes management, and general preventive health services. The dollar value of those experiments that have SIBs as a financing mechanism is not precisely known but is estimated to be small compared with overall state spending for health care.

Governors exploring public health programs and options for funding programs through SIBs should consider the following approaches:

- **Identify the right public health program.** Governors and other state leaders should identify a health-related priority or program for which innovative service delivery is a possibility or where budgetary incentives are misaligned among agencies or even levels of government. By aligning a SIB with a previously identified health priority, officials can streamline activities across the state and create an opportunity to test strategies that otherwise could be difficult to initiate within current program and budgetary structures.
- **Evaluate the rewards and risks of using a SIB to finance a health service paid for by the state.** In its strongest form, a SIB transfers the significant financial risk of failure to perform from the state to the financial intermediary and, in turn, the private sector. Even under that circumstance, however, states bear the cost not only of failed services but also of providing necessary services through alternative means.

Although SIBs might provide future budgetary savings, state leaders should consider that financing a comparable activity in the traditional mode could produce future savings comparable to those expected from a SIB.

- **Recognize a SIB is a means of financing not a source of new funds.** SIBs are an alternative to pay-as-you-go financing that shifts cash payments by the state from the current period to a future date. Ultimately, state revenues will be necessary to pay for the services financed by a SIB arrangement if the SIB provider meets its targets. Any short-term budgetary relief a SIB provides depends on whether the state must appropriate current funding to cover the future liability the SIB creates.
- **Focus on measurement issues.** A SIB can focus on a specific and measurable target, but estimating the budgetary savings or avoided social costs of reaching that target can be difficult and deserves attention from the onset. For example, early applications of the SIB idea have been in criminal justice because the return from reducing recidivism is easy to measure relative to more complex situations. Spending for some health programs is driven by the number of eligible recipients; thus, the baseline spending against which saving would be calculated requires projecting both the number of recipients and spending per recipient. In addition, health outcomes, even for small populations, might be determined by factors for which the funded intervention does not account (for example, housing or transportation policies). An alternative calculation based on outcomes for a control group versus an experimental group is not always feasible in a health-related setting. Finally, the effects of policy interventions on spending can occur over many years.

² Ibid.

- **Choose an intermediary and scrutinize its choice of a provider.** States will need to contract with an intermediary (a private or nonprofit organization) to oversee the structuring and management of the SIB as well as the provider that intermediary chooses. The intermediary’s stake in success provides an incentive for effective and efficient management that is perhaps stronger than that for a public manager. To increase the potential for success, states should ensure that the intermediary understands the health issue the program addresses and has experience managing such programs that is comparable to that of appropriate public agencies. Area expertise and experience are necessary for selecting and evaluating provider performance and setting realistic performance goals.
- **Recognize transactions costs.** All public programs, regardless of how they are financed, require spending on administration and, in most cases, contracting. Those activities are costly and must be taken into account when deciding to use a SIB to provide health services. For instance, the concept of affordability should be extended to include recognition of future trade-offs that will have to be made in those years when payments for a SIB’s performance will leave less budgetary room for other programs. In addition, states must recognize the substantial cost of the administrative time required to develop a SIB, which could last as long as two years, as well as long-term administrative costs for the life of the SIB.

A General Context

A critique of the way governments deliver social services and make budgetary choices, whether in health, housing, or criminal justice, underlies the idea of the social impact bond (SIB)—that small nonprofit groups using innovative approaches to deliver health and social services are producing (or could potentially produce) better outcomes at a lower long-term cost

than traditional programs. Because the innovative approaches deliver better services more effectively today, they arguably could reduce costs that would have had to be paid in the future. For example, if an innovative program is more successful in reintegrating people released from jail into the community and those people are less likely to commit crimes and be jailed in the future, then the cost of effectively providing service today will be offset by avoiding the cost of incarceration in the future. If the discounted value of those avoided future costs is greater than the innovative program’s cost for preventing recidivism, advocates of SIBs would present the program as “paying for itself.” The critique continues, that government often fails to take advantage of such opportunities. Budgets are tight and political support lacking to either reduce spending in areas where it is ineffective or to increase revenues to support new initiatives. At the agency level, government managers tend to fund the same programs year after year without serious regard for their effectiveness, because rigorous evaluation requires additional funding. Even when presented with an opportunity to produce future budgetary savings by innovating today, government managers lack the incentive to fund potentially effective innovation because the anticipated future savings might not accrue to the implementing agency’s budget.

