



# Social Impact Bonds 101

## Defining an Innovative New Financing Tool for Social Programs

Jitinder Kohli, Douglas J. Besharov, Kristina Costa

March 2012

Imagine a company in Washington, D.C., with 100 employees, 47 of whom are 65 years of age or older. [Ample scientific research](#) indicates that adults who do not even moderately exercise have an increased risk of many health problems, including diabetes, cardiovascular disease, and some cancers. Using the [Physical Inactivity Cost Calculator](#) developed at East Carolina University's College of Health & Human Performance, we know that if 5 percent of the inactive employees at that company exercised just a bit, it could save the company \$62,300 in annual health-related costs.

The 100-employee company in Washington is similar to the U.S. Senate. And even in as intractable an organization as Congress, it would surely cost less than the projected \$62,300 in savings to persuade four currently sedentary senators to start walking from their offices to votes instead of taking the [Senate Subway](#).

Unfortunately, despite evidence about the effectiveness of preventive services in areas such as health care, education, and homelessness, budget officials and appropriators infrequently direct resources toward them.

But an innovative new financing mechanism called the Social Impact Bond may help change that. Social Impact Bonds, or SIBs, take traditional government funding structures and turn them on their head. Instead of paying costs upfront for a set of services, SIBs allow government to focus funds on approaches that work—without paying a dime if agreed-upon outcomes are not achieved.

Preventive services, as in health care, are an area where government and nonprofits are most excited about the possibilities of Social Impact Bonds. Government can too often be penny-wise but pound-foolish, cutting funds for programs that may actually save money down the road. But SIBs could fund preventive interventions without making government decision makers nervous about paying for something that may not prove effective.

---

## A definition of Social Impact Bonds

A simple definition of Social Impact Bonds, established in our [issue brief](#) on the subject, is as follows:

An arrangement between one or more government agencies and an external organization where the government specifies an outcome (or outcomes) and promises to pay the external organization a pre-agreed sum (or sums) if it is able to accomplish the outcome(s).

---

## What makes Social Impact Bonds unique?

To be sure, the Social Impact Bond arrangement is more complicated than this simple definition suggests and requires government agencies to behave in unfamiliar ways. For instance, for a SIB to work, agencies must place few, if any, controls on how the external organization seeks to accomplish the outcome. Unlike performance contracts, in which activities are funded upfront and government agencies often release a bonus payment for achieving defined outcomes, all payments in the SIB model are entirely contingent on the outcomes being achieved. If the external organization doesn't achieve the outcome, the government doesn't pay.

---

## Where will Social Impact Bonds most likely be useful?

Social Impact Bonds are still in their infancy, and there remains a great deal to learn. But early applications of SIBs will most likely be in areas where:

- Government agencies believe they will save money as a result of the outcome being achieved
- Outcomes are observable and measurable within three to eight years
- Social interventions are shown to be effective in achieving the outcome
- Few negative consequences exist if the external organization determines it cannot achieve the outcome and discontinues services

Some specific program areas that governments in the United States are beginning to explore for Social Impact Bonds include reducing recidivism, reducing homelessness, preventive health services, workforce development, and helping unemployed persons re-enter the workforce.

---

## Advantages of Social Impact Bonds

Social Impact Bonds provide a genuine way for government to direct funds toward interventions that work since activities that don't achieve outcomes under a SIB will not receive taxpayer dollars.

Social Impact Bonds can also help overcome one of the most persistent shortcomings of government programs: the tendency to divide money and information into different “silos,” preventing programs and agencies from working together effectively.

The best way to lower Medicare costs for the average beneficiary, for instance, may be through some combination of early cancer screenings, nutritional consultations to prevent diabetes, and, yes, incentives to be more physically active. The optimal combination of preventive measures is likely to be different for every person. But in government there are frequently different programs and funding streams separately focusing on each measure. With a Social Impact Bond for preventive health care, however, there is a strong incentive for the external organization to coordinate different approaches to achieve the desired outcome and receive their payment.

Sometimes government agencies may find it difficult to shift funds away from ineffective programs because of poor data or political pressures. But with a Social Impact Bond, there are strong incentives and sufficient freedom for the external organization to direct funds to approaches that work—and the process of doing so is “depoliticized.”

Social Impact Bonds could be an effective way of taking innovative interventions that have worked in one area or location and “scaling up” the approach elsewhere. With SIBs, external organizations are encouraged to identify interventions that have already worked in order to assure themselves that they will achieve the outcome and receive their payment.

---

## Challenges for government

While Social Impact Bonds may seem relatively straightforward, there are several issues for government to consider:

- It is both difficult and essential to define a meaningful, measurable outcome.
- Payments must be based on what achieving the outcome is worth to government in potential savings and to society in potential benefits, not on how much achieving the outcome will cost the external organization.
- Agencies must cede decisions about how to achieve the outcome to the external organization.

- Agencies must find ways to offer the external organization firm guarantees that they will be paid if they achieve the outcome.
- Because there are strong incentives for the external organization to stop providing services if they do not think they will achieve the outcome, agencies should carefully negotiate mechanisms for an orderly termination of the SIB arrangement.
- Payments should ideally be funded by a combination of agencies that benefit from the outcome being achieved because benefits will accrue across multiple agencies and possibly across different levels of government.

Social Impact Bonds are an exciting and innovative new way to fund social programs. But they aren't a panacea, and there will be program areas where it will be impossible to overcome the above challenges. Government agencies will need to think very carefully about where SIBs will work best in their program areas.

---

## Conclusion

Despite the challenges, Social Impact Bonds present a real opportunity to better solve egregious social issues through partnerships between the government, nonprofits, and the private sector. SIBs can improve the quality of public services, save taxpayer money, and offer new approaches to providing social services without requiring government to assume all of the financial risk. But most importantly, SIBs will help ensure taxpayers receive significantly better returns for their investments.

This is the first in a [series of articles](#) about Social Impact Bonds and is published to complement to our issue brief on the subject, which goes into much greater detail about the SIB mechanism, its benefits, and its challenges. Our next installment in this series will focus on the contracting stage of the SIB agreement.

*Jitinder Kohli is a Senior Fellow with the Doing What Works project at the Center for American Progress. Douglas J. Besharov is a professor at the University of Maryland School of Public Policy and a senior fellow at the Atlantic Council. Kristina Costa is a Research Assistant at the Center for American Progress. The Center for American Progress's work on Social Impact Bonds is supported by the Rockefeller Foundation.*