Testimony of
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Hearing on Social Impact Bonds

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Good afternoon Chairman Reichert, Ranking Member Doggett and the Members of the Subcommittee. My name is David Juppe and I am currently employed as the Senior Operating Budget Manager with Maryland's Department of Legislative Services. In this capacity I have analyzed operating and capital budgets for 25 years in a non-partisan role. I also teach a graduate class in public sector budgeting for the University of Baltimore's MPA program. In 2012, working with my colleague Kyle McKay, our agency evaluated the proposed use of Social Impact Bonds by the Department of Public Safety and Correctional Services. I appreciate the opportunity to address the subcommittee on the findings of our review of Social Impact Bonds and my observations on their benefits and risks.

Background

Social Impact Bonds represent a new variation on public sector performance-based contracting with private or non-profit providers. Unlike the traditional model, Social Impact Bonds introduce third party financing to provide multi-year funding to the providers. Advocates of this arrangement suggest that the following benefits accrue to each party:

- Providers receive a guaranteed multi-year stream of revenue to support services;
  - Providers can use this funding to develop new and innovative programs to address certain public policy goals;
- Successful outcomes lead to a return on investment to the investor(s);
- Government agencies do not need to provide any payment up front and instead only pay if successful outcomes are achieved; and
  - Program risk is said to be transferred to the private or non-profit sector. If outcomes are not achieved the government does not need to repay investors.

Why Social Impact Bonds? Why Now?

The concept for Social Impact Bonds originated in 2010 at the Peterborough Prison in the United Kingdom. Investors would receive a rate of return based on specified reductions in the rate of recidivism. Since then, several states in the U.S. are either implementing or considering Social Impact Bonds as a financing mechanism.

My opinion is that spending cuts by all levels of government following the "Great Recession" of 2008 have resulted in a reduction in contracts and thus limits to the cash flow of private and non-profit service providers. Social Impact Bonds appear to offer an alternative revenue stream to maintain or increase government contracts without the limitation of up-front government appropriations. Similarly, public-private partnerships have also gained in popularity as cash strapped governments lack the capacity to issue additional debt for large capital projects.

Risks

There are several risks associated with Social Impact Bonds. These include:

1. <u>Higher costs to the government</u>**:** On their face it is difficult to see how Social Impact Bonds are more advantageous than traditional direct contracts between government agencies and providers. Successful program outcomes under the Social Impact Bond model will lead to the

payment of a return on investment, which can exceed a double digit rate of return, in addition to the standard direct service costs[1]. This is in addition to expense for independent evaluation.

Another aspect highlighted by Kyle McKay is that governments are not likely to realize up-front savings due to a need to appropriate program costs annually to ease investor concern about payment. As a result, funds will be encumbered until program outcomes are achieved.[2] This is also a likely necessity for most government agencies given the difficulty agencies may face in securing a lump sum payment for the total costs of a multi-year program.

2. <u>Overstated cost savings and the likelihood of success</u>**:** In Maryland I have seen many proposals for new programs in the last 25 years, all designed to improve policy outcomes and produce cost savings to the State's budget. An all too common mistake stems from a "fixed cost fallacy." This fallacy involves dividing the total number of cases, such as the average daily population of a prison, into the total cost of the facility or agency. For example, a proposal may assume an estimated savings of $30,000 per year for each individual who is not returned to incarceration. This assumption, however, overstates the savings unless an entire facility were to close. In this example, the actual savings is the variable cost per inmate for food, medical costs, and supplies. When Maryland conducted its study of Social Impact Bonds the variable cost per inmate was only $4,600. Thus a program designed to reduce readmissions by 100 inmates would not save $3,000,000 a year (100 inmates times our hypothetical $30,000 total per capita cost) but would instead only save $460,000 (100 inmates times the annual variable cost per inmate of $4,600).

The study that we conducted in Maryland's looked at reentry programs that were designed to reduce recidivism in the adult prison population. We assumed 250 annual program participants, with a projected outcome that recidivism would be reduced by at least 10%. This outcome assumption was more optimistic than the outcomes demonstrated to date in Peterborough. The study found that instead of producing savings, the program would cost the state $3.9 million.[3] Many of the interventions considered in social impact bond programs are valuable tools in a broader set of policies. But social impact bonds will not typically produce savings that are large enough to justify the added expenses of the model compared to traditional methods of finance.