To advocates, the partnership that a SIB requires is a solution to the problem that the standard operating procedure of the current pay-as-you-go approach poses. The government’s budget constraint is removed, at least temporarily, by the intermediary’s willingness to pay the cost of the services provided by the nonprofit as they are incurred and to receive payment from the government at a contractually specified future date if the service provider meets specified performance goals. That arrangement is sometimes portrayed as riskless to the government because in its strictest form, the government does not pay if the provider fails to meet the agreed-upon targets, a determination made by an independent evaluator that all parties have

agreed to in the contract underlying the partnership.³ (A similar justification has supported the use of public–private partnerships [PPPs]. See Appendix A on page 13 for a discussion of the relationship between SIBs and PPPs.) Furthermore, evaluation is built into the SIB model so that government has evidence of programs efficacy and is forced by contract to make fiscal decisions based on that evidence.

That critique, in its strongest version, includes overgeneralizations. States are currently financing innovation in health and social service programs in many variants of the traditional mode. Those traditional forms rely on funds that are appropriated in a state’s annual or biannual budget cycle. In many instances, funding for programs both innovative and traditional is not as closely tied to performance goals as programs that SIBs finance are meant to be. The variants of programs financed in the pay-as-you-go model, however, span a wide range, from direct provision by public agencies to contracts with private providers that can involve payments for a level of effort or feature incentive provisions that reward or penalize contractors based on their performance. States conduct evaluations of programs in a variety of ways, often through research partnerships with nonprofits and academic institutions. In some states, SIBs can grant temporary relief from tight budgets by pushing expenditures into the future. In others, state law or budget rules require that funds necessary to pay for the liability a state assumes when entering into a SIB be set aside. In that case, a SIB does not provide any fiscal relief and is not a substitute for making difficult budgetary choices.

SIBs can finance innovations that hold the potential to improve health care outcomes and demonstrate how outcomes-based standards can be applied to public spending. For example, they can be a tool to test the

premise that programs that address the underlying social determinants of health today can reduce health care spending in the future. They are not unique in that regard, however: Innovative programs financed in more traditional ways can accomplish the same purpose. For example, traditionally funded programs that have supported public health innovations that teach patients how to manage asthma, reduce exposure to asthma triggers, and avoid the cost of hospitalizations demonstrate that additional spending today could reduce both budgetary and social costs in the future. Research grants can provide funds to evaluate those programs. In their strongest form, SIBs are strictly pay-for-performance contracts, an arrangement widely considered necessary to increase the benefits of state spending in virtually every area. SIBs can also be useful in overcoming the disincentive for state agencies to fund a program that reduces the state’s overall spending on health care but might not result in direct savings in the funding agency’s budget.

Is a Social Impact Bond Right for My State?

Governors and other state policymakers should take the following additional points into account when considering a health-related SIB:

- **The governor has identified a health-related priority that is not being funded in the traditional budget process.** Governors and state leaders are continually leading efforts existing health priorities. For example, states are working to invest in prevention and population-based interventions to reduce the incidence and burden of chronic disease as well as reduce the growth in health care spending. Aligning a SIB with a previously identified health priority can streamline activities across the state and provide an opportunity to test strategies that might be

³ Office for State, Tribal, Local and Territorial Support, Centers for Disease Control and Prevention, “Public Health Law and Policy Innovations: Social Impact Bonds,” *Public Health Law*; <http://www.cdc.gov/phlp/docs/sib-brief.pdf> (accessed November 18, 2014); and Kristina Costa, “Fact Sheet: Social Impact Bonds in the United States” (Washington, DC: Center for American Progress, 2014), <http://www.americanprogress.org/issues/economy/report/2014/02/12/84003/fact-sheet-social-impact-bonds-in-the-united-states> (accessed November 18, 2014).

difficult to initiate within current program and budgetary structures, for example, difficulty in obtaining a multiyear appropriation.

- **A program has sufficient evidence that it can produce improved outcomes and reductions in costs.** SIBs are largely experimental, intended to drive innovation and collect evidence through testing of financing and delivery concepts that can later be brought to scale through standard contracting measures. Although SIBs are intended to allow for experimentation and innovation, because of the level of financial risk placed on investors, SIBs should be pursued only for those interventions for which sufficient evidence exists to be confident that they can be successful.⁴ States can determine whether an intervention proposed for a SIB has a strong evidence base by conducting literature reviews and in-depth analyses. For example, in the New York State SIB addressing prison recidivism, the program offered by the service provider, Center for Economic Opportunity (CEO), had previously undergone an independent randomized control trial conducted by MRDC, a nonprofit social and education policy research organization. The evaluation showed that CEO’s program reduced recidivism by between 9 percent and 12 percent among all participants and by 30 percent for a high-risk population. As a result, CEO was chosen to expand this program and target high-risk individuals as determined by the state’s COMPAS risk assessment tool.⁵ Investors will be interested in social programs or models that have a strong chance of success and are likely to provide a return on their investment. In addition,

investors want a track record of success from the chosen service provider. That service provider should have a system of performance measurement and a history of performance-based management success.⁶

- **A program has been carefully examined to ensure it can deliver long-term, scalable results including reductions in costs over time.** There is a long history of demonstration programs that were successful as small pilots but could not achieve the same results on a larger scale. Programs are often delivered across different systems and agencies, such as housing or welfare systems, meaning that they must account for a wide variety of rules, regulations, and operating structures to be successful. Accordingly, when a program achieves positive results, it is often difficult to identify the specific factors or operational functions that were instrumental in fostering success.⁷ Within that context, it could be difficult to ensure that a scaledup program would be successful. That type of uncertainty for a SIB could discourage intermediaries, investors, or service providers from participating in the program. Similarly, states may be discouraged from participating in programs for which short-term performance measures might not be reliable indicators of achieving long-term goals.

