WHEN HIGH FINANCE MEETS AGE-OLD PROBLEMS

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Preventing problems rather than trying to fix them afterward makes sense, yet even when prevention has been shown to work and save money, it often doesn't get supported or funded. That is why people are getting excited about an innovative approach to reshaping how government and nonprofits work together to deliver better social outcomes.

In a short amount of time, a pilot study under way at a prison 75 miles north of London has generated interest across the globe and will likely be getting its next test in Massachusetts. The experiment is to use a new financing tool—a "social impact bond," also called a "pay-for-success contract"—to bring market solutions to society's problems.

The way it works is the government contracts with nonprofits to deliver certain social outcomes, such as fewer incarcerations or reduced homelessness. If the nonprofit achieves those outcomes, which reduce government spending over time, the government reimburses the nonprofit and pays a return. If the nonprofit does not achieve the outcomes, then it is not repaid. For example, in the United Kingdom case, if the nonprofits can reduce reincarcerations of criminals by a target amount, the government will pay for the program costs.

The bond aspect comes into play if intermediaries are used as part of the model to raise funds from the private sector to provide working capital to the nonprofits. But given that there's the chance that government won't pay if the outcomes aren't achieved, the word "bond" is a misnomer. The investment is more like venture capital.

"Times are tight for everyone," says Alex Zaroulis, spokeswoman for the Massachusetts Department of Administration and Finance, which has requested proposals from nonprofits and intermediaries on pay-for-success contracts. "We don't want to put taxpayer dollars at risk for unproven programs." She and others within the Commonwealth are hoping to use social-innovation financing to learn faster about what works and to pay only for success, rather than the promise of success.

Show Me

Social programs are frequently under pressure to prove their value. Some, such as food banks, do not return savings to taxpayers and so are judged based on their civic and social benefit. Others however, such as those that reduce criminal behavior or reduce reliance on high-cost emergency care and services, can yield economic as well as social benefits. Even among these double-bottom-line programs, however, it is not always clear which programs are delivering results. What exactly are those results? Are they as good as they can be? If so, how can the program be replicated or scaled to provide still greater value? At a time when states remain leery of spending, given the damage from the recession, the stakes for nonprofits and program providers remain high. Want government funding for your program? Then show me the results, and by the way, show me the money.

You can't blame states for focusing on results. Just the opposite. Many on both sides of the political spectrum in the United States and abroad have praised impact investing as a responsible approach to better understanding and supporting social programs that work. And to put it mildly, the upside is significant. According to the Coalition for Evidence-Based Policy, which reviewed 10 major federal social programs for effectiveness, nine of the 10 major social programs were found to be ineffective.

The review authors warn, "It would be a mistake to jump to the conclusion that nothing works in social policy" since many components within these large social programs (for example, nurse-family partnerships within the early childhood program) do in fact work. It's just that when small pieces that work well get mixed together with those that don't work so well, the outcomes overall turn out to be pretty dismal. All the more reason to find out where the successes are and replicate those. Moreover, say the authors, citing a poverty rate of one in six Americans and poor U.S. progress on issues such as K-12 education, "the problems that these programs are designed to address have not gone away."

Social impact bonds, which move financial risk from taxpayers to service providers and focus on outcomes over outputs, seem well suited to address these problems. Andrew Wolk, founder and CEO of Root Cause—a nonprofit based in Cambridge, Massachusetts, that focuses on advancing innovation for social impact—sees the most potential in the bonds' ability to "force conversation among government agencies and between government agencies and nonprofits about outcomes." He believes that the contractual arrangements, although complex, represent an easier alternative than realigning all of the sometimes overlapping government programs that have touch points with at-risk or vulnerable groups of people. Citing a study on how Texas was investing $8 billion with 87 different nonprofits, he argues that the beauty of social impact bonds is that they will help to "change the rules of the game" about how public and private sectors can partner and assess performance.

Giving It a Try

Roughly 30 states and local governments are looking into social impact bonds, many spurred by federal pilot programs announced by the Obama Administration in early 2012. Massachusetts is the frontrunner in testing out the approach. The Commonwealth reached out to nonprofits and intermediaries in two issue areas: chronic homelessness and youth at risk of reentering the corrections system.

For the youth focus, Massachusetts is interested in providing services that can help to reduce recidivism among the roughly 750 youth who age out of the juvenile justice system each year. That rate, at 30 percent arrested and ultimately convicted for new offenses within one year of release, leads to high costs for the state: approximately $45,000 per inmate per year.

Molly Baldwin, executive director of ROCA, a nonprofit based in Chelsea, Massachusetts (with a replicated effort in Springfield providing intervention services to high-risk young people), says ROCA did "a lot of homework on scaling" their program and assessing different scenarios in preparing their proposal for the youth-justice issue. "It's great and really important for the state to say what they are doing, who they are serving, how they are making a difference, and moving financing in that direction."[1]

Mark Hinderlie, president and CEO of Hearth, a Boston-based nonprofit focused on ending elder homelessness, thinks social impact bonds are a brilliant idea for overcoming the lack of comprehensive and stable funding that constrains progress in his field. Having seen his organization's budget cut by $400,000 since 2008 because of state fiscal constraints, Hinderlie is hopeful that the bonds will help to provide needed services with fewer bureaucratic funding limitations. Referring to a Boston Health Care for the Homeless study, Hinderlie says health care costs the public two to three times what it would if a homeless person were in a stable housing arrangement. Providing stable housing "is a way to save money, get better outcomes, and help vulnerable people."

Hype and Skepticism

There is a lot of excitement around social impact bonds, but also skepticism. It's not clear yet how many programs will be able to demonstrate a return on investment to the taxpayer or how many have success metrics that can withstand rigorous third-party evaluation. Perhaps early childhood intervention effects, college completions, or hospital readmissions will be the next areas?

Time will tell how quickly the approach expands and also whether investors reliably recoup their capital. The latter will influence whether social impact bonds come to been seen as predictable instruments like municipal bonds or remain a niche product similar to venture philanthropy. If social impact bonds do find a footing among investors, they will have to overcome the perception some people hold that "financial innovation" is harmful sleight of hand. Top-rated tranches of early childhood intervention, anyone?

No one denies that social impact bonds are complex. And with that complexity, comes cost. The consulting firm McKinsey conducted a pro-forma analysis showing that the same program directly funded by government would take eight years to break even, but that through the social impact bond structure it would take 12 years. So why not just skip the middleman and fund programs directly? The answer from Tracy Palandjian—CEO and cofounder of the Boston office of Social Finance, a leading intermediary whose parent organization is involved in the UK pilot—is that political cycles, annual budget calendars, and short-term thinking have been barriers to government action on important social problems. By moving risk from the government to the private sector, proponents of social financing hope they will be able to bring innovative programs to scale in a way that the current system doesn't facilitate.

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Endnote

1 For background on ROCA, see John Ward, "Giving At-Risk Youth a Chance," *Communities & Banking* 22, no. 4 (fall 2011), http://www.bostonfed.org/commdev/c&b/2011/fall/Ward_Roca_at-risk_youth.pdf.