The Appeal and Limitations of Social Impact Bonds

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Social impact bonds are a new way of financing social welfare programs – by attracting private-sector investors with promises to repay them with interest if the programs they invest in meet specified benchmarks of success. Invented in 1988 by an economist from New Zealand, these bonds have recently begun to spread from one country to the next – first used in England, then in the United States, and now in Canada, Australia and beyond. They are the latest example of what some call the "neoliberalization of the welfare state," where government functions are modified to imitate market logics. The idea of social impact bonds appeals to many influential actors, public officials and the socially influential alike, but early research findings and past experiences with similar approaches suggest possible limitations and downsides.

An Evolving Approach

In 1988, New Zealand economist Ronnie Horesh presented a paper at the Australian Agricultural Economics Society arguing that what he called "social policy bonds" could fund worthwhile preventive social welfare interventions that could produce savings over time for governments. Ideas for such programs existed, he argued, but even if evidence suggested they could mitigate social problems and produce future savings, governments might not be willing to fund them because they are experimental. Horesh's primary example was programs that could reduce unemployment and enable governments to pay less for aid to the unemployed. A social policy bond, he maintained, could enlist private investors to fund the experimental, preventive program, in return for the promise of repayment with a bonus or dividend if the program met agreed-upon goals. Strictly speaking, this sort of funding investment would not pay accrued interest as a true bond does. Horesh's social policy bonds were to be tradable on a secondary market; the social impact bonds that are starting to get implemented are not.

Investors in social impact bonds are supposed to be repaid only if an outside evaluator provides evidence indicating that the program meets specific designated targets – such as reducing recidivism among ex-felons over a five year period. Sometimes the period of evaluation is even longer. Even so, the possibility of repayment and bonus returns to investors – to be paid by governments that share savings from reduced social-welfare costs – can be high and enticing. If real social and fiscal gains happen, the returns can exceed what investors would get from many publicly-traded stocks.

Since the idea was launched, the public rationale for social impact bonds has shifted. The idea that experimental, preventive programs could attract investor funding continues to arouse interest. But because governments are now short of tax revenue in the wake of the Great Recession, they have another reason to try to attract private investor funding. Future-oriented experiments aside, when taxpayers worry about the existing costs of social welfare programs, the idea of getting private investors to fund services gains added appeal for policymakers.

In fact, social impact bonds were implemented only after governments became strapped for funding after the Great Recession. In 2010, the City of London initiated a social impact bond to fund a program to help ex-felons transition out of prison and become reintegrated into the community. Since then, the use of bonds has spread, with programs popping up in New York City, New South Wales, Australia, Canada, New Zealand, and selected states across the United States.

Experiences in the United States

The administration of President Barack Obama has created a Pay for Success initiative to use social impact bonds to fund social programs. According to the White House announcement of more than half a billion in funding for fiscal year 2014, the President, working in conjunction with the Departments of Labor, Justice, and Education,

aims to empower cities, states and nonprofits to support more public-private partnerships that produce measurable results in their communities.... Pay for Success programming... [will encourage] innovative work underway at state and local levels across a wide array of sectors including workforce development, reducing recidivism, homelessness, aging, asthma management, disability and early childhood education.... Efforts are in some form of development in at least 14 states ... and that number continues to grow.

California and Massachusetts have developed an especially strong interest in using Pay for Success grants to launch social impact bond efforts. Specifically, the latter state has used federal funds to develop a $27 million initiative to reduce repeat sentencing to prison among young offenders who remain at risk for further wrongdoing after they leave confinement.

Possible Downsides for Democratic Government

It is too soon to know if social impact bond programs will work out as hoped by governments and investors. Yet as we await more definitive evidence, we should be wary of potential disadvantages and unintended consequences.

- Too much reliance on social impact bonds can discourage the use of sustained taxpayer funding for vital social welfare programs.

- This approach might induce politicians to mount programs with immediately measureable objectives, even when such social programs cannot address the most pressing social needs.

- Program administrators could likewise be induced to focus on meeting measureable bond program goals at the expense of downplaying other important activities.

Overall, the use of social impact bonds for purposes beyond funding start-up experiments could shift power over social programs from voting citizens and taxpayers toward investors driven by hopes for financial profits. Whenever market processes are introduced into public endeavors, the obvious risk is that profit logics can begin to crowd out public goals and needs, trumping democracy. As social impact bonds spread, we need to watch closely to be sure that such deviations from democratic values do not take hold.

Research and data for this brief were drawn from the author's own ongoing projects, along with Steven VanRoekel and Jonathan Greenblatt, "Pay for Success – An Innovative Approach to Improve

Results and Save Money," Whitehouse Office of Management and Budget, July 2013.