It also is possible that programs have features that diminish their ability to scale for longer-term positive effects and savings. For example, the high level of financial risk placed on investors and service providers might provide an incentive for

⁴ McKinsey & Company, *From Potential to Action: Bringing Social Impact Bonds to the US*, (2012), http://mckinseysociety.com/downloads/reports/Social-Innovation/McKinsey_Social_Impact_Bonds_Report.pdf (accessed November 18, 2014).

⁵ Social Finance, *Investing in What Works: “Pay for Success” in New York State*, (2014), <http://www.socialfinanceus.org/sites/socialfinanceus.org/files/Detailed%20Summary%20of%20NYS%20PFS%20Project.pdf> (accessed July 29, 2015).

⁶ Third Sector Capital Partners, *Case Study: Preparing for a Pay for Success Opportunity* (2013), <http://www.thirdsectorcap.org/news/case-study-preparing-for-a-pay-for-success-opportunity> (accessed June 19, 2015).

⁷ David Butler, Dan Bloom, and Timothy Rudd, “Using Social Impact Bonds to Spur Innovation, Knowledge Building and Accountability,” Federal Reserve Bank of San Francisco, *Community Development Investment Review*, http://www.mdrc.org/sites/default/files/SIB_SFReserve.pdf (accessed November 18, 2014).

the service provider to select healthier or more engaged participants. Selection bias of that type or other design features that make it easier to achieve success in the pilot phase do not accurately reflect the program’s prospects of success among a broader population.⁸ Therefore, states should carefully review a program’s design to ensure that it adequately reflects the true makeup and needs of the broader population. Further, the program itself might target an issue or problem that can be largely solved through a successful, short-term intervention or affects a small population.⁹ In those cases, a state should carefully weigh whether the cost of the program is sufficiently offset by projected short-term savings, because scalability is diminished. Those determinations will require consideration of the effect of any administrative costs the state must absorb related to SIB contracting, oversight, and evaluation processes.

- **A large enough population for the project allows for a valid evaluation of outcomes and for potentially greater efficiencies and financial gain.** To determine whether an outcome can be attributed to a specific program or intervention as opposed to chance, a sufficiently large sample size is imperative for a state to compare randomly selected intervention and control groups (where a control group is feasible).¹⁰ That constraint, however, can eliminate programs that target small numbers of high-cost populations and are not always practical in a health setting. Adequate sample sizes, however, can allow for greater efficiency and financial gain in certain programs. For example, a recidivism project that targets a

small number of prisoners may see only limited financial benefit from slight reductions in its prison population compared with the funds invested for the program. Conversely, a larger-scale recidivism project that substantially reduces a prison population may be able to derive significant downstream savings from the ability to reduce staffing or even close a facility.¹¹ In addition, economies of scale in SIBs can help lower the burden of overhead program costs, such as salaries, legal fees, or costs associated with investor due diligence; those fixed costs constitute a smaller proportion of the total budget as the program grows.

- **Intermediaries, investors and service providers are identified and there is an adequate transfer of financial risk.** Buy-in from intermediaries and the investor community is the foundational of a SIB-financed intervention. States can identify potential intermediaries in several ways. Some states and localities have used competitive procurement processes to select intermediaries; others have simply chosen an intermediary they feel has the level of experience or expertise necessary to execute the project. Although more time intensive, the competitive procurement process can allow states to identify entities to which they might not otherwise have access.¹² Those intermediaries can be responsible for the management and operation of a SIB, including soliciting investors and contracting with service providers.¹³ All parties involved in the contract should agree in advance on the performance targets and payment structure if targets are achieved. In addition, the

⁸ David B. Juppe, “Testimony of Dr. David B. Juppe—U.S. House Committee on Ways and Means, Subcommittee on Human Resources Hearing on Social Impact Bonds” (September 9, 2014).

⁹ Ibid.

¹⁰ Hanna Azemati et al., “Social Impact Bonds: Lessons Learned So Far,” Federal Reserve Bank of San Francisco, *Community Development Investment Review*, <http://www.frbsf.org/community-development/files/social-impact-bonds-lessons-learned.pdf> (accessed November 17, 2014).

¹¹ Ibid.

¹² Ibid.

¹³ Ibid.

intermediary and investors should be willing to assume an adequate level of financial risk if those goals are not achieved.

