Statement of

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on

Social Impact Bonds

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Chairman Warner, Ranking Member Ayotte, and Members of the Task Force, my name is Kyle McKay and I am currently an analyst with the Texas Legislative Budget Board. I would like to thank you for the invitation to appear before you today to discuss social impact bonds.

The primary difference between social impact bonds and prior attempts to link outcomes to payments is the inclusion of investors. According to proponents, social impact bonds and the inclusion of investors can increase the extent of evidence-based policy, encourage innovation in service programming, produce costs savings to governments, and invoke government expenditures only after success is demonstrated. For governments facing revenue constraints for political or economic reasons, social impact bonds may appear to be the silver bullet for social services. However, the benefits may be based largely on wishful thinking. Yet the risks and costs to governments from engaging in this type of model are real, which is why an in-depth study conducted at the Maryland Department of Legislative Services led to the recommendation that the state not pursue social impact bonds.

Common Misconceptions about Social Impact Bonds

After conducting research with the Maryland Department of Legislative Services, I have discovered a number of misconceptions surrounding social impact bonds. Five common claims should be closely examined:

1. *Social impact bonds will provide new capital for programs*

It is important to remember that if the program operated in conjunction with a social impact bond is successful, the government will have to pay for the program. Thus, governments should budget for this potential payment by appropriating funds in advance. Though it may be technically possible to appropriate funds after outcomes have been demonstrated in spite of fiscal best practices and balanced budget rules, investors will likely seek a secured source of income for repayment. As a result, the governments of Massachusetts, New York City, and the U.K. are pre-funding potential outcome payments.[1]

Given the costs of attorneys, consultants, and program evaluators, the potential for a return on investment to third-parties, and a second tier of program managers, using a social impact bond relative to direct financing will therefore *increase* pressure on the budget, as the government must set aside *more* funds than even the investors provide to the program. In Massachusetts the state is liable for up to $27 million in payments. The investors, in contrast, are providing only $12 million in funding. This is why McKinsey, which is generally supportive of social impact

[1] In Massachusetts, for example, there is "a sinking fund requirement under which the secretary shall request an appropriation for each fiscal year that the contract is in effect, in an amount equal to the expected payments that the commonwealth would ultimately be obligated to pay in the future based upon service provided during that fiscal year, if performance targets were achieved." *Fiscal Year 2012 Appropriation Act.* Available at http://www.mass.gov/governor/legislationeexecorder/legislation/an-act-making-appropriations-for-the-fy2012.html. In New York City, Bloomberg Philanthropies assumed the liability of the government by providing $7.2 million to "be held by MDRC in a guarantee fund to back the loan." *Bringing Social Impact Bonds to New York City,* New York City. Available at http://www.nyc.gov/html/om/pdf/2012/sib_media_presentation_080212.pdf

bonds, said "this tool is a more expensive way to scale programs than if government simply contracted directly with a service provider."[2]

2. *The government pays only for success*

Given the additional upfront cost to the government for potential success payments and fees to intermediaries if the program works, there is really only one scenario where a social impact bond could plausibly be cheaper than direct financing: when investors pay for failure.

On a prospective basis, this means that governments should look for projects that have something close to a 50 percent chance of success. Programs that have been proven to work should be financed directly by agencies, as direct financing is substantially more cost-effective and will allow the government to capture the entire amount of any cost savings associated with the program. Conversely, if the chances of success are closer to 0 percent, then it obviously begs the question of why investors and the government would engage in a program they believe is likely to fail.

In addition to the challenge of selecting a program with something approximate to a 50 percent chance of success, the government must also have a high degree of confidence in the commitment of the private investors to realize a loss in the event that the program fails. However, the complexity and difficulty of designing a social impact bond contract may impede this goal. RAND Europe found, for example, that in Peterborough, "complexity in some instances meant that the actual transfer of risk is not clear."[3]

This complexity is inherent to the model. Attempting to manage social services through contract attorneys, consultants, financial intermediaries, and an all-or-nothing payment model based on an evaluation will inevitably produce a contract that is complex and subject to unforeseen contingencies and weaknesses.

Even if the contract is written in a way that conclusively shifts risk by the terms of the contract, this does not preclude investors (or even providers) from breaking the contract and leaving the government with the responsibility for ongoing operational costs. In fact, in Massachusetts, the investors have a formal early termination clause where they can cancel the program after two years if the program is not performing well.[4] In this scenario, the government would have incurred significant startup costs associated with designing and executing the contract only to have the program cancelled early.