3. <u>Short-term incentives that could impact outcomes:</u> Due to the pressure to succeed it is possible that Social Impact Bonds could be subjected to some of the following problems:

Creaming/self-selection bias: Programs may seek to initially treat the easiest cases or those deemed most likely to succeed;

Short-term focus: Programs may also be developed which produce short-term results, in lieu of alternatives which could lead to greater long-term savings. More importantly, a program may appear to be successful based on one study or over a short-term but may over time turn out

[1] Department of Legislative Services, "Evaluating Social Impact Bonds as a New Reentry Financing Mechanism: A Case Study on Reentry Programming in Maryland," (Annapolis, MD: January 2013) 3.
[2] Statement of Kyle McKay on Social Impact Bonds Government Performance Task Force U.S. Senate Committee on the Budget, (1 May, 2014), 1.
[3] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/341684/peterborough-social-impact-bond-report.pdf

to be an unsuccessful approach. It takes time to evaluate and refine programs in order to determine their true worth. For example, Maryland implemented a military boot camp style program in its prison system in the early 1990s that combined rigorous exercise, job training, education, and job placement. Inmates volunteered for the six-month program in lieu of a longer sentence. Initial results were encouraging, but over time it was determined that in Maryland and other states such programs were not an effective method of reducing recidivism. Maryland ended its boot camp program in fiscal 2010. The point is that the value of research accrues over time, not in a single evaluation, so expecting a single evaluation to conclusively prove a new concept is too simplistic;

Flight to proven programs instead of innovative programs: Even though advocates suggest that Social Impact Bonds will result in the development of new and innovative treatment strategies, it seems more likely that the pressure to produce results will instead have the opposite effect. It seems more likely that established treatment methodologies would be pursued in order to attract investors.

Another aspect related to this point is that governments currently possess the means to use the private or non-profit sectors to identify and implement new and innovative strategies. The State of Maryland, for example, is currently in the process of soliciting proposals to construct a new light rail line linking New Carrollton to Bethesda. The proposals are to be structured to permit maximum use of innovative approaches to build and operate the transit line.

4. Long-term risks: Unlike in the private sector where an investor may not have much recourse, it is possible that unsuccessful investors may petition their elected officials for partial or full compensation. Over the long-term, absent positive outcomes, Social Impact Bonds are also unlikely to hold investor interest. If investors select programs that are already known to work, the value to governments would appear to be minimal. Providing investors with a risk premium for bearing little to no risk will simply drive up costs for governments.

5. Measuring risk and calibrating the return on investment: Currently there are no standards pertaining to any limit to the return on investment except for whatever is negotiated on a case by case basis. In the bond markets, risk is often assessed by bond rating agencies. Greater risk of nonpayment results in higher interest rates (and thus higher costs to the issuer). According to the daily paper *The Bond Buyer* even lower rated 5-year bonds (e.g., Baa on August 26, 2014) paid yields of 2%. Why should an investor in a short-term Social Impact Bond be compensated with a double digit rate of return?

Issues to Consider for Legislation

Proposed legislation pertaining to social impact bonds should address the following:

- Would funds be provided in the form of grants, loans, or loan guarantees?
- Would the federal government be acting as financier of total program costs or a portion;
  If only a portion is to be funded with federal dollars, how will that amount be determined/limited?
- Will the evaluation of outcomes ensure that variable costs are used to determine the actual savings, instead of total per capita costs?
- Should there be a limit on the level of investment return?

- Would treatment populations be subject to fully randomized selection to limit bias?
- How will it be determined how much the federal government shall receive in the event of cost savings?

Conclusion

Social Impact Bonds represent a new innovation in public sector finance. Proponents suggest that this mechanism offers government the ability to shift risk to the private & non-profit sectors to achieve savings through the implementation of innovative programs. However, as a budget professional with 25 years of experience in state budgets, the benefits to government seem less apparent upon closer scrutiny. Governments at all levels can simply contract directly with providers without paying a return on investment to third party investors. Until a more extensive set of evaluations can provide evidence for the impact and value of social impact bonds, governments should continue to utilize proven methods of operating and financing programs.