- **State resources are available upfront to cover the administrative costs related to the development and operation of a SIB.** Upfront state resources will be necessary to support functional activities of the state related to SIB development and operation, including developing the SIB contracts and agreements as well as monitoring and maintaining relationships with intermediaries as the program is implemented. Such activities include internal staffing capacity and technological infrastructure for information sharing and communication with the intermediary throughout the duration of the project.¹⁴ Conservative time estimates for SIB contract design and negotiation are between nine months and two years,¹⁵ although that period is influenced by the experience and ability of government officials to negotiate performance-based contracts.¹⁶ States might also set aside resources to manage marketing and communications activities, maintain transparency, and keep stakeholders informed. States must have the resources to cover any administrative costs of the SIB during the planning phase. In some instances, philanthropic partners have provided resources to cover those initial

transaction costs. Ongoing costs are shared between the government and the intermediary as negotiated during contract design.¹⁷ The planning timeframe could be shortened and associated costs lowered, however, as more states develop internal capacity to negotiate SIBs and best practices are shared among states.¹⁸

- **There is a reasonable expectation of support for the SIB from the state legislature.** The governor's office's involvement is critical in the strategic planning phase to align the SIB with the governor's vision for the state. In addition, legislative buy-in and approval are fundamental to the development, operation, management, and financing of the SIB intervention, because state leaders will need to determine to what extent a SIB requires legislative or regulatory action in their state.¹⁹

State and local governments will vary in their ability to make binding, long-term financial commitments for a SIB. For example, some states might face legislative and budgetary challenges relating to future appropriations. Investors could be wary of agreeing to a SIB contractual arrangement if legislation or state budgetary agreements fail to ensure that investors will receive repayment upon successful achievement of outcomes targets.²⁰ States typically appropriate funds for one- or two-year periods, which can diminish the attractiveness of a SIB to states as well as investors.

¹⁴ The Harvard SIB Technical Assistant Lab estimates that at least one full-time public employee is required for the duration of the program to manage government involvement in the SIB.

¹⁵ Jeffrey Liebman and Alina Sellman, *Social Impact Bonds: A Guide for State and Local Governments* (Cambridge, MA: Harvard Kennedy School Social Impact Bond Technical Assistance Lab, 2013), <http://siblab.hks.harvard.edu/files/siblab/files/social-impact-bonds-a-guide-for-state-and-local-governments.pdf> (accessed June 5, 2015).

¹⁶ Jeffrey Liebman, *Social Impact Bonds* (Washington, DC: Center for American Progress, 2011), <http://siblab.hks.harvard.edu/files/siblab/files/american-progress-report-social-impact-bonds-feb-2011.pdf> (accessed June 5, 2015).

¹⁷ Jeffrey Liebman, "Response to the U.S. Department of Treasury Request for Information, 'Strategies to Accelerate the Testing and Adoption of Pay for Success Financing Models'" (Cambridge, MA: Harvard Kennedy School Social Impact Bond Technical Assistance Lab, 2013), http://siblab.hks.harvard.edu/files/siblab/files/sib_lab_response_to_federal_rfi_v3-1.pdf (accessed June 5, 2015).

¹⁸ National Governors Association, interview with Sebastian Chaske, Harvard Kennedy School Social Impact Bond Technical Assistance Lab, March 31, 2014.

¹⁹ Although the need to legislate will vary among states, certain states, such as Massachusetts and Connecticut, have enacted legislation related to SIBs; Kristina Costa, Sonal Shah, Sam Ungar, and the Social Impact Bonds Working Group, "Frequently Asked Questions About Social Impact Bonds," (Washington, DC: Center for American Progress, 2012), <http://cdn.americanprogress.org/wp-content/uploads/2012/12/FAQSocialImpactBonds-1.pdf> (accessed November 19, 2014).

²⁰ Ibid.

Because a SIB creates a potential future liability, state appropriators will need to work under the assumption that all performance targets will be met and funds will come due to investors. However, such assumptions could overestimate actual future obligations if service providers do not meet all performance targets, and state appropriators might be reluctant to commit funds in excess of what may actually be paid out in the future. If feasible, states could consider passing legislation that authorizes and appropriates funds for multiyear contracts and allows for the redirection of unused funds in future years. For example, the authorizing legislation enacted in **Massachusetts** established a “sinking fund,” or a fund of accumulated appropriations, over the life of its SIB contract that requires the state to request appropriations each year up to the maximum payments allowed under the contract. The state can use this fund to make payments when they are due, eliminating the need for state legislature to make large one-time appropriations at a future date.²¹

In discussing appropriations and budgeting, it is worth noting that both executive and legislative budget officials tend to frown on mechanisms designed to carve out special treatment for any particular program. No matter how deserving, commitment to a program’s future funding places at a disadvantage all other programs competing for future-year dollars, because such a commitment would tie the hands of a future governor or legislative body, leaving them fewer options to adjust future spending in line with future priorities.