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[2] *From Potential to Action: Bringing Social Impact Bonds to the U.S.,* McKinsey on Society. Available at http://mckinseyonsociety.com/social-impact-bonds.

[3] *Lessons learned from the planning and early implementation of the Social Impact Bond at HMP Peterborough,* RAND Europe. Available at http://www.justice.gov.uk/downloads/publications/research-and-analysis/moj-research/social-impact-bond-hmp-peterborough.pdf

[4] *Pay for Success Contract Among the Commonwealth of Massachusetts, Roca, Inc. and Youth Services, Inc.* Available at http://hkssiblab.files.wordpress.com/2012/11/ma-pay-for-success-contract-roca-project-executed-1-7-2013.pdf

3. A focus on outcomes will encourage innovation in programs

Though there is a non-trivial risk of early cancellation, there is perhaps an even stronger risk that the high-stakes nature of the outcome payment will drive investors to select programs with an already proven record.

According to a paper published by the Federal Reserve Bank of San Francisco from the evaluation group MDRC: "Profit-seeking investors will be most interested in social programs or models that are proven."[5] Consistent with these expectations, according to the Center for Law and Social Policy, "investors appear to be sticking to models that have already been extensively evaluated."[6]

4. The programs will save governments money

Proponents argue that social impact bonds will result in decreased expenditures and thus cost savings to the state. This reduction in expenditures is necessary to justify the risk premium or "success payments" made to investors and social impact bond participants. However, pilot programs do not operate at a scale large enough to produce significant cost savings to the government.

In Maryland, for example, we used well established cost estimation techniques with our state agencies to model a potential pilot program impact. We built an optimistic model, where the program produced positive outcomes at the higher end of what is seen in meta-analytic studies. We also assumed very low costs for designing and implementing the contract and evaluation at only $700,000 (in Massachusetts these costs are approximately $2 million). Despite the highly optimistic assumptions, we found that even for a relatively large criminal justice reentry pilot program in Maryland, a 10 percent reduction of re-imprisonment for program participants would at best produce a 6 percent discount to the total cost of operating the pilot program.[7]

There are certainly some criminal justice reforms that can improve outcomes and reduce expenditures. The problem with the assumptions of cost savings in social impact bond programs is that pilot programs are just too small to have any meaningful impact on the fixed costs of government agencies. This is why an independent evaluation by RAND Europe of the Peterborough program found that the prison reentry program "is too small to deliver substantial 'cashable' savings" for the government.[8]

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[5] David Butler, Dan Bloom, and Timothy Rudd. *Using Social Impact Bonds to Spur Innovation, Knowledge Building, and Accountability*. Available at http://www.mdrc.org/sites/default/files/SIB_SFFedReserve.pdf.
[6] Lower-Basch, Elizabeth. *Social Impact Bonds: Overview and Considerations.* Center for Law and Social Policy. Available at http://www.clasp.org/resources-and-publications/publication-1/CLASP-Social-Impact-Bonds-SIBs-March-2014.pdf
[7] *Evaluating Social Impact Bonds as a New Reentry Financing Mechanism: A Case Study on Reentry Programing in Maryland*. Maryland Department of Legislative Services. Available at http://works.bepress.com/cgi/viewcontent.cgi?article=1002&context=kylemckay.
[8] *Lessons learned from the planning and early implementation of the Social Impact Bond at HMP Peterborough*

5. *Social impact bonds will encourage evidence-based policy*

Although discussions about social impact bonds sometimes operate under an assumption that research and evidence are unique to social impact bonds, there are vibrant communities and collaborations between researchers, practitioners, and policy makers that have existed in many policy domains for long periods of time. The addition of investors will not resolve outstanding research questions or implementation challenges.

In fact, there is a significant risk that social impact bonds may distort the research process. One lesson from the criminal justice literature is that program quality and model fidelity is often key to the success of rehabilitative programs. Even when an agency settles on a program design based on the research literature, a common challenge is finding ways to consistently operationalize the program in systems that are not always philosophically or operationally open to changes.

Though the programs that operate in Massachusetts and Peterborough appear to fit the mold of best practices suggested by an established body of research, these programs may or may not provide generalizable knowledge on how to scale their success more broadly across criminal justice systems. To the extent that these programs have additional resources or advantages—even in such non-tangible ways as heightened professional motivation from public scrutiny—they may not be so easily replicable.