What Is The Process For Implementing A Social Impact Bond?

When a governor has determined that a SIB is right for

his or her state, that state would seek to contract with an intermediary (a private or nonprofit organization) to oversee the structure and management of the SIB.²² The work of developing a contract between the intermediary and state government can be lengthy and complex. At a minimum, both parties (and investors) will want to know the identity of the entity that the intermediary will engage to provide the agreed-upon service. That entity’s reputation and evidence of similar successful interventions are of critical interest to the government and investors. Note that in some cases those services might have been funded through normal state programs. The contracting parties need to establish performance benchmarks (outcomes) that trigger payments, the structure of those payments, the rate of return on capital invested, and the evaluation method that will determine whether benchmarks have been met. In some instances, such as in Massachusetts, the state, the intermediary, and the service provider enter into a three-way contract that has detailed, predetermined terms for engagement and responsibilities for all parties.²³ Although such a contract allows the state to retain more control over the intervention, states that pursue such contracts should expect higher transaction costs and less transfer of risk to the private sector.

The intermediary solicits capital from private commercial or philanthropic investors and structures the agreement on how much and under what circumstances investors would be paid. Investors, however, have balked when confronted with the risk of not recovering their investment.²⁴ To help reduce the financial risk to private investors, states have been asked to consider providing some portion of upfront capital or assuming some level of downside risk.²⁵

²¹ J. Liebman, *Social Impact Bonds*.

²² Ibid.

²³ Commonwealth of Massachusetts, “Pay for Success Contract Among the Commonwealth of Massachusetts, Roca Inc. and Youth Services, Inc.” (2014), <http://www.thirdsectorcap.org/wp-content/uploads/2015/03/final-pay-for-success-contract-executed-1-7-2013.pdf> (accessed November 7, 2014).

²⁴ Steven H. Goldberg, “The Investor Perspective,” *The Social Impact Bond Tribune* 2 (January 2013), http://payforsuccess.org/sites/default/files/sib_trib_no_2.pdf (accessed November 17, 2014).

²⁵ Steven Godeke and Lyel Resner, *Building a Healthy & Sustainable Social Impact Bond Market: The Investor Landscape*, Report for the Rockefeller Foundation (December 2012), http://payforsuccess.org/sites/default/files/godeke_consulting-social_impact_bond_investor_landscape.pdf (accessed November 26, 2014).

Some states have considered serving as guarantors of investor loans, helping reduce the level of risk for private investors by giving them either a cap on potential losses or some level of guaranteed return even if the program is unsuccessful.²⁶ Such actions, however, undermine one of the primary motivations a state has to enter into a SIB: the shifting of significant financial risk from the state to the private sector. As an alternative, states have sought to engage foundations or other philanthropies as risk guarantors. States have also experimented with repayment structures that provide interim and smaller payments for partially met program targets to reduce potential investor losses.²⁷

In some states, law or budget rules require that a contract liability to pay in the future be treated as if it were current spending. The principle underlying such constraints recognizes that most state services are funded on a year-to-year or biannual basis and that shifting payments to the future for one purpose could leave funding for other purposes at a disadvantage in the state's budget cycle, particularly when a state is legally required to balance its budget. States that operate in that way deny SIB-funded programs that special advantage of temporary budget relief.

One of the most difficult aspects of a SIB contract negotiation is reaching agreement on how the intervention's effectiveness will be evaluated. Reaching agreement about data sources and analytic techniques can be especially challenging.²⁸ The greater the specificity about criteria, processes, data sources, and analytic techniques established in advance of the SIB launch, the lower the likelihood of disagreement about the effectiveness and savings (if any) ultimately attributed to the intervention. For that reason, an independent evaluator is often engaged

to measure the outcomes of SIBs. Obligations and evaluation methodology are typically indicated in the contract between the state and the intermediary. The independent evaluator will certify achievement of the outcome by using a methodology that each party has approved in advance, if possible. The evaluator then will notify the government or governmental agency if the predetermined outcome has been achieved so that payments can be made.

When funding is secured and contracts are signed, the intermediary manages program implementation, operation, and evaluation.²⁹ Those functions include contracting with and overseeing the work of the service providers—for example, a social service organization, hospital, or community-based clinic.

How Are States Using Social Impact Bonds to Finance Innovations in Public Health?

The majority of SIBs currently in operation in the United States address homelessness and recidivism. The first state-led SIB initiative in the United States was launched by **New York** in December 2013 and focuses on reducing recidivism rates of individuals recently released from prison. The 5.5-year SIB raised \$13.5 million from investors, including Bank of America, Merrill Lynch, and the Laura and John Arnold Foundation, to support reentry programs that provide job training, transitional employment, job placement, and job retention support for the target population. The program uses a randomized control trial, and payments are triggered at the end of year three and year five if an independent evaluator certifies a five-percentage-point difference between employment rates and placement in transitional work between the treatment and control group members as well as a 36.8 day difference in the average number of days of incarceration per person

²⁶ T. Rudd, *Financing Promising Evidence-Based Programs*.

²⁷ S. H. Goldberg, "The Investor Perspective."

²⁸ J. Liebman, *Social Impact Bonds*; and Deloitte, *Paying for Outcomes: Solving Complex Societal Issues Through Social Impact Bonds*, <http://www2.deloitte.com/content/dam/Deloitte/nl/Documents/public-sector/deloitte-nl-social-impact-bonds.pdf> (November 17, 2014).

²⁹ T. Rudd, *Financing Promising Evidence-Based Programs*.

between the two groups.³⁰

State and local governments are beginning to explore how innovative public health programs can be financed through SIBs (see Table 1 on page 11). SIBs can be an attractive option in the health field for several reasons. First, they offer an experimental approach to financing and delivering traditionally grant-funded programs. Grant-funded programs are typically bound to federal or state restrictions, but SIBs can present an opportunity to try more flexible approaches to service delivery. Second, certain public health programs have demonstrated a meaningful return on investment. Examples of evidence-based programs include pro-grams focused on tobacco cessation, oral health, and asthma reduction.³¹ Finally, states are exploring ways to transform their health systems to systems that focus on prevention and population health and need options for paying for innovative nonclinical and preventive services.

In 2012, Fresno, **California**, launched a project to evaluate the feasibility of using a SIB to finance home-based programs to reduce asthma-related emergencies among high-risk children.³² Although program results are not yet available, the Fresno SIB team estimates a net savings potential of \$1,000 to \$5,000 per child per year in reduced Medicaid costs for children in the program group compared with a randomized control group. More definitive results are expected later in 2015.³³

In 2013, **South Carolina** began to develop a SIB focused on expanding the Nurse Family Partnership (NFP) to serve more than 2,700 new families over three years. The SIB's goal is to enable the state to ensure continuity of care for pregnant women, provide preventive services to this population, and expand program sites and locations to underserved areas.³⁴ South Carolina selected this intervention because of validated research demonstrating that NFP can lead to returns of \$2.88 to \$5.70 per dollar invested in NFP services.³⁵

Conclusion

Current interest in and experimentation with SIBs play a small part in state efforts to establish the viability of service delivery models that states can replicate through traditional performance-based contracts. When a SIB has provided evidence of an effective social intervention, states would have less need for the SIB model and could return to normal contracting procedures.

Governors can play a key role in SIB development by thoroughly considering the pros and cons of such programs and by viewing them as experimental vehicles for proving the value of innovative social programs and delivery models. Governors interested in SIBs should work with their legislatures to ensure that they have adequate authority to fund such projects. They should also dedicate staff resources to the development

³⁰ New York State Division of the Budget, "Investing in What Works: 'Pay for Success' in New York State—Increasing Employment and Improving Public Safety. Detailed Project Summary" (2014), http://www.budget.ny.gov/contract/ICPFS/PFSProjectSummary_0314.pdf (accessed November 7, 2014).

³¹ James Lightwood and Stanton Glantz, "Effect of the Arizona Tobacco Control Program on Cigarette Consumption and Healthcare Expenditures," *Social Science & Medicine* 72 no. 2 (January 2011): 166–72, <http://www.sciencedirect.com/science/article/pii/S0277953610007999> (accessed November 7, 2014); Trust for America's Health, "Examples of Successful Community-Based Public Health Interventions (State-by-State)" (August 2009), http://www.cahpf.org/GoDocUserFiles/601.TFAH_Examplesbystate1009.pdf (accessed November 7, 2014); and National Center for Environmental Health, Division of Environmental Hazards and Health Effects, Centers for Disease Control and Prevention, "Asthma's Impact on the Nation" (March 2013), http://www.cdc.gov/asthma/impacts_nation/asthmafactsheet.pdf (accessed November 7, 2014).

³² Social Finance, "The California Endowment Awards Grant to Social Finance and Collective Health" Press Release, March 25, 2013, <http://www.socialfinanceus.org/sites/socialfinanceus.org/files/imce/user/u104/Fresno%20Asthma%20Demonstration%20Project%20Press%20Release.pdf> (accessed November 7, 2014).

³³ National Governors Association, interview with Rick Brush, Collective Health, March 30, 2014.

³⁴ Nurse-Family Partnership, "State Profile 2014: Nurse-Family Partnership in South Carolina," http://www.nursefamilypartnership.org/assets/PDF/Communities/State-profiles/SC_State_Profile.aspx (accessed November 7, 2014).

³⁵ Nurse-Family Partnership, "Costs & Benefits: The Economic Return on Investment" (February 2007), <http://files.givewell.org/files/Cause3/Nurse-Family%20Partnership/B/Cost-BenefitOverview-1.pdf> (accessed November 7, 2014).