The point is not to that we should be looking for the perfect program and the perfect evaluation, because that is not possible to realize. Programs operate in rich contextual environments of human society that will always create some wrinkle in our ability to precisely estimate and describe causality. The point is that one program evaluation does not make a body of research. But an overemphasis on linking the outcome to an all-or-nothing payment could easily reduce the utility of the evaluation for policymakers and future researchers.

The Hidden Risks of Social Impact Bonds

Though the purported benefits may not be as obtainable as advocates may claim, the appeal of innovation and experimentation may still attract many. It is important, however, to consider a number of significant risks to governments engaging in social impact bonds before making a decision to engage in a resource-intensive experiment. These risks have been shown to be persistent and problematic across a large number of policy domains following decades of attempts to link payments to outcomes.

Essentially, attempts to link performance to payment have been plagued by problems associated with Campbell's law, which states that "the more any quantitative social indicator is used for social decision-making, the more subject it will be to corruption pressures and the more apt it will be to distort and corrupt the social processes it is intended to monitor."[9]

[9] Campbell, Donald. *Assessing the impact of planned social change.* Evaluation and Program Planning. Volume 2 (1), 1979. Available at http://eric.ed.gov/?id=ED303512.

In education, for example, the American Statistical Association has found that the use of outcome based models "can have unintended consequences that reduce quality," in part because the models are highly complex, subject to error, and generally show "that teachers account for about 1% to 14% of the variability in test scores." A focus on the outcomes that are easily measurable can discourage teachers, incentivize teaching to the test, and distract us from "the majority of opportunities for quality improvement [which] are found in the system-level conditions."[10]

Health care provides an excellent tangible example of this phenomenon. Pay-for-performance regimes have been shown to produce mixed results, with only a limited number of examples that have produced long-term sustainable improvements.[11] But there are a multitude of examples where governments have had to contend with gaming and distortions. The Centers for Medicare and Medicaid Services (CMS) has seen first-hand how a pay-for-performance program simply resulted in "pay-for-reporting" rather than a change in outcomes.

Immediately after introducing payment reductions in 2008 for preventable complications that occur during Medicare inpatient surgeries and admissions, the rate of complications for central line infections reported to CMS dropped by over 50% in a single quarter. A careful examination by researchers using lab data, however, showed that there was no meaningful change in the real rate of complications, indicating that the change reported to CMS was due to a gaming of the reporting mechanism. The incentive had no impact on quality but CMS did lose the ability to use a key data set for understanding complications during surgery.[12]

In all of these instances, the percentage of payment at risk represented less than 50 percent of the total income to the actors. Simply adding an investor will not erase these problems. Instead, there is a risk that the introduction of an investor will exacerbate the problems typically experienced as the amount of funding at-risk increases and investors assume a primary role for establishing what constitutes evidence.

These risks are substantial, but the risk that should be the most concerning is the opportunity cost of building such complex mechanisms which focus on very narrow goals and program types. Building a highly sophisticated contracting and financing mechanism to focus on one small program may impede the capacity of agencies to engage in broader policy evaluation and change.

A social impact bond financed reentry program in criminal justice, for example, depends on a system of private service delivery external to the public agency. This may be counterproductive where integration with current public programs would increase efficiency and efficacy. Reentry programming often starts in many jurisdictions at the point of entry into the prison or jail system. Creating a new system separately administered by the private sector may hamper operational

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[10] *ASA Statement on Using Value-Added Models for Educational Assessment*, American Statistical Association. Available at http://www.amstat.org/policy/pdfs/ASA_VAM_Statement.pdf.

[11] *Health Policy Brief: Pay-for-Performance*, Health Affairs. Available at https://www.healthaffairs.org/healthpolicybriefs/brief.php?brief_id=78

[12] Farmer SA, Black B, Bonow RO. *Tension Between Quality Measurement, Public Quality Reporting, and Pay for Performance.* JAMA. 2013;309(4):349-350.

integration, especially if the agency were to seek to implement large scale re-organization or policy changes which could jeopardize the pilot study evaluation.

Conclusion

In short, it is my personal opinion that social impact bonds are expensive and risky. They may also distract governments from a more comprehensive, sustainable approach to improving public policy. Across a variety of policy areas, we have learned that measuring outcomes and using monetary payments to incentivize behavior change is difficult and often produces mixed results. There is no evidence to suggest that simply throwing investors into the fray will resolve the ongoing limitations and problems. Instead, they may very well exacerbate the challenges.

Thank you for the opportunity to provide testimony today. I would be happy to answer any questions.