Table 1. Status of Social Impact Bonds with a Public Health Focus as of April 2015³⁶

State	Status of Operation ³⁷	Focus Areas
Arkansas	Considering	Recidivism
California	In Development	Maternal and Child Health
Colorado	Considering	Recidivism
Connecticut	In Development	Substance Abuse/Maternal and Child Health
Hawaii	Considering	Early Childhood Education/Development
Illinois	In Development	Recidivism/Youth Development
Massachusetts	Active	Recidivism/Chronic Homelessness/Supportive Housing
Michigan	In Development	Maternal and Child Health
Minnesota	In Development	Supportive Housing/Workforce Development
Nevada	Considering	Early Childhood Education/Development
New Mexico	Considering	Mental Health
New York	Active	Recidivism
New York	In Development	Diabetes/Maternal and Child Health
New York	Considering	HCBS/Supportive Housing
North Carolina	Considering	Early Childhood Education/Development
Oklahoma	Considering	Recidivism
Oregon	Considering	Preventive Health
South Carolina	In Development	Maternal and Child Health
Utah	Considering	Recidivism / Substance Abuse/Mental Illness
Virginia	Considering	Maternal and Child Health
Washington	Considering	HCBS/Supportive Housing/Early Childhood Education/Development

Note: SIBs that have a public health focus include those that target social determinants of health, including housing, education, and economic and job stability.

³⁶ Nonprofit Finance Fund, “Pay for Success U.S. Activity,” <http://payforsuccess.org/pay-success-deals-united-states#sc> (accessed June 3, 2015).

³⁷ Status of Operation: An “active” classification means that services are already being delivered. States that have identified a scope and are in the process of finalizing contracts are classified as “in development.” States that have not defined scope and are in the process of soliciting stakeholder feedback are classified as “considering.”

of SIBs and ensure that the state is getting appropriate value for its money. Moving forward, states should continue to share lessons learned so that SIBs can be further refined and evaluated for their effectiveness in

improving population health outcomes and creating conditions that could lead to sustainable funding for public health interventions through traditional contracting models.

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Appendix A. Social Impact Bonds: A Form of Public-Private Partnership

Despite their name, social impact bonds (SIB) are in fact not bonds. From the government's point of view, they are contracts with an entity that will provide a service or intervention designed to improve societal or population-focused outcomes.³⁸ The SIB contracting model emphasizes outcomes, known as *pay for success* (PFS). As the name implies, PFS models pay service providers only if the provider meets agreed-upon performance targets.³⁹ A SIB-type PFS model uses outside investors to capitalize the intervention. The intent of the model is to establish contractual incentives that induce service providers to deliver better outcomes than current programs at lower costs. SIBs can shift significant financial risk to private investors; under a SIB contract, the government would, in financial terms, have a liability to pay investors when a service provider meets pre-established contractual benchmarks, with no (or little) obligation to pay if the provider falls short.⁴⁰

The SIB arrangement can be seen as a type of public-private partnerships (PPP), or contractual arrangement between a government and one or more private entities in which the private entities assume some level of risk. PPPs have been used to improve the effectiveness and efficiency of various public-sector programs for decades.⁴¹ The Organization for Economic Cooperation and Development (OECD) defines a PPP as an agreement between the government and one or more private partners (which may include the operators and the financiers) according to which the private partners deliver the service in such a manner that the service delivery objectives of the government are aligned with the profit objectives of the private partners and where the effectiveness of the alignment depends on a sufficient transfer of risk to the private partners.⁴²

Thus, states familiar with PPPs will be able to understand SIBs, because they share structural and operational similarities. Although states have employed PPPs in the transportation sector, primarily for infrastructure development, in principle they can also be used for delivery of services. European countries have used PPPs for projects in defense, environmental protection, hospitals, information technology, and prisons.⁴³

A practical difference between PPPs and SIBs lies in the formal relationship between the government and the service provider. States that have developed PPPs often engage directly with the private-sector provider to negotiate the scope of work, expectations, and payment.⁴⁴ In contrast, SIBs engage an intermediary to negotiate the terms of the contract, raise private capital, and identify service providers. Traditional PPPs are two-party contracts between the government and service provider, while SIBs rely on the intermediary to coordinate service provision and government payment.

OECD has sounded several cautionary notes for governments considering the use of a PPP that can have unique implications when considering a SIB. Among the most important considerations are affordability, risk transfer, and competition.

³⁸ McKinsey, *From Potential to Action*.

³⁹ John K. Roman et al., *Five Steps to Pay for Success: Implementing Pay for Success Projects in the Juvenile and Criminal Justice Systems* (The Urban Institute, June 2014), <http://www.urban.org/UploadedPDF/413148-Five-Steps-to-Pay-for-Success.pdf> (accessed November 14, 2014).

⁴⁰ Social Finance, "A New Tool for Scaling Impact: How Social Impact Bonds Can Mobilize Private Capital to Advance Public Good," February 2012, <http://www.socialfinanceus.org/sites/socialfinanceus.org/files/small.SocialFinanceWPSingleFINAL.pdf> (accessed November 14, 2014).

⁴¹ Organization for Economic Cooperation and Development, *Public-Private Partnerships: In Pursuit of Risk Sharing and Value for Money* (Paris, France: OECD Publishing, 2008).

⁴² Ibid.

⁴³ Ibid.

⁴⁴ Michael B. Gerrard, "Public-Private Partnerships," *Finance and Development* 38 no. 3 (September 2001), <http://www.imf.org/external/pubs/ft/fandd/2001/09/gerrard.htm> (accessed November 17, 2014).

Affordability

Savings to the state, what OECD calls *value for money*, is the combination of quality, contract features, and price calculated over the life of the project and serves as the foundation for PPP or SIB viability. In principle, affordability is about whether a project falls within the government's budget constraints and whether the sum of future payments can be justified by the benefits received.⁴⁵ When a state decides between traditional contracting options and a PPP or SIB, it should assess which option is most affordable and will deliver the greatest value for the money.

Although it is widely assumed that a private-sector provider will generally deliver a service at lower cost than a public-sector agency, three considerations can undermine that assumption. In the first instance, administrative costs imposed on the public sector, notably during the precontract phase, can be substantial and offset at least a portion of any cost savings the project produces.⁴⁶ Second, private investors typically expect a rate of return above the raw cost of service provision. That rate of return is negotiable and generally based on risk. The higher the rate of return allowed the private sector, the lower the savings to the public sector. Third and perhaps most important, states rarely budget for longer than one or two fiscal years depending on the frequency of legislative sessions.⁴⁷ As discussed earlier, a key consideration is whether the government officials have or can obtain authority to commit money in future years when payments come due for a successful SIB. To the extent that future spending must be appropriated or reserved when the SIB is initiated, affordability may become more difficult to maintain. In addition, states may consider how appropriations decisions affect individual state agencies that may bear disproportionate budgetary burden for a particular project where benefits accrue to the entire department.

Financial Risk Transfer

The question of who ultimately bears risk is critical to the evaluation of a PPP or SIB. *Risk* here is defined as the link between bearing the cost of failure and the efficiency of the project. Solely engaging private partners to carry out the functions of the project without bearing financial risk and responsibility is not sufficient. Financial risk sharing with private partners provides the incentive to finish projects in a timely manner, improve efficiency, and provide a more accurate forecast of expenditures.⁴⁹ Actions that private investors take in negotiations over SIBs to reduce their risk run counter to a state's interests. Allocating an appropriate level of risk to private partners should take into account tradeoffs for both parties.⁴⁹ Efficient risk allocation means that risk should be allocated to the party best able to manage it. In that instance, the party best able to mitigate the risk or afford the consequences should bear that risk for the project. States should consider private partners that have the financial capital to assume substantial financial risk or those that have previous experience around the chosen service and may be able to influence the efficiency and success of service delivery. Other types of risk also should be considered, such as supply and demand, legal, and political risk.⁵⁰ Finally, because financial misalignment often exists when health care services are reimbursed on a fee-for-service basis, intermediaries that propose financing mechanisms that allow health care providers to bear risk for the success of the intervention should be considered.

⁴⁵ Organization for Economic Cooperation and Development, *Public-Private Partnerships*.

⁴⁶ Marcus Ahadzi and Graeme Bowles, "Public-Private Partnerships and Contract Negotiations: An Empirical Study," *Construction Management and Economics* 22 no. 9 (November 2004): 967-978, <http://www.tamu.edu/faculty/choudhury/articles/28.pdf> (accessed November 17, 2014).

⁴⁷ Ron Snell, "State Experiences With Annual and Biennial Budgeting," National Conference of State Legislatures, April 2011, <http://www.ncsl.org/research/fiscal-policy/state-experiences-with-annual-and-biennial-budgeti.aspx> (accessed November 18, 2014).

⁴⁸ Limited to institutional settings.

⁴⁹ Organization for Economic Cooperation and Development, *Public-Private Partnerships*

⁴⁹ *Ibid.*

⁵⁰ *Ibid.*

Competition

Within PPPs, competition in both the pre- and postcontract phases is important. In the precontract phase, a competitive bidding process can increase the incentive for private entities to maximize efficiency and ensure that the government achieves value for the money or savings it seeks.⁵¹ In the postcontract phase of a traditional PPP, states often sign a contract with a sole private entity that becomes a monopolistic provider for the project. In a market where competition is absent and a private partner is the sole provider of a service, the state and consumers may experience high prices as services extend beyond the initial contract period.⁵² Intermediaries should be encouraged to maintain flexibility and diversification in their contracts with providers to prevent monopolistic pricing.

⁵¹ Ibid.

⁵² Ibid.